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A European Contract Law, or an EU Contract Law Regulation for Consumers?

ABSTRACT. The paper informs about initiatives of the EC Commission to create a set of instruments for advancing a European contract law, in particular a ''common frame of reference.'' It questions the underlying assumptions in the still somewhat unclear and open Commission communications. It doubts whether EU has any competence to harmonise contract law under the internal market jurisdiction of Art. 95 EC. As an alternative, it proposes the elaboration and eventual adoption of an EU consumer contract law regulation (ECCLR) based on Art. 153 (3) b) EC which would take direct effect and be limited to minimal, yet directly applicable rules on consumer protection in contract law.

''EIN GESPENST GEHT UM...."

Led by a famous, though somewhat dated saying of the founding fathers of communism, Marx and Engels (1972, p. 461), one may discover that *"Ein Gespenst geht um in Europa"* - "a ghost is going around in Europe,'' this time of course not concerned with commu¬ nism, but with European contract law. This "Gespenst" is keeping lawyers in the EU busy. The EU Commission, as the sponsor of the "Gespenst" and explicitly encouraged by the European Parliament,[1] is publishing communications" (2001, 2003, 2004), a progress report (2005), organising conferences, offering a website, pouring out re- search money. After successfully launching European consumer con¬ tract and commercial practices directives and scrutinising their not always successful implementation in weary Member States, it aims at the cathedral of legal thinking and writing'': contract law as such. A new player in the global dialogue on contract law is emerging: the European Union. These initiatives were seemingly well prepared by

the so-called "Lando" Commission, an independent study group of prestigious European private law professors who worked out a whole treatise on "European principles of contract law" and published three copious volumes of detailed provisions and comments (Lando & Beale, 2000; Lando, Clive, Prum, & Zimmerman, 2003) - a comprehensive restatement of comparative European contract law, as it seems.

What is the place of consumer law in this ambitious initiative? Is it the corner stone of an emerging European contract law, or the "Aschenputtel" ("Cinderella"), which has to stand aside in this great ambition? The Commission itself seems to take the view that after all the protracted debates on consumer law directives, something "more noble" and more prestigious must be undertaken than simply giving the European consumer more information and confidence when making use of the internal market's shopping mall. We will take a closer look at the different Commission initiatives in this area in the later sections of this paper.

Several authors in this journal have voiced scepticism, but also hope as far as including the consumer law *acquis* in this initiative is concerned. Weatherill (2001) has pointed to the constitutional limitations of competence of the Community in the area of contract law. Karsten and Sinai (2003) have insisted on the special place of consumer law in the context of a European contract law because of its mandatory character. Karsten and Petri (2005) found the Commission's idea of establishing a "common frame of reference" to be a promising starting point for including and perhaps even improving the consumer law *acquis* in the new European contract law edifice. A whole issue of JCP (Hartlief, 2004; Hondius, 2004; Micklitz, 2004a; Staudenmayer, 2004; Wilhelmsson, 2004b) was dedicated to the protection of the weak party in European contract law.

The first part of the paper will first give an overview of the state of discussion on a "European contract law." The next section will take a critical look at the existing initiatives both from a legal and from a conceptual point of view. The author will then develop his own idea of strictly separating the work undertaken in preparing a "Restatement of European contract law," which does not have any binding character, and the codification of the existing consumer contract law *acquis* in a truly "European (or rather EU) Consumer Contract Law Regulation (ECCLR)," following predecessors in a system of "multi-level governance" which characterises EU law (Reich, 2005).

IS THERE A ''EUROPEAN CONTRACT LAW'' AND SHOULD IT BE CODIFIED?

A Case for a "European Contract Law"?

As can be seen, the EU consumer contract law *acquis* is quite remarkable, and there has been no other area in contract law, which has been subject to so much EU legislative influence. For many au¬thors, the new-born consumer contract law could serve as a nucleus for a codification of European contract law, should there be political will and legal expertise behind such proposals. Such a codification could also help to overcome the obvious deficits of the existing *acquis,* namely its highly selective and haphazard character, its inherent contradictions, its *ad-hoc* terminology, its lack of effective remedies, its differences as to the approach taken towards harmonisation (minimal vs. total harmonisation).

The existing preparatory work on a European contract law has however taken a somewhat different direction. The internal market philosophy of the Community has been its starting point. This phi¬losophy is based on contractual autonomy (Reich, 2004a) present in primary and secondary Community law, but it has never been codified expressly. If such a codification could be attained it would lead to a truly European - or EU - contract law. ''Ideally'' it would be able to overcome the present system of 25 (or 26, including Scots law!) con¬tract laws which must be co-ordinated by the mechanisms of private international law, in particular the Rome Convention, itself based on party autonomy.

It has been argued, particularly by Basedow (1996), that such a European contract law would well serve the purposes of the internal market and thereby fall into the competence of the Community:

- It would create uniform conditions for marketing in Europe.
- It would avoid risks obtained by the choice of or submission to an unknown legal order.
- It would save transaction costs to parties contracting cross-border wise.

Basedow has even advocated the possibility of a Community con¬tract regulation, which would be applicable if the parties had not ex¬pressly contracted out of it. In contrast to the existing bits and pieces of existing mandatory, mostly consumer contract law in the Community,

it would allow the parties freedom of choice and would only apply if no other legal regime had been chosen. It must be regarded, under this concept, as a hypothetical prolongation of the free will of the parties: What reasonable legal order would they have agreed on to settle their potential conflicts?

Private Initiatives: The European Principles

The ideas of Basedow and other supporters of a European contract law were at first not so much taken up by political institutions of the Community but by private initiatives. The best known is the elaboration by a study group under the chairmanship of Professor Ole Lando (Lando & Beale, 2000). Two volumes of principles have been published in 2000 and have led to an intense discussion; a third one followed recently (Lando et al., 2003).

We will not take up this discussion, but simply refer to the leading articles of the "Principles." Article 1:102 expressly recognises the principle of freedom of contract. It is limited only by

- the principle of good faith
- fairness in commercial transactions, Article 1:201
- mandatory provisions as far as recognised by the principles, Article 1:103
- the principle of co-operation in order to make the contract effective, Article 1:102: *pacta sunt servanda.*

The Principles can be applied either by express agreement or if the parties refer to "general principles," *lex mercatoria* or similar rules, or if they have not chosen any law at all. Their application is not limited to cross-border transactions. The Principles function as a supplementary legal order if the applicable law does not contain adequate rules, Article 1:101.

The true area of application of the Principles - should they become of any legal importance in the future - will however be cross-border commercial transactions in the EU. They do not suit consumer contracts (which are not even mentioned as such!) because of the substantial amount of mandatory law that the Community has adopted. The rules on unfair contract terms try to take over some EU concepts, e.g., in Article 4:110 the concept of "unfair terms not individually negotiated," Article 5:103 the *contra preferentem-rule,* and Article 8:109 on clauses excluding or

restricting remedies, but their potential enforcement and legal consequences in case ofunfairness do not meet Community law requirements (Micklitz, 2004a). They would either have to be singled out in a separate Consumer Code or be introduced *tel quel* into the Principles.

The Commission Communication of2001

The Community has so far not made any proposals in the direction of codifying contractual autonomy in a European Civil Code or some similar instrument. The European Parliament has on several occasions adopted resolutions encouraging or even urging Community institutions to pave the way towards a European contract law or even a Civil Code. The work done by private working groups, and the publication ofthe "European Principles" in particular, has greatly encouraged this work.

The Commission published a Communication on 11 July 2001 on European Contract Law.[2] This Communication aroused lively comment and controversy in the research community (Van Gerven, 2004; Weatherill, 2001), which can be read in a publication edited by Grundmann and Stuyck (2002). In May 2002, the Commission reported on the reactions to its Communication and made known its intention to publish a Green or White Paper summarising proposals for future action.[3]

The Commission Communication of July 2001 did not present a European contract theory, nor any suggestion as to how to proceed under the existing legal basis. It merely referred to the principles of "subsidiarity" and "proportionality":

> Moreover, legislation should be effective and should not impose any excessive constraints on national, regional or local authorities or on the private sector, including civil society (Commission, 2001, para 44).

It summarised the existing *acquis* in private law (not only contract law) and put forward four options for action, namely:

I. No action.
II. Promote the development of common contract law principles leading to greater convergence of national laws.
III. Improve the quality of legislation already in place.
IV. Adopt new comprehensive legislation at EC level.

The Communication then goes on to discuss the *pros* and *cons* of the different options, without making clear suggestions as to what direction to follow.

Later discussion concentrated on the methodology of the Com¬ munication and on the viability of the options suggested. There seemed to be agreement that option I is not feasible and is not really an option (Reich, 2002, p. 279). Option II is already under way with the several private initiatives towards a European contract law. It remains to be discussed whether option III or option IV is preferable:

- Option III would concentrate on existing mandatory law, for example, in consumer and labour law. It would to some extent contradict the concept of autonomy and follow more the philosophy of "adequate protection" and "legitimate expectations" (Reich, 2006, pp. 222-232).
- Option IV is more in line with ideas on autonomy merged into general principles of contract law, already present in particular in the Rome Convention and indirectly in the fundamental freedoms.

The Communication of May 2002 defined the next steps to be ta¬ ken, namely:

- To identify areas in which the diversity of national legislation in the field of contract law may undermine the proper functioning of the internal market and the uniform application of Community law.
- To describe in more detail the option(s) for action in the area of contract law which have the Commissions' preference in the light of the results of the consultation. In this context, the improvement of existing EC legislation will be pursued and the Commission in¬ tends to honour the requests to put forward legislative proposals to consolidate existing EC law in a number of areas.
- To develop an action plan for the chronological implementation of the Commission's policy conclusions.

The question remains as to the feasibility of the path chosen by the Commission. As Wilhelmsson (2002, p. 90) writes:

> One may ... question this starting point. Does European identity really require unified systems of law - or unified social and cultural structures in general? Is not the prevailing European identity the opposite one?

This criticism can be rephrased in accordance with the concept of autonomy as developed here: Does autonomy not imply that the parties themselves take care of the law they want to govern their contractual relationships (Study Group, 2004, p. 656)? And do the fundamental freedoms as such not reveal a preference for a decentralised contract law? Protection can either be left to secondary EU legislation, or to conflict rules, or to a combination of both.

New Action Plan of 12.2.2003

In the meantime the Commission has proposed a new action plan.[4] This aims at a combination of options II and IIII. It plans to establish a mix of non-regulatory and regulatory measures to attain more coherence in European contract law. In addition to sector-specific interventions, this should include measures:

- To increase the coherence of the Community *acquis* in the area of contract law.
- To promote the elaboration of EU-wide general contract terms.
- To examine further whether problems in the European contract law area may require non sector-specific solutions, such as an optional instrument.

Most importantly, it proposes a common frame of reference for terms frequently used in European directives, such as "damage," "conclusion," and "non-performance" of a contract, to avoid the inconsistencies that result from the divergent use of concepts in different directives.

In such a project, the concept of autonomy and its limits will have to be defined more clearly than in the somewhat haphazard approach of today's incremental law-making process.

The "Common Frame of Reference" (CFR)

The Commission's work on the 2003 action plan has shown first results insofar as it has greatly encouraged comparative legal studies in the EU which now have to be extended to the new Member States (Reich, 2004b). The most ambitious part of this work is concerned with elaborating a "common frame of reference" (CFR), which was presented in some detail in a Commission communication of 11.10.2004.[5]

This CFR should be based on research and "stakeholder participation" (doubts expressed by Hesselink, 2004). It should combine - in good comparative law tradition - best solutions with regard to national law, the *acquis,* and international law such as the 1980 UN Convention on the International Sale of Goods (CISG). Its structure would start with fundamental principles, then define key concepts, and develop model rules. In its first phase it should be limited to contracts of sale and services as well as retention of title of movables.

The status of such a CFR is however not yet clear (Study Group, 2004, p. 662; Wilhelmsson, 2004a). Is it meant to be the core of a common EU contract law (perhaps extended to some aspects of security interests in movables)? Will it only be applicable to cross-border transactions, or is it meant to substitute or at least to supplement the existing national codifications or contract laws? How will it relate to international law instruments such as CISG, a convention which with the important exception of the UK has been ratified by most Member States (Ramberg, 2004, p. 25)? At the moment, the Commission seems to prefer a non-binding instrument, which would avoid competence dilemmas.

THE UNCLEAR STATUS AND CONCEPT OF A EUROPEAN CONTRACT LAW

The Competence Dilemma

Does the EU have any competence to adopt a general European contract law on the basis of its internal market jurisdiction according to Article 95 EC (Weatherill, 2001, pp. 356-371)? At the time of writing the Commission takes a very cautious approach; it seems to prefer a recommendation to a formal legal instrument. But the development of Community law has shown many examples where at a later stage a non-binding instrument was turned into a directive. It is quite obvious that via the above mentioned initiatives the Commission wants to establish the EU (and itself!) as a new player in the inteinational contract law concert. It must therefore be carefully scrutinised whether there is really a place for such a new player.

Let us start our analysis not with complex legal reasoning, but with pointing to a paradox: Contract law in market economies is based on the principle of *freedom of contract,* and this includes freedom *to* contract (each party is free to decide on whether or not to contract at

all), freedom *for* contract (freely choosing partners), freedom *in* contract (freedom of contract contents and terms), and freedom *out of* contract (choice of applicable law and jurisdiction), and these principles are guaranteed by EC law (Grundmann, Kerber, & Weatherill, 2001, pp. 4-7; Reich, 2006, pp. 268-279). Of course there are limits to this freedom, for example set by rules on consumer protection, non-discrimination, competition, and the like. Some specific areas of (non-mandatory) contract law overlap with mandatory civil law, e.g., on security interests in movables, or in areas where liability may be based both on contract and tort (v. Bar & Drobnig, 2004). According to the authors of this comparative and empirical study, it seems that parties to a cross-border contract, especially small and medium enterprises (SME), overestimate the "possibilities of party autonomy in structuring contracts ... in their effect as regards extra-contractual liability" (p. 466). With regard to security interests in movables, the concepts of Member States for the regimes on transfer of property differ considerably; with regard to conflict rules, the traditional principle of "lex *rei sitae*" is opposed to freedom of contract and freedom of choice, and will frequently make it impossible to maintain security interests in movables in cross-border transactions (p. 46).

It is surprising that the Commission does not take these obvious obstacles to an internal market as the starting point for its efforts to work on a European contract law. In the past, the EU was usually concerned with harmonising these restrictions on marketing freedoms by referring to its internal market jurisdiction. The above-mentioned Communication of the Commission does not even mention these areas where indeed an harmonisation effort may be necessary and useful for internal market purposes, even though many obstacles in traditional legal thinking in the Member States would need to be overcome.

Competence to Adopt Mandatory Rules - No Competence for Facilitative Rules

The very freedom of contract in private law means that the parties, in an ideal-type situation, are free to establish their own rules governing their contract. Contract law as it has traditionally developed contains a set of instruments to make these autonomous decisions effective by provisions on "meeting of minds," form, cancellation rights, to protect parties against fraud and deception, to regulate the position of third parties to the contract, and to establish non-mandatory rules for

performance of the contract and remedies in case of breach or non-performance. Grundmann/Kerber (2001, pp. 281-285) correctly calls these rules "facilitative" or "default" rules, in German "dispositives Recht." National contract law has developed complex and differentiated sets of these facilitative rules. Very few of these rules are mandatory, at least in B2B (business-to-business) transactions. In case of cross-border transactions, rules of private international law such as the Rome Convention or international instruments such as the CISG contain coordinating mechanisms in the case of conflicts on applicable law, always respecting party autonomy as far as possible.

Why should the EU intervene in this process by creating a body of European facilitative rules? Isn't this a violation of the principle of subsidiarity in Article 5 (2) which allows the Community to take action only "if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of scale or effects of the proposed action, be better achieved by the Community." In the case of contract law, parties take action themselves and refer to Member State (or international) "default" rules of contract law only insofar as actual or potential gaps exist in their transactions. The argument of Basedow (1996) that an internal or common market needs a set of common rules on contracts is not convincing because the parties, under applicable Member Sate law or *lex mercatoria,* make the rules themselves, or it must be extended beyond contract law *strictu sensu.* The mere argument that transactions costs would be saved is not enough to invoke a Community jurisdiction in this field - which would have to be non-mandatory in any case and would have to compete with national and international law as well as the *lex mercatoria.*

The importance of freedom of choice in contract law has been stressed by the ECJ. It has denied the applicability of the free movement rules where commercial partners can avoid Member State law restricting their freedom. In the *Alsthom* case, the Court was concerned with the question of whether the French rules on strict liability of a seller with regard to defects in a product in the chain of distribution amount to a restriction on free movement of goods in the sense of Articles 28 and 29 EC. The Court insisted that

> the parties in an international contract are generally free to determine the law applicable to their contractual relations and can thus avoid being subject to French Law.'

This amounts to an implicit recognition of the parties' freedom to contract. If a party is free to avoid a Member State rule restricting its freedom in contract with regard to applicable liability rules as in *Alsthom,* there is no place for Community law intervention. This im¬ plies that there is really no need for the EU to adopt "facilitative" contract law rules because this is left to the parties themselves (or the jurisdiction which is applicable to their contract).

One may of course argue that even in B2B relations partners may not negotiate on equal terms, and that there is a need to help in particular small and medium-sized undertakings to find the right contract law for their transaction by offering them a set of (non-)- mandatory rules of contract law, at least in cross-border transactions. The Commission, in its last Communication (2004, point 2.3), is referring to an "optional instrument" which may take the form of a regulation or a recommendation, and which either provides for an *opt-in* or an *opt-out* possibility for the parties, that is the parties to a contract may expressly or implicitly choose this instrument as basis for their transactions. As far as the *opt-in* solution is concerned, such an instrument exists already in the form of the European Principles mentioned above. With regard to the *opt-out* version, some problems inherent in the relation of an optional instrument to international conventions such as the CISG must at least be mentioned. The CISG has chosen a combination of an *opt-out* and an *opt-in* solution regarding its applicability to cross-border B2B transactions. It applies to contracts of sale between parties domiciled in different states if these States have ratified the CISG (e.g., EU Member States with the exclusion of the UK), and second when, according to the choice of law, the law in a State Party of the Convention applies (Ramberg, 2004, p. 26). So far the Commission has not clarified the relationship between the CISG and a possible optional instrument.

EC Jurisdiction With Regard to Mandatory, in Particular Consumer Contract Law

In contrast to facilitative contract law, there is ample experience with mandatory, most notably consumer contract law. On the one hand, there is no explicit EU competence to legislate in consumer law and in particular in consumer contract law, unlike in environmental law. On the other hand, the new Article 153 (3) EC as introduced by the

Amsterdam Treaty allows a double path of EU involvement in consumer affairs, namely by adopting

- measures based on the internal market competence of Article 95 EC
- measures which support, supplement, or monitor the policy pursued by the Member States.

Seemingly, the second of these paragraphs contains a rather weak authority for contract law legislation, while the first has to be measured against the criteria used by Article 95 EC itself, which have as their object the establishment or functioning of the internal market, that is by eliminating either barriers to free movement or distortions of competition. The mere existence of differences in national legislation or regulation is not sufficient to justify Community legislation (Reich & Micklitz, 2003, paras 1.20-1.24; Weatherill, 2004, pp. 12-17). While contract law as such will rarely create barriers to trade and therefore can hardly be used to eliminate them, different contract law rules, particularly of mandatory character as in consumer law, may indeed create distortions of competition. This "negative approach" has therefore been used by the EU institutions to justify their involvement in consumer contract law. Another, more positive element was added by referring to the goals of consumer policy as enshrined in Article 153 (1) itself: to promote consumer information and to protect their economic interests, e.g., by creating minimum standards on pre-contractual information in direct and distance selling, by increasing freedom of choice through rights of withdrawal, by establishing rules on the transparency and fairness of pre-formulated terms and guarantees, and by ensuring quality standards through mandatory rules on compensation and warranties (Lurger, 2002).

This approach has come under pressure when the ECJ, in its famous tobacco advertising judgment of 5.10.2000,[7] decided to substantially curtail the rather "loose" use of the internal market power for consumer protection legislation. This judgment has provoked an intense debate among European legal scholars as to whether there is a genuine EU competence in contract law in general and in consumer contract law in particular which will not be followed in detail here (Roth, 2001; Weatherill, 2001, pp. 363-368). The case, and this should not be forgotten, concerned a particularly strict EU directive on prohibiting any type of tobacco advertising and even allowed Member States to go beyond it since it was meant to be a minimum directive.

One can of course doubt the usefulness of such rules to combating health risks (which was the main justification behind this directive), but from a purely legal point of view the judgment referred to some particulars of EU law which are not present in consumer contract law:

- EU law expressly excludes harmonisation in health policy affairs, per Article 152 (4) c) EC, and the annulled Tobacco Advertising Directive[8] tried to circumvent this restriction by being based on the internal market jurisdiction; there is no similar restriction with regard to consumer contract law - quite to the contrary, as the very wording of Article 153 (3) EC clearly demonstrates.
- The Tobacco Advertising Directive did not improve the circulation and marketing of tobacco products, but restricted it severely, in particular by the minimum protection clause (Howells & Weatherill, 2006, p. 134).
- It did not help the functioning of the internal market by increasing competition because the prohibition on advertising practically prevented the appearance of newcomers.

Later cases have softened this rather radical approach of the ECJ, namely by recognising that measures for the establishment and functioning of the internal market may also serve to protect consumers' health, and that they can be taken to avoid future distortions of competition which are not unlikely to happen, e.g., by presumed unilateral Member State action.[9] In intellectual property matters, the ECJ was quite generous in allowing EU legislation on the patentability of biotechnological inventions.[10] Why should the Community not be allowed to do in favour of consumers what it is justified to do for traders? Functioning consumer markets have two partners, namely business and consumers, and both need protection of their specific economic interests.

Such a broad understanding of Community jurisdiction in consumer law matters recently found explicit recognition by the Court in its *Leitner* judgment:[11]

> It is not in dispute that, in the field of package holidays, the existence in some Member States but not in others of an obligation to provide compensation for non-material damage would cause significant distortions of competition, given that. non-material damage is a frequent occurrence in that field. Furthermore, the Directive . . . .is designed to offer protection to consumers and, in connection with tourist holidays, compensation for non-material damage arising from the loss of enjoyment of the holiday is of particular importance to consumers.

This statement is remarkable since the Court not only justified Community jurisdiction in the field of package holidays, but extended the unclear concept of compensation in the Directive to include non-material damage which was recognised by some Member States (e.g., Germany, UK), but not by others (e.g., Austria), referring to the somewhat artificial argument of avoiding distortions of competition.

Can a "Common Frame of Reference" Overcome the EU Competence Dilemma?

The Commission, in its different Communications on contract law, did not expressly evoke the competence question even though it will be crucial in initiating a legislative programme on European contract law. Its ambitions seemingly go beyond its competence.

The remarks on the CFR are also concerned with EU consumer law,[12] mostly with regard to improving the present and future *acquis* (Commission, 2004, point 2.1.1; Staudenmayer, 2004). One of its particular points of concern is the so-called "minimum harmonisation clause" which is inserted in most consumer protection directives but which the Commission (2002), in its strategy paper on consumer policy, has itself questioned. It seems to read the tobacco advertising judgment in such a way that it excludes or severely restricts minimum harmonisation (for a discussion, see Howells & Weatherill, 2006, pp. 135-137).

Under this traditional approach, Member States enjoy the freedom to enact more protective rules or to extend their sphere of application, which has on several occasions been supported by the case law of the ECJ.[13] New consumer protection directives, e.g., on distance marketing of financial services[14] and on unfair commercial practices,[15] explicitly aim at a total harmonisation, even though the final text has not completely taken over this strict approach and still allows Member States more protective provisions, at least in certain areas and during a certain time (for a critique, see Howells, forthcoming). At any rate, the Commission faces strong opposition to its attempts at total harmonisation (Micklitz, Reich, & Weatherill, 2004, pp. 386-395; Study Group, 2004, pp. 670-673; Wilhelmsson, 2004b), which severely restrict Member State competence. This paper will not go into details of this conflict but proposes a more flexible way out of it.

The Commission is still very vague in its proposals on how to improve and amend the existing consumer protection directives. It merely puts forward certain questions for consideration:

- Is the level of consumer protection required by the directives high enough to ensure consumer confidence?
- Is the level of harmonisation sufficient to eliminate internal market barriers and distortions on competition for business and consumers?
- Does the level of regulation keep burdens on business to a minimum and facilitate competition?
- Are the directives applied effectively?
- Which of the directives should be given the highest priority?
- Does consumer contract law need to be further harmonised?
- Is there scope for merging some of the directives to reduce inconsistencies between them?

These are certainly important questions, the answers to which have not yet taken a clear direction. It seems that the Commission is not merely proposing a restatement, perhaps with some slight technical corrections. It has more ambitious ideas, including a codification of the *acquis* and the aim of complete harmonisation. Some directives may even be abolished or "reduced" in their protective ambit due to supposed negative effects on competition, or to critique from "stakeholders" which are asked to participate in the review, most notably concerned business communities which may not ''like'' certain directives because they allegedly impose an unreasonable burden on businesses for market entry. It is also not clear how the - mandatory - consumer law should be placed within an instrument that is mostly related to ''facilitative'' law.

Staudenmayer (2004, pp. 279-284), the Commission official responsible for the project on European contract law, discusses several possibilities, e.g., including consumer law in an "optional instrument," or making it a candidate for the actual use of the CFR. Karsten and Petri (2006, pp. 41-44) are quite optimistic in their account of the CFR, suggesting the inclusion of a "package on the consumer going shopping" and the "consumer going travelling," to be taken from the existing, quite elaborate *acquis.* It remains to be seen how the further work on the CFR is advancing. This paper is proposing an alternative way to success.

AN ''EU CONSUMER CONTRACT LAW REGULATION (ECCLR)''?

Competence for a ECCLR?

At the time of writing a definite judgment on the future of European contract law or even the CFR is premature. This author would support a separate codification of EU consumer law as part of the general project on improving the existing *acquis* (Rosler, 2004, p. 205 against Hondius, 2004, p. 250). This should be done by creating a *European Consumer Contract Law Regulation (ECCLR)* (Reich, 1994).

The ECCLR as such could be based on Article 153 (3) lit b) as being a "measure to support... the policy pursued by Member States." All Member States have now established their national consumer contract law, either on their own or by implementing EU directives. Hence, the general principles of an overall EU approach to consumer protection based on information and fairness before entering into and within transactions, with specific rules on "cooling-off-periods in direct and distance marketing, on unfair terms, and on legitimate quality expectations, could easily - as rather well developed areas of EU consumer contract law - be elaborated and ''codified.'' It would be a "measure" of legislative character, which is expressly recognised in the (somewhat scant) practice under Article 153 (3) b) (Howells & Weatherill, 2006, p. 128; Reich & Micklitz, 2003, para 1.23). In its Directive 98/8/EC on unit pricing,[16] the EU has used Article 153 (3) b) for a truly legislative measure. There seems to be no reason not to continue this approach, thereby avoiding the intricacies of the internal market competence.

The transformation of existing directives into directly applicable regulations meets the requirement of effectiveness, which the Commission itself put forward as a criterion for reviewing existing European consumer protection directives. It has often been said that directives are in harmony with the subsidiarity principle as written down in the Protocol on Subsidiarity, attached to the Amsterdam Treaty.[17] Indeed, para 6 says that "directives should be preferred to regulations," but under the qualification "other things being equal." In practice, the implementation of directives has shown long delays, has used different methods of implementation, and has caused additional distortions of competition. Several Member States had to be taken to Court before finally implementing a long adopted directive. In the case of minimal harmonisation directives, the differences in the level of protection among Member States were indeed considerable, sometimes even

greater than before "harmonisation" - a fact deplored by the Com¬ mission itself. The use of directives as an instrument for consumer protection has unfortunately not been a success story.

The E C J case law on denying directives "horizontal direct effect" has meant that the individual consumer who is supposed to be pro¬ tected by a directive cannot invoke it in litigation against a trader, because directives cannot as such impose obligations against private persons, only against the state (Reich, 2006, pp. 16-24). It is true that the E C J has tried to overcome these deficits by instruments such as the requirement of "Community conforming interpretation of national law" as a substitute to direct effect. It has even suggested the possi¬ bility of state liability for breach of Community law obligations by the non-implementing Member States. But this puts an additional burden and risk upon the consumer: He or she must take up two different types of litigation with considerable time and cost risks. This is usually not an attractive perspective especially when small consumer claims are at stake (Howells & Weatherill, 2006, p. 144).

The use of the instrument of a *Regulation* according to Article 249 (2) EC would avoid these difficulties. The Community should learn from past practice that in areas where protective standards are nec¬ essary and required by primary Community law, e.g., Article 153 E C , the two-step procedure of adopting directives and then waiting for their Member State implementation (or not) before the consumer can invoke his/her rights, is simply not sufficient and adequate.

An example of the use of regulations in the consumer interest have been the overbooking regulation 295/91,[18] recently replaced by regu¬ lation 261/2004.[19] They are based on Article 80(2) E C , namely the rules on transport, and not on Article 153 on consumer protection. But there is no reason to believe that competence for genuine con¬ sumer protection based on Article 153 would be weaker than within the context of transport policy which usually is concerned with sup¬ pliers and not so much with customers of transportation services. The new regulation establishes quite a detailed system of (minimum) consumer rights according to Article (1), including rights to compen¬ sation (Art. 7), reimbursement (Art. 8), care (Art. 9), redress (Art. 13), and information (Art. 14). Exclusion and limitation clauses are ex¬ pressly (and with direct effect!) forbidden (Art. 15). The application is not limited to cross-border flights, but to all flights from and to EU airports (Art. 3 (1)). These regulations set an interesting precedent for a truly consumer oriented Community regulation.

Minimal vs. Full Harmonisation

Questions as to minimal harmonisation would not arise, per Article 153 (5) EC which reads:

> Measures adopted pursuant to. . . (para 3b) shall not prevent any Member State from maintaining or introducing more stringent protective measures. Such measures must be compatible with this Treaty. The Commission shall be notified of them.

This may be the very reason why the Commission may not want to use Article 153 (3) b) as a basis for an ECCLR. It should be remembered that the question of full or minimal harmonisation was one of the dividing points in the debate on the recently adopted Unfair Commercial Practices Directive 2006/29/EC (Micklitz, 2004b, pp. 75-76). The finally adopted text devised a compromise formula. As far as information duties are based on EU contract law, including its minimal harmonisation provisions and having contract law consequences, these requirements can still be applied, per recital 15 and Article 3 (2). As far as commercial practices law of Member States, e.g., on advertising, contains more restrictive provisions, these can be applied for a transitional period of 6 years after 12 June 2007, that is the date when the directive must be transposed into Member State law, Article 3 (5). It only applies to B2C, not to B2B practices (Howells, forthcoming).

Directive 2006/29 thereby recognises that at least contract law, as far as it is harmonised by the EU, cannot be subject to full harmonisation. Therefore, the minimum protection clause expressly included in Article 153 (5) EC would avoid much doubt as to the scope of application of the regulation and its impact on Member State contract law.

Contents of the ECCLR

In this short overview, it is impossible to give a detailed description of a potential ECCLR. It would have to fulfil certain requirements:

- It should consolidate the *acquis,* i.e., eliminate existing contradictions, improve its legal structure and terminology, and coordinate remedies, in particular in case of violations of information requirements by the trader.
- It should develop a general part of EU consumer contract law, e.g., the concept of consumer, the principles of information and fairness as leading guidelines of consumer protection in

implementing Article 153 (1) EC, its internationally mandatory character, the principles of judicial protection and effective remedies, including group actions, guidelines on Codes of practice, and ADR instruments with consumer participation.

- It should attempt to include into the Code contractual aspects of financial services, which so far, with the exception of consumer credit and some rules on payment systems, have been regulated mostly under institutional aspects.
- In respect of the principles of proportionality and subsidiarity, per Article 5 (2, 3) EC, the ECCLR should be mostly concerned with *"essential" rules* on consumer protection in the EC and leave details to the Member States. Complete harmonisation of consumer contract law is an illusion and should not even be a goal of EU policy, as Article 153 (5) clearly shows.

It is still premature to determine whether the ECCLR should be extended to include rules on fairness in marketing, always keeping in mind that consumer law should be an instrument to "enable consumers to make their choice in full knowledge of the facts, in order to let them participate actively in the internal market" (Radeideh, 2004, p. 244). After the adoption of Directive 2006/29/EC on Unfair Commercial Practices, it remains to be seen how this instrument is implemented, and how the new rules on full vs. minimal harmonisation function in practice. This may still take some time. Consumer contract law, on the other hand, is more advanced, and the ongoing efforts of the Commission to "get a hold on contract law" could at least result in a consolidation and codification of consumer protection rules.

The Annex of Directive 93/13: A Black List - ora "Non-List"?

The ECCLR could clarify, for instance, the somewhat unclear character of the so-called "indicative, non-exhaustive list of terms which may be regarded as unfair" which, according to Article 3 (3) of Dir. 93/13/EC, are written down in an Annex. The Court took the view that, with regard to its implementation, it is sufficient that the list be included in the *travaux preparatoires* if they are regularly consulted by the judiciary in interpreting the law.[20]

With regard to their effects in consumer contracts, it seems that some of the clauses could be blacklisted as such because they deprive consumers of essential rights. The legal nature of others, however,

depends on an overall assessment of the contract at hand and of the law of the Member State in question, which excludes their straightforward blacklisting (for the UK approach, see Micklitz, 2006, pp. 387-399). The ECJ seemed to have this difference in mind in two recent, seemingly contradictory judgments regarding jurisdiction clauses and prepayment clauses, respectively.

Jurisdiction clauses. They were litigated before the Court in *Oceano."* Several Spanish clients were sued by a book-club company at its place of business but not at their residence, because a jurisdiction clause was inserted in the standard contract form. The Spanish judge was not sure whether he could raise the issue of his territorial incompetence *ex officio* because he regarded the jurisdiction clause to be unfair under Article 3 (2) of Directive 93/13/EC and Nr. 1 lit q) of the Annex. The Court gave a somewhat unclear answer:

> a jurisdiction clause must be regarded as unfair within the meaning of Art. 3 of the Dir. (93/13/EC) *in so far as"* it causes contrary to the requirement of good faith, a significant imbalance in the parties rights and obligations existing under the contract to the detriment of the consumer.

The Court insisted on the protective ambit of Directive 93/13/EC. This means that the judge should be able to raise *ex officio* the potential unfairness of the jurisdiction clause, and that he should apply and interpret his national law in conformity with Community law. However, the Court did not completely condemn the jurisdiction clause, but left this to the national judge, depending on the circumstances of the case. There is, though, great likelihood that such unilateral clauses are unfair because they contradict the principle of effective judicial protection (Reich, 2006, p. 242; Vasiljeva, 2004).

If jurisdiction clauses would be blacklisted in a regulation taking direct effect, this would have to be coordinated with a similar provision contained in Article 17 of the Jurisdiction Regulation (EC) 44/2001,[23] which however only applies to cross-border litigation and, according to the new Article 15 (1) lit c) depends on a prior direction of the activity of the trader towards the consumer's place of residence (Reich, 2006, p. 245; Vasiljeva, 2004).

Prepayment clauses. Letter (b) of the Annex mentions exemption clauses, letter (o) of the Annex concerns clauses "obliging the consumer to fulfil all his obligations where the seller or the supplier does not perform his." These clauses were indirectly before the ECJ in the

case of *Freiburger Kommunalbauten.*[14] The municipal construction company had sold to Mr. and Mrs. Hofstetter a parking space to be built by the former. Under the relevant clause, the whole of the price was due already on delivery of a security by Freiburger Kommunal-bauten, irrespective of any progress made in the construction. The referring German Federal Court was inclined to the view that the clause was not unfair but was not free from doubt and therefore re¬ferred to the ECJ. To the surprise of observers, both AG Geelhoed and the Court declined to review the clause but left this to national courts. With regard to the legal importance of the Annex, the Court went on to say:

> The Annex to which Article 3 (3) of the Directive refers only contains an indicative and non-exhaustive list of terms, which may be regarded as unfair. A term appearing in the list need not necessarily be considered unfair and, conversely, a term that does not appear in the list may none the less be regarded as unfair (para 20).

This means that the ECJ cannot decide on the unfairness of a particular clause without knowing the national law that forms the background of the decision and the circumstances of the individual case (Rott, 2006). The reference procedure of Article 234 EC is limited to interpreting Community law, but not supposed to decide questions concerning the mixture between national and EU law. The Court implicitly opted for a theory ofjudicial restraint on contract law matters - an option that should be kept in mind when proposing a genuine ECCLR. It should blacklist those clauses only, which are unfair as such, without the need to refer to national law in order to determine their legal effects. Since EU law does not have any rules on the contents of the obligations of the professional party to a contract, it cannot rule whether a prepayment clause as in the case of *Freiburger Kommunalbauten,* is really unfair or not. This must be left to Member State law under the minimum harmonisation rule of Art. 153 (5) EC. Such clauses should therefore not be included in the regulation.

CONCLUSION

The paper has put forward the argument that the ongoing work on a "European contract law" is so far based on a shaky conceptual and legal basis. This does of course not rule out support for the ongoing

comparative law initiatives and projects, which are under way in many jurisdictions. But one must caution against their transformation into any officially endorsed EU instrument. On the other hand, there is agreement that the already existing *acquis* in EU consumer law needs consolidation and even codification. This should take the form of a regulation, based on Article 153 (3) (b) EC. It would have a double advantage. It would be directly applicable without waiting for protracted and differentiated Member State implementation, and it would allow minimal harmonisation without excluding Member State differentiation in consumer contract law if the States so decide. It therefore meets the principles of conferred jurisdiction, subsidiarity and proportionality, as spelled out in Article 5 EC. Unlike a EU contract law, a ECCLR would not be a *"Gespenst"* but a chance for a truly integrated internal market which lives up to the expectations of Article 153 EC.

NOTES

[1] Resolution of 6.5.1994, OJ C 105/518 of 1994.

[2] Communication from the Commission to the Council and the European Parliament on European Contract Law, Com (2001) 398 final; also published in Weatherill (2001, pp. 377-399).

[3] Reactions to the Communication on European Contract Law, http://europa.eu.int/comm/consumers/consint/safeshop/fairbuspract/contlaw/indexen.htm.

[4] Communication from the Commission to the European Parliament and the Council - A more coherent European contract law - An action plan. Com (2003) 68 final, [2003] OJ C 63/1.

[5] Com (2004) 651 final.

[6] Case C-339/89 Alsthom Atlantique v Compagnie de construction mecanique Sulzer SA [1991] E C R I-107 at para 15.

[7] C-376/98 Germany v European Parliament and Council [2000] E C R I-8419.

[8] Directive 98/43/EC of the European Parliament and the Council of 6 July 1998 on the approximation on the laws, regulations, and administrative provisions of Member States relating to the advertising and sponsorship of tobacco products, [1998] OL L 213/9.

[9] C-491/01 R v Secretary of State for Health *ex parte* British American Tobacco (Investment) Ltd. *et al,* [2002] E C R I-11453.

[10] C-377/98 Netherlands v EP and Council [2001] E C R I-7079.

[11] Case C-168/00 Simone Leitner v TUI Deutschland [2002] E C R I-2631 paras 21-22.

[12] On its present status, see the different approaches by Howells and Wilhelmsson (2003) and Stuyck (2000).

[13] C-361/89 de Pinto [1991] E C R I-1189 para 22.

[14] Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and

amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, [2002] OJ L 271/16.

[15] Directive 2006/29/EC of the European Parliament and of the Council of 11 May 2006 - ''Unfair Commercial Practices Directive,'' [2006] OJ L 149/22.

[16] Directive 98/6/EC of the European Parliament and of the Council of 16 February 1998 on consumer protection in the indication of the prices of products offered to consumers, [1998] OJ L 80/27.

[17] Protocol No. 30/1997 on Subsidiarity and proportionality.

[18] Council Regulation (EEC) No 295/91 of 4 February 1991 establishing common rules for a denied-boarding compensation system in scheduled air transport, [1991] OJ L 36/5.

[19] Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, [2004] OJ L 461.

[20] Case C-478/99 Commission v Sweden [2002] E C R I-4147.

[21] Joined cases C-240-244/98 Oceano Grupo editorial v Rocio Murciano Quintero et al. [2000] E C R I-4491.

[22] Reich and Micklitz (2003, para 13.22) insist that the words in italics were not translated in the German version and caused some confusion about the ambit and scope of the judgment.

[23] [2001] OJ L 12/1.

[24] Case C-237/02 Freiburger Kommunalbauten G m b H Baugesellschaft & Co KG v Ludwig und Ulrike Hofstetter [2004] E C R I-3403.

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AGGREGATION AND DIVISIBILITY OF DAMAGE FROM THE EUROPEAN CONFLICT OF LAWS PERSPECTIVE

Thomas Thiede*

I. Preliminary Remarks

Conflict of laws has changed fundamentally in the last decade(s) as a result of the activities of the European legislator. Alongside the international conventions and the - now sometimes overruled - national law, a set of unified rules applicable to cases with a relationship to a foreign jurisdiction and foreign law has been enacted on the European level. In almost all conflict of laws fields, the hitherto applicable national rules have been replaced by directly applicable European regulations, e.g. the rules on international jurisdiction in civil and commercial matters (Regulation 44/2001, hereafter 'Brussels I Regulation') as well as on the law applicable to non-contractual ("Rome II") as well as contractual matters ("Rome I"), in all European Member States. 1

A. The Basic Principles of Conflict of Laws

Basically, in all cases with a foreign element, e.g. when the damage is incurred in one state but the harm was actually caused in another, conflict rules set out to achieve two goals: Firstly, international cases should be decided in harmony, i.e. different judgments from different courts dealing with an identical case are to be avoided and secondly, every case should be subject to the law of the jurisdiction to which the closest connection exists; no national law should be applied to a case without any substantive connection to the geographical, personal or other general circumstances. 2

In order to secure these objectives, two fundamentally different but interrelated sets of rules must be applied concordantly. First of all, the rules on international jurisdiction must be consulted in order to find a court to determine the case. Secondly, the conflict rules provide the answer to the question which respective national substantive law should be applied by the court seised. Experience shows that some national courts tend to apply their own substantive law *(lex fori)* without any further consultation of the conflict rules because their *own* 3

I dedicate this paper to my parents, Dipl.-Ing. Hannelore and Dipl.-Ing. Hans-Jorg Thiede.

substantive law (scil. their *lex fori)* is the law the judges are most familiar with. However, this approach contradicts the principle of international legal harmony: Skipping the test on conflict of laws would allow the (merely allegedly legitimate) claimant to choose a court and thereby a legal system which does not have the closest connection to the case at hand but has other aspects favourable to the claimant, e.g. it may award very high amounts of damages or have a particular evidence scheme.[1] The conflict rules, as meta-law,[2] prevent this kind of *forum shopping* by assigning just one national law exclusively to the case, regardless of where the claim is litigated. However, this positive effect was subject to limitation since, up until the recent European unification, the conflict rules themselves were only national substantive rules: Different conflict rules, originating from different *leges fori,* assigned different national substantive laws to the one case. Therefore, the European harmonization of the rules on international jurisdiction and the conflict rules are of exceptional significance since their unification and the fact that they prevail over national law ease the above-mentioned problems to a very large extent: Basing their decision on the same rules to determine the competent court seised and the law applicable to cases with a foreign element, every European court of whatever national jurisdiction, refers ultimately to the same substantive law.

4 The considerations described above are the best example of the legal principles derived from the logics of conflict of laws on a methodological level. They are, however, only one part of the legal principles governing the methodology of this particular field of law. In addition, the general principles derived from the substantive law ultimately applied must always be considered when new conflict rules are to be put into legislation, existing rules are to be interpreted or when loopholes in the existing codes or case law have to be closed. Such an approach is constitutive, since last but not least substantive law, international jurisdiction and conflict rules are part of the same jurisdiction, which should not be contradictory in itself but establish a coherent system of legal rules.[3]

It is, however, reasonable to recognize a right of a claimant to choose between different courts according to his specific action when it comes to certain fact patterns (infra no. 10). Such a choice is, however, regarded as *forum shopping* when it is made to alter that party's substantive legal entitlements to his own advantage or, accordingly, to the disadvantage of his opponents. As a result, the law would no longer be providing a certain and predictable norm, neutrally applied between the parties. Cf. *R.J. Weintraub,* Choice of Law for Quantifications of Damages, 42 Texas International Law Journal (Tex. Int'l L.J.) 311, 317. This principle is generally elaborated in *F. Bydlinksi,* System und Prinzipien des Privatrechts (1996) 92 ff. and subsequently reintroduced to conflict of laws by, e.g. *S. Habermeier,* Neue Wege zum Wirtschaftskollisionsrecht (1997) 191 ff.; *J. Kropholler,* Das Unbehagen am forum shopping, in: Festschrift Firsching (1985) 165 ff.; *C. von Bar,* Grundfragen des internationalen Deliktsrechts (Juristen Zeitung) JZ 1985, 961 ff.

For this term consult *R. Wietholter,* Begriffs- oder Interessenjurisprudenz - falsche Fronten im IPR und Wirtschaftsverfassungsrecht, in: Festschrift Kegel (1977) 213 ff.; *W. Muller-Freienfels,* IPR in der Normenhierarchie, in: Festskrift Hellner (1984) 369 ff.; *C. von Bar/P. Mankowski,* Internationales Privatrecht, vol. I (2003) no. 214; *T. Thiede/K. Ludwichowska,* Die Haftung bei grenzuberschreitenden unerlaubten Handlungen, Zeitschrift fur Vergleichende Rechtswissenschaft (ZVglRWiss) 106 (2007) 92, 94.

The consideration of these basic principles is last but not least demanded by fundamental rights in the respective national jurisdictions, the Charter of Fundamental Rights in the future Treaty

This is supported by the fact that most principles of substantive law are determined and well-documented on a broad comparative basis. Furthermore, it is easier to observe these principles at a supra-national level, since in this context the legislator is not constricted by individual national interests but broadened by supra-national ambition. Hence, supra-national comparative analysis of the law ultimately applied should be taken into consideration when any legislation or legal practice in the area of conflict of laws is concerned and must be considered when conflict rules are to be enacted or interpreted.

B. Relevant scenarios for questions of aggregation and divisibility of damages

It should come as no surprise that an area of law which deals at best with questions of bilateral contracts or road traffic accidents as well as transnational marriages does not cover questions of aggregation and divisibility of damage to a great extent. Consequently, literature covering this specific question is almost absent. Furthermore, one has to be aware of the basic paradox of conflict rules: Specific legal concepts such as aggregation and divisibility of damage cannot be determined within the conflict rules since these rules contain material reference to the underlying legal problem only as far as the respective principles of the law ultimately applied are concerned.[4] Nevertheless, from the perspective of the logic of conflict of laws, one may quite bluntly assume that in general any aggregation of damage in terms of competent courts and applicable law certainly fits better into the above-described principles of this area of law: If damage is internationally split and occurs in several national jurisdictions, the efforts to have a single competent court and especially a single applicable law may be antagonized. 5

How divisibility of damage, e.g. in cases of different damage from the same cause, different consequential damage from the same direct damage and, finally, different damage from similar poses problems for the pursuit of the latter objectives of the conflict of laws regime is illustrated below by means of two different scenarios basically downgrading the specific problems in the Questionnaire to terms and realistic fact patterns in conflict of laws. 6

SCENARIO 1: One single tortfeasor causes a multitude of (direct and consequential) damage in different states.

SCENARIO 2: A multitude of tortfeasors cause one single damage in one state.

of Lisbon as well as European Convention of Human Rights. Cf. *H. Koziol/T. Thiede,* Kritische Bemerkungen zum derzeitigen Stand des Entwurfs einer Rom II-Verordnung, ZVglRWiss 106 (2007) 235, 239; *K. Siehr,* Wechselwirkungen zwischen Kollisionsrecht und Sachrecht, Rabels Zeitschrift fur Auslandisches und Internationales Privatrecht (RabelsZ) 37 (1973) 466, 475; *J. v. Hein,* Das Gunstigkeitsprinzip im Internationalen Deliktsrecht (1999) 27; *C. von Bar,* Grundfragen des internationalen Deliktsrechts, Juristenzeitung (JZ) 1985, 961, 966.

Scil. whether a liability is joint and solidary or not can *de facto* only be answered when the law applicable is already established.

II. International Jurisdiction

A. Introduction

7 The needs of the common European market means the European legislator has long been active in the area of international jurisdiction.[5] As early as in 1968 the Brussels Convention on Jurisdiction and the Enforcements of Judgments in Civil and Commercial Matters[6] was adopted by the Member States of the European Community and came into force in 1973 in the EC Member States at that time.[7] Subsequently, the Brussels Convention was amended by four accession conventions until it was replaced for fourteen[8] of the then fifteen EC Member States by Regulation 44/2001 on Jurisdiction and the Recognition and Enforcements of Judgments in Civil and Commercial Matters ("Brussels I Regulation")[9] adopted by the EC Council in December 2000, which entered into force on 1 March 2002. The Regulation, like the Convention earlier, lays down rules on direct jurisdiction, applicable by the court seised of the original action in determining its own jurisdiction, and the recognition and enforcement of judgments given in other Member States of the European Union in which the Regulation applies. In contrast to the prior Convention, the Regulation is directly applicable in the Member States under art. 249 (2) EC Treaty.[10]

8 The material scope of the Brussels I Regulation is defined by its art. 1 whereunder the Regulation applies only to civil and commercial matters. Hence, for the Brussels I Regulation to be applicable, the subject matter of the dispute must be of a *"civil or commercial nature"."* Consequently, the Regulation does not apply to a dispute between a private person and a public authority arising out of acts by the public authority in the exercise of its powers as such, but on the other hand, is applicable when neither party to the dispute is a public body or where a public body was not acting in exercise of its official powers.[12]

Cf. Recital 2 of the Brussels I Regulation: *"Certain differences between national rules governingjurisdiction [...] hamper the sound operation ofthe internal market. [•••]"* [1972] Official Journal (OJ) L 299, 32.

I.e. Germany, Belgium, France, Italy, Luxemburg and The Netherlands.

From 1 May 2004 it has also applied in the ten states which joined the European Community under the Treaty of Athens, cf. Athens Act of Accession, art. 2 and Annex II, Part 19 (A) (3).

[2001] OJ L 12, 1.

Since Denmark does not participate in Title IV of the EC Treaty in general and, as a consequence, legal instruments adopted in the field ofjudicial cooperation in civil matters were not binding upon or applicable in this state. This situation was regarded as highly unsatisfactory and a convenient solution was found by means ofpublic international law: The EU concluded a separate Convention with Denmark implementing the Brussels I Regulation as an international treaty, see [2005] OJ L 299, 62; [2005] OJ L 300, 55.

ECJ 14 October 1976, 29-76 *LTUvEurocontrol* [1976] ECR 1541.

ECJ 14 October 1976, 29-76 *LTUvEurocontrol* [1976] ECR 1541; 16 December 1980, 814/79 *Netherlands v Ruffer* [1980] ECR 3807; 22 April 1993, C-172/91 *Sonntag v Waidmann* [1993] ECR I-1963; 1 Oktober 2002, C-167/00 *VKI v Henkel* [2002] ECR I-8111; 15 May 2003, C-266/01 *TIARD v Staat derNederlanden* [2003] ECR I-4867.

The basic rule of the Brussels Regulation concerning direct jurisdiction is enshrined in art. 2 of the Brussels I Regulation providing that *"persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that state"."* In order to ascertain whether the defendant is domiciled in a Member State under this article, art. 59 of the Regulation, dealing with the question of which country's definition of domicile is to be used, stipulates the own definition of the court of the EC Member State seised in order to determine whether a person is domiciled in that state *(lexfori).* Only when the courts wants to reject the defendant's domicile at the forum is it obliged to apply the definition of the state in which it assumes the defendant's domicile might be (lex causae).[14] 9

B. Special jurisdiction

An exaggerated preference for the defendant's domicile does not always provide the most appropriate, optimal solution in all situations, actions and claims. Accordingly, the Regulation provides for particular alternative jurisdictions if the defendant is to be sued in the courts of a state other than that of his domicile. In such cases, the choice of court is given to the plaintiff and it is not open to any of the courts involved to override the plaintiff's choice on any grounds.[15] As the European legislator has frequently emphasized, this freedom of choice was introduced in view of the existence in certain well-defined cases of a particularly close relationship between a dispute and the court which may be most conveniently called upon to adjudge the disputed matter.[16] One exception, however, is of interest with respect to the subject of aggregation and divisibility of damage: art. 5 (3) of the Regulation, stipulating that in matters relating to tort, delict or quasi-delict, a person domiciled in a Member State may be sued in another Member State *"in the courts of the place where the harmful event occurred".* 10

The rationale behind this long-standing rule in favour of the defendant's domicile was analysed excellently by the E C J in 17 June 1992, C-26/91 *Handte v TMCS* [1992] E C R I-3967 noting that the rule reflects the purpose of strengthening the legal protection of persons established within a particular current "national" jurisdiction, and rests on an assumption that a defendant can normally most easily conduct his defence in the courts of his domicile. See also E C J 28 September 1999, C-440/97 *Groupe Concorde v "Suhadiwarno Panjan"* [1999] E C R I-6307. Furthermore, the defendant presumably keeps most of his assets at his domicile and hence enforcement against his person or property can most easily be effected there. Thus, the rule tends to concentrate both adjudication of the merits and enforcement of the judgment in the same country, thereby avoiding unnecessary procedural complications.

E.g. if the Austrian courts, having decided on the basis of their own definition that a person is not domiciled in Austria, want to know whether the defendant is domiciled in Poland they must apply the Polish definition of domicile. For legal entities see art. 60 Brussels I Regulation.

Notably, the regulation does not provide any escape clause rule, which would allow the court, seised to refer to any more close relationship, e.g. a common habitual residence.

Cf. Recital 11 of the Brussels I Regulation stipulating that "The *rules of jurisdiction must be highly predictable and founded on the principle that jurisdiction is generally based on the defendant's domicile and jurisdiction must always be available on this ground save in a few well-defined situations in which the subject-matter of the litigation or the autonomy of the parties warrants a differing linkingfactor[...]."*

11 To begin with, the court has already decided upon facts which correspond to some extent to SCENARIO 1 above involving a horticultural company in the Netherlands, mainly depending on the waters of the Rhine for irrigating its plants, which suffered from the pollution of the river's water by the discharge of saline waste from a potash mine established in France.[17] Up to this decision concerning the wording of art. 5 (3) Brussels I Regulation it was particularly unclear whether the courts of the country where the *wrongful act took place* (i.e. France) or the courts where the *resulting infringement of the protected right arose* (i.e. The Netherlands) had jurisdiction over the matter.[18] The ECJ held that the text must be understood as covering *both* the place where the infringement - *and not only the damage* - occurred[19] and the place where the event giving rise to it took place and, as a rationale, referred to the respective equal proximity of both courts to the wrongful conduct or the infringement sustained - with the result being that the defendant must be sued, at the choice of the plaintiff, either in the courts at the place where the infringement occurred or in the courts at the place where the event giving rise to it occurred. It must be noted that these two options are not exclusive and do not deprive the plaintiff of his right to sue in the country of the defendant's domicile pursuant to the general provision.[20]

12 These places may, and quite frequently will, coincide, but nevertheless, this rule poses problems in cases concerning an international divisibility of damage, i.e. multi-state torts such as, for example, invasions of personality rights (SCENARIO 1). How this affects jurisdictional issues was demonstrated by a case of a libel action brought by an English woman against the publisher of a French newspaper of which 0.1% was distributed in the United Kingdom.[21] Evidently,

[17] ECJ 30 November 1976, 21-76 *Handelskwekerij G.J. Bier BV v Mines depotasse d'Alsace SA* [1976] ECR 1735; see *J. Schacherreiter,* Leading Decisions (2008) no. 261.

[18] The prevalent opinion understood the art. 5 (3) Brussels I Convention as an alternative to the general rule resulting only in a jurisdiction at the actual place of conduct (i.e in this example France), see *G.A.L. Droz,* Competence et execution des jugements en Europe [2002] no. 76; *M. Weser,* Convention communautaire sur la competence judiciaire et l'execution des decisions [1975] no. 225bis; *E. Mezger,* Drei Jahre EG-Zustandigkeits- und Vollstreckungsubereinkommen in Frankreich, Recht der Internationalen Wirtschaft (RIW) 1976, 345, 347.

[19] Cf. this now also holds true for France, see *S. Galand-Carval,* Aggregation and Divisibility of Damage in France: Tort Law and Insurance, (contained in this volume) no. 47 ff. referring to Cass. Civ. 11 January 1984, Bull. Civ. no. 360; See also Cour de cassation, 11 May 1999, Journal du Droit International (J.D.I.) 126 (1999) 1048.
This seems to constitute a major change in the French judicature: See with a referral to the *"lieu de prejudice":* Cour de cassation, Urteil vom 25. Mai 1948, Revue critique de Droit International Prive (Rec. crit. DIP) 39 (1949) 89; Cour d'appel Paris, 18 October 1955, Rev. crit. DIP 45 (1956) 484 ff.; or "loi *du lieu oil le dommage a ete realise":* Cour de cassation, 8 February 1983, J.D.I. 111 (1984) 123, 125; finally *"[...] que la loi applicable a la responsabilite extracontractuelle est celle de lEtat du lieu oil le fait dommageable s'estproduit; que ce lieu s'entendaussi bien celui du fait generateur du dommage que du lieu de realisation de ce dernier".* Cour de cassation, 14 January 1997, Rev. crit. DIP 86 (1997) 504, 505.

[20] Infra no. 9.

[21] ECJ 7 March 1995, C-68/93 *Fiona Shevill v Presse Alliance SA* [1995] ECR I-415. The defamatory statements related to alleged money-laundering for drug-traffickers by a bureau de change in Paris in which the plaintiff was temporarily employed.

vesting jurisdiction in both the courts of the state where the harm occurred and at the place of wrongful conduct is highly problematic: To begin with, it was unclear whether a particular court is at the place where the harm occurred or where the wrongful conduct took place. Furthermore, at first glance the solution might amount to a situation where the victim could basically obtain the right to combine several courts of jurisdiction, e.g. suing the publisher in England and France respectively, and each time in respect of the full damage.

The E C J became aware of this preposterous invitation to *forum shopping* and tried to correct the consequences by introducing certain limitations on the choice of the plaintiff: Firstly, the court draws a distinction between the initial injury and consequential losses, and it refuses to permit a plaintiff to sue in the courts of any place where he has merely suffered pure economic loss consequential on an initial infringement of his protected right sustained elsewhere. Hence, only the primary infringement of the protected right is relevant for the assessment of the competent court under art. 5 (3) Brussels I Convention.[22] This rule extends to secondary victims who may only sue in the jurisdiction where the primary victim was harmed. Finally, in the libel case above, the court held that the publisher could be sued in the place of the wrongful conduct, i.e. at *his establishment* for *all the harm* caused by the defamation, or before the courts of *each country* where the publication was distributed and caused damage. However, in the latter case, the courts of each country have *jurisdiction solely in respect of the damage caused within their own territory."* 13

It should not automatically be assumed that the limitations proposed by the European Court entirely solve the problems of divisibility of damage as regards international jurisdiction. In cases of infringement of personality rights, for example, the rule that neither indirect damage suffered elsewhere than in the original place nor damage suffered by secondary victims vests jurisdiction in national courts, leads to a situation where a plaintiff claiming compensation for his mental affliction suffered in England and brought about by a defamatory publication concerning his son which was distributed only in France may only 14

Cf. E C J 11 January 1990, C-220/88 *Dumez vHessischeLandesbank* [1990] E C R I-49; 19 September 1995, C-364/93 *Marinari vLloyds Bank* [1995] E C R I-2719; 27 October 1998, C-51/97, for both decisions *J. Schacherreiter,* Leading Decisions (2008) no. 262 and 263.

This solution basically descended from a French approach to the specific problem. However the "original" French solution basically reduced the application to the *lex fori* by introducing a certain causal connection and an application of the place where the harm (and not the original infringement of the legal interest, *sic!)* occurred (supra fn. 19): *"Attendu, en revanche, que les dommages provoques par l'edition et la diffusion, en Allemagne, des publications litigieuses n'ont aucun lien de causalite avec ceux resultant de la diffusion de ce dernieres en France; que, dans ces conditions, ces dommages ne se rattachent a ce tribunal ni par lieu de realisation, ni par celui des actes fautifs; que ce tribunal est en consequence incompetent pour connaitre de l'action en reparation du prejudice subipar la demanderesse en Allemagne [•••]"* T G I Paris, 27 A p r i l 1983, Rev. crit. DIP 72 (1983) 672, 674. Hence, a fundamental difference to the scheme of *Shevill* arises, cf *J.-M. Bischoff* annotation to Cass. C i v., 14 January 1997, Rev. crit. DIP 86 (1997) 505, 513.

sue the publisher in France, but not in England. Correspondingly, the test on whether a distant harm is adequately consequential on an initial injury to give jurisdiction to a local court may render rather poor results, e.g. if a Parisian lawyer wants to sue in France arguing that defamatory statements, although spread by the defendant in England only, have caused him financial damage in France by losing him English clients. Finally, the limitation on recognition and jurisdiction according to the national borders of the state where the harm occurred constitutes a return of the court to the *actor sequiturforum rei* rule, admittedly with a certain shift towards the courts where the harm occurred. Despite the fact that this accentuation of the latter court(s) proves appropriate since these courts have the closest connection to the alleged victims of the damage, victims who have suffered considerable damage in several countries are well advised to consult legal experts in order to select the Member State or a combination of Member States where their prospects of successful litigation are best.[24]

15 The above considerations so far only reflect SCENARIO 1 and possible plurality of losses in different places. Vice versa a situation where multiple tortfeasors act as principal and servant might become relevant for this provision (SCENARIO 2), i.e. whether the plaintiff can hold the principal liable at the place where only the servant acted. One should bear in mind that virtually all European jurisdictions and accordingly the *Principles of European Tort Law* (PETL) hold the principal liable when he "acts" via an instructed and (socially) dependent accomplice.[25] Hence, it seems reasonable to extend the jurisdiction to that principal even when he himself or his accomplice are not domiciled at the place where the harmful event giving rise to the damage occurred, since ultimately the person enlarging his sphere of action via assistants should bear the risk of court proceedings in the country where said assistants acted.[26]

C. Ancillary jurisdiction and concurrent proceedings *(lispendens)*

16 Whereas the special jurisdiction under art. 5 (3) Brussels I Regulation fits SCENARIO 2 only in special circumstances, art. 6 of the Regulation provides for a much broader scope of aggregation of different claims against multiple tort-

[24] *M. Bogdan,* Private International Law Aspects of Trans-Border Invasion of Personality Rights by the Media, in: A. Beater/S. Habermeier, Verletzungen von Personlichkeitsrechten durch die Medien (2005) 138, 142; see also *C. von Bar,* Personlichkeitsschutz im gegenwartigen und zukunftigen deutschen internationalen Privatrecht, in: Law in East and West/Recht in Ost und West, Festschrift zum 30jahrigen Jubilaum des Institutes fur Rechtsvergleichung der Waseda Universitat (1988) 575 ff.; *W. Nixdorf,* Presse ohne Grenzen: Probleme grenzuberschreitender Veroffentlichungen, Gewerblicher Rechtsschutz und Urheberrecht (GRUR) 1996, 842, 844; *H. Schack,* Grenzuberschreitende Verletzung allgemeiner und Urheberpersonlichkeitsrechte, Archiv fur Urheber-, Film-, Funk- und Theaterrecht (UFITA) 108 (1988) 51, 66; *P. Mankowski,* Art. 5 in: U. Magnus/P. Mankowski, Brussels I Regulation (2007) no. 207 ff.

[25] See, art. 6:102 (1) PETL.

[26] See *E. Rabel,* Conflict of Laws, vol. II (1960) 318: *"Hence, the theory advocating the law of the place of acting is entirely antiquated if it stresses physical movements. Not the locality where a person operates, but that to which his operations are directed, is material. "*

feasors. According to this provision, the Brussels I Regulation recognizes the desirability, in the interest of the sound administration of justice and of reducing the risk of conflicting judgments, that related disputes be decided together in a single proceeding and allow for the joining before a single court of closely connected claims over which several different courts would ordinarily be competent under the Regulation. Hence, art. 6 Brussels I Regulation provides ancillary jurisdiction over co-defendants, even if the court seised would not have had jurisdiction to entertain the additional claim in its own right, i.e. under art. 2 or 5 (3) Brussels I Regulation.[27] Basically, the provision holds that a *"person domiciled in a contracting state may also be sued[...] where he is one of a number of defendants in the courts for the place where any one of them is domiciled."*[28]

Apparently, this exception to the general rule of art. 2 Brussels I Regulation - presumably stipulating a jurisdiction other than that of the defendant's domicile - substantially aggravates the danger of misuse by resulting in proceedings being brought against a number of defendants with the sole object of ousting the jurisdiction of the particular courts where one of the defendants is domiciled. Accordingly, two general conditions of its application must be met. To begin with, jurisdiction over a connected claim against a defendant domiciled in another Member State belongs exclusively to the courts of the domicile of one of the other defendants.[29] Furthermore, the European Court of Justice[30] held that, to justify that claims against various defendants domiciled in different Member States be heard and determined by one single court, there must be a *connection* between the various actions brought by the same claimant against the different defendants of such kind that it is expedient to hear them together in order to avoid irreconcilable judgments.[31] When this particular condition is met, does not depend on whether the loss caused is indivisible or not:[32] The Court clearly referred on several occasions only to the risk of judgments if decided separately rendering contradictory results, even if those judgments were mutually 17

Moreover, this principle is given negative effect by art. 27-30 preventing concurrent actions in different Member States in similar or related issues.

Consistently, the Regulation extends to a counterclaim, so as to enable a defendant who counterclaims against a local plaintiff to join a foreign co-defendant to the counterclaim and similarly to a claim by a third party (joined by a defendant) against local or foreign plaintiffs.

In particular, there is no requirement that one certain claim must be more essential to harm ultimately caused and the court at the "the spider at the centre of the web" is exclusively empowered to hear the multiple connected claims, however small the claimed contributory part by the others defendants might have been. Cf. *H. Muir Watt,* Art. 6, in: U. Magnus/P. Mankowski, Brussels I Regulation (2007) no. 23, 25.

ECJ 27 September 1988, 189/87 *Kalfelis v Schroder* [1988] ECR 5565; 27 October 1998, C-51/97 *Reunion Europeenne v Spliethoffs Bevrachtingskantoor* [1998] ECR I-6511.

ECJ 27 September 1988, 189/87 *Kalfelis v Schroder* [1988] ECR 5565; 27 October 1998, C-51/97 *Reunion Europeenne v Spliethoff's Bevrachtingskantoor* [1998] ECR I-6511.

In particular, it rejected the French notion of indivisibility as a requirement of ancillary jurisdiction - which was proposed in order to secure that possible other courts are not ousted - had no place within the scheme of the Convention. See ECJ 24 June 1981, 150/80 *Elefantenschuh v Pierre Jacqmain* [1981] ECR 1671.

exclusive and could even be executed separately.[33] Any further remarks on the quality of the connection necessary, however, could not be gathered since the European Court stated explicitly that it was *"for the national courts in each individual case whether that condition is satisfied"*[34] thus basically referring the questions back to the national courts and giving them significantly more leeway when assessing possible jurisdiction over multiple defendants.

18 Quite similar to the problem explained above is the question of when proceedings simultaneously *pending* in courts of different Member States could effectuate jurisdiction in respect of disputes, which are factually and legally the same.[35] Concerning two related cases, art. 28 Brussels I Convention basically confers upon the courts of the respective Member State discretion to stay their proceeding in favour of the first court seised, in order to constrain irreconcilable judgments. As far as identical cases, i.e. identical claimants and identical facts are concerned, art. 27 Brussels I Regulation provides a clear and effective mechanism for resolving cases of *lis prendens* and related actions by primarily establishing a test based on chronological priority,[36] according to which a court subsequently seised is required to decline jurisdiction in favour of the first court seised, instead of performing a judicial evaluation of the relative appropriateness of the two fora.

III. Applicable Law

A. Introduction

19 It is worth reiterating the basic concepts from the start: When only the rules on international jurisdiction are applied, the court seised applies its substantive national law, i.e. its *lex fori* and the result of the case depends on where it is brought to a national court. Such state of law has long been considered unsatisfactory and in particular during the past century several earnest but unsuccessful attempts at the elaboration of a unified legal act on the law applicable to non-contractual obligations on a European level have been undertaken.[37]

[33] A differentiation concerning the basis of claim (see, ECJ 27 September 1988, 189/87 *Kalfelis/Schroder* [1988] ECR 5565; 27 October 1998, C-51/97 *Reunion Europeenne v Spliethoffs Bevrachtingskantoor* [1998] ECR I-6511), however, was proposed by the court, but, as recently as 2007 given up. See, ECJ 11 October 2007, C-98/06 *Freeportplc v OlleArnoldsson* [2007] ECR I-8319.

[34] Supra fn. 31.

[35] However, especially art. 28 Brussels I Regulation differs in structure as well as function: Whereas art. 6 Brussels I regulation addresses the court originally seised of a claim and allows to extend its jurisdiction, art. 28 provides for related actions, which are each *already pending* before the courts of different Member States. The main difference, however, lies within the original competence of the courts seised: art. 28 Brussels I Regulation allows to join proceedings pending before originally *competent* courts - whereas art. 6 vests jurisdiction in an otherwise incompetent court by virtue of the close connection described above, see no. 17.

[36] *Prior tempore potior iure.*

[37] The Hague Conference on Private International Law adopted, inter alia, two conventions in the field of tort law concerning cases of *traffic accidents* and *product liability* in 1973 and 1971 respectively. See <http://www.hcch.net>. Given the restrictions to single issues by the Hague

Finally, in 2003 the European Commission officially addressed the issue, presenting a new proposal, which was critically discussed and re-drafted several times. Finally, a revised[38] version resulted in the enactment of Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II Regulation).[39] It entered into force on 11 January 2009 for all cases where the damage event occurs thereafter.[40]

The Rome II Regulation covers all non-contractual obligations in *"civil and commercial matters"* having multistate contacts of the kind and pertinence that implicate the laws of more than one state. This scope of the Regulation is, however, restricted by a list of specific exclusions and the application of its general rule in art. 4 (1) is further limited by a number of special rules covering product liability, unfair competition, environmental damage, infringements of intellectual property rights and industrial action. Furthermore, violations of privacy and rights relating to personality are so far excluded, waiting for a respective study and further clarification pursuant to the review clause of art. 30. This research extends to a study on the effects of art. 28 with respect to the Hague Convention of 4 May 1971 on the law applicable to traffic accidents:[41] so far the Regulation is highly unsatisfactory because art. 28 provides that the Regulation regime *"shall not prejudice the application of international conventions to which one or more member states are parties at the time when this Regulation is adopted and which lay down conflict of law rules relating to non-contractual obligations"*. 20

Conference, the European Union attempted a more comprehensive agenda and presented a draft convention on the harmonization of the conflict rules in contractual as well as non-contractual obligations also in the early 1970s. See, RabelsZ 38 (1974) 211. With the expansion of the European Community, this ambition ultimately abated and the decision was made to abandon the tort provisions of the draft convention and instead concentrate on conflict rules for contract conflicts resulting in the Rome Convention on the Law Applicable to Contractual Obligations 1980.

The idea of a harmonization of the rules concerning non-contractual obligations was revived in the late 1990s, when the European Community acquired in the course of the so-called "Vienna Action Plan" legislative competence in the field of conflict of laws under art. 61 and 65 Treaty of Amsterdam of 2 October 1997.

[38] Already in 2001 there was an unpublished version of the green book (cf. *J. von Hein,* ZVglR-Wiss 2003, 528, 533), followed by a preliminary draft in May 2002. After consultation, an amended proposal was adopted in July 2003 (COM 2003 427 final). Due to the needs of the then *newly established* conciliation procedure under art. 251 EC Treaty, the European Parliament's Committee on Legal Affairs presented several reports by *Diana Wallis* on the topic - differing substantially from the Commission proposals - and this was comprehensively commented on. After long and difficult negotiations, compromises on the most controversial issues were reached while others were suspended to a future revision of the Regulation. For an initial overview cf. *B.A. Koch,* European Union, in: H. Koziol/B.C. Steininger (eds.), European Tort Law 2003 (2004) 435 no. 1 ff.; *id.* in: European Tort Law 2005 (2006) 593 no. 10 ff.; id. in: European Tort Law 2006 (2008) 487, no. 3 ff.

[39] OJ L 199, 31.7.2007, 40-49.

[40] Presumably, a drafting error in art. 32, 31 Rome II may suggest an earlier date of application, cf. *Koch,* European Tort Law 2006 (fn. 38) fn. 3.

[41] Supra fn. 37.

21 In the light of the Hague Convention on Traffic Accidents - which provides extraordinarily complex and rather outdated rules on traffic accidents ultimately leading to a rejection of this Convention by the better part of the European Member States - different legal regimes now govern that area in which the most practical and especially numerous conflict cases arise, i.e. international car accidents. This inevitably results in cases of *forum shopping* facilitated ironically by a community instrument originally aimed at preventing suchlike iniquitous behaviour.[42]

B. General rule and (prevailing) special rules

22 The thus limited general rule of the Regulation stipulates the *lex loci delicti,* (mis-) understood however, by the Rome II drafters as the law of the place of the injury or of the infringement of the protected interest *(lex loci damni).* According to the Regulation, the applicable law shall be the law of the country in which the harm *occurs,*

> "irrespective of the country in which the event giving rise to the damage occurred" (art. 4 (1) Rome II Regulation) and "regardless of the country or countries in which the indirect consequences could occur. Accordingly in countries of personal injury or damage to property, the country in which the damage occurs should be the country where the injury was sustained or the property was damaged respectively."[43]

23 The European legislator held that such *"principle of the lex loci delicti commissi is the basic solution for non-contractual obligations in virtually all the member states"* though it admitted that the *"practical application of this principle [...] varies".*[44] And, indeed, the *lex loci delicti* is the basic rule in all Member States. Nonetheless, the allegation by the European legislator that the *lex damni* is used as the compelling connecting factor must be called into question given that some countries opt for the place of conduct in general,[45] others

For a more detailed analysis of the problem, see *T. Thiede/M. Kellner,* "Forum Shopping" zwischem dem Haager Ubereinkommen uber das auf Verkehrsunfalle anzuwendende Recht und der Rom-II-Verordnung, Versicherungsrecht (VersR) 2007, 1624.

See Recital 17 of the Regulation. For a further elaboration of this principle of lex *loci damni* an example (slightly transformed from the Case Study in the original Questionnaire) may illustrate the inherent problem: In a car park in State A, just before crossing the border with State B, D decides to poison P. Unbeknown to P, D puts a noxious chemical into P's water bottle, which is in P's luggage for his trip to State C via State B. While in State B, P gives some of the contaminated water to his dog, which he has taken with him on his journey. Shortly after, the dog starts to vomit, making a mess of P's car. After arriving in State C, P himself takes a sip from the water and consequently falls sick, suffering from stomach cramps. Moreover, whilst still in State C, P has to pay € 150 to the vet for examining his dog. As far as the compensation for the cleaning of the car is concerned, the law of State B would be applied since the dog's poisoning resulted there in the damage to P's car. Accordingly, P's pain and suffering would be determined according to the laws of State C since his condition was sustained there. Only the costs of the vet are a consequential loss and would, hence, be determined according to the laws of State B. See Recital 15 of the Regulation.

Austrian PIL Act of June 15, 1978 § 48(1); Polish PIL Act 1965 art. 33(1).

opt for the place of injury,[46] others apply the law of the place of conduct in some specified cases and the law of injury in other cases,[47] still others leave the question unanswered,[48] and, finally, some Member States allow the victim or the court to choose between the laws.[49] Hence, it would have been far more auspicious if the Rome II codifiers had realised that the current national codes contain at least important allusions to the *lex loci delicti commissi* and not merely variations of the application of a general principle of *lex damni.* As already explained above, the scope of art. 4 Rome II Regulation is additionally somewhat limited by specific exclusions set out in the Regulation. Surpris¬ ingly, it must be noted that questions concerning the predominantly important fact patterns were deemed too major and too special a category to leave to the *lex damni* rule, with the result that the legislator referred them to the - other¬ wise obliviously disregarded - *lex loci delicti commissi.*

This, however, amounts to a situation where the legislator alleges to have found 24
a consensus on a general rule but then subjects such in (almost) all relevant cases to an otherwise concealed rejected rule. In the light of this *lex specialis* approach by the drafters and the existing and accessible national codes and case law explained above, comparative research of the basic principles gov¬ erning tort law in general and, accordingly, conflict of laws in the area of tort, would have been far more propitious than this game of hide and seek - and might have revealed a general principle governing this field of conflict rules.

Basically, it is understood in all European Member States, and, accordingly, 25
in the *Principles of European Tort Law* (PETL), that the main purpose of tort law is the *restitutio ad integrum* - the (full) compensation of damage.[50] This basic principle is, however, limited to the extent that this damage is attribut¬ able to the tortfeasor - a rule wisely enshrined in the old rule of *casum sentit dominus.* In addition, it is generally agreed that tort law has an additional aim of *prevention,* since having to compensate basically has a deterrent effect.[51] Accordingly, these general objectives pursued by substantive tort law can be translated into terms of conflict of laws.[52] The general idea of compensation and a general focus on the indemnification of the victim *primafacie* suggests the application of the *lex damni:* The victim's legitimate expectations focus on the protection provided by the law of the country where he participates in public intercourse and, thereby, exposes his rights and interests to potential infringements.[53] The victim of a wrongful act is typically not a qualified law-

[46] Dutch PIL Act, art. 3(2); English PIL Act 1995 § 11.

[47] See Portuguese Civ. Code, art. 45 (1), (2); Swiss PIL Act, art. 133(2).

[48] Spanish Civ. Code art. 9; Greek Civ. Code, art. 26; Czechoslovakian PIL Act of 1963, art. 15.

[49] EGBGB, art. 40(1); Hungarian PIL Decree of 1979 § 32(1)(2); Italian PIL Act of May 31, 1995, art. 62(1).

[50] See, art. 1:101 PETL.

[51] *U. Magnus,* Comparative Report, in: U. Magnus (ed.), Unification of Tort Law: Damages (2001) 187; *F. Bydlinksi,* System und Prinzipien (1996) 190 ff.; *M. Faure,* Economic Analysis, in: B.A. Koch/H. Koziol (eds.), Unification of Tort Law: Strict Liability (2002) 364 ff.

[52] Cf. infra no. 4.

[53] *G. Wagner,* IPRax 2006, 372 (374).

yer; nevertheless, one may assume that he has confidence in the standards of compensation at the place where the harm occurred, very often the place of his habitual residence. Moreover, the development of systems not primarily based on some concept of reproach for misbehaviour and which instead shift the focus to at least additional or even entirely different aspects such as objective danger *("strict liability")*[54] may support the application of the *lex damni.*[55] Accordingly, some authors[56] assume that in modern tort law and in the context of conflict of laws, a focus on the loss sustained and, thus, the application of the *lex damni,* is required by liability for exposure to loss and the fact that in some instances of liability there is, moreover, hardly any prerequisite other than causation of the damage sustained (strict liability). Finally, an application of the law at the place where the harm occurred is considered simpler in SCENARIO 2 above: If multiple wrongful acts in different jurisdictions are the *conditio sine qua non* for *one* detrimental result, the application of the *lex damni* seems to be the simple and straightforward solution for the judge.

26 All these arguments may be valid in themselves, but they focus only on the victim's interests. Such general concerns for the victim are excessive and to this extent somewhat misplaced. An appropriate solution must focus on the interests of all parties involved, including those of the tortfeasor. As already stated, substantive law dictates that a person has to compensate for another person's injury only if certain requirements of liability are met: A person is only under obligation to render compensation if the damage is legally attributable to him - *casum sentit dominus."* Accordingly, for questions of conflict of laws, it is necessary to determine which law should provide the criteria for this attribution. In cases of liability based on fault, the law of the state where the conduct in question took place governs these criteria since everybody has to comply with the rules and standards of that country in which he acts (assuming that this is the place of his habitual residence). To the same extent, the confidence of the victim in the relevant standards of the state where the harm occurred has to be considered whereas simultaneously the expectations of the tortfeasor according to the standards of the state where he commits the tortious action must be taken into account. To begin with, an attributable, negligent behaviour by the wrongdoer requires in any case that he was able to recognise the legal standards with which he had to comply beforehand. These considerations argue for the place of conduct, the *lex loci delicti commissi."*[57]

[54] *B.A. Koch/H. Koziol,* Comparative Conclusions, in: B.A. Koch/H. Koziol (eds.), Unification of Tort Law: Strict Liability (2002) 395 ff.

[55] See on this topic only *H. Stoll,* Zweispurige Anknupfung von Verschuldens- und Gefahrdungshaftung im internationalen Deliktsrecht? in: Festschrift Ferid (1978) 397.

[56] *T. Kadner Graziano,* Gemeineuropaisches Internationales Privatrecht (2002) 218.

[57] Accordingly, there is no "level playing field" as suggested by *G.Wagner,* Internationales Deliktsrecht, die Arbeiten an der Rom II-Verordnung und der europaische Deliktsgerichtsstand, Praxis des Internationalen Privat- und Verfahrensrechts (IPRax) 2006, 372 (376); *T. Kadner-Graziano,* Das auf auBervertragliche Schuldverhaltnisse anzuwendende Recht nach Inkrafttreten der Rom II-Verordnung, RabelsZ 73 (209) 1 (36).

[58] Moreover, the deterrent effect of tort law also supports the application of the law of the place of conduct, since the threat of future liability can only induce prudent behaviour if the potential

In this stalemate situation between the two possible connecting factors, the argument of the simplicity of application of *lex loci damni* remains. When this line of reasoning is applied to the test of aggregation or divisibility of damage, the results rendered may no longer seem acceptable in SCENARIO 1: Especially in cases concerning intellectual property and personality rights,[59] the *lex damni* rule may actually result in exorbitant difficulties since damage may occur in more than one geographical location and, thus, a multitude of laws may be rendered applicable. This results in a difficult mosaic assessment *(Mosaikbeurteilung)* of one single claim, i.e. the separation of the overall harm into several independent torts, which then should be subsumed by one single court.[60] 27

Indeed, in cases of multiple tortfeasors' conduct resulting in only one injury as in SCENARIO 2, the current rule may provide acceptable results at first glance. However, when the scenario is varied to a situation where the conduct results in multiple damage events in *different* countries, due to the mosaic assessment of the respective losses, the internal recourse of the respective tortfeasors would be entirely corrupted: If multiple tortfeasors are liable under several laws, their internal redress may be determined differently by the laws applied, e.g. in cases where one law applied has specific provisions which exclude a recourse action against the other wrongdoers.[61] Since according to art. 20 Rome II Regulation the internal recourse of the tortfeasors is governed by the law applicable to the respective original claim, the problem of the mosaic assessment would be exponentially aggravated and a coherent recourse action between the tortfeasors would not be possible. Hence, the argument of simplicity must also be rejected. 28

The foregoing general remarks are not intended as a general argument for a general application of the law at the tortfeasor's place of wrongful conduct, but instead to take account of the fact that tort law in general does not focus solely 29

tortfeasor is aware of the applicable standards of conduct; this is most likely in respect of the standards at the place of conduct. Furthermore, the proposition that modern tort law and particularly strict liability demands a focus on the loss sustained must be rejected: Liability based on fault is still the core of tort law (See, *P. Widmer,* Bases of liability, in: European Group on Tort Law, Principles of European Tort Law (2005) 68; *C. v. Bar,* The Common European Law of Torts, vol. I (1998) no. 11.) and, in addition, strict liability is not liability for any loss sustained - strict liability regularly covers situations of extraordinary danger requiring a correspondingly extraordinary allocation of responsibility and is applied in cases where a highly significant risk of harm remains despite all proper precautions taken by the defendant. (See, *B.A. Koch,* Strict Liability, in: European Group on Tort Law, Principles of European Tort Law (2005) 105.) Nonetheless, there is no clear-cut concept of strict liability, not even within any single jurisdiction. Hence, every proprietor of an exceptional source of danger will assume that the law of the place where this danger is actually situated will be applied to the basis, scope and the design of the respective liability and calculate the risk accordingly.

[59] Which are excluded under the Rome II Regulation, infra no. 20.

[60] Promoting this solution: *P. Mankowski,* Art. 5, in: U. Magnus/P. Mankowski, Brussels I Regulation (2007) no. 212.

[61] See, *H. Stoll,* Rechtskollisionen bei Schuldnermehrheiten, in: Festschrift Muller-Freienfels (1986) 665; *W.V.H. Rogers,* Comparative Report on Multiple Tortfeasors, in: W.V.H. Rogers, Unification of Tort Law: Multiple Tortfeasors (2004) 292.

on the victim's issues but also on those of the tortfeasor and seeks to balance both sides. Therefore, it would have been advisable for the European legisla¬tor to consider the conflicting interests of *both parties* in the general rule so far as justifiable. Such a rule would not even have to be designed from scratch since practicable solutions already exist in some national codes and have been proposed by academics in the last century.[62] Last but not least, the arguments for the application of the *lex loci delicti commissi* do not demand exclusive consideration of this specific jurisdiction. An exception is justified in cases where the tortfeasor is aware of the cross-border nature of his action and where damage in another country is *foreseeable* to him;[63] in this case the application of the law of the state where the harm was incurred does not conflict with the legitimate expectations of the tortfeasor (and in case of multiple tortfeasors, their internal recourse) since he violated the conduct standards of that state. In other words, the key question in such cases should be whether, under the given circumstances, a reasonable person could have foreseen that his conduct in one state would produce injury in the other state. A general rule according to this basic principle would have rendered the numerous exceptions to the current rule unnecessary and would have balanced the legitimate interests of both parties.

30 It should not be forgotten that the drafters of Rome II proposed quite a similar idea in art. 17 of the Regulation providing that, regardless of which law gov¬erns the non-contractual obligation, *"account shall be taken [...] of the rules of safety and conduct which were in force at the place and time of the event giving rise to the liability"* (emphasis added) when determining the actor's liability. Nevertheless, this rule does not introduce a rule of choice of law but merely al¬lows, on a discretionary basis and in an evidentiary sense, mere consideration of this factor. Despite the use of the imperative *"shall",* art. 17 does not require the court to apply the rules of conduct and safety of the place of conduct, but only to "take them into account". It is doubtful whether this provision actually solves the general problem outlined above and one sees that only two future possibilities for the application of *lex loci delicti commissi* to unforeseeable and, thus, non-attributable damage remains: Either the general rule of art. 4 is maintained without any relation to its purpose, thereby producing inconsistent (or rather unjustifiable) results, or the rule is generally left aside by way of analogy to art. 17. This future gadgetry should have been avoided, since the wording "take into account" ought to be taken seriously, simply because analo-

[62] See Swiss PIL Code art. 133 Abs. 2: "[...] *Tritt der Erfolg nicht in dem Staat ein, in dem die unerlaubte Handlung begangen worden ist, so ist das Recht des Staates anzuwenden, in dem der Erfolg eintritt, wenn der Schddiger mit dem Eintritt des Erfolges in diesem Staat rechnen musste".; G. Beitzke,* Auslandswettbewerb unter Inlandern, Juristische Schulung (JuS) 1966, 140: "Wer *ins Ausland hinuberwirkt, muss die Folgen dieses Handelns, also Rechtsguterverletzung im Ausland, in Betracht ziehen und auch priifen, ob er hier nicht einen unerlaubten Eingriffin eine Rechtssphdre begeht, einen am Erfolgsort ungerechtfertigten Erfolg herbeifiihrt.";* acknowledging the result hile basically denying the arguments above *T. Kadner-Graziano,* RabelsZ 73 (209) 1 (36, Fn. 111).

[63] It would manifestly be absurd to assert that every case of cross-border damage is foreseeable. If that were the case, the above special rules (no. 22) for instance would not be necessary at all.

gies in conflict of laws enhance the tendencies of national courts to apply their *lex fori,* resulting in internationally counter-productive judgments as shown by the following, final chapter of this report.

C. Personal injury

So far only divisibility from the perspective of procedural issues has been discussed. But, even apart from SCENARIOS 1 and 2 above, a specific problem arises due to the different levels of compensation awarded in different states. Here, a material category of damages, i.e. compensation for personal injury[64] leads to a conflict of laws phenomenon commonly referred to as *depegage:* 31

> SCENARIO 3: The Spanish motorist E runs over the Englishman G.B. in Spain. The latter is rescued at the last-minute by physicians. G.B. is left paraplegic, unable to work and will need constant medical treatment for the rest of his life.

Basically, the national courts would have to award damages according to the law applied; in this example Spanish law provides the statutory scale according to which damages have to be awarded under the general rule of art. 4 Rome II Regulation. However, due to the relatively low costs of substitute pleasures in Spain, the amount of compensation for personal suffering will be inadequate in the United Kingdom, i.e. the damages will not be sufficient and the basic principle of *restitutio in integrum* will not be observed. Moreover, the opposite example also produces unsatisfactory results, e.g. when an English motorist in the United Kingdom runs over a Latvian pedestrian. The Latvian would receive damages according to the English statutory scale for personal suffering and thereby would be awarded an amount of damages much higher than is necessary in Latvia having regard to the cost of substitute pleasures for the harm sustained there. 32

In general, two fundamentally different approaches to this dilemma are up for debate: Either cases of personal loss are consistently assessed by *one* law, e.g. the (foreseeable) place of injury or, alternatively, the otherwise uniform legal relationship is split up as a result of subjecting the prerequisites of liability and part of its consequences to different laws, e.g. to submit the compensation of personal injury to the law of the victim's place of habitual residence *(depegage).* 33

Rather unsurprisingly due to the relatively high awards for personal injuries in quota and amount there, it has been most notably the English courts which have had to address this dilemma several times in recent years. originally, the English "double actionability rule" required that the tort was actionable under the laws both of forum, i.e. *English* substantive law, and the jurisdiction where the tort was committed[65] - ultimately leading the English judge to an assess- 34

[64] For a more detailed analysis of the problem with further references, see T. *Thiede/K. Ludwichowska,* ZVglRWiss 106 (2007) 92 ff.

[65] Cf. *Chaplin v. Boys* [1971] Appeal Cases (A.C.) 356 (H.L. 1969)

ment of damages according to his *lexfori, English* substantial law. This rule was ultimately abolished in 1995 by the Private International Law Act 1995 (Miscellaneous Provision) creating a general presumption for application of the law of the state where the injury was incurred[66] unless it is *"substantially more appropriate"* to apply some other law.[67] This general revision of the law in this area did not, however, stop English courts from continuing to apply their *lex fori* for the measurement or quantification of damages. As recent as 2006 in *Harding v Wealands",* the House of Lords labelled these questions as procedural, so that the law of the forum - English law - rather than a foreign law, is applicable to questions of measurement and quantification. And, indeed, according to the legislative history of the statute, Parliament originally intended that *"[...] issues relating to the quantum or measure of damages are at present and will continue [...] to be governed by the law ofthe forum; in other words, by the law of[...] the United Kingdom. [The] courts will continue to apply our own rules on quantum ofdamages even in the context ofa tort case where the court decides that the 'applicable law' should be some foreign system oflaw so far as concerns the merits ofthe claim."*[69]

35 Beyond doubt, the English approach to the personal injuries dilemma, i.e. classifying quantification of damages as procedural, is absurd since the quantification of damages is bottom-line and *"what all the huffing andpuffing at trial is about".*"' Nevertheless, in the course of the legislative process of the current Rome II Regulation in the European Parliament, the English rapporteur proposed (and Parliament approved) quite a similar approach: The parliamentarians insisted on the insertion of an exception to the general rule in cases of personal injuries, to the effect that the court seised should apply *"for the purposes of determining the type of claim for damages and calculating the quantum of the claim [.,.] the individual victim's place of habitual residence [...]".*" The European Council as well as the Commission rejected this amendment and finally a compromise was found in the form of the insertion of Recital 33 of the Regulation providing that when *"quantifying damages for personal injuries in cases in which the [wrongful conduct] takes place in a State other than that of habitual residence ofthe victim, the court seised should take into account all the relevant actual circumstances ofthe specific victim, including in particular the actual losses and costs of after-care and medical attention."* In addition, a Review Clause was implemented into the Regulation, demanding a study on the national differences in compensation levels not later than 2011.[72]

Cf. Private International Law (Miscellaneous Provisions) Act 1995, § 11.

Cf. Private International Law (Miscellaneous Provisions) Act 1995, § 12.

Harding v. Wealands [2006] United Kingdom House ofLords (UKHL) 32, [2006] 3 Weekly Law Reports (W.L.R.) 83.

Harding v. Wealands [2006] U K H L 32, [2006] 3 W.L.R. 83, para. 37.

R.J. Weintraub, Choice of Law for Quantification of Damages: A Judgment of the House of Lords Makes a Bad Rule Worse, 42 Tex. Int'l L.J. 311 (313).

Eur. Parl. Final (A6-0211/2005 of27 June 2005).

Art. 30 Rome II Regulation.

The English and European parliamentarians argued that their solution provides a viable solution for the victim - he will be compensated according to the standards at his habitual residence. As a consequence, differences in the amount of damages awarded in personal injury cases in Europe are adjusted to a very large extent. Moreover, the assignment of damages to the victim's place of habitual residence could support the general mobility of individuals in Europe since a victim would be entitled to compensation as if he was at home. Last but not least, Parliament argued that in connection with the direct or alternative jurisdiction of the Brussels II Regulation, the assessment of damages would ultimately be easier for the judge since the place of habitual residence will regularly coincide with the *lex fori."* 36

The general lack of research conducted by the European Parliament is best illustrated by the last argument: As explained earlier, the Brussels II Regulation grants international jurisdiction at more places than the *lex fori* of the victim, i.e. the place where the conduct took place, the place where the harm occurred and, generally, at the habitual residence of the defendant.[74] There may be coincidence of course - but not necessarily. Naturally, a court at the habitual residence of the victim is often most convenient for the latter - but, as already illustrated above, the convenience of the victim is not a general standard applied in conflict of laws. Hence, it is to be assumed that two different jurisdictions will be applicable to the case. With the potential divergence of the law of the habitual residence of the victim from the *lex fori,* a further disadvantage to this solution becomes obvious: The law applicable to the case will be doubled. For example, the law at the place where the harm occurred will be applied to the prerequisites of liability whereas another law, i.e. the law at the habitual residence of the victim, will be applied to evaluate the consequences of the wrongful conduct. Even if the *lex fori* and the law at the habitual residence of the victim coincide, a second law, i.e. the *lex damni,* will be applicable to the same case. Hence, the solution supplied by *depegage* is not practical at all. 37

This divergence is not limited to practical considerations but extends to a dogmatic unsustainability: A *depegage* in a single case results in a legal situation formerly non-existent in both of the laws applied to the case and, hence, different from the legal situation in both jurisdictions. This dogmatic inconsistency provokes numerous shortcomings. Thus, even the alleged enhancement of the mobility of European citizens and sound administration of justice in particular cases must be seriously doubted since the application of two sets of liability regimes result e.g. in two different awards for damages in the same road traffic accident if the victims have their habitual residences in two different countries. Furthermore, it must be considered that the national legislators do not award damages arbitrarily but in connection with the prerequisites of the claim. Regularly, higher standards governing the prerequisites lead to gener- 38

Eur. Parl. Final (A6-0211/2005 of 27 June 2005).

Cf. infra no. 10 ff.

ous indemnification of damages and *vice versa.* In cases with strict liability at the place where the harm occurred and a liability based on fault at the habitual residence of the victim, a detachment of basis and result of liability is not only impractical but also simply preposterous.

39 The *depegage* solution to the personal injuries dilemma draws the protective cloak of his domestic jurisdiction around the victim, ignoring the legitimate expectations of the tortfeasor. Judges may find it obnoxious to have to explain to tortfeasors why the amount of damages ultimately awarded to the victim does not depend on the specific situation and the particular case but rather on the habitual residence of the latter: Why should liability depend on the question of whether the pedestrian knocked down is of domestic or foreign citizenship? It must be emphasized that the thin or "egg-shell skull" rule[75] does not apply here since this basic principle refers more to the physical constitution of the victim than his place of residence.

40 Furthermore, countries with a lower standard of indemnification or a *bareme* system are not likely to embrace a *depegage* solution. If a citizen of such a country commits a tort in which a national of a country with a high standard of indemnification is injured, e.g. a road traffic accident, the compulsory liability insurance is obliged to pay - from the insurer's perspective - an extraordinarily high amount of damages. The payment is added to costs that are used to calculate future premiums not only for the tortfeasor but for the whole insurance pool, i.e. all other policy holders,[76] causing such to increase. Moreover, the above-described criterion of foreseeability must be duly taken into account: If the tortfeasor cannot reasonably foresee the need for insuring at the higher level, it is unfair to impose the law of the habitual residence of the victim for the compensation of the latter.

41 Thus, the *depegage* solution focuses (yet again) too much on the (alleged) victim and discounts the legitimate interests of the tortfeasor. Moreover, it must be called into question whether this solution is still the application of law in general: No legislator can reasonably foresee what will happen if the prerequisites of a claim are disconnected from its results. Hence, a *depegage* is subject to chance and thus arbitrary.

42 Finally, the fact that the United Kingdom has agreed to be bound by Rome II[77] and that the Council and Commission rejected the European Parliament's proposal and concluded the above-mentioned agreement not to authorize the application of the law of the victim's habitual residence but only to take it *"into*

M. Lunney/K. Oliphant, Tort Law: Text and Materials (3rd ed. 2003) 274; *T. Thiede/K. Ludwichowska,* ZVglRWiss 106 (2007), 92 ff.

See, e.g. *D.J. McNamara,* Automobile Liability Insurance Rates, 35 Insurance Counsel Journal (Ins. Couns. J.) 1968, 398, 401.

Council Common Position (EC) No. 22/2006 of 25 Sept. 2006, art. 15, 2006 O.J. (C 289E) 68, 70, para. 35.

account" (emphasis added), must be welcomed.[78] In the face of the above arguments, the resulting constraint, which narrows the scope and impetus of the Parliament's amendment considerably, should be taken seriously - otherwise *forum shopping* to English courts would be maintained in the above-described manner.

IV. Conclusion

Whereas some national solutions may have been the result of the demand for the protection of national citizens and may be understandable from this perspective, the European institutions recently documented a gross misunderstanding of conflict of laws in general: The subject is not a technical switchstand for the overcoming of fundamental differences in national legal systems. It is impossible to circumvent differences resulting from a foreign element by means of policy considerations which only focus on the victim and the best indemnification for said victim. Conflict of laws is not an annex to the existing national liability rules but a coherent and delicate system in itself, which has to be understood in terms of its principles before significant changes are introduced. Hence, any change must be tested against all law-fact patterns in this area of law. Such a test is provided by all cases of divisibility and aggregation of damage and should hence be regarded in future European enterprises in this area. 43

See *M. McParland,* Tort injuries aboard and the Rome II Regulation: a briefwakeup-call for existing claims, [2008] Journal of Personal Injury Law (J.P.I.L.) 221; *A. Rushworth/A. Scott,* Rome II: Choice of law for non-contractual obligations, [2008] Lloyd's Maritime and Commercial Law Quarterly (LMCLQ) 274, 294.

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RESEARCH ARTICLE

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Dilemma of Confidentiality in International Commercial Arbitration

Abstract Arbitration is universally used in the settlement of international commercial disputes largely due to its inherent confidentiality. However, the expedient element of the confidentiality is encountering challenges mostly owing to public interest or other reasons. This article not only discusses the grounds of confidentiality in arbitration, but also the effective way of its helping those people who wish to respect the confidentiality in international commercial arbitration.

Keywords confidentiality, international commercial arbitration, international commercial disputes, public interest

In the field of international business, arbitration is an alternative dispute resolution procedure by which the parties agree to submit their dispute to a private forum, where an arbitrator, or a panel of arbitrators, decides claims after hearing testimony and evaluating evidence.[1] Arbitration is a means for settlement of business disputes. With its efficiency and facility, it allows the parties to avoid the litigation procedure. It is universally used in the settlement of international commercial disputes largely due to confidentiality. Confidentiality is widely recognized as one of the major benefits of arbitration. Recently, however, the expedient element is encountering challenges mostly due to public

[1] Darren K. Sharp & Laurence R. Tucker, *Traversing Legal Labyrinths in Arbitration,* 66 J. Missouri Bar 24 (2010).

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interest or other reasons. Is there really a general obligation of confidentiality in arbitration proceedings? Whilst there is little controversy about the privacy of arbitrations, it is less clear regarding confidentiality. This article will discuss whether confidentiality shall be respected by discussing several cases and the arbitration rules; the grounds of confidentiality in arbitration will also be discussed. The authors desire this essay to be not only a base for academic study, but also a helpful reminder to businessmen and women in their common transactions, as well as jurists, judges and lawyers, in connection with international commercial arbitration.

1. Arbitration Widely Used in Solving International Commercial Disputes

one of the fundamental principles of contract litigation is the judicial presumption in favor of arbitrating disputes. Arbitration, courts tell us, is more expedient and economical than litigation in the courts.[2] For years now, more legal disputes in international business are being resolved in arbitration.[3] International commercial arbitration has gained worldwide acceptance as one of the preferred means of international dispute resolution. With the globalization of the economy, most multinational corporations prefer arbitration as the effective way to settle their disputes; the reasons are encapsulated in the following statement made by J. Meason and A. Smith who believed that advocates within the business community believe that arbitration is preferable over litigation because arbitration is thought to be informal, faster, less costly, equitable, a way to avoid unfavorable publicity, relatively conciliatory and absorbs less management time.[4] Another primary reason for the prevalence of arbitration is the expectation that the awards issued by an international arbitral tribunal will receive worldwide recognition by countries that are members of international conventions on the enforcement of arbitral awards,[5] especially by members of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention), adopted by diplomatic conference on June 10, 1958. The various reasons of advantages caused the arbitration to be accepted and used

[2] E.g., *KFCNat. Management Co. v. Beauregard,* 739 So. 2d 630, 631 (Fla. 5th D.C.A. 1999). Public policy favors arbitration as an efficient means of settling disputes because it avoids the delays and expenses of litigation.

[3] Deborah Karakowsky, *Resolving the Conflict: The Federal Arbitration Act versus the Bankruptcy Code,* Houston Lawyer 34 (January/February, 2010).

[4] James E. Meason & Alison G. Smith, *Non-Lawyers in Int'l Commercial Arbitration: Gathering Splinters on the Bench,* 12 Northwestern J. Int'l L. & Bus. 27-28 (1991).

[5] Daniel E. Gonzalez & Maria E. Ramirez, *Int'l Commercial Arbitration: Hurdles When Confirming a Foreign Arbitral Award in the US,* Florida Bar J. 59 (2009).

widely in the settlement of international commercial disputes.

2 The Confidentiality of International Commercial Arbitration

It is often said that confidentiality is one of the benefits of international commercial arbitration and one of the principal reasons why business people have made arbitration the forum of choice for the resolution of international commercial disputes. A potentially important consideration in designing dispute resolution provisions is the extent to which proceedings will be confidential, and confidentiality of the arbitration process is regularly mentioned as one major advantage of arbitration. Asking any lawyer about the advantages of arbitration compared to litigation and one of the answers would undoubtedly be that arbitration is confidential. Confidentiality encourages candor, a full exploration of the issues, and enhanced acceptability to an arbitrator. Also, confidentiality allows the parties to reach agreements during the arbitrational proceedings as well as the possibility of continuing commercial relations between them.[6] Confidentiality in arbitration is seen as providing the best chance to save the underlying business relationship.[7] Arbitration has become synonymous with confidential proceedings such that the confidentiality of arbitral proceedings has been said to be taken for granted.[8] others have gone further and suggested that the parties place the highest value upon confidentiality as a fundamental characteristic of international commercial arbitration. No authority is generally cited for such a proposition but it is seen as implicit or as a corollary to an agreement to resolve a dispute by way of arbitration.[9]

Confidentiality in international commercial arbitration means that hearings in international commercial arbitration are held in camera and that the arbitration award cannot be published without consent of the parties.[10] In practice, arbitration hearings are virtually always closed to the press and public, and both submissions and awards often remain confidential.

There are two aspects to confidentiality: (1) confidentiality between the parties

[6] Ramon Mullerat OBE, *Ethical Rules for Int'l Arbitrators-8,* at http://www.cidra.org/articles/ethics/ethicalrules-08.htm (last visited March 5, 2010).

[7] Meason & Smith, fn. 4.

[8] Hans Bagner, *Confidentiality: A Fundamental Principle in Int'l Commercial Arbitration?* 18 J. Int'l Arb. 243-49 (2001). H. Bagner also stated that according to a statistical survey of US/European users of int'l commercial arbitration conducted in 1992 for LCIA by the London Business School, confidentiality was listed as the most important perceived benefit.

[9] See Ronald Bernstein, The Right Hon, Sir John Donaldson et al., *Handbook of Arbitration Practice* (3rd edition), Sweet & Maxwell (London), at 193 (1998).

[10] See Pieter Sanders, *Quo Vadis Arbitration? Sixty Years of Arbitration Practice, A Comparative Study,* Kluwer L. Int'l (The Hague), at 4 (1999).

who must rely on the obligation imposed or implied by law; (2) the extent to which the substance of the proceedings and any documents, information, or other evidence is protected against disclosure in subsequent or concurrent proceedings.[11]

2.1 The Confidentiality Relating to Subjects

Several persons are engaged in the process of arbitration: the arbitrators, the parties' employees and offices, the administrative personnel of the arbitration institution, and third parties who will be somehow involved with the proceedings, including witnesses.

In principle, unless otherwise agreed by the parties or required by applicable rules or law, an arbitrator should keep confidential all matters with respect to the arbitration proceedings and decisions. An arbitrator should not discuss a case with persons not in the arbitration unless the identity of the parties and details of the case are sufficiently obscured to eliminate any realistic probability of identification.

of course, witnesses who testify before an arbitral tribunal are not necessarily bound to secrecy, but some rules, as those of the Zurich and Geneva Chambers of Commerce, might be construed in such a way that witnesses are bound to respect the confidentiality of arbitral proceedings, at least when duly warned by the arbitral tribunal. Under some arbitration regulations, the arbitral tribunal has power to exclude from the proceedings any person who is not privy to it.[12]

2.2 The Confidentiality Relating to objects

The extent to which documents, pleadings, witness statements, etc., are protected depends upon both the substantive law of privilege and procedural law's concern with the duty or obligation of disclosure and of admissibility of evidence. In practice, arbitration is widely used in that the parties may decide to keep the award confidential, and the proceedings are conducted in a private arena free from the intrusive inquisitiveness of the press and other outsiders. The issues involved in a commercial dispute may be of such a sensitive nature that it would not be in the interest of the parties (or one of them) to litigate it in open court. Issues involving trade secrets, poor quality, or defective products are better settled outside the view of the public, a number of aspects of an arbitration

[11] Hakeem Seriki, *Confidentiality in Arbitration Proceedings: Recent Trends and Developments,* J. Bus. L. 300 (2006).

[12] See art. 53(c) of the WIPO Rules.

proceeding as to which there may be confidentiality concerns. These include: briefs or other materials prepared and submitted during the proceedings, documents used as evidence in the proceedings, testimony or other oral evidence presented in the proceedings, the deliberations and thought-processes of the tribunal, and the award. In such cases the parties may opt for a private dispute resolution system. The parties could also, as part of their agreement, decide to keep any ensuing award confidential between themselves.[13] Arbitration thus provides participants the opportunity to resolve their disputes without unneeded publicity that might poison the dispute resolution process.

Confidentiality differs from privacy. The two terms are often used together and sometimes even used interchangeably. However, the two terms should not be confused. The Chief Justice Mason, delivering the judgment of the majority of the High Court in Esso, drew a distinction between privacy and confidentiality. He held that whilst arbitration proceedings were private, it did not follow that a duty of confidentiality was applicable.[14] It appears undisputed that arbitration is private in nature. Privacy has been defined as the interest in controlling the gathering and disclosure of personal information about oneself.[15] In the context of arbitration proceedings, privacy means the absence from the arbitral process of strangers to the arbitration.[16] The concept of privacy in arbitration prevents the tribunal or any of the parties from insisting that the dispute be heard together with another dispute even in situations where the two disputes are so closely related that considerable practical advantages would be obtained from hearing them together. On the other hand, confidentiality is a much broader concept than privacy. It relates to the rights and obligations of the parties to arbitration with respect to documents and other materials produced during the arbitral process.[17] Although, confidentiality is very much a corollary of privacy, it does not follow that the fact of privacy will accord protection from subsequent disclosure. Clearing the meaning of confidentiality from privacy is necessary for the further research of the characteristics of confidentiality in international commercial arbitration.

[13] Okezie Chukwumerije, *Choice of Law in Int'l Commercial Arbitration,* Quorum Books 1CNew York), at 8 (1994).

[14] Meef Moh, *Confidentiality of Arbitrations—Singapore's Position Following the Recent Case of Myanma Yaung Chi Oo Co. Ltd. v. Win Win Nu Gordon Smith,* 37 Vindobona J. Int'l Aomm. L. & Arb. 38 (2004).

[15] See Raymond Wacks, *Privacy and Press Freedom,* Blackstone Press (London), at 10-21 1(61995).

[16] "Strangers" have been defined by Brooking J. in *Esso Australian Resources v. Plowman* [1994] 1 VR 1 as "persons whose presence is not necessary or expedient for the proper conduct of the proceedings."

[17] See Moh, fn. 14 at 38-39.

3 Legal Basis for the Principle of Confidentiality

What is the legal basis for the principle of confidentiality? The confidentiality comes from the character of arbitration as a private form of jurisdiction, from the contract when parties entering into an arbitration agreement, and from the customary arbitration law.

The Anglo-Americans ground the duty of confidentiality on the relationship existing between the parties. Three doctrines are alternatively applied:[18] (1) The duty of confidentiality is implied in fact, e.g., where the parties are bound by a contract; (2) the duty of confidentiality derives from a fiduciary relationship, it is then implied in law; (3) the owner of the confidential information has a "property interest" or "property right" in the trade secrecy.

Some institutions have provided in their rules for the confidentiality of the proceedings held under their authority. For example, the London Court of International Arbitration (LCIA) has tried to tackle the issue of confidentiality in its arbitration rules, and does so in article 30 (as below):

> 30.1 Unless the parties expressly agree in writing to the contrary, the parties undertake as a general principle to keep confidential all awards in their arbitration, together with all materials in the proceedings created for the purpose of the arbitration and all other documents produced by another party in the proceedings not otherwise in the public domain—save and to the extent that disclosure may be required of a party by legal duty, to protect or pursue a legal right or to enforce or challenge an award in bona fide legal proceedings before a state court or other judicial authority.
>
> 30.2 The deliberations of the arbitral tribunal are likewise confidential to its members, save and to the extent that disclosure of an arbitrator's refusal to participate in the arbitration is required of the other members of the Arbitral Tribunal under articles 10, 12 and 26.
>
> 30.3 The LCIA Court does not publish any award or any part of an award without the prior written consent of all parties and the arbitral tribunal.

This decision represents another interesting twist in the perpetually difficult question in international arbitration of how confidential arbitration really is.[19] Also, the most complete regulation can be found in articles 73-76 of the WIPO Arbitration Rules.[20] However, other institutional rule systems are silent

[18] Francois Dessemontet, *Arbitration and Confidentiality,* Am. R. Int'l Arb. 314 (1996).

[19] Jonas Benedictsson & Anders Isgren, *Confidentiality in Arbitration in Sweden,* at http://www.bakernet.com/NR/rdonlyres/EF0F8244-4C8D-4977-9F3C-1AD5A659F527/29684/ConfidentialityinArbitrationinSweden.PDF (last visited March 5, 2010).

[20] See Dessemontet, fn. 18 at 306 (1996).

regarding confidentiality. While both the International Chamber of Commerce and United Nations Commission on International Trade Law Arbitration Rules state that arbitration hearings are to be private; neither makes any reference to the confidentiality of materials or awards produced in the course of proceedings. The Rules of the Arbitration Institute of the Stockholm Chamber of Commerce provide that both the SCC Institution and the arbitration panel should maintain the confidentiality of the arbitration. There is no express obligation on the parties to do so. Also, the SCC apparently has no immediate plans to make amendments to its present rules.[21]

In China, although the Arbitration Law of the PRC provides a clear mandatory duty of confidentiality, and its article 40 specifies that arbitration shall be conducted in camera unless the parties agree otherwise, there is no express obligation on the parties to do so. Confidentiality orders issued by the arbitral tribunal cannot bind a person who is not a party to the arbitration, such as clerks, interpreters, and witnesses. However, in terms of Chinese Civil Procedure Law, violating the duty of confidentiality is regarded as a substantial matter, which is governed by the civil law.[22] Breaching an obligation of confidentiality does not affect the proceedings and the outcome of the final award under the Chinese Arbitration Law.

4 Is There an Obligation of Confidentiality?

Confidentiality of the arbitral process is regularly mentioned as one of the advantages of arbitration, because the dispute in arbitration is not disclosed to the outside world. Until recently, it was also widely assumed that confidentiality was an essential characteristic of international commercial arbitration, and, still today, it is submitted that parties, when resorting to arbitration, regard the privacy of arbitration as one of the factors in favor of their choice.

A number of national courts around the world have considered the issue of confidentiality in arbitration. Unfortunately, the jurisprudence is sporadic and inconsistent. A number of English cases have recognized an implied obligation of confidentiality but deal with particular claims of confidentiality on a

[21] See Benedictsson & Isgren, fn. 19.

[22] As such, the party would bring a lawsuit to the court if he deemed that the other party had violated the duty of confidentiality. Article 120 of the Civil Procedure Law of China provides that a case involving trade secrets may not be heard in public if a party so requests. However, article 134 further provides that the court shall publicly pronounce its judgment in all cases, whether publicly tried or not. Therefore, the order for confidentiality is not supported by the current Chinese law. See Stephen Zheng, *Arbitral Interim Measures in the Mainland of China,* at http://www. chinalegalaid.org/english/law/list.asp?newsid=132 (last visited March 5, 2010).

case-by-case basis. For instance, in *Dolling-Baker v. Merrett* case,[23] the English Court of Appeal found that an implied obligation of confidentiality existed in the arbitration process. Following the rationale of Dolling-Baker, the court affirmed that confidentiality was an essential characteristic of arbitration. Another English case also proved that the duty of confidence exists. In *Ali Shipping Corporation v. Shipyard Trogir,"* the English court re-asserted the Dolling-Baker principle, and held that there is a duty of confidentiality created by the law as part of every arbitration agreement. The court recognized the following exceptions to the confidentiality principle: the consent of the parties, the presence of a court order requiring disclosure, the "reasonable necessity" of disclosure to the protection or the enforcement of a parties' legal rights, and finally, where disclosure is necessary in the interests of justice, even though the obligation of confidentiality generally extended to documents prepared in contemplation of arbitration or used in the process, transcripts, notes of evidence, testimonial evidence, and the award. However, the court stated that the obligation of confidentiality would not be allowed to impinge on the fair disposition of the action. The courts in France[25] have recognized a similar implied duty.

However, a recent Australian case threw a stone in the so far undisturbed pond of confidentiality. In 1995, the High Court of Australia, in *Esso v. Plowman,"* made considerable inroads onto the accepted view that the private nature of arbitration necessarily gave rise to an implied confidentiality obligation. Confidentiality of the arbitral procedure, therefore, requires more comment than before.[27] In the famous *Esso Australia Resources Ltd. et al. v. Plowman case,* which concerned a dispute between Esso and the Australian Minister for Energy and Minerals over public utilities and information related to the prices charged to the public, the High Court of Australia found that the obligation to maintain confidentiality was not intrinsic to arbitration.[28] This case arose out of agreements for the sale of Bass Strait gas by Esso/BHP to two Victorian public utilities, the Gas & Fuel Corporation and the State Electricity Corporation. Esso/BHP sought an increase in the price of the gas supplied pursuant to the

[23] *Dolling-Baker v. Merrett,* 2 All E.R. 890 (Eng. C.A. 1991), and *Hassneh Insurance Co. of Israel v. Mew,* 2 Lloyd's Rep. 243 (Q.B. 1993).

[24] *Ali Shipping Corp. v. Shipyard Trogir,* 1 Lloyd's Rep. 643, 2 All E.R. 136 (Eng. C.A. 215998).

[25] E.g., *Bleustein etautres v. Societe True North & SocieteFCB Int'l,* 1 Rev. Arb. 189 (2003), Paris Commercial Court; as discussed in *Handbook of ICC Arbitration, Commentary, Precedents, Materials* (1st ed.), Michael Buhler & Thomas Webster eds., 2005.

[26] *Esso Australia Resources Ltd. & Others v. Plowman,* 183 C.L.R. 10, 128 A.L.R. 391 (1995).

[27][28] See Sanders, fn. 10.

[28] Claude R. Thomson & Annie M. K. Finn, *Confidentiality in Arbitration: A Valid Assumption? A Proposed Solution!* Dispute Res. J. 76 (2007).

agreement. The utilities refused to pay. The agreements contained arbitration clauses and the dispute was referred to arbitration pursuant to those clauses. The utilities sought disclosure of information relating to the calculations justifying the proposed price increases, but in the absence of confidentiality agreements Esso/BHP was not willing to provide. The utilities refused to enter into confidentiality agreements. Esso/BHP insisted, pointing to the commercially sensitive nature of the information of which disclosure was being sought. During the course of the arbitration, the Minister of Energy and Minerals of the State of Victoria stated that he intended to publicly disclose all the information that Esso/BHP had revealed over the course of the arbitration proceedings. This information included commercially sensitive information such as estimated gas reserves, profit margins, production costs.

Chief Justice Mason's strong stand in rejecting the notion of confidentiality in arbitration may be attributable to the fact that there was a clear public interest element involved in the Esso decision. This was shown when Chief Justice Mason pointed out that in *Hassneh Insurance v. Mew,* the exceptions to the implied term forbidding disclosure of information disclosed in arbitration were too narrow, as it did not recognize that there may be circumstances in which third parties and the public have a legitimate interest in knowing what has transpired in an arbitration which would give rise to the public interest exception.[29] One wonders whether the Esso decision would have been different if there had been no public interest involved. It may well be that the Australian courts would have followed Dolling-Baker and Hassneh and not have adopted the conflicting approach.[30]

Over Esso/BHP's objections, the Australian High Court supported the Minister's right to disclose such information, concluding that: (1) A duty of confidentiality cannot be implied in an agreement to arbitrate since confidentiality is neither an inherent attribute of arbitration nor part of the inherent nature of the contractual relationship between the parties; (2) Even if there were a duty of confidentiality, that duty is not absolute and may be

[29] The public interest exception was tentatively recognized in the English decision of London and *Leeds Estates Ltd. v. Paribas Ltd.* (no. 2) [1995] 1 EGLR 102. In that case, Mance J. held that a party to court proceedings was entitled to call for the proof of an expert witness in a previous arbitration in a situation where it appeared that the views expressed in that proof were at odds with his views as expressed in the court proceedings. This was to ensure the interests of individual litigants involved and the public interest were fulfilled. However, it should be noted that Potter L.J. stated in his judgment in *Ali Shipping Corp v. Shipyard Trogir* that Mance J. was actually referring to the public interest in the sense of the interests of justice, namely the importance of a judicial decision being reached on the basis of the truthful or accurate evidence of the witnesses concerned. This was to be distinguished from the wide issues of "public interest" contested in the Esso decision.

[30] See Moh, fn. 14 at 46.

curtailed where public interest demands.

Although this rejection of confidentiality in arbitration led to strong reactions, such as in the Journal of the London Court of International Arbitration, the General Editors qualified the decision as a "dramatic decision... contrary to the widespread understanding elsewhere (including England)."[31] The decision in Esso Australia still has been applied in *Commonwealth v. Cockatoo Island DockyardPty Ltd.* and *Jennings Group Ltd. v. Glen Centre Pty Ltd.* cases.

The ChiefJudge Mason of the *Australia Esso* case, who delivered the majority judgment, held that confidentiality is not an essential attribute of private arbitration, whether on the ground of long arbitration custom and practice, or to give efficacy to the private nature of the proceedings. This conflicts with the decision ***in****Dolling-Baker v. Merrett & Another* case, in which the English Court of Appeal found that the essentially private nature of an arbitration created an implied obligation of confidentiality and granted an injunction restraining one party to the arbitration from disclosing in a subsequent action documents relating to the arbitration. Parke identified an implied obligation as the basis for the confidentiality attaching to documents used in arbitration or engendered in its courts. His Honor observed that it is a question of an implied obligation arising out of the nature of arbitration itself. When a question arises as to the production of documents or indeed discovery by list or affidavit, the court must, it appears to me, have regard to the existence of the implied obligation, whatever its precise limits may be.

The courts in Sweden and the United States have rejected a general implied duty of confidentiality.[32] In Sweden, the principle of implied confidentiality is not recognized. This was confirmed in the decision of the Swedish Supreme Court in *Bulgarian Foreign Trade Bank Ltd. v. Al Trade Finance Inc.,*[33] where it was held that there was no implied duty of confidentiality in private arbitrations. A similar approach was adopted by the US courts in *United States v. Panhandle Corp,*[34] where the Federal Government sought to have Panhandle, an American company, produce documents from an arbitration of International Chamber of Commerce (ICC) between Panhandle's subsidiary and the Algerian state oil company. In this case, the US Federal government was seeking the production of the documents relating to ICC proceedings in Geneva between a Panhandle subsidiary and Sonatrach, the Algerian national oil and gas company. Panhandle argued that the arbitration was confidential in nature and that disclosure would frustrate the parties' expectations. Panhandle's only argument against production

32 See Sanders, fn. 10.

[32] See Thomson & Finn, fn. 28.

[33] Case T-1881-99 (Swedish Supreme Court, 2000).

[34] 118 F.R.D. 346 (D. Del. 1998).

of the documents was to the effect that the ICC Rules require documents pertaining to an arbitration to be kept confidential. It based this argument on Internal Rules of the ICC Court, such as article 2, which provides that the confidential character of the work of the ICC Court must be respected by anyone who participates in it in any capacity. However, the court found that these Rules were meant to apply internally and to govern members of the ICC Court, not the parties to arbitration proceedings or the independent arbitration tribunal that conducts those proceedings. The court held that there was no inherent duty of confidentiality unless the parties contracted for it, and that the ICC Rules placed no obligation of confidentiality on arbitrating parties.[35] This case found that the duty of confidentiality does not exist.

Therefore, people cannot help arguing whether confidentiality is an implied obligation or not during the arbitration process, and people are more confused when they come to the Sweden case, *Bulgarian Foreign Trade Bank Ltd. v. AI Trade Finance Inc.,* because the appellant (the Bulgarian Bank) was successful in the District Court, but lost in the Appeal Court and the Supreme Court. Early in the arbitration proceedings, the respondent (AI Trade Finance Inc.) released details of the dispute and an interim award to an international arbitration journal. After the final award was rendered, the claimant (the Bulgarian Bank) then applied to the Stockholm City Court to nullify the award. The court nullified the award, stating that the respondent had committed a fundamental breach of contract in revealing confidential information to the press, and stating that confidentiality comprises a basic and fundamental rule in arbitration proceedings. However, the Supreme Court made reversal remarks: The UN E C E arbitration rules do not contain an obligation of secrecy which makes it a breach of the arbitration clause to reveal the outcome of the proceedings to any journal or newspaper. Furthermore, there is no fundamental principle of Swedish law that arbitration proceedings are secret.[36]

When it comes to the issue, another field for arbitration award shall not be neglected; that is the arbitration rules for sports. In terms of the Court of Arbitration for Sports (CAS), the arbitration award is open to the public unless under very exceptional circumstances and put forward by the involved parties. With the current booming of worldwide sports, the number of disputes arising from such fields is ascending, and, undoubtedly, such disputes and arbitration awards are in the limelight of the public owing to the enthusiasm for just solutions for sport-related issues. This new trend is attracting the attention not only of the athletes, the sports management companies, but also the legal

[35] Hakeem Seriki, *Confidentiality in Arbitration Proceedings: Recent Trends and Developments,* J. Bus. L. 301 (2006).

[36] See Benedictsson & Isgren, fn. 19.

scholars, and it will definitely affect the confidentiality of arbitration.

5 Public Interest Policy or Protection of Confidential Information?

While confidentiality is often cited as a major advantage to dispute resolution through international arbitration, the secrecy of arbitration proceedings and awards is far from certain. That is there is no clear duty of confidentiality in most international arbitration and arbitral awards are sometimes made public, either in enforcement actions or otherwise. Both arbitration awards and submissions can in principle be obtained by governmental regulators in many countries.[37] Therefore, parties should not assume that arbitration proceedings, including evidence, arguments, and awards, are confidential merely because they are private. There is no generally accepted rule that an agreement to arbitrate imposes a duty of confidentiality on the parties to the resulting arbitration.

In *the Department of Economics Policy & Development of the City of Moscow v. Bankers Trust Company and International Industrial Bank;*[38] the appellant, the Department of Economic Policy and Development of the City of Moscow (Moscow), appealed against the first instance decision of Justice Cooke in which he ruled that his judgment dismissing an application under Section 68 of the Arbitration Act should remain confidential. The arbitration took place in private and the award was published only to the parties.[39] The Section 68 application was itself heard in private. However, prior to and during the arbitration, Bankers Trust Co. (Bankers Trust) had notified various financial institutions about the matter. Furthermore, Justice Cooke's judgment was not marked private, and a legal research website obtained a copy of the judgment and published a summary. Bankers Trust immediately objected. The judgment demonstrates that the English courts will undertake a balancing exercise between the public interest in the administration of justice being transparent on the one hand, and the protection of genuinely confidential and sensitive information on the other. Such an approach ought, in theory, to give appropriate protection to the interests of the particular parties while permitting the law to develop through the publication of judgments relating to arbitration matters whenever possible. There are some jurisdictions in which publicity is difficult to avoid when challenging arbitral awards, since the

[37] Gary B. Born, *Int'l Arbitration and Forum Selection Agreement,* Kluwer L. Int'l (London), 38 at 11 (2006).

[38] *Department of Economic Policy and Development of the City of Moscow v. Bankers Trust Co.* [2004] EWCA Civ 314; [2005] Q.B. 207 (CA (Civ Div)).

[39] Section 68 of the English Arbitration Act 1996 enables a party to arbitral proceedings to apply to the court to challenge an award on the ground of serious irregularity affecting the tribunal, the proceedings or the award.

arbitral award will be physically annexed to the public court documents. But parties selecting England as the seat of their arbitration can have some confidence that the underlying details of their dispute will remain confidential, even if the matter comes before the courts, where truly confidential or sensitive information is involved.[40]

What is the better approach? Actually, there is no simple answer which could be applied in all circumstances. As we can see, the main reason that most cases precluded from confidentiality is the public interest policy, such as the *Australia Esso/BHP v. Plowman* case, in which the High Court held that "Even if there were a duty of confidentiality, that duty is not absolute and may be curtailed where public interest demands." As for the *English Ali Shipping Corporation v. Shipyard Trogir* case, though it admits that the duty of confidence exists, it also held that this duty is not absolute, and the exceptions had to be defined, including the interest of justice demands disclosure of information.

6 Conclusion

Since national traditions are so different on this issue and the legal and institutional rules are scant, such as under *Esso v. Plowman,* a statutory duty to inform a State Agency may prevail on the intended confidentiality of the information generated for, or during, the course of the arbitration proceedings. The same view has been held in the United States for the confidentiality duty of the arbitrator. Under Swiss law, administrative statutory requirements of disclosure cannot be said to automatically overrule confidentiality duties that are premised on private or criminal law. Thus, it is useless to quarrel whether there exists a worldwide principle of confidentiality in the arbitration proceedings or not, and it is ridiculous to place emphasis on the merits of confidentiality. Therefore, the parties should be aware enough to include a comprehensive provision as part of the dispute resolution clause in their contracts, if they wish to protect confidential information from later disclosure.

For these reasons, arbitration clauses undoubtedly become not only predominate but are nowadays almost universal in international commercial contracts.[41] This was the recommendation of the drafters of the UNCITRAL Notes on Organizing Arbitral Proceedings (1996), such an agreement might include: (1) types of information to be kept confidential, e.g., reserve, seismic and other technical data, evidence, arguments, documents and information obtained in discovery, the course of proceedings, content of award; (2) measures

[40] Richard Hill, *Case Comment: Confidentiality of Arbitration in Court Proceedings,* 7 Int'l Arb. L. Rev. 50 (2004).

[41] Justice Kerr, *Int'l Arbitration v. Litigation,* J. Bus. L. 165 (1980).

for maintaining confidentiality; (3) circumstances in which confidential information may be disclosed.

Therefore, if parties want to be sure that their arbitration will be confidential, they should now make it expressly so in their arbitration agreement (e.g., article 30 of the LCIA Rules). Suggested language would be as follows: The dispute resolution proceedings contemplated by this provision shall be as confidential and private as permitted by law. To that end, the parties shall not disclose the existence, content, or results of any proceedings conducted in accordance with this provision, and materials prepared and submitted in connection with such proceedings shall not be admissible in any other proceeding, provided, however, that this confidentiality provision shall prevent a petition to vacate or enforce an arbitral award, and shall not bar disclosures required by law. The parties agree that any decision or award resulting from proceedings in accordance with this dispute resolution provision shall have no preclusive effect in any other matter involving third parties.

Another step which a party could take to protect confidentiality in arbitration would be to seek a confidentiality stipulation or protective order in the arbitration, initiated by agreement of the parties, or at the request of one party and direction of the arbitrator. As the stipulation is a contract between the parties, violation of the stipulation renders the violator liable for breach of contract damages. Additionally, the stipulation may be subject to an order for specific performance.

In fact, such provisions cannot ensure complete protection against disclosure compelled by judicial or administrative order. Additionally, the extent of such protection depends upon the law of the jurisdiction where disclosure is sought and the nature of the information. Fortunately, the law of trade secrets has just received its first universal acceptance with article 39 of the TRIPS, which the arbitration community should take into account.

The burden of the proof is on the party claiming that the information desired to be protected is actually secret, or was before the wrongful disclosure occurred. Confidentiality may cover memorials by the parties, written depositions and affidavits, expert reports, and all compilations of technical or commercial data, except the ones that were already published online, or in trade journals or technical reviews. On the contrary, the documents pre-existing to the arbitration are not necessarily secret. They may be stamped as confidential, or they may have been compiled in such circumstances where it is most likely that they were considered as confidential. Otherwise, no automatic protection should attach to them.[42]

In legal practice, it is hard to estimate which tendency is better, in order to strengthen the power of confidentiality or to wash it out gradually. Why not look

[42] See Dessemontet, fn. 18 at 308 (1996).

at the issue from another perspective on confidentiality in international commercial arbitration? The main point we have to make clear is why businessmen and women are choosing arbitration rather than litigation. Holding such a perception in mind, most disputes or debates may very well be coped with acceptably.

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European Private International Law, Uniform Law and the Optional Instrument*

Peter Huber**

I. The Optional Instrument According to the Action Plan

The Action Plan[1] raises the question of whether it would be adequate to create an optional instrument in the field of European contract law. Of course, the action plan does not try to give any definite answers. Its main purpose is to start a discussion about the matter. Nevertheless it contains important information as it sets the frame in which the discussion has to take place. I would therefore like to start by having a look at what the action plan actually says about the optional instrument.

There are several points which can be structured under two headings: the scope of application of the optional instrument and the contents of the optional instrument.

1. The Scope of the Optional Instrument

a. Cross-Border Contracts Only

In my view, the Action Plan proceeds on the assumption that the optional instrument is - at least for now - intended for use in cross-border contracts. It is meant to exist parallel to the national rules, rather than replacing them completely[2]. I will therefore restrict my paper on the issue of cross-border contracts.

The Action Plan is supposed to "provide parties to a contract with a modern body of rules particularly adapted to cross-border contracts in the internal market".[3] One advantage, according to the Commission, is that this would provide the parties with a "neutral" set of rules on which it may be easier for them to agree than on one of their respective national laws. A second advantage is supposed to derive from the fact that the economic operators would become (more) familiar with the rules of the optional instrument which would encourage them to conclude cross-border-contracts thereby facilitating the cross-border exchange of goods and services. The Action Plan expressly states that this is of particular importance to Small and Medium sized Enterprises (SMEs) and consumers.

b. Opt-In - Opt-Out[4]

Any legal instrument for cross-border contracts has to give an answer to the question of whether it will only apply if the parties choose it as the applicable law or whether it should apply in an objectively described set of circumstances. This is the question of opt-in or opt-out which has been dealt with by Karen Battersby already, so that I will keep the matter short.

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Communication from the Commission to the European Parliament ant the Council: A More coherent European Contract Law - An Action Plan. Official Journal 15.3.2003. C 63/1 Nr. 89 et seq.

Action Plan (Fn. 1), Nr. 90, 92.

Action Plan (Fn. 1) Nr. 90.

The Action Plan does not give a definite answer to this matter: Both an opt-in-solution and an opt-out-solution are therefore possible. In my opinion, however, the possibility of an opt out must be given, even if one decides that the instrument can apply on a purely objective basis.

c. Areas Covered by the Optional Instrument

The action plan does not give any detailed guidelines regarding the areas to be covered by the optional instrument. The instrument is supposed to take into account the common frame of reference as a basis, but does not have to cover all of the areas dealt with there. Furthermore, it is left open whether the instrument should "cover only general contract law rules or also specific contracts".[4] This is a very interesting remark on which we are going to come back later.

Finally, one further issue is raised by the Action Plan, i.e. the relationship between the instrument and the Vienna Convention for the International Sale of Goods (CISG). The answer is, however, left open: Everything is possible therefore, from a rival international sales law in Europe to a solution in which the instrument would simply not govern the matters covered by the CISG.[5]

2. The Contents of the Optional Instrument

As for the contents of the optional instrument, the Action Plan addresses two points. First, it says that the optional instrument should take into account the common frame of reference. Secondly, it lays particular stress on the principle of contractual freedom which is supposed to be one of the guiding principles of the instrument. The Action Plan draws several conclusions from this: First, the parties should be free to adapt the instrument to their needs.[6] Secondly, mandatory law is supposed to be restricted to a narrow field, for example consumer protection.[7]

II. The Existing Framework

The optional instrument will not operate in a legal vacuum. It will have to fit into the existing system of private international law in Europe, and it will have to compete with other legal instruments dealing with international contracts.

1. Private International Law

a. Present State

(1) Rome Convention

At present, the most important set of rules is provided by the Rome Convention of 1980. I assume that it is well known to all of us and I therefore restrict myself to a very brief overview.

[4] Action Plan (Fn. 1) Nr. 95.

[5] Action Plan (Fn. 1) Nr. 96.

[6] Action Plan (Fn. 1) Nr. 93, with express reference to Art. 6 CISG.

[7] Action Plan (Fn. 1) Nr. 93 f.

The Convention starts from the principle that the parties may choose the law applicable to their contract (Art. 3). Although its freedom of choice is, as a rule, rather wide, there are nevertheless certain restrictions, i.e. in consumer contracts (Art. 5(1)), in individual contracts of employment (Art. 6 (1)) and with regard to certain mandatory rules (Art. 3(3), 7(1), 7 (2)). An issue which has raised controversial debates is whether the parties can choose a set of rules which is not part of the law of a state, for example the recently published UNIDROIT Principles of International Commercial Contracts or, more generally, the so-called *lex mercatoria.*

In the absence of a choice of law by the parties, the Convention follows the principle of the proper law, the contract then being governed by the law of the country with which it is most closely connected (Art. 4). In the interests of legal certainty, the Convention provides for several presumptions. The basic rule here is that the contract is presumed to be most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has his habitual residence (Art. 4(2)). Other presumptions concern contracts on immovable property and contracts of carriage. Finally, there is an "exception clause": The court can disregard these presumptions if the case is more closely connected with another country (Art. 4(5)).

Under certain conditions the Convention contains special rules for weaker parties (consumers and employees, Art. 5, 6). The choice of a law by the parties to the contract may not deprive a consumer or an employee of the protection of the mandatory provisions of the law which would be normally applicable to them - as designated in accordance with the general rules of the Convention - in the absence of a choice of law. In the absence of a choice of law, a consumer contract is governed by the law of the country of the consumer's habitual residence, and an employment contract is governed by the law of the place in which the employee habitually carries out his work in performance of the contract or in the absence of such a place, the law of the place in which he was engaged.

The scope of the Convention is rather far-reaching. It covers the law of contract in a very broad sense, in particular its interpretation, matters of performance or non-performance, extinction and nullity of the contract and matters of prescription (Art. 10). However, several matters are excluded from its scope of application, e.g.: status and legal capacity of natural persons; the economic affairs of the family matters (wills, successions, marriage settlements, contracts covering maintenance responsibility); negotiable instruments; company law; arbitration and choice of forum agreements; trust agreements (Art. 1(2)); certain insurance matters.

(2) Rules in Sectoral Instruments

A number of secondary instruments (in particular directives) contain certain rules on the applicable law. This is true in particular for many of the consumer protection directives which usually say that the consumer must not be deprived of his rights by the choice of a third state, if the contract has a close connection to the territory of the Member States.[8]

See f.ex. An. 7(2) Directive 1999/44/EC on certain aspects of the sale of consumer goods and associated guarantees; Art. 6(2) Directive 93/13/EEC on unfair terms in consumer contracts: Art. 12(2) Directive 97/7/EC on the protection of consumers in respect of distance contracts.

These rules (to be precise: the national rules which transform them) take precedence over the Rome Convention (cf. Art. 20 Rome Convention).

b. Plans for Reform

The status quo that I have just outlined is, however, about to change. The Commission has presented a Green Paper on the conversion of the Rome Convention into a Community instrument and on its modernisation." The paper raises 20 specified questions. Amongst these issues are, *inter alia:* the problems resulting from the dual system of the Rome Convention on the one hand and the conflict rules in the sectoral instruments on the other; the relationship between the Rome Convention and existing international conventions; the rules on insurance contracts; the choice of non-state law; the consumer protection rules; the rules on mandatory provisions.

These few examples show that most of the issues arising with regard to the future optional instrument will be touched by the reform of the Rome Convention. The conflict of laws framework for the discussion of the optional instrument is therefore rather vague at the moment, particularly where consumer rules and mandatory provisions are concerned.

2. Uniform Law

a. CISG

The optional instrument as envisaged by the Action Plan will not be limited to rules on the applicable law, but is intended to provide a set of material rules actually governing and deciding the relevant contract law issues. It will therefore have to compete with other instruments aiming at the same objective.

The central player in this field is undoubtedly the Vienna Convention on the international sale of goods which is in force in more than 60 states worldwide and commonly regarded as a success story. We will come back on it later.

b. UNIDROIT

There are, however several other instruments which provide uniform rules in the field of contract law, for example the UNIDROIT-Conventions on International Factoring and on International Financial Leasing - both in force in several states - and the UNIDROIT-Convention on International Interests in Mobile Equipments (not yet in force).[10] These instruments concern special contracts or special areas of the law. If the optional instrument were to cover these areas, one will have to take into account that these instruments exist, to ask whether a separate instrument is necessary or whether it could be an option to simply join these Conventions.

Another instrument which has gained considerable importance over the last few years are the UNIDROIT Principles of International Commercial Contracts", which

* Green Paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations in a Community instrument and its modernisation. 14.1.2003. COM (2002) 654 final.

"' For detailed information see www.unidroit.org.

" Unidroit (ed.), Principles of international commercial contracts. 1994. See also www.unidroit.org/english/principles/pr-main.htm, with information on the planned enlargement of the Principles.

cover general matters of contract law (such as formation of the contract, validity, interpretation, performance and non-performance). These principles are not a Convention in the traditional sense, as they are not supposed to be ratified and applied as part of the national law of the Contracting states. They are rather a body of soft law, one could also say a codification of the *lex mercatoria*. What are they meant for in practice? According to the preamble they

- shall be applied when the parties have agreed that their contract be governed by them,
- may be applied when the parties have agreed that their contracts be governed by general principles of law, the *lex mercatoria* or the like,
- may provide a solution to an issue raised when it proves impossible to establish the relevant rule of applicable law,
- may be used to interpret or supplement international uniform law instruments,
- may serve as a model for national and international legislators.

The practical relevance of the UNIDROIT-Principles should not be underestimated. The Unilex-Database[12] counts 72 judgments and arbitral awards which apply or refer to these principles.[13] Let me simply quote from a Swedish arbitral award in a case where there was no choice of law clause in the contract:

"This leads the Tribunal to conclude that the issues in dispute between the parties should primarily be based not on the law of any particular jurisdiction, but on such rules of law that have found their way into international codifications or suchlike that enjoy a widespread recognition among countries involved in international trade. Apart from international conventions such as the Convention on International Sales of Goods (CISG) and other conventions that are not directly applicable on a licence agreement, the only codification that can be considered to have this status is the UNIDROIT Principles of International Commercial Contracts. The UNIDROIT rules have wide recognition and set out principles that in the Tribunals opinion offers a protection for contracting parties that adequately reflects the basic principles of commercial relations in most if not all developed countries. The Tribunal determines that the rules contained therein shall be the first source employed in reaching a decision on the issues in dispute in the present arbitration."[14]

c. European instruments and initiatives

Finally, and last, but certainly not least, there are already instruments on the European stage. The Principles of European Contract Law have been steadily growing and and now cover most areas of the general law of contract and of the general part of the law of obligations, including rules on cases of plurality of parties, on the assignment of rights and on the prescription of claims. They therefore deal

[12] www.unilex.info.

[13] See also *Bonell (ed.)*, The UNIDROIT Principles in practice, 2002: Unidroit Principles of International Commercial Contracts - Reflections on their use in International Arbitration. ICC International Court of Arbitration Bulletin. Special supplement, 2002.

[14] Separate Arbitral Award 117/1999. rendered in 2001. Arbitration Institute of the Stockholm Chamber of Commerce, Stockholm Arbitration Report 2002:1, p. 58. with observations by H Kronke. p. 65: see also www.unilex.info.

with more areas of contract law than the UNIDROIT-Principles. However, in so far as they deal with the same issues, the rules they offer are largely similar to each other - an observation which may go back to the fact that a considerable number of people served on the drafting committees for both instruments. The scope of application of the European Principles, too, is similar to the mechanisms provided for in the UNIDROIT-Principles:

Article 1:101: Application of the Principles

(1) These Principles are intended to be applied as general rules of contract law in the European Union.

(2) These Principles will apply when the parties have agreed to incorporate them into their contract or that their contract is to be governed by them.

(3) These Principles may be applied when the parties:

(a) have agreed that their contract is to be governed by "general principles of law", the "lex mercatoria" or the like; or

(b) have not chosen any system or rules of law to govern their contract.

(4) These Principles may provide a solution to the issue raised where the system or rules of law applicable do not do so.

It has to be kept in mind that the work on the European Principles has not come to an end. It is carried on within the framework of the Study Group on a European Civil Code.[15] There is, inter alia, a draft of a chapter on sales contracts, which is closely connected to the General Rules of the Principles. Thus, for instance, draft Art. 401 says that if the delivered assets do not conform to the contract, the buyer may exercise the rights provided in the general part of the Principles, except where the rules in the special sales chapter derogate from them. It is obvious that the European Community should not ignore these Principles when preparing the optional instrument provided for in the Action Plan. The same is true of the Draft of a European Contract Code which has been presented by the Academy of European Private lawyers.[16]

III. Options for the Optional Instrument - Commercial Sales Contracts

In the first part of my paper I have tried to outline the framework into which an optional instrument would have to fit. Let us now have a closer look at what exactly is left for an optional instrument as it is envisaged by the Action Plan. This is not the place to attempt an exhaustive study on this matter. I will therefore focus on commercial sales contracts, leaving aside for the moment the question of consumer contracts and other types of contract.

1. The CISG - A Central Player ... In Need of Support

As I have indicated already, there is no way of ignoring the Vienna Convention on international sales contracts in this field. It is in force in most of the Member States -

[15] Cf. www.sgecc.net.

[16] *Gandolfi (ed.),* Code Europeen des Contrats - Avant-projet, 2001.

prominent outstanders are the U.K and Portugal - and frequently applied both in court decisions and arbitral awards.[17]

If one talks to practitioners in this field, it appears that the application of the Vienna Convention is often expressly excluded in the contracts (which is admissible under Art. 6 of the Convention). This does not mean, however, that it does not have practical relevance. In fact, the court decisions show that the cases falling under the Convention very often concern small and medium-sized enterprises which do not normally spend much time and money on having their contracts drafted by highly paid lawyers.[18] So there is an important area where the Vienna Convention is applied frequently. Let me just add a short remark on the economics of harmonisation which have been dealt with here by my colleague, Gerhard Wagner, last year: It is exactly for these SMEs that the harmonisation of international contract law may lead to a reduction of transaction costs, thereby leading to beneficial economic effects.[19]"

a. Scope

The Vienna Convention applies, broadly speaking, to international commercial sales. It does, on the other hand, not cover consumer sales. The dividing line between commercial sales and consumer sales can be summarised as follows: A sale is not covered by the Convention if the buyer buys the goods for his private use and if this was foreseeable for the seller.

The Convention in principle aims at providing solutions for all major issues arising in an international sales contract. Thus it provides rules on the formation of the contract, on the obligations of the seller and the respective remedies of the buyer, on the obligations of the buyer and the respective remedies of the seller, and on several related issues such as the assessment of damages.

b. Gaps

There are, however, questions which are not settled in the Convention. The most prominent examples are to be found in Art. 4 and Art. 5.

Art. 4 reads:

"(...), except as otherwise expressly provided in this Convention, it is not concerned with: (a) the validity of the contract or of any of its provisions or of any usage; (b) the effect which the contract may have on the property in the goods sold."

According to Art. 4 lit. a, the validity of the contract is not governed by the Convention. This means that several key issues of contract law are not dealt with in the Convention, voidness for illegality or immorality; the control of standard terms with regard to their contents[20]; voidness for fraud; possibly - but subject to

[17] Cf. the databases at www.cisg-online.ch and www.uniiex.info.

[18] Cf. also *G. Wagner,* CMLR 39 (2002) 995, 1017 et seq.

[19] *G. Wagner,* CMLR 39 (2002) 995,1018etseq., who also points out. however, that the mere harmonisation of the law of cross-border contracts will not reduce the transaction costs of large multinational enterprises which act in the different Member States through subsidiaries. Wagner concludes however, that nevertheless a harmonisation of the cross-border-rules would be advisable as a first step.

[20] But note that the question whether the standard terms have been incorporated into the contract, falls under the Art. 14 et. seq. of the Convention.

controversial debates - the question of whether the buyer can avoid the contract for error/mistake on the qualities of the goods.

There are other contractual issues which are not dealt with in the Convention even if the Convention does not expressly say so: the limitation of claims; questions of agency and authority to bind; possibly - but again controversial - also questions of set-off and the currency of payment.[21]

Let me simply mention further provisions in that sense: Art. 4 lit. b excludes the effects the sales contract may have on the property in the goods from its scope of application, and Art. 5 states that the Convention does not apply to the liability of the seller for death or personal injury caused by the goods to any person.

The Convention contains a rule which deals with these gaps in general. Art. 7 para. 2 reads:

"Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

As most of the issues named above cannot be solved by referring to the general principles of the Convention they have to be dealt with under the applicable national law. It is needless to say that both the application of the relevant rules on private international law and the potential application of a foreign law create delay, uncertainty and mistakes.

Let me sum up the status quo for commercial sales: We do have a widely accepted international convention dealing with many of the central issues of commercial sales. We do have to acknowledge, however, that this Convention does not cover everything and that quite often one has to have reference to private international law and national law.

2. Some Options

What are the options for a future optional instrument? As I have mentioned earlier, the Action Plan does not favour any particular solution, but expressly invites comments on how to proceed. Let us therefore got through different possibilities:

a. "Let's Go for It" - the Self-Cantered Approach

One could, of course, simply ignore the fact that the Vienna Convention exists and create a separate instrument dealing with commercial sales.

In my opinion, however, it would be very unfortunate to choose this option for the following reasons which distinguish according to whether the instrument chooses the opt-in-solution or the opt-out-solution.

If it were the opt-in-solution, I think that the instrument would only rarely come to be applied, for two reasons: First, the parties to international contracts do not really

[21] See on these matters more detailed *Ferrari, in: Schlechtriem (eel).* Kommentar zum Einheitlichen UN-Kaufrecht. 3. Aufl. 2000, Art. 4 Rn. 12 et seq.

like to choose international conventions anyway, and secondly, if they think about choosing one, my guess is that they would choose the well known Vienna Convention and not the new European instrument.

If the instrument were based on an opt-out-system (i.e. if it were to be applicable to "European" sales contracts simply because certain objective criteria (e.g. the place of business of the parties) are fulfilled), the instrument would of course come to be applied in many cases. But I do not think that it would be wise to do so: What we would do by this, is to give up a rather well-developed body of case law and literature on the Vienna Convention. We would, even worse, bring European contract law out of tune with the rest of the world and jeopardise one of the few success stories of the international harmonisation of law. We would without any need add another layer of uniform law to a system which is already complicated enough, and we would have to find precise rules on when exactly the optional instrument, the Vienna Convention or national law should apply.[22] Legal life would certainly not be easier!

When making these submissions I am fully aware that the Study Group on a European Civil Code is presently working on a chapter on the law of sales. So there will be in the not too distant future a European text on sales law which I am sure will be of a very high standard. Nevertheless I would argue that, as long as we are only talking about cross-border contracts, we should rather go along with the Vienna Convention than with any new European text. The reasons for this are the ones I have just indicated. This is not in any respect meant to criticise the work on these new rules. I am sure they will have a substantial impact on any future discussion on the harmonisation of the internal sales law. And it may very well be that, once we reach the stage where we also think about harmonising the internal law of contract we will have to take up the question of whether it then is reasonable any longer to have different sets of rules for domestic and for cross-border contracts. But as long as we are only talking about cross-border contracts - and that is, in my opinion, the perspective of the optional instrument - I would give preference to staying in line with the rest of the world.

b. "Sit Back and Relax" - the Casual Approach

Instead of the "let's go for it"-approach described just now, one could also imagine a "sit back and relax" - position, i.e. being happy with the Vienna Convention and doing nothing on the European level.

This again, I submit, would not be the ideal way to take. Of course, nothing would change to the worse, but on the other hand, we would miss an opportunity to remedy the weaknesses which we still encounter in the field of international sales law. In particular, the above-mentioned gaps in the system of the Vienna Convention would still have to be filled by having recourse to national law.

3. A Proposal

For these reasons I would favour a third approach which accepts the existence and the importance of the Vienna Convention, but covers its open flanks.

See also *Gerhard Wagner*, CMLR 39 (2992) 985. 1018.

I perfectly see and accept that the European Community could not seriously offer an optional instrument providing a loose collection of patchwork for the Vienna Convention, giving a short rule on the issue of fraud here, another one on the currency issue there etc.

However, as we have seen, many of the gaps in the Convention relate to the general law of contract. On the other hand, we do not (yet) have an international Convention dealing with these matters.

I would therefore suggest an optional instrument for commercial sales contracts supplementing the CISG. This instrument should

- contain general rules on contract law, similar in scope to the Principles of European Contract Law (general part of the instrument),
- limit its specific rules on commercial sales to a simple reference to the Vienna Convention,
- provide that the Vienna Convention, as far as it goes, takes precedence over the general rules of the optional instrument,
- take the form of a regulation in order to assure its binding force.

A solution along these lines would, in my view, have several positive aspects: First, we would not endanger the harmonisation already reached in the field of commercial sales, but would, on the contrary, extend this harmonisation to all Member States, including the ones which have not ratified the Vienna Convention so far. Secondly, still remaining in the field of commercial sales, we would elegantly fill the gaps which exist in the rules of the Vienna Convention. Finally, such an optional instrument would not close the door for other kinds of contracts. It would provide a separate set of general contract rules which could, as a rule, be applied to all sorts of contracts, for example to contracts for the provision of services or to consumer sales, if one wishes to include those into the optional instrument (for example at a later stage or on an opt-in basis).

4. Details

If one decided to follow the solution I have just outlined, a lot of questions, of course, remain to be answered. Let me simply raise a few of them:

a. Incorporation of the Vienna Convention

First, there is a technical issue: How do we go about "including" the Vienna Convention into the rules of the optional instrument?

The objective is clear: It must be guaranteed that (a) the Convention is incorporated into the optional instrument and (b) that this has binding effect on all Member States. The second submission is all the more important because, up to now, not all of the Member States have ratified the Convention (cf, for instance, the UK, Portugal).

In any case, the instrument should contain an explicit reference to the Vienna Convention as the applicable law for sales contracts. If one is not convinced that this

reference in a binding Community instrument is sufficient to give the provisions of the Convention binding effect even in former "non-party-states", the European Community as such could think aboutjoining the Convention under Art. 281, 300 of the EC Treaty, thereby making the Convention binding for all Member States (Art. 300 VII EC Treaty).

b. Criteria for the Sphere of Application of the Instrument

The second point is not limited to the Vienna Convention, but relates to the optional instrument as a whole, including therefore the rules on general contract law. It is the issue of opt-in - opt-out. We have talked about this already, so I would like to keep the matter short: On the assumptions and submissions I have made so far, I would submit that it is preferable to choose the opt-out scenario, i.e. to define certain objective criteria which trigger the application of the optional instrument, but which can be overruled by an agreement of the parties.

Generally speaking, several questions would then have to be addressed: Which are the relevant objective criteria leading to the application of the instrument? If the chosen criteria are given, what do the parties have to do, if they want to exclude the application of the instrument, in particular: does the agreement to exclude the application of the instrument have to be expressly stated? Can the parties "opt in" if the objective criteria are not given, and if so, does this have to be done explicitly or is it enough if they simply choose the law of a Member State?

I do not want to submit a definite and detailed system of application here, but I could very well imagine a solution along the following lines:

(1) The instrument applies if both parties have their place of business in a Member State. If this is the case, the parties can exclude the application of the instrument, but have to do so explicitly, e.g.: "The (optional instrument) is not to apply to the present contract".

(2) The instrument applies if (one of the parties has its place of business in a Member State and if) the parties have chosen it as the applicable law to their contract. For the sake of clarity the instrument should expressly say whether this choice must explicitly refer to the instrument (e.g.: "The (optional instrument) is to apply to the present contract") or whether it is sufficient if the parties simply chose the law of a Member State (which is the predominant opinion under the relevant rules of the Vienna Convention[23]). Let me add that, in my opinion, if the optional instrument takes the form of a regulation, the question of whether the parties can choose non-state law will not arise.

(3) It is a matter for further discussion whether one should provide that the optional instrument applies if only one of the parties has its place of business in a Member State. The answer will in the end depend on the fundamental question of what one really intends to achieve with the instrument: If it is merely aimed at facilitating cross-border-trade within the Internal Market[24], then it does not seem absolutely

Cf. Ferrari, in: Schiechtriem (ed), Kommentar zum Einheitlichen UN-Kaufrecht, 3. Aufl. 2000. Art. 1, nr. 72 and Art. 6, nr. 22.

This may be the underlying idea of the Action Plan, cf. Nr. 90.

necessary to include these cases. If, however, one wants to go a little further and create a common law for international contracts in Europe, it may be advisable to cover these cases, too. By doing that, one would avoid that the national courts have to apply different rules according to whether the second contracting party has its place of business in the Community or not.

(4) Finally, I would submit that the instrument should not provide for a similar rule to Art. 1 lit. b of the Vienna Convention which provides that the Convention applies, if the private international law of the forum leads to the application of the law of a Member State. This provision has always been criticised, has led to a very complicated system of reservations under the Convention and is - in my view - not necessary in order so secure a reasonable sphere of application for the optional instrument.

c. What to Say?

Having determined when the optional instrument should apply we arrive at what is likely to be the most difficult question: What should the general contract rules of the optional instrument actually say?

The issue as such may be difficult, but we do not start from zero. We have, as I have indicated, several projects from which we can draw inspiration. On the European level, I have mentioned the Principles of European Contract Law and the Draft of the Academy of European Private lawyers. Of course, these valuable restatements and elaborations should be given substantial recognition in the process of drafting the optional instrument.

However, I would like to sound a note of caution: We should not limit ourselves to these instruments simply because they bear the label "European". It would, in my view, be highly deplorable if we did not give proper regard to the Unidroit Principles of International Commercial Contracts. These Principles have, as I have pointed out, found widespread recognition all over the world, and, I might add, from the (limited) experience I have personally had with them, they operate reasonably well. We should bear in mind that the more we go along with the Unidroit Principles, the more we achieve not only a European harmonisation, but a world-wide one.

IV. Other Contracts

So far we have only been dealing with commercial sales contracts. However, there are, of course, many other contracts which might be worthy of harmonisation. I cannot go into detail here, but would simply make two observations:

The first observation is that the proposal I have made is of course open to be applied to other contracts as well. Indeed, if the optional instrument - apart from the reference to the Vienna Convention for commercial sales - restricts itself on rules of general contract law, it will, as a rule, be possible to apply its general contract rules to other specific contracts, if one wishes to do so. In detail, of course, there can be intricate questions with regard to its sphere of application and its interaction with the applicable national law. It may therefore be advisable to take a cautious approach to

the matter at first by providing that the optional instrument only applies to other contracts than commercial sales contracts if the parties have expressly agreed on this (opt-in solution). The alternative, of course, would be to provide detailed rules on these contracts, too, thereby creating a far-reaching instrument with a general part of contract law, a part on commercial sales which refers to the CISG, a part on service contracts which contains specific rules for those contracts, etc.

The second observation concerns the issue of consumer contracts. In this area of the law we have to take into account that we have reached a relatively high level of consumer protection in the EC by virtue of the sales directive, of the other consumer directives and of the E-commerce Directive. If this protection on the level of national law is sufficiently secured in private international law by the follow-up instrument to the Rome Convention, a separate body of rules on cross-border consumer contracts does not seem to be absolutely necessary. On the other hand, the proposal I have made, is open for including rules on consumer contracts and consumer sales. So I would not like to exclude this possibility.

V. Conclusions

(I) Commercial cross-border sales

(1) In the field of commercial cross-border sales an optional instrument would be a useful step to take.

(2) The optional instrument should provide general rules of contract law (general Part of the instrument) and restrict the rules on commercial sales to an incorporation of the Vienna Sales Convention (CISG).

(a) Incorporation of the CISG

The CISG is in force in most of the Member States and has found widespread recognition throughout the world. Ignoring the CISG in an European optional instrument would bring Europe out of tune with (large parts of) the rest of the world and create new uncertainties with regard to the sphere of application.

On the other hand, the CISG does not cover all the issues regarding commercial sales contracts. The gaps in its sphere of application largely fall into the area of the general law of contract. These gaps could be filled by an optional instrument which provides such general rules on contracts.

(b) Scope of the rules on general contract law

The optional instrument should therefore contain rules on general contract law (e.g. formation, validity, non-performance, possibly prescription...). In case of a conflict between the general rules and the CISG, the CISG should take precedence.

(c) Models for the rules on general contract law

When drafting the rules on general contract law, one should take into account the existing European restatements and drafts (e.g. the Principles of European

Contract Law). Particular weight should, however, be given to the UNIDROIT Principles of International Commercial Contracts which have found substantial recognition throughout the world.

(3) The optional instrument should take the form of a regulation.

(4) The sphere of application of the optional instrument should follow the opt-out approach.

(a)The "objective applicability" should depend on the place of business of the parties. It is open for discussion, whether one requires both parties to have their place of business within the Community or whether one regards it as sufficient if one of the parties has its place of business in the Community.

(b) The requirements for an agreement by the parties to apply or to exclude the application of the optional instrument should be precisely defined in the instrument in order to avoid uncertainty.

(II) Other cross-border contracts

The general part of the optional instrument could serve as a general basis for other cross-border contracts than commercial sales (e.g. service contracts, consumer sales), but does not necessarily have to do so. If it does, an opt-in solution would be advisable. Alternatively the optional instrument could also contain specific rules for these contracts.

(DT)Domestic contracts

The optional instrument could be open for an application to domestic contracts. If it does, an opt-in solution would be advisable.

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RESEARCH ARTICLE

Limits to International Banking Consolidation

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Abstract Heterogenous banking supervision and regulation is often consid¬ ered as the most important impediment for Pan-European Bank mergers. In this paper we identify other more fundamental reasons for a limited degree of cross-country integration in retail banking. We argue that the distribution of regional liquidity shocks may pose a natural limit to the extent of cross-border bank mergers. The paper derives the impact of different underlying stochastic structures on the optimal structure of cross regional bank mergers. Imposing a symmetry restriction on the underlying stochastic structure of liquidity shocks we find that benefits from diversification and the costs of contagion may be optimally traded off if banks from some but not from all regions merge. Under an additional monotonicity assumption full integration is only desirable if the number of regions with diverse risks is sufficiently large.

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1 Introduction

The integration of the European banking sector has so far mainly been limited to the wholesale market. The lack of pan-European banks however is the major obstacle to an integration of the retail bank market. It is often argued that large cross-country mergers of banks have mainly been impeded by the heterogenous banking regulation and supervision in the European union.[1] This paper questions whether indeed the heterogeneity in the regulatory and supervisory regimes in Europe is the only reason why cross-country bank mergers in the European Union have been limited and have failed to create a truly pan-European bank. A banking system that relies on international institutions provides an insurance mechanism against national liquidity shocks. However, cross border transactions and mergers can bring about a risk of financial contagion, i.e. they may increase systemic risk. A liquidity shortage in a single region can spill-over to other regions if large financial institutions are fully liable for their foreign branches.

We develop a model of banks as managers of different liquidity risks related to Kashyap et al. (2002). However, unlike Kashyap et al. (2002)we follow Allen and Gale (2000) and assume regional liquidity shocks as the primary source of banks' liquidity risk. Banks can choose to operate in different regions. Banks offer regional households with uncertain intertemporal consumption preferences a liquidity insurance through deposit contracts as in Diamond and Dybvig (1983). However, in each region there is some risk associated with the fraction of depositors having early consumption needs. A bank that operates in more than one region can insure depositors against regional liquidity risks. However, it risks that liquidity shortages in other regions spill over and adversely affect its entire business. Using this framework we show that a partial integration of the retail banking sector with banks operating in several but not all regions may actually be optimal given a certain fundamental stochastic structure of regional specific liquidity shocks.

Obviously, any system of cross regional financial integration can be supported by some underlying stochastic structure of liquidity needs. In order to gain further insights one needs to distinguish more and less realistic scenarios. In our paper we impose a symmetry assumption which excludes positive or negative correlations of shocks across regions. We show that even if all regions are entirely symmetric and no particular correlation between the liquidity

[1] Barros et al. (2005) argue in their report on the integration of European banking along these lines.

shocks of specific regions is assumed, it is not necessarily optimal to have either a fully integrated or a nationally fragmented banking system. On the contrary, we find that in many cases a multinational bank that optimally trades off the diversification benefits and the costs from negative cross-regional spillovers is only operating in several but not all countries. Hence, the problem of finding the optimal size of multinational banks often has an interior solution in which banks operate only in a subset of the countries of an economic area.

Our results hold if the number of regions with different risk structures is not abundant. If this was the case then - by the law of large numbers - a complete merger of banks in all existing regions would help to diversify away all risks. Moreover, financial distress in single regions would not cause the breakdown of the entire system because the excess liquidity need in one region would be relatively low. However, if the number of regions is limited, the financial distress in one region may cause a breakdown of a bank that operates in the entire economy. This is what we shall assume in this paper.

Similar to banks in Kashyap et al. (2002) deposit institutes in our framework try to economize on their overall liquidity risk by combining negatively correlated liquidity risks across regions. Consequently, if it is very likely that two regions are hit by (offsetting) liquidity shocks a two-regional bank merger (or a bank operating in two regions, respectively) can reduce the overall liquidity risk of the financial institution. If it is on the other hand rather likely that a liquidity shock only occurs in one region at the same time, then the risk that such a regional shock might induce a collapse of the multinational banks is too high. Multinational banks are inefficient in this case—banks should operate only in one region. Liquidity risk that is concentrated on single regions makes it desirable to partition the economy completely.

Furthermore, we also show that segmentation is always preferable if households' risk aversion is not too strong. In this case, consumers do not heavily rely on banks' ability to insure against individual liquidity shocks; i.e. banks do not provide much liquidity transformation. Given that premature liquidation of asset is not too costly, regional liquidity shortages are not too problematic in this case because planned consumption is close to the liquidation value of assets. Thus the benefits from diversifying regional liquidity shocks is limited. However, financial contagion is particularly costly in that case. Instead of receiving the high long-term repayment on their deposits, patient depositors will only realize the liquidation value if a multiregional bank turns out to be illiquid because of a liquidity shortage in some other region.

In our paper we introduce the notion of financial turbulence. Financial turbulence is characterized by situations in which all regions simultaneously display unusually high or unusually low liquidity needs: A liquidity shortage in one region is always accompanied by an abnormal (positive or negative) liquidity stance of the same size in all other regions. We show that a high relative likelihood of financial turbulence makes limited financial integration particularly desirable.

To understand the intuition consider an economy with four regions. In this case it is always preferable for a bank to operate in at least two regions,

because if one region faces a liquidity shortage the second region could have an offsetting liquidity shock. If the second region is also hit by a negative liquidity shock the two regions are not worse off than if they were served by separate banks. Contagion does not occur in this case with a two regional merger. Adding additional regions, however, brings about the risk of financial contagion. Whenever, the two initial regions have offsetting liquidity shocks a liquidity shortage in the additional regions would cause a failure of the multi-regional bank. At the same time it is rather unlikely that the additional regions have sufficient excess liquidity to compensate a liquidity shortage in both initial regions. Moreover, in cases with excess liquidity in the two considered regions a merger with other regions leads very likely to a liquidity transfer to other regions with less liquidity. Thus given a high relative likelihood of financial turbulence it is optimal for banks to operate in only two of the four regions.

While our model shares the common feature of banks as managers of liquidity risks with Kashyap et al. (2002), our model differs from theirs in several respects. Most important is probably that in Kashyap et al. (2002) banks' main objective when combining liquidity risks is to minimize costly cash holdings. In contrast, in our model banks try to smooth consumption for their stake holders taking negatively correlated liquidity risks. In this respect our paper is also closely related to models that analyze the costs and benefits of integrated interbank bank markets like Allen and Gale (2000)and Freixas et al. (2000). They show that an integrated interbank market may serve as a means for banks to mutually insure against negatively correlated bank specific liquidity shocks. But when deciding to integrate through the interbank market banks do not take into account the risk of financial contagion. For a two regional economy Fecht and Griner (2004) analyze the decision of banks to integrate through the interbank market trading off the benefits from diversifying idiosyncratic liquidity shocks against the costs from contagion in case of aggregate liquidity shortages. Fecht and Griner (2004) also show that interbank integration does not capture all benefit from financial integration even ifregional specific liquidity shocks are the only benefit from integration. A cross-regionally active bank could provide even smoother consumption possibilities than regional banks being insured over the interbank market. This paper extends the framework of Fecht and Griner (2004) to multiple regions but focuses only on financial integration through cross-country bank merger. Intriguingly, we find that even though cross-country mergers allow to reap the maximum benefits from cross-border integration (as compared to interbank market integration) depending on the distribution of the regional liquidity shocks it is still not necessarily optimal for banks to operate in all regions of an economy.

In the next section we describe the underlying assumptions of our model. Section 3 analyzes the decision of banks to expand across borders and shows that for a fairly broad set of parameter settings banks optimally expand to some but not all regions. In Section 4 we discuss the main policy implications ofthese findings and Section 5 concludes.

2 The model

2.1 Households

The economy consists of four regions $I = 1, 4$. Each region consists of a mass 1 of households with the same stochastic utility function

$$U_i(c_i; C2) = \S j u(c_i) + (1 - \S j)\, u(C2),$$

with

$$u(c) = \frac{1}{1-Y} c_i^{1-Y} \quad \text{and} \quad y > 1 \quad \text{and} \quad \S, e \{0; 1\}$$

In each region I households do not know whether they can derive utility from consumption in $t = 1$ or $t = 2$. They only know that with a probability qi they will turn out to be impatient and want to consume in $t = 1$. The probability qI of becoming an impatient household (which is at the same time the regional fraction of impatient households) is itself stochastic:

$$j \S j d j = qi \quad \text{with} \quad qi \; e \; jo; \; 1J .$$

With probability a the fraction of impatient consumers in all four regions equals 1/2. With probability $(1 - a)$ in at least one of the regions $qi = 2$. This means that in one or more regions either a high (1) or a low (0) fraction of households wants to consume early.

2.2 Stochastic structure

In an economy with four regions and two types of liquidity shocks there are $3^4 = 81$ possible realizations of the shocks. The set of possible probability distributions is given by the unit simplex with 81 dimensions. In order to impose some further structure on the problem we assume that each situation with a given number of shocks is equally likely. This implies that shocks are not correlated across regions. Call the conditional probabilities of each event with i shocks p, $i = 1, 2, ..4$; i.e. pi is the conditional (on the fact that there is a liquidity shock somewhere) probability that there is an early (or late) liquidity shock in one particular region and no shock in the other three regions. In this analysis we restrict our attention to the limit case with $a \sim 0$. We have:

$$8p1 + 24p2 + 32p3 + 16p4 = 1,$$

i.e. there are 8 possible constellations with one single shock, 24 possible constellations with 2 shocks and so on. Four prototype situations will be distinguished:

1. financial risk $p_1 = 1/8$ $(p_2 = p_3 = p_4 = 0)$.
2. limited turbulence $p2 = 1/24$ $(p1 = p3 = p4 = 0)$.

3. significant turbulence $p_3 = 1/32$ ($p_1 = p_2 = p_4 = 0$).
4. turbulence $p_4 = 1/16$ ($p_1 = p_2 = p_3 = 0$).

Any other stochastic structure is a convex combination of these 4 regimes.

Our second, stronger assumption is that liquidity shocks which affect a smaller number of regions are more likely. Under such a ***monotonous risk structure*** $8p_1 > 24p_2 > 32p_3 > 16p_4$. This assumption will only be needed for one particular result on the desirability of full financial integration.

2.3 Technology

There is one direct investment technology available in the economy. In $t = 0$ households can invest in the technology. Because it is not observable whether a particular household is patient or impatient, there is no direct insurance mechanism against liquidity risks available. Furthermore, there is no financial market in $t = 1$ available in which households from the four regions could participate.

	7=0	*7=1*	*t = 2*
finished	-1	0	*R* > 1
liquidated	- 1	+ 1	0

We assume that the long-term returns are sufficiently large and/or that the degree of households' risk aversion is sufficiently high that

$$\frac{3}{2} > R(1-Y)/Y,$$

As we shall see below this assumption ensures that a bank operating in all four regions and offering the optimal deposit contract will collapse even if only in one of the four regions an early liquidity shock occurs.

Besides direct investment households can invest their endowment at a bank. Banks offer deposit contracts with alternative repayments in both periods, ***{dl; d2}.*** There is one bank in each region. However, banking markets are contestable. Therefore banks are forced to offer the deposit contract that maximizes the expected utility of depositors.

If banks cannot repay all depositors withdrawing in $t = 1$ all depositors (even those initially not withdrawing in $t = 1$) receive the same pro-rata repayment. Thus we abstract from sequential service constraints and thereby exclude purely expectation driven bank runs.

2.4 The optimal deposit contract

Given our assumption that liquidity shocks are sufficiently unlikely ($a \sim 0$) the optimal deposit contract maximizes households expected utility

$$E[U(d1; d2)] = {}^{1}u(dl) + {}^{1}ud)$$

subject to the budget constraint

and is always given by

2

which yields a regular payoff at date 2 of

$$2R^{1/Y}$$

3 The optimal degree of financial integration

3.1 Useful results

There are cases in which only the likelihood of a bank's bankruptcy determines the ranking of consumer utility. This holds if the risk aversion parameter Y is sufficiently large.

Proposition 1 *Consider two banks i, 2 that go bankrupt with some probability at,a*, provide customers with normal payoffs (df, dJf) with probability bt,b„ and provide the normal payoff df at date* 1 *and R at date* 2 *with probability ct, a. For all R < oo and* $0 < b_{.}, c_{1\,j\,2} < 1$ *there is a Y such that for all Y > Y bank* 1 *is preferable to bank* 2 *if it has a lower default probability, i.e. if at < a.*

Proof An individual who is extremely risk averse maximizes his minimum payoff. The optimal contract fixes identical payoffs in both periods.

$$\lim df = \lim d_2^M =$$

Moreover, for Y going to infinity utility is larger if and only if the probability of the lowest payoff, 1 is minimized. To see this verify that the utility of bank 1's customers may be written:

$$ai\frac{1}{Y}\,{}^{*\prime\prime\prime} + V_{x-1}$$

$$J=i-4$$

with $\& = d^{f}, df, d^{f}, R > 1$ and $x = 2b_1, 2b_1, 2ci,$ 2c,. The result follows from

$$\lim_{Y \to \infty} \frac{a, - л , ' ' + \sum_{j=1-3} V\, Xj\text{-}* - c^{1-Y}}{1 - Y} = \frac{1}{1 - Y} \left| al + \lim_{Y \to \infty} \left\{ Xjc^{1-Y} \right| = \frac{1}{1 - Y} al. \right.$$

Thus for sufficiently risk averse households banks' prior aim is to minimize the probability of a default due to a liquidity shortage. Achieving or efficiently distributing excess liquidity becomes subordinated.

Our second result relates to situations of low risk aversion. In such cases there is almost no consumption smoothing since $c_1 \sim 1$ and $c_2 \sim R$. The loss from a financial crises in a single region is negligible because all consumers would optimally consume one unit anyway. However, in other regimes there may be contagion in cases in which some consumers prefer to consume at the later date. Therefore, for low values of Y separation is strictly preferred to any other regime.

Proposition 2 ***For all R there is a*** $Y > 1$ ***such that for all*** $1 < Y < Y$ ***separation is strictly preferred to any other regime.***

Proof For a risk-neutral individual the optimal contract fixes $d^{f} = 1$, $d^{f} = R$. To see this, consider the ratio of the maximum date 2 payoff R and normal date 2 payments, $d^{f} = {}_{k<}1^{2E1}/'Y^{1}+i$:

$$\frac{R}{d_2} = \frac{R}{R(1-Y)/Y+1} = \frac{R + R}{2R} = \frac{R^{1/Y} + R}{2R^{1/Y}} = \frac{1 + R}{2 + 2} = \frac{1 + R^{\frac{Y-1}{Y}}}{2 + 2}$$

$$\lim_{Y \to 1} \frac{1}{2} + \frac{R^{\frac{Y-1}{Y}}}{2} = 1.$$

Hence, under separation, early consumers realize their desired consumption even in the event of a liquidity shortage in the respective region due to $q = 1$. Thus the benefits from diversifying liquidity shocks cross-regionally are close to zero. However, the costs of financial contagion are substantial in this case. If the considered region has no liquidity shortage because some depositors are patient ($q_i < 1$) a liquidity shortage in other regions can still force a multiregional bank into liquidation. In that case late consumers in region j would not realize the payoff R but only the liquidation return 1. Thus with any cross-regional integration households yield lower expected utility because there is a risk of liquidation for late consumers due to financial contagion. The rest follows from the continuity of utilities in Y. •

We now use the first result to derive the optimal structure of the banking sector in cases with highly risk averse depositors.

3.2 Separation

Financial integration is particularly costly if shocks are limited to single regions ($p_i = \frac{1}{8}$). In such a situation a financial merger has two effects: (i) a positive liquidity sharing effect in case of a positive liquidity shock in one region and (ii) a contagion effect which is particularly likely. This is due to the fact that in half of all cases the aggregate liquidity shortage leads to a collapse of a cross-regionally active bank.[2] Liquidity shocks can never offset each other in this case.

Proposition 3 (i) ***Consider an economy with only financial risk*** $(8p_i = 1)$. ***For all R there is a Y such that for all Y > Y separation strictly maximizes expected household utility. Utility strictly decreases in the order of integration.*** (ii) ***Consider an economy under limited financial turbulence*** $(24p_i = 1)$. ***For all R there is a Y such that for all Y > Y separation and full integration maximize expected household utility. Intermediate integration yields inferior results.***

Proof (i) Table 1 relates to a situation with regionally concentrated financial risk. In this case $p_i = 8$. Each row represents one situation in which one particular region is affected by a shock. A black square (•) represents excessive liquidity ($q = 0$), an empty square (•) too little liquidity ($q = 1$). A zero represents normal liquidity. Separation yields maximum utility. 2-integration introduces a loss due to contagion in case 6. 3-integration introduces a loss due to contagion in cases 6 and 7, and so on.

(ii) Table 2 relates to a situation with limited financial turbulence, i.e. two regions are affected by a shock. Consider the risk of bankruptcy for consumers in region 1 in a merger with region 2. Bankruptcy occurs in 9

[2] Keep in mind that we assume that each region is large enough to induce a financial collapse of the entire system.

Table 1 Regionally concentrated financial risk, $p_i = 8$

Case/region	1	2	3	4	
1	•	0	0		0
2	0	•	0	0	
3	0	0	•	0	
4	0	0	0		•
5	•	0	0	0	
6	0	•	0	0	
7	0	0	•	0	
8	0	0	0		•

cases (4,6,11,14,16,18, 20, 23,24). Under separation bankruptcy occurs in 6 cases. Under 3 integration in 9 and under full integration in 6 cases. •

3.3 Existence of an interior solution

A limited merger of only two banks may be the optimal solution when an abnormal liquidity demand in all regions is the most likely type of shock. In our model this corresponds to the case where $16 \cdot p4 = 1$. We refer to such situations as cases with likely *financial turbulence.*

Proposition 4 *Consider an economy with likely financial turbulence* ($16p_4 = 1$). *For all $R > 1$ there is a lower bound y such that for all $y > y$ 2-integration strictly maximizes expected household utility.*

Table 2 Limited turbulence, $24p2 = 1$

Case/region					
1		•		0	0
2		•		0	0
3		•		0	0
4		•		0	0
5		0		•	0
6		0		•	0
7	0	0		•	•
8	0	0		•	•
9	0	0		•	•
10	0	0		•	•
11	0	•	•	0	
12	0	•	•	0	
13	•	0		•	0
14	•	0		•	0
15	0	•	•	0	
16	0	•		•	0
17	•	0		0	
18	•	0		0	
19	•	0		0	
20	•	0		0	
21	0	•		0	
22	0	•		0	
23	0	•		0	
24	0	•		0	

Table 3 Financial turbulence,

Case/region	1—2		3	4
1				
2				
3				
4				
5				
6	●	●	●	.
7	.	.	.	.
8	●	●	●	.
9				
10				
11	●	●	●	.
12	●	●	●	.
13	●	●	●	.
14	●	●	●	●
15	●	●	●	●
16	•	•	•	•

Proof Table 3 relates to a situation with financial turbulence: there is a shock in every region. Consider the risk of bankruptcy for consumers in region 1 in a merger with region 2. Bankruptcy occurs in 4 cases (13-16). Under separation bankruptcy occurs in 8 cases, under 3-integration in 8 cases, under 4 integration in 5 cases. •

The possible welfare gain from 2-integration (versus separation) arises when there are opposite liquidity shocks in those two regions. A possible cost arises when region 1 is characterized by a high liquidity need and region 2 has a normal liquidity status. In this case liquidity is transferred from region 1 to region 2. However, as seen in Section 3.1 for sufficiently risk averse households these costs are always overcompensated by the benefit from the reduced default risk.

Adding two more regions (i.e. a complete merger of all four regional banks) raises the cost of financial contagion significantly but adds little to the positive insurance effect. If financial turbulence is the most likely outcome (meaning that all four regions have different liquidity needs than usual) then adding two more regions can only help in those cases where the two initial regions have been subject to the same - early - liquidity shock. If the two regions have an excess liquidity they would be forced to share this excess liquidity with the two additional regions if they have less liquidity. But more importantly, given that the two initial regions have offsetting liquidity shocks expanding the bank to two additional regions increases the risk that a liquidity shortage from the other regions causes a default of the entire bank.

A similar result is obtained for a case of significant financial turbulence.

Proposition 5 ***Consider an economy under significant financial turbulence*** $(32p, = \backslash)$***. For all*** $R > 1$ ***there is a lower bound*** y ***such that for all*** $y > y$ ***3-integration strictly maximizes expected household utility.***

Table 4 Significant financial turbulence, 32p3 = *1*

Case/region	1 2			3	4
1	I	D		D	o"
2	D	I		I	0
3	D	D		I	0
4	I	D	I		0
5	D	I	D		0
6	I	I	D		0
7	D	D	D		0
8	I	I	I		0
9	I	I		0	₀I
10	I	I		0	
11	I	D		0	
12	D	I		0	
13	D	D		o	
14	D	I		o	D
15	I	D		o	D
16	D	D	0		D
17	I		0	I I	
17	I		0	I D	
19	I		0	D I	
20	D		0	I I	
21	D		0	D D	
22	D		0	D I	
23	D		0	I D	
24	I		0	D D	
25	0		I I I		
26	0		I I D		
27	0		I D I		
28	0		D I I		
29	0		D D I		
30	0		I D D		
31	0		D I D		
32	0		D D D		

Proof Table 4 relates to a situation with significant financial turbulence: there is always a shock in 3 of the 4 regions. Consider the risk of bankruptcy for consumers in region 1 in a merger with region 2 and 3. Bankruptcy occurs in 10 cases (cases: 1, 3, 5, 7,13,16, 21, 22, 29, and 32). Under separation bank¬ ruptcy occurs in 12 cases, under 2-integration in 12 cases, under 4 integration in 16 cases. •

3.4 Full integration

Proposition 6 (i) ***Full integration can only be uniquely optimal under a risk structure which is a convex combination of limited turbulence and turbulence.*** (ii) ***Under a monotonous risk structure full integration is never optimal.***

Proof (i) Under financial risk and significant turbulence full integration is the worst of all options. It is optimal under limited turbulence and preferred to separation under turbulence. From what we have learned so far under full separation the conditional probability a liquidity shortage at the bank is:

$$_{7T1} = pi + 6p2 + 12p3 + 8p4.$$

Under 2-integration it is:

$$\pi_2 = 2p_1 + 9p_2 + 12p_3 + 4p_4.$$

Under 3-integration it is:

$$\pi_3 = 3p_1 + 9p_2 + 10p_3 + 8p_4.$$

Under full integration it is:

$$\pi_4 = 4p_1 + 6p_2 + 16p_3 + 5p_4.$$

An appropriate convex combination of p2 and p4 yields the following bankruptcy risk.

Under separation it is:

$$= \frac{6}{24} + \frac{8}{16} = \frac{1}{2} \quad \frac{1}{4}$$

Under 2-integration it is:

$$\frac{9}{24} + (1 - \alpha)\frac{4}{8} = \frac{1}{8} + \frac{1}{4}$$

Under 3-integration it is:

$$\frac{9}{24} + (1 - \alpha)\frac{8}{16} = \frac{1}{2} \quad \frac{1}{8}\alpha$$

Under full integration it is:

$$p_4 = \alpha\frac{6}{24} + (1 - \alpha)\frac{5}{16} = \frac{5}{16} \quad \frac{1}{16}\alpha$$

For $\alpha \geq 1$ full integration is uniquely optimal.

(ii) Under a monotonous risk structure $8p_1 > 24p_2 > 32p_3 > 16p_4$. One can easily verify that this is incompatible with full integration dominating separation.

It is important to note that complete integration is particularly bad in those situations in which regions one and two are hit by a positive shock (see Table 3). In most situations it is not good to integrate them because they would have to share their excess liquidity with the two other regions (cases 10-12). If by contrast regions one and two are both hit by a negative shock then integration usually does not help (cases 14-16). It only helps in the case where the two remaining regions are affected by a positive shock (case 13). If the shock in regions one and two offset one another then integration does not help if liquidity is balanced in the rest of the economy and it is bad if there is a need for liquidity in the rest of the economy (case 1 and 5). Only if there is excess liquidity in the rest of the economy integration has a benefit (case 2).

Consequently, when financial risk is dominant, separation is a good option. When financial turbulence is likely, less than complete integration may be a good choice. Under a monotonous risk structure full integration is not desirable for risk averse consumers.

In sum, this analysis shows that there are natural limits to the international integration of the retail banking business. For depositors being sufficiently risk averse banks major concern is to limit the risk of severe liquidity shortages. Thus banks enlarge their regional scope to diversify regional liquidity shocks. Given that even in large economic areas regional liquidity shocks cannot be fully diversified, a bank merger can never fully eliminate the risk of financial contagion, i.e. the risk that a liquidity shortage in one region triggers a collapse of the entire multiregional bank. Thus a trade-off emerges: Expanding the business to additional regions enables a bank to diversify liquidity shocks in certain states of the world while in other states it creates the risk of contagion within the bank. We have shown that there is an interior optimum to this trade¬ off because contagion is particulary likely under a fully integrated banking system—almost independently of whether financial turbulences are limited to a subset of regions or not.

4 Policy implications

The major policy conclusion of this analysis is straightforward: Given that there are fundamental economic reasons that limit the scope for extensive cross-border retail banking integration, policy initiatives that try to foster the cross-border penetration of retail banking markets and encourage cross¬ country bank mergers in the Euro area might be futile. Banks that try to economize their liquidity risk simply find it optimal to operate in some but not all regions of the European Monetary Union.

Apparently, these implications hinge on the assumption that multinational banks are fully liable for deposits collected abroad. This means that we implic¬ itly assume that banks choose a branch structure to expand abroad. Allowing instead for a subsidiary structure of multinational banks enables those financial institutions to reduce the exposure to regional shocks and to close down illiquid subsidiaries if they endanger the stability of the entire multinational bank. This would reduce the risk of contagion within a multinational bank while still allowing to realize the benefits from cross-border diversification. Consequently, if the effects pointed out in our analysis indeed prevent broader cross-border banking integration, promoting subsidiary instead of branch structures for multinational banks could help accelerate integration in the retail banking business in the Euro area.

Of course, deriving policy conclusions from such a stylized model requires some qualifications. In particular the robustness of the results with respect to the peculiar stochastic structure assumed in the model deserves some com¬ ments. Because we assume that states with an abnormal liquidity stance in at least one region occur with a probability close to zero, the probability of a crisis and depositors' repayments in a crisis do not affect banks' portfolio choice and the deposit contract they offer. If liquidity shocks would occur with a significant positive probability banks would have an incentive to hold liquidity buffers. In this case banks have an additional motive to expand their regional scope: Apart from minimizing the risk of contagion they can also economize on their

liquidity holdings, similar to banks in Kashyap et al. (2002). This adds to banks' incentives to expand abroad. However, banks ability to economize on liquidity holdings is constraint by minimum reserve requirements if they exceed the voluntary holding of working balances. Consequently, this approach suggests that the comparably large reserve requirements in the Euro area could also hamper the retail banking integration in the Euro area as compared to the U.S.

Similarly, the assumption that regional liquidity shocks are uncorrelated is of course stylized and it is important to understand to what extend the policy implications of our model are driven by this assumption. Generally, a positive correlation of shocks across regions may result when aggregate demand in the different regions is correlated e.g. due to international trade links and a common monetary policy. In such cases benefits from financial integration are very limited because the scope for diversification is reduced. Thus to the extent that the European Economic and Monetary Union has lead to regionally more synchronized business cycles it has also diminished the diversification benefits that banks can realize by merging across borders.

However, following Krugman (1991) real economic integration fostered by the European Economic and Monetary Union contributes to greater specialization in regional industrial structures. This in turn should lead to more idiosyncratic and uncorrelated regional shocks being more favorable for cross-border mergers according to our findings. But apparently what particularly fosters multinational banks operating in all regions of an economy are strong negative correlations. Such counterbalancing shocks in several countries could, for instance, result from significant cross-border portfolio shifts, i.e. portfolio reallocations within the Euro area due to flight to quality or flight to safe havens. However, harmonization in financial regulation and supervision in Europe should contribute to investors' confidence in the stability and resilience of the financial systems of all EU countries making flight to quality episodes between different regions in the European union rather unlikely. Accordingly limits to cross border activities or financial mergers as pointed out in our model may naturally arise.

The present paper is skeptical about gradualism in financial integration. Even if a large financial institution that diversifies away all risks is feasible in practice, the present analysis points out that a cost has to be borne along the way to such a conglomerate if the merger process evolves gradually. In the process of expanding to a fully diversified multinational bank such an institute may be inefficiently fragile at some point. Thus particularly during the process of consolidation European financial regulators and supervisors need to vigilantly watch the resilience of expanding financial institutions.

5 Conclusion

Limited cross-border integration of the retail banking sector in the Euro area is not necessarily indicating that institutional obstacles are prohibiting cross-border bank mergers. More fundamental economic reasons can prevent the

emergence of pan-European banks. Based on our theoretical model we were able to prove that given a limited number of regions in an economic area it may not be optimal for banks to expand their business to all regions. Under the assumption that the probability of an abnormal liquidity status in all regions decreases as the scope of the economic area increases, banks minimize their liquidity risk by operating in some but not all regions, even if the regional liquidity shocks are uncorrelated.

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ARTICLE

Mandatory rules and public policy in international contract law

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Abstract Mandatory rules and public policy count as important institutions in the field of conflicts of laws. They are closely connected with one other. Their definitions, fixing the requirements for their application, deserve special attention. The paper attempts to identify changes introduced in this connection by the Rome Convention and the recently adopted Rome I Regulation.

Keywords Mandatory rules • Public policy • Rome Convention • Rome I Regulation • Law applicable to contractual obligations

1 General introduction

Mandatory rules and public policy have numbered among the favourite topics of academics of various legal backgrounds and in scholarship for many years. Sometimes the topic is regarded as 'professorial' but the issues have proven to be important in terms of their practical application. Mandatory rules, in particular, as governed by Regulation No. 593/2008 on the Law Applicable to Contractual Obligations (Rome I)[1] represent an area in which there have been radical changes in approach—especially if compared to the Convention on the Law Applicable to Contractual Obligations

[1] OJL 177/6 of 4.7.2008.

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(Rome Convention).[2] It should be noted at this point that the topic being considered becomes very broad and complex if one starts to consider concepts which are relevant in individual legal systems. It is difficult to tackle all aspects of it in this analysis. Moreover, the terms 'mandatory rules' and 'public policy' themselves are not understood in the same way in all legal systems, sometimes even being regarded as overlapping. As a result, certain misunderstandings may occur should attempts to unify the laws of individual states be pursued. However, both terms are closely connected with one other. Defining them, and defining the requirements for their application through a Regulation, may be considered a very useful exercise.

1.1 The concepts of *mandatory rules* and *overriding mandatory rules*

Mandatory rules are generally defined as rules which cannot be derogated from by contract and which will be held binding by a legal system. This definition applies only at the general level. The situation is more complicated in the international environment where internal mandatory rules should be distinguished from, respectively, 'internationally' mandatory rules, overriding mandatory rules and/or super-mandatory rules.

On the one hand, there are internal mandatory rules which cannot be contracted out of by the parties within the framework of a particular legal system; such rules may simply be excluded by the choice of a different law by the parties. These rules are governed by contract law, for example, in stipulating elements which are deemed essential in certain types of contract, in stipulating the details of offer and acceptance, the conditions for validity and invalidity of legal acts, for the discharge of obligations, for the recognition of obligations, waiver, etc. These are typical provisions of private law.

On the other hand, there are so-called overriding mandatory rules—mandatory rules in international cases, which cannot be contracted out by the parties by choosing the law of another country. These rules claim to be taken into account immediately, irrespective of the governing law. Examples of such rules are foreign exchange controls, price regulations, foreign trade embargos, various tariff provisions, rules on cartels, on competition and on restrictive practices, environmental protection legislation, highway traffic safety codes, building safety codes, *etc.* What is typical of these rules is their strictly compulsory nature requiring their direct application irrespective of the governing law chosen by the parties or imposed by the relevant conflict rule. Such rules are intended to safeguard especially important public interests on which the state having passed the rules, insists upon and therefore must be ensured.

Generally speaking, if such imperative rules are part of the *lexfori,* the judge applies them directly irrespective of the governing law of the contract. Problems may appear if the overriding mandatory rules of a legal system, other than those of the forum state, claim international application or assert entitlement to be taken into consideration. In the past this question appeared to be rather delicate from a political perspective (nationalisation measures, various administrative licences conditioning validity of contracts, *etc.),* but it remains quite topical even today.

[2] OJ C334/1 of 30.12.2005.

These rules are mostly of a public law nature; sometimes, quite exceptionally, we may find them in private law, particularly in connection with the so-called 'publicisation' of private law, since states tend to intervene in originally and purely private law areas, such as consumer protection or the protection of employees. The question may be raised of how far the state may go, and whether rules for consumer protection or, more generally, the protection of weaker parties fall within the ambit of overriding mandatory rules. Various opinions have been published both on this.[3]

It should also be noted that the distinction between these two categories of mandatory rules used to be hardly understood in common-law countries as it is one unknown to English law, at least not as explained above. It is thus more than welcome that today these concepts are defined at European Union level.

12 The concept of public policy, *ordre public*

Mandatory provisions are sometimes called 'public policy' rules; however, it is necessary to distinguish precisely between these two terms. Public policy, or *ordre public,* means a widely accepted rule of private international law: the application of a rule of the law of any country specified by the conflict rules may be refused, but only if such application is manifestly incompatible with the public policy of the forum. 'Public policy' means such principles of the forum state as must be insisted upon without any exceptions, *i.e.,* the most basic notions of morality and justice. The purpose is to prevent foreign legal values incompatible with the fundamental principles of national public policy from being applied in the domestic legal system. Classical examples of a refusal to apply foreign law which are determined by conflict of laws rules can be found in the area of family and succession law. Such an approach appears to be quite exceptional in international contract law but even here some examples can be found, such as expropriation without compensation, the impermissibility of claiming late payment interest along with the fulfilment of obligation, *etc.*[4]

Generally, we should distinguish overriding mandatory rules (so-called *lois de police* or *Eingriffsnormen)* from public policy (known as *ordre public* or *offentliche Ordnung).* Overriding mandatory rules are enforced irrespective of the law determined by the conflict rule; as such, they precede the application of the conflict rule and claim their application whatever the content of the governing law may be. On the other hand, a public policy exception applies after the conflict rule has determined the governing foreign law, whose nature is subject to examination and whose application may later be refused as a result of a public order reservation. Thus, a public order reservation or public policy (in this sense, these two terms are synonyms), is of a defensive nature. Public policy is given a negative meaning here.

[3] See *Giuliano/Lagarde* Report [4], note 3. to Article 7. Compare e.g. the often cited decision of German BGH: "Das deutsche Verbraucherkreditgesetz zahlt nicht zu den zwingenden Vorschriften des Art. 34 EGBGB, da es dem Schutz des einzelnen Verbrauchers dient", 13.12.2005-XI ZR 82/05, RIW 53, 389 (2006).

[4] In particular, Islamic law prohibits the collection and payment of interest.

2 Overriding mandatory rules

2.1 Conceptual clarification and case-law examples

2.1.1 'Overriding mandatory rules'

The concepts of mandatory rules and overriding mandatory rules deserve further clarification. It has already been stated that overriding mandatory rules are involved only in international contexts and represent provisions to which a state attaches such importance that it requires them to be applied whenever there is a connection between the legal situation and its territory, whatever law is otherwise applicable to the contract.[5]

The question is very often asked of where the border is located between mandatory rules that are 'overriding' and those that are not. The Rome Convention makes no essential distinction between rules of a public law or private law nature. The *Giuliano/Lagarde* Report gives examples of the rules on cartels, competition and restrictive practices, consumer protection and certain rules concerning carriage.[6] However, case-law in some countries has established the view, particularly with respect to the protection of weaker contracting parties, that overriding rules are only those which protect not only the interest of individuals but also the interests of the collectivity, *i.e.,* these provisions are directly aimed at public interests. The German Bundesgerichtshof, when considering the German *Verbraucherkreditgesetz,* came to conclusions that "Zwingende Normen im Sinne des Art. 34 E G B G B sind Normen, die beanspruchen, einen Sachverhalt mit Auslandsberuhrung ohne Rucksicht auf das jeweilige Vertragsstatut zu regeln. Diese Voraussetzung erfullen nur Vorschriften, die nicht nur dem Schutz und Ausgleich widerstreitender Interessen der Vertragsparteien und damit reinen Individualbelangen dienen, sondern daneben zumindest auch offentliche Gemeinwohlinteressen verfolgen..."[7] This understanding does not fully correspond to the examples provided by the *Giuliano/Lagarde* Report, nor to decisions of other courts.[8] Such inconsistencies, which are extremely relevant in practice and may significantly reduce legal certainty, should be prevented by the definition of overriding mandatory rules directly stipulated in Article 9 Rome I.

2.1.2 Domestic and foreign overriding mandatory rules

Further clarification is needed in the issue whether a particular case is subject to the overriding mandatory rules of the forum law, or to the overriding mandatory rules of

[5] *Green Paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation,* C O M (2002) 645 final, 33.

[6] *Giuliano/Lagarde* Report [4], note 4. to Article 7.

[7] See the above-mentioned judgment of the German B G H 13.12.2005, R I W 5/2006, 389. ("Mandatory rules in the terms of Art. 34 I A C C (E G B G B) are rules which aim to regulate international cases without taking account of the lex causae involved. This provision only applies when a certain element of public interest is present, and not only when the protection of and reconciliation between conflicting interests of the contracting parties—i.e. purely individual interests—are at stake...").

[8] Cour de cassation, 1ère civ., 19.10.1999, R.C.D.I.P. 89, 30 (2000), with critical comments—irrespective of the Rome Convention—by *P. Lagarde.*

foreign law, which may not only be the proper law of contract *(lex causae),* but also other than the proper law, *i.e.,* the law of a third country.

As far as the overriding mandatory rules of the forum law *(i.e.,* the domestic rules of the court hearing the case) are concerned, the court will always apply them regardless of whether the *lex fori* in the particular case is also the proper law of the contract. This is a traditional principle directly incorporated in the legislation of many states. It appears to be natural and logical that the court will directly apply these rules although they do not form part of the governing law, but the rules must really be 'overriding'. For example, the French Cour de Cassation has concluded that if construction work is carried out in France, regulations providing for the protection of contractors under the French Act of 31 December 1975 constitute *lois de police* within the meaning of Article 3 of the Code civil and Articles 3 and 7 of the Rome Convention.[9] The Austrian Oberster Gerichtshof, considering the credit transaction of an Austrian foreign-exchange resident with a German bank, which was subject to German law under the Austrian conflict rules (the seat of the bank was relevant), has concluded that the governing German law may not prevent the applicability of the Austrian foreign-exchange law.[10]

Foreign overriding mandatory laws are in a position much inferior to that of domestic overriding mandatory laws as far as the court hearing the case is concerned. Traditionally, courts declined to give effect to foreign public laws. However, there have been cases, usually ones which are well-known and even famous today, where the contrary has happened. In the *Nigerian Artefacts* case, the German Bundesgerichtshof considered the validity of a contract of insurance of artefacts during their carriage from Nigeria to Germany. The transaction was governed by German law. Nigerian law, which was not the proper law of the contract, prohibited the unlicensed export of artefacts. The German court held the contract to be unenforceable as immoral under German law.[11] In *Regazzoni* v. *K C Sethia Ltd.* a contract (designated in the documents as a sale CIF Genoa) was in fact intended to be performed by exporting the goods from India in breach of the Indian prohibition on exports destined ultimately for South Africa. The contract was governed by English law. The House of Lords ruled that ". ..English courts will not enforce a contract if its performance involves doing an act in a foreign and friendly state which violates the law of that state."[12]

The courts in both cases took into account foreign public laws, which were not the proper law of the contract. It should be noted that the courts did not apply foreign public laws directly: rather they relied on general provisions or principles of their own national law. Nevertheless we may conclude that foreign public laws were 'given effect' to. And this is substantial with respect to Article 9 Rome I.

However, courts do not always decide matters in the same way. A comparison of the *Ingmar* and *Allium* cases deserves attention.

[9] Courdecassation, 3emeciv., 06-14.641, at http://www.courdecassation.fr/IMG/pdf/CASCIV 20080001 0001 p000 P-2.pdf.

[10] OHG Wien, 2 Ob 573/92, 30.9.1992, ZfRV 34, 124 (1993).

[11] BGH 22.6.1972, NJW 26, 1575 (1972).

[12] [1958] AC 301.

The European Court of Justice in *Ingmar* v. *Eaton*[13] ruled that the United Kingdom Commercial Agents Regulation (implementing Directive 86/653/EEC), which guarantees certain minimum termination rights to commercial agents, must be applied where the commercial agent carried on his activity in a member state. This was so notwithstanding the fact that the agency agreement concluded by the commercial agent Ingmar, a company established in the United Kingdom, with a principal Eaton, established in California, was expressly governed by the law of California. Although the parties had chosen foreign law to govern their contract, and the transaction involved a relationship between traders, the agent was provided with extraordinary protection under the *lexfori—i.e.,* Community legislation in this case.

The *Ingmar* v. *Eaton* judgment was delivered on 9 November, 2000. Two weeks later, on 28 November, 2000, the French Cour de Cassation delivered a decision to the completely opposite effect in the similar case of *Ste Allium* c. *Ste Alfin et Ste Groupe Inter Parfums." Alfin,* a New York company, had made an exclusive representation agreement with the French company *Allium* for the distribution of American perfumes in France. The parties selected the laws of New York as the governing law. The relationship was terminated and the agent demanded special compensation under the French Commercial Code (implementing EC Directive 86/653/EEC). The Cour de Cassation explicitly refused to assign to the relevant provisions of the Commercial Code the character of 'une loi de police applicable dans l'ordre international'. It categorised the provision as a mere 'loi protectrice d'ordre public interne', i.e.,an internal mandatory rule.

This leads to the conclusion that the categorisation of a certain rule as 'overriding' will always depend upon the views of whatever court decides the case. It is however possible to define certain limits to respect, and guidelines to follow, by the court.

2.1.3 'Giving effect' to and/or 'application' ofthe overriding mandatory rules

A question is raised quite frequently as to whether one can really talk about the 'application' of foreign overriding mandatory rules. In considering the case-law it is apparent that courts do not treat this issue in a uniform manner. If phrases and wording in the above-mentioned (and many other) judgments are compared, the following conclusion may be drawn: domestic rules are 'applied'.[15] Foreign public rules, however, are usually not applied but the court 'takes into consideration' or 'gives effect' to such rules, for example, when the judge holds that, due to foreign public law, the obligation is invalid, the performance is impossible, *etc.* In this connection, Bogdan writes pertinently about the 'factual effects of foreign public law'.[16] Rome I distinguishes directly between 'application' with respect to overriding provisions of the forum law on the one hand, and the possibility of 'giving effect' to the overriding mandatory provisions of a specified foreign law on the other. However, this seems to be rather a positivist comparison and we may expect further analyses to be pursued.

[13] C-381/98 *Ingmar* [2000] E C R I-9305.

[14] Arret n°2037 du 28.11.2000, Cour de cassation—Chambre commerciale, Clunet 128, 511 (2001).

[15] *Ingmar,* paragraph (26).

[16] *Bogdan* [2], p. 677.

2.2 Overriding mandatory rules in national law of some countries and in international agreements or conventions

National laws usually do not contain any special provisions in this respect; what they may do is regulate the applicability of domestic overriding mandatory rules. The Swiss Statute of Private International Law of 1987[17]—which does contain special provisions—is one of only a few exceptions in this regard. Some other states—such as Belgium[18] and Bulgaria[19]—have been inspired by the wording of Article 7(1) of the Rome Convention,

Certain solutions may be found in some international conventions as their application has priority over national law. Examples of such international conventions or agreements are the Agreement on International Monetary Fund, the Hague Convention on the Law Applicable to Traffic Accidents, or the Hague Convention on the Law Applicable to Agency. In particular, the famous Article VIII, 2 b of the Bretton Woods Agreement on the International Monetary Fund has frequently been used as an argument, and in some cases even a solution, with regard to foreign exchange regulations. This provision is stipulated in an international agreement binding on the International Monetary Fund member states and, I would argue, provides a guarantee that foreign exchange regulations will be observed before courts in almost all countries in the world regardless of whether or not there is any special provision.

2.3 The Rome Convention

Mandatory rules, as mentioned above, are found in several provisions in the Rome Convention, but their meaning is not always identical. The basic distinction, which is unfortunately not reflected in the English term 'mandatory', is found, on the one hand, in Article 3(3) of the Convention, which defines them as "rules of the law at the country which cannot be derogated from by contract", *i.e.,* internal mandatory rules, and, on the other hand, in Article 7 of the Convention, which regulates 'overriding' mandatory rules in the new terminology.

2.3.1 Internal mandatory rules

Mandatory rules in sense of Article 3(3) of the Rome Convention are internal mandatory rules, enforceable in the case of so-called single country contracts,[20] where all elements are connected with one country only but the parties have chosen the foreign law, without this law having any relation to the situation regulated. This is the principle of protection against the intention of parties to avoid mandatory laws of the country relevant to the contract; it would usually apply to cases that are not 'truly international'. The choice of foreign law need not be pursued merely in order to avoid a particular law. Parties generally can, in compliance with the principle of autonomy of

[17] See Article 19, Bundesgesetz uber das internationale Privatrecht of 18.12.1987.

[18] See Article 20, Code de droit international prive of 16.7.2004.

[19] See Article 46, Bulgarian Statute of Private International Law of 4.5.2005.

[20] Notion used in *Bogdan* [1], p. 124.

will, choose the law of another state.[21] Sometimes, parties may find it convenient to use the same law for associated transactions, *e.g.,* a chain of sale of the same goods. However, the applicability of this provision is quite restricted.

2.3.2 International mandatory rules

Mandatory rules are regulated primarily by Article 7 of the Convention, relating to international (i.e., 'overriding' in current terminology) mandatory rules covering both the mandatory rules of the law other than the proper law of contract—which are covered by Article 7(1), and the mandatory rules of the forum—which are governed by Article 7(2).

The provision of Article 7(2) has been generally accepted and its interpretation essentially creates no problems except for the definition of the term 'mandatory' (as to which see the text above). There is a question as to whether Community (now European Union) legislation is part of the mandatory rules of the forum within the meaning of Article 7(2), particularly in connection with the *Ingmar* judgment.[22]

2.3.3 International mandatory rules of third countries

Attention should be paid to Article 7(1) as it attempts to regulate the position of mandatory rules of law of another country, which require application irrespective of the governing law. Such rules must be of a strictly imperative nature. Another requirement is that the rules have been adopted in a country having a close relation to the facts of the contract.

The relevant factor in deciding whether to give effect to such rules are their nature and purpose as well as the consequences of their application or non-application, which is a very realistic approach.

This provision has been subject to many debates and disputes, but primarily theoretical and academic, since its practical application has been essentially lacking.[23] Having considered the somewhat unclear content of this provision, its interpretation and the conditions for the application of this rule, seven member states[24] have not ratified this part of Article 7, invoking the possibility of an express reservation under Article 22. This does not mean that this provision has been the subject of negative assessment only and has been of no significance. On the contrary, as has already been mentioned, the wording of this provision was incorporated into the legislation of some countries. Decisions of some courts having used reservation with respect to Article 7(1) Rome Convention have also been described, including the fact that some courts admitted the effect of foreign public rules in their decisions, such as Germany or the United Kingdom. In addition, judicial decision-making has been influenced by the wording of Article 7(1) although this provision is referred to just in the reasoning of some judgments.

[21] *Giuliano/Lagarde* Report [4], note 8. to Article 3.

[22] See, inter alia, *Max-Planck-Institut* Comments [7], p. 316 with further references.

[23] See in particular *Lando/Nielsen* [5], p. 1687.

[24] Germany, Ireland, Estonia, Luxembourg, Portugal, Slovenia and United Kingdom.

The Arbitration Court in Prague resolved a question as to whether or not an imperative foreign trade regulation of Hungary, which was neither the proper law of contract nor the law of the forum state, should have been taken into account. The claimant, a Czech company, claimed damages against an Austrian company, arising out of a mandate contract governed by Czech law. The arbitration clause was in favour of the Arbitration Court in Prague. The defendant invoked particular public rules of Hungarian law which were allegedly contravened by the transaction. The arbitrators arrived at a conclusion that it would have been up to the defendant to prove the existence and wording of those Hungarian rules, which the defendant failed to do.[25] This arbitral award expressly admitted the principle of applicability of foreign imperative rules although the foreign public law was not taken into consideration in that particular dispute in the end. Arbitrators, in their positive approach towards foreign overriding mandatory rules, expressly relied on Art. 7(1) of the Rome Convention, although the Convention was not binding on the Czech Republic at that time.

2.3.4 International mandatory provisions of the proper law of contract

Article 7(1) of the Rome Convention is explicitly confined to the mandatory rules of third countries. Logically, a question arises whether a similar regime is applicable to international mandatory rules of the proper law of contract. We may rely on the principle, although it is not generally accepted, that the proper law of the contract, the *lex causae,* should include all its relevant mandatory rules, including the provisions of a public-law nature. Per argumentum *a maiori ad minus* it is possible to relate the regime of international mandatory rules of third countries laid down in Article 7(1) to the mandatory rules of the proper law.

2.3.5 Conversion of the Rome Convention into a community instrument

Both the Green Paper on the Conversion of the Rome Convention of 1980 into a Community Instrument and Its Modernisation (C O M (2002) 645 final) and the Proposal for a Rome I Regulation (C O M (2005) 650 final) list provisions which should be subject to amendment and modernisation, mandatory rules included. Under the Proposal, based on the replies of member states to the Green Paper, having enabled decisions referring to the concept of foreign mandatory provisions (including those member states which entered reservations on Article 7(1)), the utility of the rule would seem to be confirmed. It is therefore essential in a genuine European justice area for the courts to be able to have regard to another member state's mandatory provisions where there is a close connection with the case and where a court action has already been brought by the claimant.[26]

3Rome I

One of the most significant changes introduced by Rome I has undoubtedly been the regulation of mandatory rules. The amendment, in general, should be assessed

[25] Arbitral Award No 78/92 of 22.3.1995, in details *Pauknerova* [8], p. 575.

[26] Proposal for a Regulation Rome I, C O M (2005) 650 final, 7-8.

positively but it should also be noted that there are certain issues that may give rise to debates and differing interpretations.

3.1 Mandatory rules in Article 3(3) and (4)[27]

3.1.1 Article 3—Freedom of choice

Rome I, like the Rome Convention, enables the parties to choose a governing law even for a 'single-country' contract. Compared to the Rome Convention, the wording of Rome I on relevant mandatory rules is more precise and has been expanded by one paragraph (4) which specifically relates to Community (now European Union) law.

The Regulation makes the provisions of the Rome Convention clearer, and distinguishes mere 'mandatory rules' from 'overriding mandatory rules'. It confirms the provisions of Article 3(3) of the Rome Convention to the effect that such choice of law in 'internal' situations means merely the choice of the dispositive provisions of the law chosen and that the parties cannot prevent, through this choice, the applicability of domestic mandatory rules. Moreover, paragraph (4) explicitly provides that where the parties choose the law of a non-member state and the situation is located in one or more member states, where no important contact to that non-member state exists, such choice cannot prevent the application of mandatory provisions of the forum, implementing Community law. The *Ingmar* judgment is referred to in this context, emphasizing the interests of the Community (now the Union). It should however be stressed that in *Ingmar* there was direct connection with the chosen law of California, since it was the law of the seat of one of the contracting parties.

On the other hand, there is a condition for the application of Article 3(4) of Rome I, namely the requirement that the facts given have no relation to the law chosen except for the choice of law.[28] The wording is aligned, as far as possible, with Article 14 of Rome II (Regulation No. 864/2007 on the law applicable to non-contractual obligations).[29]

3.2 Analysis of Article 9—overriding mandatory provisions

3.2.1 Article 9(1) Definition

Article 9(1) has been inspired by the judgment in *Arblade.*"" This definition is undoubtedly valuable compared to the Rome Convention, and it brings light to the concept of 'overriding mandatory rules'. Today we can clearly distinguish between mandatory rules which cannot be derogated from by agreement on the one hand,

[27] Commentary regarding articles on weaker party contracts and other relevant articles was omitted with respect to the limited length of this contribution.

"*Freitag* [3], p. 116.

[29] OJL199/40 of31.7.2007. See Rome I, Preamble, (15).

"Joined cases C-369/96 and C-376/96 *Arblade* [1999] ECR I-8453, in particular paragraph (31). *Arblade* concerned restrictions to the freedom to provide services. See also Proposal for a Regulation Rome I, COM (2005) 650 final, 7.

and 'overriding' mandatory rules in the sense of Article 9 on the other. The definition emphasizes not only the imperative nature of new rules but also their content representing the public interests of the country concerned, such as its political, social or economic organisation. Objections are sometimes raised that the definition is too broad and could result in the interpretation that overriding mandatory rules can also include 'ordinary' or 'common' mandatory rules of contracts.[31] It is therefore desirable that the concept in this sense should be clarified by case-law.

3.2.2 Article 9(2) Overriding mandatory provisions of the forum law

The application of the overriding mandatory provisions of the law of the forum will not apparently be subject to serious doubts as it follows smoothly from Article 7(2) of the Rome Convention. Today, as a result of the *Ingmar* judgment, it is necessary to understand this concept as incorporating European law as part of the *lex fori.*

3.2.3 'Overriding' mandatory rules of the proper law of contract

Unlike Article 7(1) of the Rome Convention, which expressly includes only mandatory rules of third countries, Article 9(1) Rome I is free from such a distinction. It appears to be logical that overriding mandatory rules of the proper law of contract should be applied as such, if with the reservation that, *in concreto,* these may be manifestly incompatible with the public policy of the forum. The question can be raised whether we can use the adjective 'overriding' in such cases since these provisions do not 'override' other rules but, on contrary, create part of the governing law.

3.2.4 Article 9(3) Overriding mandatory provisions of the law of the country of performance

3.2.4.1 Definition The definition of overriding mandatory provisions is very narrow compared to the traditional understanding of this concept. Only the rules of the *lex loci solutionis* will remain relevant and only then when they render the performance unlawful. Paragraph (3) underwent a complicated gestation, and is the result of a compromise aimed at satisfying the United Kingdom, which decided, contrary to their original position, to opt in. The final wording of the provision was inspired by the famous English precedent *Ralli Brothers* v. *Naviera?*[2] The case concerned a charterparty governed by English law for a voyage from India to Spain. The contract provided for the payment of freight in Spain on arrival, but during the voyage a new Spanish decree fixed a maximum freight which was lower than the originally agreed rate. *Ralli Brothers* had failed to pay the agreed freight. The claim to recover the difference between the agreed freight and the maximum limit was dismissed. The Court of Appeal held that under English law as the proper law, the Spanish decree had the effect of frustrating the obligation to pay the agreed freight insofar it exceeded the statutory limit. The court declared the contract unenforceable.

[1] ‚Einfach' zwingendes Vertragsrecht—*Mankowski* [6], p. 147.

[2] *Ralli Brothers v. Cia Naviera Sota y Aznar,* [1920] 2 KB 287.

'Unlawfulness' of performance should be interpreted in such a way that the relevant mandatory rules link the sanction of invalidity, ineffectiveness, *etc.* with the performance in question.

The court *can* give effect to such rules—but there is no duty for the court to do so and it may apply its discretion. Should a rule have 'overriding' character, this nonetheless does not mean that effect must be given to it. The judge will consider, among other things, the nature and purpose of such rules and the consequences of their application or non-application. Such considerations will be of a practical nature, *e.g.,* whether the impact of the mandatory rules is only theoretical or whether, on the other hand, it may lead to actual impossibility of performance.

3.2.4.2 Place of performance The place of performance or 'the country where the obligations arising out of the contract have to be or have been performed' is sometimes difficult to define and its definition may lead to a certain obscurity. In the first place, it is not fully clear under what law the 'place of performance' is to be determined. As suggested by the case-law on Article 5(1) (b) of Regulation (EC) No. 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels I),[33] regarding the definition the place of performance of an obligation, this issue causes problems particularly where several places of performance exist.[34]

A possibility seems to exist of determining the place of performance under Article 12(1) (b) Rome I on the scope of law applicable, under which the law applicable to a contract by virtue of this Regulation governs, *inter alia,* performance. Thus the place of performance would be determined under the *lex causae.* The second alternative is to determine the place of performance under the law of the forum. It appears to be more convenient to preserve the literal wording of Rome I although the determination under the law of the forum may be more welcome by judges.

Another issue is whether the actual place of performance or the legal place of performance are to be considered.[35] It seems to be more relevant that the actual place of performance should be considered in cases where the performance has already been completed.

3.2.4.3 Scope of application Finally, due to the fact that the definition in Article 9(3) is narrow and restricts the relevance of overriding mandatory rules merely to public laws of the place of performance, the question should be asked of whether it is possible to give effect also to mandatory provisions of law other than the law of the place of performance, for example in cases where the export restrictions of the country other than the place of performance are breached, or where competition restrictions of the exporting state will be violated, or exchange control regulations of a country other than the country of the performance will be breached, *etc.* These are examples of classical overriding public laws, which are not provisions of the law of the place of performance. This seems to be quite a serious question to which an

[33] OJ L 12/1 of 16.1.2001.

[34] E.g. Case C-386/05 *ColorDrack* [2007] ECR I-3699.

[35] In particular *Freitag* [3], p. 114.

obvious answer would be that such provisions should not be complied with. Effect can be given merely to provisions precisely defined in Article 9(3): nothing seems to suggest an extensive interpretation ought to be given to this.

It is obvious that many traditional mandatory rules stand outside the scope of this definition but may be relevant in the enforcement of judicial decision in the country having issued such mandatory rules. The question is how the courts will deal with this issue.

4 Public policy

4.1 Conceptual clarification

The public policy reservation is, unlike overriding mandatory rules, a traditional and classical institution defined in a similar way in both national legislation and case-law, and in international instruments; in its essence, it does not give rise to many interpre¬tive difficulties. The judge uses the public order reservation only exceptionally—in particular in contract law- and in a negative, *i.e.,* defensive, manner. *Ordre public* serves as defence against the undesirable effects of a foreign law the application of which is refused on this basis.

For example, the case *RoyalBoskalis* v. *Mountain"* involved a threat by the Iraqi government to detain the contractor's equipment and personnel in Iraq as the first Gulfwar became imminent. An agreement made under such pressure (a "finalisation agreement" governed by Iraqi law) was held illegitimate by English law arguing that it had radically departed from the public policy of the forum country. In another case, *Ciefrangaise de credit et de banque c. consorts Atard,* the public order reservation was used against foreign nationalisation (Algeria) without indemnity with regard to contractual debts relating to a nationalised enterprise.[37]

Therefore, *ordre public* intervenes with respect to legal rules that would otherwise be applicable as part of the governing law. The refusal to apply such foreign rules means that these rules will usually have to be replaced by other rules, and the other (substitute) law should be, according to the prevailing legal opinions, the law of the forum.

Traditional requirements for the use of the public order reservation are a suffi¬ciently intensive relation of the case to the state of the forum and a 'manifest'—*i.e.,* significant and apparent—violation of basic principles of social, governmental and legal system of the forum state. European public order is sometimes mentioned in this context represented by rulings of the Court of Justice such as *Hoffmann,' Krom-bach," Renault*[40] and others. We should distinguish between *ordre public* in the

'*Royal Boskalis v. Mountain* [1999] QB 674 (CA).

'Civ. 23.4.1969, R.C.D.I.P. 58, 717 (1969).

'Case 145/86 *Hoffmann v. Krieg* [1988] E C R 645.

°Case C-7/98 *Krombach* [2000] E C R I-1935.

"Case C-38/98 *Renault* [2000] E C R I-2973.

conflict of laws and *ordre public* in procedural law where this reservation is raised against the recognition and enforcement of foreign judgments due to, for example, the breach of fair trial principle.

The public policy reservation has been codified in the national law of many countries. A precise definition has been introduced recently by Article 21 of the Belgian Private International Law Code. Traditional provisions regarding public order can be found in international conventions.[41]

4.2 Rome Convention and Rome I

Traditional provision for *ordre public* can also be found in Article 16 of the Rome Convention. Apparently, the wording is negative in its form and will only be used in really exceptional circumstances, as has been made clear in the *Giuliano/Lagarde* Report.[42] Moreover, the result must be 'manifestly' incompatible with the public policy of the forum. *Giuliano* and *Lagarde* stress that it goes without saying that this expression includes Community (now European) public policy, which has become an integral part of the public policy of the member states. However, the application of this provision in contract law can be seen only exceptionally.

The wording of Rome I is similar to that of the Rome Convention. It is obvious that the application of this provision will also be exceptional as the foreign law must be 'manifestly incompatible' with the public policy of the forum.

5 Conclusions

This paper has sought to identify changes introduced by Rome I in matters connected with mandatory rules and public policy. It appears to be evident that many issues have not been finally resolved and will be subject to further debates, particularly regarding the scope and conditions of the application of Article 9 of Rome I.

Another practical question is how the content of foreign public rules should be ascertained—in particular, where these rules do not form part of the proper law of the contract: different approaches exist in this respect in various member states.

The last issue to be mentioned is the narrow connection between both notions, as expressly confirmed by the Recital 37 to the Preamble to Rome I. It is obvious in this definition that both notions are closely interconnected and the transition from one to another is smooth and fluent. We should take their overlapping nature into account even in the future.

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[41] E.g. Article 10 of the Hague convention on the law applicable to traffic accidents.

[42] *Giuliano/Lagarde* Report [4], note to Article 16.

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TRIPS-PLUS FREE TRADE AGREEMENTS AND ACCESS TO MEDICINES

ABSTRACT. The battle over access to essential medicines revolves around the rights to issue compulsory licenses and to manufacture and export generic versions of brand name drugs to *expand* access. Global brand name pharmaceutical firms have sought to *ration* access to medicines and have used their economic and political clout to shape United States trade policy. They have succeeded in getting extremely restrictive TRIPS-Plus, and even US-Plus, intellectual property provisions into regional and bilateral free trade agreements. Asymmetrical power relations continue to shape intellectual property policy, reducing the amount of leeway that poorer and/or weaker states have in devising regulatory approaches that are most suitable for their individual needs and stages of development. While the overall trend is disturbing, some recent activities in the World Health Organization and evidence of greater unity behind health-based TRIPs flexibilities provide some grounds for cautious optimism.

KEYWORDS: access to medicines, Agreement on Trade-related Aspects of Intellectual Property Rights, Free Trade Agreements, intellectual property, HIV/AIDS drugs, World Health Organization, World Trade Organization, Doha Round

INTRODUCTION

In recent years developing countries, non-governmental organizations (NGO) activists, multinational corporations and their home governments increasingly have clashed over intellectual property policies. The dramatic expansion of intellectual property rights threatens to reduce access to life-saving medicines. Intellectual property policies have contributed to the high cost of essential medicines, keeping them out of reach of the world's poor. The strong trend toward transforming life-saving drugs into private commodities for sale at premium prices through higher levels of intellectual property protection has made them less available to those who need them most. This paper examines the "North-South" politics of access to HIV/AIDS drugs by analyzing the politics surrounding patent policies pertaining to drugs. Challenges to providing effective access to medicines include trade pressures, economic coercion, multi-layered governance (i.e., local, national, bilateral, regional, and international), the complexity of

intellectual property policy, and unequal access to resources and institutions.

This article starts by highlighting what is at stake. It goes on to highlight the controversies between global pharmaceutical firms and their champions, and the access to medicines campaign. The next section discusses the structural power of global pharmaceutical firms and some problematic instances of their exercise of that power. The subsequent section examines TRIPS-Plus[1] provisions in bilateral and regional Free Trade Agreements (FTAs) that present barriers to access to essential medicines. It then explores some examples of resistance to this trend in the World Health Organization and in Thailand, and finally offers conclusions about the prospects for a TRIPS-Plus future.

WHAT IS AT STAKE?

At the global level, the most important international public law governing intellectual property rights is the 1995 Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) administered by the World Trade Organization (WTO). Unlike most international law, TRIPS is binding and enforceable. The WTO may authorize states to sanction those found to be in violation of the agreement. TRIPS reflects the interests of intellectual property owners. TRIPS extends patent rights for 20 years, requires developing countries to offer patent protection for pharmaceuticals, sharply circumscribes the conditions under which states may issue compulsory licenses, and reduces states' autonomy in crafting domestic intellectual property policies that suit their diverse levels of innovation and economic development. Overall, TRIPS reflects and promotes the interests of global corporations that seek to extend their control over their intellectual property. These firms, acting through the United States government (and with the support of Europe and Japan), largely captured the WTO process and succeeded in making public international law to suit their particular needs.[2]

[1] TRIPs-Plus refers to provisions that either exceed the requirements of TRIPS or eliminate flexibilities in implementing TRIPs.

[2] Braithwaite, John and Drahos, Peter, *Global Business Regulation* (Cambridge: Cambridge University Press, 2000), p. 12; Mathews, Duncan, *Globalizing Intellectual Property Rights: The TRIPS Agreement* (Routledge, London New York, 2002), p. 7; Sell, Susan K., *Private Power, Public Law: The Globalization of Intellectual Property Rights* (Cambridge University Press, Cambridge, 2003), p. 75.

The rationale for intellectual property rights is that they provide incentives for the creation and dissemination of innovation. Without the compensation made possible by intellectual property rights, public goods will be underprovided. However, the merits of granting exclusive rights to intellectual property owners have to be balanced against the economic effects of higher product and transaction costs and the potential "exclusion from the market of competitors who may be able to imitate or adapt the invention in such a way that its social value is increased."[3] This trade-off is particularly acute in medicines; generic imitators can increase social value by providing affordable alternatives to brand name drugs thereby increasing access for the poor.

The market-based, or commodification, justification for strong intellectual property rights is that patents and licenses provide incentives to "increase the number of commercially available products and thereby serve the public interest."[4] However, it is important to ask: which publics are served? In health, stakeholders include non-generic pharmaceutical companies, generic pharmaceutical companies, public sector health providers, and people who need health care. Rights-holders benefit, as do those who have the resources to participate in the commercial market. But market-based solutions alone fail to serve the poor and the marginalized, such as the millions afflicted with HIV/AIDS in Africa and Asia. Of the estimated 42 million infected with HIV/AIDS in the developing world, and the 6 million with full-blown AIDS who need anti-retroviral treatment to stay alive, only 300,000 are receiving these drugs and 100,000 of them are in Brazil.[5]

Market mechanisms to deliver innovation into the public domain fail spectacularly in the oligopolistic markets of the contemporary life sciences industries. Indeed, "international markets for technologies are inherently subject to failure due to distortions attributable to concerns about appropriability, problems

[3] Trebilcock, Michael and Howse, Richard, *The Regulation of International Trade* (London, Routledge, 1995), p. 250.

[4] Lieberwitz, Rosa, "Book Review: the Marketing of Higher Education: the Price of the University's Soul: Universities in the Marketplace: the Commercialization of Higher Education; By Derek Bok", *89 Cornell Law Review* (2004), p. 763, 782.

[5] Lamptey, Peter, "Future Challenges in the Global Fight against HIV/AIDS in Developing Countries", 17 *Emory International Law Review* (2003), p. 645, 650.

of valuing information by buyers and sellers, and market power, all strong justifications for public intervention at both the domestic and global levels."[6] Therefore, the policy challenge is where to strike the balance, and to pursue options that may maximize the benefits provided by intellectual property rights while minimizing the harms produced by over-extension of such rights. Policymakers must make room for humanitarian intellectual property policies that promote social goals such as protecting public health and ensuring access to essential medicines. Intellectual property policy is not merely economic; it is normative, social and political. It is not just about expanding the economic pie, but is also about the distribution of scarce resources.

ACCESS TO MEDICINES: ARGUMENTS AND ACTORS

The battle over access to essential medicines revolves around the rights to issue compulsory licenses and to manufacture and export generic versions of brand name drugs to *expand* access. Global brand name pharmaceutical corporations seek to restrict the ability of generic manufacturers to produce and distribute essential medicines; they seek to *ration* access.[7] African countries in the grip of the HIV/AIDS pandemic, Brazil, India, Thailand, and their non-governmental organization (NGO) advocates have sought to clarify interpretations of TRIPS that permit compulsory licensing, parallel importing, generic manufacture and export. The debate over TRIPS and access to medicines has galvanized a broad range of stakeholders. Brand name pharmaceutical companies, developed and developing country governments, the Office of the United States Trade Representative (USTR) the USTR, NGOs representing public health and consumer interests, and generic drug manufacturers are all participating in this vigorous debate. Among the competing values embedded in TRIPS are the generation of knowledge, the facilitation of "undistorted" trade, and the protection of public health.[8]

Maskus, Keith, and Reichman, Jerome H., "The Globalization of Private Knowledge Goods and the Privatization of Global Public Goods" 7 *J. Int'l* Econ. L (2004), p. 279, 288.

[7] I thank Ken Shadlen for urging me to clarify this point.

[8] Shaffer, Gregory, "Recognizing Public Goods in WTO Dispute Settlement: Who Participates? Who Decides?", 7 *J. Int'l* Econ. L. (2004), p. 459, 460.

On one side of the TRIPS and access to medicines debate are those who support strong intellectual property protection for pharmaceuticals and argue that, if anything, TRIPS is too weak. These advocates highlight the high costs of developing new drugs, the importance of strong property rights as incentives for innovation, and the need for substantial compensation for providing life saving drugs.[9] The brand name global pharmaceutical industry, the United States, and the USTR promote this perspective. It has also been influential in the WTO and the World Intellectual Property Organization (WIPO). The industry fears that any expansion of cut-rate drugs will undermine its markets, particularly if they find their way into high income industrialized country markets. They also are eager to develop markets in middle-income countries in Asia and Latin America. Global pharma highlights the potential health dangers of widespread generic production, "piracy," and the use of drugs without the supervision, dosing instructions, and regulatory controls covering global pharma's products.[10]

Perhaps the most frequently offered argument from supporters of global pharma is that the big problem is not patents but poverty.[11] Industry-supported American think tanks such as the American Enterprise Institute and the International Intellectual Property Institute (IIPI) have promulgated this view. Recent statements by Mickey Kantor, former US Secretary of Commerce and former USTR-turned-industry-lobbyist, Harvey Bale (head of the International Federation of Pharmaceutical Manufacturers & Associations—IFPMA), and Eric Noehrenberg (IFPMA) continue to echo this "poverty not patents" line.[12]

Grabowski, Henry, "Patents, Innovation and Access to New Pharmaceuticals", 5 *J. Int'l* Econ. L. (2002), p. 849, 850-853.

[10] Symposium, "Global Intellectual Property Rights: Boundaries of Access and Enforcement", 12 *Fordham Intell. Prop. Media Ent. L. J.* (2002), p. 675, 729.

[11] Calfree, John E, "Patently Wrong: Free Drugs are No Panacea for Poor Nations", *Wash. Times,* Jan. 28, 2003, at A21; Bate, Roger and Tren, Richard, *Do NGOs Improve Wealth and Health in Africa?* at http://www.aei.org/docLib/20030612_batepub.pdf (June 12, 2003).

[12] Noehrenberg, Eric, Report of the Commission on Intellectual Property Rights, Innovation and Public Health: an Industry Perspective, *84 Bulletin of the World Health Organization* (2006), p. 419, 420; IFPMA, *WHO Commission Report on Biomedical Innovation, Patents and Public Health Contains many Sound Proposals but Mistakenly Underestimates Vital Role of Patents,* April 3, 2006 *at* http://www.ifpma.org/News/NewsReleaseDetail.aspx?nID=3D4628 (2006); Mickey Kantor, *US Free Trade Agreements and the Public Health,* submission to WHO CIPIH *at* http://www.who.int, 1, 5 (2005).

The United States-based Pharmaceutical Research and Manufacturing Association (PhRMA), an industry lobbying group, frequently cites a "Harvard study" that "proves" that patents are no obstacle to access to antiretroviral medicines in Africa.[13] Amir Attaran was an adjunct lecturer in public policy at Harvard, and his coauthor, Lee Gillespie-White, worked for a PhRMA-supported think tank IIPI. The oft-cited paper originated as a study that PhRMA commissioned with its think tank (IIPI) headed by Bruce Lehman, former United States Commissioner of Patents.[14] The United States trade delegation relied on this then-unpublished study in its Talking Points in late September 2001 in the run up to the WTO Doha Ministerial meeting.[15]

PhRMA is hardly subtle about its efforts to enlist academics to promote its cause. The *Washington Post* has referred to these as "hall-of-mirrors techniques by which special interests amplify their arguments through seemingly unconnected third parties."[16] For example, for 2004, PhRMA budgeted $1 million for an:

> [I]ntellectual echo chamber of economists - a standing network of economists and thought leaders to speak against federal price control regulations through articles and testimony." It has set aside $550,000 "for placement of op-eds and articles by third parties" and at least $2 million for outside research and policy groups "to build intellectual capital and generate a higher volume of messages from credible sources" backing industry positions. Overall, the group will devote $12.3 million to "alliance development," ... with ... economists, doctors, patients, and minority groups.[17]

Substantively, advocates of PhRMA's position object to any weakening of intellectual property protection through public health exceptions. They reject compulsory licensing as a policy tool to bring the costs of essential medicines down. They reject parallel importing,[18] whereby states can take advantage of differential pricing policies and import the cheapest version of the brand name patented pharmaceutical product. Harvey Bale of IFPMA criticized a recent World Health Organization (WHO)[19] report for its repeated

[13] Attaran, Amir and Gillespie-White, Lee, "Do Patents for Antiretroviral Drugs Constrain Access to AIDS Treatment in Africa?", 286 *JAMA* (2001) p. 1886, pp. 1888-1891.

[14] Abbott, Frederick "The Doha Declaration on the TRIPS Agreement and Public Health: Lighting a Dark Corner at the WTO" 5 *J. Int'l* Econ. L. (2002), p. 469, 485, n. 62.

[15] *Id.* At 485.

[16] *Behind the Lobbying Curtain,* Wash. Post, June 9, 2003, at A20.

[17][18] *Id.*

[18] Symposium, *supra,* n. 10, at 727.

[19] CIPIH Report at www.who.int/intellectualproperty (2006).

references to compulsory licensing "as a panacea for fundamental poverty and structural problems in developing countries' health care systems."[20] In fact, no one has ever touted compulsory licensing as a panacea for poverty but rather as an instrument for promoting competition thus lowering prices. Instead, PhRMA advocates promote increased foreign aid, and drug donations from firms.

On the other side of the debate is an alliance of developing country governments and NGOs campaigning for access to essential medicines. They argue that patent protection *is* a barrier to access and that public health exceptions to patent rules are necessary to prevent needless deaths. They advocate compulsory licensing, generic competition, parallel importation, and fixed rates of compensation for pharmaceutical companies. It is noteworthy that none of these advocates has ever *denied* that poverty is a problem. The "poverty not patents" rhetoric sets up a false zero-sum metric. Of course poverty is a huge problem, but it is not one that we can fix quite so quickly and easily as altering the specific patent policies that *do* contribute to the problem of access.

Among the most outspoken advocates of this position are James Love of American consumer activist Ralph Nader's Consumer Project on Technology (CPTech), and Ellen 't Hoen of Medecins Sans Frontieres (MSF). They consistently have attacked PhRMA's positions on these issues. Ellen 't Hoen points to strong intellectual property protection as one important barrier to access; she argues that patent protection leads to high prices and limited access.[21] MSF and other NGOs have expressed a number of concerns about TRIPS, including high drug prices, reduced availability of quality generic alternatives, inadequate research and development into tropical diseases, and bilateral pressures on developing countries to adopt patent protection that exceeds the requirements of TRIPS.[22] Furthermore, Love has challenged PhRMA's claims that its companies spend $500-800 million developing each new drug, and has argued that the majority of important HIV/AIDS drugs were actually developed by the public National Institutes of Health (NIH), and funded by taxpayers' dollars.[23] Love and others also offered

[20] IFPMA, *supra,* n. 12.

[21] Hoen, Ellen 't, ''TRIPS, Pharmaceutical Patents, and Access to Essential Medicines: A Long Way from Seattle to Doha'', 3 *Chi. J. Int'l* l. (2002), p. 27, 29.

[22] *Id.* At 29-30.

[23] Consumer Project on Tech., Background information on Fourteen FDA Approved HIV/AIDS Drugs (June 8, 2000) *at* http://www.cptech.org/ip/health/aids/druginfo.html.

detailed substantive critiques of the Attaran and Gillespie-White "poverty not patents" argument.[24]

Brazil, India, and the African group of countries have been leaders in the intergovernmental efforts to address their public health emergencies. Health care activists have praised Brazil's policies of providing universal access to HIV/AIDS drugs.[25] Brazil has used the threat of compulsory licensing to negotiate steep drug discounts with global pharma. It also has committed resources to producing generic drugs. Its policies have helped to create a market for high quality generic drugs.[26] Creating a market has encouraged competition that has brought HIV/AIDS drugs prices down from $10,000 to $150 a year per patient.[27] As a WHO report concludes, "[c]ompetition is perhaps the most powerful policy instrument to bring down drug prices for off-patent drugs."[28] Above all, the access to medicines campaign endorses the right of developing countries to compulsory license drugs, to produce, export, and import generic drugs, and to take advantage of parallel importing to seek out the lowest cost medicines.

German Velasquez argues that in recent years developing countries have won an important victory in the WTO for access to medicines.[29] The Doha Declaration of November 2001 affirmed WTO Member States' rights to implement TRIPS in such a way as to protect public health and to promote access to medicines for all.[30] After extensive and protracted negotiations, Member States also resolved the question of countries' ability to export generic drugs produced under compulsory license to countries lacking pharmaceutical manufacturing capacity (the so-called Paragraph 6 agreement). The deal authorized any member state lacking sufficient

[24] Symposium, *supra,* n. 9, at 732-735; Consumer project on Technology et al., Comment on the Attaran/Gillespie-White and PhRMA Surveys of Patents on Antiretroviral Drugs in Africa, *at* http://www.cptech.org/ip/health/africa/dopatent-smatterinafrica.html (Oct. 21, 2001).

[25] Rosenberg, Tina, ''Look at Brazil'', *N.Y. Times,* Jan. 28, 2001 Section 6 (Magazine), at 26.

[26] Symposium, *supra,* n. 10, at 702.

[27] But see MSF on the continued high costs of second-line therapies, www.msf.org

[28] Quoted in Abbott, *supra,* n. 14, 472, n. 702.

[29] Velasquez, German Bilateral Trade Agreements and Access to Essential Drugs, Bermudez Jorge A. Z and Oliveira-Auxiliadora, Maria, Intellectual Property in the Context of the WTO TRIPS Agreements: Challenges for Public Health, ENSP/WHO - Oswaldo Cruz Foundation, 63 (2004).

[30] WTO, *Declaration on the TRIPS Agreement and Public Health,* Ministerial Conference, Fourth Session, Doha. WT/MIN(01)DEC/W/2, November 14 (2001).

pharmaceutical manufacturing capacity to import necessary medicines from any other member state. This waiver of TRIPS Article 31(f) (restricting compulsory licensing only to supply one's domestic market) included procedural safeguards to prevent diversion of cheap medicines to rich countries' markets.[31] Now, generic copies of drugs made under compulsory license can be exported to countries lacking production capacity.[32] The decision also included a Chairman's Statement, emphasizing the "Members"shared understanding' that the Decision will be interpreted and implemented on a 'good faith' basis in order to deal with public health problems and not for industrial or commercial policy objectives" and their agreement to take steps to prevent drug diversion to third markets.[33] According to Love, the Chairman's Statement was approved by Pfizer Chief Executive Officer (CEO) Hank McKinnell and the office of Karl Rove, President Bush's Deputy Chief of Staff in charge of policy.[34] In December 2005, Member States adopted the waiver as an amendment to TRIPS that includes Article 31bis, the waiver, one annex on terms and conditions, and an appendix on the assessment of pharmaceutical manufacturing capabilities.[35] A number of African delegations were pleased with the outcome, despite the fact that it did not mirror their original proposals. One delegate expressed relief that the uncertainty generated by the waiver was resolved as it is now a permanent part of TRIPS.[36] However, despite this forward

[31] WTO Council on TRIPS, *WTO Decision on Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health* IP/C/405 at http://wto.org (2003); Matthews, Duncan, ''WTO Decision on Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health: A Solution to the Access to Medicines Problem?'', 7 *J. INTL* ECON. L. 73.

[32] IP-Watch, *WTO States Agreement on TRIPS and Public Health on Eve of* Ministeral, 6 December, *at* http://www.ip-watch.org (2005).

[33] Matthews, Duncan "Is History Repeating Itself? Outcome of the Negotiations on Access to Medicines, the HIV/AIDS Pandemic and Intellectual Property Rights in the World Trade Organisation'', *Electronic Law Journal LGD,* 2004, p. 1, 11. Available at: http://www2.warwick.ac.uk/fac/soc/law/elj/lgd/2004_1/matthews 2004.

[34] Love, James, *No Gift to the Poor: Strategies used by the US and EC to Protect Big Pharma in WTO TRIPS Negotiations,* WORKINGAGENDA *at* http://workingagenda.blogspot.com/2005/12/no-gift-to-poor-strategies-used-by-us.html. (2005).

[35] IP-Watch, *supra,* n. 32.

[36] IP-Watch, *African Countries Ready to Accept TRIPS and Public Health Deal* December 6 *at* http://www.ip-watch.org (2005).

movement for access to medicines, Velasquez warns that TRIPS-Plus provisions of FTAs may "dash the hopes raised by Doha."[37] The following sections of this article explore this possibility.

THE PHARMACEUTICAL INDUSTRY: PROFITS, POWER, AND PERILS

Global pharmaceutical firms have become increasingly profitable and politically powerful, especially in the United States' trade policymaking context. The pharmaceutical sector is characterized by marked economic concentration that has only increased over the past several decades. The combination of expanded intellectual property rights and relaxed anti-trust enforcement has led to economic concentration in the life sciences industries. In pharmaceuticals just since 1999, Zeneca acquired Astra, Hoescht acquired Marion Merrel Dow, Sandoz and Ciba-Geigy merged, Glaxo Wellcome and SmithKline Beecham merged, Pharmacia and Upjohn merged with Monsanto, Sanofi-Syntelabo SA was the object of a hostile takeover by Aventis, and Pfizer's acquisitions made it the largest world company with revenues of $53 billion in 2004 (roughly 40% more than #2 GlaxoSmithKline).[38] The global market shares of the largest non-generic pharmaceutical companies in 2003 were as follows: Pfizer, 11%; GlaxoSmithKline, 6.9%; Merck & Co. 5%; AstraZeneca, 4.8%, and Johnson & Johnson, 4.7%.[39] This situation has translated "economic power into greater influence over policymaking that has hitherto been seen as the realm of the public sphere."[40]

The increasing commercialization of medicine means that the diseases of the poor will be ignored by firms for sound economic reasons.[41] As a number of commentators point out, across a broad range of products, the current system skews research towards rich

[37] Velasquez, *supra,* n. 29, 65.

[38] Rosenberg, Barbara, "Market Concentration of the Transnational Pharmaceutical Industry and Generic Industries: Trends in Mergers, Acquisitions and Other Transactions", In Roffe, Pedro, Tansey, Geoff Vivas-Eugui, David (eds.), *Negotiating Health: Intellectual Property Rights and Access to Medicines,* vol. 65 (2006).

[39] *Id.* at 69.

[40] Buse, et al., "Globalisation and Health Policy: Trends and Opportunities", In: Kelly Lee et al (eds.). *Health Policy in a Globalising World,* vol. 261 (2002).

[41] Dutfield, Graham, "Should We Terminate Terminator Technology?", *European Intell. Prop. Rev.* (2003), p. 491, 495.

and middle-income countries' markets and sectors.[42] In the public health sector this means the neglect of tropical diseases in favor of cancer and so-called lifestyle drugs (i.e., for obesity, balding, and erectile dysfunction). For example, only 13 of 1233 new drugs marketed between 1975 and 1997 were approved for tropical diseases. ''As a result, the rhetoric of strong intellectual property rights leading to innovation that meets social needs rings particularly hollow in this setting.''[43]

According to Peter Drahos the US and its IP activist industries have been engaged in a "one-way ratchet" for intellectual property, systematically obtaining higher levels of protection.[44] The International Chamber of Commerce points out that, "the chain of national intellectual property laws will only be as strong as its weakest link, and the ability to meaningfully enforce rights will be crucial.''[45] Industry lobbyists are eager to point out that nothing in TRIPS prevents states from adopting *stronger* forms of protection, and the US and its industries increasingly are coordinating enforcement through a number of venues. The structural power of global firms is reflected in the membership of key policy making committees in US trade institutions. These committees assist US trade negotiators in designing policies for multilateral, regional and bilateral trade. The USTR's Industry Trade Advisory Committee on Intellectual Property Rights includes representatives of Pfizer, Eli Lilly and Company, PhRMA, Merck & Company, Inc., Biotechnology Industry Organization, Time Warner, Inc., International Anti-Counterfeiting Coalition, Recording Industry Association of America, Intellectual Property Owners Association, John Wiley and Sons, Inc., and Association of American Publishers. *None* of these

[42] Barton, John, *Nutrition and Technology Transfer Policies,* (2003) *at* http://www.iprsonline; Lettington, Robert, *Small-Scale Agriculture and the Nutritional Safeguard under Article 8(1) of the Uruguay Round Agreement on Trade-Related Aspects ofIntellectual Property Rights: Case Studies from Kenya and Peru* (2003) *at* http://ww.iprsonline; Rai Arti and Eisenberg, Rebecca, ''The Public Domain: Bayh-Dole Reform and the Progress of Biomedicine", 66 *Law and Comtemporary Problems* (2003), p. 289.

[43] Hammer, Peter, ''Differential Pricing ofEssential AIDS Drugs: Markets, Politics and Public Health'', 5 *J. Int'l* Econ. L. (2002) p. 883, 888.

[44] Drahos, Peter, ''Securing the Future ofIntellectual Property: Intellectual Property Owners and their Nodally Coordinated Enforcement Pyramid'', 36 *Case Western Reserve J. Int'l* Law (2004), p. 53, 55-61.

[45] International Chamber of Commerce, *Current and Emerging Intellectual Property Issues for Business: a Roadmap for Business and Policymakers, at* http://www.iccwbo.org, 1, 13 (2005).

firms or organizations is pressing for more balance between private rights and the public domain. The reach of these advisory committees can be quite broad and US-based firms work with their subsidiaries abroad to develop support for their positions. Significantly in the November 2002 US congressional elections a group of global PhRMA firms, headed by Pfizer CEO Hank McKinnell, raised $30 million for Republican congressional campaigns.[46] Not coincidentally, the Bush administration has been very supportive of and responsive to global pharma's objectives and strategies.

Industry representation in the USTR advisory committees, overlapping memberships in industry associations such as the PhRMA, Business Software Alliance (BSA) and the International Intellectual Property Alliance (IIPA) increase the information exchange among private actors and the USTR to monitor compliance, negotiate and enforce TRIPS-Plus[47] deals and lobby at national and multilateral levels. For example, Microsoft is a member of the IIPA, BSA and IFAC-3.[48] In addition to these more formal vehicles for representation and influence, firms also participate in ad hoc mobilization groups such as the American BioIndustry Alliance (ABIA).[49] Jacques Gorlin founded the ABIA in 2005. Gorlin was a key player in the original TRIPS negotiations as consultant to the Intellectual Property Committee (IPC). The IPC, made up of 12 CEOs of US-based global firms with large intellectual property portfolios, mobilized transnational private sector and governmental support for TRIPS and drafted major portions of TRIPS.[50] Gorlin formed the ABIA to continue industry advocacy in multilateral, bilateral, and US government forums. Member companies include: Bristol Myers-Squibb, Eli Lilly, Hana Biosciences, General Electric, Merck, Pfizer, Procter & Gamble and Tethys Research (ABIA). At least half of these firms participated in the original IPC. Gorlin serves as President, and Susan Finston, formerly of PhRMA, serves as Executive Director. ABIA is leading the lobbying fight to preserve and promote patents on life forms and is targeting activities at WIPO, WTO and Convention on Biological Diversity (CBD). The ABIA plans to lobby its allies, the US, Australia, Canada,

Ireland, Doug, "Under the Counter", *POZ Magazine, at* http://www.poz.com/articles/1056_7008.shtml(2006).

[47] TRIPs-Plus refers to provisions that either exceed the requirements of TRIPS or eliminate TRIPS flexibilities.

[48] Drahos, *supra,* n. 44, at 69.

[49] *At* http://www.abialliance.com

[50] Sell, supra, n. 2.

Korea, Japan and New Zealand, as well as work with India's bio¬technology industry to try to soften India's negotiating stance.[51] This thick and overlapping network has resulted in a centralized system of private governance that enlists the U S T R for legitimation and enforcement and heightens opportunities for rent-seeking.[52]

Patents confer withholding power, the ability to restrict use, by constructing scarcity.[53] Patent owners can refuse to license patented products or processes, as James Watt did in the case of his steam engine technology.[54] Patent owners can refuse to make their products or processes available. The following pharmaceutical cases illustrate how this power to withhold can imperil public health.

Brand name pharmaceutical companies responded to developing country and N G O access campaigns by announcing generous price reductions, and expanded availability of their products for H I V/ A I D S patients in developing countries. However, having earned their public relations kudos and positive reactions from their share¬holders, they have not always followed through on their pledges. For instance in 2002 the sole producer of tenofovir disoproxil fumarate (Viread®), an important antiretroviral drug with fewer side effects for A I D S patients, Gilead announced that it would make Viread available at reduced prices to 97 developing countries through its Viread Access Program.[55] Over three years later, Viread is registered for use in only six countries.[56] Gilead has not even *requested* marketing clearance in most developing countries.

Abbott Laboratories received approval of Kaletra in the US in October 2005. Kaletra is a second-line fixed dose combination of protease inhibitor lopinavir and booster ritonavir (L P V/r) that has particular advantages for developing countries' H I V / A I D S patients.

[51] IP-Watch, *Biotech Industry Fights Disclosure in Patents on Three IP Policy Fronts,* M a r c h 2 *at* http://www.ip-watch.org (2006).

[52] Drahos, *supra,* n. 44, at 77.

[53] M a y, Christopher and Sell, Susan K., *Intellectual Property Rights: A Critical History* (Boulder: Lynne Rienner, 2006), p. 36.

[54, 55] Id. 38.

[55] Medecins Sans Frontieres, *Gileads* Tenofovir 'Access Program' for Developing Countries: A Case of False Promises? February 7 *at* http://www.doctorswithout-bordersorg/pr/2006/02-07-2006.htm (2006).

[56] *Id.* The six countries are: the Bahamas; G a m b i a; K e n y a; R w a n d a; U g a n d a; and Zambia.

Patients need only take 4 pills a day (versus six) and the pills require no dietary restrictions. Crucially the formula is heat stable, requiring no refrigeration.[57] WHO has recognized LPV/r as an essential medicine as part of a second-line HIV/AIDS therapy once first-line failure has occurred. Since May 2002 Abbott has been selling an earlier, non-heat stable formulation in Africa and least developed countries for $500 per patient per year. MSF has asked Abbott to register the new drug in developing countries and to set an affordable differential price for the new drug in developing countries. Abbott has claimed that it first needs to acquire a Certif¬ icate of Pharmaceutical Product (CPP) from Europe (the drug is manufactured in Germany) before it can register the new drug in developing countries. However, according to WHO guidelines and US regulations CPP's may be issued by the *exporting* country (the US FDA in this instance).[58] MSF placed a Kaletra order for 400 MSF patients in nine countries in March 2006. While Abbott announced that it would make the new drug available for $500 per patient per year in African and least developed countries, the drug is unavailable for purchase because Abbott has not registered it anywhere but South Africa. As MSF states, ''if access to needed drugs depends on the marketing policies of pharmaceutical compa¬ nies, then the lives ofmillions ofpeople with HIV/AIDS remain at risk.''[59]

A particularly pernicious example of this is the Gleevec case in South Korea. Gleevec is a leukemia drug that was developed with assistance from the US Orphan Drug Act, under which the US government paid for 50% of the private sector costs of clinical tri- als.[60] Swiss drug maker Novartis owns the patent. The drug costs roughly $27,000 per year per patient in the US, keeping it out of reach of most. In late 2001 Novartis suspended supply of Gleevec to South Korea because Novartis failed to get the price it sought

[57] Doctors Without Borders, *Abbott's* New and Improved Kaletra: Only in the US ... But What about the Rest of the World? March 14, *at* http://www.doctorswith-outborders.org/news/hiv-aids/kaletra_briefingdoc.cfm (2006).

[58] Doctors Without Borders, *Unnecessary Delays by Abbott: The "CPP" Myth Debunked,* March 14 *at* http://www.doctorswithoutborders.org/news/hiv-aids/kale-tra_cppdoc.htm (2006).

[59] Doctors Without Borders, *More Empty Promises: Abbott Fails to Supply Critical New AIDS Drug Formulation to Developing Countries,* April 27 *at* http://www.doc-torswithoutborders.org/pr/2006/04-27-2006_1.cfm (2006).

[60] Ip-health, *Re: Callfor Endorsements on Glivec [sic] from South Korea,* Nov. 30 *at* http://lists.essential.org/pipermail/ip-health/2001-November (2001).

from the South Korean government. The US, Switzerland, and Japan had accepted the price of US$19.50 per pill[61] during the Novartis-South Korean negotiations. Novartis directly approached Korean leukemia patients offering them a co-payment exemption if they would convince the South Korean government to accept that price. The patients refused. Rather than negotiating a lower price, the South Korean government sought to contain costs by excluding chronic phase chronic myelogenic leukemia (CML) patients from insurance coverage. Hae-joo Chung, Director of Equipharm project, issued a plea on behalf of the People's Health Coalition for Equitable Society for global consumer and health groups to endorse its quest to get the South Korean government to restart negotiations with Novartis and resume supply - even if meant resorting to compulsory licensing in line with the Doha Declaration on TRIPS and Public Health.[62] These health groups appealed to the Korean Intellectual Property Office and requested adjudication for the grant of a non-exclusive license to import generic Gleevec from India for the public interest, because Korean CML patients were imperiled by unstable supplies and high prices.[63]

While Novartis is a Swiss company, the USTR supported Novartis in this case. Facing declining profitability in the European market, makers of potentially high profit drugs like Gleevec are turning to emerging middle income markets in Asia and Latin America to make up the difference.[64] In order to ensure the success of this strategy they must fend off generic challengers in these markets. As Benevisti and Downs suggest, the USTR intervened on behalf of Novartis in order to "prevent a precedent that might eventually damage the profitability of products manufactured by its own firms."[65] Indeed, the Korean decision to reject the generic importation option under compulsory license incorporated the very language that USTR Robert Zoellick had been promoting in his efforts to limit the scope of the Doha Declaration on TRIPS and Public Health. The Korean government denied the petition on the grounds that CML was neither "infectious" nor likely to cause "an

[61] Daily dosages range from 4 to 8 pills a day.

[62] Ip-health, *supra,* n. 60.

[63] Ip-health, *Text of Korean Decision in Glivec Case* Mar. 10 *at* http://lsits.essential.org/pipermail/ip-health/2003/March (2003).

[64] Benvenisti, Eyal, and Downs, George, "Distributive Politics and International Institutions: the Case of Drugs", 36 *Case Western Reserve J. of Int'l* l. (2004), pp. 21-52.

[65] *Id, at* 29.

extremely dangerous situation in our nation.''[66] As James Love of CpTech remarked, '"the US government does not control the price of drugs in its own country but it is telling Korea what they should charge."'[67] More accurately, the US is telling Korea to do as the US does and let the sellers (Novartis, in this case), set the price.[68] This example highlights the intrusive reach of what Drahos calls the ''nodal enforcement pyramid'' that global IP-based firms and their governments deploy.[69] Asymmetrical power relations and the political influence of global high-technology industries continue to shape intellectual property policy. Given the expansion of intellec¬ tual property rights and unequal distribution of economic and political power across the globe, developing countries face sub¬ stantial challenges in navigating the system to their benefit.

Finally, brand-name pharmaceutical firms have continued to engage in aggressive tactics in developing countries. While the 1998 South African case in which brand name pharmaceutical firms sued Nelson Mandela is well known,[70] an ongoing case in the Philip¬ pines demonstrates that these tactics persist. Pfizer is suing the Phil¬ ippine government for parallel importing the Pfizer drug Norvasc for high blood pressure. In the Philippines this product is only available from Pfizer. In the Philippines Norvasc costs twice as much as it does in Indonesia and Thailand. India sells the drug for 650% less than the Philippine price. The Philippines imported and registered, but did not market, 200 tablets of the patented drug from India.[71] The Bureau of Food and Drug (BFAD) provided Pfizer with written assurances that it would not market the drug until Pfizer's patent expired. Pfizer charged the government with infringement, and is not only suing the BFAD and Philippine International Trading Corporation (PITC) but is also suing BFAD Director Leticia Barbara Gutierrez and Emilio Polig (a BFAD

[66] IP-health, *supra,* n. 62; *See also* Abbott, Frederick ''The WTO Medicines Decision: World Pharmaceutical Trade and the Protection of Public Health'', 99 *A. J. Int'l* L. (2005), pp. 328-336.

[67] Love, quoted in Benvenisti and Downs (2004), *supra,* n. 64.

[68] E-mail from Kenneth Shadlen, Lecturer in Development Studies, the London School of Economics, April 26, 2006, on file with author.

[69] Drahos (2004), *supra,* n. 44.

[70] Bond, Patrick ''Globalization, Pharmaceutical Pricing, and South African Health Policy: Managing Confrontation with US Firms and Politicians'', *29 Int'lJ.* of Health Services (1999), p. 765.

[71] IP-Watch, *Pfizer Fights IP Flexibilities in the Philippines,* April 30 *at* http:// www.ip-watch.org (2006).

officer) for damages. Pfizer claims that it is acting to protect its patent and denies that it is a parallel importation case because Pfizer does not believe that the Indian supplier was a Pfizer-authorized source. PITC has filed a countersuit against Pfizer. Stanford alumni and graduate students launched a signatory campaign to oust Pfizer CEO Henry McKinnell from the Stanford Advisory board over Pfizer's ''bullying'' ofPhilippine government drug regulators.[72]

In attacking portions ofthe 2006 WHO Commission on Intellec¬ tual Property, Innovation, and Public Health (CIPIH) report[73], Eric Noehrenberg of IFPMA argued that the report repeated the ''myth that patents give the power to set prices.''[74] He goes on to state that ''such a misrepresentation ignores the effect of competi¬ tion between drugs.''[75] However, in the Philippines case it is precisely the *lack* of competition that has caused the problem, and Pfizer actively is seeking to prevent or at least delay competition.

This behavior clearly poses dangers to public health. Expanded intellectual property rights, economic concentration and strong-arm tactics against vulnerable populations add up to a precarious situa¬ tion. These cases highlight the vulnerabilities associated with rely¬ ing only on the decisions of private companies. As Drahos and Braithwaite conclude:

> Patent-based R & D is not responsive to demand, but to ability to pay ... Much of what happens in the...health sectors of developed and developing countries will end up depending on the bidding or charity of biogopolists as they make strategic commercial decisions on how to use their intellectual property rights.[76]

FTA TRIPS-PLUS PROVISIONS:BARRIERS TO ACCESS

In recent years intellectual property protection has been dramati¬ cally expanded, notably through the WTO TRIPS but also in bilat¬ eral and regional free trade agreements (FTAs). The baseline for property rights has moved quite far in the direction of private

73 *Id.*

73 WHO, *CIPIH Report, at* http://www.who.int/intellectualproperty (2006).

74 Noehrenberg, Eric, ''Report of the Commission on Intellectual Property Rights, Innovation and Public Health: an Industry Perspective'', 84 *Bulletin of the World Health Organization* (2006), p. 419.

76 *Id.*

76 Drahos, Peter with Braithwaite, John, *Information Feudalism: Who Owns the Knowledge Economy?,* (Earthscan, London, 2002), pp. 167-8.

reward over public access. Rights which used to be considered to be privileges or exceptions have superseded obligations of rights holders to the public. To insist that all countries adopt high protectionist standards of protection denies them the opportunity to pursue the public policy strategies that every "developed" country enjoyed. Lax intellectual property protection, compulsory licensing, working requirements, keeping certain sectors off-limits in terms of property rights, parallel importing, and discriminating against foreign rights holders were all key features of the developed countries' public policy strategies.[77] Intellectual property rights should be the servant, not the master, of broader public policy goals. However, in the past twenty years intellectual property rights have been elevated from servants to masters - crucial for their own sake.

Focusing on TRIPS and the letter of the law, one can see that TRIPs offers much flexibility for states to tailor their intellectual property policies to suit public policy goals. However, public international law such as TRIPS is embedded in a broader context of asymmetrical power relationships between developed and developing countries, and between producers and consumers of the fruits of intellectual property. This context reduces the amount of leeway that poorer and/or weaker states have in devising regulatory approaches that are most suitable for their individual needs and stages of development.

One of the most important assets for developing country negotiators is peripheral vision to stay abreast of the proliferation of intellectual property policymaking in diverse institutional settings. The US and the EU have been able to exploit resource disparities and shift forums whenever it suits their interests. This holds true of the shift from WIPO to WTO and back again,[78] as well as the shifting between multilateral, bilateral and regional negotiations. Bilateral and regional agreements threaten to undermine any gains that developing countries may bargain for or achieve in multilateral settings. At the end of the Uruguay Round negotiators did not share consensual assessments of TRIPS. Negotiators from the United States and the European Union tended to see TRIPS as a floor - a minimum baseline for intellectual property protection. By

[77] May and Sell, *supra,* n. 43, 107-131.

[78] Sell, Susan K., *Power and Ideas: North-South Politics of Intellectual Property and Antitrust* (State University of New York Press, 1998); Drahos and Braithwaite, *supra,n.* 2.

contrast, developing country negotiators saw it more as a ceiling - a maximum standard of protection beyond which they were unwilling and/or unable to go.

Given this perspective, it should come as no surprise that the US and the EU aggressively have been pursuing efforts to ratchet up TRIPS standards, to eliminate TRIPS flexibilities and close TRIPS loopholes. Playing a multi-level, multi-forum governance game, countries like the United States have been able to extract a high price from economically more vulnerable parties eager to gain access to large, affluent markets.[79] Bilateral Investment Treaties, Bilateral Intellectual Property Agreements, and regional FTAs concluded between the US and developing countries, and between the European Union and developing countries invariably have been TRIPS-Plus.[80] According to Dylan Williams, "a recent US Congressional Research Service report states that the United States' main purpose for pursuing bilateral FTAs is to advance US intellectual property protection rather than promoting more free trade."[81]

TRIPS permits countries to exceed TRIPs standards and the US has been pressuring them to do so. It has offered countries WTO-Plus market access in exchange for TRIPs-Plus policies.[82] Particular provisions in these bilateral and regional trade agreements include: (1) data exclusivity provisions; (2) prohibitions of parallel importation; (3) linkage between drug registration and patent protection; (4) highly restrictive conditions for issuing compulsory licenses; (5) expanded subject matter requirements; and (6) patent term extensions. All of these provisions have been crafted by the

[79] Abbott, *supra,* n. 66, pp. 350-354.; Correa, Carlos, "Investment Protection in Bilateral and Free Trade Agreements: Implications for the Granting of Compulsory Licenses", *26 Mich. J. Int'l* L. (2004) p. 331; Vivas-Eugui, David, *Regional and Bilateral Agreements and a TRIPS-plus World: the Free Trade Area of the Americas (FTAA),* Quaker United Nations Office, Quaker International Affairs Programme, and International Centre for Trade and Sustainable Development, *at* http://www.quno.org. (2003).

[80] Drahos, Peter, "BITS and BIPS: Bilateralism in Intellectual Property", 4 *Journal of World Intellectual Property* (2001), 6; Duffield, Graham, "Sharing the Benefits of Biodiversity: Is there a Role for the Patent System?", *Journal of World Intellectual Property* (2003).

[81] Williams, Dylan, "World Health: A Lethal Dose of US Politics", June 16, 2006. *Asia Times* Online *at* http://www.atimes.com (2006).

[82] Shadlen, Ken, *Policy Space for Development in the WTO and Beyond: the case of Intellectual Property Rights,* Tufts University, Global Development and Environment Institute, Working Paper No. 05-06, 11 *at* http://ase.tufts.edu/gdae (2005).

brand-name pharmaceutical industry and serve to reduce the availability of affordable drugs. I will discuss each of these in turn.

Brand name pharmaceutical firms favor data exclusivity provisions because they offer new rights and opportunities to maximize returns on their products by delaying competition. Under Article 39.3 of TRIPs WTO members must protect undisclosed test data on pharmaceutical products against unfair competition. Brand name pharmaceutical companies are required to submit efficacy and safety test data as part of the drug approval process. However, the FTA provisions require signatories to grant at least five years of data exclusivity counted from the date on which the product was approved (10 years for agrochemicals), whether or not it was patented and whether or not the data was disclosed. It also covers chemical entities that are not new.[83] As Musungu and Oh point out, "the first registrant of a new pharmaceutical product may obtain data protection even in the case of old and well known products."[84] These provisions are designed to require generic pharmaceutical producers to generate their own clinical trial test data, rather than rely on safety and efficacy findings of the brand name drugs in the generic drug approval process. Jerome Reichman points out that restricting the use of clinical trial data "could effectively empower rights holders to negate a state's ability to authorize marketing approval of equivalent drugs for a period of five to ten years."[85]

Brand name pharmaceutical companies, in effect, have acquired a new form of intellectual property right in their test data and information generated by that data.[86] As industry lobbyist Mickey Kantor points out, "data exclusivity is an independent intellectual property right, not to be confused with protection of patents."[87] This new right is independent of patent status and therefore presents a huge obstacle to generic competition. The US-CAFTA

[83] Correa, Carlos, *Implications of Bilateral Free Trade Agreements on Access to Medicines,84 Bulletin of the World Health Organization* (2006), p. 399, 401.

[84] Musungu, Sisule and Oh, Cecilia, *The Use of Flexibilities in TRIPS by Developing Countries: Can They Promote Access to Medicines?* CIPIH Study 4C. August. *at* http://who.int.org 1, (2005), pp. 59-60.

[85] Reichman, Jerome H., *Undisclosed Clinical Trial Data Under the TRIPS Agreement and Its Progeny: A Broader Perspective* 1 (2004). Available at http://www.iprsonline

[86] Shadlen, *supra,* n. 82, 19.

[87] Kantor, Mickey *US Free Trade Agreements and the Public Health* submission to WHO CIPIH, *at* http://www.who.int 1, 5 (2005).

agreement's Article 15.10 is the most extensive version of such provisions. In CAFTA Article 15.10 (a) & (b) fixed term prohibitions "are *distinct from patents.* They prevent marketing approval of drugs that are off-patent (e.g., in either or both the United States and [the CAFTA country]. *A restriction on marketing approval becomes another form of monopoly here granted in ways that the* TRIPS *Agreement does not require.*"[88] Would-be generic competitors will hesitate to move forward in this forbidding regulatory framework.

To require the patent owner's consent for marketing approval for a patented item means that it will be nearly impossible to use compulsory licensing as permitted by TRIPS. According to Abbott, "even if a license is granted to a generic producer/importer, the patent owner will be able to prevent marketing of the equivalent medicine (because it will not consent or acquiesce to marketing). The generic product cannot be put on the market on regulatory grounds, regardless of the grant of license with respect to the patent. [89]

Parallel importation is the importation of patented goods from another country. Under TRIPs, countries are free to determine the type of exhaustion regime they want to have. The principle of patent exhaustion refers to the patentee's ability to control the first sale of a product where the product is patented. The US has a national exhaustion regime, which has been incorporated into a number of FTAs. Under the US's national exhaustion regime the patent holder is the only person who has the authority to make the first sale of the product in the US. This prevents the importation of the patented product from another country without the permission of the US patent holder, drastically curbing the opportunities for parallel importation. This policy drove many American senior citizens in the past several years to take buses to Canada to purchase cheaper versions of brand name drugs. By contrast, proponents of access to medicines recommend an international exhaustion regime. Under this TRIPS-compliant alternative regime, the first sale of a patented product *anywhere* exhausts the patent holder's right to block parallel importation. For example using parallel importation,

[88] Abbott, Frederick *The Doha Declaration on the TRIPS Agreement and Public Health and the Contradictory Trend in Bilateral and Regional Free Trade Agreements,* Quaker United Nations Office, Occasional Paper 14, April *at* http://www.quno.org 1, 7 (2004). (emphasis in original).

[89]

countries can take advantage of differential pharmaceutical pricing policies in order to obtain cheaper patented goods. If a brand name pharmaceutical company sells a patented product more cheaply in country *x* than country **y,** country *y* could import the drug from country **x.** By mandating *national* exhaustion regimes, the FTAs are TRIPs-plus by eliminating a TRIPs-compliant opportunity to access more affordable patented drugs; this is especially crucial in the case of second-line HIV/AIDS drugs that are patented and for which no generics are available.

Patent protection and drug registration are linked in many TRIPs-Plus agreements. Under these provisions national health authorities are required to refuse to provide marketing approval to a generic drug if a patent on the drug is in force, unless the patent owner consents to such approval; additionally, the health authorities must inform patent owners of any applications for generic product approval.[90] This linkage and the data exclusivity provisions have a chilling effect on generic competition and compulsory licensing. In Abbott's view, they are designed to prevent registration and marketing approval of generics and "appear designed to negate the effective use of compulsory licensing by blocking the marketing of third party medicines during the term of patents. [91]

TRIPs permits compulsory licensing, albeit with some significant restrictions. The TRIPs amendment adopted in negotiations just before the WTO Hong Kong Ministerial meeting in December 2005 incorporated some cumbersome procedural requirements. However, TRIPs retained far more flexibility to issue such licenses than the bilateral and regional agreements have done. Under these agreements compulsory licensing is restricted to a very limited set of circumstances. For example, in both the US-FTAs with Singapore and Jordan compulsory licenses may not be issued except in the event of "national emergency or other circumstances of extreme urgency" (US-Singapore FTA, Article 16.7(6)(b)). Chapter 15 of the US-Morocco FTA limits use of TRIPs flexibilities to particular diseases (HIV/AIDS, malaria and tuberculosis and other epidemics) and to circumstances of "extreme urgency or "national emergency. The US had pushed for these exact limits during the deliberations over Paragraph 6 of the Doha Declaration but was rebuffed. Now it is seeking to incorporate its preferred language in the FTAs with the aim to sharply curtail the possibility of generic

Correa, *supra,* n. 83, 401.
Abbott, *supra,* n. 88, 1,12.

competition and compulsory licensing.[92] Chapter 15.9(2) of the US-Morocco FTA also requires Morocco to give up its right under TRIPs 27.3(b) to exclude plants and animals from patentability, thereby effectively expanding the subject matter available for patent protection.[93]

As Mickey Kantor claims, "Article 31, the Doha Declaration and the Paragraph 6 compromise are fundamentally 'exceptions' to the intellectual property protections embodied in the TRIPS Agreement... But these exceptions cannot swallow the rule: strong intellectual property protections remain essential to foster innovation and creativity."[94] Interestingly in the US, which has one of the strongest patent protection regimes in the world, medical R&D spending has doubled between 1995 and 2002; however in this same period, "the registration of new products has declined, as well as the therapeutic significance of products reaching the market... Pharmaceutical innovation has declined both in quality and quantity.[95] This fact raises important questions about the correlation that industry asserts between strong patent protection and innovation.

Finally, a number of the FTAs incorporate automatic patent term extensions beyond TRIPs' 20-year term. These extensions are not limited in time, despite the fact that the US limits extensions to compensate for delays in marketing approval to 5 years. Therefore the bilateral and regional agreements are not only TRIPs-Plus but are in fact, *US-Plus*. These agreements provide for automatic extensions for delays in patent examination and marketing approval. This is troubling in developing countries because their patent offices are under-staffed and stretched to the limit. According to Correa, because the grounds for patent term extension:

> Under FTAs are *independent, cumulative,* and *with no maximum period,* nothing seems to prevent a patent from being extended for *x* years due to a delay in its granting process, and for *y* more years due to a delay in the marketing approval process... These mechanisms will have the effect of making the public pay for any administrative delays, and generate increased flow of payments to pharmaceutical companies that can hardly be justified by any additional benefits to patients in developing countries.[96]

[92] *Id.* 10.

[93] Id.

[94] Kantor, *supra,* n. 87, 9.

[95] 't Hoen, Ellen "Report of the Commission on Intellectual Property Rights, Innovation and Public Health: a Call to Governments", 84 *Bulletin of the World Health Organization* 421 (2006).

[96] Correa, *supra,* n. 83, 401.

Significantly these provisions inject considerable uncertainty into the calculations of would-be generic competitors and could delay the introduction of competing and affordable products.[97]

Mickey Kantor offered a vigorous defense of TRIPs-Plus provisions in the bilateral and regional trade agreements reflecting the brand name pharmaceutical industry position. He takes issue with critics who "allege that TRIPS-plus provisions "extend beyond those expressly set forth in the TRIPS Agreement and thus violate TRIPS.[98] He argues that the provisions are TRIPS-compliant. His rhetoric misses the point. Provisions that "expressly extend beyond those set forth in TRIPS" are *by definition* TRIPS-Plus. He himself states that the "provisions often are more specific and provide greater intellectual property protection.[99] No one has ever charged that TRIPS-Plus provisions were *illegal* or *violated* TRIPS. Indeed, TRIPS explicitly provides that states may adopt provisions that exceed requirements of TRIPS. Critics of TRIPS-Plus provisions question their merits on public health, moral, human rights and economic development grounds.

RESISTANCE TO TRIPS-PLUS TRENDS

In recent years developing countries have begun to challenge the discrepancy between the multilateral rules and the TRIPS-Plus standards proposed in regional and bilateral agreements.[100] In late 2005, Ecuador and Colombia broke off talks with the US over TRIPS-Plus provisions and had refused to agree to TRIPS-Plus standards. However, in late February 2006 the US and Colombia concluded an agreement that includes TRIPS-Plus standards despite the best efforts of some Colombian negotiators to counteract them.[101] In Russia's simultaneous negotiations for its accession to the WTO as well as for a bilateral deal with the United States, Russia's lead negotiator on WTO accession, Maxim Medvedkov, has endorsed TRIPS but has balked at the TRIPS-Plus demands.

[98] Kantor, *supra,* n. 87, 3.

[99] *Id.*

[100] This resistance is neither limited to medicines nor to the trade arena. See Chon, Margaret "Intellectual Property and the Development Divide", 27 *Cardozo Law Review* (2006), p. 2821.

[101] IP-Watch, *Groups Decry Impact of IP and Health Terms in US Trade Agreements* March 3 *at* http://www.ip-watch.org (2006).

He stated that "'I think we have to draw a line between WTO and bilateral issues.'"[102] This reflects Russia's view of TRIPS as a ceiling and not a floor.

In May 2006 South American Ministers of Health from Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela issued an important Declaration on intellectual property, access to medicines and public health.[103] Noting the link between patents and the high cost of medicines, the Ministers endorsed their commitment to the Doha Declaration and expressed their intent to maintain TRIPS flexibilities such as compulsory licensing, parallel importing, and Bolar exceptions (that speed the registration of generic drugs). Furthermore they explicitly rejected TRIPS-plus provisions such as linking patent grants with marketing approval, and expanding the scope of patentability (e.g., patents on plants, animals, and second uses of known formulations).

In June 2006, the Committee on International Trade Law[104] adopted a resolution expressing concern over some WTO Member countries' pursuit of provisions in bilateral and regional agreements "that could not be secured through multilateral negotiations and urged governments to "refrain from using bilateral and regional trade negotiations and agreements to limit or eliminate flexibilities" in TRIPS "to support the protection of public health and to promote access to medicines for all. [105]

Resistance also has been emerging from WHO activities, and protests over the US-Thai FTA negotiations have become particularly sharp. This section first discusses activities at WHO, then the US-Thai FTA protests. It ends with a discussion of how these two threads intersected with US industry lobbyists' efforts to interfere

[102] IP-Watch, *Official: In WTO Talks US Pushes Russia to Restrictive TRIPS Standard,* October 24 *at* http://www.ip-watch.org (2005).

[103] *Declaratoria de Ministras y Ministros de America del sur Sobre Propiedad Intelectual, Acceso a los Medicamentos y Salud Publica* Geneva, May 23, 2006. I thank Maria Auxiliadora Oliveira for alerting me to the significance of this Declaration, and to Nicoletta Dentico for sending me both the full text and an unofficial English translation (on file with author).

[104] "composed of experts from around the world (including individuals who have served in important positions at the WTO and the European Commission, who are members of national Supreme Courts, who have served as senior trade negotiators and so forth)" Frederick Abbott, *Resolution of the International Law Association on Trade Agreements and Public Health,* Ip-Health Digest, vol. 1, #2088, message 2 June 20, 2006. http://www.cptech.org

[105] Id. Resolution No. 3/2006, International Trade Law Committee.

with the WHO and the Thai resistance in early 2006. The intersection between the US-Thai FTA and WHO processes provide a particularly vivid illustration of Drahos' discussion of the murky, deliberately opaque thicket that is industry-driven "nodal governance. [106]

WORLD HEALTH ORGANIZATION

The WHO is a specialized agency of the UN system. Its mandate is to direct and coordinate authority for health work.[107] The WHO has the largest budget of all the specialized agencies, with an annual budget of "$1.8 billion dollars contributed by its 193 member states."[108] Since TRIPS, the WHO increasingly has been drawn into trade issues, and NGOs have had considerable access to the institution.[109] Even though global pharma has an important voice in the WTO through its powerful OECD member states that contribute significant funding, at times the WHO has been criticized for its "failure to cooperate with the private sector. [110] For instance, in 1998 the US threatened to withdraw its WHO funding.[111]

WHO has set its work in the context of international human rights law, and has adopted access to essential medicines as an element in compliance with the right to health.[112] Under a human rights rubric, intellectual property is recast as "a social product with a social function and not primarily as an economic relationship. [113] According to critics of the access campaigns:

> By advocating these human rights of access, IP skeptics seek to create a conflict with intellectual property rights, which give their owners the right to control and

[106] Drahos, *supra,* n. 44.

[107] Stein, Eric "International Integration and Democracy: No Love at First Sight", 95 *Am. J. Int'l* L. (2001), p. 489, 497.

[108] Volansky, Mark J. Comment, "Achieving Global Health: A Review of the World Health Organization's Response", 10 *Tulsa J. Comp. Int'l* L. (2002), p. 223, 229.

[109] Stein, *supra,* n. 107, 489, 498.

[110] *Id.*

[111] Williams, *supra,* n. 81.

[112] Seuba, Xavier, "A Human Rights Approach to the WHO Model List of Essential Medicines", 84 *Bulletin of the World Health Organization* (2006), p. 405, 405.

[113] Chapman, Audrey, "The Human Rights Implications of Intellectual Property Protection", 5 *J. Int'l* ECON. L. (2002), p. 861, 867.

exclude others.... Since advocates view "human rights obligations" as having "pri¬ macy" over economic policies and agreements, then it follows that intellectual property rights are secondary, to be treated as limited exceptions.[114]

The human rights rubric seeks to elevate the rights of *patients* over patents, and to provide avenues for reporting violations of interna¬ tional human rights agreements. In November 2005 the UN Com¬ mittee on Economic, Social and Cultural Rights issued a General Comment highlighting the fact that intellectual property rights were limited in time and scope, whereas human rights were timeless.[115] While advocates of a human rights framing of access to health acknowledge that it is no panacea,[116] it does offer a broad rubric to mobilize stakeholders working on narrower issues to recognize their mutual interests.

The May 2003 World Health Assembly (WHA) meeting on improving access to essential medicines was particularly volatile. The United States presented a resolution that neglected even to *mention* the Doha Declaration and did little more than assert the value of strong intellectual property protection as a stimulus for innovation.[117] The US proposal further requested the WHO to refer member states to the industry-friendly WTO and WIPO for assistance in implementing TRIPS obligations.[118] Brazil proposed a resolution, supported by Bolivia, Ecuador, Indonesia, Peru, Venezuela, and South Africa on behalf of the members of the WHO African Region. The Brazilian proposal reflected developing

[114] Schultz, Mark and Walker, David, *How Intellectual Property Became Contro-versial: NGOs and the New International IP Agenda* 6 ENGAGE *at* http://www.ngowatch.org. 82, 84 (2005).

[115] Nygren-Krug, Helena Hogerzeil, Hans *Human Rights; A Potentially Powerful Source for Essential Medicines,* 84 Bulletin of the World Health Organization 5 (2006), 410.

[116] Industry boosters such as the US-based Federalist Society have co-opted this framing to assert that intellectual property rights are "human rights." They have adopted a real property discourse that obscures the very important differences between real property (which is scarce) and intellectual property (in which scarcity is *constructed* by law). http://www.fed-soc.org

[117] Posting ofNathan Ford, Nathan.FORD@london.msf.org, to IP-Health List-serv, *Sparks Fly Over Patents and Vital Drugs at World Health Assembly,* Lancet, May 31, 2003, *available at* http://lists.essential.org/pipermail/ip-health/2003-May/004816.html. (2003).

[118] Posting of Cecilia Oh, ceciliaoh@yahoo.com, to IP-Health Listserv, Third World Network Info. Service, *WHO Adopts Resolution on IPRs and Public Health After Wrangling Over Text,* Third World Network, May 29, 2003, *available at* http://lists.essential.org/pipermail/ip-health/2003-May/004815.html. (2003).

countries' concerns about access to medicines and called for an independent commission to examine the relationship between intellectual property rights, innovation, public goods, and public health. The developing countries sought an international committee much like the UK Commission on Intellectual Property Rights,[119] which was critical of overly strong patent rights as a barrier to access.[120] When it was clear that no one supported the US resolution, the Brazilian, American, and several African delegations worked out a compromise that a WHO committee adopted by consensus.[121] The resolution called for the establishment of a time-limited independent commission, the Commission on Intellectual Property Rights, Innovation and Public Health (CIPIH), and it omitted any reference to TRIPS-Plus obligations in bilateral and regional trade agreements. NGOs bemoaned the fact that the developing countries' proposals had been watered down in the compromise. However, the resolution prominently featured the Doha Declaration and endorsed the NGO/developing country approaches to the medicines issue by emphasizing the neglect of tropical diseases, the Doha Declaration's recognition that pharmaceutical products require special treatment, and the negative effects of patent protection on drug pricing.[122] Further, the resolution underscored the importance of making full use of TRIPS flexibilities. The director-elect of the WHO, Lee Jong-wook, announced measures to make Brazil's AIDS policy the foundation for the WHO efforts in this area. He asked the Brazilian Health Minister to release Paulo Teixeira, head of the administration's AIDS program, "to formulate the new policy for combating AIDS throughout the world, based on Brazil's experience."[123] This represented important recognition of Brazil's leadership role and support for the developing countries' and NGO positions.

[120] Commission on Intellectual Property Rights, *Integrating Intellectual Property Rights and Development Policy, at* http://www.iprcommission.org/papers/text/finalreport/reportwebfinal.htm 1, 22 (2002).

[121] World Health Assembly, *Resolution of the World Health Assembly: Intellectual Property Rights, Innovation and Public Health* WHA56.27 *at* http://www.who.int (2003).

[122] WHO, *Intellectual Property Rights, Innovation and Public* Health, 28 May. WHA 56.27 *at* http://www.who.int (2003).

[123] Posting of Mike Palmedo, mpalmedo@cptech.org, to IP-Health Listserv, *WHO to Adopt Brazilian Model to Fight AIDS/HIV,* Fin. Times Ltd., May 21, 2003, *at* http://lists.essential.org/pipermail/ip-health/2003-May/004779.html. (2003).

In April 2006 the WHO's Commission on Intellectual Property Rights, Innovation and Public Health (CIPIH) finally issued its report making numerous recommendations for improving health in developing countries.[124] The report's definition of "innovation" represented a major discursive breakthrough. For the first time, innovation has been defined as including not only the standard "discovery" and "development" components, but also *"delivery."* As Ellen't Hoen of MSF points out, "the report stresses that innovation is only meaningful when people can have access to the results of the innovation."[125] This is the first time that access has been linked to innovation. It is significant insofar as it changes the debate. Just as today one cannot talk about intellectual property without talking about public health, perhaps several years from now people will begin to assume a necessary relationship between innovation and *access.*

Furthermore, the report explicitly characterizes intellectual property protection as a means and not an end.[126] The report recommends that governments avoid provisions in bilateral trade agreements that could restrict access to medicines.[127] It urges companies to: adopt transparent and consistent pricing policies; reduce prices for developing countries; and avoid filing patents or enforcing them in low-income developing countries in ways that would inhibit access to their products.[128] Overall it highlights how the current patent-based system of drug development is inadequate to serve the needs of the poor.

A former Bush aide and USAID lawyer sharply criticized the CIPIH report for its bias in favor of generic drugs and its criticisms of US FTAs, which he defends as "the best tool to raise economic growth, and therefore health, in the developing world."[129] This focus on macroeconomic growth typically obscures these policies' distributional effects. As Margaret Chon points out:

[124] CIPIH Report, *at* http://www.who.int/intellectualproperty (2006).

[125] Ellen 't Hoen, "Report of the Commission on Intellectual Property Rights, Innovation and Public Health: a Call to Governments", 84 *Bulletin of the World Health Organization,* (2006), p. 421.

[a] Id.

[127] World Health Organization, "CIPIH Report: Main Recommendations", 84 *Bulletin of the World Health Organization* (2006), p. 351 (emphasis added).

[126, 128, 129] *Id.*

[129] Gardner, John, *Healthcare in the Developing World: Obstacles and Opportunities,* Tech Central Station May 9 2006 *at* http://www.tcsdaily.com/article.aspx7id=051906B (2006).

This approach dovetails with the interests of intellectual property industries whose short-term goals of maximizing revenue generation are not necessarily aligned with society's long term dynamic goals of maximizing innovation. While severely problematic even in the domestic welfare generating context, this type of crude welfare calculation can have brutal consequences in the context of intellectual property globalization.[130]

The CIPIH Report explicitly acknowledges the limitations of this prevailing instrumental perspective and calls for new approaches to medical R & D to better serve the poor. While it did not go as far as some health activists would have liked,[131] it is still a significant step forward for WHO in addressing health gaps.

At the WHA in late May 2006, Member States adopted a resolution, ''Public Health, Innovation, Essential Health Research and Intellectual Property Rights: Towards a Global Strategy and Plan of Action.[132] This resolution called for the establishment of an intergovernmental working group to develop a global framework to meet health needs by setting essential health R & D priorities and devising mechanisms for sustainable funding of R & D to meet public health needs. Kenya and Brazil had first proposed a needs-driven approach to essential health,[133] and exercised notable leadership in keeping this issue on the front burner throughout the deliberations. As James Love stated in praising the resolution, ''R&D is too important to be left up to one person (Bill Gates), one country (US NIH/CDC) or private investors only. It is also the beginning of a serious discussion of how we can reconcile incentives to innovate with access.''[134] These developments represent significant momentum at the WHO to consider alternative approaches to the TRIPS-Plus zeal of the US and its firms.

[130] Chon, *supra,* n. 100, 2831.

[131] Correa, Carlos, "the Commission on IPRs, Innovation Public Health - A Critique'', 122 *South Bulletin,* 15 April, 198, 198-199 *at* http://www.southcentre.org (2006). Professor Correa was one of the Commissioners.

[132] World Health Organization, *Public Health, Innovation, Essential Health Research an Intellectual Property Rights: Towards a Global Strategy and Plan of Action,* A59/A/Conf. Paper No. 8 27 May 2006 *at*www.who.int (2006).

[133] EB117 R13 *at*www.who.int.org

[134] James Love, *CPTech Statement on WHA Passage of Historic Resolution on: Public Health, Innovation, Essential Health Research and Intellectual Property Rights: Towards a Global Strategy and Plan of Action,* May 27, 2006 *at* http://lists.essential.org/pipermail/ip-health/2006-May/009631.html (2006).

THAILAND, FTA NEGOTIATIONS, THE US AND WHO

Thailand is another noteworthy site of resistance to the one-way TRIPS-Plus ratchet. Thailand was one of the first to suffer in the HIV/AIDS pandemic and the US has targeted Thailand as a culprit in numerous trade disputes over intellectual property and pharmaceuticals. PhRMA consistently has complained about Thailand and the USTR placed Thailand on its Section 301 Watch List every year between 1996 and 2000.[135] In 2001 Thai activists challenged Bristol-Myers Squibb over its antiretroviral drug didanosine (DDI) because the public US National Institutes of Health developed the drug. That same year the US threatened to impose trade sanctions against Thailand if it pursued compulsory licensing to produce DDI. "In 2002, a Thai court cited international statutes when it ruled that Thai HIV/AIDS patients could be injured by patents and had legal standing to sue if drug makers holding patents restricted the availability of drugs through their pricing policies. This verdict was upheld in January 2004 and Bristol Myers-Squibb settled out of court, surrendering its version of the drug to the Thai Department of Intellectual Property.[136]

The US has been trying to negotiate a US-Thai FTA and these deliberations became embroiled in a national political crisis. On April 4, 2006 caretaker Prime Minister Thaksin Shinawatra announced his decision to relinquish his claim as Prime Minister.[137] "After one of the longest anti-government mobilizations in Thailand's history. . . anti-government protestors forced Thaksin not to accept"[138] the post. While initially protesters focused on Thaksin, the People's Alliance for Democracy (PAD) expanded its attack to include the US-Thailand FTA negotiations. Prime Minister Thaksin had been conducting these negotiations unilaterally without consulting Parliament.[139] Eager to develop and expand Asian markets for its firms' pharmaceutical products, the US is hoping that a US-Thai FTA can provide a template for similar deals with Malaysia and Indonesia.[140]

[135] Sell, *supra,* n. 2, 128.

[136] Williams, Dylan C, "World Health: A Lethal Dose of US Politics", 16 June 2006, *Asia Times* Online *at* http://www.atimes.com (2006).

[137] Jacques-chai Chomthongdi, *Thaksin's* Retreat: Chance for Change or Consolidation of Power? 5 April, 2006 *at* http:// www/ftawatch.org (2006).

[138] *Id.*

[139] Williams, *supra,* n. 136.

[140] *Id*

On January 9th 2006, the chief American WHO representative to Thailand, Dr. William Aldis, published an opinion piece in the Bangkok Post warning Thailand about the high stakes involved in the US-FTA negotiations. His op-ed appeared in the midst of the sixth round of US-Thai FTA negotiations in Chiang Mai. He wrote that:

> If the outcomes of other US bilateral trade negotiations are anything to go by, Thailand may well be in for a rough ride. . . .To the surprise of many observers, these countries[141] have bargained away reasonable flexibilities and safeguards in the implementation of intellectual property rights provided by the World Trade Organization.[142]

He went on to point out that of over 600,000 Thais living with HIV/AIDS more than 80,000 have access to life-prolonging treatments "thanks to the supply of cheap locally produced generic drugs, and the target is 150,000 by 2008. As a result, Aids (sic) deaths in Thailand have fallen by an extraordinary 79%.[143] He concluded by stating that "giving up internationally agreed flexibilities in the implementation of intellectual property rights would put at risk the survival of hundreds of thousands of Thai citizens, and would likely bankrupt the 30 baht scheme in the process. [144]

In late March 2006, the late WHO director-general Lee Jong-wook[145] transferred Dr. Aldis from Bangkok to a research position in New Delhi. An Asia Times Online investigative report into this transfer revealed US industry lobbying behind what amounted to a demotion. At the time of his death in May 2006, according to the report, "Lee had closely aligned himself with the US government and by association US corporate interests, often to the detriment of the WHO's most vital commitments and positions, including its current drive to promote the production and marketing of affordable generic antiretroviral drugs. [146] Lee recalled Dr. Aldis after

[141] Australia, Chile, Morocco, Singapore, Bahrain and Central American countries.

[142] Aldis, William, *It Could Be a Matter of Life and Death: Thailand Should Think Carefully about Surrendering its Sovereign Right under WTO and Access to Cheap Medicine in Exchange for an FTA with the United States,* 9 January 2006. Bangkok Post *at* http://www.bangkokpost.com/News/09Jan2006_new19.php (2006).

[143] [144] *Id.*

[144] *Id.* The 30 baht scheme refers to the inclusion of HIV treatment in Thailand's 30 baht health care program which is designed to contain costs and make essential medicines affordable to those in need.

[145] He died of a sudden brain hemorrhage on the eve of the WHA meeting in late May 2006.

[146] Williams, *supra,* n. 135.

serving just over 15 months in what is traditionally a four-year posting.[147] While a regional WHO official in New Delhi attributed Aldis' removal to his "inefficiency," "Thai officials who worked alongside him through the 2004 tsunami and on-going avian-influ¬enza scare have privately contested this characterization."[148]

In fact, it appears that Dr. Aldis was being punished for his January op-ed opposing the TRIPS-Plus provisions of the US-Thai FTA proposals. The British medical journal *The Lancet* implied as much in its June article in which it characterized Dr. Aldis' transfer as a direct result of the editorial and "was a clear signal of US influence on WHO."[149] Aldis was critical of the US' mixing of commercial and public-health agendas and "chafed at WHO regional headquarters' instructions to receive representatives from US corpo¬rations and introduce them to senior Thai government officials to whom the private company representatives hoped to sell big-ticket projects and products."[150] During the spring of 2006, Pfizer and IBM requested WHO personnel in Thailand to facilitate access to senior Thai officials; "some senior WHO staff members have expressed their concerns about a possible conflict of interests, as the requested appointments were notably not related to any ongoing WHO technical-assistance program with the Thai government."[151]

On March 23, 2006, a US ambassador to the UN in Geneva met with Lee privately and expressed concerns about Aldis' edito¬rial. "A follow-up letter from the US government addressed to Lee impressed Washington's view of the importance of the WHO to remain 'neutral and objective' and requested that Lee personally remind senior WHO officials of those commitments."[152] The next day Lee contacted the regional WHO New Delhi office and told it of his decision to recall Aldis.[153] A Bangkok-based US official leaked the news of Aldis' transfer. A senior WHO official believes that Lee's decision and the US government's news leak were "specifically designed to engender more self-censorship among other WHO country representatives when they comment publicly

147 id.
148 id.
149 Benkimoun, Paul, "How Lee Jong-wook Changed WHO", 367 The *Lancet,* June 3, (2006), p. 1806.
150 Williams, *supra,* n. 136.
151 id.
152 id.
153 id.

on the intersection of US trade and WHO public-health policies."[154] Williams concludes that the Bush administration's tactics of trying to bring UN agencies into line with US commercial and political interests come at the expense of the WHO's "stated mission, commitments and global credibility as an impartial and apolitical actor."[155] In the meantime, Suwit Wibulpolprasert, senior adviser to the Thai Public Health Ministry, has requested that WHO provide an explanation for Dr. Aldis' abrupt removal.[156] At the time of this writing[157] this issue has sparked considerable consternation about lack of transparency and suppression of freedom of speech for WHO employees, but remains unresolved.

CONCLUSION

Contemporary trends are both disturbing and hopeful. The close ties between PhRMA, USTR and campaign contributions mean that US policy will likely remain aggressive. Furthermore, the revolving door that allows former high-level policymakers like Mickey Kantor to turn around and profit as lobbyists also erodes any image of policymakers as disinterested stewards of the "public interest." Inappropriate interference with agencies, like WHO, in pursuit of corporate agendas compromises the integrity of the agencies. These murky and opaque ways of conducting business provide ample opportunity for policies that put profits ahead of people. The recall of Aldis was a particularly ham-fisted example of US interference behind the scenes.

On the other hand, one may hope that revelations of inappropriate interference will provoke enough outrage to lead to new measures to ensure transparency. South American health ministers' unity behind TRIPS flexibilities and against TRIPS-Plus provisions is another hopeful development. They have pledged to be involved

[154] Id.

[155] *Id.*

[156] *String Pulling: Aldis Warned Against Thai-US Free Trade Pact,* The Bangkok Post June 20, 2006 *at* http://www.bangkokpost.com/News/20Jun2006_news03.php (2006).

[157] June 23, 2006.

in trade policymaking; to the extent that they are able to do so they can work to keep access to medicines a priority in trade negotiations. In any event it seems clear that they will not stand by the sidelines and let their governments bargain away TRIPS flexibilities without a fight.

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ORIGINAL PAPER

The new generation of international investment agreements: recent developments in the Asia-Pacific region

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Abstract Over the past decade, a number of countries in the Asia Pacific region have concluded a new generation of FTAs that liberalise trade in goods and services while also containing investment protection provisions. This paper provides an overview of the recent trends giving special attention to the impact of Investor State Dispute Settlement (ISDS) cases which has influenced the evolution of investment rule-making over the last decade. The paper asserts that investment disputes have influenced the refinement of the provisions of the new generation of investment agreements as well as the inclusion of a series of procedural and substantive innovations in these agreements.

Introduction

More than 40 years ago, European countries initiated the process of concluding bilateral investment treaties (BITs) to protect the private property of their investors in the territory of developing countries. Today, it is the countries of the Asia-Pacific region that are among the most dynamic participants in the process of concluding investment agreements. By June 2007, the Asia Pacific Economic Cooperation (APEC) countries had concluded almost 800 BITs representing about 30% of all agreements negotiated world-wide. China ranks second among all countries for the number of BITs concluded.

International investment agreements (IIAs) that have been negotiated to date generally fall into two groups. The first group, which is the most numerous, consists of BITs negotiated between two states to protect and promote investment of investors of one party in the territory of the other party. Those treaties date back to 1959 and traditionally have had a relatively uniform content that, until recently, had

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not changed markedly since their inception, apart from the introduction of provisions on investor-state dispute resolution in the 1960s.

A second group of IIAs consists of Free Trade Agreements (FTAs) containing investment chapters. These are agreements negotiated among countries, frequently from the same region, to facilitate the cross border movement of goods, services, capital or people. The term FTA, which is used here in a generic sense, ranges from agreements that only provide for economic cooperation to agreements that create a common market. Such agreements may be bilateral, plurilateral, regional, interregional or multilateral. They may involve states at the same or at different levels of economic development.

During the past decade, a number of countries, particularly those in the Asia-Pacific Region, have concluded a "new generation" of FTAs that liberalize trade in goods and services, while also containing investment protection provisions. This new generation of FTAs, like the new generation of BITs, has produced innovations in IIA practice. Further, during the same period, an increased number of Investor-State dispute settlement (ISDS) cases have generated a growing body of jurisprudence touching upon key procedural and substantive aspects of investment law.

This paper purports to provide an overview of recent trends in the negotiation of the new generation investment agreements, giving special attention to the impact of ISDS cases on the evolution of investment rule-making in recent agreements negotiated in the Asia-Pacific region. In particular, we argue that international ISDS experience over the last decade has influenced the development of a new generation of IIAs in the Asia-Pacific Region. This new group of IIAs is mostly composed of investment chapters negotiated in the context of FTAs between several countries of the Asia-Pacific Region and the United States. This paper asserts that investment disputes have influenced the refinement of the provisions of this new generation of IIAs as well as the inclusion of a series of procedural and substantive innovations in these agreements.

The paper is structured as follows. "Recent trends in international investment agreements" will present an overview of the context in which investment negotiations have taken place over the last decade. "Effect of ISDS jurisprudence on investment rule-making" focuses on how the ISDS experience has impacted the investment rule-making in several countries of the Asia-Pacific Region. In particular, the section will infer the main features of new generation of IIAs and explain how such features respond to challenges derived from the interpretation of substantive and procedural provisions included in previous IIAs. "Conclusions" addresses the implications of all these developments for the countries of the Asia-Pacific region, and also presents some final reflections on next steps that these countries could take to implement the lessons learned from the ISDS experience.

Recent trends in international investment agreements

An overview of the international investment agreements that have been negotiated over the past decade show five major trends.

- Proliferation of International Investment Agreements (IIAs)

First, the number of IIAs negotiated world-wide has increased dramatically over the last 10 years. As shown in Fig. 1 although the number of Bilateral Investment

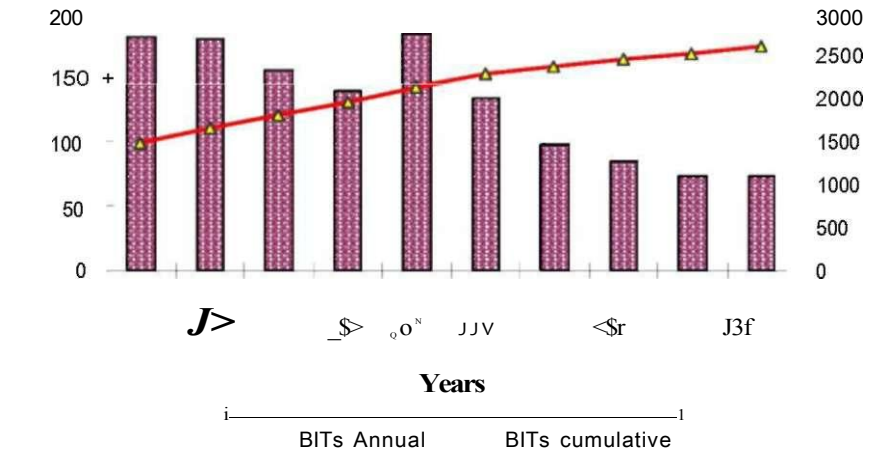

Fig. 1 Number of cumulative BITs : 1997-2007 Source: U N C T A D (http://www.unctad.org/iia)

Treaties (BITs) negotiated by year has declined over the last 5 years, the cumulative number of these agreements has continued to increase, reaching by June 2007, approximately 2,593.

Furthermore, in recent years, international investment rules have increasingly been adopted as part of Free Trade Agreements (FTAs). These agreements, in addition to containing a variable range of trade liberalization and promotion provisions, contain commitments to liberalize and/or to protect investment flows between the parties. The number of economic integration agreements worldwide has been growing steadily and, by the end of 2007, reached approximately 250. At least 68 new agreements were concluded between 2004 and end 2007. Thus, as Fig. 2 shows, while the rate at which new BITs have been concluded has slowed down, the

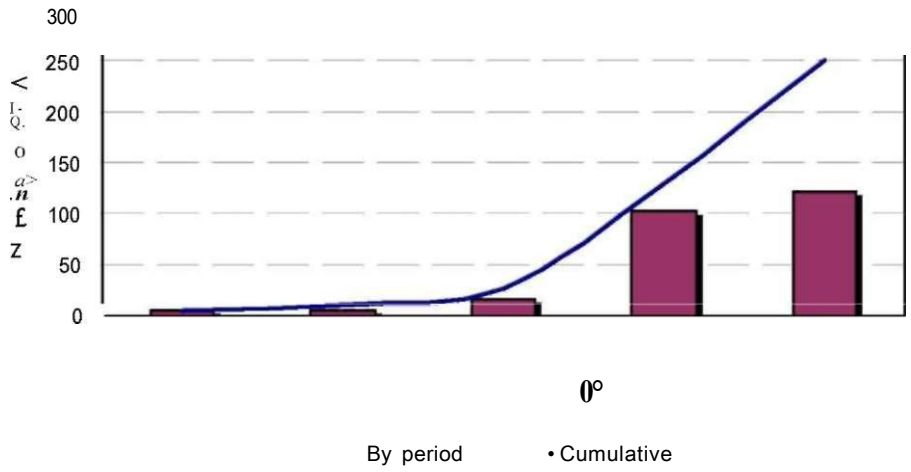

Fig. 2 Proliferation of Free Trade Agreements with Investment Provisions: 1960-2007 Source: U N C T A D

rate at which new FTAs with investment provisions have been concluded is increasing.

- Increased sophistication and complexity

A second trend characterizing the context in which IIAs have been negotiated over the last decade is that negotiations of these treaties tend to include an expanded range of issues. Numerically, traditional BITs limited to the protection of established foreign investment continue dominating the IIA universe. Nevertheless, a growing number of BITs include more sophisticated investment protection provisions as well as liberalization commitments. Compared to BITs, RTAs show far more variation in their scope, approach and content. Moreover, recent FTAs tend to encompass a broader range of issues that in the most comprehensive agreements may include not only investment protection and liberalization, but also trade in goods and services, intellectual property rights, competition policy, government procurement, temporary entry for business persons, transparency, the environment, and labour rights. Recent FTAs concluded by countries such as Australia, Chile, Japan, Singapore, and the United States are especially comprehensive and detailed.

Not all recent IIAs have followed this pattern, however. Some recent agreements have remained rather narrow in their coverage of investment issues. These limit themselves to establishing a framework for cooperation on promotion of investments. Recent examples include the FTAs between the European Free Trade Association (EFTA) countries and Romania and Croatia; bilateral Trade and Investment Cooperation Agreements between Canada and South Africa; and the ASEAN Framework Agreements with China and India (2002 and 2003, respectively). They lay down general principles with respect to further investment liberalization, promotion and protection and pave the way for the future creation of a free trade and investment area. Other examples include a number of framework agreements on trade and investment relations between the United States and countries in Africa and the Middle East. The cooperation provided for is typically aimed at creating favourable conditions for encouraging investment, notably through the exchange of information. It is also common for such agreements to setup consultative committees or a similar institutional arrangement between the parties to follow up on the implementation of negotiated commitments and to discuss and study possible obstacles to market access for trade and to the establishment of investment.

Further, international investment rules are becoming increasingly sophisticated. Some recent IIAs include significant revisions of the wording of various substantive treaty obligations. One major impetus for these revisions was the conclusion and implementation of the North American Free Trade Agreement (NAFTA) among Canada, Mexico, and the United States. Arbitrations under the investor-state dispute resolution provision of NAFTA raised issues or resulted in arbitration that prompted the parties to reconsider some of the language used in their IIAs. For example, the United States subsequently modified the language of its BITs and FTAs to clarify the meaning of "fair and equitable treatment" and the concept of indirect expropriation. Both changes were intended to limit the scope that arbitral tribunals might otherwise have given to the relevant provisions of the BITs.

As discussed below, some recent FTAs have also made significant innovations in investor-state dispute resolution procedures. Among the objectives pursued with these

changes is to increase transparency by authorizing open hearings, publication of related documents, and the submission of *amicus curiae* ("friend of the court")briefs bynon-disputants who have an interest in the outcome of the dispute. Another goal of the innovations is to promote judicial economy by providing for early dismissal of frivolous claims and by attempting to prevent the presentation of the same claim in multiple fora. Other changes aim to foster sound and consistent results, include provisions for an appeals mechanism and consultation with treaty parties on certain issues.

- Increased South-South Cooperation

Third, over the last decade, there has been increased South-South cooperation as far as negotiation of IIAs is concerned. Although, developed countries seeking to protect their investments continue to be the most active treaty makers, many developing countries, however, are also extremely active participants in the process of concluding IIAs. This reflects in part their desire to attract foreign investment, but also their emerging status as sources of outward investment. For example, by June 2007, China had concluded 119 BITs and was second only to Germany in the number of BITs concluded. Among developing countries, A P E C members include many of the most active participants in BIT negotiations. As shown in Table 1 below, by June 2007, the Republic of Korea had concluded 87 BITs, Malaysia 66 and Indonesia 60. A l l together, A P E C members had concluded a total of 799 BITs by June 2007, representing about 30% of all BITs.

- Increasing activism in Investor-State Dispute Settlement

The fourth trend characterizing the context in which IIAs have been negotiated is the increased number of investor-State disputes. Provisions concerning investor-State dispute settlement have been included in IIAs since the 1960s. However, the

Table 1 Number of BITs concluded by A P E C countries, June 2007

Name of economy	Number of BITs
China	119
Korea, Republic of	87
Malaysia	66
Indonesia	60
Russian Federation	53
Chile	52
United States	48
Viet Nam	49
Philippines	35
Thailand	38
Peru	31
Singapore	30
Canada	25
Australia	22
Taiwan Province of China	20
Mexico	23
Hong Kong, China	15
Japan	12
Brunei Darussalam	5
Papua New Guinea	5
New Zealand	4

Source: U N C T A D (http://www.unctad org/iia)

use of these provisions to institute arbitral proceedings has been rare until the last decade. From 1987—when the first investor-State dispute based on a BIT was recorded under the arbitral proceedings of the International Centre for Settlement of Investment Dispute (ICSID), under the auspices of the World Bank, until April 1998, only 14 BIT-related cases had been brought before ICSID, and only two awards and two other settlements had been issued.[1] However, since the late 1990s, the number of cases has grown enormously. As Fig. 3 illustrates, the cumulative number of treaty-based cases had risen to at least 290 by the end of 2007, with 182 brought before ICSID (including ICSID's Additional Facility) and more than 100 before other arbitration fora.[2]

International investment disputes can also arise from contracts between investors and governments; a number of such disputes are (or have been) brought before ICSID, other institutional arbitration systems or ad-hoc arbitration. They have not been included in these data, except where there is also a treaty-based claim at stake. More than two-thirds (70%) of the claims were filed within the past 4 years, with virtually none of them initiated by governments.[3]

The surge in the number of claims can be attributed to several factors. First, increases in international investment flows lead to more occasions for disputes, and more occasions for disputes combined with more IIAs are likely to lead to more cases. Second, with larger numbers of IIAs in place, more investor-State disputes are likely to involve an alleged violation of a treaty provision and more of them are likely to be within the ambit of agreed dispute settlement procedures. Another reason may be the higher complexity of recent IIAs, and the regulatory difficulties in their proper implementation. Further, as news of large, successful claims spreads, more investors may be encouraged to utilize the investor-State dispute resolution mechanism. Greater transparency in arbitration (e.g. within the NAFTA) may also be a factor in giving greater visibility to this legal avenue of dispute settlement.

Interestingly, the majority of the countries of the Asia-Pacific region still have not been frequently subjected to ISDS procedures—with the exception of Mexico, Canada, the United States and the Russian Federation. According to UNCTAD[4], at least 73 governments—44 of them in the developing world, 15 in developed countries and 14 in South-Eastern Europe and the Commonwealth of Independent States—have faced investment treaty arbitration. Argentina tops the list with 46 claims lodged against it, 44 of which relate at least in part to that country's financial

[1] *Asian Agricultural Products Ltd. v. Republic of Sri Lanka,* ICSID Case No. ARB/87/3, 27 June 1990 (United Kingdom of Great Britain and Northern Ireland/Sri Lanka BIT). Note: unless otherwise indicated, all cases can be found on the ICSID webpage at http://www.worldbank.org/icsid/cases/cases.htm or at http://ita.law.uvic.ca/chronological_list.htm.

[2] United Nations Conference on Trade and Development (UNCTAD) (2008) *Latest developments in Investor-State dispute Settlement, IIA MONITOR No. 1, 2008, International investment agreements,* (Geneva: United Nations).

[3] The sole known exception is a 2003 State-to-State dispute between Chile and Peru that was lodged in response to an investor-State claim filed by a Chilean firm, Zucchetto *(Zucchetto S.A. and Zucchetto Peru S.A. v. Republic of Peru,* ICSID Case No. ARB/03/4). The State-State procedure was discontinued, and the investor-State case was only recently decided. In other instances, States have set up claims commissions to deal with investor-to-State cases, such as the Iran-United States Claims Tribunal.

[4] *Supra* note 5.

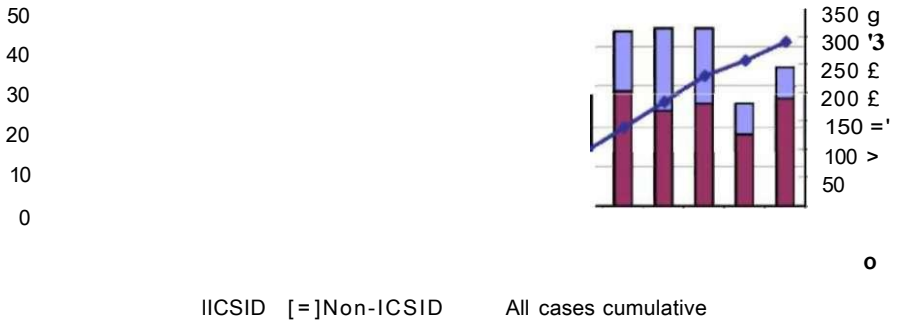

Fig. 3 Known investment treaty arbitrations, (cumulative and newly instituted cases, by year)

crisis early in this decade. Four new arbitration cases were submitted against Argentina in 2007. Mexico continues to have the second highest number of known claims (18), with no new cases in 2007. The Czech Republic has the third highest number of claims filed against it, with 14 (with two new cases filed in 2007). Canada and the United States come next, with 12 cases each. Ecuador, India and Poland (with 9 cases each), Egypt, Romania, and the Russian Federation (with 8 cases each), Ukraine and Venezuela (7 cases each), Turkey (6 cases), Hungary, Kazakhstan and Moldova (with 5 cases each) also figure prominently. Further, six countries faced arbitration proceedings for the first time in 2007, all from the developing world or economies in transition (Armenia, Bosnia and Herzegovina, Costa Rica, Guatemala, Nigeria, and South Africa)[5].

Recent cases have involved the whole range of investment activities and all kinds of investments, including privatization contracts and state concessions. Measures that have been challenged include emergency laws put in place during a financial crisis, value added taxes, rezoning of land from agricultural use to commercial use, measures on hazardous waste facilities, issues related to the intent to divest shareholdings of public enterprises to a foreign investor, and treatment at the hands of media regulators. Disputes have involved provisions such as those on fair and equitable treatment, non-discrimination, expropriation, and the scope and definition of agreements.

The rise in investment disputes has had two significant effects. First, these disputes are yielding awards that interpret the legal obligations of the contracting parties, which in turn has caused some countries to reexamine and reconsider the scope and extent of such obligations. As will be explained in "Effect of ISDS jurisprudence on investment rule-making" below, ISDS experience over the last decade has had a significant impact on investment rulemaking in the Asia-Pacific region, leading some countries to develop a "new generation" of IIAs with distinct normative features.

Second, the rise in investment disputes poses a particular challenge for developing countries. Their financial implications can be substantial, both from the point of view of the costs of the arbitration proceedings and the awards rendered.

[5] *Supra* note 5.

Information about the level of damages being sought by investors tends to be patchy and unreliable. It is, nonetheless, clear that some claims involve large sums. Furthermore, even defending against claims that are not ultimately successful entails a significant financial cost.

Effect of ISDS jurisprudence on investment rule-making

Investor state dispute settlement practice has led some countries of the Asia-Pacific Region, in particular the United States and Canada, to realize that the specific wording of IIA provisions does matter, and that it can make a significant difference on the outcome of an investment dispute. Thus, it is no coincidence that over the last couple of years, a new generation of IIAs has been gradually emerging. This "new generation" of IIAs falls mainly into two groups: The first group consists of FTAs containing a chapter on investment. Originally influenced by NAFTA, such treaties have been concluded between the United States and countries such as Singapore and Australia, and have started to be negotiated between the United States and other ASEAN countries such as Malaysia and Thailand, but also in the east side of the Pacific Region with countries such as Chile and Peru. A second group of IIAs comprises BITs incorporating important innovations, and which are exemplified by the new model BITs of the United States and Canada. Mexico has also started to revise its model BIT when negotiating with its investment partners.

Normative developments

The normative evolution in both these FTAs and BITs show five main features:

- First, some recent IIAs have deviated from the traditional open-ended, asset-based definition of investment. Instead, they have attempted to strike a balance between maintaining a comprehensive definition of investment and yet not to cover assets that are not intended by the Parties to be covered investments.
- Second, the wording of various substantive treaty obligations has been revised. Learning from the technical intricacies faced in the implementation of NAFTA's chapter 11 and other agreements, new IIAs clarify the meaning of provisions dealing with absolute standards of protection, in particular, the international minimum standard of treatment in accordance with international law and indirect expropriation.
- Third, these IIAs address a broader scope of issues-not only specific economic aspects like investment in financial services, but also other kind of issues where more room for host country regulation is sought. The protection of health, safety, the environment, and the promotion of internationally recognized labour rights are areas where new IIAs include specific language aimed at clarifying that the investment promotion and liberalization objectives of IIAs must not be pursued at the expense of these other key public policy goals.
- Fourth, recent IIAs include transparency provisions, which represent an important qualitative innovation compared to previous IIAs. From a trend of conceiving transparency as an obligation to exchange information between

States, these IIAs tend to establish transparency also as an obligation with respect to the investor. Further, transparency obligations are no longer exclusively geared towards fostering exchange of information, but also as transparency in the domestic process of rulemaking, aiming to enable interested investors to participate in it.

- Fifth, new IIAs contain significant innovations regarding investor-State dispute settlement procedures. Greater transparency in arbitral proceedings, including open hearings, publication of related legal documents, and the possibility for representatives of civil society to submit "amicus curiae" briefs to arbitral tribunals is foreseen. In addition, other very detailed provisions on investor-state dispute settlement are included in order to provide for a more legal-oriented, predictable and orderly conduct at the different stages of the ISDS process.

Greater precision in the definition of investment

Over the last decade, one aspect that generated concern in some countries has been the interpretation by some arbitral tribunals of the concept of "investment" under the applicable IIA. It has been considered that some of these interpretations were too broad, and went beyond what the contracting parties conceived as "investment" when negotiating the IIA. For instance, in the case of *Pope & Talbot v. Canada*[6], the tribunal found that a market share through trade could be regarded as part of the assets of an investment; and in *S.D.Myers v. Canada*[7] the arbitral tribunal held that the establishment of a sales office and commitment or marketing time formed a sufficient investment.

One approach of avoiding an over-reaching definition of investment is called a "closed-list" definition. This approach differs from the broader asset-based definition in that it does not contain a conceptual chapeau to define the term "investment";it rather consists in an ample, but finite list of tangible and intangible assets. Originally envisaged as an "enterprise-based" definition used in the context of the U.S.-Canada Free Trade Agreement, this approach evolved towards the definition used in article 1,139 of NAFTA. Subsequently, the "closed-list" approach has been frequently used by several APEC member countries in the definition of "investment" included in their IIAs. Box 1 provides the example of Article 96 of the Free Trade Agreement (FTA) between Japan and Mexico which illustrates this approach.

Box 1: Definition of investment—the closed list approach

The term "investment" means:
- (AA) an enterprise;
- (BB) an equity security of an enterprise;
- (CC) a debt security of an enterprise:
- (aa) where the enterprise is an affiliate of the investor, or

[6] *Pope & Talbot, Inc. v. The Government of Canada,* UNCITRAL, Interim Award on Merits, 26 June 2000; Award on Merits, 10 April 2001; Award on Damages, 31 May 2002; Award on Costs, 26 November 2002.

[7] *S.D. Myers, Inc. v. Canada,* UNCITRAL, First Partial Award, 13 November 2000.

- (bb) where the original maturity of the debt security is at least 3 years, but does not include a debt security, regardless of original maturity, of a Party or a state enterprise;
- (DD) a loan to an enterprise:
- (aa) where the enterprise is an affiliate of the investor, or
- (bb) where the original maturity of the loan is at least 3 years, but does not include a loan, regardless of original maturity, to a Party or a state enterprise;
- (EE) an interest in an enterprise that entitles the owner to share in income or profits of the enterprise;
- (FF) an interest in an enterprise that entitles the owner to share in the assets of that enterprise on dissolution, other than a debt security or a loan excluded from subparagraph (CC) or (DD) above;
- (GG) real estate or other property, tangible or intangible, and any related property rights such as lease, liens and pledges, acquired in the expectation or used for the purpose of economic benefit or other business purposes; and
- (HH) interests arising from the commitment of capital or other resources in the Area of a Party to economic activity in such Area, such as under:
- (aa) contracts involving the presence of an investor's property in the Area of the Party, including turnkey or construction contracts, or concessions, or
- (bb) contracts where remuneration depends substantially on the production, revenues or profits of an enterprise; but investment does not mean,
- (II) claims to money that arise solely from:
- (aa) commercial contracts for the sale of goods or services by a national or enterprise in the Area of a Party to an enterprise in the Area of the other Party, or
- (bb) the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (DD) above; or
- (JJ) any other claims to money, that do not involve the kinds of interests set out in subparagraphs (AA) through (HH) above;"

During the last decade, the "closed-list" definition of "investment" has also begun to be used in the context of BIT negotiations. In 2004, Canada abandoned the asset-based definition of "investment" in its FIPAs and opted to incorporate in its new Canadian BIT model a relatively detailed "closed-list" definition of "investment. " In addition to being finite, the list contains a series of specific clarifications to avoid applying the agreement to certain kinds of assets that otherwise would fall under the investment definition.

Another approach used to make the definition of "investment" more accurate has been to qualify an otherwise very broad definition. Accordingly, numerous IIAs, such as the investment chapters of several free trade agreements signed between the United States and Latin American countries incorporate a definition of "investment" in economic terms, that is, they cover, in principle, every asset that an investor owns and controls, but add the qualification that such assets must have the "characteristics of an investment". For this purpose, they refer to criteria developed in ICSID practice, such as "the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk". This approach is complemented by explicit exclusions of several kinds of assets, which are not to fall within the category of covered investments under the agreement. The approach referred to above clearly indicates that for an asset to be considered as a covered investment, three requisites must concur as a minimum. First, the asset must be owned or controlled by an investor as defined by the agreement; second, the asset must have the characteristics of an investment; and third, the asset must not fall within any of the excluded categories.

The definition does not list all the characteristics that an asset must have in order to be considered an investment. However, the definition does include some minimum parameters, namely the commitment of capital, the expectation of gain or profit, or the assumption of risk. The inclusion of these criteria within the definition of investment has the effect of excluding *ab initio* certain assets—arguably this would be the case for real estate or other property, tangible or intangible, not acquired in the expectation or used for the purpose of economic benefit or other business purposes. However, the wording of the definition means that in the case of other kind of assets, the determination as to whether they fall within the scope of a covered investment has to be undertaken on a case-by-case basis.

Clarification of several key substantive obligations

A second trend in investment rulemaking derived from the ISDS experience over the last decade relates to the revision of the wording of various substantive IIA obligations. New IIAs have tended to clarify the meaning of several substantive provisions, in particular those dealing with absolute standards of protection, such as the international minimum standard of treatment and expropriation.

In the case of the international minimum standard of treatment, new IIAs include a provision, which explicitly clarifies that the obligation undertaken by the Contracting Parties is to accord covered investments treatment *in accordance with customary international law.* According to these IIAs, the latter includes the notions of fair and equitable treatment and full protection and security. The IIAs also define each of these standards. It is evident that the negotiators of these agreements have taken into account the issues discussed in recent N A F T A chapter 11 arbitrations. An example of this trend is the relevant article included in the investment chapter of the Free Trade Agreements negotiated between the United States and Chile, Central America, Colombia and Peru, that reads as follows:

Box 2: Minimum Standards of Treatment of investments

1. Each Party shall accord to covered investments treatment in accordance with the customary international law minimum standard of treatment of aliens, including fair and equitable treatment and full protection and security.
2. For greater certainty, the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights. The obligation in paragraph 1 to provide:
   (a). "fair and equitable treatment" includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world; and
   (b). "full protection and security" requires each Party to provide the level of police protection required under customary international law.
3. A determination that there has been a breach of another provision of this Agreement, or of a separate international agreement, does not establish that there has been a breach of this Article.

The provision cited above is complemented by an Annex, which clarifies the understanding of the IIA parties regarding the concept "customary international law".

Box 3: Customary International Law

The Parties confirm their shared understanding that "customary international law" generally and as specifically referenced in Article 11.5 and Annex 11.B results from a general and consistent practice of States that they follow from a sense of legal obligation. With regard to Article 11.5, the customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens."

The language of the clause cited above is self-explanatory. This seems to be exactly the intention of the Contracting Parties, partly as a result of the experience with article 11.5 of NAFTA. The debate regarding the fair and equitable treatment clause in chapter 11 of NAFTA, and more recently in some BIT disputes, has shown the risks of including unqualified language in IIAs. The wording of those clauses could be broad enough to apply to virtually any adverse circumstance involving an investment, making the fair and equitable treatment provision among those most likely to be relied upon by an investor in order to bring a claim under the investor-State dispute settlement proceedings. The inclusion of language clarifying the content and scope of the minimum standard of treatment in new IIAs may be particularly relevant to counterbalance two recent trends in ISDS practice.

Expropriation is the other area where recent IIAs have introduced clarifying language. As was explained before, the lack of clarity concerning the degree of interference with the rights of ownership that is required for an act or series of acts to constitute an indirect expropriation, has been one of the most controversial issue during the last decade (UNCTAD, 2000). The number of ISDS cases acknowledging that an indirect expropriation has occurred have been scant. Nonetheless, parts of civil society in some countries have expressed fears that the prospect of investor-State arbitration arising out of alleged regulatory takings could result in a "regulatory chill" on the grounds that concern over liability exposure might lead host countries to abstain from necessary regulation.

Within this context, recent IIAs contain provisions clarifying two specific aspects. First, a text has been included in order to make it explicit that the obligations regarding expropriation are intended to reflect the level of protection granted by customary international law. Second, such clarification has been complemented by guidelines and criteria in order to determine whether, in a particular situation, an indirect expropriation has in fact taken place. In this regard, it is clarified that an adverse effect on the economic value of an investment, as such, does not establish that an indirect expropriation has occurred. It is further stated that, except in rare circumstances, non-discriminatory regulatory actions by a Party aimed at protecting legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations. Annex 10-D of the Free Trade Agreement between Chile and the United States illustrates this trend as shown in Box 4.

Box 4: Expropriation

The Parties confirm their shared understanding that:

1. Article 10.9(1) is intended to reflect customary international law concerning the obligation of States with respect to expropriation.

2. An action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.
3. Article 10.9(1) addresses two situations. The first is direct expropriation, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure.
4. The second situation addressed by Article 10.9(1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.

(a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by- case, fact-based inquiry that considers, among other factors:

(ii) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

(iii) the character of the government action.

(b) Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."

What are the motivations behind the inclusion of these clarification clauses in some IIAs? Do these clauses reflect the intention of the contracting parties to "correct" any particular trend in the jurisprudential interpretation of expropriation clauses? It could be argued that provisions like the one cited above provide some important guidance for future cases. Another significant role of such clarifying provisions may be that they serve as a signal for civil society. By including such language, governments may acknowledge the concerns of certain sectors of civil society regarding to what they perceive as a "regulatory chill effect" of ISDS proceedings. To respond to these concerns, a provision like the one cited above indicates that IIAs are not intended to put in question the regulatory power of host States.

Balance between investment protection and other public policy objectives

In addition to the features already mentioned, some new IIAs address a broader scope of issues. The protection of health, safety, cultural identity, the environment, and the promotion of internationally recognized labour rights are some of the areas where these IIAs include specific language aimed at clarifying that the investment promotion and liberalization objectives of IIAs must not be pursued at the expense of these other key public policy objectives. Different techniques have been used for that purpose. While some IIAs have included general treaty exceptions, other treaties have opted for positive language in order to reinforce commitments of the contracting parties to safeguard certain values; some IIAs have combined both.

Examples of IIAs including exceptions to safeguard flexibility for regulation are the new U.S and Canadian model BITs. The latter includes a series of exceptions to preserve a wide fan of public policy objectives, such as the protection of human, animal or plant life and health, the integrity and stability of the financial system, cultural industries and essential security interests.

Countries have not only opted to use exceptions, but have also included positive language into the IIAs to protect other public policy objectives, notably the protection of the environment and the respect for core labour rights. Once more, the

legal techniques used for such purpose vary among the different IIAs. One approach has been to make reference to these values in the preamble of the agreement. Other IIAs have included "side agreements" to protect labour and environmental standards. Among other aspects, it is made clear that investment promotion and liberalization will not impair the capacity of the contracting parties to protect the environment or labour rights in their respective territories. The same technique can be observed in the NAFTA and in the Free Trade Agreement between Canada and Chile. Other IIAs have incorporated specific provisions in the investment chapter as well as in additional sections on labour and environment.

Promotion of greater transparency in the process of domestic rule-making

A fourth feature of some recent IIAs is the qualitative evolution in the conception of the transparency obligations for purposes of the agreement. In addition to the obligation of the Contracting Parties to publish their laws, new approaches include the investors in transparency regulations, providing them not only with rights, but also with obligations vis-a-vis the host State. Second, this new method conceives transparency beyond the traditional notion of publication of laws and regulations. Rather, it also focuses on the process of rulemaking, attempting to use it as an instrument to promote the principle of due process. Thus, in addition to enabling investors to know and understand the applicable rules and disciplines affecting their investments, this new approach attempts to use transparency as a tool to enable interested persons to participate in the process of investment-related rulemaking. An example of this approach is article 19 of the 2004 Canadian Model BIT:

Box 5: Transparency

1. Each Party shall, to the extent possible, ensure that its laws, regulations, procedures, and administrative rulings of general application respecting any matter covered by this Agreement are promptly published or otherwise made available in such a manner as to enable interested persons and the other Party to become acquainted with them.
2. To the extent possible, each Party shall:
   (a) publish in advance any such measure that it proposes to adopt; and
   (b) provide interested persons and the other Party a reasonable opportunity to comment on such proposed measures.
3. Upon request by a Party, information shall be exchanged on the measures of the other Party that may have an impact on covered investments."

The approach illustrated above applies transparency not only to existing legislation, but also to draft bills and regulations. In this respect, article 19.2 above provides that to the extent possible, the Contracting Parties shall publish in advance any proposed measure of general application that affects investments and also "... *provide interestedpersons and the other Party a reasonable opportunity to comment on such proposed measures'"* This approach, which is also used in the new U.S. model BIT, represents a qualitative leap in the content and rationale of transparency provisions in IIAs. Several reasons justify this assertion.

First, under this approach, transparency no longer means just information, but also participation in investment rulemaking. Second, the obligation does not provide

an exclusive right to a foreign investor vis-a-vis the host country. Rather, the obligation is to provide a reasonable opportunity to all interested persons to comment on proposed investment-related measures. Thus, the obligation is not only applicable to the contracting parties with respect to the investors of the other contracting party, but also between each contracting party and its own citizens.

It is true that for some countries, to develop the mechanisms to effectively comply with principles of due process may entail legal reforms and financial costs. On the other hand, if those adjustments are necessary it is because the developing countries concerned lack a modern body of administrative law and implementation procedures, a sine-qua-non requisite not only for the modernization of the administration of justice, but for strengthening democratic institutions in general. Within this context, transparency provisions in IIAs may be significant not only for the generation of a more predictable business climate in favour of foreign investors, but more important from a development perspective-to foster a more legalistic and rule-oriented administrative practice, which is in the general interest of the population of the host country.

The emphasis of some IIAs on using transparency provisions to strengthen the principle of due process of law is also evidenced by some additional obligations. An example is the BIT between the United States and Uruguay (2005), which includes within the transparency provision additional explicit obligations on administrative procedures and the right of an impartial review and appeal of administrative decisions on investment-related matters. Once more, these kinds of obligations matter not only because of the more predictable investment climate they tend to generate, but also because of the institutional strengthening that their full compliance may entail for the entire citizenry of the countries concerned.

Innovations in ISDS procedures

Some recent IIAs regulate in more detail ISDS procedures[8], providing greater guidance, both to the disputing parties and tribunals, with respect to the conduct of the arbitration proceedings. During the first part of the last decade, chapter 11 of N A F T A influenced significantly the features of the investor-State dispute settlement provisions in many other IIAs. More recently, it is the experience with the increasing number of investment disputes that has triggered innovations included in new IIAs.

Traditionally, most IIAs have had very few general provisions on ISDS procedures. This trend changed with N A F T A , which for the first time regulated a series of aspects of arbitration proceedings. N A F T A ' s chapter 11 devotes a whole section to ISDS procedures. Recent IIAs negotiated among various A P E C countries have continued with this trend, and have even taken the evolution in rulemaking one step further ISDS procedures are one of the areas where significant developments in IIAs have taken place over the last decade.

[8] One important exception to this trend is the Free Trade Agreement negotiated between Australia and the United States, which lacks investor-State dispute settlement provisions. This outcome can only be explained by the reciprocal trust of both O E C D Parties in the efficiency and effectiveness in the application of the rule of law in Australia and the United States.

Recent IIAs have incorporated various innovative provisions directed to foster four general objectives: First, they have purported to provide greater control by the contracting parties over arbitration procedures; second, they promote the principle of judicial economy in investment-related disputes; third, they seek to ensure consistency among arbitral awards; and fourth, they promote greater legitimacy of ISDS within civil society. These objectives are derived from the experience on investment disputes that several countries of the region have gathered over the last decade.

Conclusions

Over the last decade ISDS practice has touched upon numerous procedural and substantive aspects of arbitration and investment law. Despite the significant case load, it should be noted that jurisprudence is still in its early stages, and the majority of the cases submitted to arbitration during the last couple of years are still in process.

It is possible to identify two important lessons derived from the ISDS practice over the last decade. One is that the increase in investment disputes has tested the wisdom to negotiate IIAs with extremely broad and imprecise provisions. The broader and more imprecise a particular text is, the more likely that it will lead to different, and event conflictive, interpretations. This will not only make it more likely that a dispute between the investor and the host State arises, but it will also improve the possibility of delegating to the arbitral tribunal the task of identifying the meaning that the provision under dispute should have. Clearly, one of the objectives of IIAs is to foster predictability and certainty for investors, but also for host States, and in this regard, having investment provisions drafted broadly and imprecisely do not serve the interests of either of these parties.

A second important lesson derived from ISDS practice is that, when negotiating IIAs, countries not only should pay attention to the particular wording of the text of the agreement. Equally important, parties should bear in mind the future interaction between the IIA and the arbitration convention(s) referred to by the latter, and in particular, ICSID. For a dispute to fall within the jurisdiction of ICSID, it is necessary to comply with the objective requirements of jurisdiction included in Article 25 of the ICSID Convention. Thus, not everything that the parties agree to be subject to arbitration under an IIA may in fact fall within the jurisdiction of ICSID.

The development of a new generation of IIAs, a significant number of which have been negotiated by countries of the Asia-Pacific Rim in the context of Free Trade Agreements with the United States, shows that several governments have been attentive to the developments in ISDS practice. Observing how previous IIAs are interpreted and applied by arbitral tribunals, some governments have come up with new provisions and new language which addresses most of the problems evidenced in the context of investment disputes. In this sense, it could be said that new generation IIAs represent the response on the part of those governments to the various procedural and substantive issues raised in the context of ISDS practice over the period.

New generation IIAs have made the definition of investment more precise, have redrafted and clarified several provisions dealing with standards of protection, have improved and redefined the concept of transparency in the context of investment agreements, have clarified that investment protection and liberalization must not be

pursued at the expense of other key public policy objectives, and have updated and modernized ISDS procedures, *inter alia,* fostering increased information and participation of civil society in those proceedings. Regardless of the particular merits that each of the mentioned improvements may have, the surge of new generation IIAs demonstrates a trend which is even more important from a systemic perspective, that is, that governments are being responsive to the challenges posed by new realities.

The increase in the number of investment disputes is often associated with numerous challenges for developing countries. As will be explained below, it is true that developing countries are confronted with important challenges as a result of the increase in investment-related litigious activity. However, the existence of such challenges should not obscure the fact that the intensification of ISDS is symptomatic of two extremely positive trends for developing countries.

One of them is the legalization of investment dispute resolution. Indeed, the fact that until the last decade there was a limited number of ISDS cases does not mean that until that turning point in history there were not investment-related disputes. Historically, international investment-related disputes have existed since very long ago. Thus, it is nothing new that disputes arise. What is certainly an innovation is the fact that investors and their countries of origin, rather than relying on other means to solve their grievances, are increasingly relying on international law to solve them. In perspective, this is a remarkable development in the path towards a more stable, fair and balanced international order. Indeed, nowadays, the use of "gun boat diplomacy" to deal with investment-related disputes seems barbarian, however, civil society tends to forget that just a century ago that was the means through which investment-related disputes were often solved.

The legalization of the international investment system obviously serves the interests of all the involved parties, investors, developed and developing countries. However, given that developing countries lack the economic, political or military might of industrial nations, they should be the most interested ones in pursuing the legalization of the international investment system, as the only means at their disposal to defend their interests in a world prone to conflict, lies in the strengthening of the rule of law at the international level.

A second positive aspect which is evidenced by the increase in ISDS activity is that such trend is gradually motivating developing host countries to improve domestic administrative practices in order to avoid future cases. Indeed, the ISDS experience shows that in addition to fostering the rule of law at the international level, that result is fostered in the domestic front as well. Fostering greater rigour, discipline and due process in the application of legislation is a goal which should be pursued in every country—developing as well as developed. ISDS procedures are instrumental in fostering this objective. Of course, to make that happen, important capacity building initiatives must be undertaken. In this regard, further work is required in four different fronts.

First, governments of countries of the Asia-Pacific Rim, in particular those of developing countries, must learn how to use the international investment adjudication system. International investment law is a complex and specialized subject, with multiple sources and in constant evolution. Thus, to develop the domestic capacities of governments and private sector of developing countries is

paramount. The current level of dependence on foreign assistance for these countries to be able to adequately defend their interests in international arbitration cases is not fair or advisable for the health of the international investment system as a whole.

Further, having more capable and informed government officials in developing countries, who fully understands the content and implications of IIAs, is not only in the interest of developing countries, but in the best interest of foreign investors and developed countries as well. Better prepared officials would likely increase the possibility of a better administration of domestic law and diminish the need of foreign investors to invoke ISDS procedures to defend their interests.

A second front of action relates to one of the less acknowledged but more important benefits IIAs can entail for developing countries. IIAs are important not only because their potential international impact in terms of attracting FDI or sending positive signals to foreign investors. Equally important, there is the domestic impact these IIAs can have in developing countries. IIAs can become instrumental to foster key domestic reforms in developing economies—which are often postponed—in order to promote the modernization of their institutions and in this way, incentive fair and sustainable economic development. Although in the short term, investment disputes may entail a significant financial burden for developing countries, it is important not to oversee the potential effect ISDS can have in fostering domestic reform.

To a great extent, promotion of transparency, due process and a strict application of the rule of law is the best way to avoid investment disputes. Indeed, for a developing country, the best way to win an investment dispute is not to have it in the first place. Further, the role of the rule of law in fostering economic development has been widely acknowledged in international economic literature. Through appropriate capacity building, the developing countries of the Asia-Pacific region could improve their discipline in the administration of investment-related laws and regulations and in this way, not only avoid the possibility of being subject to investment disputes, but also, improve the general investment climate.

A fourth front of action is clearly civil society. It is likely that the interaction between national investment policies and IIAs will undergo a broader political debate. This would be a positive development in the sense that that more awareness and information about the importance and role of IIAs in general and ISDS in particular could yield a stronger and more coherent policies in the long run.

Furthermore, interaction between foreign investors and host States will likely continue to increase in the future. Within this context, rather than resisting the development of international regimes, there is need for making civil society understand the importance of those regimes in promoting a more rule-oriented and predictable international order, and as a result a more stable, fair and peaceful world to live. To reach those objectives, international law and capacity building are necessary.

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RESEARCH ARTICLE

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Thoughts on the Theories and Practice of Chinese Private International Law

Abstract "The parties can only choose facultative legal norms," "the parties of all foreign-related civil and commercial cases may agree to choose Chinese law as the applicable law governing their legal relationship," and "the applicable law to the contract chosen by the parties shall not avoid the mandatory provisions of Chinese law"—such viewpoints that have substantial influence among the theorists and in the judicial practices of Chinese private international law are actually based on misunderstandings of Chinese private international law. It is a task of the private international law community of China to eliminate such misunderstandings, hence facilitating the healthy development of Chinese private international law.

Keywords choice of law, evasion of law, *lexfori,* overriding statutes

It is well known that in theoretical research, legislation and judicial practices there is a big gap between the private international law of China[1] and that of the countries of developed rule of law in the west. The reasons for this are various, including the historical and the realistic, the subjective and the objective. The author believes that there are certain misunderstandings in both the theoretical research and the practice of Chinese private international law, which constitute an important factor affecting its development towards perfection. Based on the author's understanding of the legislation and theories of private international law

[1] Unless otherwise specified, China's private international law mentioned in this article only refers to private international law of the Mainland of China, which does not include that of China's Hong Kong, Macau and Taiwan regions.

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in the countries of developed rule of law like Germany and Switzerland, the author thinks that the viewpoints and practice in the following aspects to be elaborated regarding the theories and practice of Chinese private international law are in essence "cognitive misunderstandings" of Chinese private international law, though they have substantial influence in the Chinese private international law community. The author takes the liberty of questioning and criticizing such viewpoints and practice, hoping to provoke thinking by the predecessors and colleagues from the academic circle on some critical issues of Chinese private international law.

1. The Contract Parties Can Only Choose Facultative Legal Norms

An influential viewpoint in the theories and judicial practices of Chinese private international law is: The applicable law chosen by the parties to a contract is limited to facultative laws, and the law chosen by the parties shall not go against the mandatory provisions of *lex fori*. One of China's influential textbooks of private international law points out when discussing the application of law to contracts: "Scholars of most countries believe that though autonomy of will is a basic principle in solving legal contractual conflicts, it does not rule out the general applicability of certain mandatory laws. The discretionary choice of the parties can only be done within the boundary of facultative laws and cannot violate the mandatory provisions of laws. If the applicable law defined according to the autonomy principle contradicts with *lex fori* or the mandatory legal provisions of other relevant laws, the court normally would not apply it."[2] In *Hong Lu v. United Airlines* of the US, a dispute over compensation for international air passenger transportation damages, the Shanghai Jing'an District Court expressed a similar viewpoint. The court pointed out in its verdict, "Article 126 of the *Contract Law of the People's Republic of China* provides that 'the parties to foreign-related contracts can choose the applicable law for resolution of contractual disputes, unless otherwise stipulated by law. If the parties to foreign-related contracts do not make the choice, the law of the country which has the closest connection with the contract shall apply.' This is the embodiment in Chinese law of the principle of 'autonomy of will of the parties' in choosing the law to apply to foreign-related cases, and has become an important principle in handling civil and commercial legal relationships in various countries of the world. The principle of 'autonomy of will of the parties' is relative and subject to restrictions. There are certain restrictions on the principle of 'autonomy of will of

[2] Guangqing Qu, **J+^feIES** (The Principle of Conflict Laws), Law Press (Beijing), at 122 (2004).

the parties' in the legislation of various countries, and these are mainly reflected in three ways: Firstly, the law chosen by the parties must have a substantive relationship with the parties or the contract; secondly, the law chosen by the parties shall not violate public order; and thirdly, the law chosen by the parties shall not violate mandatory provisions. The parties must choose the law that has a substantive relationship with them or the contract between them provided the mandatory legal provisions are not violated."[3]

It must be noted that though the aforesaid viewpoints are quite influential in the academic circle of Chinese private international law, they do not conform to the current status of private international law of many countries as understood by the author. As for whether the applicable law to contracts should have a substantive relationship with the parties or the contract, Article 3 of the *European Community Convention on the Law Applicable to Contractual Obligations* of 1980 ("Rome Convention") explicitly provides that the parties to a contract can freely choose the law of any country as its applicable law without requiring that the law chosen should have any substantive relationship with it or its parties. Article 25(1) of the *Private International Law of South Korea,* adopted in 2001, expressly stipulates that "the law chosen by the parties explicitly or impliedly governs the contract. The implied choice of law must be able to be reasonably confirmed according to the content of the contract or the overall situation of the case." This article does not require that the law chosen by the parties should have any substantive relationship with the contract or the parties themselves; furthermore, it expressly allows the implied choice of law by the parties, and the law chosen by such implied choice is not required to have any substantive relationship with the contract or the parties. Article 145 of China's *General Principles of Civil Law* of 1986 and Article 126 of the *Contract Law* of 1999 both expressly stipulate that parties to foreign-related contracts may choose the applicable law for resolution of contractual disputes; neither of the articles stipulates that the law chosen by the parties must have a substantive relationship with the contract or the parties. Therefore, the viewpoint that the legislation of various countries requires that the law chosen by the parties must have a substantive relationship with the contract or the parties does not conform to the state of the legislation in major jurisdictions, but it has (unfortunately) become a cognitive misunderstanding that has had a significant impact on the theories and practice of Chinese private international law. Actually the situation is just the opposite: The existing private international law of many countries including China, South Korea, Germany, France, the U K , Switzerland, Austria, and Finland expressly allows the parties to choose freely the law of any country as the law

[3] Qingsen Xu & Huanfang Du, **HfefAfeilJ'lJiJ'I/r** (Case Analysis of Private International Law), China Renmin University Press (Beijing), at 8 (2009).

applicable to a contract; only for the law applicable to a few, special categories of contract such as consumer contract[4] and employment contract, the private international law of some countries (including Germany, Switzerland and France) imposes restrictions on the parties' free choice of the applicable law to contract, so as to better protect the interest of the weaker parties to such contract.

The viewpoint that the parties to the contract may only choose facultative laws is another error in the theories and practice of Chinese private international law. This viewpoint not only runs squarely against the majority position in the private international law of most countries with developed rule of law, but also does not conform to the basic doctrinal theories of private international law, for the following reasons:

Firstly, though the choice of law within the area of conflict of laws for contract and the freedom of contract within the area of substantive law may display some similarities in form, and are both reflected in the legal effects of the agreement between the parties, there is a salient difference in the specific content and legal consequence of the two: The choice of law refers to the parties' right to choose the law that governs the establishment and the effect of the contract between them; the legal consequence of the validity of such choice determines that the main contract[5] is effective only if so determined by the applicable law to the contract chosen by the parties instead of *lex fori* or other laws; while freedom of contract in the substantive law mainly means that parties to the contract can freely agree on and amend the content of their contract. The principle of freedom of contract only allows that the content of the main contract between the parties reflects the real expression of their will. Whether the clauses of the main contract agreed by the parties can take legal effect, it must be determined by the applicable law to the contract. As a result, the well-known civil law maxim that the freedom of contract shall not be used to violate the mandatory legal provisions of the forum state cannot lead to the conclusion that the choice of law shall not go against the mandatory laws of the forum state. The freedom of contract falls within the substantive law, while the choice of law is within the scope of conflict of laws, and there is an obvious difference between the nature, content, and boundaries of the two.

Secondly, as the content of the choice of law contract is the applicable law governing the effect of the main contract between the parties, assuming that the law chosen by the parties is limited to the facultative law of the country selected, and assuming that a Chinese company and a US company have chosen the

[4] The Western scholars usually refer to these contracts as "specially protected contracts."

[5] The choice of law between the parties is by itself a contract, which is called the choice of law contract. In order to differentiate from such contract, the contract signed by the parties under the substantive law is normally called the main contract.

Japanese law as the law applicable to the sales contract between them according to Article 126 of China's *Contract Law,* the applicable law for such sales contract will only include the facultative Japanese law. According to the nature of the facultative law, when there is any discrepancy between the facultative law and the clauses of the sales contract, the application of the facultative law will be ruled out. Thus, not only can the applicable law chosen by the parties to govern the establishment and effect of the sales contract not solve the issue of the establishment and effect of the sales contract, but its application is also likely to be ruled out due to the discrepancy between its provisions and the clauses of the sales contract. This obviously contradicts the real purpose of the parties' choice of the applicable law to the contract and does not conform to the legislative purpose of Article 126 of China's *Contract Law.*

Thirdly, if the applicable law chosen by the parties cannot rule out the application of China's mandatory laws, or of all the mandatory laws of the Mainland of China still apply even if the parties choose to apply foreign laws or extra-territorial laws to govern the legal relationship between them, China's legislators should not only allow the parties to foreign-related contracts to choose the applicable law, but also allow the parties of all foreign-related civil and commercial relationships to choose foreign law or extra-territorial law. Thus by this logic the parties of any foreign-related tort, marriage and property matter could choose the applicable law for such legal relationship through agreement. This is because, under the argument offered, no matter which country's law is chosen by the parties as the applicable law, the mandatory provisions of Chinese law will apply, even if China's legislators allow the parties of legal relationships to choose the applicable law to such relationships in all areas of private international law. For example, by allowing the parties to freely choose the law applicable to a divorce or to dealings in real properties, China's legal system would not be damaged in any way. For such choice of law would not rule out the application of China's mandatory laws, while the facultative laws of China allow themselves to be ruled out by the parties through agreement.

However, as things currently stand, China's legislators prohibit the parties from choosing the law in any area except for contract; in the fields of marriage, divorce, and especially real properties, the private international law of most countries including China does not allow the parties to choose the applicable law. The only rational explanation for such a legislative status given to domestic and foreign laws is that the function of the applicable law in adjusting the rights and obligations of the parties to foreign-related legal relationships determines that the applicable law must include facultative laws and mandatory laws. As an inevitable consequence of applying the applicable law, both the mandatory laws and the facultative laws of the countries including the state of forum except for the one to which the applicable law belongs are ruled out. Since the marriage law

and the real property law of a country are normally mandatory legal norms, legislators of such countries (including China) forbid the parties to freely choose the applicable law governing legal relationships inherent in marriage, divorce and real properties so as to prevent the application of their own marriage law and real property law from being ruled out due to the choice of foreign laws or extra-territorial laws by the parties.

Based on the foregoing analysis, the rational conclusion can only be that the choice of law in the conflict of laws may not only rule out the facultative law of the state of forum, but also rule out its mandatory laws. When the parties to the contract choose a foreign law or extra-territorial law as the applicable law to the contract, in principle the application of all of the facultative and mandatory laws of the Mainland of China is ruled out, and the court in the Mainland of China can only apply the foreign law or extra-territorial law to determine the effect of the contract and the rights and obligations of the parties. Such conclusion not only is the common understanding of the legal scholars and the practitioners of private international law in continental Europe, but also has been proven by the judicial practices of the Supreme Court of China. In the case of cargo release without collecting the bill of lading (B/L) involving American President Lines Limited (APL), Feida Electric Appliance Factory (Feida), Feili Company (Feili) and Great Wall Company (Great Wall), one of the top 10 cases of China in 2002, the carrier A P L released the cargo to the Buyer without collecting the original bill of lading, and later the Buyer did not pay the Seller Feida, which had delivered the goods but did not receive the price. The bill of lading involved in the case was a named B / L , and its paramount clause stipulates that the disputes arising from the B / L shall be governed by the U S' *Carriage of Goods by Sea Act* 1936 or *Hague Rules* 1924. According to the US law, A P L's release of cargo without collecting B / L is legal and should not be liable to any liquidated damages. According to *lex fori,* i.e., Chapter 4 of China's *Maritime Law,* A P L's release of cargo without collecting B / L constitutes the breach of the contract, and thus A P L is liable to pay liquidated damages. The Supreme Court of China deemed that the parties' choice of the US law as the applicable law to the contract was legitimate, and ruled out the application of all of the mandatory and facultative legal norms of China's *Maritime Law* according to the choice of the law. It applied the US law, ruling that A P L's release of cargo without B / L conformed to legal provisions hence A P L was not liable, and rejected Feida's claim.[6] In fact, in practice it is very common for the ocean bill of lading to explicitly stipulate that the carrier's responsibility be governed by *Hague Rules* or the law of a specific country, and the law related to the carrier's responsibility is a mandatory law among the laws of most

[6] See Ruiting Qin, #^fe&<J_It_'5~# (The Theories and Practice of Conflict of Laws), University of International Business and Economics Press (Beijing), at 247—48 (2007).

countries including China's *Maritime Law*. Therefore, if the law applicable to the contract as chosen by the parties through agreement is considered to be limited to facultative legal norms, the applicable legal clauses relating to the carrier's responsibility in the bill of lading will become void for violating the mandatory laws of the state of forum, but such conclusion obviously does not conform to the existing legislative and judicial practices of most countries.

Of course, the author must point out that although the parties' choice of a foreign law or extra-territorial law to govern a contract can rule out the application of the mandatory legal norms of the forum state, it can only rule out most of such norms. According to the legislation and the judicial practices of many Western countries with developed rule of law, such as Germany, Switzerland and Belgium, two legal norms of a special nature of the forum state, i.e., "overriding statutes" and public order norms, must be applied in cases mandatorily even if the parties to the contract choose a foreign law/extra¬ territorial law or the court determines according to the principle of the closest connection that a foreign or extra-territorial law applies to the contract. Therefore, to be exact, in private international law, based on the different level of the mandatory effect, we should divide a country's private law and regulations into four categories: facultative legal norms, general mandatory legal norms, overriding statutes and public order legal norms.[7] The mandatory effect of these four legal norms increases in sequence. When the parties choose a foreign law/extra-territorial law as the applicable law to the contract, the facultative legal norms and the general mandatory legal norms are superseded by the relevant provisions of the applicable law to the contract, but the "overriding statutes" and public order legal norms of the state of forum must be applied forcefully. The law applicable to the contract as chosen by the parties not only cannot rule out the application of these two special norms, but also cannot conflict with the two special norms. In the case of conflicts, the application of the applicable law to the contract will be ruled out because of the mandatory application of the two kinds of special norms.

2 The Court Can Apply Chinese Law if the Parties Agree to It

As discussed above, the choice of law in the conflict of laws has the effect of ruling out the application of mandatory laws of the forum state. Consequently, though private international law of most countries allows the parties to foreign-related contracts enjoying the freedom to choose the law, in areas other than the

[7] For the detailed differences between facultative legal norms, general mandatory legal norms, "overriding statutes" and public order legal norms, see Ruiting Qin, **HKfAfe** (Private International Law), Nankai University Press (Tianjin), at 166-72 (2008).

contract, the right of the parties to choose the applicable law for the legal relationship is restricted to varying degrees in many countries. Because in principle the contract only has legal effect between parties to the contract, and most of the clauses in the contract law of various countries are normally facultative, the parties' free choice of the applicable law to the contract normally does not damage the interest of any third party, the public interest, or the forum state. This is the main reason why Article 126 of China's Contract Law and the conflict of laws for contracts of most Western countries expressly stipulate that the parties to the contract can freely choose any country's law as the applicable law. However, in areas other than contracts, such as torts, property right, marriage and family, and decedents estates, since the legal effect often involves third persons other than the parties, allowing the parties of these areas to freely choose foreign laws or extra-territorial laws as the applicable law for the legal relationship between them is likely to damage the legitimate interest of innocent third parties. Furthermore, Chinese laws that govern the legal relationships of these areas are mostly mandatory laws. For these reasons, China's legislators have not granted the parties the right to choose the applicable law for the legal relationships in these areas, but have adopted the objective connecting points to determine the applicable law in all the areas other than contracts. Nonetheless, in the judicial practices, some courts in China mistakenly think that regardless of the nature of the foreign-related case, as long as the parties agree to apply a specific law, (especially when the parties both agree to apply the law of the Mainland of China), the court can or should apply the law (especially the law of the Mainland of China) to the case. This is an obvious misunderstanding in the judicial practices of Chinese private international law.

In *Tipco Asphalt Public Co. Ltd. v. Islamic Republic of Iran Shipping Lines,* a claim for compensation for infringement of maritime transport of goods, the Shanghai Maritime Court on the one hand defined the case as a dispute over compensation for infringement of maritime transport of goods, and on the other hand applied the law of the Mainland of China in the trial of the case upon the agreement of the parties. The Shanghai High Court also applied the law of the Mainland of China to reach the judgment but did not state the reasons thereof.[8] From the wording "upon the agreement of the parties," the court of first instance applied the law of the Mainland of China as the applicable law based on the choice of the law of the Mainland of China by the parities through agreement. However, the case involved the dispute over compensation for infringement of maritime transport of goods. According to Article 146 of the *General Principles of Civil Law,* compensation for infringement should apply the law of the place

[8] Civil Judgments of Shanghai Municipal High Court (2003), *Hu Gao Min Si Zhong Zi* no. 133.

where the infringement occurs, and the parties do not have the right at all to choose the applicable law for infringement. Therefore, the court's adherence to the choice of the parties by applying the law of the Mainland of China as the law applicable to infringement obviously breaches Article 146 of the *General Principles of Civil Law*.

In the appeal involving the dispute over the infringement on the exclusive right to use registered trademarks between the Chengdu Manabe Coffee Culinary Culture Co. Ltd. and the Kohikan International Ltd. of the Republic of Mauritius,[9] the judgment of both the court of first instance and the court of second instance explicitly pointed out that as both parties had not reached an agreement on the applicable law, according to Article 146(1) of the *General Principles of Civil Law of the People* S *Republic of China,* the law of the place where the tort occurred should apply to the compensation for tort. As the alleged tort by the Chengdu Manabe Company occurred in the People's Republic of China, the law of the People's Republic of China should apply. The judgment shows that the court would have allowed the parties of a foreign-related tort to choose the applicable law through agreement. Moreover, the court thought that the applicable law for tort chosen by the parties to have effect of prior application, only when the parties did not choose the law should the law of the place where the tort occurred as stipulated in Article 146 of the *General Principles of Civil Law* be applied. In the appeals involving the dispute over tort between the appellants—Yuqin Qin and Shenzhen Renmin R. South Securities Exchange Department of Jutian Securities Co. Ltd.,[10] the court of first instance expressed a similar viewpoint. The judgment pointed out: "The parties did not make any agreement on the applicable law; according to the stipulation that the law of the place where the tort occurs should be applied for tort disputes, the law of the People's Republic of China shall apply in the case as the tort of the case occurred in China."

In Yida Marine Fisheries Co. Ltd. v. China International Marine Fisheries Corp., an action for compensation of damages caused by the erroneous detention of a vessel, vessel 235, there was a collision in a foreign country,[11] as vessel 236, which belonged to the Shengde Company, collided with Vessel 9203 which belonged to the defendant, i.e., China International Marine Fisheries Corp. in the sea area of Pakistan, and Vessel 9203 sank. The defendant mistakenly regarded Vessel 235 that belonged to the plaintiff as a sister vessel of Vessel 236 which in fact did not belong to the plaintiff, and applied to the Karachi Court of Pakistan

[9] Civil Judgments of Sichuan Provincial High Court (2004), *ChuanMin Zhong Zi* no. 162.

[10] Civil Judgments of Guangdong Provincial High Court (2004), *Yue Gao Fa Min Si Zhong Zi* no. 2.

[11] See www.vipchinalawinfo.com (last visited August 28, 2009).

to detain Vessel 235 and Vessel 236. The vessel 235 was detained for 22 days. The plaintiff instituted legal proceedings in the Xiamen Maritime Court, asking the court to order the defendant to compensate for the loss the vessel 235 suffered by the illegal detention of Vessel 235 for 22 days totaling RMB 1,036,200, together with litigation fees and attorney fees incurred to the plaintiff in the court in Pakistan which was about RMB 300,000, and the interest of the aforesaid amounts.

Xiamen Maritime Court believed that the case was a dispute over liquidated damages for a foreign-related maritime tort, and that the law of the country where the vessel was detained should normally apply. "However, given that both parties have residence in China, and the basis for the defendant's application for vessel detention is vessel collision, while the flag country of the colliding vessels is the People's Republic of China; furthermore, in the prosecution and defense both parties invoked the law of the People's Republic of China and agreed to solve their dispute according to the law of the People's Republic of China, therefore, according to the stipulation of Article 146 of China's *General Principles of Civil Law,* this court establishes the law of the People's Republic of China as the applicable law for this case." In fact, Article 146 of China's *General Principles of Civil Law* expressly stipulates that the court can apply the law of the place of domicile of both parties as the applicable law for the tort. Since the case involved dispute over a foreign-related tort, and both parties had residence in China, the court could by all means define Chinese law as the applicable law for the tort directly based on Article 146 of China's *General Principles of Civil Law*. Nevertheless, after stating that both parties have residence in China, the court's verdict further pointed out that as in the prosecution and defense both parties invoked the law of the People's Republic of China and agreed to solve their dispute according to the law of the People's Republic of China, the law of China was applied as the applicable law. The author does not think Xiamen Maritime Court's extra analysis and statement are superfluous, for it reflects a relatively common misunderstanding in the judicial practices of Chinese private international law: As long as the parties of foreign-related cases agree to apply Chinese law, Chinese law can (or should) be applied as the applicable law. The judgment of second instance for the case made by Fujian Provincial High Court justifies the author's viewpoint. The judgment of second instance did not correct the court of first instance's erroneous reasoning on the application of law. On the contrary, it expressly observed that "in the litigation both parties agree to apply Chinese law as the applicable law for this case, and according to the provisions the agreement should be recognized." Tianjin Municipal High Court expressed exactly the same viewpoint in the dispute over liquidated damages for personal injury in the harbor operation involving the appellant—Jin Yang Shipping Co. Ltd. The judgment of the court reads, "in the first trial both the appellant and the

appellee expressly agreed that the China's Supreme Court's *Specific Provisions on Liquidated Damages in the Trial of Marine Personal Casualty Cases Involving Foreign Parties (for Trial Implementation)* should apply, and in the second trial neither of the parties objected to this, so the court believes that the law of the People's Republic of China and relevant provisions of the Supreme Court of China should be applied in handling this case."[12]

The aforesaid misunderstanding exists not only in the area of tort, but also in other areas of Chinese private international law. It is known to all that because the numerous clauses principle is adopted in property law, the substantive property law of most countries forbids the parties to create new property right through agreement, furthermore the conflict of principles of property law in most countries also does not allow the parties to choose the law applicable to the property rights through agreement. However, in the case of an assets ownership dispute between the plaintiff—Fuyun Development Co. Ltd. ("Fuyun Company") and the defendant — Chengdu Xinjin Baozhu Liquor Co. Ltd. ("Baozhu Company"),[13] Chengdu Municipal Intermediate Court expressly acknowledged the effect of the parties' choice of Chinese law as applicable to the property right. The court noted in its judgment, "in this case, Fuyun Company suits Baozhu Company for the dispute over confirmation of the ownership of the yeast liquor stored in the storehouse of the Baozhu Company. The place where the behavior occurs is within the territory of the People's Republic of China, and both parties state that the law of the People's Republic of China shall be applied. Therefore the case should be governed by the law of the People's Republic of China."

In the case of a dispute over the unjust enrichment of marine cargo transportation among the appellant—Guizhou Wengfu Phosphorus Chemical Import and Export Co. Ltd. ("Wengfu Company"),[14] and the appellees—Sino Transpac Corp. ("Sino Company") and the Universal Chartering Inc. ("Universal Company"), Universal Company signed a time charter contract with Bulktrans (Europe) Corp. ("Bulktrans") on October 9, 1998, specifying that the Universal Company would rent the Vessel Meraks of Bulktrans. On the same day, the Universal Company signed a voyage charter contract with the Startrade Pacific Inc. ("Startrade"), stipulating that Startrade would rent the Vessel Meraks from the Universal Company to ship 20,000 tons of bag-packed chemical fertilizer from Zhanjiang port and Beihai port of China to Chittagong of Bangladesh. On October 12, Wengfu Company entered into a voyage charter contract with Sino

[12] Civil Judgments of Tianjin Municipal High Court (2003), *Jin Gao Min Si Zhong Zi* no. 87.

[13] Civil Judgments of Chengdu Municipal Intermediate Court (2005), *Cheng Min Chu Zi* no. 850.

[14] Civil Judgments of Guangdong Provincial High Court (2004) *Yue Gao Fa Min Si Zhong Zi* no. 53.

Company. Then they stipulated that Wengfu Company would rent the Vessel Meraks from Sino Company to ship 11,000 tons of bag-packed heavy calcium carbonate from Zhanjiang port to Chittagong of Bangladesh. On October 28, Wengfu Company remitted the freight of USD 199,584 through the Bank of China Guizhou Branch to the account designated by Sino Company. However, after the Vessel Meraks departed from Zhanjiang port, Universal Company instructed the Vessel Meraks to stop off in Singapore on the pretext that the freight had not been received thus the transportation could not be completed. In order for the voyage to continue, on December 23, the consignor Wengfu Company and the Serrex (Hong Kong) Ltd. ("Serrex") signed a three-party agreement with the Universal Company according to which Wengfu Company paid USD 150,000 to the Universal Company on January 19, 1999. The Wengfu Company stated that in the voyage related to the case, Sino Company was the carrier in the contract while the Universal Company was the actual carrier. In the same voyage both Sino Company and the Universal Company claimed freight from Wengfu Company, causing Wengfu Company to pay in total USD 369,584 for the voyage. With this, plus the freight of USD 138,849 paid to the Universal Company by the Zhanjiang Foreign Shipping Company, the carrier received a total amount of USD 508,433, USD 299,015 more than the receivable freight of USD 209,418 for the voyage. According to the stipulation of Article 92 of *the General Principles of Civil Law of the People's Republic of China,* the extra amount received by Sino Company and the Universal Company constituted unjust enrichment. For this reason, Wengfu Company instituted legal proceedings with the Guangzhou Maritime Court on April 1, 2002, requesting Sino Company and Universal Company to jointly return RMB 2,496,863.9 together with the interest to Wengfu Company.

The first-instance judgment of the Guangzhou Maritime Court considered the case a dispute over unjust enrichment of marine cargo transportation. Both Wengfu Company and the Universal Company chose to apply the law of the People's Republic of China to solve the substantive dispute in the case. As a result, the law of the People's Republic of China was applicable for the dispute over unjust enrichment between Wengfu Company and the Universal Company. The Wengfu Company and Sino Company did not make any agreement on the application of law. Because the dispute over unjust enrichment between the parties occurred in the performance of the voyage charter contract, the law that governed the voyage charter contract should be applicable for resolving the dispute over unjust enrichment between Wengfu Company and Sino Company. The voyage charter contract did not contain a choice of law clause. According to Article 145(2) of the *General Principles of Civil Law of the People's Republic of China,* the law of the country that has the closest connection to the contract

should apply. The voyage charter contract was signed by means of facsimile; the loading port, the domicile of the lessee, and the court for dispute resolution were in the People's Republic of China; the discharging port was in Bangladesh, and the domicile of the lessor was in Singapore. Therefore the People's Republic of China has the closest connection with the case. The applicable law for the voyage charter contract should be the law of the People's Republic of China, and the dispute over unjust enrichment arising from the execution of the contract should also be resolved according to the law of the People's Republic of China. Finally, the court held that according to the law of China, the amount collected by Sino Company and the Universal Company did not constitute unjust enrichment.

The Wengfu Company objected to the first-instance judgment and appealed to Guangdong Provincial High Court. It was noted in the second-instance judgment of Guangdong Provincial High Court that "the court believes that the case is about dispute involving foreign parties. The court of the original trial has jurisdiction over the case and applied the law of the People's Republic of China in handling the case based on the choice of the parties and the principle of the closest connection. The parties do not have any objection to this, and the court supports the rule."

It can be seen from the aforesaid various cases that although according to China's existing legislation, parties may choose the applicable law only with respect to a contract,[15] in the judicial practices, whether in the area of tort where the existing legislation of China forbids the concerned parties to choose the law, or in the areas of ownership rights in movables or unjust enrichment, where the existing legislation of China does not have express provisions, the choice of the parties of Chinese law as the applicable law for the legal relationship between them has been accepted by the courts in the Mainland of China. Moreover, the second-instance judgment of the case over the unjust enrichment of marine cargo transportation among the appellant (Guizhou Wengfu Phosphorus Chemical Import and Export Co. Ltd.) and the appellees (Sino Transpac Corp. and the Universal Chartering Inc.) extends the scope of the principle of autonomy of parties to all "disputes involving foreign parties," i.e., all international civil and commercial cases. This judicial practice of Chinese private international law has far-reaching implications. We can view this as a breakthrough to Chapter 8 of China's *General Principles of Civil Law* formulated in the era of the planned economy; we can also view it as Chinese judicial practices to fill in a gap in the legislation of Chinese private international law and the "case law" unique to China. However, the author is more inclined to believe that the practice derives from judges in some Chinese local courts having inadequate theoretical

[15] Art. 126 of China's *Contract Law,* art. 145 of *General Principles of Civil Law,* art. 269 of *Maritime Law,* and art. 188 of *Civil Aviation Law.*

knowledge and insufficient understanding of private international law, a fact compounded by a major misunderstanding of the judicial practices of Chinese private international law. The reasons are set out as below:

Firstly, although the main part of China's existing private international law, i.e., Chapter 8 of *General Principles of Civil Law,* was formulated in the era of the planned economy, some of its content already lags behind the needs of the time, and there are some salient legislative loopholes. Both the adjustment of the existing law through cases and the closure of legal loopholes through judicial decisions require the judge to explicitly point out the inadequacy of the existing law and illustrate the legal loopholes. In the tort case mentioned above, by allowing the parties to choose Chinese law, the judge revised the principle for the place of tort specified in Article 146 of China's *General Principles of Civil Law,* but did not state the weakness of the principle for the place of tort or the reason for not applying the principle; in the case of unjust enrichment involving foreign parties, the judge filled in the gap of the legislative loophole in China's conflict of laws for unjust enrichment by allowing the parties to choose *lex fori,* but in the judgment of the court the existence of the legislative loophole was not mentioned. As a result, the judgments of the aforesaid cases tends to lead to another conclusion: The judges were not familiar with China's existing private international law in holding wrongly that China's existing private international law allowed the parties to choose Chinese law as the applicable law in all civil and commercial cases involving foreign parties.

Secondly, the judges "created" a conflict rule that is not recognized by China's existing private international law in the cases cited above: "The parties of foreign-related civil and commercial legal relationships can choose Chinese law as the applicable law for such relationships." Nonetheless, among all cases mentioned above, we cannot find any reasoning or argumentation to support the judges in formulating such a rule of conflicts. Whether it is in the countries implementing the Anglo-American law system or in the countries adopting the continental law system, if judges wish to break through the existing legislation and create new legal rules (provided that they have such right), they must conduct a careful assessment and offer detailed reasoning and argumentation. They must, on the one hand, explain the inadequacy of the original rules or the existence of legislative loopholes and the necessity of closing such loopholes, and on the other hand, prove the rationality and feasibility of the new rules that are created by judges. Only with sufficient reasoning and argumentation can the "rules" created by judges become the basis for judgment and a "case law." Creating a rule at will without any reasoning and argumentation, any legal procedural basis, or any demonstration and explanation of rationality and feasibility of its substantive content runs against the basic principles of a society with rule of law, and is nothing but an arbitrary ruling or even unjust adjudication,

which should not and cannot become the guiding judicial principles of any country.

Thirdly, in any case, "judge's creation of law" is based on judges' conscious creation of new rules. In the aforesaid cases, though the judges accepted the conflicts rule that "the parties can choose Chinese law as the applicable law," and established the applicable law for the cases according to such a rule of conflict, they did not expressly state that such rule was a rule not yet included in China's existing private international law, or explain the necessity and rationality of applying such a conflict of rules, let alone state whether such a conflict of rules had legal effect and why it had legal effect. In the court judgments discussed above, there is no evidence showing that judges were consciously creating the conflicts rule that "the parties can choose Chinese law as the applicable law."

To sum up, recent Chinese judicial practices that allowed the parties of legal relationships involving obligation and property rights other than the contract to choose *lex fori,* i.e., in the relevant cases, Chinese law as the applicable law, is not a legitimate development of Chinese private international law (unless the laws and regulations of China's existing private international law are revised). Rather, they represent an abuse of *lex fori* due to some judges' lack of understanding of private international law in China, and a misunderstanding in the judicial practices of China's private international law.

3 The Evasion of Law Is Constituted if the Law Chosen by the Parties Does Not Conform to the Mandatory Stipulations of China

Law evasion occurs in the area of marriage and family law; and this phenomenon is amply evidenced in the histories of Western countries in these areas, where parties seek to evade the mandatory law forbidding divorce in the *lex fori* by changing their nationality. After World War II, as increasing Western countries legislated to recognize the principle of free divorce, the motive and purpose for law evasion by the parties do not exist anymore, and consequently there are few cases of law evasion in the Western countries. Chinese private international law adopts the principle of *lex fori* in the area where law evasion is common, such as divorce involving foreign parties, thus ruling out the possibility from the perspective of legislation of evasion of the legal norms for divorce in the Mainland of China by the parties. Consequently real evasion of law rarely occurs in the judicial practices in the courts of the Mainland of China. However, the Supreme Court of China still formulates provisions regarding law evasion in the form of judicial interpretation. Article 194 of the *Opinions of the Supreme Court on Several Issues Concerning the Implementation of the General Principles of Civil Law of the People's Republic of China (for Trial Implementation)*

("Opinions on the General Principles of Civil Law")[16] of 1988 stipulates that "parties' behaviors of evading Chinese mandatory or forbidding legal norms do not have the effect of applying foreign laws."

According to the judicial practices of the courts of the Mainland of China, nearly all the cases in which the Chinese courts apply Article 194 of the *Opinions on the General Principles of Civil Law* occur in the area of contracts involving foreign parties especially parties from Hong Kong and Macau. In these cases, courts normally determine that the choice of law by the parties as the applicable law to the contract constitutes the evasion of law in private international law, thus finding the choice of law between the parties invalid according to Article 194 of the *Opinions on the General Principles of Civil Law.* In *Beijing Jinghuang International Building Co. Ltd. v. China Life Insurance (Overseas) Co. Ltd.* Hong Kong Branch, regarding a dispute over a loan contract,[17] both parties agreed in the *Loan Agreement* on the application of the law of Hong Kong. The Supreme Court of China thought that, as the liability between the parties belonged to the category of foreign debt, the choice of the law of Hong Kong by the parties as the applicable law to the contract evaded the registration administration for foreign debt of the foreign exchange administration authority of the Mainland of China, and such a law evasion did not have legal effect according to Article 194 of the *Opinions on the General Principles of Civil Law.* As a result, the mainland law of the People's Republic of China was found to apply in this case. According to the law of the Mainland of China, as the *Loan Agreement* signed by both parties violates the foreign debt registration and administration system of the Mainland of China and the *Interim Provisions on Statistics and Supervision of Foreign Debts* approved and promulgated by the State Council, it should be deemed as void. In the case of a dispute over a guarantee contract between the appellant—Shantou Hongye (Group) Co. Ltd. and the appellees—Bank of China (Hong Kong) Co. Ltd. and Shantou SEZ Xinye Development Co. Ltd.,[18] the guarantee contract between the parties expressly stated that the Hong Kong law should be applied. The Supreme Court of China was of the opinion that as the guarantee involved in the case was provided by mainland companies for the foreign currency loan of a Hong Kong company, it was a dispute over guarantee contract involving foreign parties. Although the guarantee contract specified that Hong Kong law would apply, according to Article 194 of the *Opinions on the General Principles of Civil Law,* when the parties of foreign-related contracts choose the law, they cannot evade

[16] ***Fa (Ban) Fa*** (1988) no. 6, implemented on April 2, 1988.

[17] Civil Judgments of the Supreme Court of the People's Republic of China (2005), *Min Si Zhong Zi* no. 7.

[18] Civil Judgments of the Supreme Court of the People's Republic of China (2002), *Min Si Zhong Zi* no. 6.

the mandatory or forbidding legal norms of the Mainland of China. There are mandatory provisions on guarantee for foreign parties in the Mainland of China, and if the law of Hong Kong governed the guarantee contract, the above-mentioned provisions would obviously be evaded. Therefore, the agreement between the parties on the application of the law of Hong Kong for the guarantee contract did not have legal effect, and the law of the Mainland of China should be applied as the applicable law in this case. In the case of a dispute over debts and a guarantee contract among the appellants — the Starflower Investment Services Ltd. ("Starflower Company"), the Hangzhou Golden Horse Real Estate Co. Ltd. and the Hangzhou Future World Amusement Park Co. Ltd. ("Future World Company"),[19] it was specified in the guarantee contract that it should be construed according to and governed by the law of Hong Kong, and the judgment of the first trial did not analyze the application of law but directly applied the substantive law of the Mainland of China. The Supreme Court of China was of the opinion that since China implemented a foreign exchange control system, when the Future World Company as a Corp. of the Mainland of China provided a guarantee for the Starflower Company (a foreign company), it must register with the foreign exchange administration authority. The Starflower Company agreed with the Future World Company that the guarantee contract should be governed by the law of Hong Kong, which evaded the registration system for foreign guarantees of the Mainland of China. According to Article 194 of the *Opinions on the General Principles ofCivilLaw,* the agreement on the application of the law of Hong Kong was invalid and the mainland law of the People's Republic of China should be applied to the guarantee contract. In the case of a dispute over a guarantee contract between the appellant [Bank of China (Hong Kong) Co. Ltd.] and the appellee (China Great Wall Industry Corp.),[20] the parties agreed that the foreign exchange guarantee shall be "construed according to and governed by the law of Hong Kong." The Supreme Court of China was of the opinion that the completion of approval and registration process for a company of the Mainland of China to provide foreign exchange guarantee was a mandatory requirement of the law and regulations of the Mainland of China. Under the circumstances, the process of examination, approval, and registration was not completed, thus the relevant agreement on the application of the law of Hong Kong between both parties violated the mandatory provision of the laws and regulations of the Mainland of China. According to Article 194 of the *Opinions on the General Principles of Civil Law,* the behavior of evading China's mandatory or forbidding legal norms by the

[19] Civil Judgments of the Supreme Court of the People's Republic of China (2004), *Min Si Zhong Zi* no. 21.

[20] Civil Judgments of the Supreme Court of the People's Republic of China (2001), *Min Si Zhong Zi.* no. 16.

parties does not lead to the application of foreign laws, and the choice of the law of Hong Kong of China should also be governed by this provision. Because the parties of the case evaded the mandatory law and regulations of the Mainland of China, the law of Hong Kong was not applied, but it was rather decided that the law of the Mainland of China should be applied as the applicable law.

Based on the aforesaid judicial practices, the Supreme Court of China promulgated the *Provisions of the Supreme Court on Several Issues Concerning the Application of Law in Trial of Foreign-Related Civil and Commercial Contract Disputes"* ("Judicial Interpretation on Foreign-Related Contracts") on July 23, 2007. Article 6 of the Judicial Interpretation stipulates: "The behavior of the parties of evading the mandatory provisions of the law and administrative regulations of the People's Republic of China does not have the effect of applying foreign laws, and the contract dispute should be governed by the law of the People's Republic of China."

From the above discussion we can see that the viewpoint that "if the applicable law to the contract chosen by the parties violates the mandatory stipulations of the Mainland of China, an evasion of law is constituted" is not only accepted by the judicial practices of the courts of the Mainland of China, but also officially recognized by the Supreme Court of China. However, the author believes this viewpoint is a misunderstanding and an abuse of the system of forbidding law evasion, and it evidences a cognitive misunderstanding of Chinese private international law. Analyzed from the theories of private international law, whether law evasion in private international law can occur in the contract area is by itself an issue worthy of exploration; and the determination of the constituting of evasion of law through a choice of law by the parties warrants even more discussion. This is because on the one hand, the parties to the contract are allowed to choose the applicable law to the contract, and on the other hand, the choice of law by the parties is deemed as invalid on the pretext of evasion of law. Apparently this is self-contradictory. In a jurisprudential analysis, as long as the legislature chooses a connecting point that can be willfully changed, the parties have the right to change such connecting point in a foreign-related civil and commercial relationship, when allowed by the conflict laws of *lex fori*. Unless the behavior of the parties is an obvious abuse of their right, the court normally cannot deem that the behavior of the parties constitutes an evasion of law; otherwise, judicial practices would disrespect legislation. If the legislature chooses a changeable connecting point, while stipulating that the behavior of intentionally changing the connecting point by the parties constitutes evasion of law, it will result in self-contradiction. For this reason, though the legal system

[21] Judicial Interpretations (2007) no. 14, adopted at the 1429th meeting of the Trial Committee of the Supreme Court on June 11, 2007 and implemented since August 8, 2007.

that defines the conditions of an evasion of law came into being relatively early, it fails to play much role in the judicial practices of private international law in many countries: Germany's Munich Private International Law Review notes that if the legal system about evasion of law in Germany's private international law (not limited to the conflict of laws for contract) is not meaningless at all, it has very limited meaning;[22] Vischer, a prominent Swiss scholar of private international law, even thinks that as real evasion of law rarely occurs injudicial practices, there is no need to cover the issue of evasion of law in legislation. Influenced by this viewpoint, *Private International Law of Switzerland* of 1987 which is considered as the most complete legislation in this area by the international community, does not provide for any evasion of law.[23] In China's existing legislation, Article 126 of the *Contract Law* establishes the principle of autonomy of parties as the primary principle in determining the applicable law for foreign-related contracts, but it does not stipulate any restriction on the scope within which the parties can choose the law. Whether the motive of the parties in choosing certain foreign law/extra-territorial law as the applicable law to a contract is to evade the application of *lex fori* or is for the fairness and reasonableness of such foreign law/extra-territorial law cannot be easily determined in practice; furthermore, the author's review of this area has revealed the fact that no legislation in any country, including China's *Contract Law,* stipulates the specific motives on which the choice of law should not be based. Allowing the parties to freely choose a foreign law or extra-territorial law as the applicable law to the contract, it means granting the right to the parties of ruling out (by way of the choice of law) the application of *lex fori,* including its facultative legal norms and general mandatory legal norms. In this sense, if legislation on the one hand grants the parties the freedom to choose the applicable law to the contract, while stipulating that the parties cannot choose the foreign law or extra-territorial law based on the motive or purpose of evading the mandatory legal norms of *lex fori,* there is an obvious self-contradiction. It is in this sense that Sonnenberger pointed out in the most authoritative journal on private international law, i.e., Munich Private International Law Review, "On the occasion that choice of law is allowed, evasion of law has nothing to do with the motive for the choice of law of the parties."[24] When the court determines the applicable law to the contract according to the principle of the closest connection,

[22] *Muenchener Kommentar zum BGB (Internationales Privatrecht),* Einleitung IPR, RdNr. 759, S. 379.

[23] Frank Vischer, *10 Jahre IPR unter besonderer Beruecksichtigung des Internationalen Schuldrechts,* in *Private Law in the International Arena,* edited by Juergen Basedow, Isaak Meier, etc. T. M. C. Asser Press (Hague), at 803 (2000).

[24] *Muenchener Kommentar zum BGB (Internationales Privatrecht),* Einleitung IPR, RdNr. 759, S. 380.

since the closest connection should be a substantive relationship rather than an "artificially fabricated relationship" that has nothing to do with the contract itself, different from such connecting points as the domicile of the parties, the place of performance of the contract, and the location of the subject matter, the place of the closest connection may not be maneuvered as a connecting point, and therefore the possibility of an evasion of law almost does not exist when the applicable law to the contract is determined according to the principle of the closest connection.[25] Consequently, Article 18 of the *Code of Private International Law of Belgium* of 2004 expressly excludes the contract from the specific areas in which the evasion of law by the parties is forbidden. The article stipulates: "For matters in which the parties cannot freely dispose of their right, in the determination of the applicable law the facts caused and behaviors conducted by the parties only for evading the designated law should not be considered." According to the article, in the contract area, where the parties can freely dispose of their right, any facts caused or any behaviors conducted by the parties should not be deemed as evasion of law.

This article expresses the opinion that the aforesaid tendency of the Supreme Court of China and Article 6 of the *Judicial Interpretation for Foreign-Related Contracts* to condemn the free choice of law of the parties to a contract as evasion of law arises from confusing the differences between two systems of private international law: prohibition of evasion of law and the direct application of "overriding statutes." According to the literature known to the author, the cases where the courts at various levels in China including the Supreme Court of China determine that the choice of law by the parties constitutes an evasion of law are basically related to the foreign exchange administration regulations of the Mainland of China, especially to the areas of foreign-related guarantee and loan. In those cases, both parties agreed on the application of the law of Hong Kong in the contract, several appeals were lodged at the Supreme Court of China, and in its judgment the Supreme Court of China considered without exception that the parties' choice of the law of Hong Kong evaded foreign exchange administration regulations of the Mainland of China, and declared the choice of law to be invalid according to Article 194 of the *Opinions on the General Principles of Civil Law*. Then, they applied *lex fori*—the law of the Mainland of China—as the alternative law. However, if the Supreme Court of China considers that "as long as the applicable law chosen by the parties does not mandatorily require the approval and registration of foreign debts and foreign-related guarantee contracts, the choice of law constitutes an evasion of foreign exchange administrative regulations of the Mainland of China, therefore the choice of law is void" is

[25] Ruiting Qin, `**H-olBW`feSai-fe-`Efe** (Theories and Practice of China's Conflict Laws for Contracts), (5) ***$>mXVCffl%ffi#Wi.*** (Journal of Chinese Studies) 208 (2008).

correct, since at present the laws of most countries and regions do not provide that foreign-related guarantee contracts must go through an approval and registration process, the choice of foreign laws or extra-territorial laws by the parties of foreign-related guarantee contracts will be basically deemed as an evasion of law in practice. Consequently, the viewpoint of the Supreme Court of China will cause the principle of autonomy of parties specified in Article 126 of the *Contract Law* to exist only in name in the area of foreign-related guarantee contracts.[26]

In fact, in the aforesaid cases, the provisions of the *Regulations on Foreign Exchange Administration* concerning foreign debt registration and the approval and registration process of foreign-related guarantee contracts should be applied, but not because of the lack of the applicable law caused by the invalid evasion of law since the choice by the parties of the applicable law to the contract is based on the express authorization of Article 126 of the *Contract Law,* which obviously is not evasion of law; nor is it based on the reservation system of public order since it should be the basic principles of China's constitution and laws, and the ideas of fairness and justice generally accepted by the international community establish the public order of Chinese private international law. In legal hierarchy, the *Regulations on Foreign Exchange Administration* is obviously lower than the constitution and laws, and thus, to take it as the public order of Chinese private international law seems to "abuse the reservation system of the public order."[27] The stipulation of the *Regulations on Foreign Exchange Administration* relating to foreign debt registration and the approval and registration process of foreign-related guarantee contracts should be applied in the aforesaid cases because it belongs to the "overriding statutes" of the state of forum—the Mainland of China.[28] The *Regulations on Foreign Exchange Administration* not only explicitly stipulates that the foreign-related guarantee and the handling of foreign exchange business should be approved by the foreign exchange

[26] Id.

[27] For the distinct differences between the public order reservation system and "overriding statutes," see Qin, fn. 6 Ch. 10.

[28] There are various names of such rule in China and overseas countries, including mandatory rules, internationally mandatory rules, *lois de police,* rules of immediate application, lois d'application necessaire, Eingriffsnormen, overriding statutes, self-limiting rules and spatially conditioned rules. See Thomas G. Guedj, *The Theory of the Lois de Police, A Functional Trend in Continental Private International Law—A Comparative Analysis with Modern American Theories,* 39(4) Amer. J. Comp. L. 661-97 (1991). Accordingly, such names have been translated in different ways in China, such as laws for immediate application, mandatory rules, overriding regulations, interventional rules, invasive rules, norms with regulated room, self-limiting rules and police law.

administration authority,[29] but also specifies administrative penalty measures for ensuring the implementation of the regulations. According to the *Regulations on Foreign Exchange Administration,* providing foreign-related loan or guarantee in violation of China's foreign exchange administrative regulations not only leads to civil liability,[30] but the people involved will also bear administrative and even criminal liability.[31] This not only demonstrates that the foreign exchange administrative regulations of the Mainland of China concerning foreign-related loans or guarantees mainly protect the interest of public laws, but also illustrates the "interventional intention" of such regulations. Meanwhile, in the Mainland of China, there are dedicated administrative institutions (such as the foreign exchange administration authority) responsible for the implementation of these regulations. According to Munich Private International Law Review and the judicial practices of the federal courts of Germany, the explicit "interventional intention," primarily protecting the interest of public laws, and execution by administrative institutions are the most outstanding characteristics of "overriding statutes." If a regulation has any of the characteristics mentioned above, it is likely to be deemed as an "overriding norm" by a German court.[32] China's foreign exchange regulations relating to the approval and registration of foreign-related loans and guarantees have all these three characteristics. Thus such regulations obviously fall within "overriding statutes" of the Mainland of China. As Chinese private international law has not yet provided for the determination and application of "overriding statutes," there are different opinions in the academic literature regarding the concept and nature of this kind

[29] Art. 24, 25 and 27 of the original *Regulations on Foreign Exchange Administration;* articles 18, 19 and 20 of the revised *Regulations on Foreign Exchange Administration* (2008).

[30] The loan contract or guarantee contract is invalid.

[31] Art. 41 of the original *Regulations on Foreign Exchange Administration* provides that in case of engagement of foreign exchange business without the approval of foreign exchange administration authority, the illegal proceedings will be confiscated by the foreign exchange authority and the business will be banned; if a crime is constituted, criminal responsibility will be investigated and prosecuted according to law. Art. 44 provides that for the following behaviors that violate the administration of foreign debts, institutions within the territory of China will be warned by the foreign exchange administration authority with a notice of criticism circulated, and will be imposed on a penalty of between RMB 100,000 and RMB 500,000; if a crime is constituted, criminal responsibility will be investigated and prosecuted according to law: providing foreign-related loan without approval; releasing foreign currency bond overseas without approval in violation of the state's stipulations; providing foreign-related guarantee without approval in violation of the state's stipulations; or other behaviors that violate foreign debt administration. Art. 43 and 44 of the revised *Regulations on Foreign Exchange Administration* (2008) have similar provisions.

[32] *MuenchenerKommentarzum BGB (InternationalesPrivatrecht),* art. 34 EGBGB, RdNr. 20 ff., S. 2142 ff.

of regulations.[33] At the same time, conflicts between the "overriding statutes" of the Mainland of China as they appeared in China's judicial practices and the applicable law to the contract cannot be avoided. Consequently, the Supreme Court of China adopts a roundabout approach by forbidding law evasion to make the application of the foreign exchange administration regulations possible, which express an "interventional intention" of the Mainland of China. Nevertheless, we should realize that the system of direct application of "overriding statutes" has become a system of private international law recognized by the existing legislations of most countries.[34] Indeed, recognizing the "overriding statutes" of the state of forum and giving it the effect of direct application have become an obvious trend in the legislation of conflict of laws in various countries. The avoidance of the independence of the system of direct application of "overriding statutes" by the judicial practices of the Supreme Court of China according to Article 6 of the *Judicial Interpretation on Foreign-Related Contracts,* and the mandatory application of the "overriding statutes" of the state of forum by a roundabout way through forbidding evasion of law, run against the global trend of the conflict of laws of today's world. They contradict Article 126 of China's *Contract Law* and are likely to create in practice the confusion in the application of the three kinds of private international law systems, namely public order reservation, overriding statutes and law evasion. Hence the roundabout way of the Chinese courts is neither reasonable nor necessary, thus in general bringing about more disadvantages than advantages. Therefore, to recognize the existence and effect of "overriding statutes" of the Mainland of China legislation, revise Article 6 of the *Judicial Interpretation on Foreign-Related Contracts* as soon as possible, and further improve the application system of "overriding statutes," as well as the Chinese system for prohibiting the evasion of law, should be the priority task for Chinese legislators of private international law.

4 Conclusion

During the past thirty years of reforms and opening up, the development of

[33] For details, see Qin, fn. 6 Ch. 10.

[34] In the countries where specific legislation is formulated concerning "overriding statutes," Art. 1193 of *Civil Code of Russian Federation,* art. 6 of *Execution Law of the Civil Law of Germany,* art. 16 of *Private International Law of Italy,* art. 36 of *Code of Private International Law of Tunisia,* art. 45 of *Code of Private International Law of Bulgaria,* art. 10 of *Private International Law of Korea* and art. 21 of *Code of Private International Law of Belgium* specifically provide for the public order reservation system. Such legislations that provide for the public order and "overriding statutes" in separate clauses also indicate the independence of the system of "overriding statutes."

Chinese private international law has been tremendous. The contributions made by scholars of Chinese private international law to the theoretical research and the legislative and judicial practices of Chinese private international law are also generally recognized.[35] However, compared with the private international law of the countries with advanced judicial systems, there are obvious gaps currently in Chinese private international law in both theory and practice.[36] There are various reasons for those gaps, and concerted efforts on a number of aspects are required to fill these gaps. The scholars of Chinese private international law should neither take full responsibility of these gaps, nor are they able to fill these gaps alone. Nevertheless, the continuous efforts of the academic circle of Chinese private international law are undoubtedly indispensable and absolutely necessary to fill such gaps. Chinese private international law must be further developed and improved to enable it to have its due position in the international community. In order to eliminate as quickly as possible the aforesaid misunderstandings of Chinese private international law, further develop and improve Chinese private international law, and enable Chinese private international law to acquire its due status in the international community and to become worth of a globally leading nation, the author hereby makes the following proposals:

Firstly, it is necessary and desirable to enhance the study of private international law of the countries with advanced legal system, especially the countries in the continental law system represented by France and Germany. By learning from their advanced theories and legislative experiences in the area of

[35] For details, see "The *Global Forum of Private International Law—Speeches in the Annual Conference of the Private International Law Society of China 2007 and the Ceremony of the Private International Law Society's 20th Anniversary*" by leaders of the society, including Depei Han, Jianming Cao and Jin Huang, in the *Yearbook of China's Private International Law and Comparative Law* (vol. 11), Jin Huang, Yongping Xiao and Renshan Liu eds., Peking University Press (Beijing), at 1-21 (2008).

[36] Many foreign countries have formulated codes of private international law with relatively complete legal systems, but for China's private international law, there is still no legislation in many areas, including movable (personal) property rights, voluntary service, illegal profit, and the personal and property relationship of marriage. In theoretical research, the issues that have emerged in China's judicial practices such as the difference between overriding statutes, evasion of law, and public order regulations, the applicable law for property rights when the place of property changes, and the retroactive effect of the applicable law for a contract after-the-fact, are all not covered in some textbooks of private international law that have national influences. In terms of judicial practices, from the annual judicial practices commentary on China's private international law published in each *Yearbook of China's International Private Law and Comparative Law,* it can be noticed a huge gap between the judicial practices of China's private international law and those of the countries in advanced rule of law.

private international law, we can develop and improve Chinese private international law. Private international law originated on the European continent. Bartolus (the forefather of private international law) and Savigny (the father of modern private international law) are both famous jurists in the European civil law tradition. For this reason, since the birth of private international law the European continent has always been the place with the most sophisticated legislation, theory and judicial practices of private international law. The implementation of the European Union's (EU) *Rome Regulation I* and *Rome Regulation II* has successfully unified the rule of conflict of laws for obligation among 26 of the EU's member countries[3'], turning the ideal of uniform judgment among courts of various countries, which scholars of private international law all over the world have been pursuing for centuries, into reality within the EU. This is the best proof of the advanced nature of the private international law of the European continent. However, due to such reasons as language barriers and the difficulty in collecting legal materials, the research of Chinese scholars on Continental private international law, especially on German and French private international law, lags far behind their study of the Anglo-American law system. For example, some prominent theories and systems of private international law of the European continental countries, such as "overriding statutes" and coordination, rarely receive attention in the works of Chinese private international law, which inevitably hinders the theory development of the Chinese private international law. With these theories underdeveloped, the development of the legislation and judicial practices of Chinese private international law will also be difficult. Consequently, it is imperative for China to enhance the introduction, learning, and study of advanced theories and legislation of private international law from advanced countries such as France, Germany, and Switzerland.

Next, the professional training of the Chinese judges, especially those engaged in foreign-related trials, should be enhanced and their professionalism should be drastically improved when conducting foreign-related civil and commercial trials. For historical reasons, judges of many local courts in China have not yet received effective legal education. Since China implemented the national judicial examination, there has been substantial improvement in the professionalism of judges. Still, some judges who are engaged in foreign-related trials fail to study private international law systematically until now. Since private international law is characteristic of strong applicability and practicality, historically many important theories and systems of private international law were originated in judicial practices. Thus, without dramatic improvement of the professionalism

[3'] Among 2' member countries, only Denmark has not joined the *Rome Regulation I* and *Rome Regulation II* yet.

and skills of the Chinese judges, the theories and practice of Chinese private international law can hardly improve. In this sense, a great progress in the professionalism and skills of the Chinese judges involved in the foreign-related trials is critical to the development of Chinese private international law.

Finally, it is imperative to reinforce the research on foreign laws and the pursuit of comparative law. Private international law is designed to solve the conflicts of law among countries; without comparison and research of national laws, it is impossible for private international law to develop and improve. Consequently, enhancing the research on foreign laws and comparative law in China is an important premise for developing and improving Chinese private international law. China has not only a large number of legal communities,[38] but also an enormous market demand for the research and application of foreign laws.[39] The author strongly believes that China has not only the need but also the capacity to develop highly advanced theories of private international law and to draft a fair and reasonable code of private international law based on an in-depth research on the laws of nations.

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[38] According to statistics published on the websites of China's Ministry of Education and Ministry of Justice, there are over 58,000 scholars who are engaged in the teaching and research of law in China's higher education institutions, and the number of registered lawyers has exceeded 156,000.

[39] According to statistics released in the *Gazette of the Supreme Court,* no. 3, 2008, courts at various levels in the Mainland of China accepted nearly 30,000 foreign-related cases including those involving Hong Kong, Macau and Taiwan regions in 2008. The parties of many cases demand in different levels for understanding and application of foreign laws.