Sylvia Mercado Kierkegaard (ed.)

International Law and Trade

Bridging the East-West Divide

International Law and Trade Conference
May 10- 11, 2007 Proceedings

International Law and Trade: Bridging the East-West Divide
ISBN13: 978-87-991385-2-4
ISBN10: 87-991385-2-2

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Ed. by

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Ankara Barosu Yayınları (Ankara Bar Association Press)
1000 Adet basılmıştır. (1000 copies)

1.Baskı /1. Edition

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Bu kitap Ankara Barosu tarafından bastırılıp dağıtılmıştır. Her bir makalenin telif hakkı eserin yazarına ait olup, yazarların görüşleri Ankara Barsounu bağlamaz.

This book has been printed and distributed by the Ankara Bar Association. Views expressed by the writers are not binding on the Ankara Bar Association.

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Baskı /printing : Teknoform Basım Yayım Dağıtım Ltd.Şti.
Tel : +90 312 478 03 55

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Revised Edition

ISBN13: 978-87-991385-2-4
ISBN10: 87-991385-2-2

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This book has been made possible through the support of the Ankara Bar Association.

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Foreword

International trade law is expanding rapidly during the era of globalization. The rules of the trade game and global economics are being refined to cope with market liberalization and intense market competition. Rapid evolution has occurred in several business areas that would have been difficult to predict only a few years ago. This has been made possible by new technologies, which provide unprecedented opportunities for economic development. International trade agreements involving information technology, international telecommunications and financial services have been concluded within the framework of the World Trade Organization (WTO), and new international trade policies are being developed that shape the way trade is conducted. This dynamic business environment presents continuing challenges as lawyers, businesspersons, and policymakers seek to stay abreast of current developments.

What then is international trade? It covers a wide and diverse spectrum which is reflected in this book. The articles shed light on issues such as IPR, arbitration, environment, IT law, and particular matters in multilateral and bilateral trade agreements. The articles illuminate controversies and at the same time, contribute to enrich the legal and economic literature

This book offers a collection of research papers written and presented by some of the world's top experts on international trade law and economics at the International Conference on Law and Trade held in Istanbul on May 10- 12, 2007. The Conference was organized by the International Association of IT Lawyers in cooperation with Istanbul Bilgi University, a leading institution in Turkey for the study and development of technology law. The purpose of the Conference was to build communities among constituencies interested in these varied yet related topics, including researchers, policymakers, practitioners, and business people, who are seeking to develop new ideas and to enhance their understanding of the international trade environment. Access to the international perspectives of participants representing six continents and more than two dozen countries provides an enriching and unique experience.

The book has taken shape as a result of contributions from a number of individuals and through the generous support of the Ankara Bar Association. We are grateful to all the authors, sponsors, and program committee members, and in particular to those from the IT Law Research Center of Istanbul Bilgi University

This book provides new perspectives, challenges and recommendations about trade. We invite you to read more in the following pages.

Sylvia Mercado Kierkegaard

Editor

Table of Contents

International Trade & Maritime Law

A Comparison of US Judicial and NAFTA Panel Review of Trade Remedy Cases 1
Juscelino F. Colares and John W. Bohn
Sound Science and Trade Barriers: Democracy, Autonomy and the Limits of the SPS Agreement 10
Edward Morse
Bridging the Gap in the Doha Talks: A Look at Services Trade 21
Rafael Leal-Arcas
GATT/WTO and MEAs: Resolving the Competing Paradigm.....31
Abdul Hasseb Ansari
Iraq's Accession to the WTO: Commitments and Implications.....43
Bashar Hikmet Malwaki
Need for FLCs in India with Respect to Honouring the GATS.....53
Krishnendu Sen and Ritankar Sahu
Traditional Knowledge, the CBD and the TRIPS Regime: Synthesising the Discordant Discourses at the WTO.....62
Vydyanathan Lakshmanan
Rescuing the Inexhaustible (The Issue of Fisheries' Subsidies in the International Trade Policy.....71
Ekaterina Anyanova
The Development of Maritime Laws in Malaysia-Selected Issues.....83
Faizah Nazri Abd Rahman

Trade and Investment

An East-West Contrast of Foreign Direct Investment on Small Business Development.....89
David Floyd & Sandhla Summan
Truth Finding: Do Subsidies Continue After Privatization?.....94
Yu Wu
Foreign Direct Investment in India with Special Focus on Retail Trade.....102
Tanay Kumar Nandi and Ritankar Sahu
Buying Properties in Malaysia? Highlight on Laws, Policies and their Implications on Foreign Land Ownership.....115
Nor Asiah Mohamad

World Economy and Globalisation

Globalization and China's Pathway in Quest for a New Identity.....125
Wei Dan
How To Cope with the Globalization : Recommendations for the EU Novel Members.....132
Amos Avny

International Law and Trade: Bridging the East-West Divide

Table of Contents

Human Rights and Governance

The Prohibition of Bribery of Foreign Public Officials under the South African Legislation and the African Union Convention: An Examination of its Strengths and Weaknesses……..…140
Omphemetse Sibanda

Structuring Money Laundering Control as Mechanism for Controlling Corruption In Nigeria: Need for Enhanced International Cooperation.....150
Charles O.Adekoya

International Human Rights Law: Providing Measurement Tools for CSR.....157
Diego Quiroz-Ornate and Mhairi Aitken

Legal and Technological Developments Concerning eGovernment Services in Poland.....169
Paul Przemyslaw Polanski

Democracy and Human Rights: Reappraising the Rhetoric of "Interdependence and Mutual Reinforcement".....179
Ubong E. Effeh

Corporate Governance, Business and Finance

The Legal Implications of Reputation Risk Management for Franchisors.....186
Tom Burns

The New EU Services Directive: Metaphor for Europe Today; Model for Expanding International Harmonization Tomorrow.....196
Patrick Hugg

Relieving the Burden of UK Capital Taxation on Business.....205
Tim Vollans

Auditor's Liability towards Third Parties within the EU: A Comparative Study between the United Kingdom, The Netherlands, Germany and Belgium.....214
Ingrid De Poorter

Recent Developments of Corporate Governance in the Global Economy and the New Turkish Commercial Draft Law Reforms 223
Cuneyt Yuksel

Financial Collateral Arrangements.....235
Gulenay Rusen

Virtual Meeting of Shareholders and its Immediate Rewards.....245
H. Jaap van den herik and Svetla Pencheva

Possibilities of Measuring the Option Clauses' Value in Sports Contracts: Empirical Study.....251
Jiří Strouhal

Intellectual Property Rights

Taking Patents Seriously.....266
Helen Gubby,Pieter Kleve and Richard De Mulder

Intellectual Property Rights from an Islamic Perspective.....273
Salah Zaineddin

I™ : Avatars as Trade Marks.....279
Angela Adrian

The Purpose of Copyright Protection in Jordan & Canada: A Brief Comparison.....297
Saleh Al-Sharie

International Law and Trade: Bridging the East-West Divide

Table of Contents

Consumer Protection

Consumer Protection and Commercial Transactions in Malaysia.....311
Talat Mahmood Abdul Rashid
Current International Trends in International Product Liability Law.....319
Esin Kucuk Sengur

Arbitration & Mediation

Waiver of a Right to Arbitrate by Resort to Litigation, in the Context of International Commercial Arbitration.....329
Peter Gillies and Andrew Dahdal
Integrating 'Equity' and 'Mediation' into International Commercial Arbitration to make it More Economical and Just 340
Syed Khalid Rashid'
Recognition & Enforcement of 'Foreign Arbitral Awards': A Comparative Study.....346
Anirudh Dadhich and Arun Kumar Bajaj
Mediation in an IP context: WIPO or ICC? 356
Ioanna Thoma

Cyberlaw

Towards Privacy-Preserving Data Mining in Law Enforcement.....360
Stijn Vanderlooy, Joop Verbeek and Jaap van den Herik
Erroneous Execution of Payment Transactions: What Will Be New in the Future?.....369
Reinhard Steennot
Spam, Spamdexing and Regulation of Internet Advertising 379
Paul Przemyslaw Polanski
Some Remarks on the Jordanian Electronic Transaction Act.....388
Hisham Tahat
The Importance of Live Link in Child Abuse Cases (Incest).....393
Norbani Mohamed Nazeri
Virtual Criminal Law in Boundless New Environments.....399
B.J.V. Keupink
The *You Tube* Case: Privacy Protection or the Right to Try to Have Sex on the Spanish Public Beaches? 406
Carlos Rohrmann

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A Comparison of U.S. Judicial and NAFTA Panel Review of Trade Remedy Cases

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Abstract. Empirical analysis of NAFTA Chapter 19 panel decisions shows that they are far more likely than U.S. courts to overturn U.S. agency decisions despite being bound to apply the same law under the same standard and principles of review that U.S. courts adopt. Also, Chapter 19 panels have produced outcomes more favorable to Canadian importers than have U.S. courts. This outcome illustrates that the facial legal terms of an international agreement may give a misleading impression of how it will actually be implemented, and suggests that greater attention must be paid to how it will be interpreted and by whom.

1. Introduction

The United States, like Canada and nearly every other industrialized nation, maintains "trade remedy" laws that authorize U.S. administrative agencies to impose duties on imported goods they find to be "dumped" or subsidized. These antidumping (AD) and countervailing duty (CVD) determinations are subject to review by U.S. federal courts. Chapter 19 of the Canada-United States Free Trade Agreement (CUSFTA) and its successor, [2] the North American Free Trade Agreement (NAFTA), allowed replacing review of agency decisions by national judges on trade-remedy cases with review by binational panels appointed jointly by the governments involved (Canada-United States Free Trade Agreement [CUSFTA], 1988, art. 1904; North American Free Trade Agreement [NAFTA], 1993, art. 1904). Chapter 19 requires these binational panels to review agency decisions on AD and CVD law using the same standard of review *and* substantive law as would the domestic courts they replace (CUSFTA, 1988, art. 1904(3); NAFTA, 1993, art. 1904(3)). NAFTA also prohibits domestic judicial review once one of the members requests the formation of a panel, and requires them to obey the decisions of these panels (CUSFTA, 1988, art. 1904(1); NAFTA, 1993, art. 1904(1)). The U.S. and Canadian governments adopted this arrangement as a compromise after the United States rejected Canada's demands that CUSFTA eliminate all antidumping and countervailing duties in trade between the two countries (Hart, 1989, p. 336-341). Canadians reasoned that this new mechanism for review of agency decisions would put a check on what they perceived as a predisposition on the part of U.S. agencies to rule in favor of U.S. industry petitioners (U.S. General Accounting Office [GAO], 1995, p. 3).

Prior studies of Chapter 19 agree that these panels overturn U.S. agency decisions more often than U.S. judges. Yet, none of these studies has provided an actual empirical comparison of how review has been different under these two systems. This Article reviews prior research and extends it by comparing the results of judicial review of U.S. agency determinations with Chapter 19 review

2. U.S. Trade Remedy Law

The AD and CVD law in the United States is a complex set of statutes designed to ensure that the executive branch takes action against unfair trade practices by foreign countries and/or foreign companies trading with the U.S. Usually, a U.S. manufacturer files a petition with the U.S. Department of Commerce (Commerce) (Tariff Act of 1930 (1930) § 702 & 732). The petition must claim that imports from another country have benefited from government subsidies (CVD) or are being sold in the U.S. at prices lower than in their home market (AD) (Tariff Act of 1930 (1930) § 702 & 732). After a brief preliminary inquiry into the sufficiency of the petition, Commerce then conducts an investigation to determine if the petitioner's claims are valid (Tariff Act of 1930 (1930) § 702 & 732). Concurrently, the U.S. International Trade Commission (ITC) investigates whether the

U.S. domestic industry has suffered injury by reason of such imports (Tariff Act of 1930 (1930) § 705 & 735). If both agencies make affirmative determinations, then Commerce calculates an offsetting duty that will be applied against the subject import (Tariff Act of 1930 (1930) § 705 & 735).

Agency determinations can only be reviewed by the U.S. Court of International Trade (CIT), an Article III court sitting in New York City (Customs Courts Act (1980) § 201). The U.S. Court of Appeals for the Federal Circuit (CAFC) has exclusive appellate jurisdiction over final decisions of the CIT (Federal Courts Improvement Act (1982) § 715). The U.S. Supreme Court has discretion to review CAFC decisions (Act to Improve the Administration of Justice by Providing Greater Discretion to the Supreme Court in Selecting the Cases it will Review (1988) §2), though it has reviewed only a handful of AD and CVD cases in the last hundred years. [3]

Review of U.S. agency final determinations occurs under the "substantial evidence" standard. Under this standard, the reviewing court decides whether such determinations are "unsupported by substantial evidence on the record, or otherwise not in accordance with law" (Tariff Act of 1930 (1930) § 516A). Specifically, this standard has been interpreted to be the equivalent of asking "'is the determination unreasonable?'" (SSIH Equip. SA v. U.S. Int'l Trade Comm'n (1983), p. 381 as cited in Nippon Steel Corp. v. United States (2006), p. 6). In the majority of cases, when deciding whether an agency's decision is "not in accordance with law," a court will provide some deference to the agency's legal interpretations, upholding them unless they are "effectively precluded by the statute" (PPG Indus. V. United States (1991), p. 1573). While this review process is open to all foreign parties who wish to appeal U.S. agency determinations before U.S. courts, NAFTA member countries have another option in Chapter 19 panel review.

3. The Chapter 19 Review System

Chapter 19 came into effect on January 1, 1989 (CUSFTA, 1988, art. 2105). Members agreed to waive their sovereign right to have their agency determinations be reviewed by their domestic courts, opting instead for review by binational panels (NAFTA, 1993, art. 1904(1)). Agency compliance with its country's domestic trade remedy laws, as determined by these binational panels, would be the measure of that country's compliance with its NAFTA obligations (NAFTA, 1993, art. 1904(2)). Thus, parties from NAFTA countries affected by U.S. trade remedy determinations were given the option to seek either U.S. judicial or Chapter 19 panel review (NAFTA, 1993, art. 1904(5); Tariff Act of 1930 (1930) § 516A). However, a request for the formation of a binational panel by any party who took part in the agency proceedings forecloses U.S. court review of such determinations (NAFTA, 1993, art. 1904(11); Tariff Act of 1930 (1930) § 516A).

Panels, which consist of "experts" in international trade matters (usually lawyers in private practice), are bound to apply the domestic law of the party whose agency order is challenged, i.e., the law of the importing country (NAFTA, 1993, annex 1901.2(1)-(2); Tariff Act of 1930 (1930) § 516A). More importantly, as reviewing authorities, NAFTA panels must apply "the standard of review . . . and the general legal principles that a court of the importing party otherwise would apply to" determinations of the competent agencies in the importing country (NAFTA, 1993, art. 1904(3)). Therefore, NAFTA panels reviewing Commerce or ITC trade remedy decisions are bound to (a) apply U.S. trade remedy law; and (b) employ the statutorily mandated standard of review and assume a level of deference similar to that extended to such agencies by the CIT and the CAFC (NAFTA, 1993, art. 1904(3); GAO, 1995, p. 35).

In contrast to the U.S. judicial review system where the Federal Courts of Appeal have no discretion to refuse appeals of final determinations from lower courts (Customs Courts Act (1980) § 201; Federal Courts Improvement Act (1982), § 124; Act to Establish a United States Court of Appeals for the Federal Circuit (1982), § 124) there is no appeal as a matter of right from a panel decision. Under NAFTA, only governments can file a request for an "extraordinary challenge" to a panel decision (NAFTA, 1995, art. 1904(13)). Extraordinary Challenge Committees ("ECCs") exist partly to ensure that NAFTA decisions remain consistent with domestic law and precedent, (Pure Magnesium from Canada (ECC Report), 2004, para. 29) [4] but are permitted only in relatively extreme circumstances. For example, a government can file an extraordinary challenge if a panelist is guilty of "gross misconduct," or the Panel "manifestly exceeded its powers, authority or jurisdiction…for example by failing to apply the appropriate standard of review," but even then only if such an action "materially affected the panel's decision and threatens the integrity of the binational panel review process" (NAFTA, 1993, art. 1904(13)).

4. Earlier Studies on the Record of Chapter 19 Review

Many authors have in some way sought to compare the results of Chapter 19 review of U.S. agency decisions with the outcomes of adjudication by the CIT and CAFC (Cannon, 1994; GAO, 1995; Goldstein, 1996; Jones, 2000; Krauss, 1993; Lowenfeld, 1991; Macrory, 2002; Mercury, 1995; Pan, 1999; Riccardi, 2002). They all have noted that Chapter 19 panels overturn agency decisions more often than the U.S. courts (Cannon, 1994; GAO, 1995; Goldstein, 1996; Jones, 2000; Krauss, 1993; Lowenfeld, 1991; Macrory, 2002; Mercury, 1995; Pan, 1999; Riccardi, 2002). Most consider this a desirable outcome or at least one permissible under U.S. law (Goldstein, 1996, p. 562; Jones, 2000, p. 149; Lowenfeld, 1991, p. 338; Macrory, 2002, p. 18; Mercury, 1995, p. 527-528; Pan, 1999, p. 442-444). Some studies have also compared how Chapter 19 panels review U.S. and Canadian agency decisions. They have concluded that Chapter 19 panels have showed far more deference to Canadian decisions, and have ruled more often in favor of petitioners from Canada (Jones, 2000, p. 149; Mercury, 1995, 529-539, 568-572). None of these studies, however, has systematically looked at the outcomes of all Chapter 19 decisions during both CUSFTA & NAFTA periods. They relied on either data available from the CUSFTA period or data from the earlier years of NAFTA. More importantly, no prior study has compared the results of Chapter 19 review with outcomes of U.S. judicial review.

5. Empirical Analysis of Federal Judicial and NAFTA Review of U.S. Agency Determinations on Trade Remedy Cases from 1989 to 2005

5.1 Statement of Hypotheses and Some Methodological Considerations

To empirically verify whether the agreed-upon review mechanism of NAFTA has behaved similarly to the CIT/CAFC review system, we looked at quantifiable aspects of decisions by these parallel adjudicatory systems. To confirm or refute the general impression that NAFTA panels have been less deferential to U.S. agency decisions than U.S. courts, we examined AD/CVD rate, scope and injury decisions before and after review. [5] The goal was to test the following two hypotheses: [6]

H_1: NAFTA panel review is less likely to leave rate determinations unchanged than U.S. federal court review; and

H_2: NAFTA panel review is less likely to result in rate increases than U.S. federal court review.

The first hypothesis tests specifically whether original AD/CVD rate determinations by U.S. agencies have the same "success" rate under the two review systems. By looking at whether the final results of either type of review maintain or alter the original agency decision—by reference to what happens to the rate after all review is completed—one can develop a picture of how often agency findings (whether affirmative or negative) receive deference. For our purposes, an agency "win" is either an outright affirmance by the CIT or NAFTA panel or an affirmance of a determination on remand that leaves the original rate undisturbed. Conversely, a "loss" occurs whenever the rate changes as a result of review. Assuming ceteris paribus conditions, if one detects statistically significant differences in the way the two adjudicatory systems approach agency decisions under review, one can then identify one of these two systems as being systematically less deferential than the other.

Looking at a subset of these cases, the data collected under the second hypothesis helps us answer what happens to rates when an agency is reversed. This hypothesis notably excludes cases where agencies have "won," as explained in the first hypothesis. By examining how rates change as a result of review, we attempt to detect whether a particular statistically significant trend in the direction of rates exists. Specifically, when we exclude cases where rates remain the same after review, do these adjudicatory systems differ in terms of trends in post-review rates in such a way that one tends to reduce or increase rates more than the other? If one of these review systems is more likely to reduce agency-determined AD/CVD rates than the other, then we can consider that particular system to be more beneficial to exporting interests than to the competing domestic industry in the importing country. Thus, by determining that one review system is more likely to increase (or decrease) rates than the other, we should be able to identify which set of economic interests tend to benefit more under each system—an inquiry beyond the notion of deference, tested in the first hypothesis.

5.2 The Data

To test the two hypotheses, we obtained data from a sample of completed results of CIT/CAFC review and from all NAFTA binational decisions in the period from January 1, 1989 to December 31, 2005. These results focused on determinations made by the Department of Commerce and the ITC. As we looked at each of these decisions, we monitored subsequent developments in case outcomes by looking at agency determinations on remand. Upon completion of data collection, we coded each case for purposes of hypothesis testing. In addition to summarizing the results in the text below, we provide the results in table format in the appendix.

In order to include ITC cases within our sample, we developed a method that allowed us to convert review results from injury determinations into a rate-based approach. Because of the binary nature of injury determinations in U.S. trade remedy law, final judicial or NAFTA review of affirmative injury determinations can result in either affirmance or revocation of the underlying AD/CVD duty order (Tariff Act of 1930 § 701 & 703). Therefore, an affirmance of an affirmative injury determination was coded as a decision that does not alter the rate, while a final decision vacating or calling for the revocation of a prior affirmative injury determination on remand means that the rate is in effect reduced (i.e., the rate actually disappears) as a result of the order being revoked. Accordingly, final affirmance of a negative injury determination was interpreted as a decision that leaves the rate unchanged (i.e., the rate remains at zero as no order imposing offsetting duties exists), while a court or panel-mandated remand that subsequently results in the ITC issuance of an affirmative injury remand redetermination was counted as a change in rates, since duty rates will necessarily be imposed and rates will change from zero upwards.

5.3 Statistical Comparison of Chapter 19 and U.S. Judicial Review Outcomes

5.3.1 First Hypothesis: NAFTA panel review is less likely to leave rate determinations unchanged than U.S. federal court review

Review by U.S. courts results in no change in the agency-determined rate about 68 percent of the time, while NAFTA review maintains the original rate only about 34 percent of the time. Thus, in rounded figures, over 2 challenges in 3 fail to succeed in changing U.S. agencies' rate decisions in U.S. courts. Yet, only 1 challenge in 3 at NAFTA fails to change rates. Conversely, U.S. judicial review of agency determinations change rates less than one-third of the time, while review at NAFTA does so just short of two-thirds of the time. These results demonstrate that varying the review system impacts the likelihood that rates will remain the same. To be precise, U.S. judicial review is more deferential to prior agency determinations than NAFTA binational review because it allows the status quo to stand much more frequently.

To determine whether a statistically significant relationship exists between "adjudicating system" and "rate status," we performed a Fisher's Exact Test. Obtaining a p-value less than .0001 (one-tailed), we were able to corroborate our hypothesis that NAFTA panel review is less likely to leave rate determinations unchanged than U.S. federal court review. That the source of review affects whether rates change, suggests that U.S. judicial review is more deferential to agency determinations than NAFTA as a result of the principle of judicial deference prevailing in all administrative litigation in U.S. courts.

5.3.2 Second Hypothesis: NAFTA panel review is less likely to result in rate increases than U.S. federal court review

By examining the subset of decisions where U.S. agencies were reversed, we seek to determine if the two review systems also differ with respect to the direction that revised rates assume after review is completed.

Although both review systems are more likely to decrease than increase rates when they reverse agencies, they differ markedly in terms of how often rates are increased or decreased. When U.S. courts reverse U.S. agencies, their review leads to increased rates about 32 percent of the time or almost 3 times for every 10 reversals. NAFTA does so 8 percent of the time or less than once for every 10 reversals. In relative percentages, NAFTA review is thus four times less likely to result in increased rates than U.S. court review. Conversely, after NAFTA review, rates are decreased 92 percent of the time compared to only 68 percent of the time in U.S. federal courts.

Statistical testing (p-value approximately .0212) confirmed the interpretation above, allowing us to corroborate our hypothesis that NAFTA panel review is less likely to result in rate increases than U.S. federal court review. That NAFTA review is more likely to result in rate decreases than U.S. judicial review, supports

the earlier inference that NAFTA is more beneficial to exporting interests than to the competing U.S. domestic industry seeking relief against foreign trade practices.

5.4 Why a Priest-Klein Case Selection Effect Cannot Account for the Results of Chapter 19 Litigation

Priest and Klein (1984) posited that samples consisting only of litigated cases are not necessarily representative of the larger population of disputes about which one draws causal inferences. [7] In light of this, one may question whether a case selection effect might actually account for the demonstrated propensity of Chapter 19 panels to rule against U.S. agency decisions. If fewer challenges to NAFTA mean only stronger cases are being pursued, the difference in reversal rates between the two systems may be a result of case selection, rather than an indication of less deference in the Chapter 19 system.

Data on the frequency of Canadian appeals refute this conjecture. First, from 1989 through 2003 (the most recent year for which statistics on agency orders are available), the U.S. issued 15 AD/CVD orders on Canadian imports (International Trade Administration [ITA] (a), 2006; ITA (b), 2006; ITA (c), 2006), all of which were appealed to Chapter 19 panels. That Canadian parties chose to challenge every order a U.S. agency issued against their exports—all leading to NAFTA decisions without a single settlement—shows how unselective they have been with respect to their decisions to appeal. That Canadian appeals have become more frequent since the creation of Chapter 19 review refutes the notion that these cases are somehow made up of stronger claims.

5.5 Pre-Chapter 19 Litigation Results in Cases Involving Canadian Goods

A comparison between litigation patterns in challenges to U.S. agency determinations on Canadian goods before and after the creation of Chapter 19 is necessary. Should Chapter 19 reversal rates match those of U.S. judicial review in the years immediately preceding its creation, one would be forced to conclude that Chapter 19 is not deciding Canadian cases differently than would the U.S. courts it replaced. We now examine the rate of U.S. agency wins and losses during the post-*Chevron* period that preceded the creation of Chapter 19 (1984-1988).

While a perfect comparison between the datasets in the two periods is not possible due to lack of information on the status of rates (pre- and post-review), we can still roughly determine the extent to which U.S. agency decisions were maintained (or changed) by analyzing published court opinions involving Canadian goods in the relevant period. A search of published CIT decisions produced 17 separate cases brought by U.S. domestic industry, U.S. importing industry or Canadian producers.

Of these 17 cases, the U.S. government won 10 (58.82 percent), with other parties winning 7 (41.18 percent). While this analysis does not reveal what happened to the rate after court review, it uses U.S. government wins as a proxy for agency affirmance and, therefore, deference. We suspect that if we had the data on rates before and after review, some of these cases would result in rates being left ultimately unchanged, since, as we learned from our other sample (1989-2005) that not all court reversals lead to rate decreases on remand. Regardless, this means that at least 58 percent of cases resulted in no change in rates. In comparison with the 34.15 percent U.S. agency win rate at NAFTA, this is quite a change. Furthermore, we can surmise that non-agency parties went from a less than 42 percent win rate before NAFTA to a 66 percent win rate, which is a significant increase. Thus, we can conclude that change in review systems brought a greater agency reversal rate.

Of course, this analysis combines under the label "other parties" Canadian and U.S. plaintiffs (U.S. domestic industry and U.S. importers). But for the desire to reverse prior agency action, these parties have opposing interests. Therefore, we analyzed these 17 cases according to whether the party who won had a preference to maintain or increase duty rates (U.S. government and U.S. domestic industry), or was attempting to reduce or eliminate these rates altogether (Canadian producer and U.S. importer). Bearing in mind that U.S. agencies won 10 of these cases, if one takes note of the fact that, among the 7 wins for other parties, 3 wins are for U.S. domestic industry, one can conclude that pro-rate parties won (at least) 76.47 percent of these pre-NAFTA cases, much higher than the 23.53 percent win rate for anti-rate parties.

These changes in rates of agency reversal and duty rate reductions show a systemic pattern: far from mirroring preexisting litigation patterns in U.S. judicial review, the switch from CIT adjudication to Chapter 19 review has profoundly altered the general profile of outcomes in favor of Canadian producers and against U.S. agencies and U.S. domestic industry. More importantly, they corroborate the notion that Chapter 19 panels have not behaved like the U.S. courts they replaced.

5.6 Examining Alternative Causation Theories

Conceivably, one could argue that the reported differences between the two systems merely reflect a pro-U.S. bias in U.S. courts. Therefore, NAFTA results are different because its panels are simply providing a more "correct" interpretation of the law (though this would still mean that NAFTA panels were not fulfilling their mandate to apply U.S. law in the same fashion as the U.S. courts). However, there is reason to think otherwise (Colares & Bohn, 2007). If this were true, this conclusion would still have momentous implications. CIT judges are highly qualified U.S. lawyers, who are appointed for life under strict Article III requirements specifically to shield them from political influence. They typically have many years' experience on the bench, where they specialize in trade law. Their decisions are subject to appeal to the Court of Appeals for the Federal Circuit, where judges have similar qualifications and experience. Thus, if U.S. judicial review produces outcomes that are dramatically more biased against foreign nationals than do ad hoc panels of part-time adjudicators of mixed legal backgrounds, often with no prior judicial experience, whose decisions are not subject to regular appellate review, then the entire U.S. system of lifetime judicial appointment needs rethinking.

Additionally, a bias argument simplistically assumes that all U.S. parties—including the agency, the petitioning domestic industry, and the U.S. importers—have homogenous interests. The opposite is true. For example, the domestic industry would want to impose or increase duties while U.S. importers would want to eliminate or decrease them. In turn, the agency has a greater interest in seeing its earlier decisions upheld on appeal regardless of whether they authorized or denied the imposition of AD/CVD duties. Even if domestic producers could control the appointment process to "pack" the CIT with pro-duty judges (assuming U.S. importers do not form as strong a lobby), it would be much more difficult to sustain that level of control over CAFC appointments. This is the case because review of trade law decisions is a smaller part of the CAFC docket than review of other cases, such as patent cases and claims against the U.S. government. Thus, judicial appointments would be made based upon considerations other than just the candidate's views regarding trade law.

More importantly, a bias argument simply cannot undermine the CIT/CAFC's alignment with other federal administrative review. If one takes the data and statistical analysis coming from the CIT/CAFC portion of this study and compares it with the results of general appellate review of agency action in the U.S., no discrepancy appears. As Graves and Teske showed, when considering a period that predated Chevron by several years, federal appellate and Supreme Court review of administrative decisions yielded affirmance rates of up to 63 percent, which is not much different from the 68 percent affirmance rate detected in hypothesis 1 (Graves & Teske, 2003, p. 859-860). Plausibly, Chevron's call for greater deference has resulted in higher affirmance rates in all judicial review of administrative action, pushing non-trade litigation results even closer to the 68 percent affirmance rate detected in our sample. If affirmance rates of this magnitude are the norm for agency review proceedings throughout the federal judiciary, we can only conclude that the NAFTA binational review system is not acting like reviewing courts in the United States.

6. Conclusion

A striking feature of the data analyzed above is the sustained asymmetrical pattern of review results between NAFTA and CIT/CAFC adjudication. Looking in different ways at the agency-determined rates prevailing before and after adjudication, U.S. agencies consistently "lose" on NAFTA appeals at a greater rate than when those challenges are raised before U.S. courts. Similar results would normally be interpreted as uncontroversial if they emanated from parallel review systems where the substantive law or guiding principles of administrative review (or both) were different. That is not the case with review before NAFTA and the CIT/CAFC systems.

NAFTA's lack of conformity with the pattern of adjudication in all U.S. federal administrative review, including international trade, may mean more than just a mere difference in approaching U.S. substantive law. It may suggest that the NAFTA system is deficient not because it is necessarily determined to misapply U.S. trade remedy law—though such may be the effect of its decisions—but because it just "doesn't get" U.S. administrative law. The Honorable Malcolm Wilkey, a retired Judge from the District of Columbia Circuit, former U.S. ambassador and former member of a NAFTA ECC, diagnosed this problem long ago:

Why do these distinguished Panel experts make this type of error? The answer is, I suggest, that they are experts in trade law; they are not experts in the field of judicial review of agency action; they do not necessarily have any familiarity whatsoever with the standards of judicial review under United States law (Certain Softwood Lumber Products from Canada (1994), dissenting opinion).

Both empirical analysis of the above hypotheses and the systemic-wide findings of previous studies seem to support Judge Wilkey's criticism. For example, while declining to establish a causal pattern based on behavioral differences between Chapter 19 panelists and U.S. judges as the reason why their decisions differed, a prior GAO study found "significant differences between the behavioral characteristics of the binational panel process and the U.S. judicial system that it replaces" (GAO, 1995, p. 4). Further, Judge Wilkey's observation can perhaps help explain the marked increase in U.S. agency reversals in cases involving Canadian goods between the years immediately preceding and during Chapter 19 dispute settlement, during which U.S. law remained largely the same. This remains more than a theoretical discussion, however. The fact is that U.S. trade remedy law is being applied differently as a result of this two-track system. That goes explicitly against the express will of Congressional Committees (S. Rep. 103-189, 1993, p. 41-42, 126) [8] and should be the object of future reform (Riccardi, 2002, p. 727-746). Subsequent research on Chapter 19 review of Canadian agency cases would further our understanding of whether the same asymmetric pattern of adjudication extends beyond the application of U.S. trade remedy law.

Notes:

[1] The authors are grateful to the Office of the Clerk of the United States Court of International Trade, especially to Leo Gordon, former Clerk, for their assistance in the collection of data on agency remand determinations. Many thanks to Jeffrey J. Rachlinski and Kevin M. Clermont for insightful comments and suggestions in the various phases of this project.

[2] Technically speaking, NAFTA did not terminate CUSFTA, which remains in operation, as specified in NAFTA (1993) article 103(1). CUSFTA provisions that are inconsistent with NAFTA are no longer in effect (NAFTA, 1993, art. 103(2)).

[3] The last case the Court reviewed was Zenith Radio Corp. v. United States (1978).

[4] According the report, the ECC should not permit "formation of two streams of anti-dumping and countervail[ing] duty law, one developed by binational panels and one by courts; a result that is clearly antithetical to the whole construct of Chapter 19" (Pure Magnesium from Canada, 2004, para. 29). However, another report holds that a binational panel should use the same standard of review as the Canadian federal courts, even though binational panels are particularly expert in international law, to ensure "certainty, consistency, and predictability in decision-making" between decisions involving NAFTA and non-NAFTA members (Synthetic Baler Twine with a Knot Strength of 200 Lbs. or Less Originating in or Exported from the United States of America, 1995, p. 12).

[5] To simplify sentences and facilitate the flow of text in this Section, when we use the term "rate(s)," the reader should understand that we may also be referring to decisions about the scope of an order. For substantive, not textual, reasons explained in the text below, injury determinations are also subsumed under the general label "rates."

[6] Technically, "[t]he hypothesis that is actually tested is . . . the *null hypothesis*," which generally states that "there is no difference between [the two] groups [studied] or relationship between the variables . . ." (Blalock, H. M., 1979, p. 156). Accordingly, in this study, the "null" states that there is no difference between the two review systems under any of these research hypotheses.

[7] For a detailed discussion of this model, see Priest, G. & Klein, B. (1984).

[8] *See, e.g.*, S. Rep. 103-189 (1993) (explaining that the requirement that "binational panels . . . apply the same standard of review and general legal principles that domestic courts" employ "is the foundation of the binational panel system.") (p. 41-42); *accord* S. Rep. 103-189 (1993) (expressing the desire that the inclusion of judges in the panel system "would diminish the possibility that panels and courts will develop distinct bodies of U.S. law.") (p. 126).

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Appendix:

Table 1

		Adjudicating System		
		CIT/CAFC Review	NAFTA Review	Row Sum
Rate Status After Review	Same Rate	114 67.86%	14 34.15%	128
	Different Rate	54 32.14%	27 65.85%	81
	Column Sum	168	41	n = 209

Table 2

		Adjudicating System		
		CIT/CAFC Review	NAFTA Review	Row Sum
Rate Status After Review	Increased Rate	14 31.82%	2 8.00%	16
	Decreased Rate	30 68.18%	23 91.67%	53
	Column Sum	44	25	n = 69

Sound Science and Trade Barriers: Democracy, Autonomy, and the Limits of the SPS Agreement

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Abstract. This article examines the framework of the Agreement for Sanitary and Phytosanitary Measures (SPS Agreement) and assesses its impacts on domestic autonomy and authority in matters of food and environmental safety. The direct impact of the SPS Agreement appears quite limited, as only a few cases have arisen. The Agreement has not proven to be a pervasive tool for the purpose of overturning domestic policies on food or environmental safety, despite the fact that the WTO Panel or Appellate Body decisions have found that domestic measures violate the terms of the SPS Agreement. Limited enforcement mechanisms provide protection for domestic policies, though perhaps at the price of trade sanctions. Moreover, theoretical literature suggests that the SPS Agreement may indeed enhance democratic values by discounting the influence of special interests and retaining ultimate authority for enforcement within the discretion of domestic government. Important issues nevertheless remain, including the role of the precautionary principle in policymaking and the means to address normative values, such as developing moral consensus on animal welfare, in trade matters. Trade has proven to be a catalyst for change and cooperative development in this context.

I. Introduction.

The sale and distribution of food products has long been the subject of domestic regulation. Safety concerns, such as potential harms to human or animal health from food additives, pathogens, or allergens may animate these regulations. Regulations may also address environmental risks, such as diseases, invasive nonnative species, or even genetic modifications transmitted to other organisms by imports, which may be introduced into the local environment.

These regulations are not uniform, but instead may reflect varying assessments of the appropriate management of risks to humans, animals, and plants in each jurisdiction. International consensus may develop for baseline scientific standards or guidelines affecting food safety, such as those exemplified by the Codex Alimentarius Commission (www.codexalimentarius.net). However, scientific progress means that consensus is likely to be behind the learning curve. Standards for environmental protection are also still developing, as developed and developing nations work through differing priorities.

Every government has an important interest in retaining the ability to adopt protective measures for the benefit of its citizens and their environment. However, these measures also have important implications for trade. Not all regulations are enacted for the beneficent purposes of appropriately addressing health and environmental harms. Some may be designed for discriminatory purposes, to protect local industries from the effects of global competition or to achieve other competitive advantages in contravention of trade agreements. A disguised trade barrier in the form of health or environmental regulations would, if left unchecked, undermine support for free trade agreements and processes. The labyrinth of protective tariffs and quotas, which are already extant in agriculture (see FAO, 2005), lend themselves to further exploitation by indirect and surreptitious means.

Some means of winnowing out these disguised barriers – separating the wheat from the chaff, so to speak – is essential for the development of sound trade processes. For WTO members, the Agreement on the Application of Sanitary and Phytosanitary Measures (hereinafter "SPS Agreement" (http://www.wto.org/english/tratop_e/sps_e/spsagr_e.htm) provides a foundation for distinguishing between appropriate regulations and disguised trade barriers. Other agreements, such as regional free trade agreements (*e.g.*, NAFTA) and the Agreement on Technical Barriers to Trade (TBT) may also be relevant for regulations

involving labeling restrictions or similar technical constraints. However, this article focuses on the SPS Agreement.

The ability to challenge domestic regulations of sovereign states under the SPS Agreement through the WTO potentially threatens internal governance processes and impacts national sovereignty. Such challenges affect matters that may be considered core government functions, *i.e.*, protecting health and safety of citizens and the environment in which they live. Moreover, they occur through an organization that is not democratically accountable. Commentators have expressed concerns that the SPS Agreement presents "a serious threat to the democratic system of government of the WTO Members in the areas of health and environmental protection." (Christoforou, 2000, 622-23). Popular organizations have also raised an outcry in this area, as some see the WTO as threatening core values, such as environmental protection. (See, e.g., Chander, 2006). Moreover, a growing body of literature lays out the case that science itself is not purely objective, especially when it involves application to complex systems and ecologies. (See Atic, 1996; Winickoff *et. al.,* 2005). Without deference to democratically-enacted measures, the WTO could effectively become a superlegislature in which unelected trade experts become the final arbiters of scientific truth and appropriate risk management. (See, e.g., Walker, 1998).

The developing record indicates that relatively few conflicts have emerged under the SPS Agreement, and fewer still have resulted in Panel or Appellate Body decisions. Although complaining nations have indeed been successful in challenging domestic measures, no significant threat to democratic institutions has materialized. This is due, in part, to the limited enforcement mechanisms of the WTO, which allow considerable latitude for domestic democratic processes to function in determining preservation of health and environmental values. Preservation may come at a price, but it is still a matter resolved by domestic politics.

Negotiated resolutions have occurred in many cases, reflecting adaptation to accommodate local trade concerns. Moreover, the SPS Agreement may also be providing additional indirect benefits, which actually enhance democratic values. A growing body of theoretical literature argues that WTO review may enhance rationality and attention to science and risk assessment, thus undermining legislative successes of special interests posited under "public choice" theory. (See, e.g., Howse, 2004; Chander, 2006).

Important issues involving policy and science remain to be resolved. Implementation matters, such as the appropriate evidentiary burden and the role of the "precautionary principle" in policymaking, deserve continuing attention and development. Moreover, the SPS Agreement appears to provide an insufficient basis to address important future policy differences that are likely to arise. For example, current trade agreements appear poorly equipped to address growing concerns on ethical matters affecting animal treatment, which are likely to present future conflicts. In this context, trade has proven to be a catalyst for change and development of new consensus.

The organization is as follows. Part II of this article outlines key provisions in the SPS agreement. Part III provides an overview of trade disputes that have arisen under the SPS agreement, and includes a discussion of the results and their impact (or lack thereof) on domestic regulation. It also briefly discusses conflicting approaches to the burden of proof and to risk assessment, including the degree to which the precautionary principle is implemented in trade matters, and the implications of these issues for the trade environment. Part IV concludes with a look at possible future conflicts based on ethical constraints, which are inadequately addressed in the terms of the SPS agreement.

II. Overview of the SPS Agreement.

The SPS Agreement is a product of the Uruguay Round of Multilateral Trade Negotiations completed in 1993. (See Wirth, 1994, for a history.) The agreement focuses on "sanitary and phytosanitary measures" adopted by member states that may potentially impact international trade. (SPS § 1.) Such measures are those involving the protection of animal or plant life or health within the member state's territory. (See SPS Annex A, ¶ 1). Affected risks include those from pests, diseases, and disease- carrying or causing organisms, as well as "additives, contaminants, toxins … in foods, beverages, or feedstuffs." (Id.)

Article 2 of the agreement provides generally that "Members shall ensure that any sanitary or phytosanitary measure is applied only to the extent necessary to protect human, animal, or plant life or health, is based on scientific principles and is not maintained without sufficient scientific evidence…." (SPS § 2.2) As a corollary requirement, member states are also required to ensure that such measures "do not arbitrarily or unjustifiably discriminate between Members where identical or similar conditions prevail." Moreover, "Sanitary and phytosanitary measures shall not be applied in a manner which would constitute a disguised restriction on international trade." (SPS § 2.3)

Thus, the agreement reflects an ideal that sound science will form the basis for any restrictive regulatory measures. Indeed, measures are deemed "necessary" for purposes of section 2.2 if they conform to international

standards, guidelines, or recommendations. (SPS § 3.2.). Another important dimension of the agreement is harmonization of domestic standards based on the ideal of international consensus. In this regard, the Codex Alimentarus Commission has emerged as an important international body for the purpose of reflecting baseline scientific standards for international protection. (Petersmann, 2006)

Under the SPS agreement, member states are allowed to provide a higher level of protection than provided by international standards, guidelines, or recommendations. However, that member must also demonstrate a scientific justification and an appropriate risk assessment. (SPS § 3.3). For this purpose, a scientific justification must be based on an examination and evaluation of available scientific information, showing that international standards are not sufficient to achieve an appropriate level of protection. (Id.)

To the extent that an international standard or guideline is potentially applicable, however, a member state seeking to impose a more stringent standard faces an uphill challenge. Article 5 of the SPS Agreement requires member states to engage in risk assessment, which takes into account not only the applicable science, but also the potential economic consequences associated with a measure. (SPS § 5.2). Negative trade effects are to be minimized. (SPS § 5.4). Members are required to avoid arbitrary and unjustifiable distinctions in the level of protection it offers, if such distinctions "result in discrimination or disguised restrictions on international trade. (SPS § 5.5). If a less trade-restrictive measure is possible that provides similar protection, it should be adopted. (SPS § 5.6, n.3). A member seeking a more stringent food safety standard than reflected by the Codex standard, for example, would have to show that a scientific basis exists for that more stringent standard. In all likelihood, this requires showing new scientific progress that casts doubt on the protection afforded by the international standard. Not all science generates a binary conclusion, however. Complex links in causation can cause difficulty in ascertaining whether a particular agent actually causes particular results.

Article 5 of the SPS Agreement anticipates that threats may be perceived without scientific certainty of harm. It provides an important exception to the requirement of scientific evidence as a foundation for trade restrictions in section 5.7, which provides that member states may provisionally adopt measures that appear to be more restrictive than necessary if followed by a "more objective assessment of risk" and a review of scientific evidence within a "reasonable period of time." (SPS § 5.7). In effect, this allows preemptive action by members to address perceived risks for which scientific foundations have not yet been clearly developed. In this sense, the SPS Agreement may in fact embody a form of the "precautionary principle" (Wirth, 1994). It allows nations to err on the side of stopping an import that may potentially cause harm to humans or the environment, with some time to assess that harm. As discussed in part III, below, European and U.S. interests seem to apply the precautionary principle differently, as reflected in differences between their trade and environmental agreements.

III. Trade Disputes Involving the SPS Agreement.

Agricultural products and related foodstuffs account for nearly $400 billion in global trade. (See Table 1, below). Trade in commodities (Row B of Table 1) and processed foodstuffs (Row C of Table 1) have been growing substantially in an absolute sense. However, as economic development continues, agricultural exports as a percentage of total exports in other goods and services are nevertheless shrinking. (See FAO, 2005, Figure 4).

Table 1: World exports of agricultural products, (in billions of US dollars)

	1986-90	1997	1998	1999	2000	2001	2002	2003	2004
A – World exports of agricultural products	190.6	326.1	305.7	284.5	293.3	293.7	307.4	354.0	391.7
B – World exports of selected agricultural products	88.1	142.1	134.3	128.4	130.5	136.7	139.0	158.6	172.9
C – World exports of "other" agricultural products (A – B = C)	102.5	184.1	171.4	156.2	162.9	157.1	168.4	195.3	218.9

Source: Members' Participation In The Normal Growth Of World Trade In Agricultural Products - Article 18.5 Of The Agreement On Agriculture 2 (G/AG/W/32/Rev.9) (October 2, 2006).

Despite the potential benefits to consumers recognized under the classic model of free trade, governments frequently erect trade barriers. As of March 1, 2007, the WTO has listed 358 trade disputes since 1995. It appears that 134 of these disputes – or just over one third of them – have involved agricultural products, fish, and other seafood products, which are potential food sources for humans or animals.

Only a small subset of these disputes involves health or environmental concerns implicating the SPS Agreement. These disputes are listed in an Appendix. Twenty disputes alleged some violation of the SPS agreement, with eighteen of these involving food-related products. (The other two disputes involved asbestos and conifer wood.) These disputes generated only six decisions by a WTO dispute resolution panel, and only five of these produced further decisions by the Appellate Body. (See id.) Other cases are either still pending or were resolved without a dispute resolution panel. (It should be noted that these figures are based on numbered disputes, some of which involve the same issues. Separate dispute numbers reflecting complaints of different nations may result in a single decision, as in the recent decision involving genetically modified organisms. When understood in this light, nine disputes out of twenty have generated decisions.)

The fact that so few trade disputes arise under the SPS Agreement is evidence of a limited direct impact by the SPS Agreement. The SPS Agreement has not become a basis for extensive challenges to domestic regulations. With regard to GATT, some commentators have asserted that a paucity of disputes is a sign of ineffectiveness. (See Stostad, 2006 and citations therein). However, the data shown above in Table 1 indicate that trade in agricultural products is growing, and even more so in recent years. Growth casts doubt on ineffectiveness in this context, but it should be noted that trade fluctuations can occur for many reasons. (See FAO 2005). Weather conditions affecting production, domestic consumption practices (such as a shift from corn as a feed grain to ethanol production, for example) and political conditions can all affect products available for export. (See FAO, 2005). Developing practices such as aquaculture have also proven to be a significant contributor to growing exports. (Id.)

Of course, only a few cases, such as those involving hormone-fed meats or genetically modified organisms, can nevertheless have a significant impact on trade volumes. By 2003, more than 167 million acres worldwide were planted to genetically modified crops, with most of these crops in the U.S. and Argentina. (See Pew Initiative on Food and Biotechnology, http://pewagbiotech.org/resources/factsheets/display.php). Unresolved disputes such as these, where implementation of a practical solution remains to be seen, show that some issues are not solely resolvable based on science, but must also accommodate political solutions reflecting deeply held societal values.

Few cases arising under the SPS Agreement have actually continued to final decisions after initial consultations. Trade disputes are commonly resolved without proceeding to panel decisions. According to some commentators, more than half of all trade disputes are resolved in this manner. (Stostad, 2006). With full decisions affecting only nine disputes out of twenty and with decisions possible in two more, it appears that matters arising under the SPS Agreement are being resolved on an informal basis at about the same rate as other matters. For example, the dispute against Australia involving pineapple was resolved by negotiating treatments that were suitable for the parties. Informal solutions reflect some measure of success, as parties are able to negotiate effective results. This may be an effective positive externality effectuated by the agreement. Moreover, there are other disputes, generally involving genetically modified organisms, which appear to have been resolved outside the WTO altogether. (See International Centre for Trade and Sustainable Development, www.ictsd.org). Although it is not clear whether the Agreement itself played a part in those disputes, its potential application in more formal proceedings provides a backdrop that may encourage voluntary resolution.

Cases that have progressed to decisions by the dispute resolution panel have involved significant contested policy issues for the respondent members. In each case, the decisions of the Panel and Appellate Body, if applicable, found that at least some of the domestic measures being challenged violated obligations under the SPS Agreement. These Panel/Appellate Body decisions were often based in part on the respondent's failure to meet obligations required for risk assessment under the SPS Agreement, though some also involved more technical issues. (See the Appendix.)

The most recent panel decision, which involves European Communities – Measures Affecting the Approval and Marketing of Biotech Products – was adopted by the Dispute Settlement Body on November 21, 2006. (WT/DS291/34; WT/DS292/28; WT/DS293/29, 22 January 2007). The panel decision is more than one thousand pages, involving various prohibitions on biotech products. Though some measures were found to violate Article 8 of the SPS Agreement, involving undue delay in approval processes for these products, other state-specific measures were found lacking under Articles 2.2 and 5.1, based on a lack of an appropriate risk assessment. Having failed to meet the burden for required risk assessment, the measures at issue were deemed to fall under article 3.8 of the Dispute Settlement Understanding (DSU). (See WT DS 291/R, ¶ 8.63). Thus, there was a presumption of an adverse impact to the complainants on these issues under the DSU. Following this decision, the parties voluntarily agreed to a resolution process in lieu of further appeals.

Evidentiary Burdens. The paradigm emerging from WTO Panel and the Appellate Body decisions generally places a significant burden on the respondent to justify restrictive measures, both as to scientific basis and to the underlying risk assessment supporting the measure. The matter of which party bears an evidentiary burden in matters before the WTO has proven controversial and confusing, as commentators have observed that the same standards have not always been applied. (Grando, 2006). For example, in the EC-Hormones case, the Panel decision assigned the burden to the respondent to show compliance with the SPS Agreement. However, the Appellate Body instead required the complainants to show a *prima facie* case of violation of section 3.3 and the absence of risk assessment under section 5.1. (Kennedy, 1998) This is consistent with other WTO decisions, which provide that the claimant must prove the *prima facie* case. (Christoforu, 2000). Christoforu suggests that confusion may arise from misunderstandings as to the burden of persuasion versus the burden of producing evidence. (Id.)

The burden of persuasion would refer to the party who loses if the evidence is in a state of equipoise. (Walker, 1998). Walker argues that the "a complaining member should bear the burden of persuading a panel that there is no reasonable scientific basis for the defending member's sanitary measures." (Id. at 292). However, the defending member should bear an evidentiary responsibility here in order to be consistent with the structure of the Agreement. The SPS Agreement establishes a presumption that any measure based on international standards or guidelines is consistent with the agreement. (See SPS § 3.2). However, if a complainant is able to establish noncompliance (i.e., imposition of a higher standard under § 3.3), Article 5 imposes an affirmative obligation on the member state implementing the measure to ensure that a credible risk assessment has been made.

The evidentiary burden assigned to the respondent is potentially significant, in that a stronger burden reflects a pro-trade bias. Other pro-trade biases may also exist from the structure of the SPS Agreement. For example, some scholars suggest that reliance on the Codex for a baseline standard also reflects a pro-trade bias, to the extent that the Codex Commission may have shifted its interest toward trade considerations, and away from protecting consumer interests. (Lee, 2005). Whether pure and unbiased considerations from any organized group are ever possible, however, may be doubted.

In addition to reinforcing free trade values, other values also counsel in favor of assigning a significant burden to the respondent. A state enacting a protective measure is more likely to have access to the information to show that a risk assessment has been conducted. Admittedly, knowledge is not a universal basis for assigning the burden of proof. (Grando, 2006). Nevertheless, assigning an evidentiary burden to the party maintaining the measure (and presumably having done a risk assessment) would arguably be more efficient. Walker, who favors assigning the burden to the complainant, argues that "parties to a treaty should enjoy a presumption that they are complying with a treaty unless a complaining party proves otherwise." (Walker, 1998, at 291.) However, requiring the respondent to produce the basis for the measure, including relevant risk assessment, is entirely consistent with this presumption, to the extent that as much is already required under articles 3.3 and 5.

This approach also avoids a requirement that the complainant prove a negative – i.e., the nonexistence of risk. As Grando has argued, a negative can generally be restated as a positive. (Grando, 2006). To the extent that one required the complainant to prove the safety of its product, there is always the matter of completeness: have all possible risks been considered? This potentially daunting task may also be less efficient than the contrary task of proving risk of harm through a valid risk assessment, and then, as complainant, negating that risk.

Assigning an evidentiary burden to the respondent in this area also appears to favor developing countries who wish to challenge restrictive regulations in developed nations. Developing countries have been known to complain that developed countries use restrictive measures as disguised trade barriers. (See Mayeda, 2004). As reflected in the matters listed in the Appendix, the vast majority of respondents in SPS cases are developed countries. Many of these disputes have involved clashes among titans, with frequent appearances by the European Community and the United States. (See the Appendix.) Smaller economic powers, such as Latin American countries engaged in the production and export of agricultural products and Asian countries involved in fishing are also frequently involved, but often from the side of challenging, rather than defending, restrictions.

On the other hand, this approach could theoretically enable developed countries to use the SPS Agreement as a tool to target exports to lesser developed counterparts, which might be considered to be disadvantaged due to more limited resources for developing science and risk assessment. Article 10 of the SPS Agreement does, in fact, contain special provisions regarding the application of measures to developing countries. Moreover, Article 9 also provides for technical assistance to developing countries in providing for sanitary and phytosanitary requirements.

This theoretical threat of exploitation has not been realized. Additional investigation may be appropriate to evaluate the paucity of challenges to developing countries under the current regime. It is possible that

developing countries may not be adopting more restrictive measures, choosing instead to rely on international standards. Alternatively, if they are enacting such measures, challenges may not be brought because the size of the trading market does not justify the expenditure of resources to challenge such measures. It should be noted that imports of agricultural and food products in developing countries are growing rapidly. The FAO predicts that developing countries will, as a group, become net agricultural importers in the near future, thus portending future trade challenges in this area. (FAO, 2005, Figure 51).

Role of the Precautionary Principle. The matter of evidentiary burdens is also closely related to another issue presented in cases involving the SPS Agreement, which involves a difficult philosophical tension: Assuming some scientific basis for potential harms, how does one define an acceptable level of risk for purposes of sustaining a trade-restrictive measure based on health and safety? While a measure involving a rare allergen might affect only a few people, should the measure be justified to the extent that death could result, as oppose to a comparatively harmless rash? In an environmental context, potentially cataclysmic results could occur as a result of the introduction of new species or genetically modified organisms, which present potentially extensive and undetermined effects on the environment. In the *Salmon* case, the WTO Appellate Panel suggested that members have some discretion in assessing their own standards of risk, and even a standard of no risk may be acceptable. (Kennedy, 1998; Mayeda 2004). However, such an approach must be consistently applied, as an inconsistent approach (i.e., adopting a no-risk-standard for imports, but not for domestic supplies) would tend to show that the matter is not "necessary" for the protection of its citizens.

The extent to which the so-called "precautionary principle" is implemented presents a point of tension. Professor Sunstein outlines the case for a generalized belief that significant difference exists between the United States and the European Union in the willingness to use a precautionary principle in matters of safety and health in his recent book, LAWS OF FEAR. (Sunstein, 2005 at 13-18). Sunstein disputes that a generalization could be made as to whether Europeans or Americans are more precautionary as a matter of course. However, food safety is an area where precautionary tendencies sometimes appear to have played a more important role in policymaking in the European Union than in the United States. For example, in the matter of harm to the public from genetically modified organisms, the United States has arguably taken a much more laissez-faire approach than the Europeans, and indeed the international community. (Id., see also Strauss, 2006; Tickner & Wright, 2003). However, Sunstein argues that the United States is more precautionary concerning risks from carcinogens and risks from bovine spongiform encephalopathy ("mad cow disease"). (Sunstein, 2005 at 20).

Though a thorough treatment of the precautionary principle is beyond the scope of this article, its significance in trade disputes under the SPS agreement is somewhat linked to the problem of allocating evidentiary burdens. Under what Sunstein calls the "stronger form" of the precautionary principle (the weaker form being rather innocuous, suggesting simply that one should take care or be prepared, such as wearing a helmet or bringing along an umbrella), demonstrating some risk to life or health would shift the burden of proof to the party seeking to engage in the practice or product. Sunstein argues that this can amount to the impossible burden of showing that the product or practice presents no risk at all. (Sunstein (2005) at 19).

The status quo also presents risks, so that some comparative assessment is required. For example, Sunstein recounts a story of Zimbabwe rejecting a shipment of corn from the United States on the ground that it could contain genetically modified organisms. However, the risk of doing nothing could have resulted, conservatively, in the starvation deaths of thousands of citizens. (Id. at 31). (It should be noted that Zimbabwe ultimately lifted its restrictions to allow U.S. food aid in the last few days of June 2002. See International Centre for Trade and Sustainable Development, www.ictsd.org).

A requirement for exporting nations to prove the nonexistence of risk would arguably defend the integrity of domestic protective measures much more often. However, this approach would neglect the important consideration of the risks avoided and the value of substitute benefits available from using or adapting new and uncertain technologies. (Id. at 29-33). Though the precautionary principle may be embodied in some environmental agreements, such as the Cartegena Protocol, the Protocol expressly proscribes its application to trade matters under the WTO. (See, e.g., Stewart & Johanson, 2003).

Future policy prescriptions about the manner in which the precautionary principle is implemented involve deep political conflicts over comparative risks and rewards. One might argue that the balancing of these comparative risks and rewards are best left to democratic mechanisms, thus counseling deference in trade disputes. However, it is not clear that democratic mechanisms have been left out. First, the parties themselves have determined to abide by a mechanism for trade dispute resolution. Democratic accountability is thus moved backwards to the point where the member state joined the WTO. In this sense, as Professor Dresner notes, "It is difficult to argue that treaties signed by the head of government and ratified by the appropriate legislative body

constitute an infringement of democratic sovereignty. (Dresner, 2001, at 326). Such a response is potentially unsatisfying on its own, as one might question the propriety of binding future generations by delegating away one's decisionmaking power. (Chander 2005). Moreover, some uncertainties about such matters as evidentiary burdens or risk assessment, which have only been resolved by the WTO panels themselves, hardly reflect specific democratic input. Nevertheless, other reasons should also be considered.

Public Choice Theory and Democratic Responsiveness. Public choice theory teaches that democratic processes are sometimes captured by particular interest groups, which do not seek the best interests of the majority. (See, e.g., Pauwelyn, 2005; McGuinness & Movesian, 2000). Some theorists thus look at the potential for a nondemocratic organization, such as the WTO, to reinforce democracy by derailing the impact of special interest groups. (See also Howse, 1999; Chander, 2005).

Agricultural producers and processors can function as such interest groups. Economic development has resulted in a shrinking share of the population engaged in agricultural production. For example, in the U.S. less than four percent of the male workforce and less than one percent of the female workforce are employed in agriculture. (World Bank, 2006). By comparison, Bangladesh employs more than 50 percent of its workforce in agriculture. (Id.) This small population in the U.S. nevertheless apparently still wields considerable political power when it comes to trade matters.

For example, a tariff of 54 cents per gallon is currently imposed on ethanol imports from Brazil. This tariff likely raises the cost of ethanol-based fuels for American consumers, but it benefits producers of corn and investors in the ethanol industry by protecting them from lower-cost competitors. This tariff illustrates that the WTO is not always functioning in an environment of free trade. Instead, it must operate in an environment where entrenched interests have made political choices about trade. (See Pauwelyn, 2005 at 54.) Forcing democratic institutions to reexamine the basis for rulemaking may provide leverage for greater democratic responsiveness.

Limited Enforcement & Remedies. Regardless of whether one accepts the public choice critique, an additional fact also tends to reinforce the continuing authority of democratic institutions. An emerging critique of the WTO system is the absence of a reliable mechanism to enforce decisions of the dispute resolution panels. (Stonsrad, 2006; Bermann, 2006; Princen, 2004). On one hand, this system may result in imposing litigation costs without guaranteeing benefits, making the process riskier for member states that lack economic clout to impose reciprocal sanctions on noncompliant members. (Stonsrad, 2006). However, the absence of effective enforcement also provides an important benefit, in the sense of protecting internal governance mechanisms from intrusion by entities, such as the WTO, that are not democratically accountable. As Professor Chander explains, "If noncompliance became routine, then the benefits of trade liberalization would be eroded and economic productivity stifled. Nonetheless, the availability of that option helps ensure the trade regime's compatibility with national democracy." (Chander, 2005 at 1216.)

This is not a cost-free decision, but that cost is part of the free trade bargain for member states. The weighing of costs and benefits cannot be escaped, but the conditions may change – in the sense that nations consider whether to bear costs of additional trade concessions as a consequence of their noncompliance. Such decisions are likely to be undertaken through democratic processes, which thereby provide an opportunity for public deliberation about the costs that nations are willing to endure for their protective principles. However, to the extent one believes in special interest capture, there is no guarantee that the resulting judgment in this instance will be based on the public good instead of the cost to the affected special interest.

Representative systems always present risks associated with the fact that the people must depend on agents to make decisions for them. (Sieberson, 2004). Free trade, to the extent it exists, facilitates individual decision-making by allowing consumers to choose for themselves. Some solutions to food safety issues are amenable to individual choice, such rules that require labeling and thus allow informed consent by consumers. For example, organic food standards permit labeling in the U.S. and the E.U. based on strict production standards. (See, e.g. The National Organic Standards Board (U.S.) at http://www.ams.usda.gov/nosb/index.htm; Regulation (EEC) No. 2092/91at http://europa.eu/eur-lex/en/consleg/pdf/1991/en_1991R2092_do_001.pdf). Organic standards share a common requirement of rejecting genetic modifications (or at least known instances, such as food products derived from the planting of genetically modified seed), thus protecting consumers who do not wish to assume any such risks. With a labeling requirement (as opposed to a more restrictive measure allowing only organic products), those with sensitivities to allergens or pathogens are free to make informed choices about their own health, while others without such sensitivities are free to choose modified products, which are likely to enjoy a cost advantage.

This area remains controversial, as labeling standards have also been challenged as disguised trade barriers. (See, e.g., Silverglade, 2000). Moreover, labeling is ill-suited to address environmental risks, which may present the risk of externalizing costs to the public (or segments of the public) as opposed to the individual consumer. Such matters are important topics of continuing development in terms of international rules and standards and their impact on trade. (See, e.g. Dresner, 2001; Strauss 2006b).

IV. Looking Ahead.

It is important to note that the SPS Agreement goes beyond merely preventing discriminatory measures. Professor Donald Regan, a prominent commentator on WTO matters, has noted, "the SPS and TBT agreements… apply even when the challenged measure has no disparate impact on imports as opposed to locally produced goods." (Regan, 2006). In this sense, the SPS Agreement differs from the "dormant" Commerce Clause of the United States Constitution, which reflects particular hostility to discriminatory measures. (Bittker, 1999, § 6.6).

Professor Regan would characterize nondiscriminatory measures under the SPS Agreement as "domestically irrational" measures. Their implementation potentially harms not only foreign trading partners, but also the domestic citizens who wish to trade with them. (Regan, 2006). While this characterization may be descriptive of the general function of the SPS Agreement, it leaves out an important subcategory. A measure may be nondiscriminatory, and yet pursued for rational reasons affecting not just the welfare of one's own country, but also that of others.

The emerging ethical sensitivity to animal treatment provides one area which may affect future trade constraints. Trade disputes involving leghold traps and cosmetics tested on animals provide examples of matters raising similar ethical concerns. (Princen, 2004). Although these disputes did not involve food products per se, the restrictive measures at issue were not based on the effects of the imported product on the domestic user or consumer, but instead on ethical concerns regarding production methods in other countries. WTO dispute mechanisms were not involved in these disputes, and both ultimately were resolved through the development of international standards. (Id.) However, they are nevertheless instructive to the extent that trade disputes gave rise to international dialogue that generated new forms of international consensus, which took into account an emerging ethical dimension. (See id.)

In the matter of food, trade disputes have previously arisen over the matter of turtles affected by shrimp and dolphins harmed in the commercial harvesting of tuna. (Id.) The applicable trade agreement did not specifically countenance the moral objection of the United States in seeking to impose production limits in these areas. (Id.)

The absence of any provisions in the SPS Agreement to accommodate moral considerations, particularly for animal welfare concerns, may also provide new areas for future controversy. For example, local regulations in the city of Chicago have recently banned the sale of foie gras within the city limits. (Ruethling, 2006). Similar legislation will outlaw the sale of this product in the State of California by 2012. (Id.). This regulation was not based on health concerns for humans, but instead was based on ethical concerns regarding the manner of production for this product, which involves force-feeding geese with tubes to enlarge their livers. (Id.; see also http://www.banfoiegras.com).

Such measures appear to apply to both domestic and imported foie gras, and thus are not discriminatory on their face. However, it is doubtful whether such measures, which address the health of the animal being raised in another country, rather than the health of the consumer in the importing country, fits within the ambit of the SPS Agreement. There is no scientific basis for any recognized threat to domestic animal life or human life from imported foie gras. Though one might argue a risk to domestic health from the fatty nature of the food, such an argument would indeed shift the analysis in making a discriminatory claim, as other fatty foods are likely not covered.

Using Professor Regan's nomenclature, the measure would only be "domestically irrational," in the sense that it prevents some citizens, - those who do not share the majority's concern over animal welfare and would prefer to continue eating foie gras - from trading with those jurisdictions without a similar ban. However, to the extent that a society wishes to express itself regarding the morality of these practices (and indeed, in Chicago's case, the ban was adopted 48-1, Reuthling, 2006) the trade regime may not permit it – or at least not without cost. Here, too, there is a prospect for future development outside the WTO, as these matters are considered and a consensus develops.

EAM
The author gratefully acknowledges the helpful assistance of Scott Keller, Creighton Law School (J.D. Expected 2008) in researching this article, and the thoughtful comments of his colleague Steve Sieberson on an earlier draft.

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Appendix: WTO Disputes under the SPS Agreement

Dispute	Complainant(s) & (Supporters) *EC = European Union	Respondent	Allegation or Panel Report Result & Date	Appellate Report Result & Date	Date Findings Adopted by DSB	Outcome
DS18 Measures Affecting Importation of Salmon	Canada (EC; India; Norway; and United States) Request for Consultations with Respondent 10/5/1995 Request for Panel 3/7/1997 Panel Established 4/10/1997	Australia	5/12/1998 Australia violated the SPS Agreement by maintaining a sanitary measure not based on a scientific risk assessment.	10/20/1998 Australia violated the SPS Agreement by maintaining a sanitary measure not based on a scientific risk assessment.	11/6/1998	Australia allowed importation in cases where the salmon was in "consumer ready" form.
DS26 (United States) DS48 (Canada) Measures Concerning Meat and Meat Products (Hormones)	United States and Canada (Australia; New Zealand; and Norway) Requests for Consultation with Respondent 1/26/1996 Request for Panel 4/25/1996 Panel Established 5/20/1996	EC	8/18/1997 The EC violated the SPS Agreement because the EC's ban on the importation and marketing of hormone-treated meat was not based on a scientific risk assessment.	1/16/1998 The EC violated the SPS Agreement because the EC's ban on the importation and marketing of hormone-treated meat was not based on a scientific risk assessment.	2/13/1998	The EC conducted a scientific risk assessment as recommended. The United States and Canada levied import sanctions on the EC asserting changes made to the EC's Deliberate Release Directive were delayed and not based on science.
DS76 Measures Affecting Agricultural Products	United States (Brazil; EC; and Hungary) Request for Consultation with Respondent 4/7/1997 Request for Panel 10/3/1997 Panel Established 11/18/1997	Japan	10/27/1998 Japan violated the SPS Agreement because Japan's varietal testing requirement was maintained without scientific evidence and additionally was not congruent with the SPS Agreement's Article 5.7.	2/22/1999 Japan violated the SPS Agreement because Japan's varietal testing requirement was maintained without scientific evidence and additionally was not congruent with the SPS Agreement's Article 5.7.	3/19/1999	Japan abolished the varietal testing requirements and reached a mutually agreeable quarantine solution with the United States.
DS100 Measures Affecting Imports of Poultry Products	EC Request for Consultation with Respondent 8/18/1997 Request for Panel NONE	United States	The EC alleged the United States' ban on Canadian poultry violated several WTO agreements, including the SPS Agreement.	None	None	Unknown
DS134 Restrictions on Certain Import Duties on Rice	India Request for Consultation with Respondent 5/27/1998 Request for Panel NONE	EC	India alleged that the EC's system of import duties for husked rice violated several WTO Agreements, including the SPS Agreement.	None	None	No WTO panel needed to resolve dispute.

Dispute	Complainant(s) & (Supporters) *EC = European Union	Respondent	Allegation or Panel Report Result & Date	Appellate Report Result & Date	Date Findings Adopted by DSB	Outcome
DS205 Import Prohibition on Canned Tuna with Soybean Oil	Thailand Request for Consultation with Respondent 9/22/2000 Request for Panel NONE	Egypt	Thailand alleged Egypt's ban on canned tuna packed with GMO soybean oil was in violation of the SPS Agreement.	None	None	No WTO panel needed to resolve dispute.
DS256 Import Ban on Pet Food From Hungary	Hungary Request for Consultation with Respondent 5/3/2002 Request for Panel NONE	Turkey	Hungary alleged Turkey's import ban on pet food was violated the SPS Agreement.	None	None	Unknown
DS270 Certain Measures Affecting Importation of Fresh Fruit and Vegetables	Philippines (Chile; China, EC; Ecuador; India; Thailand; United States) Request for Consultation with Respondent 10/18/2002 Request for Panel 7/7/2003 Panel Established 8/29/2003	Australia	The Philippines asserted that an Australian import restriction on bananas was in violation the SPS Agreement.	None	None	Outcome pending
DS 271 Certain Measures Affecting Importation of Fresh Pineapple	Philippines Request for Consultation with Respondent 10/18/2002 Request for Panel NONE	Australia	The Philippines asserted that Australia's ban on fresh pineapple violated the SPS Agreement.	None	None	No WTO panel needed to resolve dispute.
DS 287 Quarantine Regime for Imports	EC (Canada; Chile; China; India; Philippines; Thailand; United States) Request for Consultation with Respondent 4/3/2003 Request for Panel 8/29/2003 Panel Established 11/7/2003	Australia	The EC alleged Australia's prohibition of the importation of pig poultry meat fviolated the SPS Agreement.	None	None	Outcome pending
DS291 (United States) DS292 (Canada) DS293 (Argentina) Measures Affecting Approval and Marketing of Biotech Products	United States, Canada, & Argentina (Australia; Brazil; Chile; China; Chinese Taipei; Columbia; El Salvador; Honduras; Mexico; New Zealand; Norway; Paraguay; Peru; Thailand; Uruguay) Requests for Consultations with Respondent 5/13/2003 & 5/14/2003 Request for Panel 2/23/2004 Panel Established 3/4/2004	EC	9/29/2006 The EC violated the SPS Agreement because the EC applied a de facto moratorium on the importation of biotechnology-modified products and certain products were banned without a sufficient scientific risk assessment.	No appellate panel requested.	11/21/2006	Implementation of a requirement that any product containing more than 1% of a genetically modified ingredient be labeled as containing a genetically modified organism.

Bridging the Gap in the Doha Talks: A Look at Services Trade

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Abstract: Following the suspension of the World Trade Organization (WTO) multilateral trade negotiations in July 2006 – and its subsequent resumption in February 2007 - by WTO Director-General Pascal Lamy, the world trading system must now find ways and means to integrate developing countries in the world trading system. Failing that could be perceived as a danger to the world order. This paper analyzes the legal and policy implications of the current Doha Round for the two main developed WTO Members, i.e., the United States and the European Community, and the most relevant developing countries of the WTO, such as India, Brazil, and China. The specific focus of attention will be mainly on services trade. Thoughts on alternative ways to move forward in the multilateral trading system are presented.

Key words: Doha Round, services trade, liberalization, WTO, commitments

1. Introduction

Before the creation of Doha Round in 2001, developing and least-developed countries had been marginalized in the world trading system, which brought with it serious economic implications. In 2001 in Doha (Qatar), developing countries were promised inclusion in the world trading system in order to achieve a higher level of justice and equity in the world.[1] That is why the new round is called the development agenda.[2] The argument is that a more open and equitable trading system brings peace to the world and, in this sense, the Doha Development Agenda (DDA), which aims to lower trade barriers around the world, permitting free trade among countries of varying prosperity, should not be approached as a zero-sum game –as many developing countries seem to perceive it- but as a win-win situation. The Doha Round was the result of widespread agreement among delegates at the 4th WTO Ministerial Conference in Doha that it was time to address the imbalances of previous rounds and to offer developing countries the prospect of trade talks which they could see were to their benefit. So a new Round was necessary to include poor countries in the world trading system, and to promote economic development, as well as to alleviate poverty. [3]

The initial target was to finalize the Doha Round negotiations by the end of 2005, so that the Agreement could be approved by the U.S. under the fast-track procedure, without having to undergo a lengthy debate within Congress. Although some progress was achieved along the way - notably in Hong Kong in December 2005, where rich nations agreed to eliminate all of their farm export subsidies by 2013 and to allow quota and tariff-free imports from all least developed countries – a final deal remained elusive. Successive deadlines were missed and, at the July 2006 G8 meeting in Saint Petersburg, leaders of the world's biggest economies pledged to give their trade negotiators the flexibility they needed to reach a compromise deal, deciding to hold last ditch talks during the weekends of 23-24 and 28-29 July 2006.

The discussion below chronicles the developments of the Doha Round since its suspension in July 2006 up to now.

2. Suspension of the Multilateral Talks

On July 24, 2006, WTO Director-General Pascal Lamy formally announced the suspension of the talks, bringing five years of negotiations to an end. This was due to the refusal of the United States to make bigger cuts to its farm subsidies if the EC and emerging developing countries such as India, China, and Brazil did not reduce their tariffs on agricultural and industrial products respectively.[4] Major trading powers, including the EC, are blaming the U.S. for the collapse. Trade officials have continued to meet informally since then, especially after a soft relaunch of discussions in November 2006.

This is not the first time that one of the WTO negotiation rounds has broken down. Negotiations are inevitably complex as each WTO member has a veto power over the final deal. The Uruguay round, which began in 1986 and led to the replacement of the GATT by the WTO in 1995, was frozen for over a year in 1990, due to antagonism between the EC and the U.S., although it was never formally suspended.

More recently, after the suspension of the WTO Doha negotiations, the Commission looked ready to refocus its commercial strategy on bilateral free trade agreements so as to catch up with the U.S. and Japan. Officially, concluding the Doha Round remains the European Community's (EC) number-one priority, but, since negotiations were suspended in July 2006 [5] - when last resort talks failed to bring an agreement on reducing farm subsidies and lowering tariffs, leading therefore the WTO chief Pascal Lamy to formally suspend the Doha Round - the EC has been looking for other ways to open up foreign markets and keep up with its main trade rival, the U.S., which is currently leading the race to conclude free trade agreements (FTAs) with high-market-potential countries.[6] The Commission's decision to launch new bilateral trade negotiations with countries such as India, South Korea, and the ten Association of South-East Asian Nations (ASEAN) states "could further complicate its trade regime, and divert interest from the multilateral trading system",[7] according to a bi-annual report carried out by the WTO on the EC's trade policies and practices. The Commission also hopes to negotiate more far-reaching agreements than would be possible under the WTO talks, by tackling issues such as investment, competition policy, and public procurement – known as the Singapore issues – which were dropped from the Doha agenda in 2003. This return to a system of bilateral agreements and FTAs will mean that the large WTO members would be able to strong-arm the small members and where the multiplication of trade rules and tariffs would generate higher transaction costs and damage the trading and investment environment.

Lamy warned, though, that bilateral deals could contribute to weakening the multilateral trading system, in a speech to the European Parliament's International Trade Committee on October 17, 2006.[8] Moreover, he argued that growing number of bilateral and regional trade talks risked distracting from attempts to clinch a long-elusive global deal.[9] He noted that when it came to bilateral talks, some countries appeared to be promising concessions beyond what would be needed to unblock the multilateral negotiations. While the EC will find that it might be able to address some of its specific concerns through bilateral agreements, it will not be able to answer all of them. In addition, the countries that the EC will negotiate with in these bilateral negotiations will want to see some concerns, like subsidies in agriculture, addressed somehow and that will only be through the multilateral, that is, WTO, process.

In the face of globalization, the EC must remain open. It must also ensure that markets abroad are open to its own exports. European businesses often find it difficult to access foreign markets due to high tariff and non-tariff barriers, as well as discriminatory measures applied against foreign companies. Removing such barriers is particularly important in the services sector, which represents around 70% of Europe's jobs and of the EU's gross domestic product (GDP), but which faces higher trade barriers than goods, mostly due to restrictive national regulations, such as technical standards, licensing requirements or national discrimination.

This proposal of bilateral trade agreements as a result of the suspension of the Doha talks is diametrically opposite to the EC's previous trade strategy, in which the focus was strongly on multilateral negotiations within the WTO, and free trade deals were primarily driven by the logic of development or geopolitics rather than economic interests. That said, U.S. businesses in Europe urged European Union (EU) and U.S. leaders to stop neglecting the transatlantic relationship in favour of boosting relations with China and India. They argued that the two transatlantic economies have become so highly interdependent that their future growth and job creation relies not on improving their relations with China and India, nor in completing a successful Doha Round, but in removing existing barriers to trade and investment in order to create a veritable transatlantic single market.

In relation to services trade, an ambitious deal on service liberalization was of key interest to the EC because trade in services makes up around 75% of its economy. Increased trade in services would also contribute to development goals since improved transport, IT and telecommunications, banking, and insurance sectors form the backbone of a growing economy. However, trade in services faces considerable restrictions, mostly based on national regulations, such as technical standards or licensing requirements and procedures. According to a study by Decreux and Fontagne, more could be gained, for developing and developed countries alike, from a 25% cut of the barriers in services than from a 70% tariff cut in agriculture in the North and a 50% cut in the South.[10] A study conducted at the World Bank estimates that developing countries could gain nearly $900 billion in annual income from elimination of their barriers to trade in services.[11]

Discussions in the WTO focused on establishing disciplines to ensure that domestic regulatory measures do not create unnecessary barriers to trade. Significant progress was made in this area but negotiations on market access stood still as a result of the lack of movement on agricultural and industrial market access. Furthermore, in a speech given by Lord Vallance of the European Services Forum to the EU-India Business Summit on 12

October 2006, he said that developed and developing countries will miss out on enormous potential economic gains because services have once again been taken hostage of agriculture even though the latter represents only 8% of world trade and 2% of developed countries economy.[12]

2.1. Failure of Multilateralism?

But why has multilateralism failed? The talks were suspended on 24 July 2006 after ministers from the EC, the U.S., Australia, Brazil, India, and Japan (the so-called G-6 countries) failed once again to reach a deal on agriculture and industrial goods 'modalities' -- formulae and figures for tariff and subsidy cuts, as well as exceptions to them -- primarily due to differences on farm trade. "We have missed a very important opportunity to show that multilateralism works," said WTO Director-General Pascal Lamy.[13] Lamy said that the failure represents a lost opportunity to integrate more vulnerable members into international trade - "the best hope for growth and poverty alleviation,"[14] and warned of the negative impact on the world economy with the possible resurgence of protectionism. "Today there are only losers,"[15] he stated. The same words were used by the International Food and Agricultural Trade Policy Council to express their concern.[16] Lamy believes that the Doha round fell apart because "too many negotiators focused on the small picture, forgetting the bigger one."[17] Moreover, he said that countries must shift their focus away from domestic politics and broaden their vision. The blame game over the collapse between the EC and the U.S. has been particularly intense. Brussels argues that Washington has not cut its farm subsidy ceiling deeply enough; the U.S. counters that it would have done so if only the EC had offered up greater access to its own agricultural markets. Lamy has said that countries would have to offer new concessions in order for the talks to resume.

Similar words were expressed by the Finnish Minister for Foreign Trade and Development, Paula Lehtomaki, by stating that neither industrial countries nor developing countries win upon suspension of WTO Doha negotiations.[18] Before the Board of Governors of the World Bank Group at the 2006 annual meeting in Singapore, Paul Wolfowitz, president of the World Bank, argued that

> "[e]very party in this deal needs to compromise. The United States needs to accept further cuts in spending on trade-distorting agricultural subsidies. The European Union needs to reduce barriers to market access. And developing countries such as China, India, and Brazil need to cut their tariffs on manufactures. Developing countries also need to remove trade barriers that make it harder for low-income countries to trade directly with each other."[19]

All EU Member States have much to gain from a successful outcome of the Doha Round. An open trading regime has been traditionally beneficial to European economies in the past. So the removal of some technical barriers to trade will certainly help provide additional opportunities for further success. In the specific case of the UK, services play a major part of its economy. More protectionism will be generated worldwide if the Doha Round fails.[20]

2.2. Consequences of Protectionism: Competing Views of NGOs

These protectionist tendencies of some WTO countries have recently been subject of political debate in various countries on the grounds that jobs in services were being exported from developed to developing economies. Employers in developed economies have been exporting their services to economies where the service provider is much less expensive. Some politicians, such as the UK Secretary of State for Trade and Industry Patricia Hewitt, argue in this respect that "an extra job in India is not one less job in Britain. It is not only one less person in poverty in India: it is also one more potential customer for our goods and services."[21]

Quite refreshing is Oxfam's position, which stressed the enormous cost of further delay, as "the EU and the U.S. remain free to subsidize their biggest agricultural producers and continue dumping, while developing countries continue to struggle to ensure survival of subsistence farmers and break into rich Northern markets."[22] It said the U.S. and the EC must "make fundamental changes to their offers"[23] in order to contribute to the development goal. In Oxfam's view, the EC should make more and greater concessions to keep the development negotiations on track. Friends of the Earth, who seemed delighted to see the suspension of the Doha talks,[24] argued that the WTO should have greater powers to manage trade opening to ensure that environmental and other considerations were taken into account. The failure of the talks allowed time to review and reconsider the multilateral trading system in its entirety. This was welcome news around the world because the proposed WTO deal would have further impoverished the world's poorest people and caused irreparable

damage to the environment. Some developing countries had refused to proceed because they too feared that a WTO deal would cause immense harm to millions of small and subsistence farmers. Moreover, Oxfam argued that the suspension of the Doha talks would not solve the underlying reasons why a development deal remained deadlocked and in crisis.[25] Oxfam feared that multilateralism would go further into crisis and was therefore concerned that the EC and the U.S. would turn to damaging regional trade agreements to break open developing country markets.

However, not every NGO was of the same opinion: Other NGOs more critical of free trade viewed the collapse of talks as good news for the world's poor and the environment, on the grounds that it is better to have no deal than a bad deal, calling on world leaders to use the opportunity to build a "new global trade system based on equity and sustainability."[26] According to Greenpeace, there is a need to secure a safe political and legal space for the environment and, therefore, it outlines a number of alternative approaches, which would enable governments to move the current negotiations on the relationship between trade rules and multilateral environmental agreements (MEAs) from the WTO to a more suitable forum. Additionally, the emergence of more environmental related trade disputes has re-emphasized the need for an alternative dispute settlement procedure to that of the WTO for solving trade and environment conflicts.

2.3. Trying to Get Negotiations Back on Track

Little was discussed in the way of specific new concessions that could spur the resumption of multilateral trade negotiations. Nevertheless, ministers and senior officials from WTO Members including the G-20 developing countries, the U.S., the EC, Japan, and four West African cotton producing nations pledged to work towards relaunching the stalled talks at a 9-10 September 2006 meeting in Rio de Janeiro. The meeting, which coincided with a G-20 ministerial summit, marked the first big gathering at that level since July 2006. Brazil's minister of foreign affairs said that he had seen signs of flexibility from other countries during the weekend's discussions. Upon his return to Tokyo, Japan's Agriculture, Forestry and Fisheries Minister Shoichi Nakagawa told journalists that there should be some signs indicating the end of the cessation in October 2006.

Governments needed to agree on modalities by the end of July 2006 in order to give themselves enough time to translate them into a Doha Round package of legal agreements before the mid-2007 expiry of the Bush administration's Congressional mandate to negotiate trade agreements. Without this trade promotion authority, the Bush administration is unable to submit trade deals to Congress for a yes-or-no vote without the possibility of major amendments -- and thus ceases to be a credible negotiator. However, many trade observers -- as well as senior U.S. officials -- had suggested that if an agreement were to appear to be coming together by March 2007, Congress might be persuaded to extend the administration's trade promotion authority. Failing that, the negotiations would likely remain stagnant until 2009. Since the Trade Promotion Act (TPA) of 2002 to U.S. President George W. Bush expires in July 2007, past that date, Congress will resume its power to make amendments to any trade deal presented to it, thereby making it less attractive for other WTO members to participate in negotiations as they are unsure of obtaining any real commitments from the U.S. The U.S. administration has signaled that it could attempt to extend the TPA to make an agreement more feasible.

Some Geneva-based negotiators believe that it may be possible to secure a short term extension of this trade promotion authority to cover the end of the Doha Round negotiations, even with the newly Democratic Congress. However, in order to get the Bush administration and Congress interested, there had to be hard evidence of a doable deal by the end of March 2007. That said, I would caution that there are no guarantees that attempts to win Congressional support would ultimately succeed. In fact, most analyses in the press suggest that the U.S. legislature's already-shaky support for bilateral and multilateral trade talks will be further weakened by the Democrats' ascent to power in both the House of Representatives and the Senate. In particular, the Republican Bush administration is now believed to be even less likely to get Congress to extend its fast-track negotiating authority past the scheduled expiry date next July 2007. Without this, chances to conclude the struggling Doha Round negotiations in the next year or two would virtually disappear, even if WTO Members manage to revive the talks early in 2007.

The U.S. midterm Congressional elections took place on 7 November 2006 and had been looming over the negotiations. However, U.S. Trade Representative Susan Schwab argued in a 9 November 2006 article in the Wall Street Journal that the outcome of the elections would not change Washington's stance in the negotiations.[27] Broadly restating the U.S.'s standard position, she wrote that "to break the current deadlock, we need commitments that take us beyond current positions in four key areas."[28] These are: substantial improvements by the EC, Japan, and other G-10 countries in agricultural tariff cuts, especially for sensitive products that would be exempted from the full tariff cuts; deeper cuts in agricultural tariffs by major developing

countries, including for sheltered special products; deeper EC and U.S. reductions in trade-distorting support; and cuts in industrial tariffs by developed and major developing countries.[29]

Pascal Lamy called an informal meeting of the Trade Negotiations Committee (TNC) on the morning of 16 November 2006. The stated purpose of the heads-of-delegation level gathering was to discuss the situation in the Doha Development Agenda negotiations. This was the first session of the committee charged with overseeing the Doha Round negotiations since July suspension of negotiations. This might imply that several WTO Members may use the informal TNC to agitate for the resumption of the whole multilateral trade negotiation business as usual. This would entail resuming work in all of the Doha Round negotiating committees, which have not met formally since the talks were frozen in July 2006 However, WTO Members need to decide on how to revive the talks, particularly since it was far from apparent that deadlock-breaking offers of tariff or subsidy cuts would be forthcoming.

A 10 November 2006 Green Room meeting to which Lamy invited some 20-odd influential Members - including Brazil, the EC, the U.S., Japan, Australia, New Zealand, Canada, and India - was pivotal in his decision to convene the informal TNC. According to one WTO ambassador, participants at that meeting broadly fell into two camps. Those in the first camp were reluctant to restart formal negotiations, arguing that no new concessions had been made. Resuming the talks, they said, would quickly lead to the old impasse -- this time perhaps for good. The rest, who ultimately carried the argument, countered that the July suspension had not done what it was intended to do. Instead of shocking countries into softening their stances, it had had the opposite effect of taking pressure off governments altogether. They argued that a resumption would, at the very least, force key WTO Members to say out loud that they had nothing new to bring to the negotiating table.

In a speech at Chatham House on 14 November 2006, Peter Sutherland argued that the cost of failure was potentially prohibitive, since "if the Doha Development Agenda goes out of the window so, eventually, may the effective functioning of the multilateral trading system,"[30] and further argued that once negotiations resume, WTO Members would do well to agree on an achievable, if relatively low-ambition Doha Round deal, in the interest of preserving the multilateral trading system. Sutherland emphasized that such a deal would be "well worth having and would deliver some creditable development goals."[31] More significantly, "it would show that multilateralism can deliver, before all credibility is lost."[32]

As for EU trade commissioner Mandelson's strategy for relaunching negotiations, this would be based more on convincing others that what was on the table in July 2006 would be better than having no deal at all, rather than on offering further concessions on behalf of the EU. Although in his November 2006 speech at the Hindustan Times Leadership Summit Mandelson pledged "to improve [the EC's] farm-tariff offer by adding substantially [10%] to the 39% it offered a year ago,"[33] this is exactly the same offer that was on the table before talks were suspended in July 2006. Although this offer was within close reach of the cuts demanded by developing countries, it was judged largely insufficient by the U.S. He further stated:

> "[I]f Doha fails, the systemic and economic costs will be felt everywhere. It is not just the hundreds of billions of euros annually in new goods and services trade that will be lost - but the multilateral agreements, too, that will extend duty free quota, free access for the poorest nations and straighten out customs rules and add billions of euros to developing country revenues."[34]

Lamy seemed quite confident in his December 2006 speech that it was possible to get the Doha negotiations back on track thanks to an increasing level of engagement among the various WTO Members, and conclude the Doha Round in 2007.[35] However, this could only happen if countries came forward with concrete new concessions. If this did not happen, the WTO chief warned the General Council of the WTO (the institution's top permanent decision-making body) that the Doha talks risked total collapse. That said, Lamy acknowledged that no one was going to simply come forward and specify numbers detailing how much more they were willing to offer and how much less they were willing to accept in return. He said that since there is a tradeoff between ambition and flexibility -- in other words, the deeper the overall tariff and subsidy cuts, the more flexibilities WTO Members will demand to shelter specific products from reforms -- trade officials could play with different pairs of numbers to examine potential compromises.

WTO countries would also have to test these different scenarios with influential domestic constituencies, to assess what they could tolerate. Lamy had already indicated that fully-fledged negotiations, including those at the ministerial level, could only truly restart once governments explicitly had offered deeper subsidy or tariff cuts, and had moderated what they wanted in exchange. Nevertheless, he told WTO delegates that in order to be properly prepared for this, they needed to increase the pace of informal work so that there would be no need for him to propose a compromise text. In his opinion, such a manoeuvre would be very risky, and would sit uneasily

with the bottom-up principles of the WTO.[36] So to avoid a compromise text, and following Lamy's hope, there was a meeting in January 2007 in Washington, D.C. between Commission President José Manuel Barroso and U.S. President George W. Bush, who agreed that the EC and the U.S. must urgently resolve differences that have been blocking the conclusion of a global trade pact. At the meeting, President Barroso stressed the need for the U.S. to make further concessions if the Doha Round is to succeed: "The U.S. holds the key to making a deal possible in 2007."[37] Commissioner Mandelson said after the meeting that "[t]here's not an agreement to be announced on key issues or key numbers, but there's certainly much greater understanding and a measure of convergence now."[38] U.S. Trade Representative Susan Schwab rightly said at the meeting that "nobody is going to reach an agreement on the basis of an artificial deadline [of March 2007] if the content isn't there that is substantively and politically viable."[39] Hence, even if the major trade actors of the WTO agree that there is a need to act quickly, precaution is also offered.

In services trade, during a Green Room meeting on 22 January 2007, Pascal Lamy agreed to a request by services demandeurs such as the U.S., the EC, and Japan that he emphasize in Davos that services trade is a critical component of the overall market-access negotiations. They specifically asked him to stress that meaningful offers of services liberalization could help unlock possible concessions by major developed countries in the agriculture and industrial goods talks. Domestic regulation, which refers to measures that governments apply to both local and foreign entities supplying or seeking to supply a service in their territory, has long been guarded jealously by WTO Members as their sovereign prerogative. These measures, typically covering qualification requirements, qualification procedures, licensing requirements, licensing procedures, and technical standards that suppliers have to comply with in order to be able to supply a service, have the potential to be unduly trade-restrictive.[40]

White House officials have indicated that President George W. Bush was trying to call on Congress to renew his TPA mandate, currently set to expire at the end of June 2007.[41] Extending it is widely believed to be essential to concluding the Doha Round in the foreseeable future. U.S. trade officials say that a breakthrough in the negotiations by spring 2007 would help win Congressional support for TPA renewal. But what is needed for a successful deal? For the past year, Lamy has said that the basic ingredients of a Doha deal are clear: the U.S. must agree to deeper cuts to its ceiling on trade-distorting farm subsidies; the EC must offer more agricultural market-access;[42] and developing countries, such as Brazil and India, must further reduce their industrial tariffs.

3. Resumption of the Multilateral Talks

"Mr. Chairman, for your last meeting as General Council Chair, I am pleased to be able to report some positive news: we have resumed our negotiations fully across the board."[43] With these words, Lamy officially resumed the multilateral trade negotiations in the framework of the Doha Round on 7 February 2007, which had been suspended since July 2006. In his report to the WTO General Council, Lamy said that "political conditions are now more favourable for the conclusion of the Round than they have been for a long time."[44] He added that "political leaders around the world clearly want us to get fully back to business, although we in turn need their continuing commitment."[45] As for the way forward, he added: "With regard to timing, in my view we should not attempt to set ourselves any false deadlines. We are all very much aware of the urgency of the task ahead, but it is also important to reach a substantive outcome which is acceptable to everyone."[46]

Since the negotiations stalled in July 2006, political and business leaders have acknowledged the considerable costs that would be incurred by a failure to conclude a global-trade pact.[47] Business groups have voiced their concern about the potential loss of considerable economic welfare gains, both for industrialized as well as developing countries, and about the risk of weakening the safety net that the WTO provides against rising protectionist tendencies.[48] Furthermore, the Global Services Coalition (GSC) held a series of meetings with WTO ambassadors and officials. It pressed the case for renewed efforts to be made in order to produce a more commercially attractive package of liberalization commitments in the current Doha Round.[49] Lord Vallance of Tummel, the Chairman of the European Services Forum, expressed cautious optimism about the prospects for completion of the Doha Round.[50] His comments were tempered by his warning that much more progress is needed on services if a Doha Round trade deal is to gain the support of the global services industry.[51] The industry delegation comprised more than 40 executives and association representatives of the Global Services Coalition, which includes the leading service industry associations from Australia, Brazil, Canada, the Caribbean region, Chile, the EU, Hong Kong, Japan, India, New Zealand, Taiwan, and the United States.

At the same time, at the World Social Forum 2007 - which brings together activists and movements in favour of an alternative globalization rather than the business and political elite (represented at the annual meetings of the World Economic Forum in Davos) – civil-society groups were more sceptical about reviving the

Doha Round.[52] They say that the Round has lost sight of what should have been its main priority, i.e., helping developing nations to escape from poverty.[53]

4. Epilogue and Recommendations

Since the suspension of the multilateral trade talks, EU Member States should have pressed for a wide-ranging EC approach to the Doha Round aimed at tackling the main barriers to trade in services. The EC should overcome the failure of Cancun and work on a framework for negotiations in order to secure a successful outcome of the Doha Round. The EC needs to adapt to the changes taking place in the world trading system and world trade negotiations. There remains considerable potential for further liberalization, even if the growth of South-South trade over the last decade has been quite remarkable; however, certain fields such as culture, education, health, and public services remain a barrier to the current trend of services liberalization.

The Irish poet W.B. Yeats wrote that when things fall apart, the center cannot hold.[54] The Doha round has finally fallen apart. What, if anything, can hold the WTO and the multilateral trading system together? The WTO is in seemingly inevitable float – away from the hard politics of trade liberalization and the rules that underpin it. Serious players will switch further to preferential trade agreements; and they will be tempted to disobey existing multilateral rules. In essence, the WTO suffers from severely diminishing returns. In contrast to the General Agreement on Tariffs and Trade (GATT), it has a bigger, messier, politically more controversial agenda, shot through with multiple and contradictory objectives. And decision-making is crippled in a general assembly with near-universal membership.

For future trade rounds, we need to find a more effective way of negotiating multilaterally. The WTO family has grown very much both in its number of members – at the start of the Uruguay Round, there were only 86 members - and in its agenda in the last years, which means that the legal, economic, as well as political needs and interests of the various WTO members might differ drastically. Thus, variable geometry and sectoral agreements, as opposed to a single undertaking approach, seem to me a plausible way to move forward the multilateral trade agenda, since the single undertaking approach seems too ambitious. The same is true for the EU, i.e., the so-called enhanced cooperation. This approach has the advantage of releasing the current frustration at the WTO negotiating table – and sometimes violent protests organized by civil society - because of its slow negotiating pace. However, one disadvantage is that developing countries might feel marginalized at the WTO.

Furthermore, the WTO members' ambitions must be scaled back. Experience has taught us that the expectations of the world trading system's agenda cannot be digested by the current multilateral trade negotiations. It is not possible to get decisive progress without lowering expectations for the Doha Round. Although agriculture seems to be the key issue to disentangle the Doha talks, opening up service markets remains a vital aspect of a successful outcome from the Doha Round. In this respect, many developing countries see sending services supplies under Mode 4 of the General Agreement on Trade in Services (GATS) to lucrative markets as one of the principal areas of negotiations during the Doha round. Whether the development promise of the Doha round is achieved will depend on the extent to which the present level of commitments under Mode 4 will be expanded.

Notes

[1] Among those who claim that there is potential for developing countries to benefit from trade liberalization are: Anderson, K., Maritin, W. & van der Mensbrugghe, D. "Doha Merchandise Trade Reform: What's at Stake for Developing Countries?," World Bank Policy Research Working Paper 3848, February 2006, available at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/02/15/000016406_20060215164859/Rendered/PDF/wps3848.pdf.

[2] Not everyone agrees with the governmental position that the Doha Round is beneficial to developing and least-developed countries. For severe criticisms of the Doha Round, see Oxfam Press Release, "New WTO framework doesn't add up to development," 22 June 2006, available at http://www.oxfam.org/en/news/pressreleases2006/pr060622_wto (last visited July 18, 2006); Hertel, T.W. & Keeney, R. "What is at Stake: The Relative Importance of Import Barriers, Export Subsidies, and Domestic Support," available at http://siteresources.worldbank.org/INTTRADERESEARCH/Resources/Ch2AgTradeBook_HertelKeeney.pdf; Bouet, A., Orden, D. & Mevel, S. "More or Less Ambition in the Doha Round? Winners and Losers from Trade Lberalization with a Development Perspective," available at

https://www.gtap.agecon.purdue.edu/resources/download/2508.doc (last visited July 18, 2006); Kinnman, S. & Lodefalk, M. "Economic Implications of the Doha Round," Swedish National Board of Trade, July 2006, available at https://www.gtap.agecon.purdue.edu/resources/download/2756.pdf; European Commission Press Release, "Doha Round: Some Recent Economic Analysis," MEMO/06/247, available at http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/06/247&format=HTML&aged=0&language=EN&guiLanguage=en (last visited July 18, 2006).

[3] This is certainly the position of European trade commissioner Peter Mandelson, who said at a Party of European Socialists conference in Brussels on Decent Work that far from being responsible for poor labor conditions, free trade could be a ladder out of poverty and "an engine of the very prosperity that helps societies put poor labor conditions behind them for good." "Free trade is not the enemy of decent work," he concluded; "The enemy of decent work is our willingness to turn a blind eye to it. Free trade does not mean trade indifferent to fair conditions of production." See the speaking points on "Free Trade is not the Enemy of Decent Work," given by commissioner Mandelson at a Party of European Socialists conference in Brussels on May 10, 2006, available at http://ec.europa.eu/comm/commission_barroso/mandelson/speeches_articles/temp_icentre.cfm?temp=sppm098_en (last visited May 13, 2006).

[4] Pascal Lamy, "What now, trade ministers?" *International Herald Tribune*, July 27, 2006, available at http://www.iht.com/articles/2006/07/27/opinion/edlamy.php (last visited March 6, 2007).

[5] After five years of troubled negotiations, the Doha Development Round, aimed at freeing global trade and at extending the benefits of globalization to developing countries, was suspended following the failure of negotiators to reach a compromise about reducing farming subsidies and lowering import tariffs. The resumption of the Doha talks took place in February 2007.

[6] Nevertheless, it is worth mentioning that this proliferation of bilateral trade agreements outside the WTO process is perceived as betraying the multilateral ideals that underlay the WTO and its forerunner, the GATT.

[7] World Trade Organization, "Trade Policy Review of the European Communities," WT/TPR/S/177, 22 January 2007, p. xii.

[8] See speech given by Pascal Lamy to the European Parliament's International Trade Committee, where he warned that the Doha failure will seriously weaken the trading system. Available at http://www.wto.org/english/news_e/sppl_e/sppl44_e.htm (last visited October 24, 2006).

[9] The same argument is made by a WTO report, which claims that the EC's decision to seek bilateral free-trade agreements, as well as its rising agricultural tariffs, could be detrimental to the Doha negotiations on a global-trade pact. See World Trade Organization, "Trade Policy Review. Report by the European Communities," WT/TPR/G/177, 22 January 2007.

[10] Decreux, Y. & Fontagne, L. "A Quantitative Assessment of the Outcome of the Doha Development Agenda," *Centre d'Etudes Prospectives et d'Informations Internationales Working Paper No. 2006-10*, May 2006.

[11] Anderson, K., Martin, W. & van der Mensbrugghe, D. "Doha Merchandise Trade Reform: What's at Stake for Developing Countries?" *World Bank Policy Research Working Paper 3848*, February 2006.

[12] See speech by Lord Vallance of Tummel at the Seventh EU-India Business Summit in Helsinki on 12 October 2006.

[13] See WTO News – DDA June/July 2006 Modalities, "Talks suspended. 'Today there are only losers,'" Summary 24 July 2006, available at http://www.wto.org/english/news_e/news06_e/mod06_summary_24july_e.htm (last visited September 13, 2006).

[14] Ibid.

[15] Ibid.

[16] International Food and Agricultural Trade Policy Council (IPC), "Doha Suspension: Today, we are all losers," 24 July 2006.

[17] See "U.S. chides EU on trade as WTO chief calls for big picture approach," *EU business*, 29 September 2006, available at http://www.eubusiness.com/Trade/060920111214.gx969d35 (last visited November 6, 2006).

[18] See press release of Finland's EU Presidency on General Affairs and External Relations, Competitiveness (Internal market, Industry and Research), available at http://www.eu2006.fi/news_and_documents/press_releases/vko30/en_GB/164286/ (last visited November 6, 2006).

[19] See Wolfowitz, P. "Path to Prosperity," speech delivered on September 19, 2006 in Singapore, Press release No. 3.

[20] For an insight on the costs of EC's protectionism, see Messerlin, P.A. "The EC Trade Policy and the Doha Round," *Aussenwirtschaft*, 57 Jahrgang, Heft III, Verlag Ruegger, September 2002, pp. 271-98.
[21] House of Lords, "The World Trade Organization: the role of the EU post-Cancun," 16th Report of Session 2003-04, European Union Committee, p. 13, available at http://www.publications.parliament.uk/pa/ld200304/ldselect/ldeucom/104/10403.htm (last visited March 25, 2005).
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[25] See Oxfam Press Release, "Suspending WTO talks resolves nothing," 24 July 2006, available at http://www.oxfam.org/en/news/pressreleases2006/pr060724_wto (last visited November 21, 2006).
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[27] See the op-ed by U.S. Trade Representative Susan Schwab, "U.S. elections will not change trade talks prospects," originally published in the *Wall Street Journal* on November 9, 2006, available at http://usinfo.state.gov/xarchives/display.html?p=washfile-english&y=2006&m=November&x=20061109115012SAikceinawz0.314953 (last visited November 16, 2006).
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[30] See the John Whitehead Lecture given by Peter Sutherland, "EU/U.S. trade relations – Is a free trade area an alternative to Doha?," Chatham House, 14 November 2006, available at http://www.chathamhouse.org.uk/pdf/meeting_transcripts/141106sutherland.pdf p. 3.
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[32] Ibid.
[33] See "Providing Leadership in the Doha Round," speech given by Peter Mandelson at the Hindustan Times Leadership Summit, Delhi, 18 November 2006, available at http://ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm131_en.htm (last visited November 20, 2006).
[34] Ibid.
[35] See speech by Pascal Lamy, "We can stay on track to successfully conclude the Round next year," available at http://www.wto.org/english/news_e/news06_e/tnc_chair_report_14dec06_e.htm (last visited December 18, 2006).
[36] The precedent for this comes from 1991, when the then Director-General of the GATT, Arthur Dunkel, drafted a comprehensive agreement text in an eventually successful attempt to break a deadlock in the Uruguay Round negotiations. Though roundly pilloried at the time, especially in developing countries, the Dunkel draft eventually provided much of the basis for the final agreement concluded three years later.
[37] EurActiv, "EU, US attempt Doha revival," 9 January 2007, available at http://www.euractiv.com/en/trade/eu-us-attempt-doha-revival/article-160722 (last visited January 17, 2007).
[38] Ibid.
[39] Ibid.
[40] Let us remember that Article VI of the GATS mandated WTO Members to negotiate possible disciplines on domestic regulation. The December 2005 Hong Kong Ministerial Declaration specified that new disciplines should be developed before the end of the Doha Round. See Ministerial Declaration, WT/MIN/(05)/DEC, 22 December 2005.
[41] Elliot, L. "Bush seeks to renew authority to fast track trade deal," *The Guardian*, 29 January 2007, available at http://business.guardian.co.uk/davos2007/story/0,,2001022,00.html (last visited February 12, 2007).
[42] On liberalizing agricultural markets, the G-33 argued that liberalizing developing country agricultural markets was never one of the objectives of the Doha Round. "This round is a development round, it's all focused on market access from the developing countries into the developed countries, not the other way around," Indian Commerce Minister Kamal Nath said in Jakarta in the framework of a summit on 20-21 March 2007 whose aim was to call on industrialized nations to take the lead in breaking the deadlock in the Doha Round trade negotiations.

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GATT/WTO and MEAs: Resolving the Competing Paradigm

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Abstract. Although free trade law and environmental law especially contained in multi lateral environmental agreements (MEAs) are more or less compatible, however, some twenty MEAs might create a conflicting situation with the GATT/WTO regime. Efforts through CTESS are being made to make the two regimes compatible with each other. But an amicable solution towards harmonizing them still seems to be far. It is said that if all WTO Member states have the political will to agree to one suggestion, the problem can be solved. But due to politicization of the WTO, a common view is difficult to be reached. It is true that all states want protection of the environment. It is evident from the fact that many MEAs have relatively a large number of members, and their member states are sincerely working on enforcing treaty norms contained in them. But when it comes to a conflict situation with international trade, differences among them becomes eminent. In spite of this, an optimistic view that the two regimes can be made complementary to each other is still being given importance. It is for this reason that states are forwarding their suggestions to the CTESS and the discussion is being carried forward on those suggestions. The paper critically examines the reality of 'conflict or congruity' between free trade law and environmental law, evaluates various suggestions to make the two regimes compatible with each other, and offers one suggestion that can bring about harmony and will be viable.

Key Words: multilateral environmental agreements, international free trade law, harmonizing trade law and environmental law, Committee on Trade and Environment Special Session (CTESS).

1. Introduction

After the world wars that had inflicted a serious and long-term economic injury to the world, there was a grave need to have an international trading regime based on mutual co-operation of all countries, developed and developing, rich and poor, and countries blessed with immense natural resources and deprived of them. With this driving force, negotiating countries ultimately agreed to the General Agreement on Tariffs and Trade (GATT), which contained a regime to liberalize trade designed to assure open access to global market and free movement of goods, based on the following cardinal rules: 1. 'Negative Obligation' – under which states agreed to refrain from certain actions such as unjustified regulatory requirements, which covered non-justified tariff and non-tariff barriers, subsidies, or prescriptive regulations. 2. 'Most-favoured Nation Treatment' – under which states were obliged for non-discrimination among imported products based on their national origin. 3. 'National Treatment' – under which states were duty bound not to discriminate locally manufactured goods with imported goods. Among them, it is noticeable that no state was authorized to resort to qualitative or quantitative trade barriers outside the GATT.

The GATT had already provided for an exception to the above given rules in the form of Article XX. Paragraphs (f) and (g) read with chapeau of Article XX provide exceptions, though it is asserted by some environmentalists that the application of these exceptions in cases decided cases by the GATT panel and WTO dispute settlement body (DSB) and their Appellate Bodies have been narrow and restrictive; thus, in effect, they have favoured free trade over protection/conservation of the environment. It is rightly said that the question of protection of the environment was seriously considered in 1970s, more appropriately after the United Nations Conference on Human Environment (UNCHE) 1972, scores of treaties and specific legislations made thereafter, were brought into the arena of environmental protection regime.

A number of multilateral environmental agreements (MEAs), including the Convention on International Trade in Endangered Species (CITES), the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes (Basel Convention), and the Montreal Protocol on Substances That Deplete the Ozone Layer (Montreal Protocol) utilize trade measures as prohibiting trade with non-member states as an ancillary tool to

achieve the larger policy goals of the agreements. However, this is considered to be discriminative, as a non-member state of any of the MEAs and which is a member of the GATT, will be discriminated against a state, which is a member of the GATT and the concerned MEA. This is considered as divergence between the trade law and environmental law. It is important to note here that any measure taken unilaterally by any member of the states of any MEA, which has been the case so far, instead of collective measure under it, is not considered to be a positive and acceptable measure. It is suggested that since a collective measure is compatible with the free trade rule, it will be tenable. But this does not get a great degree of support, as even this will have to be justified under the exceptions mentioned above. But the GATT/WTO does not have jurisdiction to decide any issue under MEAs' rules.

By virtue of Article 30 of the Vienna Convention on Law of Treaties, if a state is a member of the GATT and any MEA, which had already existed before the GATT came into force, the GATT will prevail. Such a situation is also resolved by *lex specialis* principle.[1] Article 31 also attempts to resolve the conflict situation by providing that two treaties should be interpreted so as to avoid any possible conflict, e.g. applying GATT article XX in a manner that permits collective MEA trade measures. In spite of these provisions, it is broadly subscribed that there is an eminent conflict between trade law and environmental law, and this should amicably be resolved. Towards this end, the Uruguay Round, which established the WTO, also took a manifest step in the recognition of the need to achieve a balance between trade and environment with the inclusion of the following language in the preamble of the Final Act embodying the results of the Uruguay Round of Multilateral Trade negotiations in Marrakesh: "Recognizing that relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of trade in goods and services in accordance of objective of sustainable development, seeking both to preserve and protect the environment and to enhance the means for doing so in manner consistent with their (parties) respective needs and concerns at different levels of development…" In April 1994, the members of GATT [2] also agreed to establish a Committee on Trade and Environment (CTE) so that both the legal regimes should be brought together with the minimum of friction. It is noticeable that so far the Committee has not come out with any amicable solutions. However, it is suggested that in order to make the MEAs compatible with the GATT/WTO regime the possibly best solution is to suitably amend Article XX of the GATT. [3] Towards this end, various other suggestions have also been offered. [4]

The purpose of writing this paper is to examine the GATT/WTO rules vis-à-vis the rules contained in various MEAs and to suggest certain amendments to be brought about in the GATT/WTO regime so that free trade and conservation of the environment go hand-in- hand. This is imperatively demanded for achieving the goals set out in the Agenda 21.

2. GATT/WTO and the Environment: Conflict or Congruity

We have noted above that the GATT/WTO regime epitomizes the triumph of economic liberalism in multilateral trading system with its three basic features, namely, 'most favoured treatment', 'national treatment', and 'abstention from non-tariff barriers'. Basically, GATT did not provide for a regime that could be totally compatible with the imperative of protection of the environment. It only provided exceptions under Article XX clause (b) and clause (g) read with the preamble of the Article, which aim at conservation of the environment. However, because of strict adherence to the provisions of these clauses and their narrow application given by the GATT Panels, WTO Panels and the Appellate Body, these clauses, in turn, favoured free trade over protection of the environment. This is evident from the reports on the *Tuna Ban I* case [5], and the *Shrimp-Turtle* case. [6] This occurred in spite of the fact that the US had imposed ban on imports of tuna and shrimp and their products, which could be justified under clause (g) of Article XX, as it was evident that the bans were to protect exhaustible natural resources (dolphins and turtles). It is notable here that the environmentalists for deciding the case in favour of free trade, criticized the GATT panel report of the *Tuna Ban I* case. [7] Contrary to this case, the reports of the *Shrimp-Turtle* case were not subjected to that level of criticism, as in this case, the attitude of the Appellate Body was considered leaning towards protection of the environment. [8] It is evident from the reports of the Panels and the Appellate Body that for some or the other reasons they decided in favour of the free trade. Although the underlined requirement of sustainable exploitation of natural resources, especially under Principle II of the Rio Declaration on Environment and Development and the Agenda 21, warrant that free trade has to be within the limits of sustainable development imperatives. If this fact is not realized and free trade is blindly augmented, a time will come when there will be no resources for trading, and then free trade will have no meaning. This is a fact. Thus, those, who hold the opinion that there is no eminent conflict between free trade law and environmental law, are at the wrong footing. [9] The GATT secretariat report has accentuated this by

stating in clear terms that there is a clash between free trade and environmental protection. It is clear in the first paragraph of the WTO preamble that its aim is to reconcile trade goals and environmental needs 'in accordance with the needs of sustainable development.'

When we come to GATT/WTO and MEAs relationship, the question of compatibility of the two has been quite a debatable issue. [10] MEAs have been made with a predominant idea to exert pressure on recalcitrant states that fail to conserve their environment. States that are members of these treaties can trade among themselves with respect to certain things that have been the subject matter of those treaties, but trade in with a non-member state is prohibited even though they are members of the GATT. If two states are members of the GATT but one of them is not a member of the MEA, the non-member state can be discriminated. This is not permitted in the GATT/WTO regime. And if a case against is filed before the WTO, it will not have jurisdiction to entertain the case, as MEAs are out of its jurisdiction. This is because the basic norm of the WTO regime as stated in Articles I and III of the GATT are based on 'equal treatment and non-discrimination' principle, and if there are exceptions to this principle, they are recognized only on the specifically prescribed basis; whereas MEAs, which have been made for the protection of the environment, are based on 'common but differential responsibility' principle, which warrants developed states to shoulder more responsibility than the developing states. Shinya Morase illustrates it as: the UN Framework Convention on Climate Change and the Kyoto Protocol imposed on Annex I parties targets for the emission reduction of greenhouse gases, with no such obligation prescribed for developing countries. As a result, goods produced in developing countries enjoy competitive advantages in developed countries' market. Since GATT/WTO law requires that all members be placed, in the principle, under the same privileges and obligations, the Annex I countries may assert to impose, in accordance to the WTO rules, countervailing measures. [11]

The other situation from which a dispute between the WTO rules and MEAs may arise is when the MEAs lay emphasis on 'process and production method'; whereas, GATT relates to 'product'. It means that even if the 'product' is clean, it can be banned under the GATT irrespective of its process and production method. The best example to illustrate is the *Tuna Ban* and *Shrimp-Turtle* cases. In these cases, there was nothing wrong with the product, as they were clean and good for health. The only concern of the United States was the catching devices followed by the exporting countries. It is notable that dolphins and turtles were not protected species under the CITES - as the CITES is an instrument which restricts international trade and, strictly speaking, is not an instrument for the protection of such species – and the fishing nets and equipments used were not of the type prohibited by international law. Thus, the process and production regulations in question were not treaty based, which led to the decision in the two cases that they were not GATT- consistent. It is for this reason that in the course of negotiation of the Montreal Protocol, the committee that drafted the Protocol's Article 4 relating to the trade restrictions with non-parties to the protocol discussed the question of compatibility of the process and production requirements with the GATT. It was understood then that such requirements were permissible under the GATT rules. As a result, Article 4 provides not only for the restriction of CFCs themselves and goods containing CFCs, but also of goods that are produced using CFCs and do not contain them.

It is notable that in *Shrimp-Turtle* case, the Appellate Body seems to have broken new ground for process and production method requirement under the GATT law. The complaint brought by Malaysia, India, Thailand and Pakistan concerned in this case the prohibition by the United States of the importation of certain shrimp and shrimp products because fishing vessels of these countries did not use turtle excluder devices or equally effective means of protecting turtles. *The Appellate Body implicitly indicated in its finding that such a process and production requirement might not be inconsistent by its very nature with GATT Article XX (g), although it held that the measures in question be considered unjustifiable under the chapeau of Article XX because of insufficient efforts made by the United States to secure a multilateral acceptance of its exclusionary programme.* In this context Shinya Murace writes: "Although there is not yet a universally accepted interpretation of the *Shrimp-Turtle* decision, an argument has been advanced that 'process and production method' may no longer be incompatible with GATT. If that is the case, however, I think that the Appellate Body has exceeded its competence as a judicial organ that is supposed to interpret and apply the existing law and not create a new law. I believe that the Appellate Boy's judicial legislation is not acceptable while the CTE, as the WTO's legislative body, has been considering the topic of 'process and production methods' for several years now without reaching a consensus." [12]

We have noted above that the jurisprudence under the GATT/WTO has shown an expansive interpretation of Article XX revealing an approach that can accommodate MEA measures. The *Shrimp-Turtle* case has renewed optimism that future cases can amicably address the MEA-WTO relationship in a positive way. This case did not directly involved an MEA trade measure but the evolutionary rules of treaty interpretation, requiring the WTO agreements to be interpreted in light of the 'contemporary concerns of the community of

nations about the protection and conservation of the environment' has opened a door for broader interpretation of Article XX, reinforced by the preamble references in the WTO Agreement to sustainable development as being an objective of the WTO. Although not relevant to the challenged measures, a number of MEAs were referred to in the *Shrimp-Turtle* case to provide a modern context to consider the meaning of the GATT. [13] However, this might not be possible unless the WTO dispute settlement mechanism has jurisdiction to decide the matters pertaining to MEAs. Actually, those who do not see any eminent clash between GATT/WTO and MEAs premise their opinion on the fact that there has never been a dispute where a trade measure taken pursuant to an MEA obligation has been challenged; and the broad interpretation of Article XX of the GATT in *Shrimp-Turtle* case (see infra) has further reduced the possibility of any future dispute. Thus, the author is of the opinion that Appellate Body can only interpret the law; it has no right to legislate. It will, therefore, be appropriate to undertake some kind of amendment in the chapeau of Article XX, which specifically states what the Appellate Body in the Shrimp-Turtle case has said. This kind of situation can also best be resolved in the MEAs itself. [14]

Anther type of conflict between GATT/WTO and some MEAs may arise when treaty norms of MEAs are implemented at the state level. This can be challenged by another state under the relevant rules of GATT/WTO. For example, if a state grants permits for tradable emissions in favour of companies situated in that country, it is nothing but enforcing the mandate contained in the Kyoto Protocol. Since these permits favour local companies, it can be contested by another country. The possibility will be more when a state allows trading between companies situated in a member country with companies situated in some selected countries only. The countries that are not given opportunity of trading might challenge this kind of trading under the GATT/WTO rules. Yet another type of conflict between the GATT/WTO and MEAs might arise if under any MEA, sanction against any state or a group of states is imposed.

The above paragraphs are enough to demonstrate that there is non-compatibility between the GATT/WTO and MEAs. [15] The WTO itself has realized this. It is for this reason that the Doha Ministerial Declaration launched negotiations under its paragraph 31 with a view to enhancing the mutual supportiveness of trade and environment on the following issues: 1. Paragraph 31(i) mandates Members to negotiate on the relationship between WTO rules and specific trade obligations set out in MEAs. Negotiations are limited in scope to the applicability of such existing WTO rules as among parties to the MEA in question. Moreover, the negotiations are not to prejudice the WTO rights of any member that is not a party to the MEA in question. 2. Negotiations were also mandated in paragraph 31(ii) on procedures for information exchange between MEAs and the relevant WTO committees, and on the criteria for the granting of observer status. Negotiations were also launched under paragraph 31(iii) on the reduction or, as appropriate, the elimination of tariff and non-tariff barriers to environmental goods and services.

Paragraph 32 of the Declaration is also relevant to these negotiations. It reads: "The outcome …of the negotiations carried out under paragraph 31(i) and (ii) shall be compatible with the open and non-discriminatory nature of the multilateral trading system, shall not add to or diminish the rights the rights and obligations of Members under the existing WTO agreements, in particular the Agreement on the Application of the Sanitary and Phytosanitary Measures (SPS), nor alter the balance of these rights and obligations, and will take into account the needs of developing and least developed countries."

The WTO has identified some 22 MEAs that have provisions that raise WTO issues, and there are a number of agreements pending might also have trade implications. Of these 22 MEAs, 13 are global agreements and 9 are regional. It needs to be noted that some MEAs have more parties than does the WTO. Notable among them are: CITES, the Montreal Protocol, the Basel Convention, the Convention on Biological Diversity (CBD) and the UN Framework Convention on Climate Change (UNFCCC). [16] In addition to these, a number of other conventions are also coming up. They also might have incompatibility with GATT/WTO rules. We have already noted about the Kyoto Protocol. The others are: the Cartagena Protocol on Biosafety, the Rotterdam Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade, and the Persistent Organic Pollutants Convention. [17]

Based on the above paragraphs, we can say with utmost surety that the conflict between GATT/WTO and environment in general and GATT/WTO and many MEAs in specific is eminent. The sustainable development imperative demands that this has to be resolved amicably soonest possible, so that free trade and environment go hand-in-hand. Those who hold a different opinion, in fact, deny this fact. They are utterly at a wrong footing. It has been accentuated by the WTO Director-General Pascal Lamy in Nairobi on 5th February 2005, while addressing the 24th Session of the Governing Council/Global Ministerial Environmental forum on "Globalization and the Environment in a Reformed UN: Charging a Sustainable Development". He called for a greater mutual supportiveness between trade and the environment. While stressing on the need to lay greater emphasis on sustainable development and to continue the Doha Round, he said, "We need to turn the page on the era in which

governments would bring conflicting positions to different fora. The right hand of the government should not compete with its left hand. The WTO, UNEP, and MEAs – as well as all other international institutions – must be put to work towards a shared sustainable development vision. The Doha Round of trade negotiations contains a promise for the environment. A promise to allow a more efficient allocation of resources – including natural ones – on a global scale through a continued reduction of obstacles to trade. But it also includes a promise to ensure greater harmony between the WTO and MEAs: a promise to tear down the barriers that stand in the way of trade in clean technologies and services; as well as a promise to reduce the environmentally harmful agricultural subsidies that are leading to over production and harmful fisheries subsidies which are encouraging over-fishing…A failure of these negotiations (Doha Round) would strengthen the hand of all those who argue that economic growth should proceed unchecked. That economic growth is supreme and need not take account of the environment. Trade, and indeed the WTO, must be made to deliver sustainable development." [18] We may or may not agree with him. But is evident from his speech that there is conflict between GATT/WTO and MEAs, and for a common goal of sustainable development, the conflict should amicably be resolved. For this purpose, the WTO's Trade and Environment Committee Special Session (TECSS) is working, but so far has failed to reach a 'legislative' solution. [19] The TEC can only suggest a legislative change in the GATT so that its conflict with MEAs could be avoided.

3. Analysis of Some Selected Means

Before the suggested changes are discussed, it will be appropriate to discuss in specific certain MEAs and the conflict situations arising out of them. For this purpose, the Montreal Protocol, the Basel Convention, the CITES and the Kyoto Protocol will be examined here.

3.1 CITES

The CITES [20], along with other conventions, attempts to conserve the global biodiversity. It endeavours to meet the challenges of extinction for whatever reasons [21] of plant and animal species facing extinction. CITES protections are proportional to seriousness of the extinction threat by negotiating the corresponding levels of restrictions on their international trade. [22] For this, it has a listing system via three lists. The restriction continues until experts make scientific observation that the trade will not threaten the species 'viability'. [23] No conflict arises as long as each Member country enforces non-discriminatory ban on the domestic sale of the product or on the international sale if agreed so by the parties. [24] Under CITES, a Member state can trade with a non-member state that provides documentation substantially conforming to the requirements of the Convention. [25] In spite of this harmony, a discriminatory action can be challenged by a GATT Member state. [26] So is the case when a non-domestic species is affected through trade restrictions. [27] At this juncture a question arises: what is the appropriate forum for resolving such disputes? The author reiterates that the WTO Dispute Settlement Body (DSB) cannot be an appropriate forum for such disputes for the following reasons: 1. When the DSB hears disputes between Member countries, it considers their obligations under the GATT only. It does not consider competing treaty obligations even when the disputing parties have ratified both the treaties. 2. The GATT Council has stated that GATT may not be competent to consider environmental issues while examining trade issues. [28] 3. The GATT's narrow drawn scope of competence could through trade restrictions effectively preclude enforcement of MEAs. [29]

3.2 Montreal Protocol

The Montreal Protocol, which was first negotiated in 1987 and then revised in 1990 [30], provides for the phasing out the use of CFCs and other ozone depleting substances by the year 2000. It provides for trade sanctions, restricting parties from trading in CFC related products with non-parties. [31] These were agreed in order to protect the Member states from economic loss because in the absence of trade restrictions, the Member states will not be able to absorb the cost of not using CFCs while non-parties will benefit by using them. [32] In such countries, the production cost will be relatively low and the old technology will continue to work. This will prompt industries of other countries to move to these countries. The preventive measures will compel these countries to accept the Montreal Protocol. In the absence of these measures, non-member countries can suffer only if their products do not have market outside. This will be possible only when consumers in Member states are environmentally conscious not to purchase any product, for example, refrigerators and air conditioners, using

CFCs, which is quite possible. [33] These restrictive measures and the hole in the ozone layer in the Antarctica regions have been the two potent driving forces for the wide acceptance of the Protocol. [34] It is believed that these restrictions will continue the HCFCs, which are substitute for CFCs, are not one hundred per cent environment friendly and they will also be phased out by the year 2030. Under GATT/WTO, the import or export ban on non-parties appears to violate GATT's non-discrimination obligation, while import restriction on products made with, but not continuing, CFCs would run foul of the GATT rules pertaining to production and process methods. [35] However, if they are challenged, Member states may take plea under Article XX (b) of the GATT. They can also plead the jurisdictional issue.

3.3 Basel Convention

The Basel Convention on the Transboundary Movements of Hazardous Wastes and their Disposal [36], but rules: that hazardous wastes should be least generated; that wastes should possibly be treated in environment friendly way at the place of their generation; and that there will be restriction on international trade in them, as it is thought that an restricted and uncontrolled trade in hazardous wastes will impair the environment and affect the human health. Thus, it mandates to strictly control the transboundary movement of hazardous wastes. The Basel Convention permits trade in wastes only in three situations: 1. where both importing and exporting countries ensure that the wastes will be disposed in environment friendly manner; 2. where wastes are to be utilized as a raw materials in producing certain other things. This has to be operative on the informed consent basis; and 3. where the shipment is in accordance with the Convention. [37] The provisions of the Basel Convention thwart the practice of dumping wastes in other countries, for what ever reasons, and getting rid of the possible hazards of the wastes. These and the measure banning the trade with non-parties to the Convention are considered as discriminatory. Likewise, if one state for the purpose of export, prefers one state on the other, will also be violating the non-discrimination provisions of the GATT. This kind of trade restriction can be attempted to be justified under Article XX (b) of the GATT, but it is not sure that the defence will be acceptable, as it will be an extraterritorial effort, which is not permissible in the GATT. [38]

3.4 Kyoto Protocol

The Kyoto Protocol has been negotiated, which has already come into force, under the U. N. Framework Convention on Climate Change Convention (FCCC), introduces a programme to reduce Green House Gases (GHGs) emissions. Reduction has to be done by Member states that are above the threshold level; other Member states have the right to emit more GHGs until they reach the threshold level, or trade emission right with other Member states (Article 17). This is allowed based on flexible mechanisms. [39] This provided an opportunity to developing and least developed countries to get financial benefit and to invest it into the development process. This is in line with one of the basic principles enshrined in the introductory norms of the FCCC. There is a common practice that that Member states have transferred their trading rights to their companies. Will it be considered as subsidy? If we answer this question positively, it will pose a big trade problem. But fortunately the world opinion is not this. Also, the emission trading will not be in conflict with the WTO regime, as long as it is non-discriminatory (prohibition on trading with non-member or non-complying states). Other subsidies, like subsidies given to encourage generating renewable energy or for manufacturing energy equipments to encourage conservation of energy, can also not be considered in conflict with WTO rules, unless they are discriminatory. [40] So is the case of environmental standards vis-à-vis international trade. [41]

Shinya Murace points out another conflicting situation. [42] He makes a specific mention about the Japanese law relating to recycling of disposed household electric appliances of 1998. The primary objective of this law is waste management rather than emission control, but it has an important aspect of conservation of resources through recycling and thus a certain bearing on emission reduction. What is interesting about this law is that it requires the producers to recycle the wastes related to their products. They are supposed to collect wastes and recycle them. This requires from them to have some kind of collection and re-cycling or disposal mechanism. This is like the law being enforced by the OECD countries as 'extended producer responsibility'. One EU Directive is also in that line. [43] These measures may be challenged as being inconsistent with the Technical Barriers to Trade (TBT) agreement by prospective foreign producers. The recycling measures may also be coupled in some cases with certain subsidies or tax reduction, in which case the same benefits may, in principle, have to be extended to foreign imports in order to be compatible with the WTO regime.

4. Proposals to Resolve the Conflict

The Committee on Trade and Environment (CTE), which is composed of WTO Members and a number of observers from various NGOs, was brought into existence with a broad based mandate, consisting of identifying the relationship between trade measures and environmental measures in order to promote sustainable development, and making appropriate recommendations to resolve the possible conflicts between trade law and environmental law, including MEAs. Since then, the CTE has been negotiating various conflict areas, and has held a number of information sessions with MEA Secretariats to deepen Members' understanding of the relationship between the WTO and MEAs. It is also making efforts to resolve the conflict between GATT/WTO and the treaty laws of various MEAs. In November 2001, at Doha Ministerial Conference, it was agreed to launch negotiations on certain trade and environment aspects contained in Paragraph 31 of the Doha Ministerial Declaration. For this purpose, the Committee on Trade and Environment Special Session (CTESS) was established, and CTE was requested to give particular attention towards negotiations. For the sake of convenience and facilitate an streamlined discussions, the CTESS has been broken down into four categories: (a) trade measures explicitly provided for and mandatory under MEAs; (b) trade measures not expressly provided for nor mandatory under the MEA but consequential of the obligation resultant of the MEA (where MEA lists possible measures and policies in order to achieve compliance); (c) trade measures not identified in the MEA but that parties may decide to implement in order to comply with MEA; and (d) trade measures not required in the MEA but where parties may implement them if the MEA contains a general provision stating parties can adopt more stringent measures in accordance with international law. The CTESS is regularly meeting to further negotiations on the three aspects of Paragraph 31 of the Doha Ministerial Declaration. In these meetings various suggestions offered by the Member sates are being considered. [44] It has not yet reached to an amicable solution acceptable to WTO members.

The CTE in 1996, suggested for 'mutual solutions based on international cooperation and consensus [45]. Similarly, in the *Tuna Ban I* case the GATT Panel emphasized on 'international cooperative arrangements'. In the *Shrimp-Turtle* case the WTO-DSB appeared to more favourable to protecting the environment. [46] But as pointed out above, it seems to be difficult for the WTO-DSB and the Appellate Body to amicably resolve the conflict situation between the WTO/GATT and MEAs.

In view of this, it will be appropriate to discuss various suggestions in finding a solution for a peaceful co-existence of the two regimes.

1. MEAs should be examined on a case-by-case basis using Article IX:3 of the WTO regime. This provision allows waiver of any obligation under 'exceptional circumstances' by $3/4^{th}$ majority of the Member states. But this suggestion has rightly been criticized for: (a) the term 'exceptional circumstances' is vague; and (b) voting will involve politics. [47]
2. The 20 existing MEAs, which have or might possibly have conflict with the GATT/WTO regime, and future MEAs can be made as exceptions to that regime. There is an existing example in the North America Free trade Agreement (NAFTA). It provides that MEAs like the Basel Convention, the Montreal Protocol and the CITES, which are listed in Article 104 of the NAFTA, will be given priority over the NAFTA. It also provides that in case of any dispute, the disputing parties will resort to the NAFTA only. Without such a provision, parties could have gone to other international bodies, such as WTO. Such precedence is subject to the following conditions: 1. the MEA prevails only to the extent of inconsistency; 2. the party to the MEA must choose the alternative, where there is a choice among equally effective and reasonably available means of complying with the MEA, that is least inconsistent with NAFTA; and 3. the measure must be specific trade obligation. By virtue of that, the MEAs will have precedence over NAFTA provisions. This seems to be workable, but in the NAFTA, there were only three countries and few existing MEAs only and they agreed to it after deliberation on it. At the WTO level, to reach to such a conclusion seems to be very difficult, because all Member states will have to agree to it; and such a decision will have to cover future MEAs also. [48]
3. Vinod Rege suggests for an alternatives to amend article XX by adding a provision on MEAs or to adopt an interpretation of Article XX that will validate existing MEAs and provide for notification for future MEAs as well as set out criteria, a 'safe harbour', they would have to fulfil to receive approval. [49] A model for MEAs might be GATT Article XX (h), which creates an exception for trade measures imposed pursuant to trade obligations. Article XX (h) is proposed to set out two approval methods: 1. Trade agreements that conform to the specific criteria will automatically be valid. 2. Other trade agreements can be evaluated on an *ad hoc* basis if they are submitted to the GATT Member states and not disapproved. Robert E Hudec suggests a different kind of amendment to the GATT. This might

provide that: 1. Negotiations of MEAs will preferably be under the auspices of the United Nations Environment Programme (UNEP); 2. The problem must relate a 'serious environmental problem'; 3. There should be a reasonable relationship between trade restriction and protection of the environment; and 4. The MEA, in question, must be formally notified to the WTO. [50] This might effectively immunize current and future MEAs from attack under the GATT/WTO regime. In this proposal, there are some difficult propositions: 1. Amendment of Article XX requires 3/4th majority of the Member states. This might be difficult because all member states are governed by their economic conditions; and for protecting their interest they have formed various groupings. This will result in politicizing all decisions to be made at various meetings of Member states. This is evident from the Doha Round negotiations. 2. There might not be consensus on 'serious environmental problem'. 3. There might be dispute on attempt in establishing 'reasonable relationship between trade restriction and the protection of the environment.

Japan's Environmental Protection Agency (EPA), on the basis of the recommendation made by an EPA Advisory Group, has proposed similar suggestion. It wants to introduce a new clause to Article XX of the GATT. It is: "undertaken in pursuance of obligations under any multilateral environmental agreement which is submitted to the Ministerial Meeting and not disapproved by it." Although this suggestion has been supported by some experts, it suffers from the same adverse points that have been pointed out above. [51]

It is notable that none of the suggestions has commanded unanimous support because they suffer from one or the other weakness, or they are unable to serve vested interests of certain groupings of states, developed, developing and least developed. However, many experts have supported the proposal creating around twenty existing MEAs and MEAs to be negotiated in future as exception to the GATT on the NAFTA pattern, [52] or to create a new clause for approval of MEAs by the GATT Member states. The author is of the opinion that considering all MEAs, existing and future, as exceptions to the GATT/WTO regime might not be a possibility; and because of politicization of international trade, the second proposal also might not be feasible. Yet another suggestion, which might be a feasible one, if designed ably, is to have one international body named World Environmental Organization (WEO) [53], which will be self contained and self-dependent on the WTO pattern. This organization should have jurisdiction to give its verdict on all conflict situations between trade law and environmental protection law, especially contained in MEAs. To have this kind of organization at this point of time may not appeal many, as at the time of negotiations of the GATT, many countries were aspiring to have a Trade Organization, but finally, there was agreement on GATT. So as to make the proposed body to have the suggested jurisdiction, all MEAs should be brought within the ambit of the Organization. An amendment in the GATT for providing this jurisdiction should be entertained. The author is of the opinion that such a resolution seems to be difficult to be passed now. But this will have to be passed because protection of the environment serves interests of all countries.

Proposals made by various jurists and economists, including mine, are grouped into three categories, status quo, *ex post* or waiver, and *ex ante* or environmental window. The supporters of the first category do not see any eminent conflict between the two regimes. Prominent among the first category is that of EU. It proposes to reverse the burden of proving in Article XX of the GATT, thus strengthening the position of parties invoking exceptions contained in Article XX on environmental cases. [54] This proposal does not carry much support, as the two regimes have eminent conflicts. The second group of proposal allows parties to waive GATT obligations in exceptional circumstances. ASEAN, along with Egypt and Hong Kong, is among the supporters. But as pointed out above, owing to the political situations, it is not possible to stick to this proposal. [55] The third grouping of proposals spell out criteria under which MEAs will be compatible with the WTO regime, either by an expansion of Article XX, or by the adoption of a collective interpretation of Article XX that would validate existing MEAs and spell out under what specific conditions the WTO would accept the use of trade measures taken pursuant to MEAs while leaving the status of future MEAs open, on a newly added paragraph to Article XX referring to the relationship between trade measures taken pursuant to MEAs, or on a newly created agreement on trade related environmental agreements. The most difficult aspect of this group of proposals is that any amendment to the GATT requires 3/4th majority followed by ratification. However, among all suggestions, the suggestion to have WEO seems to be most practicable one. But its acceptability will also not be free of disputes among the Member states. Most difficult part pertaining to this proposal might be having consensus on grouping all the MEAs having trade related provisions. [56]

As the discussions on various suggestions are on going, the author appreciates the endeavour made by the WWF for keeping some basic imperatives in the mind. [57] This is: "in the course of negotiations, the Member states should agree for the following –

a) It is necessary to reiterate the tenets listed below, all of which are based on existing international consensus, as they apply to all MEA measures and to MEA parties and non-parties, to provide guidance to WTO Members and its Dispute Settlement Body.
   - Transboundary or global environmental problems demand multilateral solutions. Unilateral actions to deal with environmental challenges outside the jurisdiction of the importing country should be avoided.
   - Multilateral environmental policy must be made and administered within multilateral environmental fora, and not in the WTO.
   - Trade measures, based on specifically agreed-upon provisions, are necessary in certain cases to achieve the environmental objectives of a MEA.
   - WTO rules should not be interpreted in isolation from other bodies of international law and without considering other complementary bodies of international law, including MEAs and internationally agreed principles.
   - Some provisions of the WTO rules do not oppose protection of the environment.
   - Co-ordination between trade and environment officials at the national level is necessary for achieving the goals of sustainable development.
   - Co-operation between the WTO and relevant MEA institutions is desirable and necessary to enhance the understanding of the relationship between trade and environmental policies.
   - If a dispute arises between WTO members over the use of trade measures applied pursuant to an MEA, they must first seek to resolve it through the dispute settlement mechanisms available under the MEA.
   - There is a benefit to having all relevant expertise available to WTO-DSB and the Appellate Body in cases involving trade-related environmental measures, including trade measures taken pursuant to MEAs.
   - Both the WTO and MEAs dispute settlement mechanism emphasize the avoidance of dispute, including through parties seeking mutually satisfactory solutions.

b) The WTO-DSB will not entertain disputes arising out of the implementation of MEAs until all avenues for resolving the dispute under the MEA in question have been exhausted.

c) It is necessary to grant to MEA Secretariats and UNEP observer status in WTO bodies and to improve information exchange between international environmental organizations (including MEA Secretariats) and the WTO.

In addition to these, the following points should be given due consideration:

(a) States should not make any attempt to undermine negotiations under paragraph 31 of the Doha Ministerial Declaration.

(b) States should not accept any attempt to undermine the MEA rules.

(c) States should not accept any attempt to undermine any MEA over other.

(d) States should not accept any attempt to make any provision for the WTO oversight of the implementation of existing MEAs or the negotiation of future MEAs.

(e) States should not accept any attempt to remove from the work programme of the CTESS the wider set of issues arising out of the relationship between MEAs and WTO rules, which have been discussed under items 1 and 5 of the Marrakesh Work Programme mandated by the 1994 Ministerial Declaration on Trade and environment.

This is notable that most of the imperatives suggested by the WWF are being followed during negotiation sessions of the CTESS. [58]

5. Conclusion

It is evident that although the GATT/WTO regime has some provisions that have compatibility with MEAs, there are about 20 MEAs that might be inconsistent with it. Ever since this has been realized, efforts at individual and institutional levels are being made to make the two regimes compatible. After the Doha Declaration, such efforts were taken up by the WTO with priority. Negotiations for finding an amicable compatibility between the two regimes are on through various sessions of the CTESS. Towards this end, WTO Member states are

forwarding various suggestions for consideration. Out of all suggestions put forth, so far three possible approached have been identified. All of them have arguments in favour and against. According to the author, there is a need to have an independent international body, named World Environmental Organization. All MEAs should be annexed to it. This international body should have jurisdiction to decide over all kinds of disputes pertaining to protection of the environment and international trade. This would require amendment of the GATT. It seems that amending the GATT is not an easy task, as trade concerns the economy of Member states, the WTO is too much politicized. However, if there is enough political will on the part of the Member states to strike a meaningful balance, which is in view of the sustainable development principles eminently desirable, between the protection of the environment and facilitating free international trade, the task cannot be impossibility. The author further suggests that this mechanism, if agreed and implemented, should be carried forward to regional free trade agreements also.

Notes:

[1] See Voon, T. (2000). Sizing Up the WTO: Trade-Environmental Conflict and the Kyoto Protocol. Journal of Transnational Law and Policy, Vol. 10, 71-108.
[2] The GATT is now known as GATT-94.
[3] See Nissen, J. L. (1997). Achieving A Balance between Trade and Environment: The Need to Amend the WTO/GATT to Include Multilateral Environmental Agreements. Law and Policy in International Business, Vol. 28, 28-34. Also see Winter, R. L. (2000). Reconciling the GATT and WTO with Multilateral Environmental Agreements: Can We Have Our Cake and Eat it Too? Colorado Journal of International Law and Policy, Vol. 11, 223-254; See the Report of the Committee on Trade and Environment Special Session (TN/TE/W/39), 24 August 2004.
[4] For some of the suggestions, see WWF - Multilateral Environmental Agreements and the WTO Rules October, 2005, available at:
<http://www.foeeurope.org/publications/ 2006/WTO_conference_proceedings.pdf>
[5] US-Restrictions on Imports of Tuna (1991). 30 International Legal Materials 1594.
[6] US-Import Prohibition on Certain Shrimp and Shrimp Products (1998). 37 International Legal Materials 832.
[7] See Baly, S. (2004). The WTO and the greening of the world; a look at WTO jurisdiction 21 Environmental and Planning Law Journal, p. 27-30; Ansari, A. H. (2001). Free Trade Law and Environmental Law: Conflict or Congruity? 41 Indian Journal of International Law, 1-43.
[8] The case was decided against the United States, as it had not made efforts to achieving a consensus about ways and means about the catching device. See *infra.*
[9] See Krist, B. (2001). Neither Friends Nor Foes, But Neighbours: An Introduction to the Relationship Between the WTO and MEAs. In The Heinrich Boll Foundation - Washington Office: Trade and Environment, the WTO, and MEAs, 29 March 2001.
[10] See Ngobese, P. Multilateral Trade and MEAs: Convergence or Divergence? Available at:
<http://www.org/dlogue/1999-02-10/NGOBESE.pdf>
[11] Shinya Murase, S. WTO/GATT and MEAs: The Kyoto Protocol and Beyond, available at:
<http://www.gets.org/pages/harmony/Murase.doc>
[12] *Ibid.*
[13] Gray, K. R. (2004) Accommodating MEAs in Trade Agreements. Paper presented at the International Environmental Governance Conference, Paris, 15-16 March 2004.
[14] See Jutta Brunee, J., & Hey, E. (Eds.) (1998). Symposium, Yearbook of International Environmental Law, Vol. 9, 3-47.
[15] For a brief history of the trade and environment debate, see Trade and Environment during the GATT, available at: <http://www.org/english/tratop-e/envir_backgrund_e_/clsl_e.htm>
[16] See Kerr, W. A. (2002). Who Should Make the Rules of Trade? – The Complex Issue of Multilateral Agreements, 3:2 Estey Cetre Journal of International Law and Trade Policy, 6-34.
[17] See Krist, B. footnote 9, at 30.
[18] His full speech is avilable at: <http://www.wto.org/english/news_e/sppl-e/sppl54_e.htm>.
[19] The Committee on Trade and Environment (CTE) is also involved with activities of the CTESS.
[20] 993 UNTS 243.
[21] Over exploitation is the main reason. For example, elephants are killed for their ivory, rhinos are killed for their horns and tigers are killed for their body parts that have medicinal value in China and some other countries.

[22] CITES provides under its different Articles for trade measures at different decision-making levels: 1. Trade measures that are legally binding (text of the convention). 2. Trade measures decided by the Conference of Parties (COP). 3. Trade measures decided by the Standing Committee (SC). 4. Trade measures recommended by the Animal Committee/ Plants Committee. Trade measures suggested by the Secretariat of the COP and SC. 5. Strict domestic trade measures was adopted by the parties.
[23] See McDonald, J. (1993). Greening the GATT: Harmonizing Free trade and Environmental Protection in the New World Order. Environmental Law, Vol. 23, at 397; Kelly Jade Hunt, K. J. (1996). International Environmental Agreements in Conflict with GATT – Greening GATT After the Uruguay Round Agreement. The International Lawyer, Vol. 30, at 163.
[24] See Baker, B. (1993). Protection Not Protectionism: Multilateral Environmental Agreements and the GATT. Vanderbilt Journal of Transnational Law, Vol. 26, at 437.
[25] For trade-related measures, see Articles II to XIV of the Convention.
[26] See Ansari, A. H. at. 29, footnote 7.
[27] See *United States Restrictions on Imports of Tuna,* 30 ILM1594 (1991). In *United States restriction on Import of Tuna*, GATT Document DS29/R (1994), this view was not supported.
[28] See GATT's follow-up to the UN Conference on Environment and Development, GATT Doc. SR/48/1, 2 December 1992. The author feels that in view of the latest developments on trade law and environmental law, this has faded.
[29] See Ansari, A. H. at 32, footnote 7.
[30] See Montreal Protocol on Substances that Deplete the Ozone Layer, Sep. 16, 1987, 26 ILM 1550 (1989). The Amendment can be seen in 32 ILM 874 (1992).
[31] Article 4 of the Protocol may be referred.
[32] See Articles 2 to 4B of the Protocol.
[33] This is notable here that because of this reason, countries like Malaysia, which are leading exporters of refrigerators and air conditioners have accelerated the phasing out process; because, if they do not do that, they will not have overseas market for their products.
[34] Some commentators are of the opinion that trade restrictions will continue play a positive role. See, for example, Houseman R. & and Zaelke, D. (1992). Trade, Environment and Sustainable Development: A Primer. Hastings International and Comparative Law Review,535-580.
[35] See GATT Secretariat: Trade and Environment Report, Doc. 1529 (1992).
[36] See generally, Ansari, A. H. supra note 7.
[37] For trade-rlated measures provided in the Convention, see Articles 3-9.
[38] See Import Ban: The Pride of the Basel Convention (An Update on Implementation and Amendment – September 1995) available at: http://www.greenpeece.org/~comms/97/toxic/bbp.html; Commission on Environment: The Basel Convention Export Ban Amendment – A Business Perspective, 8 November 1999 available at: <http://.iccwbo.org/id/index.htm>; Guruswamy, L. (1998). Environment and Trade: Competing Paradigm in International Law. In Anghie, A & Sturgess, G (Eds.), Legal Vision of the 21st Century: Essays in the Memory of Christopher Veeramantary (pp. 543-576). Hague: Kleuwer International; Ansari, A. H. at 23, footnote 7.
[39] The other two flexible mechanisms are: Joint implementation (Article 6) and Clean Development Mechanism (Article 12).
[40] It is notable here that if subsidies are considered to be violative to the WTO rules, the aggrieved states will have right to impose countervailing duty.
[41] See Brack, D., Grubb, M & Windram, G. (1999). International Trade and Climate Change Policies (eds.).London: RIIA Energy and Environment Programme?/Earthscan Publications; Thomas L. Brewer,T. L. The WTO and the Kyoto Protocol: Interaction Issues, available at: <http://www.faculty.msb.edu/brewest/Brewer%20WTO-KP%2011.pdf>; Cosbey, A. The Kyoto Protocol and the WTO, International Institute for Sustainable Development (IISD), available at: <http://www.iisd.org/pdf/kyoto.pdf.7>
[42] See footnote 11. .
[43] EU: Directive on Waste Electrical and Electronic Equipments, June 2000.
[44] For suggestions offered by various countries, see Knigge, M. Report on Trade and Multilateral Environmental Agreements (Edited by, Duncan Brack), June 2005, available at:<http://www.cat-e.org>
[45] See the WTO, Committee on Trade and Environment, Report of 1996, WT/CTE/1, 12 November 1996.
[46] The *Shrimp/Turtle* appellate decision strengthened the right of the state to adopt conservation measures by a liberal interpretation of GATT Article XX (g). Moreover, the Appellate Body acknowledged the relevance of the

preamble including the aim of sustainable development in interpreting Article XX of the GATT. See the Report of the Appellate Body on the case, Wt/DS58/AB/R, 12 October 2001. Also see, Haverkamp, J. (2001). The Conflict Between the WTO and MEAs – In the View of the US Government Only a Theoretical Problem. In Foundation, H. B. (Ed.): Trade and Environment, the WTO and MEAs – Facets of A Complex Relationship. Washington, DC: Heinrich Boll Foundation, 71-90.

[47] See Matsushita, M, Schoenbaum, T. J. & Mavroidis, P. C. (2003). The World Trade Organization: Law, Practice and Policy, Oxford: The Oxford International Law Library, 458.

[48] See North American Free Trade Agreement, 17 December 1992, 32 ILM 289.

[49] See Rege, V. (1994). GATT and Environment -Related Laws Affecting the Trade of Developing Countries. 28 Journal of World Trade, p. 28.

[50] Ibid.

[51] For example, Shinya Murace, footnote 11. The writer is of the opinion that, "This is a combination of ex post and ex ante approaches, and in my view, the proposed method is most appropriate for harmonizing the conflicting obligations of free trade under the WTO/GATT on the one hand and the protection of the environment under MEAs on the other."

[52] ASEAN supports this suggestion. See Submission by ASEN, WT/CTE/W/39, 24 July 1996.

[53] See Jennifer Haverkamp, J. (2001). The Conflict between the WTO and MEAs – In the View of the US Government, Only a Theoretical Problem. In The Heinrich Boll Foundation, Washington Office, Trade and Environment, the WTO, and MEAs: Facets of a Complex Relationship, Washington DC, March 2001, p. 5. Also see generally, Pauwelyn, P. (2004). Conflicts of norms in public international law: how WTO law relates to other rules of international law. American Journal of International Law, Vol. 98, p. 855; Pauwelyn, J. P. (2004). Law of the World Trade Organization for Protection of the Environment. European Journal of International Law, p. 575; Rogers-Kalas, P (2001). International Environmental Dispute Resolution and the Need for Access by Non-State Entities. Colorado Journal of International Law and Policy, Vol. 12, p. 191; Safrin, S. (2002). Treaties in Collision? The Biosafety Protocol and the World Trade Organization Agreements. The American Journal of International Law, Vol. 96, p. 606.

[54] See the Submission by European Communities, WT/CTE/W/170, 19 October 2000.

[55] See R. L. Winter, R. L. (2000). Reconciling the GATT and WTO with Multilateral Environmental Agreements: Can We Have Our Cake and Eat It Too? Colorado Journal of International Law and Policy, Vol. 11, p. 248.

[56] See Esty, D. (1994). Greening the GATT. Washington, Institute for International Economics; Moltke, K. V. (2000). Research on the Effectiveness of International Environmental Agreements: Lessons for Policy Makers? In Barcelona, Effectiveness of Environmental Agreements and EU Legislations, p. 9; Barret, S. (2003). Environment and Statecraft: The Strategy of Environmental Treaty-Making. London: Oxford University Press.

[57] See WWF, Multilateral Environmental Agreements and WTO Rules, 16 October 2005. See at: http://www.pand.org

[58] See Summery Reports of Committee on Trade and Environment-Special Session (CTESS) on its various sessions, specially the Summery Report of the 14th Session of February 2006, and Reports of the Chairman of Committee on Trade and Environment – Special Session on its various sessions, especially of July 2006, at the WTO website.

Iraq's Accession to the WTO: Commitments and Implications

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Abstract. Iraq has kicked off the procedures to accede to the WTO through the organization's full working party accession process. In its accession, Iraq is expected to agree to an arduous package of legal and economic reform. Having plunged into the WTO with the belief that accession is its best hope for a prosperous future, Iraq will now face many challenges. Some industries may lose out to competition. Yet liberalizing its market and integrating its economy with the rest of the world will ultimately benefit Iraq because it will stimulate reform and provide trade protections it otherwise would not enjoy. Iraq has made a wise investment by negotiating for WTO membership. Iraq's accession terms could be rigorous, but they represent not only a cost, but also an investment. WTO membership can be a helpful tool for achieving greater prosperity for Iraq because it encourages progressive domestic policies.

1. Introduction

In September 2004, Iraq applied to accede to the World Trade Organization (WTO) through its full working party process. The cornerstone of the Iraqi government's long-term economic objectives has been to increase trade and support economic growth via regional and global integration. Accordingly, Iraq has actively pursued WTO membership.

WTO accession is a lengthy and difficult process. WTO membership, however, will not come without sacrifice. There could be concern over Iraq's future and whether it will be able to implement its membership obligations. As a young democracy and fledgling market economy, Iraq should pursue policies designed to strengthen rule of law, establish political checks and balances, and foster a thriving civil society.

This paper argues that, despite Iraq's potential onerous accession commitments, WTO membership will benefit Iraq by furthering its goal of achieving increased economic prosperity through trade. Part 2 of this paper outlines Iraq's legal framework for making trade policy. Part 3 explores the WTO accession process. Part 4 speculates some of Iraq's specific commitments that it will undertake in its accession to the WTO. Parts 5 and 6 highlight the benefits of WTO membership and the challenges resulting from the WTO requirements of economic liberalization. Finally, the paper concludes by arguing that Iraq will face challenges and disadvantages during WTO accession negotiations and membership. However, Iraq can greatly benefit from WTO membership by implementing reformatory and progressive domestic policies.

2. The Legal Framework for Making and Enforcing Trade Policy

The Iraqi Constitution provides for the legal, institutional, and procedural framework to be followed in instances where the government of Iraq enters into international agreements such as those under the auspices of the WTO. Under article 107 of the Iraqi Constitution, federal authorities have exclusive power over, inter alia, foreign negotiations and policy as well as customs policies. No governate or region, including the Kurdish territories (Dohok, Arbil, and Sulaimaniya), has the right to set its own its trade policy including tariffs. However, according to article 110 of the Iraqi constitution, federal authorities share powers over regional customs with regional authorities. At the current time, there are customs centres belonging to the government of Kurdistan which share borders with Turkey and Iran. These customs centres levy tariffs which are not transferred back to the central government (Manafy, 2005)

The detailed legal arrangements for local and regional governments in Iraq are not fully crystallized yet and part of an ongoing political process. The lack of clear legal structure over local or regional governments' authority to apply taxes, set regulations for investment, or grant benefits to domestic firms or domestic goods may raise problems and uncertainty. The federal authorities in Iraq will have to take appropriate judicial or other

action to ensure that WTO-inconsistent measures taken by local or regional governments would be brought into conformity with Iraq's obligations.

Any agreement entered into by Iraq in the context of its WTO accession negotiations must be certified by the Council of Representatives (Parliament) by a two-thirds majority. After approval of the international agreement concerned by the Council of Representatives, it is delivered to the President of the Iraqi Republic. Such an agreement is considered ratified after fifteen days from the date of receipt.

The next question that arises after ratification is the legal status of WTO agreements. The Law for Entering into Treaties of 1979 sets forth the legal status of treaties that Iraq has ratified and endorsed by the standard legislative means. In this regard, the Law for Entering into Treaties of 1979 commits Iraq to compliance with all international conventions, agreements, and protocols properly ratified. Upon ratification by Iraq, WTO agreements will have the status of enforceable law. Additionally, upon ratification, WTO agreements take precedence over a conflicting Iraqi law and would result in the non-application of the inconsistent Iraqi law.

3. Iraq's Accession Process

The WTO accession process formally begins when a country informs the WTO Director-General of its desire to join. Typically, by the time a country applies for membership, the applicant has already obtained observer status (Hoekman & Kostecki, 2001). The WTO General Council then forms a "working party" of members to examine the application. The applicant must then submit to the WTO a memorandum describing any aspects of the country's trade and economic policies that would potentially affect obligations contained in the WTO agreements. This memorandum forms the basis for negotiations between the applicant and the working party. After basic principles and policies have been resolved with the working party, individual WTO members enter into bilateral negotiations with the applicant country over the specific undertakings that the applicant will agree to as a condition of WTO membership. Upon completion of these bilateral negotiations, the applicant country will face multilateral WTO talks. The working party then finalizes the accession terms in three documents: the working party report, the protocol of accession, and the attached schedules containing the new member's specific liberalization commitments. The final accession terms are then presented to the WTO body for a vote. If two-thirds of the WTO's existing members vote in favor of accession, then the applicant may sign the protocol and join the WTO.

Iraq first obtained observer status at the WTO on February 11, 2004 (Pruzin, 2004). Iraq used its time as an observer to learn more about the organization and prepare for an eventual bid for WTO membership. Iraq applied for WTO membership in September 2004. On December 13, 2004, members of the WTO agreed to commence negotiations with Iraq for eventual membership. The approval of membership application resulted in the establishment of accession working party for Iraq which will serve as the respective forum for negotiations on membership. On December 15, 2006, the WTO appointed Colombia's WTO ambassador Claudia Uribe to chair the working party charged with Iraq’s accession process (IZDIHAR Project, 2006). The appointment of the chair opens the door for formal face-to-face negotiations. Iraq has already submitted a memorandum on its foreign trade regime, an information-gathering exercise that constitutes the first step of the accession negotiations. Replies from Iraq to questions posed by WTO members about its foreign trade regime were circulated to governments on November 28, 2006. The events leading to the start of Iraq's WTO accession are summarized in Table 1 below.

Table 1: Events Leading Up to the Start of Iraq's WTO Accession

Year	Event
2004	Iraq granted observer status in the WTO
2004	Iraq notifies the WTO of intent to negotiate terms of membership
2004	Working party on Iraq's membership to the WTO established
2006	Circulation of Iraq's memorandum of foreign trade regime and responses to questions
2006	Selection of the chairperson of Iraq's working party

A number of complications and intervening events prolonged the procedural aspect of Iraq's accession process. Questions have been raised as to whether Iraq qualifies as a state or territory "possessing full autonomy" in the conduct of its external commercial relations, the criteria set down in article XII of the 1994 WTO Charter for membership. At the time Iraq applied for observership in the WTO, it was governed by a U.S.-led Coalition Provisional Authority (CPA) and the Iraqi Governing Council, which was appointed by CPA Administrator L.

Paul Bremer. Iraq regained full sovereignty on June 30, 2004 under an agreement between the CPA and the CPA-appointed Iraqi Governing Council whereby Iraq's transitional National Assembly will elect leaders with the CPA and the Governing Council then dissolved. Although Iraq might not have the sovereignty at the time it requested observership seat, Iraq have had full sovereignty by the time it officially applied for WTO membership.

Furthermore, Iraq's membership application was linked to the dispute between the United States (U.S.) and European Union (EU) over the awarding of $8 billion in reconstruction contracts in Iraq, from which certain EU member states, including Germany and France, have been excluded (Kirwin, 2003). The plurilateral WTO Government Procurement Agreement (GPA) requires participating countries to award contracts on a non-discriminatory basis. The GPA contains exceptions, however, for national security purposes and for developing countries in certain situations. The U.S. argued that it was not bound by the GPA rules on reconstruction contracts in Iraq because they concerned humanitarian assistance. The U.S. has an exception built into its WTO commitments with respect to procurement by the U.S. Agency for International Development that excludes contracts for foreign assistance purposes. Therefore, as a matter of law, Iraq construction contracts are not subject to the U.S. WTO obligations. Nonetheless, at a practical level, the U.S. desired for broad participation in Iraq contract bidding process by foreign companies which offer a competitive advantage and lower price.

4. Future Iraqi Accession Protocol

When one takes into account the size of Iraq's economy, its status as a developing country, and the degree to which Iraq until very recently operated as a centrally-planned economy, it is expected that Iraq will endure a lengthy accession process to the WTO. Moreover, because there is no standard WTO accession protocol, Iraq will seek membership on terms it negotiates with the WTO based on its bargaining position. Given Iraq's resources and bargaining power, it can effectively achieve either better or demanding accession terms than what other countries got.

Iraq is expected to take on many concessions due to increased substantive coverage of the Uruguay Round agreements including intellectual property protection, trade in services, and agriculture which broadened the scope of commitments demanded as a price of admission (Leebron, 1995). A wide range of Iraq's current laws will have to be revised in order to ensure that Iraq's trade regime complies with WTO rules. Below are some of the more significant concessions that Iraq will agree to in its future accession protocol.

4.1. Market Access in Goods

Pursuant to CPA Orders No. 38 and No. 54, imported goods into Iraq are currently subject to a "reconstruction levy" of five percent *ad valorem* (Memorandum on the Foreign Trade Regime, 2005). However, CPA Order No. 38 provides for certain exemption from the reconstruction levy, including among others for food, medicines and medical equipment, goods delivered as humanitarian assistance and goods imported by international or not-for-profit organizations. The five percent reconstruction levy continues to be imposed in lieu of tariffs since the previous tariff schedule of 1997 is not effective. Iraq needs to change its tariff system to become consistent with the WTO. To this end, Iraq has to adopt the Harmonized System for classifying goods, as other WTO members did, in order to begin to establish trade statistics and procedures for its application. When Iraq completes its goods classification and tariff schedule, it would have to reduce tariffs on industrial goods to a certain average, as agreed upon with other WTO members during accession negotiations, and to sustain this average against future increase.

4.2. Agriculture

In old Iraq, the state provided seeds, fertilizers, pesticides, sprinklers, and tractors at low cost. However, as part of WTO accession, Iraq will have to eliminate subsidies on agricultural goods but with few exceptions. For example, Iraq can still maintain state involvement in certain agricultural research and development activity. In the new capitalist economy, the Iraqi state provides little, if any, support. Due to rehabilitating of the Iraqi agricultural sector and adjustments brought by phasing out subsidies on agricultural goods pursuant to the WTO rules, some of Iraq's five million agricultural workers, most of whom are family farmers, will lose their jobs in the agricultural sector (Cha, 2004). The Iraqi agricultural sector will face a tougher competition in the face of agri-businesses of major agricultural exporters such as those of the U.S. and Australia.

Iraq's best chance for long-term economic welfare is to follow the developed countries' successful model of decreasing agrarian output in favor of industrial production (Bhala, 2003). Such a model needs not to signify the end of Iraqi agriculture because some level of sustainable agricultural production is essential to address rural development. It does, however, require diversifying crops in order to shift from producing solely for domestic consumption to exporting higher-value crops. Such a system will generate higher farmer incomes, and Iraq can import less-expensive agriculture products from neighbours who have a comparative advantage in their production. Therefore, Iraq's policy of active participation in the WTO trading system has the potential to improve farmer welfare, while increasing trade and diversifying the economy.

4.3. Subsidies

By signing the Agreement on Subsidies and Countervailing Measures (SCM Agreement), Iraq in effect will agree to make subsidies to state-owned enterprises (SOEs) subject to countervailing duty actions. Currently, Iraq provides a set of direct subsidies to SOEs in the form of state-funded salaries for companies whose facilities have been damaged in whole or in part where companies are unable to recover such funds in the absence of aid (Memorandum on the Foreign Trade Regime, 2005). Moreover, the Iraqi government provides indirect subsidies to SOEs in the form of reduced prices for electricity, fuel, and water; and exemption from taxes such as import and export taxes, reconstruction tax, and variable services taxes. With limited exceptions, Iraq is expected to agree not to take advantage of the special provisions in the SCM Agreement that are applicable to developing countries. For example, according to article 27.13 of the SCM Agreement, certain benefits conferred pursuant to the privatization program of a developing country WTO member are not actionable through the imposition of countervailing duties. However, other WTO members may pressure Iraq not to reserve the right to benefit from these and a number of other benefits extended to developing countries under the SCM Agreement. Iraq also will have to eliminate export subsidies on industrial goods upon accession.

4.4. Safeguard and Anti-dumping Rules

The WTO Safeguards Agreement permits members to impose safeguards or otherwise WTO-inconsistent quotas and tariffs temporarily in exceptional circumstances if certain criteria are met. For example, under articles 2.1 and 7 of the Safeguard Agreement, before resorting to safeguards, a country must show "serious injury" to domestic industry as a result of increase imports and must apply the safeguard in a non-discriminatory manner. In case of dumping, where an exported product is sold below the home market price or cost of production, a WTO member can impose anti-dumping duties on that dumped product. Iraq currently has neither safeguard nor anti-dumping legislations. Therefore, Iraq cannot apply the safeguard or anti-dumping provisions on imported products until such legislations are drafted. This state of affair will restrict the ability of Iraq to retaliate against increased or dumped imported products.

4.5. Market Access in Services

Iraq imposes a set of limitations in many service sectors. The forms of limitations on foreign participation in the services sector concern the specific kind of work to be performed or nationality of the service provider. Under the General Agreement on Trade in Services (GATS), Iraq will have to liberalize a number of service sectors that were previously closed or severely restricted to foreign investment. For example, access to professional legal services is reserved for Iraqi nationals (Memorandum on the Foreign Trade Regime, 2005, Annex 7). Some fields of legal services such as domestic family law or domestic litigation are not open to foreign law firms. Thus, foreign law firms can advise or consult on foreign or international law only. Iraq can resist pressures to open up its legal service sector to foreign lawyers. Iraq could argue that the limitation on type of services offered by foreign law firms is necessary to protect the public from incompetent foreign lawyers and to preserve the integrity of the legal profession in Iraq whereby Iraqi practitioners enjoy special and full knowledge of the local Arabic language and the civil legal system.

Iraq imposed limitations on foreign participation in other service sectors. Postal and courier is a sector subject to state monopoly by the Ministry of Communications. State-run establishments are the only permitted providers for inland waterway transport. Regarding maintenance and repair of aircraft, Iraq rules require that only qualified Iraqis of at least 18 years old may perform the work concerned. The Iraqi natural resources sector is still closed to foreign investment. Additionally, the financial capital market and the Iraqi Stock Exchange are still closed to foreign participation. In sum, Iraq will make commitments in all sectors covered by the GATS,

including financial, telecommunications, and distribution services. The GATS grants Iraq some flexibility in scheduling its commitments to liberalize trade in services. However, this flexibility could be challenged by recent WTO dispute settlement cases such as Mexico's telecom case and the U.S. gambling case (Report of the Panel on Mexico-Measures Affecting Telecommunications Services, 2004; Report of the Panel on United States-Measures Affecting the Cross-border Supply of Gambling and Betting Services, 2004). Therefore, Iraq needs to take care in scheduling future commitments. For instance, Iraq could liberalize certain service sectors but without being written in its WTO schedule of specific commitments. Iraq could also modify or withdraw some of its commitments under GATS, although other countries may seek compensatory trade concessions. Iraq is building a new economy based on knowledge-based industries. Trade in services could offer Iraqi service providers, many of whom are small and medium-sized businesses, great potential of opportunities.

4.6. Intellectual Property Protection and Enforcement

The international protection of intellectual property has been a global issue of paramount importance. Nearly all countries acknowledge the need to protect intellectual property in some form, recognizing that intellectual property is an asset derived from the discovery or creation of a new product, process, or information that has commercial value. In 1994, the signatory countries of the General Agreement of Tariffs and Trade signed the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs), an ambitious international convention that sets forth an international baseline for patent, copyright, and trademark protection (Levy, 2000). In addition to providing procedures for the settlement of intellectual property disputes, one practical effect of TRIPs has been the harmonization of the world's intellectual property laws.

Iraq has three basic intellectual property laws. These are: Law No. 3 for the Year 1971 for the Protection of Copyright, Trademark and Descriptions Law No. 21 for the Year 1957, and Patents and Industrial Designs Law No. 65 of 1970. These laws do not comply with the TRIPs Agreement in many aspects. For example, the Copyright Law No. 3 for the Year 1971 is not entirely consistent in its use of terms such as the "author" and "original author," or in its references to rights of copyright and holders of such rights. In addition, article 10.2 of TRIPs requires that WTO members protect compilations of data or other material, whether in machine readable or other form. However, article 2.13 of the Iraqi Copyright Law No. 3 for the Year 1971 refers only to data but not to other material, does not make clear whether works "in machine readable or other form" are included, and does not clarify whether all compilations of data are protected or only those that "by reason of" the selection and arrangement of their contents constitute intellectual creations. The Iraqi Copyright Law No. 3 for the Year 1971 does not address whether the exclusive right to adapt a work, found in article 8.2, includes the right to make a cinematographic adaptation of the work. Articles 20.3, 20.4 and 20.6 of the Copyright Law No. 3 of 1971 provide that in certain circumstances the term of protection starts to run when the work "was made available to the public for the first time." Article 12 of TRIPs, however, requires that when the term is calculated on a basis other than the life of a natural person, it should start to run from "the end of the calendar year of authorized publication." Since authorized publication might occur long after the work was first made available to the public, it appears that the term of protection under the Iraqi law will be significantly shorter than required in some cases.

The Iraqi Trademark and Descriptions Law No. 21 of 1957 does not require in article 2 that the mark be visually perceptible. This is in compliance with article 15.1 of the TRIPs Agreement which states that WTO members may require for trademark registration that the mark be visually perceptible. As such, Iraqi trademark law recognizes smell and sound marks. The recognition of sound and smell marks may raise certain complexities. The registration of fragrances could present complex challenges for trademark examiners in Iraq. It would be unclear how fragrances will be categorized, catalogued, preserved during the registration period, or search and test them for confusing similarity. Article 16 of the Iraqi trademark law is not in full compliance with TRIPs. Any decision made by the Trademark Registrar is subject to appeal before the Minister of Industry and Minerals. On the other hand, the TRIPs agreement requires review of decisions by independent administrative or judicial bodies. The Iraqi trademark law, when amended, needs to recognize the use of modern technology so as to permit filing of electronic trademark applications. This will lead to cost-cutting and efficiency in the registration process as well as less need for papers.

Regarding patent protection, article 2 of the Iraqi Patents and Industrial Designs Law No. 65 of 1970 grants a patent for inventions, but without clarifying the conditions for granting a patent as required by the TRIPs Agreement. Article 27 of the TRIPs Agreement requires an invention to be new, involve an inventive step, and be capable of industrial application. Article 3 of Iraq patent law excludes certain inventions from patentability. However, these exceptions are not compatible with article 27.2 of the TRIPs Agreement which permits members to exclude from patentability certain inventions in order to protect public order, morality, and human or animal

or plant life or health. Moreover, article 27.3 of the TRIPs Agreement allows countries to exclude from patentability diagnostic, therapeutic, and surgical methods, and plants and animals. Therefore, Iraq patents law will have to be amended to accommodate these exceptions. Articles 9-11 of Iraq patents law relate to inventions during employment contract. These articles refer in several places to "just compensation" but without further elaboration. For example, it is unclear how "just compensation" is determined and what happens if there is a dispute between an employer and employee regarding the amount of "just compensation." When drafting a new Iraqi patent law, just compensation should be determined according to the value and importance of the invention, whether the inventor employee has used tools or materials from the work, and any return given to the employer. If the employer and the employee could not agree on the amount of just compensation, then the competent court will determine the amount. Furthermore, article 33 of the Iraqi Patents and Industrial Designs Law No. 65 of 1970 allows appeal of the decision of Registrar to invalidate the patent before the competent Minister. However, the TRIPs Agreement in article 32 requires an opportunity for judicial review. Finally, article 41 of the Patents and Industrial Designs Law No. 65 of 1970 provides the period of protection for industrial model as 7 years. This is a violation of article 26.3 of the TRIPs Agreement which provides that the period of protection shall be at least 10 years.

Iraqi intellectual property laws are short on enforcement. For example, Iraqi intellectual property laws do not provide the competent authorities with the right to act upon their own initiatives in suspending the release of goods that are suspected of infringing intellectual property rights. In addition, Iraqi intellectual property laws are absent any reference to border measures taken by the customs service to suspend the release of imported goods, which are suspect of being pirated copies. This is in clear violation of articles 51-60 of the TRIPs Agreement. Therefore, a new Iraqi regulation shall be issued which will basically require the customs service to halt the clearance of goods upon an order from the competent court. The regulation will also require maintaining a record As discussed earlier, many of Iraq's intellectual property laws are outdated and do not meet international standards. Therefore, Iraq must enact TRIPs-compliant legislations. To achieve this goal, the Council of Ministers has established a National Committee representing all Iraqi ministries, professions, unions and private sector to prepare a new intellectual property law which covers all relevant intellectual property rights and in compliance with the TRIPs Agreement, the Berne Convention, the Paris Conventions, and the Rome Convention (Al-Jabari, 2007). The National Committee intends to draft a comprehensive intellectual property law having all the elements of intellectual property rights in one place in order to be a legislative source and easy reference.

In acceding to the WTO, Iraq could ask for the transitional periods, up to 5 or 10 years, found in article 65 of the TRIPs Agreement to implement its commitments. The transition period can be used to effect the necessary changes in domestic Iraqi legislation and practice. However, based on the experience of several accessions, there have been few and limited cases of granting transition periods to implement the legal standards in the TRIPs (Gerhart, 2002). Major WTO members such as the U.S. and EU insist that countries seeking to join the WTO agree to comply fully with the provisions of the TRIPs Agreement immediately upon accession to the organization. The U.S. and EU argue that no-transition period position is necessary to ensure that the integrity of the WTO system is maintained. For the U.S. and EU, it is important to maintain consistency in allowing no-transition periods for acceding countries. Otherwise, an unfortunate precedent may be set, and longer and longer transition periods would be requested.

4.7. Transparency-Related Commitments

WTO accession encompasses not only commitments to eliminate tariff barriers and subsidies to trade in goods and to open service sectors to foreign participation. In addition to trade liberalization commitments, the WTO agreements include a special set of obligations that aim to promote transparency, predictability, and fairness in the implementation of Iraq's WTO obligations. Article X of the GATT 1994, which is based mainly on U.S. administrative law, requires that all trade-related laws, regulations, and rulings be promptly published and administered in an "impartial and uniform" manner (Fallon, 1997). The TRIPs Agreement devotes an entire chapter to enforcement obligations, and the GATS, in addition to publication and notification requirements, requires setting up "enquiry points" to provide information at the request of any member. Thus, the transparency-related obligations contained in the WTO agreements encompass not only the publication of trade-related laws, but also their accessibility as well as fair and effective implementation.

There has been much written regarding the differences between Iraq's legal culture and that of Western countries, including debate on the degree to which Iraq is a country governed by "rule of law" (Brown, 1997; Hamoudi, 2005). This paper does not address all of these questions but instead describes the transparency-related rules that will bind Iraq as a WTO member and the challenges that remain in implementing these obligations.

Any assessment of Iraq's efforts towards establishing transparency, uniform application of law, and judicial review should be mindful of the mammoth task that the Iraqi government faced at the end of 2003, when the legal and political systems were wrecked and had to be rebuilt from scratch (McGovern, 2003). Viewed from this perspective, the progress that Iraq would make in establishing a judiciary and a practicing bar are incomplete but nonetheless substantial.

In its accession to the WTO, Iraq will agree that only those WTO-related laws, regulations, and other measures that are published and readily available to other WTO members and to the public shall be enforced, and that Iraq shall make drafts of all such documents available for comment prior to their implementation or enforcement. In addition, Iraq may be pressured to establish or designate an official journal for the publication of WTO-related rules, regulations, and other measures and to make copies of the journal readily available. Iraq should agree to establish an inquiry point where all such information may be obtained. Finally, Iraq will have to agree in its protocol to apply and administer all WTO-related laws, regulations, and other measures in a "uniform, impartial and reasonable manner." Scepticism exists regarding Iraq's ability to meet this obligation, which assumes the existence of enforcement institutions with clear lines of authority and the capacity to render neutral decisions. There is often a gap between creating laws and institutions on the one hand and implementing and enforcing these laws on the other.

Iraqi law currently requires that all legislation be published, typically in the official gazette and sometimes in a national daily newspaper. The obstacle in implementing the WTO publication requirements relates less to Iraq's formal legislation than to making public the overlapping rules and less formal interpretations of law issued. Even assuming that all governmental decrees that have the effect of law are published, as a practical matter it is very difficult to access them. Therefore, Iraq may need to set up a website so as to make current information regarding the WTO accessible to the public, provides links to Iraq's WTO-related laws and regulations, and allows visitors to ask questions.

There are a number of characteristics of Iraq's legal system that could impede the impartiality and predictability of those who administer the law. First, Iraqi legislations tend to be drafted in vague terms and lacking specific definitions. These broadly worded rules create a broad sphere of authority and promote discretionary decision-making on the part of interpretive bodies. Second, the authority among Iraq's legislative bodies to create law is ill-defined. Sometimes, this results in a proliferation of overlapping or contradictory laws at all levels of government. Finally, those vested with broad discretion to interpret and implement the laws tend not to be neutral but rather are influenced by a range of extralegal factors, including political influence of political parties, corruption, and the traditional importance of personal relationships (Brown, 2002).

Iraq faces institutional barriers to promoting transparency and fairness. There are social and political impediments to judicial independence which are rooted in Iraq, making progress in these areas can only be achieved over time. The Iraqi judiciary was re-established in 1970s in a manner that reflected the strong ideological influence of the former Baath party. Many judges lacked either a university education or legal instruction, and they were transferred to their posts from the Baath party or from the military (Roberts, 2004). Although more exacting qualifications for judges, including minimal education and other requirements have been required, the Iraqi judiciary still somewhat politicized. The impediments that undermine the neutrality of Iraqi judges include: political influence by political parties, the lower status of judges vis-à-vis administrators, the funding of courts and the resulting dependence of judges on the government, the pull of personal connections, and outright corruption. Widespread corruption in Iraq not only impedes effective lawmaking, but also can incite violence among disaffected groups. These factors will operate to prevent effective implementation of Iraq's transparency-related obligations, particularly the requirement to allow judicial review of administrative decisions.

WTO accession could provide a catalyst for Iraq's evolution away from a legal system driven by power relationships and towards a rule-based legal system. WTO accession could further legal reform by enhancing the professionalism of the courts and reducing government influence. Notwithstanding its limitations, Iraq's success in this endeavour would represent a significant step forward. Over time, Iraq could make progress in creating the legal framework necessary to support a market economy.

5. Cost/Benefit Analysis of Accession

The Iraqis tend to be sensitive to foreign interference in their domestic affairs and attach a great deal of importance to reciprocity and mutual benefit in relations with the West. To some degree, this can be attributed to a history of treatment that Iraq suffered at the hands of Britain and the U.S. (Lock-Pullan, 2007; Youngs, 2006). Viewed from this perspective, one wonders why Iraq would agree to WTO accession terms that, among other

things, will require it to make broad and deep market access commitments across goods and services sectors and there are obvious reasons why Iraq would view WTO membership as beneficial. Iraq stands to benefit from the recognition and prestige that WTO membership brings, especially in the Arab region where WTO membership is the exception rather than the rule. WTO membership will deepen Iraq's integration into the world economy. In other words, Iraq would avoid isolation in its relations with other countries in an increasingly interrelated world. Moreover, WTO accession would help promote diversification in the country's economy and reduce its dependence on oil exports, which now account for more than ninety-five percent of Iraq's foreign exchange earnings. By acceding to the WTO, Iraqi exports would be subject to lower tariffs and other trade barriers. Iraqi consumers are likely to benefit as a result of trade barriers reduction through wider choice of products and lower prices. Conversely, the costs of remaining outside of the WTO may well exceed the costs of joining.

There are a number of theories that can be offered to explain why Iraq may have treated the issue of WTO accession with some degree of urgency. First, Iraq wishes to finalize its accession prior to the conclusion of the Doha Round of trade negotiations which commenced in 2001 (Nanda, 2005). Prior to the conclusion of the Doha Round, Iraq would have to negotiate on matters such as tariffs, services, and intellectual property. However, in post-Doha round, Iraq may need to negotiate on reforming domestic regulatory practices inside its borders in areas such as competition policy. Second, the economic and financial problems in other Arab countries likely served as a "wake up" call for Iraq, signalling the need to complete its process of economic reform. The worsening impact of the state-owned sector as a drag on economic growth, combined with the crisis in the state-owned financial sector, were problems that could not be ignored any longer. In this respect, Iraq may have viewed WTO accession as generating necessary momentum to complete the most politically difficult stage of Regional economic integration has also served as a stepping stone for WTO membership. Iraq acceded to the Greater Arab Free Trade Area (GAFTA) in 1997 (Abbas, 2004). Iraq has adhered to GAFTA's declarations, treaties, and agreements, including the requirement to lower tariffs. Joining GAFTA is important in the WTO context because it signalled Iraq's commitment to the liberalization of its economy. Beyond Arab countries, Iraq has concluded bilateral trade agreements. For example, the U.S. and Iraq concluded a 2005 Trade and Investment Framework Agreement designed to promote trade and investment between the two countries.

6. The Economic and Political Implications of Iraq's Accession to the WTO

The essential function of the WTO has been described as providing the means to "resolve conflicts of interest within, not between, nations (Roessler, 2000). A more vivid analogy, along these same lines, characterizes the WTO as a "mast to which governments can tie themselves to escape the siren-like calls of various pressure groups." Although these descriptions were made with reference to Western political tradition, Iraq's situation provides a contrasting, but equally illustrative, example. While a recent democracy, Iraq nonetheless must deal with its own unique range of groups protecting their respective vested interests. These interests include central versus regional governments, powerful ministry officials, the managers of Iraq's SOEs, and the diversity of interests across Iraq's various areas, which is pronounced due to the unevenness of economic growth within the country. Finally, there are divisions among different political factions within Iraq--some are convinced of the need to aggressively pursue market reform, while others are more reluctant, even reactionary.

What role will the WTO play in the economic and political spheres in Iraq? WTO accession will act not just as a lever to force reform, but it will also serve to lock in economic reform and make it irrevocable. In adopting the rules in Iraq's protocol of accession, the WTO framework acts as a sort of constitution, imposing economic discipline by constraining the ability of those in Iraq who might wish to take a different course of action. Thus, Iraq's accession could illustrate how the commitments imposed as a condition of WTO membership may provide the political leverage necessary to move difficult economic reforms to the next stage. In terms of imposing market discipline on Iraq, one could say the WTO is analogous to the International Monetary Fund (IMF).

The most direct form of discipline that WTO accession brings is the increased competition Iraqi companies and enterprises will face from opening up to foreign trade. While liberal economic reform can lead to vulnerability due to increased dependence on the international financial and trading regimes, it can also stimulate needed economic growth. Foreign competition could threaten the collapse of some of Iraqi industries, but foreign participation will force Iraqi industries to more effectively compete against this participation. Iraqi industries could learn and improve from the example and competitive pressure of foreign companies. Further, Iraq could buffer its move toward market economy by providing assistance such as mitigating the effects of privatization on laid-off.

While Iraq would undergo dramatic economic and even legal changes in the process of joining the WTO, Iraq's integration with the world market may overtime lead to political and social liberalization as well. It is worth noting that Iraq has already undergone extensive political reform over the past three year (Fandl, 2006). Compared to Western norms, one such political change is the democratic-style elections in Iraq.

As Iraqi people enjoy increased wealth and personal liberty as a result of market reform, a number of diverse groups in the society will create formal and informal organizations to promote their interests. These organizations may include farmers, consumers, industry associations, labour unions, and religious movements. The Iraqi government is softening its rules regarding the ability of non-governmental organizations (NGOs) to operate, diversify, or otherwise expand their activity, especially in light of the many contributions that they provide. The Iraqi government needs to liberalize constraints on social organizations as a "safety valve" to relieve the pressure created by discontent of economic reform. The Iraqi government needs to allow greater input by citizen groups in policy-making.

By lowering barriers, Iraq would speed the process of removing government from vast areas of people's lives. In the past, virtually every Iraqi citizen woke up in a house secured by the government, went to work in an entity run by the government and read newspapers published by the government. State-run workplaces also operated the schools where they sent their children, the clinics where they received health care, and the stores where they bought food. When Iraq joins the WTO, people will leave these government-controlled workplaces. The government no longer will be everyone's employer, landlord, shopkeeper and nanny.

Another factor that could further lead to political and social liberalization is the widespread availability of information over the Internet. The public can access political information at ease. The Iraqi government will have to encourage Internet use and allow foreign participation in the telecommunications industry as means of modernizing its economy.

The dramatic scope of legal and economic reform in Iraq could create a crisis of values. The vacuum created by political liberalization and the introduction of a modernized legal framework in Iraq could cause a rise in corruption and a sort of moral schizophrenia. This potential crisis of values mirrors similar crises experienced by other countries such as Yugoslavia, where dramatic legal and economic reform, along with the disintegration of the country, fuelled intense nationalism, ethnic cleansing, and war (Somer, 2001). What remains to be seen is whether the weakening of Iraqi government control and economic dislocation, resulting from economic reform, will ultimately produce mass unrest or whether it will produce growth and gradual political liberalization.

7. Conclusion

Iraqi trade officials have initiated WTO membership negotiations and are keen to complete the accession talks as soon as possible. To this end, a thorough review of Iraqi commercial laws and regulations and other relevant laws will have to be completed with a view to removing unnecessary restrictions to local and international trade and to assessing where Iraq's laws and regulations need change or development to become consistent with the WTO rules.

As far-reaching and potentially onerous, the commitments that Iraq will undertake in its WTO accession will open the Iraqi market to competition. These commitments will cover areas such as trade in goods, services, intellectual property, and transparency. With many decades of paternalistic cradle-to-grave government policy, it is hardily perceivable that economic reforms would be easy on people. The negative effects of WTO accession should not be downplayed. The message is that, while painful in the short term, WTO membership would be beneficial for Iraq in the long run. In other words, it is unrealistic to expect that these benefits will be immediately realized. Moreover, Iraq needs gradualism, not an instant trade liberalization, to make advances from a closed economy dominated by state-owned monopolies and subsidies toward a competitive and modern economy open to world trade.

There is a need for the Iraqi government to recognize the necessity of building political institutions sufficient to support a market economy. In addition, the government should understand the need for a stable legal infrastructure, including neutral application and enforcement of the law, to support a market system. Fostering neutral and predictable application of law provides the means of promoting stability. Therefore, Iraq needs to introduce a reform package aimed at improving the judiciary, including initiatives requiring all future judges to pass a national judicial examination, provide specialized training for judges, and introduce a system of law clerks.

It is hard to predict at this stage how long the WTO accession negotiations would last. The conflict in Iraq can possibly act as considerable drags on its WTO accession. Moreover, the current domestic political instabilities may threaten future economic gains. Even in a best-case scenario of a short war, the impact of the

conflict on trade and accession will depend on how quickly political stability can be re-established and maintained in Iraq. Over the coming years, Iraq will be tested. It will be tested economically through painful adjustments resulting from Iraq's exposure to the world market. It will also be tested legally and politically as a result of an increasingly independent, informed, and economically diverse population. WTO membership will not be a panacea for Iraq's problems and membership is not an end in itself. Iraq needs to address non-WTO related fundamental problems such as restoring peace, physical infrastructure, natural resource management, and sustainable development. However, by adopting the path of reform and joining the WTO, Iraq has invested in its future.

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Need for FLCs In India With Respect To Honouring the GATS

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Abstract: Since India became a signatory to the General Agreement on Trade in Services (GATS), it has been increasingly involved in multilateral negotiations for opening up its borders to international trade in services. The GATS was negotiated in the Uruguay Round of multilateral trade negotiations in 1994, and regulates trade in all service sectors between its 149 member countries. Lawyers engaged in providing legal services in foreign countries generally act as 'foreign legal consultants' (FLC), providing advice on international law or other non-domestic laws. India needs to liberalize its policy in foreign trade more in order to avail of the advantages of the globalization of trade in services. This research paper aims at understanding the setbacks to the liberalization of the Indian legal services sector and realizing the potential allowing the entry of FLCs in select areas of the sector and permitting the collaboration of Indian and foreign lawyers/law firms.

1. Introduction

The GATS is the first and only set of multilateral rules and commitments covering Government measures which affect trade in services. Recognizing the need to build further upon the agreement and progressively liberalize trade between member nations, the treaty commits them to start fresh negotiations, [1] which have been underway since January 2000. [2]

Liberalization is an essential precursor for the GATS to function properly. Liberalization under the GATS has been held to have multiple benefits to a country's economy. The competition fostered at the international level creates an impetus for development of economic infrastructure within the nation, access to the international market of world-class services improves the scope for innovation while foreign investment helps the domestic market to grow; to say nothing of the spill-over benefits of new technology that is brought in by Foreign Direct Investment (FDI) in the rest of the economy. All this ultimately results in lowering of prices and improvement of the services available to the consumer, as well as an increase in job opportunities. [3]

The GATS applies to all trade in services, including professional services and thus legal services. In the WTO "Services Sectoral Classification List" (document MTN.GNS/W/120), "(a) legal services" are listed as a sub-sector of "(1) business services" and "(A) professional services". This entry corresponds to the CPC number 861 in the United Nations Provisional Central Product Classification. In the UN CPC the entry "legal services" is sub-divided in "legal advisory and representation services concerning criminal law" (86111), "legal advisory and representation services in judicial procedures concerning other fields of law" (86119), "legal advisory and representation services in statutory procedures of quasi-judicial tribunals, boards, etc." (86120), "legal documentation and certification services" (86130) and "other legal and advisory information" (8619). [4] (Refer to Annex 1 for a list of the relevant UN CPC definitions.)

2. Regulation of Modes of Supply of Services

The GATS covers all major ways by which services can be rendered to clients- the four 'modes of supply', which are:

- Cross Border Supply
- Consumption Abroad
- Commercial Presence
- Presence of Natural Persons

(Refer to Table 1 for a comparative description of the four modes of supply. [5]) In these regards, once a country makes a binding liberalization commitment, it can't reverse its decision easily. The only option available is the costly permanent removal of commitments through GATS article XXI or through dispute resolution proceedings. [6]

3. Importance of Trade in Services

The importance of trade in the service sector is undeniable- in 2005, the worth of commercial service exports was estimated at over US$2.4 trillion.[7] Of the four different modes of supply, cross border supply accounts for 28 percent of the total world trade in services, amounting to approximately US$ 504 billion. Consumption abroad accounts for 14 percent, amounting to approximately US$ 252 billion. Commercial presence accounts for 57%, amounting to approximately US$ 1025 billion. Movement and presence of natural persons accounts for only 1 percent, amounting to approximately YS$ 18 billion. [8]

4. Position of India

The service sector is a fast-growing part of the India economy and forms an important part of its GDP. Services contribute to 54 percent of the economy and, growing at 7 percent, will amount to 60 per cent in the next five years.[9] Services contributed as much as 68.6 per cent of the overall average growth in GDP in the last five years between 2002-03 and 2006-07. Presently, the share of the service sector in India's overall GDP is 55.1 percent. [10] In 2004, while India's share in world merchandise exports was 0.8 per cent, its corresponding share in world commercial services was 1.9 per cent. India's services exports have shown a remarkable growth of 225%- from $17.6 billion in 2000-01 to US$39.6 billion in 2004-05. India's imports in commercial services has also grown from US$ 20 billion in 2000-01 to US$ 40.9 billion in 2004-05 which is 2% of the total imports of world trade (US$2095 billion) in commercial services. For the financial year 2004-05, India ranked 16th as a services exporter and 15th as services importer in the world trade in commercial services. [11] According to the NASSCOM-McKinsey 2005 report, IT and BPO industries are expected to generate an export revenue of US$ 60 billion by 2010, not even including export of software products.[12] India is thus fast emerging as a leading player in the global service sector, with promise for further growth in the near future.

5. The Legal Services Sector- The International Market

A broad definition of legal services would include advisory and representation services as well as all the activities relating to the administration of justice (judges, court clerks, public prosecutors, state advocates, etc.). This second aspect, however, is effectively excluded from the scope of the GATS as in most countries it is considered a "service supplied in the exercise of governmental authority" according to Article I (3) (c) of the Agreement. The GATS covers all advisory and representation services in the various field of the law and in statutory procedures. [13]

The growth of international trade through liberalization has thrown open new vistas of possibility for the legal profession, particularly in the field of business law. Consequently, this legal services sector has shown a steady and substantial growth in the past decades. Sectors such as corporate restructuring, privatization, cross-border mergers and acquisitions, intellectual property rights, new financial instruments and competition law have generated an increasing demand for more and more sophisticated legal services in the past years. Unfortunately there are no comprehensive disaggregated data on the size of the sector, as legal services are often bundled together with other professional services or business services.[14] It has been estimated that in the European Community the number of professional providers of legal services has grown on average by over 20% in the period 1989-1993, while in the United States it has tripled between 1973 and 1993.[15] It has been estimated that together there were in 1992 125.000 suppliers of legal services in Japan.[16] In the early 1990s the output of legal services represented 14% of all professional services and 1.1% of the economy in a "representative" industrialized country.[17] In 1992 the output of legal services in the United States was $US 95 billion, while in the European Community it reached $US 52 billion.[18] The demand for legal services comes from business organizations as well as from individual citizens. Business organizations involved in international transactions form the principal source of demand for legal services for business law and international law. A legal services

supplier based in the firm's country of origin will obviously have a marked advantage in understanding and dealing with the client's business requirements.

Foreign lawyers supplying legal services cross-border or by means of establishment act in the vast majority of cases as foreign legal consultants (FLC), that is to say, they provide advisory legal services in international law, in the law of their home country or in the law of any third country for which they possess a qualification. Domestic law (host country law) still plays a marginal role in international trade of legal services, due to the high barriers represented by qualification requirements, which, like domestic law, are shaped along national lines.

Most of trade in legal services still takes place cross-border (mode one)- which principally involves transfer of legal documents or advice through telecommunication devices- or via the temporary stay of natural persons travelling as individual professionals (mode four) or as employees/partners of a foreign established law firm. Affiliate trade of legal services is still limited as suppliers often find the costs and the difficulties associated with establishing a commercial presence too high, especially if compared to the relatively lower barriers to cross-border transactions.[19] It has been estimated that the number of lawyers who move abroad on a permanent basis (modes three and four) is very small, a few thousand, if compared to a total of over 300.000 lawyers travelling abroad occasionally.[20] Due to the high costs and risks involved, affiliate trade is still limited to the large law firms and is mostly directed towards the world major financial and business centres (Brussels, Frankfurt, Hong Kong, London, New York, Paris, Singapore, Tokyo) where the demand for legal work in the fields of business law and international law is highest.

6. The Legal Services Sector- The Indian Market

With over 800,000 practicing lawyers, the legal profession in India is one of the largest in the world- second only to the United States. [21] The legal profession in India is regulated by the Advocates Act, 1961 and the Bar Council of India Rules, 1975. In India, Legal services can be provided only by natural persons who are citizens of India, who are on the rolls of the advocates in the states where the service is being provided. The service provider can either be a sole proprietorship or a partnership firm consisting of persons similarly qualifies to practice law. [22] In order to be eligible for enrolment as an advocate, a candidate has to be citizen of the country or a country which allows Indian nationals to practice as per the reciprocity treatment, has to hold a degree in law from an institution/university recognized by the Bar Council of India (BCI) and be at least twenty one years of age. [23]

Although India is a founder member of the WTO and is under an obligation for progressive liberalization, as of now it has not made any commitments regarding the opening up of the legal sector.[24] As can be seen from the provisions of the Advocates Act, 1961, foreign law firms cannot establish a practice in India. There are several such impediments to be found in the regulatory system which limit the scope of law in India as a profession, preventing it from rising to the level of its international counterparts. For example, partnerships are the only model by which law firms can exist; further modes such a limited liability partnerships or limited liability corporations are not permitted [25]. Furthermore, the maximum number of partners is fixed at 20, [26] thus further restricting law as an industry. Also, lawyers are not allowed to advertise in any form or any circumstances. [27] Law firms are also restricted from multidisciplinary practices. [28]

However, in recent times, there has been a growing sentiment in India's legal community that liberalization should be gradually permitted in the legal sector. The Law Commission, headed by Justice Jeevan Reddy, published a "Working Paper on the Review of the Advocates Act 1961" in autumn 1999. Section 4 is entitled "Entry of Foreign Legal Consultants and Liberalisation of Legal Practice", in which it was recommended that foreign law degrees should be given recognition in India, and that rules be framed for standardizing and regulating the entry of foreign legal consultants in India, and that the legal services sector be liberalized. The country could choose, as per its needs, whether to adopt "full" or "limited" licensing approaches. Under full licensing, foreign lawyers are integrated as full members of local profession with no restriction on the scope of practice, provided they fulfil certain basic conditions. In contrast, under limited licensing approach, the scope of practice is limited to advice on home country law, excluding all court work, host country law and law of any other jurisdiction where the foreign lawyer is not qualified and licensed. The necessary approach could be decided keeping in mind both the interests of the Indian lawyers, as well as the need to conform with growing needs of globalization. [29]

In October 1999, a high level committee was constituted by the government under the chairmanship of Mr. S. V. S. Raghavan to formulate a new model of competition regulation for India. The report also stated that

the Indian legal sector be liberalized and opened up to foreign competition in order to promote efficiency.[30] The Raghavan Committee further stated that:

> "It is in this context when existing barriers based on citizenship or nationality is increasingly becoming irrelevant, that, it is necessary to promote competitive quality in legal services and full accountability therefore on the part of the lawyer. It is desirable top promote large partnerships of lawyers to enable them to be globally competitive in efficiency and quality of services rendered. Very few firms in India provide what is called the "single-window services", which means, providing not only legal, but accountancy, financial and other services to their clients. Rules should provide for multi-disciplinary partnerships (lawyers, accountants and other professionals) which would permit delivery of composite services as desired by the clients. If the legal profession desires to grow and serve in foreign soil, freedom of movement must be built into the competition policy/law. Unnecessary barriers will have to be removed to facilitate professional development and improvement in the quality of services besides building an environment for easy movement of legal professionals outside the country."

The legal services sector is full of untapped potential. Opening up the sector for liberalization will not only result in the development of the legal market here through FDI in the form of foreign law firms, but will also create opportunities for Indian lawyers to serve in foreign countries.

7. Regulatory Systems and Market Access Limitations

Legal services fall under the category of "accredited" professional services. [31] Access to the market of the legal sector can be limited by domestic regulatory authorities from which legal professionals receive their accreditation. For example, the regulatory body in India is the Bar Council of India. [32] Only those who are registered under the Bar Council are eligible to practice, [33] and it has the power to prescribe rules for granting license to advocates. [34]

Regulations applied in the professional services have as their primary objective the need to ensure and maintain a certain quality of the service, and hence to protect consumers. Typical market access limitations would include restrictions on the form of commercial presence (only natural persons or partnerships allowed), often in joint operation or joint venture with local professionals. For natural persons, entry may be subject to economic needs tests, or nationality requirements. Access of foreign suppliers may be limited to projects of above a certain amount, or to smaller building plans. National treatment limitations would include residency requirements and requirements to use local services or to employ local professionals. [35]

Concerning the types of measures applied, the most commonly observed market access limitations specific to the sector were limitations on the type of legal entity allowed for commercial presence (mode 3) of service suppliers, followed by limitations on the participation of foreign capital. Restrictions on the number of natural persons to be employed were also common (mode 4). With regard to national treatment limitations, the most prevalent were references to licensing, standards and qualifications across all modes of supply. Nationality and residency requirements were also abundant, with the latter being more numerous than the former. [36]

Qualification barriers effectively stop foreign participation in the legal sector, particularly in the practice of domestic law. However, providing legal advice (especially under mode1) is not completely ruled out. But foreign legal consultants still have to face stringent licensing requirements as regulating obstacles. [37]

8. GATS and Commitments Regarding Domestic Regulations

"Domestic regulations" refer to the non-discriminatory qualitative requirements of carrying out trade within a country. The objective of GATS is to ensure that domestic regulations (like qualification, technical standards, licensing, etc.) do not become unnecessary barriers to trade between nations. [38] Accordingly, the Working Party on Professional Services was created in February 1998. It was subsequently replaced by the Working Party on Domestic Regulation on 26th April 1999, for the development of generally applicable disciplines for all service sectors. [39]

Member states have had a contention with the form of classification used in the context of legal services- a very clear distinction was drawn between advice and representation in host country, home country and international law. As the UN CPC classification in this sector did not reflect the reality of trade in legal services, Members have preferred to adopt the following distinctions in scheduling GATS commitments, which appear

better suited than the UN CPC to express different degrees of market openness in legal services: (a) host country law (advisory/representation); (b) home country law and/or third country law (advisory/representation); (c) international law (advisory/representation); (d) legal documentation and certification services; (e) other advisory and information services.[40]

Considering legal services the Secretariat held that "the administration of justice (judges, court clerks, public prosecutors, state advocates, etc.) (...) is effectively excluded from the scope of the GATS as in most countries it is considered a 'service supplied in the exercise of governmental authority' according to Article I :(3) (c) of the Agreement."[41] However, the Secretariat also argued that "in some countries, certain notarial activities are regarded as 'services supplied in the exercise of governmental authority', like legal services pertaining to the administration of justice. However, unlike judges, court clerks and public prosecutors, who are civil servants, notaries often supply their services 'on a commercial basis', and therefore are subject to the provisions of the GATS."[42]

Following the Uruguay Round and subsequent accessions, 56 WTO member countries have made commitments in legal services. Among them, 23 made commitments in advisory host country law, 53 in advisory international law, 52 in advisory home country law, 5 in third country law and 6 in other legal services (including legal documentation and certification services and other advisory and information services). In addition, several countries made commitment in legal representation services; 21 countries made this type of commitment in host country law, 18 in international law, and 18 in home country law. Countries with commitments in all types of law include Japan and the United States. Most EU countries made commitments only in international and home country law. Canada scheduled commitments in advisory international, home country and third country law. [43]

9. General Limitations and Regulatory Barriers

Despite having made commitments in the legal service sector, most member states have imposed limitations as to the level of opening up the sector, exploiting to the maximum their right to set conditions for national treatment.[44] Common limitations to national treatment (treatment as favourable as given to domestic service suppliers) are discriminatory licensing or qualification requirements (for example, a requirement that the service supplier must be a graduate from a national law university), residential requirements, discriminatory subsidies, among others.[45]. As per the agreement of the GATS, no member may adopt "measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service".[46] However, this provision is not kindly looked upon, and often comes under severe criticism.[47]

10. Requests made by the WTO regarding India's Legal Sector

After the Hong Kong Ministerial Declaration, the Mission of Australia presented India with a list of collective requests for opening up its legal services sector on behalf of Australia, Canada, the EC, Japan, New Zealand, Norway and the USA, [48] mainly to the effect that India permits entry of foreign legal consultants. A summary of the requests [49] made is that India should:

- Take full market access and national treatment commitments in Modes 1, 2 and 3 and horizontal commitments in Mode 4.
- Allow foreign lawyers to give consultancy on the law for which he is qualified.
- Allow foreign firms to provide legal services for foreign enterprises and individuals.
- Abolish nationality requirements for obtaining qualifications.
- Allow foreign law firms to hire local lawyers.
- Give the right of voluntary commercial associations between foreign and local lawyers and law firms and to use of own name.
- Legal service provided by foreign firm could include advice and assistance relating to litigation, preparation of documents, tax and fiscal questions, legal analysis and opinions etc.
- Allow practice of home country, third country and institutional law by foreign practitioners without imposing the requirement of practicing host country law.
- Adopt a reference paper to cover recognition of foreign lawyers as fully licensed lawyers and establishment of norms for supervision of foreign establishments.

11. Conclusion

Although India has not committed itself to the opening up of its legal sector, this is not a stance they can maintain indefinitely. As such, with the combined pressure of keeping apace of globalization and its obligation towards progressive liberalization, it must eventually liberalize its legal services sector and allow the entry of foreign lawyers and law firms into the domestic market. The present situation must be dealt with visionary and proactive awareness. Efforts should be directed in preparation of the inevitable liberalization, in training Indian law professionals to meet the challenges from a truly global dimension and equipping them to rise to the level of world class competition instead of resisting the demands of a changing global market on the basis of antediluvian customs.

Notes:

[1] GATS Part IV Article XIX Paragraph 1
[2] Services Trade, World Trade Organization
Retrieved on 28th March 2007 from: <http://www.wto.org/English/tratop_e/serv_e/serv_e.htm>
[3] GATS: Fact and Fiction- Six Benefits of Liberalization, World Trade Organization
Retrieved on 28th March 2007 from:
<http://www.wto.org/english/tratop_e/serv_e//gats_factfiction3_e.htm>
[4] *Legal Services- Background Note by the Secretariat* (World Trade Organization, Council for Trade in Services, S/C/W/43, 6th July 1998)
[5] Philip Chang, Guy Karsenty, Aaditya Mattoo and Jürgen Richtering (December 1998), *GATS, The Modes of Supply and Statistics on Trade in Services*
[6] *Safeguards in GATS Important for Developing Countries,* (South Centre, September 2005)
[7] International Trade Statistics 2006, (Op. Cit.), Tables IV.1 and IV.2
[8] From the presentation of Dr. Krishna Gupta, Director, Department of Commerce, Government of India: *Services Negotiations at the WTO: 2nd May, 2006, New Delhi*
[9] *Source:* India Brand Equity Foundation
Retrieved on 28th March 2007 from: <http://www.ibef.org/economy/services.aspx>
[10] *Source:* Economic Survey 2006-07
[11] *Source:* WTO (2004), Tables 1.5 and 1.7
WTO (2000), Tables 1.5 and 1.7
[12] NASSCOM-McKinsey Report 2005- *Extending India's Leadership of the Global IT and BPO Industries*
[13] *Supra* note 4
[14] Disaggregated data on legal services are available from the OECD for Iceland and the United States.
[15] Commission of the European Communities, "Panorama of EU industry", 1997.
[16] The Economist, 18 July 1992.
[17] UNCTAD/ World Bank, "Liberalizing international transactions in services: a handbook," United Nations, New York and Geneva, 1994. The data reflect averages for Canada, France and the United States.
[18] OECD, "International Trade in Professional services: advancing liberalisation through regulatory reform," OECD Proceedings, 1997.
[19] US International Trade Commission, "Recent Trends in US Services Trade," May 1997.
[20] OECD, "Liberalisation of trade in professional services," OECD Documents, 1995.
[21] Fali S. Nariman (2006), *India's Legal System: Can It Be Saved?* (Penguin Books, New Delhi)
[22] Bar Council of India Rules, 1975, Section 47
[23] Advocates Act, 1961 [Act No. 25 of 1961], Section 24 (1)
[24] P. H. Parekh (2001), *The Global Lawyer,* (17th LAWASIA Biennial Conference, New Zealand, 4th-8th October 2001)
[25] *Supra* note 22
[26] Companies Act, 1956 [Act No. 1 of 1956 dated 18th January 1956], Section 11
[27] Bar Council of India Rules, 1975, Section 36
[28] See: *Protecting One's Turf,* (The Economic Times, 18th May 2002),

[29] *Position Paper on India,* (European Business Group, 3rd ed., October 2001)
[30] Delep Goswami (2006), *Should the Indian Legal and Accountancy Profession be Allowed to Advertise and Thrown Open to Foreign Competition?* (Executive Chartered Secretary, Volume III No. 07, July 2006)
[31] The distinction between accredited and non-accredited professional services was discussed in the Uruguay Round Working Group on Professional Services.
[32] Created and authorized under the Advocates Act, 1961
[33] Advocates Act, 1961[Act No. 25 of 1961], Sections 6(1)(a) and 29
[34] Advocates Act, 1961[Act No. 25 of 1961], Sections 15(1) and 24(1)(e)
[35] *Architectural and Engineering Services- Background Note by the Secretariat* (World Trade Organization, Council for Trade in Services, S/C/W/44, 1st July 1998)
[36] *Ibid*
[37] *Supra* note 4
[38] GATS Article VI:4
[39] See: *Overview of GATS Disciplines & Negotiations on Domestic Regulations* (Trade in Services Division, World Trade Organization)
[40] *Supra* note 4
[41] *Supra* note 4
[42] *See also:* Markus Krajewski (2001), *Public Service and the Scope of the General Agreement on Trade in Services (GATS)*, Center for International Environmental Law (CIEL)
[43] Rahmat Mohamad (2003), *Cross Border Legal Practice in ASEAN Under WTO,* (ASEAN Law Association – 8th General Assembly 2003, 29 November – 2 December 2003, Singapore)
[44] GATS Article XVII (1)
[45] Andrew L. Stoler (2004), *UNESCO/OECD Australia Forum on Trade in Educational Services,* (Workshop on Services Trade Commitments and Scheduling, Sydney, 11th October, 2004)
[46] GATS Article XVI (2)(e)
[47] See for example: John Hilary (2002), *Foreign Investment in Services: The Threat of GATS 2000 Negotiations,* (WTO Symposium, 30th April 2002, Geneva)
[48] Refer to full text, available at: <www.tradeobservatory.org/library.cfm?refID=78715>
[49] *Consultation Document on the WTO Negotiations under the General Agreement on Trade in Services (GATS),* (Government of India, Ministry of Commerce & Industry, Department of Commerce, Trade Policy Division)

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Appendix

Annex 1: UN CPC Definitions pertaining to Legal Services

8611: Legal advisory and representation services in the different fields of law:
(86111 - Legal advisory and representation services concerning criminal law) :-
Legal advisory and representation services during the litigation process, and drafting services of legal documentation in relation to criminal law. Generally, this implies the defence of a client in front of a judicial body in a case of criminal offence. However, it can also consist of acting as a prosecutor in a case of criminal offence when private legal practitioners are hired on a fee basis by the government. Included are both the pleading of a case in court and out-of-court legal work. The latter comprises research and other work for the preparation of a criminal case (e.g. researching legal documentation, interviewing witnesses reviewing police and other reports), and the execution of post-litigation work, in relation to criminal law.
8611: (86119 - Legal advisory and representation services in judicial procedures concerning other fields of law) :-
Legal advisory and representation services during the litigation process, and drafting services of legal documentation in relation to law other than criminal law. Representation services generally consist of either acting as a prosecutor on behalf of the client, or defending the client from a prosecution. Included are both the pleading of a case in court, and out-of-court legal work. The latter comprises research and other work for the preparation of a case (e.g. researching legal documentation, interviewing witnesses, reviewing police and other reports), and the execution of post-litigation work, in relation to law other than criminal law.
8612: (86120 - Legal advisory and representation services in statutory procedures of quasi-judicial tribunals, boards, etc.) :-
Legal advisory and representation services during the litigation process, and drafting services of legal documentation in relation to statutory procedures. Generally, this implies the representation of a client in front of a statutory body (e.g. an administrative tribunal). Included are both the pleading of a case in front of authorized bodies other than judicial courts, and the related legal work. The latter comprises research and other work for the preparation of a non-judicial case (e.g. researching legal documentation, interviewing witnesses, reviewing reports), and the execution of post-litigation work.
8613: (86130 - Legal documentation and certification services) :-

Preparation, drawing up and certification services of legal documents. The services generally comprise the provision of a number of related legal services including the provision of advice and the execution of various tasks necessary for the drawing up or certification of documents. Included are the drawing up of wills, marriage contracts, commercial contracts, business charters, etc.
8619 (86190 - Other legal advisory and information services):-
Advisory services to clients related to their legal rights and obligations and providing information on legal matters not elsewhere classified. Services such as escrow services and estate settlement services are included.

Table 1: The Four Modes of Supply of Services

Mode	Supplier Presence Criteria	Description
1. Cross border supply	**Service supplier not present within the territory of the Member.**	**Service delivered within the territory of the Member, from the territory of another Member (eg: giving legal advice electronically)**
2. Consumption abroad	**Service supplier not present within the territory of the Member.**	**Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member (eg: a foreigner coming to India to use the services of an Indian law firm)**
3. Commercial presence	**Service supplier present within the territory of the Member.**	**Service delivered within the territory of the Member, through the commercial presence of the supplier (eg: establishment of a foreign law firm in the Indian market)**
4. Presence of natural person	**Service supplier present within the territory of the Member.**	**Service delivered within the territory of the Member, with supplier present as a natural person (eg: a foreign lawyer entering India for business)**

Traditional Knowledge, the CBD and the TRIPS Regime: Synthesising the Discordant Discourses at the WTO

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Abstract. This paper evaluates the discussions in the WTO on the specific issues of Traditional Knowledge, the CBD and the TRIPS. Members have taken divergent approaches but have seen TK through the lens of the CBD. Neither of the arguments of complete harmony or conflict between the TRIPS and the CBD has been agreeable. The prior informed consent of indigenous peoples/governments, regulation of access to biological and TK material and benefit-sharing being the objectives of the debate, I submit that the harmony-conflict argument is unnecessary and can be overcome if the TRIPS is expressly amended to provide for CBD requirements. The paper tries to amalgamate the best from the various approaches to suggest a model regime for TK protection. It recommends that the implementation process be monitored by the TRIPS Council, obliging states to report whenever appropriate and for periodical review of the provisions.

Introduction

The possession and careful dissemination of knowledge have become increasingly significant in the context of world trade and commerce. Notably, the sources from which such knowledge might be borrowed, being the realm of intellectual property governance, and thus subject to its area of coverage, have confined the scope of affordable legal protection. This leaves a large pool of knowledge, held traditionally within aboriginal communities to be left to transnational companies for easy tapping and commercialisation. It is irrefutable that traditional knowledge lays culturally inseparable from indigenous peoples and that for the purpose of this paper, it can be argued that the protection of traditional knowledge in contemporary international law owes its origin to the sharp focus that indigenous interests have come into. That 'indigenousness' became an area of concern for international law can be readily explained given that the nation-state acted contrary to the interests of these communities, resulting in international processes being resorted to. This paper will contextualise this state of affairs to Intellectual Properties (IPs) under the TRIPS Agreement, in what appears to be an area that has shunned its hitherto westernisation and seems to be on the brink of profound inclusiveness, in terms of protection of Traditional Knowledge (TK). Though issues of food safety and farmer's rights too have occupied the discourse pertaining to the TRIPS, this paper's scope lies restricted to an analysis of the protection of TK and the issues connected therewith [1]. By the same token, the paper will have to, as a matter of obviousness, deal with questions concerning the Convention on Biological Diversity (CBD) and the to-be-forged relationship between the TRIPS and CBD.

1. Intellectual Properties and Indigenousness – Establishing the Vital Camaraderie

In this era of globalisation, the necessity to protect traditional knowledge has become a direct concern for human rights standards [3]. This is more pronounced in contexts where populations are overwhelmingly indigenous. Economic and social reasons lie at the heart of the drive against the misappropriation of indigenous knowledge. Reasons of exclusionary public markets and the consequent greater dependence on self-help as means of sustenance have been cited as most compelling to provide for a TK protection framework [4].

Till recently, the discourse on indigenous rights stood confined to the human rights regime and attempts at promoting indigenous interests repeatedly drew upon the applicable human rights laws. Paradigmatically, this modus has changed in recent years and a shift has been witnessed that has resulted in changed equations in the fight for indigenousness protection. Driven by a purely utilitarian approach, the pursuit for protecting distinctiveness has defied any inhibitive notions of how intellectual properties could serve as a tool to protect *intellectual properties*, worth the name, in the indigenous context. The philosophy of paranoia towards public consumption of private intellect had been viewed as functionally antithetical to any attempt at securing

community knowledge that sought not to maximise utility, but to prevent abuse in the hands of those who tapped the so-called *public domain* [5]. Thus, the question of indigenous peoples and intellectual properties has been an oxymoron of sorts for many. This uneasiness in the new alliance, which is benefit-conferring on the hitherto mutually ostracized phenomena, has been placated by those who have rightly argued for a new legal regime that seems to tackle what can be termed *indigenously* intellectual properties, drawing sufficiently from the robustly successful mainstream intellectual property experiences, coupled with the novelty that is demanded here [6].

Much of the *sui generis* argument has translated into processes in the corridors of lobbying in international institutions and has received impetus with the adoption of the term *traditional knowledge* by the Convention on Biological Diversity. But given that established IP laws still hold sway and that TK protection attempts have raised important implementation questions vis-à-vis the TRIPS (which as would be examined later is at a fructifying stage) mainstream intellectual property laws became necessary as a stopgap attempt. To that limited extent, viability has indeed not been a bad option to explore. Many have indeed argued that current IPs themselves should be restated to accommodate traditional knowledge [7].

I suggest that though traditional approaches to both the fields of IP and human rights, *in situ*, might render doubtful the very *raison d être* of the intercourse between them [8], such objections need to and have indeed been relegated for supervening reasons of sheer necessity. It is at this juncture that a two-fold analysis awaits this paper – one from an introductory perspective of how traditional knowledge largely fails to breach the minimum thresholds on the touchstone of TRIPS patents, copyrights, trademarks and so on [9]. Drawing upon such failure the other part seeks to examine the efforts at the WTO by making a case for harmonization between the TRIPS and the CBD, the latter having expounded a clear mandate to protect TK.

1.1 Patents

Of utmost importance of all the prevailing IPs, what seems to exploit indigenous peoples the most is patent law. Patenting of most of the products or processes that use some or the other form of traditional knowledge deprives indigenous peoples of further use of the product for any commercial purpose, and more damagingly, does not channel a portion of the huge profits raked in by the patent holders who enjoy market monopoly. There are several instances from around the world, as great as the number of tribes themselves, where multinational corporations have bio pirated indigenous knowledge, in the pharmaceutical sector especially, and have patented the ultimate product. In an insultingly overwhelming number of cases, these indigenous peoples have got nothing in return. Thus, to launch a counter to this practice, the solution seems to be that it should be explored as to how traditional knowledge itself could qualify for patent protection.

A patent is awarded to a product or process that is new, involves an inventive step and is capable of industrial application. In other words, it should be useful and non-obvious [10]. As already stated, these are minimum requirements that need to be satisfied [11]. Traditional knowledge does not qualify for protection under these paradigms since it mainly lacks manifestation in forms of 'products or processes'. It has also been within the knowledge of many for centuries and has had creators who are too many that it would be impossible, or at the least, anachronistic to determine them. Essentially, TK thus falls within the public domain and cannot be said to be new and original [12]. The patenting system therefore does not accommodate traditional knowledge within its realm.

1.2 Copyrights

Copyrights under the TRIPS essentially make applicable the relevant provisions of the Berne Convention [13]. It is a right conferred to protect the originality of authorship. As such, it demands that the copyrightable property be the original work of a person. Thus, folklore will have to be the result of the originality of a person. Satisfying this requirement becomes difficult when folklore has been common to many over ages and has been improved upon by generations. Commentators have pointed out to Australian decisions where copyright laws are being put to good use by indigenous peoples for protection against plagiarism [14]. It is true that this tendency can be extended to other jurisdictions. But however, even the Australian jurisprudence provides only a redress mechanism (injunctions mostly) against the improper use of TK and does not grant *ipso facto* copyright over traditional artworks and literature. It is also important to note that protection in the form of copyright is limited in time. The 'life of the author plus 70 years' duration is something that indigenous elements cannot agree with. What is required in this context is perpetual protection. It only goes without saying that notwithstanding responsive copyright laws, there is at least a need for modification of copyright laws to suit the needs of TK. I therefore argue that the *sui generis* advocacy needs impetus.

Various other intellectual properties like trade secrets, geographical designs, trademarks and so on do afford limited protection to TK. Moreover, questions common to all IPs arise since these are 'private rights' under the TRIPS and any community knowledge therefore poses questions as to the manner in which it could be secured. Awarding of rights should necessarily take place in the names of communities, which is not provided for by current IP laws. Much less, there are issues pertaining to benefit sharing and prior informed consent of these people that are relevant. Thus, prevailing IP laws to a large extent, it can be said, are not designed for protecting TK. As a consequence, *sui generis* mechanisms seem to take the centre-stage.

2. An analysis of the CBD

The parties to the CBD have an obligation, subject to their national legislation, "to respect, preserve and maintain knowledge, innovations and practices of indigenous and local communities embodying traditional lifestyles relevant for the conservation and sustainable use of biological diversity and promote their wider application with the approval and involvement of the holders of such knowledge, innovations and practices and encourage the equitable sharing of the benefits arising from the utilization of such knowledge, innovations and practices" [15]. This 'subject to national legislation' rider is a damper that has watered down what would have otherwise been an emphatic proposition [16]. The clause has been viewed as setting different standards for different nations, depending on the possibility and appropriateness of a regime in each country.

It has also been argued that the CBD has not provided for a framework for TK protection and has taken the IP law approach of leaving structural and procedural issues to enabling legislations of governments [17]. Perhaps much of this lacuna is the sole cause of the debate pertaining to the TRIPS and the CBD. Another concern that has been put forth pertains to Article 15 that vests sovereignty over natural resources with the parties to the Convention and not with indigenous peoples themselves. Permission to grant access to genetic resources lies with states and has also been made subject to national legislation. These inherent shortcomings remaining, the CBD, in Article 8(j), creates a *per se* obligation to protect the knowledge systems of indigenous peoples. I would therefore proceed on the premise that the CBD mandates states to protect TK and that this will have to be seen contemporaneously with the TRIPS. Indeed, parties to the TRIPS concur on the fact that the CBD does contain affirmative directions to protect traditional knowledge.

3. CBD and the TRIPS – The Areas of Interplay

At the outset, the TRIPS and the CBD seem to deal with two disparate subject-matters – intellectual property law harmonization over jurisdictions as alleviation of trade barriers and the conservation of biological diversity, respectively. This principle supports the stand that the TRIPS and the CBD can be mutually enforceable in a non-conflicting manner [18]. A group of states have therefore argued that there is no conflict between the TRIPS and the CBD. They have also suggested that the CBD itself has recognised the need to protect intellectual properties [19]. Even assuming there exists a conflict, they point out that the CBD provides for a harmonious construction vis-à-vis other treaty obligations (in case of conflict) and that impossibility of the same would render the CBD subject to obligations under other instruments, provided that such compliance does not cause serious damage or threat to biological diversity [20].

It appears that though the objects and purposes of the instruments may seemingly be different, it is nevertheless important to see protection of traditional knowledge as a CBD requirement and the TRIPS Agreement as dealing with intellectual properties that have previously gone to draw upon such traditional knowledge. It is then that they seem to deal with somewhat similarly situated things, protection of one or the other form of intangible knowledge, be it Eurocentric intellectual exertions or the traditional knowledge of indigenous peoples. Possibly, this is the area where the two instruments seem to witness a confluence. Pursuits to find a reiteration of this view are immediately satisfied. The CBD itself, in Article 16(5) acknowledges that the "Contracting Parties, recognizing that patents and other intellectual property rights may have an influence on the implementation of this Convention, shall cooperate in this regard subject to national legislation and international law in order to ensure that such rights are supportive of and do not run counter to its objectives" [21].

The above-cited arguments, founded either on rules of treaty construction or the defined domains of the purposes of each of these treaties, have however exposed that the two instruments definitely have a point of intersection, i.e., there are areas where both the instruments have concurrent application. Therefore, it cannot be argued on a normative stand that the TRIPS and CBD have no link. On a close examination of where the instruments interact, the relevance of the CBD rhetoric is amplified by the fact that, with regard to patents, Article 27.2 of the TRIPS provides members with the choice not to grant patents for reasons of *ordre public* or

morality including protection over life forms like animals, plants and genetic resources that might be detrimental to the environment. Further, Article 27.3(b) has remained the contentious provision in contemporary discourse that seeks to grant members the flexibility to deny patents over life forms and animals [22].

Broadly, issues pertaining to traditional knowledge and the TRIPS have witnessed a three-pronged approach in the agenda items of the TRIPS Council. Separate Working Groups have been established for each of them. They are –

1. The review of Article 27.3(b) as demanded by the provision itself.
2. The relationship between the TRIPS and the CBD.
3. The protection of TK and folklore.

It needs to be remembered at this juncture that these discourses within the WTO are not the only international efforts that are dealing with the issue of traditional knowledge. The WIPO and the UN have also been concerned with the same. The Working Group on Article 8(j) of the CBD is another effort with a similar mandate. In fact, the WIPO has institutionalised the debate on TK protection by setting up the Intergovernmental Committee on Genetic Resources, Traditional Knowledge and Folklore, where a document for *sui generis* protection of TK is in the offing. WTO has put for itself the question of advisability to pursue work on TK given the WIPO initiatives [23]. Thus, the forums for debate are many and the consequent "duplication" of work cannot be ignored. Rather, these efforts should be seen as revealing member nation's broad approaches and aspirations, and might afford an opportunity for each of these institutions to take cognisance of and borrow from the advancements made in the other's domain. At the same time, the activity even within the WTO has been quite a medley of the varied elements and factors connected to the issue, explaining sufficiently as to why each of the three Working Groups have not been able to seclude their primary area of concern from the other two. That does not in anyway go to show the disorientation or the lack of direction of the discourses, but only helps sustain the truth that issues of Article 27.3(b) review, *lex generalis* traditional knowledge protection, and the TRIPS-CBD cohabitation studies cannot be strictly divorced from each other or thrown into water-tight compartments. Substantive and policy implications remain for each of the three from any developments in the other two.

4. The TRIPS-CBD in WTO – Discordant Echoes

As in all issues in the WTO, driven by the capitalist-developing nations divide, the TRIPS-CBD reconciliation efforts have also evoked varied responses from member nations. As questions of construction of the two instruments, the responses of members can be placed under four categories [24]:

1. There is no conflict between the TRIPS and the CBD.
2. Though no conflict exists, further study is required as to whether any international action is necessary at least from the TRIPS side.
3. Though no conflict exists, the international patenting regime should be overhauled so as to enhance the mutual supportiveness of both the instruments.
4. There exist inherent conflicts between the TRIPS and the CBD and the TRIPS should be amended accordingly so as to remove them.

Reasons for the first of the stands have already been stated and it is needless to repeat them [25].

The second argument is not so well articulated for members have submitted that there is no manifest crisis in the existing patent systems [26]. Numerous patents beginning with turmeric, neem and the ayahuasca plant have exposed the vulnerability that current patenting systems have thrown TK to. Effectiveness, these states argue can be achieved by bringing in changes to the patent systems, short of an amendment to the TRIPS, like creation of universal databases on TK so that patent offices would have the requisite information in considering applications drawing upon TK. Detailed objections on the viability of the database model have been raised by members, including costs, comprehensiveness, and participation in accruing profits [27]. Nations that have taken up the second line of argument seem to be equivocal in their stand given that they neither suggest a feasible via media to the strongly worded first and fourth assertions nor do they recognise that problems do exist in the area of patents. Essentially, the approach seems to leave the existing binding laws the same and increase the emphasis on secondary sources that do not by themselves provide an answer to the pressing problems but only indulge in procrastination by a weak replacement with studies in transnational perspectives and database implementations.

The third of the arguments seems to capture correctly the position of the TRIPS as against the CBD as a matter of treaty interpretation. It rightly fails to see any patent conflict between the two instruments but calls for international action in the area of mandatory source disclosure of the country of origin of biological resources or

traditional knowledge. A majority of nations have favoured this course of action. Truly, this approach calls for the satisfaction of two important CBD requirements, the prior-informed consent of the state to which the genetic resource belongs to [28] and sharing of benefits from patents in a fair and equitable manner [29]. This suggestion is realistic and compatible with the need to maximise harmonization between the two instruments. In addition to satisfying CBD requirements, it infuses inherent safeguards in TRIPS that will prevent the misuse of the patenting regime. Questions of what exact actions are needed and where, have however elicited varying answers, which are discussed at a later part.

In the main, the conflict argument views Article 27.3(b) of the TRIPS to be in conflict with the CBD that ensures states their sovereign rights over genetic resources. The complete absence of any regard for prior informed consent of states or benefit sharing in case of genetic patents or TK used patents in any of the intellectual properties under the TRIPS has also bee cited as a reason justifying a conflict conclusion [30]. States that have taken this approach argue that the TRIPS, by mandating that states ought not to deny patents under the said provision for micro-organisms, microbiological and non-biological processes, makes way for privatisation of these which are supposed to be under the sovereign rights of nations under the CBD [31]. Concerns also spill over to questions of granting patents over micro-organisms in their natural forms since the TRIPS is permissive of the same [32]. As a corollary, these states opine that the TRIPS would have to exclude all genetic materials from the purview of patents for the reason that patenting of any life form restricts access to them, and might impinge upon the sovereign rights of states over them.

States that have taken the no-conflict approach seek to rebut these objections on the grounds that mere grant of patents applying a genetic resource or TK cannot amount to a deprivation of rights of states under the CBD. Further, they argue that the patenting of life in natural form as an interpretation of Article 27.3(b) is wrong and the TRIPS does not permit such patents [33]. Upon the wrong or improper application of patenting criteria as a violation of CBD standards, which has been a concern well received with both the protagonists and the antagonists, states point at post-grant protest and re-examination of patents as an effective mechanism which will revoke bad patents, as in the *Neem* case.

As already adumbrated, I view the third of the arguments that calls for specific international action as the most plausible of alternatives before the WTO. More so, it would be the most effective too, making CBD requirements TRIPS requirements themselves, once translated into action. The ultimate voice that has survived in the WTO also seems to be that of the proponents of this approach. Unanimity prevails on the basic need to further and strengthen TK protection and members reiterate their commitments under the CBD. The majority of members have ruled out either maintaining *status quo* as regards the TRIPS (the plausible consequence of the first argument) or drastic amendments in what would be the follow up action if the conflict stand is adopted. At the same time, developing nations have rejected the second alternative for being docile and without the necessary teeth to make any meaningful change to the international patenting system. Previously cited reasons would suffice to expose the same. I suggest that the third of alternatives poses and does make the best case that would strike a balance between the competing arguments of harmony and conflict between the TRIPS and the CBD. It also seeks to avoid, *a fortiori*, the controversial and academic question of assessing the legal position on the relationship between the two treaties. Rightly, on the question of construction of the two treaties, arguments that states on both sides have made seem to be tenable and ambivalence prevails if one were to take a stand. On the other hand, if the TRIPS regime were to incorporate the concerns of the third world, the theories of conflict and harmony would become a non-issue. I therefore argue that the third course of action serves the dual purposes of avoiding legal determination which might not necessarily be an easy and consensual one and delivers the goods by fulfilling CBD requirements.

5. Implementation Issues and Solutions

Having said that international action is necessary on the part of the TRIPS, there is a *fait accompli* as to how the same should be gone about. In the order of priority, the intended purposes behind these discourses are to provide for regularisation of access to genetic resources and TK, benefit-sharing, the prior informed consent of indigenous peoples/governments (this would be inherently satisfied in granting access to genetic resources and TK) and mandatory source disclosure as to place of origin. Within this context, where the debate has been brought down to the implementation parameters of the third alternative hereinbefore supported, it can be said that the discourse is taking a particularised course that might yield results. Issues do exist here to be sorted out. Two modalities that can mutually accommodate each other have been suggested.

5.1 National Approach

The first of these, largely propounded by the United States significantly reveals the tacit conceding to the genuine viability that the third option affords. The US has suggested that issues of authorised access and benefit-sharing can be best addressed through the domestic laws of members. It seeks to tackle the issue outside the intellectual property regime by providing for national laws that deal with conclusion of contracts between authorities and those who seek access to materials [34]. That would also stipulate the terms of transfer of benefits from the use of such properties to the government concerned. Civil and criminal liabilities for unauthorised access, the US says, could be prescribed for non-compliance. Further, effective control over the TK or gene applied could always be exercised by providing for prior authorisation of use of such TK or gene in other applications, regardless of whether a patent has been granted for the initial application or not.

As a necessity, apart from the fact that the CBD itself requires a contractual approach [35], the justification for national regimes has also been on account of the fact that anyone who wishes to tap TK or use a genetic resource should know the lawfully empowered authority competent to grant permission (be it indigenous representatives or government officials), the procedure involved and the finality of contracts entered into. These "points of contact" would enable the easy and pragmatic working of the system. These points could also require periodical reporting by researchers on the progress made, thus providing immediate control.

The effectiveness of such regimes, if the US submissions are any indication, would be immense. Civil liabilities could range from injunctions to suits for breach of contracts, leading to specific performance or damages (including punitive) against the party in breach. Criminal liability might be imposed for specific violations in an exclusive code for the purpose. Transnational enforceability of orders and manoeuvring conflict of laws issues could be achieved by choice of laws terms in contracts so that parties approach only the courts upon which the contracts confer jurisdiction. Arbitration could also be an option. Judgments and awards passed could be enforced in other jurisdictions under the relevant international agreements.

However, the US has continued to lay emphasis on the post-grant re-examination and revocation of patents as the best remedy where a bad patent has been granted. The measures enumerated hereinabove effectively preclude the grant of an invalid patent, but at the same time the problems that exist in enforcement of transnational judgments and awards (even under a treaty regime) have been highlighted by arguing that the contract model is weak where regional or bilateral regimes limit the extent of enforceability. It has also been pointed out by those who find shortcomings in the national approach that if copyright laws or patent laws were to be governed by international instruments like the TRIPS, then why not TK or access to genetic resources. The contract model is viewed as being weak against those who deliberately avoid the system and take shortcuts to access and use of TK. In addition, the purpose that the contract system would serve is being questioned for the reason that indigenous and local communities lack the bargaining power to make fair deals that would serve their interests. Also, where the issue pertains to access to TK, the problem with indigenous representatives' consent would be a poser since questions of competency to grant access, to enters into contracts, the binding nature of the contracts on the community and the third party, and how the benefits are shared, arise.

5.2 Disclosure Approach

The disclosure approach can itself be sub-classified into three:

1. *The TRIPS Disclosure Approach*

This approach requires an amendment to the TRIPS to expressly incorporate an obligation for all member nations to require patent applicants to disclose the source and country of a biological material or traditional knowledge in addition to submission of relevant documents evidencing prior informed consent from national authorities and fair and equitable benefit sharing to be accrued thereafter. This model is largely a development on the national approach, but for the shift from a purely "national regime with an international outlook" to a totally international one. As regards the enforcement part of the regime, this approach will inevitably have to reiterate the ones put forth in the national approach, like civil and criminal remedies. The greatest advantage however is that no specific treaty for transnational enforceability of judgements and awards would be necessary as an obvious consequence of express amendment to the TRIPS. Further, the WTO Dispute Settlement mechanism could be used to settle disputes as to the ambit and operation of the newly introduced requirements if a member feels that a patent was wrongfully granted in another country that uses its TK or genetic resource. As part of the amendment, it has also been suggested that a *non obstante* clause be included in Article 27 that will save all actions taken by members to fulfil their obligations under the CBD [36].

2. *The PCT Disclosure Approach*

On similar lines to an amendment to the TRIPS, it has also been suggested that amendments be made to the Regulations to the Patent Co-operation Treaty (PCT) under WIPO administration, to permit members to make disclosure mandatory. This proposal is completely a Switzerland initiative. The provision to be included would be merely permissive and not mandatory. The proposal is further diluted since disclosure is looked at as a formality and not a substantive obligation. However, once an enactment is made under a national regime, it would be mandatory for the state to comply with the same. Needless to say the proposed TRIPS amendment, in comparison with this proposal, is clinching and productive. Further examination of this proposal would be outside the scope of this work.

3. *Mandatory Disclosure Approach*

Better termed 'universal disclosure approach', this approach seeks not to limit TK protection or access to genes to a TRIPS or PCT phenomenon. Rather, it looks at bringing about a universal regime that will, regardless of the applicable international patent instrument, demand the country granting patent to satisfy itself of disclosure of source, prior informed consent and benefit sharing. The requirement to disclose would arise immediately once there is a *prima facie* case of use of TK or a gene. The application, failing to provide such information, would not be processed further. In addition, the establishment of a central body to act as repository of notifications from patent offices as to disclosure could be possible. Such information could then be used by all CBD parties. As to how exactly this approach could create a universal regime is unclear. It has also been asserted that before such a universalization could take place, there should be a thorough definitional analysis of what TK is so that a legal definition could stipulate what patents need disclosure and what not.

5.3 Peruvian Regime – Evaluating the Efficacy

Independently of international action or coordination, nations who have large resources of TK and genetic material have adopted their own national laws that regulate access and benefit sharing. They are of immense help in shaping the international efforts required and a limited examination of the structural modelling and the helpfulness of the same is made here.

As a forerunner, Peruvian Law 27811 [37], is the world's first *sui generis* legal regime that deals with most outstanding issues relating to TK protection, like source disclosure, prior informed consent, benefit-sharing and the procedures connected therewith [38]. The hallmark of the law is that it leaves decision-making and participation in granting permissions exclusively to indigenous peoples themselves. Rightly, the term 'collective knowledge' substitutes 'traditional knowledge', providing for community ownership of TK [39]. For the purpose of 'governing' TK a safe euphemism to self-determination indigenous peoples choose their representative organizations in conformity with traditional and customary practices [40]. Emanating from the need to perpetuate TK protection, the law does not allow complete transfer of TK to third parties. As guardians of what their ancestors left them, indigenous peoples have been given the right to commercialize TK, but not to divest their own posterity of what was only an inheritance. Though comprehensive that the legislation might appear, the law has been criticised for dealing only with TK having implications for biological diversity, and thus excluding from the scope of collective knowledge, folklore, art, dance and music [41]. But this concern seems to be addressed in a later law, No. 28216, seeking to thwart biopiracy, providing for compensation "where access to and unauthorized use… of biological resources or traditional knowledge" comes to light [42].

Though a few other national legislations do exist, it would, for the purposes of this paper be sufficient to state that the Peruvian model is indeed one that can be emulated by other nations. The Peruvian model can be incorporated be it the national approach or the disclosure approach that ultimately prevails.

6. Where is the Democratisation Discourse Taking Us?

An analysis of contemporary negotiations going on in the WTO shows signs of promise. The transnationalisation of markets as an incidence of global trade has brought with it questions of how intellectual properties need to be protected on the global level – and that is precisely the reason why the TRIPS is in place. But most appallingly, until recently the global markets for applications using traditional knowledge were capitalistic and oblivious to the misuse of TK, making the rich richer and the poor poorer. Inequitable that it was, ubiquitous happenings have thrown more morality pressures and public policy compulsions on developed nations to remedy this imbalance in growth and development. Developing nations have gained considerable headway in pushing their demands through.

As to what would happen in the WTO, whether an amendment to the TRIPS, or a *sui generis* answer outside the IP regime, will be known in the near future. With the wide variety of choices before the organization,

a regime for TK use, exploitation, upkeep and sharing should draw from the best of features of each of the models suggested and ultimately make a package that will maximise the said objectives. The focus should now move towards the following:

1. It is urgent to realise that conflict-harmony lobbies on the TRIPS and the CBD are needless and further devotion of time and energy in that direction would only delay the ultimate outcome. International action is certainly needed to render obscure the purported purpose behind the arguments.

2. International action should not stop with database implementations and get lost in the academics of TK definition, transnational experiences and the like.

3. A right choice as regards international action outside or within the TRIPS should prefer the later. Though the national approach propounded by the US is a thinkable solution, the refinement of the same into the *TRIPS Disclosure Approach* answers questions of international enforceability and provides access to the WTO Dispute Settlement Body.

4. National regimes under the TRIPS need to be more or less similar to each other in procedure so that near uniformity could be achieved in the highly technical (and now complicated) process of verification and grant of patents. Database implementations might be helpful in this context of verification.

5. Benefit-sharing terms should be scrupulously enforced and observed. Remittance of minimum sums before exploiting TK can be bargained for. Benefits, apart from being monetary, should also go towards improving living conditions, health standards and education of the communities.

6. On a national level, if indigenous peoples were to use their rights diligently, states could provide legal education to the select representatives of indigenous peoples so that they are better placed to make a fair and equitable deal, in the sense the CBD demands.

7. Peruvian law 27811 can be a model precedent in national regimes and others can follow suit.

8. Continuous post-grant surveillance of applications using TK could ensure that they do not fall into the public domain.

9. Given that numerous international treaties and forums exist where contemporaneous debates are raging on more or less similar issues, the transformation in the TRIPS could, with suitable and necessary changes, be passed over to them.

If these are to translate into action, unflinching lobbying is required of developing nations. Mere enactments might not be sufficient. Duty to report on working of the regime to the TRIPS Council could be made mandatory. An inherent review mechanism, like the one currently under Article 27.3(b) should evaluate and make recommendations for amendments or other means of action that might be necessary. That would ensure that international law could truly provide for a democratic market for the tapping, use and enjoyment of traditional knowledge – and, for the welfare of indigenous peoples and the larger mankind.

Notes:

[1] There is no universally accepted definition of the term 'traditional knowledge'. TK can be viewed as a coalescence of all the variously ramified forms of indigenous exertions as clubbed together under one terminology so that blanket protection could be offered without specification or exclusion. See, Srividhya Ragavan, (2001), 'Protection of Traditional Knowledge', Minnesota Intellectual Property Review, Vol. 2, p. 1, at 4, for a similarly broad definition.

[2] Traci L McClellan, (2001), 'The Role of International Law in Protecting the Traditional Knowledge and Plant Life of Indigenous Peoples', Wisconsin International Law Journal, Vol. 19, p. 249, at 250-51.

[3] This is not just from the perspective of the 'right to culture' which has had centripetal importance in areas of land and proprietary rights over natural resources.

[4] Rosemary J Coombe, (2001), 'The Recognition of Indigenous Peoples' and Community Traditional Knowledge in International Law', St. Thomas Law Review, Vol. 14, p. 275.

[5] See Laurence R Helfer, (2003), 'Human Rights and Intellectual Property: Conflict or Coexistence?', Minnesota Intellectual Property Review, Vol. 5, p. 47, at 52-54.

[6] Michael F Brown, (2003), *Who Owns Native Culture?*, Harvard, p. 10.

[7] Michael J Huft, (1995), 'Indigenous Peoples and Drug Discovery Research: A Question of Intellectual Property Rights', Northwestern University Law Review, Vol. 89, p. 1678, at 1679; Megan M Carpenter (2004), 'Intellectual Property Law and Indigenous Peoples: Adapting Copyright Law to the Needs of a Global Community', Yale Human Rights & Development Law Journal, Vol. 7, p. 51, at 53; see also statements of the following nations at the TRIPS Council, Australia, IP/C/W/310; EC, IP/C/W/383; Japan, IP/C/M/29, para. 157.

[8] But note that Helfer, *op. cit*., at p. 49, opines as to how even the UDHR established the much searched for IP-human rights link.

[9] For an analysis of these, see, Srividhya, *op. cit.*, at pp. 14-24.
[10] Section 5, Article 27, TRIPS.
[11] The fact that "TRIPS-Plus" bilateral agreements provide for higher minimum thresholds only throws out any case that TK can make for conventional IP protection.
[12] Folkins E Pollyanna, (2003), 'Has the Lab Coat Become the Modern Day Eye Patch? Thwarting Biopiracy of Indigenous Resources by Modifying International Patenting Systems', Transnational Law and Contemporary Problems, Vol. 13, p. 339, at 347.
[13] Section 1, Article 9, TRIPS.
[14] See Carpenter, *op. cit.*, at pp. 63-64.
[15] Article 8(j), CBD.
[16] Maui Solomon (2001), 'Intellectual Property Rights and the Indigenous Peoples' Rights and Obligations', *In Motion*, 22nd April, 2001, retrieved on 03.02.2007 from http://www.inmotionmagazine.com/ra01/ms2.html.
[17] Folkins, *op. cit.*, at p. at p.350.
[18] See statements of Australia, Canada, Japan, Korea, and United States.
[19] Article 16(2).
[20] See Article 22(1).
[21] See statements of Brazil, IP/C/M/47, para. 84, IP/C/M/26, para. 62; China, IP/C/M/36/Add.1, para. 227; India, IP/C/M/48, para. 49. This is a principled justification, apart from the Doha Declaration, as to why the WTO should entertain a debate on the CBD and the TRIPS.
[22] It nevertheless mandates that protection ought to be provided for plant varieties either using patents or a *sui generis* mechanism or a combination of both.
[23] See IP/C/W/370/Rev. 1, p. 6-9, 9th March, 2006.
[24] See IP/C/W/368/Rev.1, p.4, 8th February, 2006.
[25] These states contend that correct application of the *sine qua non* requirements for a patent would ensure the grant of valid patents. Note that even states who contend conflict concede that incorrect application of patenting criteria might, *inter alia*, lead to inconsistencies with the CBD; see Brazil, IP/C/W/228 and Peru, IP/C/W/447.
[26] The cohorts of this argument include Australia, New Zealand and Canada.
[27] Venezuela, IP/C/M/37/Add.1, para. 244; The African Group, IP/C/W/404; Brazil, IP/C/M/48, para. 39; Bolivia et al, IP/C/W/403; Brazil and India, IP/C/W/443; India, IP/C/M/39, para. 123, IP/C/M/37/Add.1, para. 253.
[28] Article 15(5), CBD.
[29] Article 15(7), *ibid.*
[30] Marcia E DeGeer, (2003), 'Biopiracy: The Appropriation of Indigenous Peoples' Cultural Knowledge', New England Journal of International & Comparative Law, Vol. 9, p. 179, at 203-204.
[31] See African Group, IP/C/W/404, IP/C/W/206, IP/C/W/163, IP/C/M/40, paras. 76-79; Kenya, IP/C/M/47 para. 68, IP/C/M/36/Add.1, para. 233, IP/C/M/28, para. 144.
[32] Kenya, IP/C/M/28, para. 141; Peru, IP/C/M/29, para. 175.
[33] EC, IP/C/W/254 and Japan, IP/C/W/236, IP/C/M/29, para. 151.
[34] Documents IP/C/M/32, 37 (Add.1), 38, 39, 42, 46; IP/C/W/434, 449, in relevant part, contain the US submissions.
[35] See ¶4, ¶7, Article 15, CBD.
[36] Brazil, IP/C/W/228, IP/C/M/33, para. 121, IP/C/M/32, para. 128; Peru, IP/C/W/447, IP/C/M/48, para. 20.
[37] Regime for the Protection of Indigenous Peoples' Collective Knowledge Associated with Biodiversity; enacted on July 24, 2002; entered into force on August 10, 2002.
[38] See Article 5, ibid.
[39] Article 1, ibid. Collective knowledge has been defined on the same understandings of TK; see Articles 2 and 3.
[40] Article 14, ibid.
[41] Ruiz, Lapena & Clark (2004), 'The Protection of Traditional Knowledge In Peru: A Comparative Perspective', Washington University Global Studies Law Review, Vol. 3, p. 755, at 780.
[42] 3rd Supplementary Provision.

Rescuing the Inexhaustible… (The Issue of Fisheries Subsidies in the International Trade policy)

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Abstract. The main causes of over-fishing are not biological or environmental, but rather economic overexploitation of the ocean's fishing resources. Since the problem is an economic one, the response to it has to be also an economic one. Proper fisheries management and restrictions on fleets' capacity (including the issue of fishery subsidies) would be very effective. A retreat from the subsidies in fisheries would considerably contribute to the conservation and sustainable use of fish stocks. However, a full retreat from the subsidies in fisheries seems to be unrealistic. Consequently a compromise has to be made and appropriate restrictions are needed not to distort positive environmental-friendly trends in subsidizing and to protect the interests of the developing fishing states. The number of people employed in fishing industry is growing every year, especially in developing countries. This regime would require a strong coordination and co-operation of governments and international organizations.

Introduction

Ocean fish numbers around 28,000 different types of species. This is more than the number of amphibians, reptiles, birds or mammals on the entire planet. It seems just innumerable… Nevertheless, humanity has succeeded in over fishing.

Many ocean fishes are ancient species that existed on the earth for more than 450 million years before the dinosaurs began roaming. For this reason alone, they deserve careful treatment and special protection. But besides this, fishes are such an essential source of protein and other nutrients in the human diet, as well as in the diets of multiple other animal and bird species, that their depletion seems almost unthinkable.

The world community has started to combat over fishing by different means and techniques: fishing of some species is totally prohibited, while for other species seasonal quotas, protection during the spawning season and minimum mesh sizes have been established (Tomasevich, 1971 p. 46).

Biological solutions like these have not worked out, however. This is not surprising, since the main causes of over fishing are not biological or environmental, but rather economic overexploitation of the ocean's fishing resources. Since the problem is an economic one, the appropriate response to it also has to be an economic one. Proper fisheries management and restrictions on fleets' capacity (including the issue of fishery subsidies) also would be very effective.

However, today's model of economic globalization presumes an open multilateral trading system functioning like clockwork. Is the restriction or abolition of fishery subsidies workable under today's economic circumstances? How should these issues be treated so as to not distort the global market, or ruin the already troubled fishing industry? What kind of legal frameworks should it have? This paper attempts to find some solutions to the foregoing problems.

1. Environmental and economical background

1.1 Overfishing

Fishing is one of the oldest human professions. Since the Middle Ages, it has been an organized industry (e.g., the catch of herring in northern Europe). The 15th century was marked by the beginning of organized catches of cod on the Grand Banks of Newfoundland. In the 17th century whaling fleets put to sea. Excluding some particular concerns (e.g., in the 14th century in England, special trawls with a fine mesh (wondyrchoums) killed enormous numbers of fish), humanity was almost sure until the 19th century that the ocean's fish stocks were

inexhaustible (Policansky, 1995 p. 652). Even in the 19th century, British biologist Thomas Huxley proclaimed the endless resources of fish in the ocean (Pearse, 1996 p. 12).

Since fishes were considered inexhaustible, access to them was entirely open and unregulated. Over time, this open access to the sea's resources became increasingly harmful. The lack of adequate management of the fisheries also contributed to the problem. The resulting overcapitalization and over fishing first led to such "global" decisions as revocation of such Grotius premises as "inexhaustibility of resources and insusceptibility to appropriation" (Knight, 1977 p. 27).

In the 20th century, not only easily accessible stocks of fish but also more elusive mammalian species (seals, otters, blue and right whales) declined. By the end of World War II, overfishing had become a critical problem.

Presently, around 60% of the major species are under threat: a fully utilized half of all species and an over fished quarter. The problem is even beyond one of "sustainability": it is already acute for the current generation, let alone for future generations. Biologists warn: in some cases the fishing stocks can never be renewed, since their over fishing could just remove the stock forever from the ecosystem.

Garrett Hardin called this over fishing problem the "tragedy of the commons". A resource that belongs to everyone and no one, the ocean's fish stocks have become a problem which everybody concerned, directly or indirectly, has to solve. This includes not only biologists and environmentalists, but the fishing industry as well. Ordinary consumers play a role too by buying threatened species at the grocery store.

Both biological and economic solutions are being applied to the over fishing problem. The question arises whether fisheries management should also be corrected from the economic point of view (Meany, 1986 p. 45). Should the free market system be restricted for environmental reasons?

The legal answers have already partly been found. The principle of the freedom of fishing on the high seas, declared in the customary law of the sea, had to be revised, or rather corrected, in light of overfishing. Arts. 61, 62 and 65 UNCLOS provide rather general rights and obligations of coastal states concerning their living resources in the EEZ. The main response is given in multilateral and bilateral treaties. The freedom of fishing was (and continues to be) restricted and subjected to specific conditions.

1.2 Fleets overcapacity

However, the main danger lies not in the open access to fish resources, but in the technological progress. Even whales were endangered only after the invention of the harpoon gun.

The freedom of fishing on the high seas (at least until the 20th century) and high prices for tuna, billfish, salmon and squid promoted high competition between states and, as a consequence, development of modernized vessels and more effective fishing methods. Governments, under these conditions of high competition, increased their fleets' capacity as much as possible, providing partial subsidies to their fishing industries.

This led to what we have now: fishing fleets that are "overbuilt" (Warren, 1994 p. 2). In other words, the amount of input money or capital oversteps the oceans' productive capacity. First, too many fishing fleets are catching too few fish (overcapitalization). Second, the new, more effective ways of fishing, like large-scale drift nets or advanced gear types and new technologies such as GPS, have drastically increased the fleets' capacity.

Natural checks on overfishing, such as the "self-renewal" of fish stocks, no longer help since fish no longer have time to reproduce their numbers (Peel, 1995 p. 1). Fisheries resources are finite—that's why proper management and certain restrictions upon catches are unavoidable if fish stocks are to be preserved at any level (Johnston, 1987 p. 3).

As far back as 1989, the available capacity of fishing fleets was already one-third more than what is needed to catch all the available fish. Currently, the fleets' harvesting capacity exceeds the amount of available fishing resources by far more than that. Today's capacity of the Canadian cod fleet alone is more than what is necessary to catch all the Atlantic cod stocks. According to the FAO's data, 4 million vessels constituted the world fishing fleet in 2004.

The current situation can be summarized as: the catching capacity continues to grow, the fishing resources continue to decrease. The threatening trends are having no significant effect on the fishing industry's practices: world fish harvests continue to rise at the expense of the more than three times overexploited fishing resources (even cod and herring).

Now humanity faces another challenge: how to reduce fleets (Iudicello, 1999 p. 70).

One of the primary solutions would be to reduce the fleets' capacity. However, its growth has been in many respects shaped by government subsidies. While the connection between overfishing and overcapacity is unquestionable, the role of government subsidies in overfishing is more questionable. Besides, 86% of the

world's decked vessels operate in Asia, 1.3% in Africa and 0.6% in South America – all in developing countries. Restrictions on fisheries subsidies could be catastrophic for the economies of these regions.

In 1990, independent experts directly indicated the need to reduce fishing capacity by at least 40%. Even the EU's Multiannual Guidance Programme (MAGP) for 1987 – 1991 stressed the need (not in a mandatory manner), however on a smaller scale (a recommended decrease of 3% in gross tonnage). Yet, except for two "obedient" member states, all the rest actually increased their fleet capacities and related subsidies.

Overcapitalization brings only a short-term increase in profit to fleets. Inevitably, overfishing reduces the gains for all fishermen. Poor management practices also add to the environmental problem. Thus, a solution to the global problem of overfishing is essential not only for environmental reasons but for economic ones, since in any case—with or without subsidies—overfishing sooner or later hurts states' budgets.

2. Fisheries subsidies and international trade

2.1 WTO development and mandate

On 1 January 1995, GATT's successor – the WTO – was established to govern and regulate international trade as a successful result of the Uruguay Round of Multilateral Trade Negotiations (MTNs). A coherent system of global economic governance, together with the IMF and the World Bank, was finally in place (Wilkinson, 2000 p. 11).

The current mandate of the WTO is strictly trade-oriented (Article III, WTO agreement). The WTO was created explicitly for the administration and implementation of trade agreements, and as a forum for multilateral trade negotiations, settlement of disputes, and review of national trade policies.

The question of whether the WTO's mandate should be broadened is being actively debated. On the agenda for possible inclusion are policies for investment, competition, policies for controlling government corruption and labor standards (Blackhurst, 1998 p. 46).

Already, the preamble of the WTO makes a reference to "sustainable development"—defining the new goal or new direction in the WTO's activity. It also served as "a rationale for the formal creation" of the CTE. The position of environmental matters in world trade policy is therefore indisputable. Its importance becomes steadily clearer. Environmental clauses could be found in the WTO Agreement on Sanitary and Phytosanitary Measures and Agreement on Technical Barriers to Trade. The significance of environmental issues and sustainable development within the WTO was stressed once more in the Ministerial Decision on Trade and the Environment issued at Marrakech (Adamantopoulos, 1997 p. 81).

On the other hand, some attempts to link trade and other policy matters have already been unsuccessful, so the fear has been expressed that integration of environmental issues into the multilateral trade order is just "a repetition of past mistakes" (Roessler, 1998 p. 221). Today's preference of trade over the environment was perfectly shown in the tuna-dolphin dispute between Mexico and the U.S., tried by the GATT panel. The reason of protection of environment (or rather Mexico's environmentally incorrect policy on dolphins by the tuna harvesting) due to "extra-territoriality": the environmental exceptions under GATT are admissible only within domestic borders or jurisdiction. There was a concern that otherwise this precedent would have allowed banning product imports only because of the differences between the environmental policy of the importing and exporting countries.

"Technically" environmental issues do not contradict trade issues. The WTO rules do not in any way disturb the environmental aims and policies. The only problem is to make the principle of equivalence between free trade and environmental protection a reality. It is obvious that it is impossible to liberate the trade and protect the environment at once. Such close linkage between environmental and trade issues could rather lead to the manipulating of both of them in the "international bargaining".

The creation of the WTO Committee on Trade and Environment (CTE) was a clear recognition of the trade implications and interrelationship with the environment and a big step toward sound and sustainable trade policies. In 1997 – 1998 CTE repeatedly grappled with the question of x whether fisheries subsidies negatively impact fish stocks and whether such subsidies require for special treatment.

The Uruguay Round clearly puts the issue of fisheries' subsidies under the WTO scope of activity and included under the coverage of the Agreement on Subsidies and Countervailing Measures (SCM) (by the way not applicable for agriculture).

2.2 WTO and fisheries subsidies

2.2.1 WTO Doha round

Since May 1997 the issue of the fisheries subsidies was raised within the WTO CTE. The CTE dealt with this matter for several years. The global character of fisheries and increasing concerns around subsidies in this industry placed this issue on the agenda of the following round of WTO negotiations. In November 2000, the WTO held its Fourth Ministerial Conference in Doha (Qatar).

The Doha WTO round started general negotiations on the disputable issues of the Agreements on Implementation on Subsidies and Countervailing Measures. Paragraph 28 of the Doha Ministerial Declaration contains the mandate on clarification and improvement of disciplines on fisheries subsidies. It was agreed there to launch negotiations on WTO's role on the issue of fisheries subsidies.

After this conference WTO Negotiating Group on Rules, under the authority of the WTO Trade Negotiations Committee has been dealing with the questions of subsidies in fishery.

However, the Doha round does not give a special mandate or authorization to the WTO Members to develop special disciplines on fisheries subsidies. It would be the first step out of the trade-oriented WTO mission.

The environmental issues, as previously mentioned, are not an empty space for the WTO. However, now they are rather generally proclaimed then concretely implemented. The consideration of such environmental issues within the WTO would be not only a great move towards sustainability, but even a historic step for the WTO.

2.2.2 Fisheries Subsidies

Overfishing and overcapacity led to the situation in the fishing industry, where revenues in this industry are exceeded by costs. In this case it would be logical to presume that fishermen should start to leave the fishery (Cunningham, Dunn, Whitmarsch, 1985 p. 98). However, it is not necessarily true. For the increase of the fishermen's income government support could be provided. This support is usually referred to as subsidies. In fisheries they are granted per unit weight of fish landed. The rates of subsidies differentiate depending on the type of fish, its geographical location, the type of fishing vessel or fishing gear, and time of year chosen for the catch (Mollett, 1986 p. 60).

Fishing subsidies are used by all countries with a fishing industry (McDorman, 1999 p. 510). The world leaders in fishing subsidies are Canada, US and EC. Not only domestic fishing could be subsidized. Sometimes governments also support the fishing in foreign waters.

Subsidies favour certain activity by means of corresponding government policy. Subsidies could look like tax breaks, lending preferences, grants or even research and development or marketing. Subsidies can also take the forms of costs reductions, like reduced costs for fuel, reduced or absent fees for use, outright grants, employment support or support of competitiveness in foreign markets. For example, fuel, bait, ice and other inputs prices or taxes can be reduced or special grants for the improvement of safety could be provided. EU used such forms of subsidies as re-deployment agreements with other countries. A number of African states received not only an access to the European vessels, but also special grants and fees.

As a result of subsidies, Canada's Northwest Atlantic offshore fleet increased its capacity more than 18 times. The subsidies of the EC fleet in 70s and 80s for its modernization doubled the gross registered tonnage, tripled its engine power and caused major declines of major fish species in EC waters.

Since the fees for the use of a public resource are reduced or eliminated, the level of their consumption increases. Even if the revenues are lower than costs, the catch continues. The prices are decreasing and demand is increasing. Subsidies strongly promote the use of technologies for the fishing vessels, leading to the overcapacity and overexploitation of fishing resources ("too many boats are chasing too few fish"). This negative result of subsidies is proven not only for the fishing resources. The forests have also been overused because of the subsidies.

Economic theory also proves that in the absence of proper sustainable fisheries management, subsidies promote fleets overcapacity.

The final negative result of the fisheries' subsidies was demonstrated by the following example. The subsidizing of a fishing fleet with the aim of its expansion and modernization since the 1960s in Canada finally caused depletion of the populations of Atlantic cod towards the end of the 1980s. Canada was competing with Europe in catches by distant-water trawlers. Because of that competition, Canada introduced the direct grants

and low-interest loans for construction of new and modernization of old vessels. The amount of large trawlers increased, and finally exceeded the capacity needed for catch of the annual quota five times. The depletion of the fish stocks (including cod) eventually caused the "financial ruin" of the fleet. The Canadian government was forced to intervene again with assistance and supporting programs and payments.

The Atlantic Fisheries Adjustment Program (AFAP) in 1990 of the Canadian government was aimed to reduce the number of fishermen, to develop the new fisheries and new kinds of activities for fishing communities. For laid-off plant workers, even special funds and new jobs were provided. A bit later even a moratorium on cod fishing and emergency assistance payments to fishermen and fish plant workers were introduced. The Northern Cod Adjustment and Recovery Program (NCARP) purposed to reduce the number of fishermen by means of early retirement payments and purchasing fishing licenses. However, fishermen just waited out the moratorium rather than seek other lines of work.

The EU is one of the largest "subsidizers" of the fisheries sector. Within the EU ($2.2 billion of fisheries subsidies per year), Denmark, Spain and France lead in the subsidizing of fisheries industry. The EU subsidizes its fisheries under the Financial Instrument for Fisheries Guidance (FIFG) with structural assistance to the fisheries and provides for special payments for fishing access to the waters of third countries. In addition, the EU itself subsidizes fisheries industry. Member states subsidize their fleets independently (State aid), however only after the Commission's approval. EU subsidies take the form of mostly non-capital grants and collective projects supporting local fisheries management and environmental-friendly initiatives.

Economically, these subsidies are not justified, since within the EU almost all of the subsidized vessels would be profitable without subsidies. However, as a result of these subsidies, the EU is one of the largest importers of fish products and the EU waters are extremely over fished. Indeed, most of the endangered fish species are also within the EU waters.

In the course of time the harmful impact of the subsidies has been more or less officially recognized. Even the reverse subsidy programs were launched to decrease the fishing capacity of fleet: some vessels were scrapped, while some fishing licenses were bought back. These programs were, however, insufficient in range and effectiveness. For example, the EU started to reduce its fleet in 1983, but continued to subsidize the construction and modernization of vessels.

Since the end of the 80s, the negative effect of the fisheries subsidies has become a focus of concern at the government level, and more detailed analyses have been conducted. In 1993 the FAO finally published worldwide estimations for fishing subsidies. Studies showed that the revenues out of fishing industry were less than operating costs, by about $22 billion. The costs of depreciation, return on investment, servicing of debt on the vessels themselves, not considered during the study, would constitute additional $10 billion. Apart from the expensive overcapacity of the fishing fleet and subsequent low market price of the fishing vessels (out of the specialized use of this kind of vessels), partly these losses were caused by subsidies. These are disturbing results…

Fisheries subsidies undermine not only the sustainability of the fishing resources. They also significantly undermine the efforts of effective fisheries management, simultaneously damaging the environment and distorting the trade.

The practice shows that the introduced subsidies "settle down" and become almost irremovable. Governments provide for insufficient information on fisheries subsidies or even make it confidential. This makes it difficult to estimate real impact of subsidies on fisheries sector.

The subsidizing of the fishing fleet continues. The attempts to reduce it face strong political opposition especially from the side of the lobbying sectors of the food industry.

The problem with subsidies is that government grants also are able in some cases to reduce fleets capacity. Environmental subsidies, applied by the EU, Japan, Canada, and the United States, try to eliminate the harmful results of the overfishing and fleets overcapacity (e.g. buying back of vessel and fishing permissions, fishermen retraining programs etc.)

Withdrawal of subsidies in fisheries would considerably contribute to the conservation and sustainable use of fish stocks. However, a full retreat from the subsidies in fisheries seems to be unrealistic. The appropriate restrictions have to be made reasonable not to distort positive environmental-friendly trends in subsidizing and to protect the interests of the developing fishing states. The number of people employed in the fishing industry is growing every year, particularly in developing countries. Around 80% of fisheries subsidies of the developing countries are caused by their wish to preserve this employment.

2.2.3 WTO legislative basis

Governmental subsidies distorting international trade, in general, were one of the most intractable problems in the development of international trade law (Thomas, Meyer, 1997 p. 150). From the economic point of view, subsidies lead to the misallocation of economic resources: overproduction and hindered market on the one hand, and deficient governmental budgets on the other hand.

Governmental subsidies are used to lower the producers' production costs. They establish an artificial price advantage. Not only trade, but also international division of labour (Siebert, 2000 p. 139) could be negatively impacted or distorted. Governmental economic aid could be an unfair advantage especially considering the competition between developed and developing countries which transforms in such a way in a struggle "against the treasuries of foreign governments". One disputes further whether disciplines on the granting of subsidies should be introduced and whether the effective remedies together with the countervailing duty would help or, on the contrary, further distort the trade.

As for legislative basis, fisheries subsidies are regulated only by the general subsidies rules of the WTO Subsidies Agreement (the SCM Agreement). Special WTO provisions are still lacking. The issue of subsidies within the WTO is regulated by the Agreement on Subsidies and Countervailing Measures adopted during the Uruguay Round. The core idea behind the original version of this Agreement (the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the GATT or the Subsidies Code) is inadmissibility of harm or harm threat to the trading partners as a result of the government subsidies to a domestic industry.

The only existing definition of the term "subsidy" is contained in the WTO's Agreement on Subsidies and Countervailing Measures. This is due to the lack of the consensus concerning the definition of the subsidy. Article 1 of the SCM Agreement provides for a two-part test to prove whether a subsidy takes place here. A government or a public body makes a financial contribution. A benefit from it must thereby be bestowed on the recipient of the contribution.

A traffic light approach has been chosen: prohibited subsidies corresponding to the red light, and permitted and non-actionable: green light. Some subsidies are not prohibited under the Agreement, however if they bring detrimental effects, an action may still be taken against them ("yellow light" or "slow down"-approach).

Against the prohibited or actionable subsidies injuring the Member State one of the remedies is available: dispute settlement process or imposition of the countervailing duty after the appropriate investigation procedure.

The SCM Agreement decides that such types of subsidies as research and development funding, subsidies to disadvantaged regions within a country and subsidies to adapt existing facilities to new environmental requirements do not distort trade.

The issue arising is whether a special legal treatment is needed to the fisheries subsides. Can the existing SCM Agreement be applied to them? The dispute settlement system of the current SCM Agreement could be applied to the fisheries subsidies. Or an issue of fisheries subsidies should be specifically addressed in this Agreement?

2.2.4 WTO strategy on fisheries subsidies

The WTO is now looking for a "win-win" solution to protect the environment and preserve the interests in fisheries of especially developing states.

At present, the WTO tries to develop the general approach to the issue of fisheries subsidies. One disputes whether one has to establish traffic-light approach or impose a broad-based prohibition.

Under a more detailed consideration, one distinguishes between the "no need" approach, the "traffic light" approach and the "special and differential treatment" approach.

Countries actively subsidizing their fisheries (Japan, South Korea, Canada) chose the "no need" approach. According to this approach, the fisheries industry does not need any special regulation. Furthermore, special treatment could rather lead to the fragmentation of the WTO subsidies regime and even possibly of the entire WTO system. Besides, the supporters of this approach doubt that overfishing was partly caused by the subsidies. They propose the cross-sectoral modification of certain provisions in the present SCM Agreement is admissible.

The "traffic light" approach permits some subsidies (green light), prohibits some of them (red light) and makes some a subject to a complaint on the basis of their adverse trade effects (yellow light or "slow down" approach). "Friends of the Fish" (Australia, Chile, Ecuador, Iceland, New Zealand, Peru, Philippines and the United States), EU, China follow this approach. Representatives of this approach clearly define subsidies, which could be harmful and should be prohibited. For example, the U.S. proposes to prohibit subsidies directly

promoting overcapacity and overfishing, or have other direct trade-distorting effects. Chile chooses more detailed approach and lists all kinds of commercial subsidies, which directly geared toward lowering costs, increasing revenues, raising production (by enhancing capacity), or directly promoting overcapacity and overfishing. EU prohibits "capacity enhancing subsidies". Environmental-friendly subsidies supporting retraining, retirement of fishermen, safety improvement subsidies, subsidies promoting better quality or working conditions, more environmentally friendly fishing methods and subsidies for the scrapping of vessels and the withdrawal of capacity are permitted.

New Zealand proposes to prohibit all subsidies causing overcapacity and overfishing, as well as other trade distortions. According to this approach the subsidizing country has to notify an amber light subsidy, otherwise it has to prove that this subsidy did not cause trade injury.

The "special and differential treatment" approach favours and makes some exclusions for small vulnerable developing coastal states by developed or more advanced developing countries.

The broad prohibition of subsidies would be difficult to achieve. In general, fisheries subsidies are supported by the strong lobby of fishing (and even food) industry. Besides, subsidies promoting the reducing of the fleets' capacity seem to be a reasonable measure in this situation. The position of the "no need" approach seems to be also not very stable, since the conditionality of the overcapacity, overfishing and fisheries subsidies is more or less acknowledged. Probably, the traffic light approach would be the chosen path for the legal regulation in this field. However, the sphere of the prohibited subsidies expects to be one of the most controversial issues, prolonging the development of WTO disciplines of fisheries subsidies.

Another controversial issue is whether the existing SCM Agreement is appropriate to deal with the fisheries subsidies or a special treatment is necessary. The matter of subsidies in the fishery sector also gets complicated by the fact that the disclosure and notification of fisheries subsidies are very poor. All fishing countries apply them. The effectiveness of the complaint under the existing SCM Agreement is rather doubtful. Not depending on the following legal destiny of fisheries subsidies, WTO rules on this matter have to comply in generally with the SCM Agreement.

3. The role and participation of other international organizations

However, the WTO reaction will not be sufficient to solve the problem of fisheries subsidies. The cooperation of states and other international organizations both at the international and national levels would be necessary.

The existing international fisheries commission designed to deal with fisheries conservation, management and scientific research don't fulfil their predestination on a full extent and represent rather some kind of "user clubs" (van Dyke, Zaelke, Hewison, 1993 p. 231). But others like FAO, OECD, APEC, UNEP etc. put their efforts into this issue. At least the joint development of data and methodologies and research on the environmental and trade implications of fisheries subsidies will be necessary. In part, they are already carrying them out. The FAO analyzes the issue of the fisheries subsidies, overfishing and overcapacity. 1999 International Plan of Action on the Management of Fishing Capacity contained the call to the FAO Members to reduce or even eliminate harmful subsidies. OECD studies the issue of governmental financial transfers (GFTs) in fisheries and their impact upon it. The APEC is also analyzing the fisheries subsidies in light of the SCM Agreement application.

Conclusions

The 1982 UNCLOS provides for the exclusive sovereign right to manage fisheries resources up to 200 nm from the shoreline to the coastal state. The Agreement for the Implementation of the Provisions of the United Nations Convention on the Law of the Sea of 10 December 1982 relating to the Conservation and Management of Straddling Fish Stocks and Highly Migratory Fish Stocks (Fish Stocks Agreement) adopted in 1995 obliges states to conservation and sustainable management of fish stocks.

Consequently, more or less states themselves are responsible for their politics with the subsidies in fisheries. However, separate national efforts on reducing or elimination of fisheries subsidies won't bring too much. In opposite, it would rather reflect the fisheries management slogan of David Cushing 'sink every other boat but mine'. Or if one rephrases Stephen Cunningham (1985), what *one country loses, immediately gains the other one.* In other words, each coastal state is interested in protection of his own fish stocks. Any other country tries to reduce this protection fence as much as possible. If one state stops to increase its fleet's capacity, his place will be sooner or later be occupied by the other one until the global international regime is developed. In

addition, a couple of nations are not able to find a common solution on the global issue of fishing. During the UNLOSC III, some participants even proposed to abolish the freedom of fishing and establish "the species approach to fisheries management".

This regime requires not only the coordinate work of governments and international organizations. The significant contribution of universities, fishermen, scientists is "a must".

If economy is a help to biology, why can't biology be of help to the economy. The overfishing problem could be (in part) solved by the farming of fishing resources. Moreover, the statistics shows that over 15 000 fish species are still not identified. Perhaps, nature will help humanity. Environmentalists stress that the proper fisheries management could assist almost totally to eliminate the harmful impact on the environment.

Over one half of the world trade in fish and fish products belongs to the developing countries. Paragraph 28 of the Doha Ministerial Declaration makes an express reference to the importance of fishing sector to the developing countries. It is not occasional. The fishing industry means work for 36 million people each year only in primary sectors. Before taking any concrete decision on the reduction or abolition of the fisheries' subsidies, one has also to consider them.

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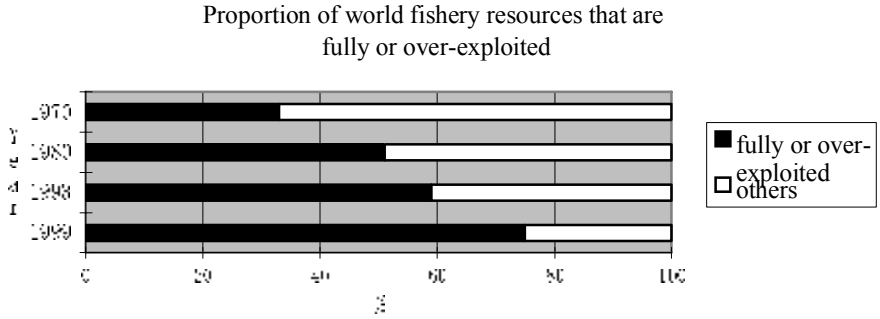
Appendix

Table 1. Types of subsidies (Based on the information from Iudicello, 1999 p. 61)

TYPE OF CAPITAL	ACTIVITY	EXAMPLES	IMPACT
Direct income	Support	Price supports, grants to remove vessels temporarily from a fishery	Support the economically marginal kinds of fishing
Producers' variable costs	Reduction	Fuel tax exemptions	Attraction of investments into the industry
Capital	Facilitation of use	Low-interest loans, loan guarantees that reduce the risk of commercial loans, tax concessions on investments	Attraction of investment into a fishery, especially when the support of commercial banks is in question
Government charges for exploitation of a public resource	Depreciation	Favorable (or even absent) charging of foreign and domestic fleets for access to the fisheries	Promotion of existing and bringing in of new fishermen
Costs of subsidiary activities	Reduction	Subsidies to the shipbuilding industry (lowering of costs for vessel construction), fish ports or fish-processing facilities	Benefits fishing fleets indirectly

Scheme 2. Fishery resources.



Source: Review of the State of World Fishery Resources, FAO 1997, The State of World Fisheries and Aquaculture, FAO 2000

The Development of Maritime Laws in Malaysia – Selected Issues

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Abstract: Malaysia is fast developing in terms of development of infrastructure, including the development of modern ports which facilitate efficient container handling. Malaysia has also invested a large amount of money to enhance its shipping fleet. All this forms part of the aspiration of Malaysia to become a maritime nation in the true sense. Nevertheless, part and parcel of a true maritime nation is the regulation of shipping matters to support the shipping industry. This paper examines the available substantive maritime laws in Malaysia and their suitability in the light of the existing modern character of shipping and international trade.

1. Introduction

The aim of this paper is to have a summary overview of the available key maritime laws in Malaysia. In the light of the call of Malaysia's government to make Malaysia a maritime nation in its 3rd Malaysia Plan in the 1970s, it is essential to have a status check of the current position relative to developments made since then. Malaysia's maritime industry has grown tremendously since then in various areas including having its own shipping fleet and modern ports which can handle vast amounts of transhipments. However, equally strong efforts do not seem to be reflected in the legal support system and regulation of the maritime activities. Nevertheless the realization of this coupled with fervent encouragement by various interest groups are slowly getting changes and improvements to be made.

Malaysia has for a long time aspired to become a maritime nation because of many reasons. Although it was only in the 1970s when the government of Malaysia declared this aspiration, early history has proven that geographically, Malaysia is an ideal location to become a centre for international trade between the East and the West and the Straits of Malacca provided the ideal route for many trading ships to ply and berth because it is a long stretch of coastline protected from the elements by Peninsular Malaysia on the eastern side and the island of Sumatra on the western side. In the old days, international merchant ships would be well acquainted with the Malacca Empire and its busy port.

2. Legislative Background

In assuring proper regulation of the maritime activities and sea trade which contribute towards 95% of the total trade of Malaysia today, many laws have been passed and adopted for this purpose. They include:

1) Merchant Shipping Ordinance 1952 [1] and various regulations made under it
2) Merchant Shipping Act (Oil Pollution) 1994 [2]
3) Ports Authorities Act 1963 [3]
4) Ports (Privatisation) Act 1990 [4]
5) Carriage of Goods by Sea Act 1950 [5]
6) Order 70 Rules of the High Court 1980

Malaysia also adopts the Marine Insurance Act 1906 and Bills of Lading Act 1855 of the United Kingdom. In terms of Admiralty jurisdiction, Malaysia also follows the United Kingdom's Supreme Court Act 1981 by virtue of Malaysia's Courts of Judicature Act 1964. The list goes further and will not be exhausted here. Suffice to say, Malaysia has made many attempts to make sure that almost every aspect of the maritime activities in which she is involved is properly regulated to ensure its smooth running and efficiency in an orderly manner.

Many of the laws are borrowed or passed down to Malaysia from its colonial history. For example the Merchant Shipping Ordinance 1952 was inherited from the Merchant Shipping Act 1894 of the United Kingdom

whilst the Carriage of Goods by Sea Act 1950 applies the Hague Rules which used to be implemented by the United Kingdom in its Carriage of Goods by Sea Act 1924. After its independence in 1957, Malaysia had severed the pipeline through which the common law, rules of equity and statutes of the United Kingdom had been continuously supplied. The laws which have been passed or decided after the cut-off date have been barricaded from automatically applying or having definitive influence over Malaysia's laws [6]. Malaysia now only applies the common law and rules of equity administered in England until 1956 in West Malaysia [7], whereas in Sabah, the common law, rules of equity as well as statutes of general application administered in England until 1951 [8] is applied. In Sarawak the cut of date for the three types of laws is 1949 [9]. Even so, none of them will apply if Malaysia has already legislated on the matter and they are also subject to suitability of the English laws to the local circumstances and inhabitants. Local conditions may also require that certain qualifications to them be made. This is a matter left to the interpretation and wisdom of the learned local judiciary to peruse and decide.

The Merchant Shipping Ordinance 1952 is the single largest legislative provision in Malaysia on various aspects of maritime law. It contains 15 parts which deal with *inter alia* matters dealing with the Malaysian Ship Registry, the Domestic Shipping Licencing Board, the International Ship Registry, certification of masters and seamen, safety of passenger ships, safety in navigation and generally, pollution, load line and loading, procedure for inquiries into shipping casualties, goods delivery, shipowners' liability, wreck and salvage, lighthouses, pilotage, and ports.

There have been many amendments made to it and one of the important ones is the Merchant Shipping (Amendment) Act 1966 [10] which gave legal effect to the International Convention for the Safety of Life at Sea 1960 (SOLAS) and the International Regulations for Preventing Collisions at Sea 1960. Malaysia then ratified SOLAS 1974 in 1983 and in order to fulfil its obligation, entrusted the Marine Department of Malaysia to provide the services of maritime search and rescue (SAR).

The latest enactments in Malaysia include the Malaysian Maritime Enforcement Agency Act 2004 [11] and the Baselines of Maritime Zones Act 2006 [12]. Also in July 2005 an Admiralty Court [13] was established in the Commercial Division of the High Court of Malaya for the first time in Kuala Lumpur, the capital of Malaysia. Another premier for Malaysia is the Practice Directions for Admiralty Actions [14] brought into effect on the 1st of February 2007 in the High Courts of Malaya.

3. Viability of Admiralty Court

There have been many debates going on between the judicial and legal practice as well as feedback from the maritime industry as to the viability of having an admiralty court dealing exclusively with admiralty matters. Most of the debates revolve around the problem of getting enough cases to sustain the workload of such a court and justify resources diverted towards its setting up. On the other hand, the reason why Malaysia has not been able to attract enough maritime law cases is said to be due to the unavailability of such a court.

Between 1997 to 2003, about 371 admiralty cases were filed but the number which actually went to trial was almost non-existent [15]. According to a report made by a judge in the High Court of Malaya [16], for the period between September 2006 until February 2007, the total number of pending admiralty cases in the West Malaysia [17] courts is 75, whereas in East Malaysia [18], the total number of pending cases is only 7. His learned experience also indicates that only 20% will end up in trial whilst the others usually expire. (Khoay, 2007). Nevertheless there is a lot of optimism in the advocated idea of setting up an Admiralty Court that is specialized in dealing with admiralty cases in order for Malaysia to become more competitive in seizing jurisdiction in comparison with more popular jurisdiction for settling disputes like London and in the context of Asia, Singapore and Hong Kong.

Other than the obvious pre-requirements of training judges in admiralty law and procedure, it is also advocated that practitioners could also act as ad-hoc judges especially during the weekends when the offices and courts are closed. (Khoay, 2007). This could overcome the problem of the fly-by-night incidents of ships avoiding arrest by berthing in the ports during the weekends when it is not possible at the moment in Malaysia to obtain a writ in rem to arrest the ship. This is because Malaysia does not as yet have a system where the sheriff can see the judge at his home during the weekends to obtain the warrant of arrest in the way that it is practiced in the United Kingdom and also Singapore. The speed by which such a warrant is obtained on any day is also very critical [19] as the sheriff has to catch the ship before it leaves port.

The issue of the Practice Direction No. 2/2007 for Admiralty Actions is hoped to achieve greater efficiency in overcoming delay. In clause 2 of the Registry heading, it is recommended that the writ of summons in actions in rem be issued within the same day of filing if the urgency of the matter in indicated with the writ in

a Certificate of Urgency. Under clause 4 a) of the same heading, the warrant of arrest and/or service of a writ of summons by the sheriff shall also be effected on the same day it was issued, either by the sheriff himself or an appointed officer appointed by him. Clause 4 b) provides that the sheriff must also issue the instrument of release within the same day of filing for release from arrest and may allow the plaintiff's or defendant's solicitor to attend to the service of the instrument on behalf of the sheriff.

A significant provision in the Practice Direction is clause 5 which deals with the situation where the Registry is closed, but the there is an urgent need to obtain the warrant of arrest, writ of summons or the release instrument. It enables the Registrar to immediately process the issue and direct the sheriff to effect the required service, execution or release if the there is an undertaking by the solicitors of the applicant to file in the required documents and effect payment on the next working day of the Registry.

In relation to writ of summons and warrant of arrest issued by any registry which is not situated in the same jurisdiction in which service or execution is to be effected, clause 7 makes certain provisions to expedite the matter. Clause 7(i) provides that the sheriff of the issuing court may request the assistance of the sheriff in the jurisdiction effecting service or execution. The writ of summons and warrant of arrest may also be faxed by the issuing court with a letter requesting for assistance to the executing court whilst the original is dispatched for immediate service and execution [20]. If the sheriff of the executing court is not available, the sheriff of the issuing court or his officer may travel at the expense of the arresting party to effect service and execution outside the jurisdiction of the issuing court [21].

A list of matters which must be expedited in being heard, disposed of by the registrar and/or judge and returned in not more than three working days have been enlisted in Clause 8. They include matters relating to conditional appearance, bail bond, quantum of security, setting aside of writ, release of res from arrest, intervention, inspection of ship, judgment by default, appraisement and sale of res, discharge of cargo, and order of directions arising out of or in relation to the res under arrest, including matters pertaining master and crew. In order for the three working days rule to apply, the urgency of the matters has to be indicated in that the applications or motions in relation to the above matter must be filed together with a Certificate of Urgency.

In relation to hearing and disposal of the matters enlisted in clause 8, the Head Judge may direct any judge or registrar of the High Court to hear and dispose of the matter if the assigned judge or registrar is unavailable [22]. Other matters in the Practice Direction deal with language of the court papers [23], deposit and undertaking for the sheriff's fees and expenses for the arrest and custody of the ship and its contents, the ability of the sheriff to effect service outside port limits, and to deal with the ship appropriately [24].

4. Outdated maritime laws

It is also suspected that the lack of popularity of Malaysia as a jurisdiction to settle maritime disputes is because of the apparently outdated maritime laws currently in use. As mentioned above, Malaysia's Merchant Shipping Ordinance 1952 as well its Carriage of Goods by Sea Act 1950 is already half a century old. Also reliance is also made to archaic English law provisions which have since been further amended or abolished to deal with inherent problems. Since Malaysia has severed the pipeline as mentioned above, she no longer receives these developments in the law. There are many aspects of Malaysia's maritime laws which are still trapped in the 'past' but the discussion in this paper will be limited to two main statutes which are the Merchant Shipping Ordinance 1952 and the Carriage of Goods by Sea Act 1950.

The Merchant Shipping Ordinance as stated above is a voluminous act which encompasses several aspects of maritime regulation. However what will be focused upon here is Part IX of the Ordinance which deals with liability of ship-owners. Part IX provides for the adoption of the International Convention relating to the limitation of the liability of owners of sea-going ships 1957 or also known as the Limitation Convention of 1957. This convention deals with the exclusion or limitation of liability of ship-owners. The shipowners' ability to limit liability for loss of or damage to goods, or loss of life or injury is dependent upon them proving the absence of actual fault or privity [25]. The concept of actual fault and privity has been criticized as causing difficulties to ship-owners relying on the limitation of liability provision because of the burden upon them to prove that there was no personal fault on the part of the controlling mind of the company in the management of the vessel which includes training of officers and crew of the ship as well as its repair and maintenance.

5. International Conventions

It was partly on this basis that the 1976 Limitation of Liability Convention was created which is said to be more certain in the determination of the right to limit liability. Under this convention, the person seeking to break the

limitation has to prove that the loss resulted from the shipowner's act or omission committed with the intent to cause loss, or recklessness and with the knowledge that loss would probably result.

In the case of *Liong Ung Kwong v Kee Hin (M) Sdn Bhd & Anor* [26] a ship was in the final stages of loading when it began to list towards the port side and continued rolling until it capsized and sank, cargo and all. Fortunately just before capsizing the mast of the ship was caught by the wharf momentarily and the master managed to order his crew to abandon ship before the mast broke and the vessel shifted away from the berth. The cargo owners then commenced action for the loss of their cargo due to breach of contract and negligence of the ship-owner and his servants or agents. The ship-owner in this case sought to rely on section 360 of the Merchant Shipping Ordinance 1952 which provides as follows [27]:

> Section 360. Limitation of owner's liability in certain cases of loss of life, injury or damage.
>
> (1) The owner of a Malaysian or foreign ship shall not, where all or any of the following occurrences take place without his actual fault or privity, namely:
>
> (b) where any damage or loss is caused to any goods, merchandise or other things whatsoever on board the ship;
>
> (d) where any loss or damage is caused to any property, other than any property mentioned in paragraph (b), or any rights are infringed through the act of any person, whether on board the ship or not, in the navigation or management of the ship, or in the loading, carriage or discharge of her cargo, or in the embarkation, carriage or disembarkation of her passengers, or through any other act of any person on board the ship,
>
> be liable to damages beyond the following amounts:
>
> (bb) in respect of such loss, damage or infringement as is mentioned in paragraphs (b) and (d), whether there is in addition loss of life or personal injury or not, an aggregate amount not exceeding an amount equivalent to one thousand gold francs for each ton of the ship's tonnage.

The main issue for the court was to determine whether the sinking of the MV Hua Leong had occurred without the shipowner's actual fault or privity, as this determines the availability of the s.360 protection to the shipowner. In this case, the day-to-day management of the ship had been delegated to a management company. It was argued by the plaintiff's counsel that it is the absence of actual fault on the part of the managers then that has to be established.

The court held that the onus is on the shipowner to prove that the event occurred without his fault because the requirement is 'without his actual fault or privity'. These words imply personal blameworthiness which is distinct from constructive fault or privity. The latter relates to the fault of his servants or agents. This was the principle laid down in Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd [28]. A shipowner's personal duty is an obligation of the shipowner which is not relinquished simply by delegating performance of the duty to someone else, unless the shipowner was not privy to the actual fault of the person employed by him. It is not approached in the positive sense in that pointing the finger to the fault of his servants or agents is insufficient. It must be negative in the sense it was not his fault. This, the court held, can take two forms.

The first relates to seaworthiness of the ship where the shipowner fails to provide safe equipment, qualified personnel and a safe system of work. The second relates to instructions to those using the equipment and system, and instructions in the proper method. In this case the vessel was found to be in a seaworthy condition physically, as well as having qualified and competent master and crew. The court also held that even if the master was negligent, it cannot be imputed to the shipowner where there is no history of negligence of the master known to the shipowner. Also, where the master or owner is not aware of objects on the seabed which could damage the ship's bottom, fault or privity of the shipowner was not what caused the ship to sink.

Another point noted by the court was that there was no need to make any admission of liability before an application for a declaration of the limitation of liability of the shipowner under s.360. The finding of the court in this case was that the shipowner was entitled to the protection of s.360.

The other statute which will be discussed is the Carriage of Goods by Sea Act 1950. This Act implements the Hague Rules [29] in West Malaysia whilst in East Malaysia, the rules are implemented by the Merchant Shipping (Applied Subsidiary Legislation) Regulations 1961 in Sabah, and the Merchant Shipping

(Implementation of Convention relating to Carriage of Goods by Sea and to Liability of Shipowners and Others) Regulations 1960 in Sarawak.

The Hague Rules was the first attempt to balance the rights and obligations of ship-owners and shippers and was suitable in those days when it was first passed because of the prevailing circumstances when operations in shipping was less complicated. Later, international trading became more complex with layers of intermediate traders and this, coupled with enhancement of navigational technology commonly caused the bill of lading to arrive later than the cargo. There was also the introduction of containerization and evolution in bulk carriage. (Selvaratnam, 2007). The inherent weaknesses of the Hague Rules became apparent and the move to improve it was called for. Hence the making of the Hague-Visby Rules [30] in 1968, and later the Hamburg Rules [31] 1979.

Malaysia has not adopted any of these later conventions, although a draft bill was made in 1970 to amend her laws to incorporate the Hague-Visby Rules. The bill was never passed until today. Since Malaysia still, despite efforts to boost Malaysia's fleet of ships, remains predominantly a shipper nation rather than a shipowning nation, the choice to remain with the Hague Rules does not seem to be appropriate. For example the limit of liability of 100 pounds sterling per package had been interpreted by the case of Sebor (Sarawak) Trading v Syarikat Cheap Hin [32] to mean exactly that instead of the value of the gold content of 100 pounds sterling. (Selvaratnam, 2007). By adopting the Hague-Visby Rules, not only the shippers will be more protected, the Malaysian fleet will also grow because shippers no longer have a reason to avoid Malaysia's port of call.

6. Conclusion

In conclusion, in line with Malaysia's quest to become a maritime nation, it is important to identify the building blocks that make it such, not only in terms of the technological and infrastructural advances but also in the development of adequate and useful laws which acknowledge and addressee the needs brought about by changes in the character of international trade by sea.

Notes:

[1] Ord 70/1952 during the time Malaysia was known as the Federation of Malaya.
[2] Act 515.
[3] (Revised 1992) Act 488.
[4] Act 422.
[5] (Revised 1994) Act 527.
[6] S. 3 of the Civil Law Act 1956.
[7] S. 3(1)(a) of the Civil Law Act 1956.
[8] S. 3(1)(b) of the Civil Law Act 1956.
[9] S. 3(1)(c) of the Civil Law Act 1956.
[10] Act 15/ 1966.
[11] Act 633.
[12] Act 660.
[13] Court 3 of the Commercial Division.
[14] Practice Direction No. 2/2007 Admiralty Actions.
[15] "New Court for Admiralty Cases", Sharidan M. Ali, MIMA Newsflash (July 2005).
[16] YA Dato' Vincent Ng Kim Khoay who heads the Commercial Division of the High Courts in Kuala Lumpur.
[17] Peninsular Malaysia.
[18] Which comprises of the states of Sabah, Sarawak, and the Federal Territory of Labuan.
[19] In Singapore this can be achieved in a mere couple of hours.
[20] Clause 7(ii) of the Practice Direction No. 2/2007 for Admiralty Actions.
[21] Clause 7(iv) of the Practice Direction No. 2/2007 for Admiralty Actions.
[22] Clause 9 of the Practice Direction No. 2/2007 for Admiralty Actions.
[23] Clause 11 – 12 of the Practice Direction No. 2/2007 for Admiralty Actions.
[24] Clause 15 – 17 of the Practice Direction No. 2/2007 for Admiralty Actions.
[25] S. 359 – 360 of the Merchant Shipping Ordinance 1952.
[26] [1998] 1 AMR 368.
[27] Only the relevant parts are cited here.

[28] [1915] AC 705.
[29] The International Convention for the Unification of Certain Rules of Law relating to Bills of Lading, Brussels, 1924.
[30] Protocol to amend the International Convention for the Unification of Certain Rules of Law relating to Bills of Lading, Brussels, 1968.
[31] The United Nations Convention on the Carriage of Goods by Sea 1978.
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An East-West Contrast of Foreign Direct Investment on Small Business Development.

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Abstract. Foreign investment continues to play a greater role in business activity across the globe. It is therefore important to assess the main trends and reasons behind this increased activity so that business can make effective decisions on how they wish to engage in further global expansion. The paper further explores the importance of country specific legislation in determining the decision whether to invest. FDI can also have positive benefits on employment and enterprise which will also be considered. This article sets out to contrast the investment flows taking place in both East and Western countries and considers the main determinants of activity in these countries. Theories of internationalisation will be drawn upon as well as the use of investment data in order to explain investment behaviour. A Business History perspective will also be drawn upon. The article then considers future possible trends in light of these recent developments.

I. Introduction

The role of foreign investment in business activity has continued to increase across the globe. This increased activity necessitates an investigation into and identification of the main trends and reasons underlying this increased activity so that business' can make strategic decisions on how they wish to engage in further global expansion. There is also a need to examine how FDI can have positive benefits on employment and enterprise.

This article sets out to contrast the investment flows taking place in both East and Western countries and considers the main determinants of this activity in these countries. To this end, analysis will draw upon theories of internationalisation which will be supported by investment data in order to explain investment behaviour. More specifically, a 'Business History' perspective will also be utilised. The article will also consider future potential trends in light of these recent developments

2. Historical Perspective: FDI

Foreign direct investment first became prominent in Western Europe after 1945.

There had, however, been some early activity tracing back to 1900 though this often involved large multinationals resource seeking in former colonies .The post war period saw the emergence of the market seeking multinational where substantial tariff barriers still existed and firms looked for avenues of entering new markets as the home markets became saturated .Table one shows the early period of FDI development.

With respect to the UK, the data shows the UK's dominant position prior to and after the Second World War. After this period America begins to take the lead. The UK predominance, as Yannopoulos 1990 suggests, may partly be explained by the fact that Japanese multinationals were setting up in the UK in an attempt to penetrate the EU market. This was possible because, in many cases, Japanese goods assembled in the UK could be classified as EU goods and subject to zero tariffs.

The 1970s and 1980s witnessed Japan emerging as a major player in FDI activity. This was possible because Japan, at this time, had the advantage of a low cost production; was focused on the production of reliable but good quality products. Japan's labour force was also well focused on the 'firm' and employees were very prepared to work a large number of hours. Efficiency seeking then became more important than market seeking in Western Europe as tariffs started to fall due to the work of the WTO.

Much FDI went into the UK in the 1980s and 1990s and small centre of excellence were formed such as silicon Glen. There were further multiplier effects from the establishment of large foreign investors and the

creation of technology parks in Wales, The Midlands and the North East in both the car and electronics sectors. Local entrepreneurs arrived to serve these local markets. Floyd 2002 shows how the number of supplier linkage varies depending on the type of investment and industry according to a study of MNES operating in Poland during the late 1990s.

In the 1990s however, costs rose in Japan due to a stronger currency and Europe and USA began to close the productivity gap to some extent. The years since 2000 have seen China and Korea also emerge with a cost advantage. These countries are also starting to create global firms in the top 500 FT index such as Samsung and Haier.

3. Current and Future Trends

Advances in free trade and the expansion of WTO membership have led to further increases in FDI activity. Firms entering Eastern countries, however, are still adopting resource seeking and market seeking strategies in many cases due to the barriers to trade that still exist. These barriers will mean that progress for new members joining the WTO will still take some time to be realised.

Foreign investment in Western Europe was dominated by USA until the emergence of Japanese FDI. Asia on the other hand has been influenced by foreign investment from Japan, USA and Europe (see Table 2). There is also a greater focus on foreign investment in the tertiary sector in Western Europe. It is only recently, for example, that China has allowed its banking sector to be open up. In addition, Liu 1997 found the international competitiveness of the manufacturing sector to be based on low cost advantage by his application of the Porter Dunning Diamond model. Park 2006 suggests that China's success is due to institutional reform that has encouraged foreign investment particularly in certain regions of the country. The World Investment Report 2006 shows China to now be producing more scientists and engineers than many developed countries and in the future China will be able to compete with Japan in the higher value added manufacturing products. There is also a regional focus for the largest investors , for example in China , Hong Kong and Japan and the top 10 Asian countries account for almost 60% of FDI in China in 2006, see UNCTAD and Invest in China figures. The EU accounts for 17% and the USA accounts for 11%.

4 Analysis and application of the literature on Foreign Direct Investment

During earlier periods, such as the 1980s, the USA accounted for a much larger share of the total investment; this was also true in Central and Eastern Europe. Investment here, however, is now more dominated by European firms due the importance of the distance factors in determining investment decisions, see Floyd 1996. In terms of entrepreneurship, Chinese entrepreneurs tend to be more export focused than those in other countries. Private enterprise now accounts for over half the wealth in China. In terms of entrepreneurship small firms are growing and now lay alongside large foreign investors in regions along the Pearl River Delta. In Beijing an area has been named Silicon Alley due to the build up of expertise in electronics and computing.

The USA's foreign investment has been aimed towards Europe rather than Asia. For instance, 41% of foreign direct investment in the UK is from USA despite the physical distance factor compared with only 11% investment in China. Some of the reasons for this may be historical in that the USA has been open to trade with the UK for hundreds of years due to its colonial past as well as being a political ally in the last two major world wars.

The main motives for foreign direct investment activity have been analysed by many scholars however historical and cultural factors as those suggested above have often been neglected. Theories of FDI stem firstly from Dunnings OLI paradigm. Ownership advantages firstly include management skill, foreign firms with these advantages may wish to bring in these skills to compete against the local firms. This has been true for both Eastern and Western countries though skill levels in Western countries have been of a higher level in many cases but of late skills in Eastern countries have also improved.

This would be the similar case for the additional ownership advantage of technology. Marketing is seen as another advantage. More sophisticated marketing has taken place in Western countries. More recently Eastern countries are opening up to foreign trade and seeing a greater variety of products.

Firms may also bring into a foreign country the further ownership advantage of capital. This helps explain why both Eastern and Western countries are happy to see foreign investment since they welcome money brought into the country and hope that foreign firms can then contribute to taxation revenues, providing firms do not avoid this by using transfer pricing mechanisms.

The final ownership advantage includes economies of scale; it is true to say that there are more opportunities for this in Eastern countries since there is a present a larger supply of low cost labour and a larger market size.

Location factors are often suggested to be most important in emerging markets. These include factors such as market size and labour costs and studies such as Floyd 2002; Meyer 1995. Market access depends both on population and income; countries such as China have larger populations than Western Europe though many Western countries have greater purchasing power. Both Eastern and Western countries offer government incentives such as low taxes to increase foreign investment and in this field the motives for Eastern and Western countries are similar. The final location factor includes political and economic stability; here investors in Eastern countries have often cited infrastructure and corruption as being the main barriers to increasing investment activity see Bitzenis 2006. In addition, China and India also suffer from a lack of patent protection which puts off foreign investors. This is something which needs to be tackled by the WTO in future years.

Internalisation advantages include choosing the best method of entering a foreign market. Williamson 1981 suggests Greenfield is the most favourable entry mode due to lower transaction costs and greater certainty. Root 1987 suggests that firms first export then try mergers or joint ventures and finally move on to Greenfield. In Western countries Greenfield is most popular see Williams 1999, however in countries such as China mergers and joint ventures have been more popular, this could be due to the fact it is better to work with a local partner in an uncertain market see Freeman 2006. The resource based view of Penrose 1959 also suggests that the entry mode decision will depend on the resources available. In the case of Eastern countries more resources are now available due to industrialisation and therefore more advanced forms of entry mode including Greenfield is becoming more popular.

More recently, more integration is taking place in China as firms are taking over suppliers as well as integrating in a forward direction in order to link in more with the distribution chains. Furthermore governments in Eastern countries have been less dictatorial on the choice of entry mode available to foreign firms of late so in this domain the motives for foreign investment are becoming similar for both Eastern and Western countries.

Other theories include Vernons product life cycle. This is more applicable to Eastern countries where low cost labour is in abundance and there is a great deal of low cost manufacturing investment at the later stages of the product life cycle. However, recently research and development at the early stages of the product life cycle is now taking place in both Eastern and Western countries though more applied research is evident in the West, see Pearce 1990. Finally Flowers theory of oligopolistic interaction suggests that multinationals often adopt the same strategies of rival firms and follow the same entry decisions into new markets. Indeed this is the case in both Eastern and Western countries alike. In the automobile sector for example the big six have now entered most markets shortly after the first foreign firm has made a presence in the market.

V. The Future and Current Observations

FDI in China has now surpassed USA, though on a per capita level it is lower than Singapore. A large proportion, 70% is in manufacturing and this may increase further as China manufactures a wider range of products. There tends to be less merger activity in China compared with Eastern Europe .China is also moving up the value chain according to Lall 2005 and has the lion share of exports in electronics as well as increasing its research activity. China is also now beginning to make links with African countries for both resource seeking activities as well as seeking potential for future low cost manufacturing. China differs to European countries in that the whole Asia region is growing faster than Europe and consequently there is less substitution taking place. The age of the population is also lower in Asia compared with Europe. The shift from agriculture into manufacturing has been much more dramatic in China compared with Eastern Europe see Sakwa 2006. China also has fewer resources than other countries such as Indonesia

Finally most FDI is likely to come from Chinese speaking countries although early investors included some Western large firms wishing to gain a first mover advantage. For example Hong Kong undertook twice the amount of FDI as all the developed countries shown in the most recent trends in FDI activity. FDI from Japan was similar to the levels of the USA indicating that this is very different from Eastern European countries where there is a greater share of European based activity. Some Western firms may have been put off by the political aspects of doing business in Asia as well as the higher levels of corruption. Cuervo-cazurra (2006) suggests that firms experiencing higher levels of corruption in their countries are more willing to engage in FDI in countries that also experience corruption.

6. Conclusion

It has been shown that foreign investment in Eastern and Western countries shows some similar characteristics. Firstly all countries are seeing an increase in such activity due to the globalisation process and the expansion of world trade. There is also a more regional focus of investment taking place. The regions differ in that there is more manufacturing investment taking place in Eastern Countries and China. There is also huge potential for economies of scale in this domain. There is also more high tech investment taking place in the West. Furthermore there is more market and resource seeking activity taking place in Eastern countries and more efficiency seeking taking place in the West. This could be a consequence of Eastern countries joining the WTO at a later date than Western countries. It has also been suggested that many Eastern countries experience higher rates of corruption and poorer infrastructure. Finally investment from the USA accounts for a much smaller percentage of total investment in Eastern countries such as China compared with European countries such as the United Kingdom. It is therefore not the distance factor but historical and political factors that may have influenced this. In the future it has also been shown by application of internationalisation theory and investment data that firms are more likely to invest in Eastern countries for higher value added manufacturing products as these ownership advantages become more developed. Thus additional components of internationalisation theory will therefore become more important when applied to Eastern country cases. In terms of entrepreneurship it has also been pointed out that entrepreneurs in Eastern Countries such as China tend to be more export focused than those in the West. This could be due to the fact that countries like China have opened up to globalisation at a later period as well as viewing the West as of great potential resource to increase local wealth. In the West there has been more focus on supplying local firms for employment as more firms see greater potential in serving local markets. Entrepreneurship has the potential to become more important in China since foreign investment has begun to occur in higher value adding manufacturing activities though investment has been targeted more on specific regions. Historically, Eastern Europe has had greater involvement in manufacturing but China has now quickly caught up. Whereas, with Western Europe's good local infrastructure, there may have been less need to focus on overseas markets, however, Eastern Europe is now catching up in this domain. For the future, globalisation of business and increased activity in the developing countries will mean that entrepreneurs in the West may have to consider investment abroad and realise the potential of foreign investor firms in order to compete more successfully.

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Table Two Utilisation of Foreign Investment in China Year 2005

Country	Number of Projects	Percentage
Total	44001	
Ten Asian Nations	30671	70.18
Hong Kong	14831	33.71
Indonesia	128	0.29
Japan	3269	7.43
Singapore	1217	2.77
South Korea	6115	13.9
Malaysia	371	0.84
Thailand	147	0.33
EU	2846	6.47
USA	3741	8.5
Germany	650	1.48
UK	553	1.26

Source Foreign Investment Department of China

Table One

Estimated Stocks of FDI 1914-1978

	1914 $m	1960 $m	1978 $m
Developed Countries	14,302	66.0	380.3
USA	2,652	32,5	162.7
Canada	150	2,5	13.6
UK	6,500	10,8	50.7
France	1,750	4,1	14.9
West Germany	1,500	0.8	28.6
Netherlands	1,250	7,0	28.4
Sweden	-	0.4	6.0
Russia	300	-	-
Japan	200.5		26.8

Source: Dunning J 1993 The Globalisation of Business, Routledge

Truth finding: Do Subsidies Continue After Privatization?

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Abstract: the theme of this article is to discuss whether a pre-privatization subsidy would be extinguished after privatization of entities. Since WTO AB held that privatization at arm's length and for fair market value may, not must result in extinguishing the benefit, it provides possibilities for the investigating authorities to develop more methodologies to examine the issue. Actually, how to define a fair market value directly influences standards employed by the investigating authorities to assess the problem. After reviewing the changes of U.S. methodologies of assessment, this article intends to clarify the crucial meaning of fair market value, claiming a fair way in which the transaction of privatization is conducted more effectively ensures realization of a fair market value.

Keywords: subsidy, privatization, fair market value, ASCM

1. Introduction

A subsidy in ASCM [1] means a financial contribution or benefit thereby conferred by governments or any public body within the territory of a member country. Subsidies exist in various forms. This article makes an attempt to address the continuity of subsidies especially after privatization. For example, a steel producer obtained a subsidy from the government while it was a state-owned enterprise. Aided by the provision of subsidies, the steel producer was encouraged to export and therefore made a great improvement in its produce. In the recent reform of this country, privatizing the steel producer was necessary, and then transferred to a new producer. A question arises here whether the privatized steel producer still enjoyed the benefit of subsidies, and accordingly would be subjected to countervailing duties [2] from other countries upon its steel exports, only because the prior steel producer did receive the subsidy before privatization. Will a non-recurring financial contribution to the previous owners still confers a benefit to the new owners and therefore qualifies as a countervailable subsidy? [3]

The WTO Panel, in many of its cases, ruled that "while Members may maintain a rebuttable presumption that the benefit from prior financial contributions (or subsidization) continues to accrue to the privatized producer, privatization at arm's length and for fair market value is sufficient to rebut such a presumption". [[4] The Appellate body clarified that privatization at arm's length and for fair market value may not result in extinguishing the benefit. However, how to define a fair market value varies and is not fixed because of the different places, time, and the methods of privatization.

In fact, the problem would become more complicated when the subsidy is offered during the process of privatization. The interplay between privatization and countervailing duties laws occurs at two main points: the treatment of past subsidies to enterprises (whether they are extinguished by the transfer of ownership), and the treatment of subsidies given in connection with the privatization process as incentives to private purchasers.[5] The second treatment is directly concerned with privatization itself.

Privatization is the transfer of property or responsibility from the public sector (government) to the private sector (business). The term can refer to partial or complete transfer of any property or responsibility held by government. There are three main methods of privatization: (1) share issue privatization – selling shares on the stock market. Share issue requires a mature and sufficiently developed capital market, otherwise it is difficult to find enough buyers, and transaction cost would be high; (2) Asset sale privatization – selling the entire firms or part of it to a strategic investor, usually by auction. As a result of higher political and currency risk deterring foreign investors, asset sales are more common in developing countries; (3) Voucher privatization – shares of ownership are distributed to all citizens, usually for free or at a very low price. It has been mainly used in the transition economies of Central and Eastern Europe, such as Russia, Poland, the Czech Republic, and Slovakia. To judge whether a subsidy is transferred to the new owner after privatization, the choice of methods of

privatization closely relates to the answer, because the standard to test the "transfer of subsidies" in privatization by an auction may no longer apply to the voucher privatization. Therefore, while U.S. intends to lists the factors to proceed to a consideration of whether the sale of privatization was at arm's length for fair market value, it needs to consider the method of privatization, but it appears not.

This article intends to analyze the basic standard set up by WTO Appellate body firstly. Pertinent to the proposed methodology and the factors that might be considered by U.S. government in the test of subsidies continuity, a clarification is made that some considered factors are not appropriate for judging whether subsidies are transferred to a new privatized entity. The article is divided into three parts: firstly, reviewing the WTO rules and cases, especially looking through the development of methodology to test the "transfer of subsidies" by U.S. government. Secondly, introducing and analyzing the new factors and possible standards of U.S. to test fair market value, in order to point out irrationality of some factors. Thirdly, identifying some unresolved problems during the process of test, and attempting to find the solutions for them.

2. The WTO rules and findings

With respect to assessing the transfer of subsidies after privatization, the only rule in Uruguay Round Agreement on Subsidies and Countervailing Measures (ASCM) concerning this problem is Article 27.13

> "The provisions of Part III shall not apply to direct forgiveness of debts, subsidies to cover social costs, in whatever form, including relinquishment of government revenue and other transfer of liabilities when such subsidies are granted within and directly linked to a privatization programme of a developing country Member, provided that both such programme and the subsidies involved are granted for a limited period and notified to the Committee and that the programme results in eventual privatization of the enterprise concerned."

In other words, in consistent with necessary conditions such as notification to the Committee, some partial subsidies can be not actionable if the subsidies encourage the privatization. As for this Article 27.13, there are three points needed to be clarified: firstly, this article only applies to developing countries, rather than the disputes between U.S. and E.C., since this article is part of Article 27 entitled with Special and differential treatment of developing countries members. However, the definition of "developing countries" is not clearly given in ASCM. Secondly, the subsidies that are only granted within or directly linked to a privatization might not be considered for countervailing duties by import countries. Virtually, the purpose of most subsidies offered during the process of privatization is to encourage privatization of entities rather than encourage exports or use of domestic over imported goods, thus such subsidies are not prohibitive subsidies. It also provides an answer to whether a concurrent subsidy with privatization, e.g. debt forgiveness, relinquishment of government revenue and transfer of liabilities, can be extinguished during the privatization, or a new subsidy to the new owners, provided the subsidies can just cover social costs. However, it only happens in privatization of developing countries instead of developed countries. Thirdly, due to the purpose of such subsidies offered to encourage privatization, they are not categorized to prohibitive subsidies, but actionable subsidies. If such subsidies are cover social costs or contingent upon export or use of domestic over imported goods, or happening before privatization, they should be actionable or even prohibitive.

Obviously, it does not answer the question of whether the subsidies offered before privatization would be extinguished in privatized entities. Nonetheless, the WTO Appellate Body in United States- countervailing Measures Concerning Certain Products from the European Communities, WT/DS212/AB/R (December 9.2002) recommended an option to assess the problem.

The Panel clarified that its findings apply only to changes in ownership that involve privatizations in which the government retains no controlling interest in the privatized producer and transfer all or substantially all the property.[6] The Panel then stated that "while Members may maintain a rebuttable presumption that the benefit from prior financial contributions (or subsidization) continues to accrue to the privatized producer, privatization at arm's length and for fair market value[7] is sufficient to rebut such a presumption" [8].

While the Appellate Body clarified that privatization at arm's length and for fair market value may result in extinguishing the benefit. Indeed, we find that there is a rebuttable presumption that a benefit ceases to exist after such a privatization. Nevertheless, it does not necessarily do so. There is no inflexible rule requiring that investigating authorities, in future cases, automatically determine that a "benefit" derived from pre-privatization financial contributions expires following privatization at arm's length and for fair market value [9].Privatization may, not must, result in extinguishing the benefit. The Appellate Body changes an irrebuttable presumption into a rebuttable presumption.

As for this case, the first question arising is why subsidies could be extinguished if the transaction of privatization is made at arm's length and for fair market value. Since a government grants a financial contribution to a pre-privatization entity, it is possible for the pro-privatization entity to get the benefit of the subsidy. The purpose of the countervailing duty law is to offset the competitive benefit enjoyed by subsidized firms. The mere change of ownership of the shares from the government to the private company does not reduce the competitive benefit and therefore it is difficult to say the prior subsidies do not pass through to new entities. Before assessing whether the finding is reasonable, the following is an example:

Consider a person ("A") who is given £100 through a government financial contribution. This £100 confers a "benefit" on A, as the recipient of the money. A then purchases a chair with the £100. He sells the chair to an unrelated purchaser, B, for its fair market value, £100. This example shows that the "benefit" of the £100 has not "passed through" to B. The government is £100 poorer and A is £100 richer; both before and after the sale of the chair. B has not benefited at all. He has exchanged £100 for a chair which is worth that amount. If the price increases in value to £ 125, A received a benefit of £100 from the government, and made a profit of £ 25 due to the increased value of his purchased asset, no benefit conferred to B. If there are too many chairs providers in the market and at the price declined by £25, B buys the chair for £75. In this case, B does not benefit from the government contribution, and the government has spent £100.

Therefore, after Firm A is owned by the state and has received financial contributions for some years, the company is valued at £100 million. Firm B, in the same industry, has the identical type of plant and equipment, but has never received any government assistance. The two companies are put up for sale in a competitive bidding process. The companies will have the same value to prospective purchasers, and they should sell for the same price. This is because a rational purchaser is indifferent between the two firms. The rational purchaser would not offer a higher price for Firm A than for Firm B simply because the former had received a subsidy. Nor would a purchaser value Firm B at a higher amount because it had never received any government assistance."[10].

However, if the privatization involves debt forgiven by the government, or tax relinquishment as negotiated, some could argue that the change in ownership did not affect the pass-through of benefits and therefore, the repayment of any remaining value of prior subsidies apart from the market value will result in their extinguishment. However, "since a given transaction is at arm's length, one must conclude that the buyer and the seller have negotiated in their respective self-interests, the buyer has taken into consideration all relevant facts, and has paid an amount which represents the market value of all it is to receive. Because the countervailable benefit does not survive the arm's length transaction, there is no benefit conferred to the purchaser and, therefore, no countervailable subsidy within the meaning of the US CVD [11. statute. The purchaser, thus, will not realize any competitive countervailable benefit and any countervailable duty assigned to it amounts to a penalty"… [12]. Accordingly, "at arm's length", to some extent, can ensure the transaction of privatization is made at market value, and the proper economic inquiry in consideration of whether benefit or advantage has pass through to a buyer should be the degree to which the authorities consider that "market value" was paid. Such consideration includes the fairness and transparency of the negotiation and sales process and adequacy of value received for the company based on commercially meaningful criteria. [13]

3. Treatment of countervailable subsidies after privatization

Reviewing the history of American cases concerning subsidies "pass-through" after privatization, we could determine whether subsidies continue to exist after privatization from the debate of U.S. national decisions. The constant change of methodologies to examine this problem reflects U.S. trade policies are seriously influenced by different interests groups. In order to determine the truth about this problem, it is necessary to research on different concerned phases. The Department of Commerce (DOC) intends to come up with standards to examine this issue. Four phases of policies and the treatment of countervailable subsidies after a privatization transaction are identified.

Phase 1. The full-extinguishment approach establishes the principle in Lime from Mexico [14] that if the privatization is at transaction at an arm's length, the subsidies before privatization do not lead to pass-through of any pre-privatization subsidies. The Mexican government sold one hundred percent of ownership in Sonocal to Bomintzha, a private company, at the price determined in the process of bidding, while considering various factors such as "the continued economic viability of the company and the preservation of employment". [15] Having determined that there was an actual sale, DOC came to the conclusion that the price paid for the privatized company reflected its market value and that "therefore no benefits to [the government owned company] passed through to [the privatized company]" [16].

Phase 2. The "Pass-Through" methodology is formulated in Certain Hot-Rolled Lead and Bismuth Carbon Steel Product (U.S. – Lead bars). [17] The DOC radically changes its policy position, assuming that all pre-privatization subsidies automatically pass through to the new owners. In this case, privatization involved debt by the government as part of the negotiated transfer of majority ownership and merger to create a new company. [18] The government did not only retain the control after privatization, but also had a negotiation with only one bidder. It resulted the petitioner argued that the change in ownership did not affect the pass-through of benefits. At last, the DOC determined that "a company's sale of a 'business' or 'productive unit' does nothing to alter the subsidies enjoyed by that productive unit". [19] This methodology was challenged under the "Tokyo Round Subsidies Code". During the course of the panel preceding, the United States amended its change-in-ownership methodology and did not defend the "pass-through methodology" to the extent that this methodology did not take account of the transaction value. [20]

Phase 3. The "Gamma Methodology", or "Partial Pass-through Methodology". In response to criticism, DOC revised the "pass-through" methodology, claiming part of any pre-privatization subsidies automatically be pass through to the new owners. The "Gamma methodology" purports to allocate past subsidies or productive assets previously owned by the recipient between the recipient of those subsidies and the purchaser of the company. A portion of purchase price can reflect part of remaining value of prior subsidies. Virtually, it means it is impossible that the totality of pre-privatization subsidies could pass through after privatization.

The "Gamma Methodology" was introduced in July 1993, a six months after DOC had introduced its "Pass-through" methodology, so that the methodology is also challenged by European Union in WTO case United States — Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom. The DOC classified such alleged subsidies as non-recurrent and thus spread them out over 18 years, deemed to be the useful life of productive assets in the steel industry. The DOC found that the alleged subsidies in question "passed through" from BSC to UES first, and then more recently to BSES.

The WTO Dispute Panel found that the privatization methodology used by Commerce in countervailing duty investigations inconsistent with the United States' obligations under the WTO Subsidies Agreement. Article 10 provides that a WTO member country is not authorized to impose countervailing duties unless there is a subsidy to offset. Article 19.1and 19.4 require the respondent to demonstrate whether a subsidy exists before countervailing duties are imposed, and criteria for finding whether a subsidy exists must include a benefit. The Appellate Body on 10 May 2000 reached the same conclusion as the panel. It held: The question whether a "financial contribution" confers a "benefit" depends, therefore, on whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market. In the present case, the panel made factual findings that UES and BSplc/BSES paid fair market value for all the productive assets, goodwill, etc., they acquired from BSC and subsequently used in the production of leaded bars imported into the United States in 1994, 1995 and 1996. We, therefore, see no error in the panel's conclusion that, in the specific circumstances of this case, the "financial contributions" bestowed on BSC between 1977 and 1986 could not be deemed to confer a "benefit" on UES and BSplc/BSES. [21] In fact, the decisions in Delverde v. United States [22] by US Court of Appeals for the Federal Circuit of 2 February 2000 prompted a review of this methodology. The Federal Circuit held that it is inconsistent with § 1677 (5) (F). "The Act did not allow the Department to presume conclusively that the subsidies granted to the former owner of Delverde's corporate assets automatically "pass-through" to Delverde following the sale. Rather, where a subsidized company has sold assets to another company, the Department need to examine the particular facts and circumstances of the sale and determine whether the purchasing company directly or indirectly received both a financial contribution and benefit from the government." [23]

Phase 4. "The same person" methodology. Pursuant to the Federal Circuit's finding, the DOC developed the new methodology and was applied to the Grain-Oriented Electrical Steel from Italy for the first time. The DOC posited two steps to analyze the existence of a countervailable subsidy after a change-in-ownership transaction. The first step under this methodology was to determine whether the legal person to whom the subsidies were given was, in fact, distinct from the legal person that produced the subject merchandise exported to the United States. If it is determined that the two persons were distinct, we then analyzed whether a subsidy was provided to the purchasing entity as a result of change-in-ownership transaction. If the original subsidy recipient and the current producer/exporter were the same person, then DOC determined that the person continued to benefit from the original subsidies, and its exports were subject to countervailing duties to offset those subsidies. [24]

This methodology, when applied in the Grain-Oriented Electrical Steel from Italy, had initially been developed in the draft. The final results of a red termination are pursuant to a court remand. In Acciai Speciali

Terni S.p.A. v. United States, Ct. No. 01-00051. [25], the DOC adopted a non-exhaustive list of factors which was used to analyze whether the subsidy recipient is the "same person" as the company under investigation: continuity of general business operation; continuity of production facilities; continuity of production facilities; continuity of assets and liabilities; and retention of personnel [26].

However, in the *United States – Countervailing Measures Concerning Certain Products from the EC*, the panel found that the same person method is inconsistent with the SCM Agreement because it `prohibits the examination of the conditions of the privatization-transaction when the privatized producer is not a distinct legal person based on criteria relating mainly to the industrial activities of the producers concerned. [27]. Thus, if the U.S. authorities find that the privatized entity is the `same person, they do not inquire into the conditions of the privatization in order to determine whether the benefit of the subsidy continues to exist.

Although the Panel held that "once an importing member has determined that a privatization has taken place at arm's length and for fair market value, it must reach the conclusion that no "benefit" resulting from the prior financial contribution (or subsidization) continues to accrue to the privatized producer", [28] the Appellate Body reversed the Panel's finding and found that same person approach inconsistent with U.S. obligations under Articles 19.1, 21.2 and 21.3 of the SCM Agreement, relating to original investigations, administrative reviews, and sunset reviews, respectively. The AB held that the obligation of WTO Members, to limit CVD's countervailing duty laws to the amount and duration of the subsid found by the investigating authority, applies to original determinations as well as to administrative and sunset reviews; but the same person methodology only applies to one administrative review conducted under Article 21.1 of ASCM. Secondly, Article 21.2 of ASCM requires that the investigating authorities in administrative procedures take into account 'positive information substantiating the need for a review'. Lead bars affirmed that 'an investigating authority, in an administrative review, when presented with information directed at proving that a benefit no longer exists following a privatization, must determine whether the continued imposition of CVD's is warranted in the light of that information.' However, when the DOC has determined that no new legal person is created as a result of privatization, it makes a conclusion without having conducted further analysis of whether privatized entity continues to receive the benefit of subsidies. Therefore, the Appellate Body found that the same person method, as such, is inconsistent with the SCM Agreement. [29] As for the sunset review, the AB came to a similar conclusion that the investigating authorities in sunset reviews also have to determine whether a benefit continues to exist, even if no new legal person is created after privatization.

4. Recent development and Analysis of "fair market value"

Recently, the DOC proposed to list some factors to assess the "fair market value" and market conditions in response to the AB finding. The following non-exhaustive list of factors might be considered:

- Artificial barriers to entry: Did the government impose exclusions on foreign purchasers from other industries, or overly burdensome/unreasonable bidder qualification requirements that artificially suppressed demand for the company? The fundamental consideration is not necessarily the number of bidders, rather, whether the market is contestable, anyone who wants to buy the company or its assets has a fair and open opportunity to do so.
- Independent analysis: Did the government perform due diligence in determining the appropriate sales price, and did it follow the recommendations of any independent analysis, indicating that maximizing its return was the primary consideration? Was the highest bid accepted and was the price paid in cash or close equivalent (and not, e.g., with an imbalanced bond-for-equity swap)
- Committed investment: were there prices discounts or other inducements in exchange for promises of additional future investment that private, commercial sellers would not normally seek (e.g., retaining redundant workers, building or maintaining unwanted capacity).

No matter how changeable are the methodologies that the DOC employed, it gradually concluded that the transaction of privatization at arm's length for fair market value may extinguish the pre-privatization subsidies although it does not necessarily do that. Nevertheless, in what conditions, the benefit of pre-subsidies continues to exist in privatized entities even though the transaction of privatization is at arm's length for fair market value?

An examination of "fair market value" is needed. First of all, it is difficult to appraise according to the relativity of fair market value. It is important to remember that any vision about value is usually subjective to a number of circumstances, i.e. place (local habits), time (moment), the existence of comparable precedents and the evaluation principles of each person involved. Any value is valid if it is applied, and worthless if not applied. The opinion of 1000 people about their intention to buy a product has no meaning if nobody buys the product.

On the other hand, if there is one single person interested in a product, it is a one-person market. In this case, any price would be a fair market price. Therefore, a fair market value is not invariable; it could change depending on the specific situation of market. For example, if a government assesses each tract before bidding to determine the minimum bid of "fair market value", but no bids are ultimately received due to the deficiencies of information, it is therefore difficult to say the minimum price set by the government is a fair market price. Similarly, it is possible to achieve the fair market value when a government negotiates with only one buyer, only if there is a single one buyer in the market.

In fact, the "fair" of "fair market value" refers not to the fairness of the amount received, but to the method by which it is determined. Accordingly, the most important feature of prices in a fair market is that they are satisfactory to both parties to the transaction, given their knowledge and voluntary participation. Thus, to ensure to obtain the fair market value, it is reasonable to require governments to open the bidding to any purchasers who qualify the requirements of bidders, and provide sufficient opportunity for those who most highly value the item being sold to participate; and the transaction is free of collusion.

Secondly, does the fair market value require governments to maximize revenue from the sale of public resources? The definition of "fair market value" is found in the United States Supreme Court decision in the Cartwright case: the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. [30] For knowledgeable sellers or buyers, they could be willing to conduct a transaction only when their own best interests can be realised. However, it is noted that there is difference between maximizing the interest of seller or buyer and maximizing the revenue of a government. A government as a special seller undertakes various responsibilities, so that it needs to take into account a "fair return to the public". It is evident that the appraisal or fair market value requirement is basically linked to the goals of increasing revenue or obtaining a fair return for state-owned properties, but is not employed where the government is attempting to develop some policy or encourage specific development goals. Therefore, when trying to encourage development, the government can accept a price below the actual value of properties or reduce the price in order to retain redundant workers, or maintain unwanted capacity when the knowledgeable and willing buyer is encumbered by undue pressure and realizes his own best interest in a fair market.

Thirdly, the reason why AB held that the pre-privatization subsidies may not be extinguished by privatization in the United States – Countervailing Measures Concerning Certain Products from the EC, is mainly because the market conditions were taken into account by AB.

1. Markets are mechanisms for exchange. Market conditions are not necessarily always present and they are often dependent on government action. Under certain conditions (e.g., unfettered interplay of supply and demand, broad-based access to information on equal terms, decentralization of economic power, an effective legal system guaranteeing the existence of private property and the enforcement of contracts), prices will reflect the relative scarcity of goods and services in the market.

2. Governments may choose to impose economic or other policies that are intended to induce certain results from the market. In such circumstances, the market's valuation of the state-owned property may ultimately be severely affected by those government policies, as well as by the conditions in which buyers will subsequently be allowed to enjoy property. In privatization, governments have the ability, by designing economic and other policies, to influence the circumstance and the conditions of the sale so as to obtain a certain market valuation of the enterprise.

To analyze the market condition, it needs examine the effect of the macro economic policies on privatization including the taxation system and legal rules pertain to privatization, regardless of a specific offer of a specific privatization, since it fails to affect the whole market. It is evident that the methodology of "fair market value" is not suitable with "market-transition economy" countries. This raises the questions of how subsidies must be treated after the company has been privatised and before the country assumes a market-economy status.

5. Conclusion

To examine whether a pre-privatization subsidy continues to benefit the privatized producer in a market-economy country, it is suggested that a process-oriented method be applied. Investigating authorities analyze different cases according to different transactions of privatization. The basic principle of the process-oriented method is the fair examination of whether the transaction of privatization is conducted by a fair way so that the producer can be privatized at arm's length and for fair market value. Therefore, the assessment of fair entry into

bidding market, and fair opportunities to obtain object is necessary. However, since the transaction is at arm's length, the price discount or other inducements could be considered as part of the fair market value.

Notes:

[1] ASCM: the Agreement on Subsidies and Countervailing Measures
[2] Countervailing duties are a means to restrict international trade in case where imports are subsidized by foreign countries and hurt domestic producers. According to WTO rules, a country can launch its own investigation and decide to impose duties to counteract the subsidies
[3] Julie Dunne, Delverde and the WTO' British Steel Decision foreshadow more conflict where the WTO Subsidies Agreement, privatization, and United States Countervailing Law intersect, 17 Am. U. Int'l L. Rev.(2001-2002) p.81
[4] WT/DS212/AB Report at Para 126; Panel Report at para.7.82
[5] David S. Da Silva Coenell, Maybe you can take it with you, after all: subsidies and privatization underdogs. countervailing duty law,25 law & Pol'y Int'l Bus.(1993-1994) p1309
[6] WT/DS212/AB/R, at paras.85 and 117, footnote177; Panel report at Para. 7.62
[7] The European Communities are using the terms "arm's length transaction" and "fair market value" in accordance with their accepted meanings:
Arm's length transaction. Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination. A transaction in good faith in the ordinary course of business by parties with independent interests… The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction.
Fair market value. The amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.
BLACK' LAW DICTIONARY, West Publishing Co. (6th Ed.1990)
[8] WT/DS212/AB Report at Para 126; Panel Report at para.7.82
[9] WT/DS212/AB Report at para.127
[10] WT/DS138/R,p.60
[11] U.S. Countervailing Duties Statute
[12] Saarstahl AG v. U.S. 858 F. Supp. 187 (CIT.7. June. 1994), See also Inland Steel Bar Co. v. U.S., 858F, Supp. 179 (CIT.7. June. 1994),
[13] WT/DS138/R,p.62, para61
[14] Lime from Mexico, 54 Fed. Reg.1753 (Dep't Comm), supra note 3, (17. January. 1989) at 1754-1755
[15] Lime from Mexico, at1755
[16] Lime from Mexico, at1755
[17] Certain Hot-Rolled Lead and Bismuth Carbon Steel Products the United Kingdom, Preliminary Determination 57 Fed. Reg. 42974 (17. September. 1992)
[18] Certain Steel Products from Sweden, and Certain Hot-Rolled Lead and Bismuth Carbon Steel Products, supra note 33, at 6234
[19] Final Affirmative Countervailing Duty Determination: Certain Hot-Rolled Lead and Bismuth Carbon Steel Products the United Kingdom; 58 Fed. Reg. 6237 (27 January 1993)
[20] United States – Leaded Bars: GATT Panel Report; para.425
[21] United States – Leads Bars: Appellate Body Report, para.62
[22] Delverde Srl v. United States 202 F. 3rd 1360 (Fed Cir. Feb 2, 2000) reh'g denied (20 June 2000). Attached as Exhibit EC - 5
[23] Delverde III, 202 F.3rd at 1364-1368
[24] Acciai Speciali Terni S.p.A. v. United States, Ct. No. 01-00051, Final Remand Redetermination, page13
[25] This "same-person" privatization methodology is the subject of appeals to the Federal Circuit in three cases: Acciai Speciali Terni S.p.A. v. United States, Ct. No. 01-00051; Allegheny Ludlum Corp. v. United States, Ct. Nos. 03-1189 and 03-1248; and GTS industries, S.A. v. United States, Ct. Nos. 03-1175 and 03-1191
[26] Ibid note 23
[27] United States – Countervailing Measures Concerning Certain Products from the EC, Panel Report, Para. 7.77
[28] United States – Countervailing Measures Concerning Certain Products from the EC, Panel Report, para.8.1 (d)

[29] United States – Countervailing Measures Concerning Certain Products from the EC, Appellate Body Report, Para 146-147
[30] United States v. Cartwright, 411 U.S. 546, 93 S. Ct. 1713, 1716-17, 36 L. Ed. 2d 528, 73-1 U.S. Tax Cas. (CCH) 12,926 (1973)

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Foreign Direct Investment in India with Special Focus on Retail Trade

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Abstract: It is to be noted that there is prevalent widespread opposition, specially by the left parties towards FDI in retail trade in India. May be in the early 1990s employing safeguards to protect domestic retailers was the need of the day. Almost more than one and a half decades down the line there is a need for Foreign Direct Investment in retail trade. It is a flawed argument that the Wal-Marts', Tescos' and Asdas' will lead to the winding up of the small scale domestic retailers. Instead it is going to provide a stiff competition to the Pantaloons' and the Westsides'. This paper starts by stressing the need of FDI in India. It uses the argument that FDI is allowed in multiple sectors and the effects have been quite good without harming the domestic economy tries to stress on the fact that FDI in retail sector must be allowed.

Keywords: *Foreign Direct Investment, Retail Trade, Winding up, Small Scale*

1. Introduction

The policy of reforms followed by Government of India in the post 1991 period recognizes the important role of foreign capital in the industrial and economic development of the country. Foreign capital inflow is encouraged not only as source of financial capital but also as a tool of knowledge and technology transfer.

The Central Government took several initiatives and measures during this period to encourage foreign investment inflows, particularly the flow of Foreign Direct Investment (FDI) into our country. Major thrust areas include infrastructure development, particularly energy, power, telecom and township development. FDI in most of the sectors/activities including manufacturing sectors are under the automatic route and require only notifying the Reserve Bank of India. Initiatives have also been taken to make procedures related to transfer of shares and repatriation more simple. The policy and procedures for induction of foreign technology have also been progressively simplified. To create a more conductive investment climate, the procedures governing approvals/clearance are continuously reviewed.

It is to be noted that there is prevalent widespread opposition, especially by the left parties towards FDI in retail trade. May be in the early 1990s employing safeguards to protect domestic retailers was the need of the day. Almost more than one and a half decades down the line there is a need for Foreign Direct Investment in retail trade. It is a flawed argument that the Wal-Marts', Tescos' and Asdas' will lead to the winding up of the small scale domestic retailers. Instead it is going to provide a stiff competition to the Pantaloons' and the Westsides'.

This paper using the argument that FDI is allowed in multiple sectors and the effects have been quite good without harming the domestic economy tries to stress on the fact that FDI in retail sector must be allowed.

2. Need For FDI In Developing Countries

WTO interest in improved conditions for foreign investment reflects the growing importance of foreign direct investment for its members and the close links between trade and investment flows.

2.1. FDI in Developing Countries

According to the UNCTAD's World Investment Report 1998, there was a dramatic increase in the annual global flows of FDI between 1985 and 1995, from around $60 billion to an estimated $315 billion. By 1997, FDI inflow had reached a new high of $400 billion and outflows had climbed to $424 billion.

Developing countries are becoming more important as host and home countries. Their share of global FDI flows increased from 21% in 1991 to an estimated 36% in 1997.

The World Bank (1998) is positive about the medium-term prospects for FDI flows to developing countries. It is likely that strong growth of output and exports in developing countries, increased economic integration and globalization of production and further liberalization of investment rules will bolster FDI flows.

The FDI to GDP ratio in developing countries increased dramatically from 0.8% to 2% in 1997 according to a 1998 World Bank data.

Despite the crisis in financial markets in East Asia in mid 1997, FDI flows into developing Asia remains strong. According to a UNCTAD data (1999), FDI flow into East, South and south-East Asia in 1998 were well above the average of US $44 billion for 1991-1995.

The Asian financial crisis has, however, provoked several significant changes in the pattern of FDI in the Asia-Pacific region:

- Intra regional investment has declined;
- European MNCs are becoming more active;
- The service sector is reviving an increasingly larger share of FDI; and
- Mergers and acquisitions are gaining more importance as a mode of investment in the region.

2.2 Share and Distribution of FDI

Statistical evidence collected by UNCTAD and supported by a 1996 WTO study indicates that:

- Almost one third of outwards FDI stock is in developing countries; and
- One third of the top 20 FDI hosts are developing countries.

The main recipients of FDI are middle income countries, due to their larger markets and rapid economic growth. In recent years however, low income countries apart from China ad India have received large amounts of FDI. FDI flows to Vietnam, for instance, increased significantly between 1991-1993, when they were worth $380 million per annum, and 1995-1997, by which time they had risen to $ 1.3 billion (World Bank 1998). Many smaller countries and LSDs, particularly in Africa, received little foreign investment.

FDI flows are highly concentrated. In the period 1985-1997, six developing countries were among the top 20 host economies for FDI (China, Singapore, Hong Kong, Thailand, Argentina and Brazil). With increasing access to FDI this concentration is lessening.

2.3 Composition of FDI flows

The composition of capital inflows has also differed dramatically across regions. While FDI comprised over 40% of net capital flows to Asia during 1989-1994, the majority of flows into Latin-American countries have been portfolio investment, with FDI accounting for little more than a quarter of capital flows to that region.

2.4 Trade Linkages

Trade policies can affect FDI in many ways:

- Low import protection levels – especially if it is bound – can be a strong magnet for export oriented FDI.
- High tariffs, in contrast, may induce tariff-jumping FDI to serve the local market.
- So-called *quid pro quo* FDI may be undertaken for the purpose of defusing a protectionist threat.

The evidence indicates that FDI and host country exports complementary, but that FDI and host country imports may be either substitutes or complements.

FDI is also viewed as a way of increasing the efficiency with which the world's scarce resources are used, for example, in helping to stimulate economic growth in many of the world's poorest countries. FDI, very little of which currently flows to the poorest countries, can be a source not just f badly needed capital, but also of new technology and intangibles such as organizational and managerial skills, and marketing networks.

2.5 FDI Incentives

Most industrialized countries have very high FDI incentives that are of concern because they may be offered with little or no knowledge of an investment project's true value to the host country. There is considerable scope

for introducing new distortions; and competition among potential host countries in the granting of incentives can drive up the cost of attracting FDI, thereby reducing or even eliminating any net gain for the successful bidder.

2.6 The World Bank's Role in Promoting and Protecting Foreign Investment

The relationship between World Bank and private investors is not a recent one. In fact, it has been envisioned during the Bank's formation and established in its Articles of Agreement [1]. The relationship between the Bank and the private sector has undergone processes of change over the years largely as a result of changes in the approach to the role of private sector in economic development.

During the 1950s the Bank was preoccupied with the promotion and facilitation of cross-border capital flows to finance post-war reconstruction. This was done through direct lending to private enterprise, which was further facilitated by the creation of the International Finance Corporation specifically for this purpose. During the state-centred import substitution years of the 1960s and 1970s the Bank shifted to development policy based on supporting the public sector and state owned enterprises (SOE).[2]

Following the Debt Crisis in the early 1980s, the Bank changed its focus to stabilization and openness. This has brought with it emphasis on trade and investment liberalization. This shift was as much a reaction to the Crisis as it was reflection of neo-classical economic thinking that dominated the Bank. [3] It is out of this concern for stabilization and openness as an instrument for stabilization as well as the dominance of neo-classical thought that the current relationship between the bank and the private sector has developed.

In the early 1990s as a result of the collapse of the eastern bloc, development thought was revamped. The last piece of evidence to the failure of the state dominated development model has been provided. Revising its approach to development [4], the Bank further institutionalized its commitment to private sector development by establishing it as a sector of specific importance. The relationship between the bank and the private foreign investor is now part of this wider Bank sector of operation, namely "private sector development" (PSD). The Bank organizes its operations geographically, by sectors and thematically. Geographic organisation reflects regional categories within which country operations are conducted. The thematic organisation reflects identified themes or issues in development thinking that needs to be tackled across different regions. The Bank approaches to develop "Sector Strategy Papers" defining its policies with regard to specific sectors that it perceives as particularly important for development.

- 'Private Sector Development' (PSD) is now one of the themes identified for the Bank's operations and with regard to which the Bank has developed detailed strategy paper. In 1993, during a process of bank reorganization, the Bank established the Finance and Private Sector Development (FPD) Vice-Presidency [5] responsible for overseeing the Bank's activities in this area across different regions and sectors. Discussion of the relationship between the Bank and private foreign investors could conveniently start with the Bank's "Private Sector Development Strategy" [6]. Understanding the policy direction of the Bank's role vis-à-vis foreign investors.
- Proceeding from an assumption about the centrality of market for economic development, the document advocates the following strategies for private sector development:
- Enhancing the investment climate, which includes 'macro-economic stability, well defined property rights, a sound judicial and contracting system, reasonable level of certainty about government policy, functioning financial institutions and a good physical infrastructure such as transport system'. The Bank's strategy emphasizes specifically the importance of the legal environment in the form of effective contract and property rules, predictable and sound governance and honest and efficient judicial system.
- Encouraging competition through domestic and international liberalization. According to the strategy paper, markets cannot function and deliver their poverty alleviation promises unless they are competitive. The strategy advocates enhanced competition through liberalization through market access to foreign goods and services and removing bureaucratic red-tape that inhibits domestic competition.
- Privatization. One of the main pillars of the strategy is encouraging private sector participation in the supply of goods and services. The paper argues specifically for privatization in building infrastructure systems and supply of basic social services. The paper maintains however that the degree of government supply versus private supply is contingent of domestic context.

Without insinuating politically induced bias, the aforementioned agenda is clearly foreign investor friendly. Promoting an investment friendly climate, openness, liberalization and privatization are clearly a foreign investor bill of rights. Appreciating however the extent to which the World Bank Group is actively

engaged in foreign investment promotion and protection cannot be achieved without closer inspection of the Bank's activities in this area.

After setting the agenda in those terms, the Strategy paper went on to describe the World Bank Group's private sector development activities. It distinguished between 'financial interventions' and non-financial activities. The Bank's financial intervention includes:

- Project lending that is geared towards enhancing the investment climate, supporting privatization or providing direct financing to private enterprise.
- Structural adjustment lending supporting legal and regulatory reforms that aim at enhancing the investment climate.
- Financing to private sector enterprises through IFC lending and equity investment. Providing political risk guarantees to foreign investors through the Multilateral Investment Guarantee Agency.
- The document noted on basis of financial date that most of these activities have increased manifolds in recent years. This reflects the growing commitment of the Bank to private sector development as a fundamental development strategy.
- Non-financial interventions refer to the Bank's practices not as a financial institution but as a 'knowledge organisation'. This is an aspect of the Bank's work that has been growing over the years. The non-financial interventions in support of private sector development more generally include:
- Providing advice to governments on matters relating to the sector such as small and medium sized enterprise, privatization and corporate government.
- Solving disputes and setting standards.
- Conducting research on matters relating to the sector.
- Providing training and capacity building.

3. Retail Business in India

3.1 Does India Need FDI in Retail?

If there are three areas of economic policy where India has been often wrong for much of the past 50 years, these are the external sector, agriculture and the importance of distribution and retailing.

The topic currently under hot debate, namely foreign direct investment in the retail sector, combines all these issues -- no wonder it's a topic of ceaseless debate. Quite apart from the economic logic or ideology, perhaps there is also a cultural/philosophical issue. The consequential rigidities of industrial and import licensing ensured that much of Indian industry remained high cost and uncompetitive, thus perversely proving the thesis of export pessimism! Indeed, in that era, Manmohan Singh's was a lonely voice not subscribing to the received wisdom. No wonder he was later the architect of the far more rational industrial, trade and exchange rate policies of the last 15 years -- the effect on balance of payments has been wholly positive[7].

During the first few plans, agricultural output was also not given its due importance till the prospect of perpetual food shortages focused the attention of our political masters. But India continued to believe more in subsidizing than in reducing waste or adding value to the output. This has led to continued rural poverty, except in some isolated pockets. One problem is that a huge proportion of perishable agricultural output like fruits and vegetables is left to rot in the fields in the absence of cold storages and transport infrastructure, and becomes a dead loss to the economy. An all too visible manifestation of the inefficiencies is the huge disparity between the price which the producer gets and the price the consumer pays -- sometimes as high as 10-20 times! Clearly, what is needed is an efficient supply chain backed by improved infrastructure, cold storages, packing and transportation. And, the traditional system of distribution, ending with the mom and pop shops or the street-side vegetable seller, is just not capable of creating it.

This brings us to the third blind spot: distribution and retailing. First, umpteen indirect taxes hamper a smooth chain. Again, for decades, financing of manufacturing was considered virtuous while finance for trade or consumption was discouraged. The middlemen were, broadly speaking, thought to be parasites standing between the producer and the consumer, contributing little to economic growth or output. The fact is that the circle of economic activity cannot be completed until what is produced reaches the consumer and, therefore, efficient distribution and retailing are very important. To quote just one example, can India imagine a vibrant automobile sector without an efficient distributor and service network and, indeed, vehicle finance? Or a fast-growing and needed housing sector without availability of housing finance?

The entry of the organised sector in retail trade is capable of mitigating, if not solving, the huge waste involved in the current system, simultaneously paying better prices to the producer and lower prices for the consumer. This is manifest to anybody visiting some of the newer supermarkets in urban/metropolitan India: the produce is cleaner, fresher, well-packed, and often cheaper than the vegetable seller on the street. This is possible because of the far more efficient distribution system which organised retail chains are employing, by cutting layers of middlemen. One very positive sign is that a way seems to have been found for the corporate sector to enter the rural economy through contract farming -- almost every day one sees major corporate names making forays in the area. If the huge margin between producer and consumer prices is one attraction, they are also perhaps inspired by what Pepsi succeeded in doing for the potato farmer in Punjab, partly to fulfil the export obligations imposed on it when it entered India.

But does India really needs FDI in the retail sector besides the domestic corporate sector? [8]

3.1. The Dire Need For Foreign Direct Investment In Indian Retail Trade

Recent indications that the government is considering foreign direct investment in retail trade have sparked off a debate on the advisability and consequence of this policy [9]. Retail trade takes place through five types of outlets -- *kirana* shops, more modern retail shops, departmental stores, supermarkets, and hypermarkets. *Kirana* shops and retail shops are a feature of our landscape. Every village and town has them. They are usually family-owned and managed. Most *kirana* shops store goods unpacked in bulk containers, from which they are measured or weighed out in paper packets by the owner. When towns become cities, departmental stores appear. Supermarkets are the next stage in the evolution of retailing. They are viable only in the bigger cities. The fear expressed by some people is that allowing FDI in retail trade and the entry of international retailers could lead to a diminution of *kirana* shops and retail stores. It is worthwhile analysing the advantages and disadvantages of the proposed policy of allowing FDI in retail trade.

One key point is that Indian government must differentiate between the interests of consumers, who constitute our population of nearly 1,100 million [10], from the interests of retailers, who may number over one million [11]. It is obvious that the interests of the consumer should take precedence over those of the retailer. FDI in retail and the development of larger stores and supermarkets have the following advantages from the point of view of consumers:

- FDI will provide access to larger financial resources for investment in the retail sector and that can lead to several of the other advantages that follow;
- The larger supermarkets, which tend to become regional and national chains, can negotiate prices more aggressively with manufacturers of consumer goods and pass on the benefit to consumers. They can lay down better and tighter quality standards and ensure that manufacturers adhere to them.

With the availability of finance, the supermarkets can invest in much better infrastructure facilities like parking lots, coffee shops, ATM machines, etc. All this will make shopping a pleasant experience. The supermarkets offer a wide range of products and services, so the consumer can enjoy single-point shopping. The argument that the advent of FDI and supermarkets will displace a large number of *kirana* shops is similar to the argument used during the era of industrial licensing, which was meant to protect small-scale industries. But eventually the inefficiencies and quality standards of the protected small-scale companies become apparent even to socialist politicians and licensing was abolished. Small-scale industries have not died. Instead, they have learnt to co-exist as suppliers to large-scale industries.

In the case of retail trade, the *kirana* shops in large parts of the country will enjoy built-in protection from supermarkets because the latter can only exist in large cities. On the other hand, the ability of supermarkets to demand pricing and quality standards from manufacturers will benefit even *kirana* shops, who can even buy from the supermarkets to sell the same products in smaller towns and villages. It can be argued that since the advantages cited above are due to the scale of operations rather than the involvement of foreign capital, why should India allow FDI in retail trade? The case for FDI has more to do with the confidence and willingness to invest large amounts in a short period as well as the expertise based on experience.

Even a modest chain of 200 supermarkets, to be set up all over India in selected towns and cities in the next three years, will require an investment of about Rs 2,000 crore (Rs 20 billion), at the rate of Rs 10 crore (Rs 100 million) per supermarket to cover the infrastructure and working capital. Each supermarket may take 2 or 3 years before it becomes profitable. There is a risk that a few of them may even fail. How many Indian entrepreneurs will be willing and able to commit this level of investment and undertake the risks involved? That is where the international experience and skills that may come with FDI would provide the confidence and capital. Apart from this, by allowing FDI in retail trade, India will become more integrated with regional and

global economies in terms of quality standards and consumer expectations. Supermarkets could source several consumer goods from India for wider international markets. India certainly has an advantage of being able to produce several categories of consumer goods, viz. fruits and vegetables, beverages, textiles and garments, gems and jewellery, and leather goods. The advent of FDI in retail sector is bound to pull up the quality standards and cost-competitiveness of Indian producers in all these segments. That will benefit not only the Indian consumer but also open the door for Indian products to enter the wider global market. It is therefore obvious that India should not only permit but encourage FDI in retail trade. Just as in the case of most products, the brand name of the supermarket chain is a strong element in its growth and success.

People have confidence in names like Sainsbury, Asda, Marks & Spencer, etc. just as they have confidence in Indian brands like the Tatas and Godrej. A possible outcome can be that Indian groups with strong local brand quality like the Tatas will collaborate with international supermarket chains like Sainsbury, to set up supermarket chains in India. It will be unwise for a government to interfere in this process.

3.2 FDI In Retail Trade And The Story Of Politics

At present, foreign direct investment (FDI) in pure retailing is not permitted under Indian law [12].

In 1993, the then finance minister Dr Manmohan Singh had changed the law to permit FDI in retail trade [13]. Dairy Farm, a multinational corporation entered India on that opening. But, the next finance minister, P Chidambaram, to curry favour with the Communists in the then United Front government, changed the law again in 1996 to ban FDI in retail trade, but as with every Indian law there is a loophole by which foreign retailers can (and some do) operate in India through local franchises.

3.3 Expert Views On The Need Of FDI in Retail sector

Industry professionals and academics, debating the hot topic of "FDI in retail sector in India" here at an interactive session organised by the Swadesh Research Institute (SRI), have expressed divergent views, with the broad agreement being only on abundant caution before opening up this sector to the Wal-Marts and Carrefours of the world.

While Dr Abhijit Sen, former co-chairman of the Nicco Group and now Honorary Consul for Sri Lanka in Kolkata, said there was empirical proof that FDI in retail will not shrink employment opportunities, going by the US example, Prof Dipankar De of ICFAI Business School, Kolkata, expressed doubts over the actual benefits that may accrue to the nation through FDI in retail. He cited a report of the UK Competition Commission, which says thousands of retail jobs were lost on the entry of hypermarkets through FDI in retail in the UK. Quoting the recently released World Investment Report for 2004-05, he said there was a distinct slowdown in investments in retail trade in developed countries. Therefore, why the Wal-Marts and others are eager to come to India, where some domestic investment in retail trade was already beginning to happen? In India, retail trade in the organised segment was only two per cent, with a whopping 98 per cent being in the unorganised sector, against China's 20 per cent and 80 per cent, respectively, according to Dr D.R. Agarwal, Director, SRI.

The size of India's highly unorganised and individually small retail trade is close to $200 billion, nearly 14 per cent of our GDP, and employs 21 million, which was about seven per cent of our total labour force. This is said to be six times bigger than that in Thailand and five times larger than South Korea and Taiwan. China's retail trade is 8 per cent of GDP and accounts for 6 per cent of total employment. FDI in retail in India, which has been recommended (to the extent of 49 per cent) by ICRIER, a New Delhi-based policy research group, is under the consideration of the Union Government. The think-tank has suggested that any opening up of FDI in retail should be gradual (3-5 years) to give the domestic industry enough time to adjust to the changes. According to Dr Sen, some 16 per cent of total employment was in retail trade, which is dominated by the hypermarkets. And this has thrown up huge employment opportunities, he maintained, disputing the assumption that allowing FDI in retail in India will shrink employment. He, however, agreed that such investments will no doubt generate a different kind of employment with varying skill sets. Dr Agarwal said though India has so far not made any formal commitment under WTO, nor has received any reciprocal market access by other countries, autonomous liberalisation of FDI in retail sector was beyond our WTO obligations. He said the Government has already taken a stand against commitment in certain areas of services that include wholesale and retail trade in WTO, "and by allowing FDI in retail outside WTO framework, Government may weaken its bargaining position in future negotiations, where they cannot promise less than what they have already allowed".

3.4 FDI in Retail: The Beneficiaries

India today is ranked among the most favoured destinations for Foreign Direct Investment (FDI), with the services sector at the top in attracting FDI in April-November 2006[15]. India has also emerged as the most attractive FDI destination in Asia with an 18 percent rate of return on equity investments, according to a study by JP Morgan. Be it setting up of special economic zones (SEZs) or investing in retail sector, many big global names are ready to come to India. The FDI inflows during the year 2006 (up to November) were over $9 billion, up a staggering 126 percent over the last year with Mauritius and US topping the share of investing countries in India. Recently, a lot of activity was witnessed in the Indian retail sector on the entry of foreign players in the country. India presently allows 100 percent foreign direct investment in cash and carry retail and 51 percent in single brand retail. This means that foreign companies willing to enter the Indian market will be able to invest up to 51 percent in setting up production facilities, distribution network and retail shops and the rest will come from Indian investors.

Experts are still divided on the problems and prospects of FDI in retail. Some say it will shrink employment opportunities, completely alter the retail distributional structure and deal a death blow to the corner shop structure. The optimists, on the other hand, see a whole range of opportunities -- from improved collection, processing and better distribution of farm products to generation of more opportunities for the rural and urban unemployed. Until now, global retailers were required to sell their products through franchises or wholesale trading. This move will help them setting their own base in India and will attract foreign capital along with better quality products and services for the consumers. India is tipped as the second largest retail market after China, and the total size of the Indian retail industry is expected to touch the $300 billion mark in the next five years from the current $200 billion.

4. Objections to FDI in Retail Trade

4.1 Protests With The Entry Of Wal-Mart

Several mass organisations including the All India Democratic Women's Association, All India Kisan Sabha, Centre of Indian Trade Unions, Democratic Youth Federation of India and Students Federation of India along with activists of the India FDI Watch held a militant protest demonstration in Delhi on February 22, 2007 against the visit of Wal-Mart officials to India to sign the Bharti-Wal-Mart deal. Protestors marched towards Udyog Bhawan [16]. Effigies of commerce minister Kamal Nath and senior Wal-Mart official visiting India, Michael Duke, were burnt amidst enthusiastic sloganeering: “Wal-Mart Go Back”. The protestors were arrested by the police. Similar protest actions were also organised in Bangalore and Mumbai. The recent deal struck between Wal-Mart and Sunil Mittal’s Bharti Enterprises is in effect a backdoor entry of FDI in retail trade in India. While FDI in retail trade is not permissible under the existing policy on foreign investment in India, the franchisee agreement with Bharti Enterprises will allow Wal-Mart to circumvent existing policy regulations and gain a foothold in the Indian market. Wal-Mart is the biggest monopoly retailer in the world which is infamous for its pathetic record of violating labour laws, union-busting, displacing small retailers and exploiting small producers of manufactured and agricultural commodities. Its entry into India, which would invariably be followed by the other multinational retailers like TESCO and Carrefour, would monopolise the retail market in India in their hands causing harmful effects to all sections of the people. It would cause large scale displacement of small retailers and squeezing of domestic manufacturers and farmers. Expansion of the Wal-Mart chains has caused massive closure of small stores and pauperisation of poor communities even in the United States. In the context of huge unemployment existing within the country, such employment displacing FDI is the last thing that the Indian economy needs at the moment. In fact what is urgently required is a strong regulatory framework for the domestic organised retail sector like the Reliance Retail, which is expanding at a rapid pace.

The UPA government had earlier allowed FDI in Single Brand Retail (SBR) as well as FDI in Warehousing and Wholesale Trade. These steps by the government were all meant to eventually pave the way for MNCs like Wal-Mart to make an entry into the retail sector. Wal-Mart has been lobbying hard to change the FDI policy regime to facilitate their entry into India for quite some time. The UPA government, while allowing FDI in single brand retail, has not been able to allow the multinational multi-brand retailers to operate in India so far because of strong resistance from the Left parties, the trade unions, trader's organisations and other sections of the people. Therefore a roundabout way of getting them into India has been devised through this apparent joint venture. This is similar to the manner in which FDI was allowed into the sensitive telecom sector; first through joint ventures with minority foreign equity ownership and then increasing the FDI cap to facilitate

majority foreign ownership. United resistance of different sections of people would have to be built up in the coming days in order to prevent FDI in retail trade in general and Wal-Mart's entry into India in particular.

4.2 FDI Threatens 3 Crore Indian Retail Traders: Left Front's Point of View

For the last four years, the Federation of Associations of Maharashtra (FAM) and similar associations in other states have been waging a campaign against the move on part of the government of India to permit foreign direct investment (FDI) in retail trade in the country. They have so far made several representations on this subject, copies of which were also forwarded to various members of parliament as well as to the offices of various political parties. It was primarily because of the support from several parliamentarians and political parties that the government of India was obliged to take a decision not to permit FDI in retail trade.

Notwithstanding all this, however, the government of India recently gave approvals to two international retail stores organisations, viz Metro GmbH of Germany and Shoprite Checkers of South Africa, to conduct "Cash and Carry Wholesale Trading" in the country. This was despite the fact that even in the year 2000 the FAM and other organisation had drawn attention to the fact that this "cash and carry wholesale" is merely a confusing phraseology coined by the international companies to conceal the real nature of their operations in retail trade. They had also pointed out that this is a crafty move on the part of foreign companies and that, once they set their shops in India, they would ultimately be conducting retail trading. Further, on the basis of detailed studies of the activities of these organisations in various countries, it was pointed out such multinational retailers, who are trying to conduct their operations under the fancy name of "Cash and Carry Wholesale" in India, resort to unfair trade practices such as predatory pricing, etc, in order to eliminate the local traders. They are in fact keen to establish a monopolistic situation where they can exploit the people at their will.

During the period October to December this year, the retailers' organisations firmly expressed their opposition to the government's approval given to the Metro GmbH to invest in Cash & Carry Wholesales Trading operation. They also voiced their serious concern that, in their considered view, this approval was nothing but to allow the Metro GmbH to enter the Indian retail market through the backdoor.

Now, in accordance with the approval granted by the government of India, the Metro GmbH, the fourth biggest retailer in the world, has already started its "Cash and Carry Wholesale" operations at two places in the city of Bangalore --- at Yashwantpur and Kanakpura. In each of these suburbs of Bangalore, the Metro has started its stores in 1, 10,000 square feet area. It has also issued over 2.50 lakh cards to its customers; these includes retailers, commercial organisations and organisations of professionals like doctors, lawyers, InfoTech company employees, architects, chartered accountants, etc. In some cases, these cards have been issued to employees of certain organisations even without explicit consent or knowledge of the concerned organisations.

The issue directly concerns millions of retailers of the country. In such a situation, the retailers are perfectly justified in apprehending that the bureaucracy in the commerce ministry is deliberately turning a Nelson's eye towards these illegitimate activities of the Metro GmbH --- for reasons best known to them. The FAM has pointed all these facts in a letter it addressed to Arun Jaitley, minister of commerce, on November 12, 2003, drawing his kind attention to the serious developments in Bangalore and has requested him to take necessary action immediately. Corrective action on part of the ministry of commerce was yet to come by the end of November. Needless to say, this poses a serious threat to the indigenous retail traders in the country. As their representatives have pointed out on various occasions, if the large foreign retail houses are allowed to conduct their activities in the country under whatever name and under whatever pretext, the retail trade in India, which is conducted largely as family businesses, would be seriously affected. Also, this will not only add to unemployment but will also affect the basic fabric of our society. Hence, the need is to appreciate that the activities conducted by the Metro GmbH at Bangalore are against our national interest and that the government has to ensure that the terms and conditions stipulated in the licence granted to the Metro are followed by it in letter and spirit. The gross violations the company is already indulging in, cannot be ignored.

A similar case is of the Shoprite Checkers of South Africa, which is the world's number 1 retailer. This company too has obtained a similar approval for retail trade and is now in the process of starting its operations; it has already acquired over 60,000 square feet space in Nirmal Life Style Mall in Mulund, Mumbai. It is also said that, in order to overcome the policy hurdles, this company is busy creating fronts in the form of Indian franchisees, which would be nothing but the company's puppets. As for the retailers associations, they have already drawn the government of India's attention to the dangers the permission granted to foreign retailers to do retail business in India would pose to the indigenous traders. For example, the Federation of Associations of Maharashtra (FAM), which represents over 750 trade associations in Maharashtra, has over the last four years taken up the issue of FDI in retail trade. This year too, it sent a letter to the union commerce ministry on March

7, and another on August 4, on this subject --- besides the one sent on November 12. But the government has failed to act in this regard.

Therefore, the Indian retailers' demand is that, as assured in writing by the former commerce minister, Murasoli Maran, the ministry must take immediate and decisive action to stop the multinational trading giants from indulging in retail trade in India and, it necessary, cancel or suspend their approval pending enquiry. They have also demanded that any such approval to any company must not be granted in future[17].

4.3 Concerns Of Left Parties To Be Addressed First

THE proposed opening up of the retail trade sector to foreign direct investment (FDI) is likely to be delayed till at least early next year. Senior Ministers in the Manmohan Singh Government told *Business Line* that the concerns of the Left parties on this issue would be addressed once the exact formulation is worked out and the final policy would be announced after that. "FDI in retail will come, but not now," the Ministers said. In fact, the Commerce Ministry, the nodal Ministry for the policy, has not yet worked out its formulation and is likely to take it up only after the World Trade Organisation (WTO) Ministerial meeting in Hong Kong next month.

"FDI in retail does not mean just setting up big shops. It has many different connotations. With nearly 25 million people coming into the middle class category in recent years, there is a need to cater to their demands," the Ministers said, clarifying that the neighbourhood general merchandise shops or the existing retail trade would not be adversely affected. "We are acutely conscious of job losses. We also have to face elections. We cannot have policies which impoverish people." The Ministers explained that modern retail trade involved sophisticated technological inputs for inventory management, supply chain logistics, cold storages, refrigerated transportation and other modern gadgets and an entrepreneur would make these investments only if he is assured of volumes.

"We are looking at that aspect of retail trade. We are not looking to replace the vegetable seller who carts his stuff from house to house, as some of the Left parties apprehend. Consequently, we are looking at formulations on how to introduce technology and investment into retail trade to cater to the needs of the growing middle class," the Ministers said, conceding that as yet no decisions had been taken. "In fact, we have invited the Left parties to help formulate the policy paper," they added. The view within the Government is that FDI in retail trade would have to be allowed in the near future in order to cater to the needs of the sophisticated customer. Besides, the employment potential, especially for low-end skilled workers, would be substantial once retail chains with big volumes step into the market[18].

5 Prime Minister's Take on FDI in Retail Trade

Prime Minister Manmohan Singh is hopeful of a "positive outcome" during the next five-six months to the debate on whether or not to allow foreign direct investment in the Indian retail sector. Taking questions after addressing a business gathering, Dr. Singh admitted that there was considerable opposition to the move, which was being discussed by the United Progressive Alliance Government. Dr. Singh said that West Bengal Chief Minister Budhadeb Bhattacharjee was trying to attract foreign investment to his State in this part of the world recently. "Now, nobody would think that communists were very good at attracting foreign direct investment, but we have a Left Front Government which is now going out of its way to create ... in West Bengal, world-class facilities to attract FDI ... ," he said. "On the whole, the competition for attracting investment is creating the right sort of signal in the minds of our politicians and those politicians who want to obstruct business practice and business processes... are increasingly becoming a minority rather than being a dominant force," the Prime Minister said. Suggesting that the "act of investment" in a country was also an "act of faith" in the future of a country, Dr. Singh told businesspersons: "Have faith in our country." Competition was a two-edged weapon; it helped those who were strong and hurt those who were weak. Stating that he would be the last one to claim that everything in India was rosy, the Prime Minister, however, pointed out that India had made a break with the past in 1991 and that economic liberalization had come to stay. Pointing to the change of governments in India in the last 15 years, Dr. Singh pointed out that no government had tried to reverse the direction of liberalization.

This process had widespread acceptance in the country, he said, and invited Asean business to come and test the waters in India. India would need a minimum investment of about $150 billion in the infrastructure sector. The "weak spot" in the country was that India had concentrated on high-tech software and had not paid enough attention to hardware. "Please come and look at the possibilities ... in the development of the hardware sector in our country," he told the assembled businesspersons. Pointing out that India today was engaged in a radical transformation of its road and rail sectors, he said modernization and expansion plans of the Delhi and Mumbai airports based on a public-private partnership were also on the horizon. "New airports are also being

built in Hyderabad, in Bangalore. So, in the next five-six years, India's infrastructure should also undergo a sea change," the Prime Minister added[19].

6 Conclusion

To understand in proper dimensions, movement of FDI globally tables have been provided as appendices. It shows why FDI is really important for the Indian Economy and definitely FDI in the retail sector too. The government is considering a proposal to bring uniformity to the level of foreign direct investment allowed in various business segments within a particular sector. At present, varied levels of FDI are permitted in different business segments in at least half a dozen areas including petroleum, aviation, media, retail, telecom and the financial sector. For instance in telecom, basic and cellular services are allowed 74% FDI, ISPs without gateway 100%, and equipment manufacturing 100%. Similarly, in the financial sector, NBFCs can have 100% FDI, private sector banks 74%, and asset reconstruction companies 49%. The department of industrial policy and promotion was likely to hold consultations with various administrative ministries on capping FDI at a common level for the sector as a whole. The sources said the primary objective behind the move was to usher in simplicity in administering FDI and foreign investment norms. There could, however, be exemptions in certain sectors, they added. A single FDI regime for a sector would also prevent companies from misusing any loopholes, a source said. Also, such a move will come handy while tackling security-related aspects. “We have seen companies denied entry into one segment in a sector have used a more liberal investment regime to enter another segment in the same sector. Having done this, they finally operated in the original segment where permission was denied,” the official said. Once there was a uniform FDI level, such loopholes would be plugged, he added. Government officials also agreed that the proposal, at initial stages now, could find its way into the national foreign investment policy. A Uniform sectoral FDI may be one of the ways to consolation of FDI. But until then FDI in retail trade should be allowed and the extent of it should not be minimized. This paper using the argument that FDI is allowed in multiple sectors and the effects have been quite good without harming the domestic economy has shown the benefits of FDI in retail sector and why it must be allowed.

Notes

[1] IBRD Articles of Agreement (1944 as amended), Art. I (ii)
[2] The World Bank, Private *Sector Development Strategy – Directions for the World Bank Group* (9 April 2002), paras. 55-57
[3] For a brief description of this evolution of development policies *see* J. Cypher/J. Dietz, *supra* note 2, pp. 208.
[4] The World Bank, *World Development Report: The Challenge of Development* (1991).
[5] This later on became Private Sector Development and Infrastructure Vice Presidency. In May 2003, a further re-organisation took place splitting this former vice-presidency into two: The Infrastructure Vice Presidency and Private Sector Development Vice Presidency. The latter is responsible for ‘strategic integration between the Bank and IFC on private sector development, investment climate issues and long term strategy for the IFC.’ *See* The World Bank Annual Report 2003, at pg. 73.
[6] The World Bank, Private *Sector Development Strategy – Directions for the World Bank Group* (9 April 2002)
[7] Refer article- http://in.rediff.com/money/2005/oct/20fdi.htm
[8] Refer article- http://in.rediff.com/money/2005/oct/20fdi.htm
[9] Refer article- http://www.rediff.com/money/2005/jul/22spec1.htm
[10] National Commission of Population (http://populationcommission.nic.in/)
[11] Refer article- http://www.euromonitor.com/Retailing_in_India_A_nation_of_shopkeepers
[12] See MANUAL ON FOREIGN DIRECT INVESTMENT IN INDIA - Policy and Procedures (By, Secretariat for Industrial Assistance, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India)
[13] Refer article- http://www.rediff.com/money/2005/feb/24swamy.htm
[14] Refer article- http://www.tribuneindia.com/2004/20040318/biz.htm
[15] Study by A.T. Kearney (Refer article- http://www.atkearney.com/main.taf?p=1,5,1,151)
[16] Udyug Bhawan: the office of the minister of commerce and industry
[17] Refer article- http://pd.cpim.org/2003/1214/12142003_maharashtra.htm
[18] Refer article- http://www.thehindubusinessline.com/2005/11/05/stories/2005110502810100.htm

[19] Refer article- http://www.hindu.com/2005/12/13/stories/2005121306991200.htm
[20] UNCTAD 2005 Report
[21] Primary includes agriculture, hunting, forestry and fishing, mining, quarrying and petroleum.
[22] Manufacturing includes food, beverages and tobacco; textiles, clothing and leather; wood and wood products; publishing and printing; petroleum products; chemical and chemical products; rubber and plastic products; non metallic mineral products; metal and metal products; machinery and equipment; electric and electronic products.
[23] Services include electricity, gas and water; construction; trade; hotels and restaurants; transport, storage etc.
[24] UNCTAD 2003 Report
[25] *Supra* Note 21
[26] World Bank Debtor Reporting System
[27] World Bank data and World Bank staff estimates

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1. IBRD Articles of Agreement (1944 as amended), Art. I (ii)
2. The World Bank (2002) *Private Sector Development Strategy – Directions for the World Bank Group*
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5. Peter Gallagher (2002) *Guide To The WTO And Developing Countries* (The HagueKluwer Law International)
6. Simon Bishop & Mike Walker (2002) *The Economics of EC Competition Law: Concepts, Application and Measurement* (London, Sweet & Maxwell)
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8. Nobert Horn Arbitration (2004) *Foreign Investment Disputes: Procedural and Substantive Legal Aspects Vol. 19* (The Hague, Kluwer Law International)
9. Centre For Trade and Development (2006) *Trade in services & India: Prospects and Strategies* (New Delhi, Centre For Trade & Development)

Appendix

Sector	1990			2003			
	Developed countries	**Developing Countries**	**World**	**Developed countries**	**Developing countries**	**Central & Eastern Europe**	**World**
Primary (inward stock)	145, 404 (10.0)	24, 727 (7.4)	170, 131 (9.5)	428, 831 (6.6)	143, 993 (7.1)	21, 498 (33.4)	594, 321 (6.9)
Primary (outward stock)	158, 187 (9.1)	867 (4.7)	159, 054 (9.0)	400, 733 (5.3)	3,178 (0.5)	554 (31.8)	404, 465 (5.1)
Manufacturing (inward stock)	595, 142 (40.8)	150, 410 (45.2)	745, 552 (41.6)	2, 081, 645 (31.7)	779, 112 (38.3)	15, 345 (23.8)	2,876,102 (33.3)
Manufacturing (outward stock)	773322 (44.3)	6109 (33.3)	779,432 (44.1)	2,117,367 (27.9)	103414 (15.5)	392 (22.5)	2,221, 174 (27.9)
Services (inward stock)	717, 147 (49.2)	157, 950 (47.4)	875, 097 (48.9)	4, 015, 555 (61.5)	1, 110, 757 (54.6)	27, 514 (42.8)	5,153,826 (59.8)
Services (outward stock)	815, 717 (46.7)	11, 350 (61.9)	827, 067 (46.8)	5, 058, 640 (66.8)	562, 409 (84.1)	795 (45.7)	5, 321, 844 (67.0)
Total (inward stock)	1, 457, 693	333, 087	1, 790, 780	6, 526, 031	2, 033, 862	64, 357	8, 624, 249
Total (outward stock)	1, 747, 226	18, 326	1, 765, 553	7, 576, 740	669, 001	1, 741	7, 947, 483

Table 1: Estimated world-wide inward and outward FDI stock by sector (mn $)[20]

Table 1 provides a share-wise decomposition of total FDI flows into primary[21], manufacturing[22] and services[23] industries during the period of 1990 to 2003. In early 1970s, the service sector accounted for only one-quarter of the world FDI stock[24]. In 1990, this share was less than one half, and by 2003, it rose to about 59%. The service sector now accounts for nearly 60% of global FDI stock as compared to 50%.

Table 2: Distribution of global inward FDI flow in services by activity, 1989-1991 and 2001-2003 (mn $)[25]

Sector	Inward FDI flows (1989-1991)			Inward FDI flows (2001-2003)			
	Developed countries	Developing Countries	World	Developed countries	Developing countries	Central & Eastern Europe	World
Electricity, gas and water	872	1247	2, 118 (2.2)	18, 621	5, 543	94	24, 258 (5.3)
Construction	572	700	1, 227 (1.3)	3, 047	2, 028	118	5, 192 (1.1)
Trade	16, 426	2, 599	19, 025 (20.1)	32, 914	14, 787	1, 287	48, 988 (10.6)
Hotels and Restaurants	3, 782	945	4, 727 (5.0)	1, 433	1, 251	18	2, 703 (0.6)
Transport, storage & Communication	1, 702	1, 290	2, 993 (3.2)	60, 339	14, 090	1, 384	75, 813 (16.4)
Finance	33, 841	2, 553	36, 393 (38.4)	92, 600	20, 923	583	114, 105 (24.8)
Business Activities	11, 591	1, 565	13, 155 (13.9)	98, 293	34, 072	673	133, 038 (28.9)
Public administration and defence	2, 435	-	2, 435 (2.6)	2, 590	-	5	2, 595 (0.6)
Education	7	5	12 (0.0)	-4	38	7	41 (0.0)
Health and social services	71	24	94 (0.1)	-	-	-	0.0
Community, social, personal service activities	2, 391	972	8, 863 (9.4)	32, 697	3, 919	6	9, 085 (2.0)
Other Services	8, 191	672	8, 863 (9.4)	32, 697	3, 919	2	36, 618 (7.9)
Unspecified tertiary	859	419	1, 277 (1.3)	6, 026	3, 054	6	9, 085 (2.0)
Total services	82, 694	12, 027	94, 721 (100)	353, 428	103, 402	1, 498	461, 028 (100)

Table 3: Long-term flows to developing countries, 1990-1998 (billions of US dollars)[26]

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Net long term resource flows	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
International capital markets	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
Foreign direct investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Table 4: FDI flows to the top ten recipient developing countries 1991, 1994 and 1997 (billions of US dollars)[27]

Country	**1991**	**Country**	**1994**	**Country**	**1997**
Mexico	4.7	China	33.8	China	37.0
China	4.3	Mexico	11.0	Brazil	15.8
Malaysia	4.0	Malaysia	4.3	Mexico	8.1
Argentina	2.4	Peru	3.1	Indonesia	5.8
Thailand	2.0	Brazil	3.1	Poland	4.5
Venezuela	1.9	Argentina	3.1	Malaysia	4.1
Indonesia	1.5	Indonesia	2.1	Argentina	3.8
Hungary	1.5	Nigeria	1.9	Chile	3.5
Brazil	1.1	Poland	1.9	India	3.1
Turkey	0.8	Chile	1.8	Venezuela	2.9
Top ten share in FDI to all developing countries (per cent)					
74.2		**76.1**		**72.3**	

Buying Properties in Malaysia? Highlight on Laws, Policies and their Implication on Foreign Land Ownership

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Abstract. The laws and policies pertaining to foreign land ownership in Malaysia have seen tremendous changes for the past two decades. The reasons may be linked to economic, political and social factors. The changes, as claimed, have to be carried out to accommodate the current needs and circumstances. Nevertheless, at the same time, frequent changes would also create uncertainty and insecurity to the purchaser especially the investors. The Malaysian government has made various efforts towards becoming a developed country, trying hard to attract foreign investors to invest in the country. At the same time, a reasonable consideration must be given to the needs of its own people. Moreover, it is equally important to protect and to ensure that the people's right shall not be sacrificed for the sake of development and especially when all the benefits will go to only a certain class of people. The history of foreign land ownership policy especially on the restrictions imposed by the laws and policies are worth noting. The legal perspectives are delineated from some important statutes such as the National Land Code, 1965, the Malay Reserve Enactments, the Malay Agricultural Settlement Act, the Aboriginal Peoples Act 1954, and also the restrictions imposed by the states since land is a state matter in Malaysia. Furthermore, some of the restrictions are traceable in the policies determined by the relevant ministries. Following this, the implication of these restrictions on foreign land ownership and also property market will be addressed.

Key words: foreign policy, land transaction, law.

1. Introduction

Past and present policies on foreign ownership in Malaysia reflect the relationship between economy and land. It is noticeable that changes in the policy have been initiated to accommodate the demands, particularly, in the housing and economic sectors. There is also connection between political state of affairs and land policy in which, the government has, in many instances revised the relevant policies in order to accommodate the needs in economic, political as well as social security.

There are a few legislations which provide definition for foreigners in Malaysia. Under the National Land Code 1965 (hereinafter will be referred to as the NLC), non-citizen is defined as "a natural person who is not a citizen of Malaysia" (Section 433A of the NLC) and foreign companies are defined according to section 4 of the Companies Act 1965. Under the NLC, foreign company is referred to include local companies registered under the Companies Act 1965 with fifty per cent or more of its voting share being held by a non-citizen, or by a foreign company(Section 433A(b). In addition, foreign interest is also defined under the Foreign Investment Committee (FIC) as of 25 March 2003 to include any interest, associated group of interests or parties acting in concert which comprises: - (a) individual who is not a Malaysian citizen including Permanent Resident; or (b) foreign company or institution; or (c) local company or local institution whereby the parties as stated in item (a) and/or (b) hold more than 50% of the voting rights in the company or institution.

Historically, the changes in the policies pertaining to foreign ownership in Malaysia took place for several times. Prior to March, 1985, it was not felt that Malaysia needed any kind of policy that limits the right of the foreigners to hold or buy properties in Malaysia. In fact, the foreigners were most welcomed and there was no restriction imposed as far as foreign interest in property acquisition is concerned. This was thought necessary for the economic development which requires technology, skills exchange as well as capital injection. The dilemma of the government is basically on how to ensure that the presence of foreigners shall not become a rival to the locals, economically and politically. At the same time, the government needs to ensure that there would be sufficient funds for future development. In this respect, foreign direct or indirect investments are vital. There are

many policies and laws supporting for the investment by foreigners in Malaysia. These programmes are expected to provide brighter opportunities for real estate development in Malaysia in the years ahead.

Nevertheless, there is always doubt and worry among the locals as to the effect of foreign ownership in Malaysia. Past experiences have reminded them to be more vigilant. Development means nothing if it is for others. The government has to think of what is left for future generation rather than continue building houses to accommodate foreigners' needs and neglect the rights of the locals for cheap and affordable quality houses. The present political climate in Malaysia seems to be healthy and encouraging the foreigners to invest in Malaysia.

Apart from the various policies and programmes encouraging foreigners to invest and stay in Malaysia, there are also other laws that continuously remain in force which to a certain extent restrict the foreigners from dealing with the property in Malaysia. Their existences are undoubtedly important to create a balance between the positive and the negative impact of foreign ownership policy. The preceding discussion revolves around the policies and laws as well as the various incentives introduced by the Malaysian government in attracting the foreign investor to invest in Malaysia.

2. Restriction Imposed by the National Land Code 1965

The NLC was enacted for the uniformity of the laws pertaining to land in Peninsular Malaysia by virtue of Art 76(4) of the Federal Constitution. With this code, Malaysia adopts a registration system based on the Australian Torrens system, where all registered transactions pertaining to land secure priority in claim and also indefeasibility of title. Thus, any land registration affected by foreigners evidenced with a land title shall be conclusive and final. The registered owners' rights are secured and can only be challenged in a court of law.

There were series of restrictions on non-citizen done through the NLC from as early as March 25, 1985 (Part 33A, Act 587 of 1984). With this amendment, foreigners can only deal with 'building' land with prior approval from the State Authority while agricultural lands were subjected to the absolute prohibition. State Authority refers to the ruler or governor of the state as the case may be (Section 5, NLC). However, in practice, the State Authority is defined in Chong Wooi Leong & 29 Ors. v. Lebbey Sdn. Bhd. (1998) 3 AMR 2065, as the Ruler acting upon the recommendation of the Executive Council of the State and for the Federal Territory, the Government of the Federation was held to be equivalent to the State Authority. There is no restriction imposed for industrial land. It can be acquired freely by the foreigners. This policy shows that the government is serious about encouraging the foreigners to invest in the country. Later, an extension to the amendment was done in September 13, 1985 via (Amendment) (No.2) Act 1985. This amendment provides that the restrictions on land dealing by foreigners shall not apply to any charge effected or lien created in their favours whether before or after the commencement of the Act (section 433B (3) (4) (5).

There was a drastic change in policy occurred in 1986 whereby no restriction was imposed on foreigners (Act A658). This move reflected the government desire to deregulate the property market which was going through a slump period from 1984 to 1986 and provides a fresh impetus to investors, especially foreigners to establish a sound footing in the Malaysian property market (Adibah, 1997:1). With the amendment, all types of land including agricultural land can be bought without any restrictions or limitations. The impact of the amendment could be seen in the number of approved application for foreign purchased properties which increases from 384 in 1993 to 1293 applications in 1995 (Teo Guan Kiang, 1997:53).

In 1988, the economic boom in Singapore and the fall of the Malaysian Ringgit to Singapore by almost 40% has triggered properties sale in Malaysia, in particular, in Johor. The Malaysian have suffered rises of prices in many other sectors which have resulted in speculation of property market, high inflation as well as a considerable high cost of living especially in Johor Bahru. As a result, the state government stated that the State Authority has the power to approve the sale of agricultural and building land (Act A832, on January 1, 1993). Once again, the government of Malaysia felt that there was a need to review the policy and the law has been amended again to include the imposition of levy by the State Authority for any purchase of property by foreigners (Act A941, 1996). The amount of levy varies according to the State Land Rules (Section 433B (2). Some states chose to follow a strict interpretation of the law that any property where deed or instrument has been signed and stamped according to Stamp Act 1949 before 16 March 1996, i.e. a month after the announcement, will not be exempted from any approval of the State Authority or subject to any levy. Nevertheless, Malacca another popular property attraction among the locals and the Singaporean opted for giving exemption for imposition of levy to any property that has yet to be transferred into the name of the new foreign purchaser.

Under section 433B (2) of the Amendment 1996, the levy has to be paid by the foreign purchaser after he obtained the approval from the State Authority except for application done under section 433E, as the application

has to come from the vendor or the disposer of the property. There is no study to show whether the levy has, to a certain extent, reduced the interest of the foreigners from buying in Malaysia.

It could be seen that the earlier amendment for restriction as to the right of the foreigners in buying properties in Malaysia was made to protect the right of the locals. However, when the economic was slow, the government relaxed the rules in order to secure more income from the dealings executed by the foreigners. The recent move and incentives for foreigners seem to make the invitation to invest in Malaysia more attractive and the success of the programme is yet to be seen. Nevertheless, past experience shows that policy and laws seem to be seasonal and short-lived.

3. Power of the State Authority

Apart from the policy on foreign ownership as provided under section 433 of the NLC, it is important to understand that in Malaysia, the State Authority has a wide discretionary power to decide on land matters (Section 14 of the NLC; Section 40, NLC; *Chiharu Yabe (Zaugg) (P) & Anor v Registrar of Land, Federal Territory* [2002] 4 CLJ 231). There is a constitutional provision which states that land is a state matter (Article 76, Federal Constitution). Thus, the power to decide on land varies according to states and contains in the State Land Rules apart from the NLC itself. Thus, even though there is a policy that any purchase of property by foreigners is exempted from any approval from the Foreign Investment Committee, but consent for any land registration is within the jurisdiction of the State Authority. It was recently reported in the media that there are still some hiccups as far as the speediness in getting the approval for transfer of ownership from the land office as well as hanky-panky withdrawal procedures set by the bank are concerned. It was reported that there were also cases where the realty agent has charged exorbitant fees for the service (www.thestar.com ;Tuesday, January 23, 2007).

National Land Council

The National Land Council is a body established under Article 91 of the Federal Constitution. It comprises of state representative with a Federal Minister as a chairman. The main function of this Council is to formulate a national policy for the promotion and control of the utilization of land in Malaysia. The formulation of the policy is to be referred and discussed with the State Governments and the National Finance Council. Sheridan and Grove (1967) viewed that adoption of land policy is difficult, if not impossible. The policy is merely directory (Sheridan and Grove, 1967:133). Therefore, any decision made by the National Land Council pertaining to foreigners shall only affect the foreigners in the particular states which choose to adopt the decision of the National Land Council.

The Foreign Investment Policy

The Foreign Investment Committee (FIC) has been established by the government under the Prime Minister's Office and is responsible for matters on foreign investment including formulating policy guidelines on foreign investment. Moreover, it also has a duty to monitor the progress and help resolve problems pertaining to foreign private investment, to supervise and advise Ministries and Government agencies concerned on all matters concerning foreign investment, to coordinate and regulate the acquisition of assets or any interests, mergers and take-overs of companies and businesses in Malaysia. The FIC is also responsible to monitor, assess and evaluate the form, extent and conduct of foreign investment in Malaysia as well as to maintain comprehensive information on foreign investment**.**

In 2004, the FIC has released its guidelines for foreign investment dealing with the acquisition of properties and the acquisition of interests, mergers and takeovers. The advantages of the revised guidelines to investors are shorter processing time and simplified procedures. The investors are required to make declaration in a prescribed format that they have met or will fulfil conditions stipulated in the guidelines; and to undertake to comply with conditions imposed by the FIC, if any. Actions will be taken against those who deliberately provide false information.

The requirement for acquisition of properties is no more stringent for foreigners, including permanent residents, as any acquisitions shall not require the FIC approval. Foreign interest is allowed to acquire property valued at more than RM250, 000 per unit with no limit on the number of property acquired as well as no condition as to the type of use.

The flexibility of the government could also be seen from the policy which allows avenue for financing from internal and external sources to support the acquisition by foreigners. Local manufacturing company owned by foreign interest is allowed to acquire residential unit valued at less than RM150, 000 but more than RM60, 000 subject to the residential unit is used only for the company's employees. Acquisition of property valued at less than RM10 million by foreign interest does not have to incorporate a local company subject to the property is only for own use. Foreign interest is only allowed to acquire agricultural land valued more than RM250, 000 or at least five (5) acres in area, whichever is higher subject to the conditions for acquisition. Acquisition of agricultural land by foreign interest is only allowed for agricultural activities on a commercial scale using modern or high technology or for agro-tourism projects and for agricultural or agro-based industrial activities for the production of goods for export. However, for these purposes, relaxation on equity condition may be considered.

Foreign interest is allowed to acquire industrial property without any price limit and must be registered under a locally incorporated company subject to the conditions for acquisition. A special issue on acquisition of property through public auction has been provided where foreigners are allowed to acquire property valued more than RM150, 000 per unit subject to the conditions for acquisition. Furthermore, any transfer of property to a foreigner based on love and affection requires the approval of FIC and is allowed among immediate family members only. Acquisition of property also includes the activities of leasing and charging the properties to the foreigners. Leasing of property for a term of 10 years and above by foreign interest requires the approval of FIC. Similarly, a disposal of property by foreign interest to another foreign interest also requires FIC approval. However, disposal of property valued at less than RM20 million by foreign interest to local interest needs only to be informed to FIC.

In addition, acquisition of property(ies) with a total value of RM10 million and above or an entire building or property development project (irrespective of value) by foreigners has to be registered under a local company and will be subject to conditions for acquisition (including equity, employment, share capital and property development). The only exemption to the equity condition is where foreigners acquire industrial property for their own manufacturing operations. Multimedia Super Corridor (MSC) status companies can purchase any properties in the MSC area without approval of the FIC, provided the property is used solely for its operational activities.

The major change of the guideline covering acquisition of interests, mergers and takeovers occurs when a foreigner acquires interest in a business of less than RM10 million, the FIC's approval is not required (previously RM5 million). However, the FIC's approval is still needed for any acquisitions involving voting rights of foreign interest(s) of 15 per cent or more in a local business, irrespective of the value of transaction. For national-interest companies (water, energy supply, broadcasting, defense and security), foreign interests are limited to 30 per cent. The government can also insist on having a golden share in the company. Equity condition imposed under the guideline is a Bumiputra equity interest of at least 30 per cent. Exemptions to this guideline include any acquisitions of a company: a) in manufacturing, which license is granted by the Ministry of International Trade and Industry; b) with MSC status; c) with status of 'International Procurement Centre', 'Operational Headquarters', 'Representative Office' or other special status as granted by the government.

The common issue raised pertaining to the FIC is whether the guidelines prepared by the committee has legal implication thus bound to be followed by all parties. In *Ho Kok Cheong Sdn Bhd & Anor v Lim Kat Hong* ([1979] 2 MLJ 224) the court held that the guidelines were issued not pursuant to any power given by law, thus the court was of the view that they do not have force of law but are of an advisory character only. Hence, non compliance with the guidelines can be taken as an act opposed to public policy. Also, the court was in the opinion that the guidelines reflect the Government's political policy, but the government's political policy is not public policy. Later in *David Hey v New Kok Ann Realty Sdn Bhd* ([1985] 1 MLJ 167) the Federal Court gave its opinion on the position of "Guidelines for the Regulations of acquisition of Assets, Mergers and Take-Over, a document produced by the FIC and held that it is more than a mere political policy i.e. a national economic policy, thus, the court could properly take judicial notice. However, later in *Thong Foo Ching & Ors v Shigenori* (1998, 4 MLJ 585) the court seemed to support the opinion that the FIC guidelines do not possess legal efficacy. In this case, Siti Norma Yaakob J (as she then was) held that a reading of the guidelines shows that there is no penalty imposed for non compliance of any of the provisions. From the very nature of the document itself and its purpose to eradicate poverty by restructuring the Malaysian society, the guidelines impose a moral obligation only on those affected to comply with their provisions. Obviously as far as the law is concerned, it does not strictly require the FIC guidelines compliance, but it has been argued that the public policy consideration may require otherwise (Arumugan Rajendran, 2002:8).

Basically, the content of the FIC guidelines provides the detailed terms and condition as to the acquisition of all types of property in Malaysia. It is submitted that the terms of the guidelines must be read with other laws for examples the National Land Code 1965 and the Companies Act 1960. It is advisable that the FIC guidelines would also have to be complied with, with respect to the acquisition of land by a foreign interest. Nevertheless, all purchasers and property players are highly encouraged to seek legal advice on the these matters before engaging in any transaction.

The Malay Reserve Land

Malay and natives titles can also be considered as a challenge to foreign ownership in Malaysia (www.nationsencyclopedia.com). The Federal Constitution as well as the Malay Reserve Enactments for states generally declares that only Malay can deal with a Malay reserve land. And the State Authority has the power to declare, revoke and replace any area as Malay reserve land. Historically, the main reason behind the introduction of the Malay reserve enactments for the Malay states by the British was to protect the Malay land from falling into the hand of the non-Malay. Based on section 433 of the NLC, any foreigner of Malay origin is prohibited from dealing with any Malay Reserve land in Malaysia. However, under certain exceptional circumstances, the strict rule on Malay reserve land can be relaxed via the wide discretionary power of the Ruler in Council which consists of the Chief Minister of the states and the Executive Council of the states. In this respect, the Ruler in Council has the power to exempt whom it deems fit and qualified to be regarded as Malay.

The Aboriginal People's Act

The Aboriginal Peoples Act 1954 (Act 134) (http://www.coac.org.my/codenavia/portals) is a product of the emergency laws served to prevent the communist insurgents from getting help from the Orang Asli. There are provisions which allow the Minister concerned to prohibit any non-Orang Asli from entering an Orang Asli area. Nevertheless, the Act does recognise some rights of the Orang Asli and it provides for the establishment of Orang Asli areas and Orang Asli reserves. It also grants the State Authority the right to order any Orang Asli community to leave and stay out of an area. An Orang Asli is allowed to remain in a particular area only at the pleasure of the State Authority. If at such time the state wishes to re-acquire the land, it can revoke its status and the Orang Asli are left with no other legal recourse but to move elsewhere. Furthermore, in the event of such displacement occurring, the state is not obliged to pay any compensation or allocate an alternative site. This title is only for the aborigines and no other people can have any dealing with this type of land except with the approval from the State Authority.

Bumiputra Provision

The emphasis on Bumiputra equity, the restriction on dealings with regard to Malay reserve land and the requirement for a certain percentage of Bumiputra equity in foreign direct investment and foreign companies have, to a considerable extent, created a barrier to some investors to invest in Malaysia.

> According to the FIC guidelines dated May 21st. 2003, Bumiputra means –
>
> (a) for Peninsular Malaysia, Malay individual or aborigine as defined in Article 160(2) of the Federal Constitution; (b) for Sarawak, individual as defined in Article 161A (6)(a) of the Federal Constitution; (c) for Sabah, individual as defined in Article 161A (6)(b) of the Federal Constitution. Bumiputra interest means any interest, associated group of interests or parties acting in concert which comprises: - (a) Bumiputra individual; or (b) local company or institution whereby Bumiputra holds more than 50% of the voting rights in the company or institution;

Bumiputra lot is also seen as a restriction to foreigners from dealing with certain category of land in Malaysia. (Adibah Awang, 1997: p.9) The effect of the endorsement of any lot with this category is to the effect that the ownership of this particular category of land limited to Bumiputra only and dealing with non-Bumiputra is not allowed. The common wordings of the restriction will appear on the document of title as "The land herein once transferred to a Bumiputra, shall not, subsequently, be sold, leased (sic), transferred in any form whatsoever, to a non-Bumiputra without prior approval of the State Authority". Any housing project in Malaysia is required to reserve 30% of the lots to the Bumiputra with a special discounted prices ranging from 5%-7% for each property.

Recently, the government has relaxed its rules on Bumiputra equity for Iskandar Development Region in Johor. This effort is welcomed by many, especially the construction players. The incentives for the region include the exemption for complying with any rules that favours Bumiputra. However, these incentives are only for companies that are approved by the Iskandar Regional Development Authority (IRDA) and the activities must be carried out in the designated zones. Nevertheless, the incentives have been received with mix feelings by the locals especially the Malay reserve owners. Issues such as public participation in development, legal implementation and enforcement, equity distribution, physical development strategy and also social development are among the agendas that require more transparent approach for better appreciation and participation.

The Malay Agricultural Settlement

Similar to Malay reserve land, the Malay Agricultural Settlement is another type of special property reserved for the Malays. It was introduced by the British by virtue of section 6 of the 1897 land enactment. The purpose behind the introduction of this category of land was to cater to the needs of the poorer class of Malays staying in the urban area like Kuala Lumpur. Matters pertaining to Malay Agricultural lands are governed by a special board known as Board of Management created under Notification 21 of the Selangor Gazette 1900. The rule also prescribes that only the Malays can occupy the land and there is no title issued to any individual owner. No dealing can be done involving this land unless with the approval of the Board. Though legally speaking the land is still considered as state's land, due to political reason, the government finds it difficult to develop the land. In Kampung Bahru, for instance, Kuala Lumpur, many efforts to develop the land have become futile. Its restriction and lack of title are among the obstacles faced by the government in dealing with the Malay Agricultural Settlement.

Sabah and Sarawak Land Code

Under the Sabah Land Ordinance, any dealing of native title with non natives is prohibited. However, any natives desirous of selling his properties to non natives must surrender the titles to the State for fresh alienation of a lease subject to new land premium payment and enhanced quit rent. Again, similar to Malay reserve land, the justification behind this restriction is to keep such lands in the hands of natives and to prevent the entry of non-natives in areas that have been declared to belong to the natives.

There are also other limitation imposed by the state on non native land i.e. town land and country land which requires the individual or company owning the land to dispose 30% of the land or shares of the company to natives within a prescribed period. Alike to the above, the reason is to ensure that the natives are able to participate in commercial, residential and industrial activities by reverse participation.

Similarly, the Sarawak Land Code (Cap 81) also has certain clear provisions restricting the rights of the non natives and under certain parts specifically prohibiting the non Malaysian from dealing with certain lands in Sarawak.

Creation of Power of Attorney

One of the ways where a person can legally act for another person is through a proper authorization or power and appointment, which is known as power of attorney. A 'power of attorney' is defined as a formal instrument by which one person empowers another to represent him or act in his stead for certain purposes (*Jowitt's Dictionary of English Law* (2nd edn). Once a power of attorney is created, the relationship of principal and agent arises between the donor and the donee of the power. Section 188 of the NLC explains that a registered proprietor of any estate or interest in land may, by power of attorney in any usual form, and either in general terms or specially authorized, and appoints any person on his behalf to execute transfers or other dealing therewith. However, a foreigner is prohibited from dealing through power of attorney with any of the reserved land or the dealings or contract shall become void for illegality (section 24 of the Malaysia Contract Act 1950).

4. Policies and Incentives to Encourage Foreign Ownership

No doubt that foreign investment directly or indirectly is important to Malaysia. Despite many restrictions on foreign ownership, the Malaysian government has continuously revised its policy in order to balance the needs for protection of local interest and contribution of foreign expertise and skills. As a result, there are various

forms of incentives offered by the government to foreign individual and companies including the taxes, property ownership, visa approval as well as exemption on certain trade policies.

Foreign Investment Committee Guidelines

In December 2006, the Prime Minister has announced that the foreigners can buy any residential property valued at RM250, 000.00 and above without the need to get the approval of the FIC and without any condition on the usage and number of properties. They can also rent, lease or trade in those properties. However, the foreigners are not allowed to buy any low cost or medium cost houses or flat which normally valued between RM42, 000 to RM150, 000. For foreign companies incorporated in ASEAN countries with a view of joint-venture business activities in Malaysia they are allowed to own offices or office spaces priced exceeding RM250, 000 without imposition of equity condition. As discussed earlier, though there are restrictions for foreigners imposed by the FIC, but there are more relaxed rules introduced in order to give a boost to the Malaysian property market.

Real Property Gains Tax

The recent government announcement (NST, Friday, March 21, 2007) is that Malaysia will scrap a capital gain tax on property from April, 1, 2007. According to the Prime minister, this is made in order to inject more excitement and dynamism into the property as well as financial sector. However, the foreigners are still required to hold the property for 5 years before it can be sold to another party. It is expected that more investors will enter the property market especially for high-end properties. Moreover, effective on the 1st of April 2007, the foreigners will not be subject to any limitation on property loans.

Malaysia My Second Home Programme

Malaysia My Second Home program is open to all foreign citizens wishing to retire or reside in Malaysia on a long term basis. It is fully endorsed by the Government of Malaysia and the immediate family (spouse and children) of the foreigner can also participate in the programme. There are many benefits offered including a 10-year Visit Pass and Multiple-Entry Visa (renewable every ten years) which will eventually provide a lifetime easy access to Malaysia (perpetual visa), right to import cars or purchase a new car, tax-free and enjoy other tax incentives, invest and own businesses in Malaysia. The foreigners may just act as if he has a second passport, or a second citizenship in Malaysia apart from enjoying a luxury lifestyle at a fraction of the costs. Furthermore, the foreigners can still retain their citizenship and all its privileges in their own country. Since its launching in 2002, there were a total of 8,723 approved applications (www.thestar.com.my) (Refer to chart No.1). The applicant is only required to comply with the financial criteria by opening a fixed deposit account of RM300, 000.00 for those aged below 50 years and RM150, 000.00 for those aged 50 years and above (http://mm2h.motour.gov.my/cms). Each foreigner is allowed to purchase up to two units of residential houses priced at RM150, 000 each. The only restriction is that the foreigners under this programme are not allowed to be employed while staying in Malaysia or involved any other activities that are considered sensitive to the local people or a threat to the country.

5. Conclusion

Previous record shows that foreign interest in Malaysia is dominant. In 1970, about 60% of the share capital of limited companies was owned by foreigners. In agriculture and fisheries, it was as high as 75% and about 72% in mining and quarrying. In commerce and manufacturing foreign ownership amounted to about 63% and 59% of total share respectively. It is said that this dominance of foreign ownership and control in the major sectors of our economy is a direct by-product of our historical past. (www.epu.gov.my) Under the present administration, practising fair and just economic distribution for all races is a matter of prime interest for Malaysia being a multi-cultural country. To apply the same practice to foreigners is again another challenging task. The question is how to strike a balance between the need to generate income through foreign capital and at the same time, not to sacrifice the rights and interest of the locals. Malaysia is moving towards becoming a developed country in the year 2020. The task ahead is very unpredictable and challenging. The restriction reflects the aspiration of the government as well as people to protect their ownership and rights in the country. The effort to relax the rules for foreigners is received with mixed feeling, worry and relief. The worry is perhaps one day Malaysian cities are

full with foreigners and though Malaysian may be proud with skyscrapers but unfortunately, Malaysian does not own it or cannot afford to own it.

As a whole, the restrictions on foreign landownership in Malaysia are varied but less effective. Most of them are particularly aimed at protecting the rights of the locals and the natives so that the properties shall not fall into the hand of the non-citizens. Nevertheless, the overflowing of certain types of houses as well as the needs for economic stimulator led the government to change its policy. The Malaysian government has recently announced various incentives and made the property ownership by the foreigner rather easy and less cumbersome. These initiatives though welcomed by certain quarters in housing sectors, nevertheless, based on past experiences; there is a worry that, the speculation in property market will, to a certain extent, create unhealthy competitiveness among the property players. The price of properties will unnecessarily increase and developers will focus more on the profitable project that may attract foreigners and thus neglect their social duty to provide affordable and quality houses for the locals. Again, past experiences show that some of the restrictions are more of temporary measures to accommodate the existing needs of the economic sector. There should be a continuous study conducted from time to time to ensure that the Malaysian will maintain the ownership status-quo and enjoy the maximum benefit from the policies.

It is important to understand that apart from introducing various incentives, Malaysia, since the times of colonialism, was trying hard to protect the interest of the locals. Initially, the effort was to protect the Malays being the natives, followed by the aborigines and later the interest of other races. Until now, this is entrenched in the spirit of the laws and policies of the government. Thus, Malaysia subscribes to the policy that can be fine-tuned to the country's economic condition and needs.

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16. The Federal Constitution 1957

Appendix 1

Chart No. 1

MALAYSIA MY SECOND HOME PROGRAMME

Country	Approved Application					TOTAL
	2002	2003	2004	2005	2006	
China	241	521	468	502	242	1,974
Bangladesh	-	32	204	852	341	1,429
Britain	108	159	210	199	209	885
Singapore	96	143	91	62	94	485
Taiwan	38	95	140	185	63	522
Japan	49	99	42	87	157	434
Others	286	596	762	727	622	2,993
TOTAL	818	1,645	1,917	2,615	1,728	8,723

Source: www.thestar.com.my/news, retrieved 1/23/2007

Globalization and China's Pathway in Quest for a New Identity

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Abstract.In the context of globalization, the concept of national identity becomes much richer and the governments' policy-makings have been largely monitored by the markets. If some countries have been more successful than others in responding to the same challenges posed by incorporation by the world economy, then the reason for these different answers is to be found in their national choices. In recent years, few developing countries have enjoyed benefits from interaction with outside world as much as China has. As a late-comer of globalization, China has been confronted with a clash between the dissolution of a traditional society and the construction of a modern one. Taking into consideration China's history, population, size, potential and geo-political influence, this article reviews her unique pathway in quest for a new identity in the era of globalization and tries to find some enlightenments equally useful for other developing countries.

Keywords: Globalization, China, Trade liberalization, Governance

I. Introduction

Globalization influences the world deeply and also enlarges the traditional perspectives of doctrine. The mercantilism of global economy and the globalization of market economies push the Nation-States into a shock; in fact we can see very different performances among different countries in the same world- some become the true beneficiaries and others are left far behind. An optimistic view believes that free trade and globalization are beneficial for virtually all people in all countries; however, the reality shows that wealth and opportunities brought by the globalization are unevenly distributed across countries. While the Nation-State continues to be the main political role in the international scenario, the concept of national interests becomes much richer and the governments' policy-makings have been largely monitored by the markets. If some countries have been more successful than others in responding to the same challenges posed by incorporation by the world economy, then the reason for these different answers is to be found in their national choices: namely, how to integrate in the wave of globalization, how to get the benefits of globalization and realize the development, how to safeguard better the national interests and have a bigger share of voice in global democratic governance?

The largest majority of people on earth live in the South. Over the past thirty years, few developing countries have enjoyed benefits from interaction with outside world as much as China has. As a late comer of globalization, China has struggled with the conflict between eastern and western cultures, as well as a clash between the dissolution of a traditional society and the construction of a modern one. Taking into consideration China's history, population, size, potential and geo-political influence, this article reviews her unique pathway in her quest for a new identity in the era of globalization and tries to find some enlightenments equally useful for other developing countries.

2. Globalization as an important way for development and prosperity

Economic globalization, a state of flux, can be understood as transnational circulation of goods, services, essential factors of production and information. Economic activities are no longer confined to national boarders but are underway in global sphere. New production patterns allow most industrial goods to have different components produced in different locations and final assembly to take place in anywhere. The essence of economic globalization is the evolution and deepening of international division of labour in the light of comparative advantage, which in turn, leads to trade expansion and international capital flow. The different levels of participation in the international division of labour give rise to convergence and divergence among economies.

The results aroused by globalization to date have been spectacular. Trade has grown twice as fast as world output over the past decade or more. Both developed and developing economies have had economic

growth and benefited from economic freedom. The globalization has raised 375 million people out of extreme poverty over the past 20 years [1].On average, poor countries that have opened their markets to trade and investment have grown five times faster than those that kept their markets closed[2]. UNCTAD figures show that, in the period 1990-2003, developing economies enjoyed an average 7.3% annual average growth in their merchandise exports against 4.9% for developed economies. In the same period, inward FDI stock in developing countries increased by over four times (by over three times, if China is excluded) - about the same as for developed countries [3].

Economic theories are read as clearly supportive of the proposition that free trade has a positive effect on economic growth and real incomes. From the classical view of the benefits of free trade [4], Adam Smith argued an absolute advantage according to which the division of labour (specialization) promotes productivity [5]. David Ricardo extended this concept to the doctrine of comparative advantage (so called "deepest and most beautiful result in all economics"). He believed that trade allows each country to specialize in what it does best, thus maximizing the value of its output. Even a country is relatively worse than any other country at producing every good, it can still benefit from free trade [6]. The Hecksher-Ohlin-Samuelson model of comparative advantage explains the benefits stemming from international trade. The character of a country's factor endowments (capital, labour and natural resources) will determine the type of goods a country will import and export. International trade serves essentially to extend the size of domestic markets, granting competitive exporters a wider range of potential consumers, and freeing labour and capital from uneconomic pursuits. New trade theory[7],taking into account imperfect competition, increasing returns to scale and changing technology, provides stronger support for free trade policies throughout the post-war[8] and suggests dynamic benefits from trade, such as greater market size, enhanced competition and technological improvements. On all accounts, trade and economic openness can promote growth through increased specialization according to comparative advantage, greater exploitation of increasing returns, learning of knowledge and technological capacities and improving economic performance through positive impacts on institutions and the political process. The idea that openness to trade is inherently good for both growth and development enjoys almost universal support and is deeply ingrained nowadays.

Like any dynamic economic change, participation in international trade creates both winners and losers, despite trade's net positive effects on the economy. Some economists argued divergence between the rich countries and the poor countries (Romer, 1986) [9], while others found empirical evidence of convergence (Sala-i-Martin, 1991) [10]. Many economic researches have been made to analyze factors that may lead to the convergence or the divergence. In our view, the increased trade in the era of economic globalization can really bring about convergence provided the internal and external limits can be surmounted.

The internal limits contain domestic policies [11], technological changes, optimization of trade structure, restructuring and reform affecting national markets and participation level in the globalization. An active participation in the economic globalization and outward orientation policies appear to be necessary components of effective development strategy and key explanations of why some countries have done better than others. Trade and investment liberalization significantly pays high dividends in terms of improved economic performance. High protection, poor governance and bad national policies in developing countries are harmful to their own development, to other developing countries and to the global system.

The external limits refer mainly to the inhibiting factors that restrict right conditions and more fair and balanced rules in favour of the developing countries in multilateral trading system, such as access to the world market, multilateral trade rules in force and other international factors.

The global inequality so far, to a large extent, represents the different levels of taking advantage of opportunities in international markets. It is a reflex of positions of the international division of labour occupied by different countries in the world economic system. It also reflects constraints on convergence and development.

3. China's engagement of the world economy over the long sweep of history

Globalization goes through various stage of development. The first stage, denominated by mercantilist expansion, began in 1450 and ended in 1850; the second stage characterized by imperial and colonial industrial expansionism occurred between 1850 and 1950; and the third stage of globalization aptly called started in 1960 and was accelerated in 1990s.

Till the end of the first stage of globalization, China was the centre of Asian tribute-trade system [12], (so-called Chinese trade network or Sino centric international order) and played an active role after the maritime expansion under Zheng He, in the early of the fifteenth century. At that time, China's competitive advantages in

terms of productivity of agriculture, handicraft industry and land and water transportation resulted in very favourable balance of trade. Ming China had a great monopoly in porcelain, ceramics, silk, gold, copper-cash and tea (after 1600) on world export market. Meanwhile, China was the major net importer of world's silver (American) through Europe and Asia and an essential importer of silver and copper from Japan. "China, not Europe, was the centre of the world" [13]. It was estimated by economic historians that in 1500, China had been the world largest economy and had the highest income per capita [14], in 1750, China's share of global manufacturing output corresponded to 33% of the world and as late as 1798, China was the richest country in the world [15], After then, China started to enter a long-term economic decline.

Around 1800, western countries, benefiting from the fruits of industrial revolution and transformation of the disadvantages in the past to own advantages, became the winners in the global economy, while China's role changed drastically. Till 1913, China's share of world manufacturing output was below than 4% and fell behind [16].

China's dramatic decline was largely due to its stagnant despotism, closed-door policies and rejection attitude of foreign technology adopted by Late Ming and Qing emperors [17]. China's lower level of incorporation in the world economy cut down its benefits from international division of labour and production specialization and reduced the national income level and capital accumulation to promote industrialization.

The resistance of Celestial Empire was finally broken by Great Britain after the Opium War at the beginning of the 1840s. As a consequence, a series of humiliating treaties (about 300 treaties and agreements) forced China to open up to the world market. Even though apparently China remained a sovereign state, it lost its economic sovereignty and autonomy, because of foreign military and economic invasion. Chinese tariff and custom administration were managed by foreign countries and foreign trade in China was also dominated by foreign firms.

The rulers of Qing China did try to respond the crisis, in the latter half of the nineteenth century, some comprador bureaucrats initiated "Westernization Movement", asserting "Chinese learning as the base and Western learning for application", with a view to introduce techniques in production and modernize weaponry. The Hundred Days Reform in 1898, aiming to generate conservative political and institutional change from above, did not gain popular support and suffered a defeat. After the Revolution in 1911, China was divided under military warlords and soon after had to face Japanese aggression. The Nationalist Party Regime restored tariff autonomy, revoked some foreign concessions and carried out a number of financial reforms, however, due to social upheavals and lack of peaceful environment, economic development was hindered and China had become one of the poorest countries in the world and posted large trade deficits by the first half of the twentieth century [18].

It is thus clear that the China's passive opening-up and engagement of the world economy pushed by western powers really protected the interests of each imperialist power instead of bringing China fair opportunities in participating the international division of labour.

After the foundation of the People's Republic, China was still very poor and eager to match its regained political pride with better living standards for the population. Right after independence, China drew reference from the Soviet Union's model, adopted a planned economy and an import-substitution strategy, choosing heavy industry as a priority of its national developments in order to catch up western powers. The expressions of import-substitution strategy could be found in official declarations, foreign trade organizations, centralized foreign exchange system and the models of import and export. The export was for import in a sense of earning foreign exchange, and the import was for the socialist industrialization and to reduce the gaps with western countries. Based on the idea of self-reliance, the State monopolized the foreign trade via a few state-operated companies; the import tariffs did not serve as an instrument of import and export; the exchange rate of national currency was over-valued; the government controlled strictly the foreign exchange rate; the export had been subsidized and China had no contacts with international economic organizations [19]. In addition, very limited capital was concentrated on capital-intensive and energy-intensive sectors; enterprises were no longer worried about profits but to achieve the state planning. However, price system distortions, low efficiency in the allocation of resources and the strategy not based on comparative advantage did not achieve a good record.

The Chinese historical facts show that neither passive interaction with the world economy under external economic control nor autarchic protectionist orientation against comparative advantage will lead to development and catching up. The only effective pathway is to take initiatives to deepen the participation of international division of labour, enhance the capacity to accept the great challenges and conduct good governance.

4. The path to national resurgence in quest for new identity

In the late of 1970s, China initiated an open policy toward the outside world. Together with closer diplomatic relations with industrialized countries, China entered some leading international organizations and achieved closer global integration.

Since the second half of 1980s, the world economy has undergone substantial and complex changes due to the new wave of globalization. Some essential factors are changing and will continue to change the formation of new international order. First of all, multinational corporations have adopted a global strategy which represents a revolutionary production model. In the second place, the technological progresses and information revolution have far-reaching repercussions on every aspects of human life. In the third place, international and regional organizations played a greater role in coordinating different views, settling global problems and seeking new rules in international arena. In the political aspect, the Cold War and the East-West confrontation ended smoothly with the demise of the Soviet Union. Democracy and the principles of free market economy were trumpeted as universal values.

China, as a late-comer, like other developing countries, has been pushed into the defensive in the context of the present stage of globalization. The economic globalization amplified the risks and costs of development, as evidenced by the widening gap between the South and the North and by emerging global threats, such as power politics, terrorism, contagious diseases and environment degradation, etc. But looking from another angle, all these have brought about historic opportunities for development.

The challenges of globalization for the developing countries in general embody mainly in two levels. The first is the link between the national economy and the world market challenges the existing institutions and the domestic governance capacity, for example, the structural imbalance within national economy, vulnerability of capital market, increasing inequality in wealth, etc. The second is in the international level, the developing countries are bearing great pressures because the new world order has not been rebuilt while the old one was not fully destroyed; and there are still many unbalanced situations or negative discrimination against the developing countries in the current multilateral system which requires more impartial institutions and rules to safeguard sustainable growth and gain credibility from all participants.

China has drawn a lesson from past frustrations and begun to adopt an open and an active attitude by implementing significant measures to introduce market economy and institutional innovations to surmount both internal and external limits, because the national economy needs the stimulus of external markets and technologies for the transition to a higher growth trajectory.

Response to the challenges of globalization depends on national capacity of reforms, training period of development, and above all, the domestic conditions and comparative advantages. As for China, it possesses abundant physical labours which represent 1/4 of world summation; with regard to the two main resources of agriculture, China is short of cultivated land and water, being each of them only 7% of world gross amount; China also lacks capital, technological and other natural resources. The domestic conditions illustrate that China has visible comparative advantage in exporting labour-intensive products and should import more capital-intensive and resource-intensive products, attract foreign capital and introduce advanced technologies. Therefore, the right strategy is to participate actively in the international division of labour and coordinate the domestic politics, society and economy with globalization process.

Over the past thirty years, China has implemented an extensive agenda of reforms which included the following points:

A. Active interaction between international environment and domestic policies

Free trade has been a critical force to bring about economic development and is seen as a means to promoting competition in China. It is estimated that about 25% of its annual economic growth is achieved by foreign trade [20]. Since 1978, China has adopted an outwardly oriented strategy, undergoing four stages: import substitution and marginal export orientation (1980-3), offsetting import substitution by export promotion (1984-90), export promotion and marginal trade liberalization (1991-3) and trade liberalization (after 1994) [21].

In 1986, the Chinese government applied to resume its GATT membership and hence started the long march of accession negotiations of the WTO. The participation in the multilateral trading system in 2001 was a strategic decision by the Chinese leadership. China can benefit from a non-discriminated treatment and a dispute settlement mechanism in the multilateral system. Chinese reformers have used consciously international rules, its international commitments and obligations to shape domestic policies, accelerate industrialization and

urbanization and deepen domestic reforms, especially, to dislodge domestic monopolies that curb growth, because openness can introduce advanced ideas, technologies and competition.

In this sense, globalization circumscribes the use of domestic industrial policy in certain ways. China precisely searches for global market forces as external action or auxiliary booster to accelerate its domestic socio-economic transition.

B. Transformation of government's role

Since 1978, China became a transitional economy in the process of marketization. Since China's economic activities were mostly under the direct control of the central government in the period of planned economy, the reforms involve the delegation of more and more economic powers to lower level governments.

The strong governing capacity of central government was beneficial to a united political framework and legal system as well as breaking a closed economy and building a unified market. However, a very rigid centralism led to low efficiency, high administrative costs and bureaucracy. In order to give more incentives to and seek cooperation from local governments, central government took an administrative and a fiscal decentralization strategy, holding sometimes laissez-faire, sometimes regulatory or promotional attitude. Local decision-making powers consist in mainly strengthening of local government's role in local economic management, such as examination and approval of projects and issue licenses to newly established firms, delivery of goods and materials, resource allocation, investment with self-financing, use of foreign investment, delegation of control of State-owned enterprises, autonomy to set prices of commodity, profit sharing with central government, etc.

In China, economic reforms depend largely on decentralization, local initiatives and innovations. In fact, tremendous economic growth of China stemmed from foreign direct investment and non-state-owned township and village enterprises, both of which rested upon the efforts of local governments.

The established special economic zones are regarded as "windows to know the world" and "laboratories of opening-up policy". The autonomy enjoyed by special economic zones consists in special institutional benefits and preferential policies, such as lower tax rates or tax exemption, higher share of revenues and so on.

On the other hand, the globalization requires further decentralization, allowing the rising civil society and local governments to undertake some responsibilities of management. The Chinese reform since 1978 is underway along the main line of decentralization from central to local and from state to society.

In short, when Chinese central government's role becomes less intrusive, market forces and other private agents have gradually permeated the economy. The government's function is concentrated on economy adjustments, market supervision, society administration and public services [22]

C. *Institutional construction and rule of law*

The biggest challenges of Chinese market transition are institutional construction and rule of law. The globalization has changed the Chinese traditional concept of "good government" into a modern idea of "good governance". Important decisions are taken as the result of a complex deliberation process in which the Government's interest is only one element within a wide angle. Civil society is growing and has the voice of the representatives of specific interests.

Economic prosperity will not lead automatically to social justice and social stability. On the way to the modernization, Chinese economy passed many stages: from natural economy of feudalism, bureaucratic-capitalist economy, planned economy to the establishment of market economy, the entry into the World Trade Organization and more active integration into the global economy. Law has been used to achieve harmony in Chinese society. Both judicial remedies and alternative dispute resolution (such as mediation and arbitration) offer different choices and approaches.

Since 1990s, China has made huge progress in terms of institutionalization of legal systems. The National People's Congress and its Standing Committee made around 400 laws, the State Council promulgated over 800 administrative regulations and the local people's congresses elaborated over 8000 local regulations. According to the commitments made by Chinese government on the Protocol on the Accession of the People's Republic of China into the World Trade Organization, more than 1000 normative documents of law have been updated or revised.

In addition to positive law, some universal political values, such as democracy, representation, human rights, responsibility and equality, rule of law, justice and cooperation have been accepted by China. The

government is implementing policies and measures within the limits of Constitution and Law in order to minimize negative impacts and increase positive impacts of globalization.

Just like other developing countries, China is also modernizing its legal system and learning from international rules and taking into consideration localism. The concept of rule of law, formal or substantial, should be planted on Chinese soil and the law is determined by specified political, economic, historical and cultural factors.

D. Participation in international democratic governance

Transnational problems require global responses. In order that globalization can have sustainable development, the new world order should meet the interests of the widest number. As the biggest developing country and the most populous country in the world, China hopes to have broad participation in international regime making and is undertaking more and more responsibilities in regional and international issues.

From China's perspective, there is a great need for global democratic governance. Democracy is essential to social peace and stability, not only within national borders, but in the world at large. In recent years, on different occasions, Chinese leaders have conveyed frequently the idea of "great harmony of the international community", which means there are not only confrontation and competition in the world but also interdependence and common interests; the diversities of ideologies and cultures should not be obstacles of exchanges and globalization should not wipe out national identity.

5. Conclusion

The Economy has been globalised, but not the politics. China's unique pathway in quest for a new identity in the era of globalization shows that each country must choose the path that best suits its own genius.

Globalization has eroded the powers of the government and has compelled the government to redefine its roles and functions. In economic matters, government's decision is subject to the scrutiny of the markets. The emergence of multilateral trade bodies, the individual empowerment that trade provides, the NGOs and multinational corporations have weakened the government powers in implementing its will.

However, in the context of globalization, the Nation-State continues to be the main political role in the international scenario and the government is still the engine to spur on social sustainable development and achieve good governance and holds the prime responsibility of facing challenges from the globalization, particularly in the developing countries. The Nation-State will never fold its hands without knowing what to do, but can evolve national policies to restrict negative effects of globalization.

Chinese experiences show us the positive role that a government facing the challenges of globalization should develop. As illustrated by history, the government intervened fully in economic life and such role was very harmful to trade and development. Since 1978, instead of continuing to impose overall restrictions on trade, China has learned to adapt better with the international environment and participated actively in the international division of labour and now is pursuing new patterns of development by creating gradually new comparative advantages and competitive advantages.

During these years of opening-up, the Chinese government brought its potentials into play, effectively addressing the opportunities of globalization and became more and more constructive in seeking the benefits of globalization. The most important thing is that through the integration with the world, China has made great achievements in establishing and enhancing its national concept and national identity.

Notes:

[1] HILLS, Carla A., (2005), "The Stakes of Doha", *Foreign Affairs,* Special Edition, p. 26, "*Studies have also confirmed a relationship between trade and productivity gains: a rise of 1 percent in the ratio of trade to GDP has been associated with 0.5 percent increase in long-term output per worker. Trade also helps reduce poverty by spurring economic growth, the main engine of poverty reduction. Statistical studies show that for developing countries, there tends to be a relatively close relationship between poverty reduction and growth*".

[2] HILLS, Carla A., (2005), p. 26.

[3] WOODS, David, (2005), "Ten Years of the WTO", in *World Trade Brief 2005,* WTO, p. 74.

[4] The classical theory bases on some unrealistic assumptions, such as perfect competition, constant returns to scale and fixed technology. Moreover, the gains from trade are primarily static in nature.

[5] SMITH, Adam, (1976), *an Inquiry into the Nature and Causes of the Wealth of Nations,* Oxford, Clarendon Press, p. 475-8.
[6] RICARDO, David, (1951), *On the Principals of Political Economy and Taxation,* vol.1, Cambridge University Press, p. 132.
[7] See for example, MANESCHI, Andrea, (1998), *Comparative Advantage in International Trade,* Edward Elgar Publishing Limited, UK, LIPSEY, Richard G, DOBSON, Wendy, (1987), *Shaping Comparative Advantage,* C.D. Howe Institute, Canada.
[8] Some famous economists contributed a lot in formulating the new trade theory, such as Krugman, Helpman, Grossman, Brander, Spencer, Lancaster, etc.
[9] ROMER, P., (1986), "Increasing Returns, Specialization and External Economies: Growth as Described by Allyn Young", *Working Paper No. 64,* Center for Economic Research, University of Rochester.
[10] SALA-I-MARTIN, Xavier, (1991), "The Classical Approach to Convergence Analysis", *The Economic Journal,* 106, July, p. 1019-36.
[11] Here, the domestic policies include industrial, technological, social and environment policies.
[12] The tribute system was indeed a patriarchal diplomatic institution, in which China stood at the center and other countries were subordinated to the Middle Kingdom by paying tribute in exchange for China's recognition. It was the only legal means of access to the Chinese market.
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[15] NOLAN, Peter, (2004), *China at the Crossroads,* Polity Press, p.122.
[16] NOLAN, Peter, (2004), p.122. See also MADDISON, Angus, (1995), *Monitoring the World Economy: 1820 – 1992,* OECD, Paris.
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How to Cope with the Globalization Recommendations for the EU Novel Members

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Abstract: Globalization, as the new way of division of labour, influences the world market and the economy of many countries. During the last decade, t changed (increased) the employment in the Service Sector in most of the EU original members and also increased their involvement in the global trade. A new member that wishes to upgrade its economy must find ways for deepening its involvement in the globalization process. It can successfully do it by finding its specific niche, by investing in infrastructures, by promoting its export-oriented industries and by encouraging the creativity, innovative and entrepreneurship drives of its people. Countries that will fail to take the right actions will stay behind and many of its competent people would seek their livening in other promising locations.

1. Introduction

During the past two years twelve nations were associated with EU. Many political statements were released and many speeches were delivered all over Europe, in the old and the new member states. The intention of this paper is to focus on more concrete issues and to propose some tools for assisting the new members to attain their national goals. After a short description of the Globalization some observations are brought on its effect on the member states. At the last section some principles are described for encouraging creativity and entrepreneurship in those countries.

2. What is Globalization?

Many agree that Globalization is among the major factors that shape today's world economy and have significant impacts on both developed and Less Developed Countries (LDCs) national economies.

Some saw Globalization together with Technology as the two major power that lead the world toward the 21st Century (P. Kotler, one of America Marketing Gurus, 1999). Others opposed it and accused it for many social miseries and economic unjust prevailing in society (N. Hertz, 2001) who was one of the world young thinkers that led the struggle against globalization because of its potential dangers for the ordinary citizens. Scholars recognize the strong impact globalization has on world economy and also point to possible dangers that might appear (.J. Stiglitz, a Nobel Price Laureate in Economics, 2003). On the other side, T. Friedman (2005) a leading writer of the "New York Times" explains how the Globalization proceeds and already reached its second phase. The World Economic Forum that convened last January, in Davos, Switzerland, well demonstrates the colossal victory of the Globalization movement all over the globe. Three major trends were observed in Davos, as the most meaningful ones that are also indicative for further development: First, the shift of economic power and influence from the industrialized nations to China and India and the other developing markets; Secondly, the general satisfaction and support for the continuation of this process; Thirdly, the move of importance from the "Big Bosses" to the small individual end–users. In order to better understand this economic phenomenon it is necessary to describe some of its main characters. Globalization, also known as the second industrial revolution, has a double impact on the industrial nations' citizens. For the short run it yields affluence and prosperity, and enabled most of them to fulfil their materialistic desires. At the long run, however, globalization demands some social-economic transformations that affect the retirement and welfare systems of many countries. The Globalization phenomenon contains the following processes:

a) Global Relocation of Industries and a New Division of Labour
b) Fifty years of a rapid advancement of technology and a fast development of communication and transportation caused manufacturing industries to seek new locations for their operation. During the past twenty years, more and more manufacturing industries moved from the traditional industrial nations to countries that have inexpensive labour force, mostly to China, India, South-East Asia and Latin America. As a result, the number of Industrial employees decreased and the share of the Service

Sector in employment increased and it became the sector, which employees the largest number of employees. Table 1 well demonstrates this move, which took place in almost all countries. On the other hand, the relocation of industries increased dramatically LDCs' share of the global production of manufactured goods.

c) Massive Expansion of World Trade Volumes.
d) Due to the "industrial relocation", the new division of labour, and the move eastward of production and manufacturing facilities, more commodities, goods and products are traded in the global market. International trade grew fast and became an important factor in the global and national economies.
e) A Rapid and Growing Trend of Industrial Merging and Acquisitions
f) Many indigenous industries are bought by, or forced to merge with international firms and multi-national corporations. As a result, local needs and preferences are frequently delayed or rejected in favour of global considerations. Life and success become difficult for single native manufacturers.
g) Increasing Power of Global and Regional Trade Organizations
h) The EU Unification process is just one among other similar Inter-regional Trade Agreements, such as NAFTA or the Asian trade agreement. These agreements dominate over many national economies and dictates activities of governments and business corporations.
i) Resemblance of Habits, Purchasing Styles, and Consumption Patterns
j) Due to the advanced technology and global media networks, the world became a "global village." Western styles, fashion, and habits are transmitted in real time to all countries. American and European icons are demanded and sold all over the globe.

In sum, the Globalization process significantly contributes to the creation of additional wealth and affluence in the developed nations and the increase of income in LDCs. It also contributes to and hasten the transformation of the "Western" economy from a manufacturing into a mostly "service" oriented economy. Although this influence opens new horizons for poor nations, it poses salient challenges before most of West and East Europe countries, which should take it seriously.

3. The Influence of the Globalization on EU Members

It is obvious that the globalization has some impacts on Europe's economy. Although the European Union is involved during the last years in the incorporation of the ten new member-states in the EU organization, still the global developments affect and guide many economic decisions of the EU members. For demonstrating the Globalization effect two elements, employment and export, will further be discussed.

3.1. Increase of Employment in the Service Sector

As previously mentioned the Globalization caused the move of manufacturing industries from the traditional industrial nations to other parts of the globe. This move resulted with increasing the industrial unemployment rate in those countries. On the other hand, employment in the service sector rose due to the increase of external trade. This type of employment change can be used for demonstrating the impact of Globalization on national economies. This impact is stronger in countries with high percentage of employees in the Service Sector. In countries where this percentage is relatively lower and more people are still employed in local agriculture and industry, the impact of the Globalization is not so significant. Table 1 demonstrates this situation. Although this criterion of Employment in the Service Sector does not suffice for determining the level of development and the level of national product, it provide quite a sound indicator for these needs. Normally, countries with high degree of Employment in the Service Sector as percentage of the total employment are also those with the higher level of Gross National Product.

3.2 A Remarkable Expansion of External Trade

The "industrial relocation" and the new division of labour spread production and manufacturing facilities all over the globe. As a result more commodities, materials, goods and products are moved, hauled and traded in the global market. This move caused international trade to grow and become an important factor in many economies. In this case we use the volume of exports for determining the impact of the Globalization process on local economies. Countries with large amounts of exports are more involved and affected by this process than non-export-oriented ones. During the last decade exports of EU countries grew by over 200 percent, from 1400

to about 3000 Billion Euros. Imports increased by over 200 percent, from 1300 to 3000 Billion Euros during the same period (see Table II).

3.3 The Combined Impact of Globalization on EU Members

Tables 1 and 2 show how the Globalization increased the employment in the Service Sector, and how it expanded exports in most of the EU Members. In table 3 more information is presented, so that some comparison could be made. For assisting the comparison additional measure of "Exports per capita" has been added. This measure indicates the variation that exists among the different nations and the share of export activities of the GNP per capita. There are nations where export is over fifty percent of the National Product and there are others, specially the large economies, where it is less than twenty percent.

Table 1: Employment in the Service Sector as % of Total Employment 1992-2003

	Country	% Employment in Services			1992-2003 Change %	GNP per capita 2005
		1992	1998	2003		
	EU 15	65.3	68.7	71.4	6.1	
	EU Zone	63.3	67.0	69.2	2.2	
	Group I					
1	UK	75.0	76.6	80.4	5.4	37600
2	Netherlands	71.9	75.8	77.7	5.8	36620
3	Luxembourg	67.6	73.0	77.2	9.6	
4	Belgium	71.0	74.2	75.6	4.6	35700
5	Sweden	72.8	72.8	74.8	2.0	41060
6	Denmark	70.6	72.2	74.5	3.9	47390
7	France	68.4	72.5	74.3	5.9	34810
8	Germany	61.2	66.8	70.3	9.1	34580
	Group II					
1	Finland	63.6	65.9	68.9	5.3	37460
2	Italy	61.8	64.3	66.5	4.7	30010
3	Ireland	58.3	62.2	65.8	7.5	40150
4	Spain	61.6	63.9	65.3	3.7	25360
5	Austria	55.6	59.9	63.3	7.7	36980
6	Greece	50.5	57.7	60.6	10.1	19670
7	Portugal	55.2	51.4	55.0	-	16170
	Group III					
1	Hungary	-	58.0	62.3	4.3	10030
2	Estonia	-	58.2	61.5	3.3	9100
3	Slovakia	-	56.2	61.5	5.3	7950
4	Latvia	-	55.8	60.8	5.0	6760
5	Czech Republic	-	53.5	56.1	2.6	10710
6	Lithuania	-	-	54.1	-	7050
7	Poland	-	48.8	53.0	4.2	7110
8	Slovenia	-	-	52.3	-	17350
	Group IV					
1	Bulgaria	-	43.2	46.4	3.2	
2	Romania	29.9	31.2	34.9	5.0	
3	Turkey	-	-	43.3	-	

Source: Eurostat

Table 1. Indicates that in 1992-2003, employment in the Service Sector grew by over 6% in the original EU member states and reached the 70% level of the total employment. In 8 countries of Group I, employment in

the Service Sector reached the level of 70 to 80 percent of the total employment, while the average annual employment growth of this group was 2 to 9%. Countries of this group were and are well involved in the globalization process and it affects significantly their economy. In 7 countries of Group II, Employment in the Service Sector was lower and reached only the 55 to 69% level. Employment in the service sector grew here faster, 3.7 to10.1/% annually. In Groups III and IV, representing the 12th new-coming countries, Employment in the Service Sector was remarkably lower and it fluctuated from 35 to 62%. The Table's figure well demonstrates the linkage between Employment in the Service Sector and the level of the nation's wealth.

Table 2 Increases of Imports and Exports, Billon Euro and percentage 1995-2005

		Imports (Billion Euro)				Exports (Billion Euro)			
		1995 B.Euro	2005 B.Euro	1995-2005 B.Euro	Change %	1995 B.Euro	2005 B.Euro	1995-2005 B. Euro	Change %
	Group I								
1	Ireland	21.5	54.7	33.2	254	28.6	88.3	59.7	309
2	Austria	45.5	101.5	56.0	223	37.9	100.0	62.1	264
3	Netherlands	120.1	288.6	168.5	240	128.9	323.5	194.6	251
4	Spain	74.7	224.2	149.5	300	64.5	150.5	86.0	233
5	Belgium	107.1	256.2	149.1	239	119.1	268.8	149.7	226
6	Germany	320.6	622.2	301.6	194	358.9	780.2	421.3	217
7	Finland	19.6	47.4	27.8	242	25.0	53.1	28.1	212
8	Sweden	43.5	89.4	45.9	206	51.5	104.6	53.1	203
9	Portugal	22.8	49.2	26.4	216	15.1	30.7	15.6	203
	Total Group I	773.9	1733.4	958.0	224	829.5	1899.7	1070.2	229
	Group II								
1	Denmark	30.9	61.0	30.1	197	35.6	68.5	32.9	192
2	Italy	142.2	305.7	163.5	215	160.9	295.7	134.8	184
3	United Kingdom	196.8	410.1	213.3	208	172.4	307.7	135.3	178
4	France	206.8	400.2	193.4	194	210.7	370.0	1593	176
5	Greece	18.1	43.5	25.4	240	7.9	13.8	5.9	175
6	Luxembourg		17.5	-			14.8		
	Total Group II	594.8	1238.0	643.2	208	587.5	1070.5	483.0	182
	Group III								
1	Poland	10.6	81.2	70.6	766	25.7	71.9	46.2	280
2	Czech Republic	26.7	61.7	35.0	232	24.9	63.0	38.1	253
3	Hungary	26.3	53.1	26.8	202	23.5	0.2	26.7	214
4	Lithuania	4.4	12.4	8.0	282	2.6	9.5	6.9	365
5	Estonia	3.2	8.1	4.9	253	2.3	6.2	3.9	270
6	Slovakia	10.6	28.4	17.8	69	9.6	25.8	16.2	269
7	Latvia	2.8	7.0	4.2	50	1.6	4.2	2.6	263
8	Slovenia	9.5	16.3	6.8	72	8.0	15.4	7.4	193
	Total Group III	94.1	268.2	174.1	285	98.2	296.2	198.0	302

Source: Eurostat

Table 2 figures show that most countries increased their annual exports by 200 to 300 percent during the 1995-2005 period. During the ten years period, 9 Countries of Group I increased their total exports by 1000 Billion Euros, which totalled to 230%, or annual exports growth of 8 to 10 percent. At the same time 6 countries of Group II increased their exports by 480 Billion Euros, totalled to 180%, or annual increase of 5 to 7 percent. Information on Group III, regarding the new members was recorded only from 1999. Although the exports growth percentage was high, 300%, the amounts were small, about 200 Billion Euros. These figures well indicate the growing importance of foreign trade in the development of European nations.

Table 3: Population, GNP per capita, Exports and Employment

	Country	Population Million 2005	GNP per capita $ 2005	Total Exports Bil. Euro 2005	Per capita Exports Euro 2005	Employment in Services% 2003
	EU 15					71.4
	EU Zone					69.2
	Group1					
1	Luxembourg	0.455	65.630*	14.8	32,527	77.2
2	Belgium	10.445	35.700	268.8	25,735	75.6
3	Ireland	4.109	40.150	88.3	21,490	65.8
4	Netherlands	16.305	36.620	323.5	19,840	77.7
	Group 2					
5	Denmark	5.411	47.390	68.5	12,660	74.5
6	Austria	8.206	36.980	100.0	12,186	63.3
7	Sweden	9.011	41.060	104.3	11,575	74.8
8	Finland	5.237	37.460	53.1	10,140	68.9
	Group 3					
9	Germany	82.501	34.580	780.2	9,457	70.3
10	France	62.519	34.810	370.0	5,918	74.3
11	United Kingdom	60.060	37.600	307.7	5,123	80.4
12	Italy	58.462	30.010	295.7	5,060	66.5
	Group 4					
13	Spain	43.038	25.360	150.5	3,497	65.3
14	Portugal	10.529	16.170	30.7	2,916	55.0
15	Greece	11.083	19.670	13.8	1,245	60.6
	Group 5					
1	Slovenia	1.998	17.350	15.4	7,707	52.3
2	Czech Republic	10.221	10.710	63.0	6,164	56.1
3	Hungary	10.098	10.030	50.2	4,971	62.3
4	Slovakia	5.385	7.950	25.8	4,791	61.5
5	Estonia	1.348	9.100	6.2	4,600	61.5
6	Lithuania	3.425	7.050	9.5	2,774	54.1
7	Poland	38.174	7.110	71.9	1,883	53.0
8	Latvia	2.306	6.760	4.2	1,821	60.8
1	Turkey	71.610	4.710			43.3
2	Romania	21.659	3.830			34.9
3	Bulgaria	7.761	3.450			46.4

Source: Eurostat

Table 3 compares the wealth of EU members (measured as GNP per capita) with the effects of the Globalization on their economy. The figures compare the "Export per capita", and the percentage of "Employment in the Service Sector" with the GNP per capita. The figures indicate that in Group 1, the most export-oriented nations, Exports exceed 50% of the economy, in Group 2 it is about 25-30%, in Group 3 it is less than 20% and in Group 4 it is around 15%. In all the first three groups employment in the Service sector is high, and growing, around 70%. In Group 5, the new EU members, both exports and employment are relatively low.

4. Recommendations for the New EU Members

a. Finding a specific area of activity

Within the global economy and within the EU market every member state, and particularly the new members, must look for an area of activity where its comparative advantage could be exercised. From a closed familiarity with East Europe I am sure that most countries there can find something specific in their area. Most nations in this region and the Baltic zone are small, 2-10 million people and every effort that would be executed could attract enough customers from Western Europe. Governments and other civic organizations must understand that the future lay in preparing jobs at home and not sending people to work abroad.

b. Investing in Infrastructure

The Service sector, which is required to employ most of the future employees, includes three large industries that should be assisted by the government. They are: Construction, Transportation and Tourism. Although private individuals and companies would carry out and execute most of the operations, government is required for clearing the way and reducing bureaucratic obstacles. This is such a crucial issue that it can affect dramatically future developments. Many opportunities are opened know in Eastern Europe but contractors and developers will prefer to act in countries where government will prepare for them the infrastructures.

c. Promoting an Export-oriented Economy

There is almost a common understanding that building an export-oriented economy is the best way to accelerate economic growth. Twelve years back I showed that trade is a better way to prosperity than foreign aid (Avny 1994). In the 21st Century, as globalization grow rapidly this recommendation is even stronger. The new division of labour, which was created with the globalization, enables to purchase in the global market all kind of merchandize in lower prices and almost unlimited quantities.

A country that wants to benefit from these new conditions must find an appropriate export for earning the required foreign currency. The government must adopt an aggressive foreign trade policy if it wishes to ensure its country development.

d. Establishing a Creative and Entrepreneurial Atmosphere

This mission seems to be among the most important factors in encouraging any type of enterprise, from a sole individual, a large organization and a superpower nation.

Adopting techniques that already have proved their effectiveness is a legitimate way for encouraging entrepreneurship. Following and imitate those methods can shorten the development process and accelerate economic growth. One of the techniques that yield good results in South-East Asia was the Bench Marking method. But, a careful observation indicates that it is not enough to imitate or copy. the critical test is the implementation. The Bench Mark technique should be designed and execute in accordance with the specific conditions and the particular mind-set of the candidate members. South-Eastern Asia's countries refer to the mind-set requirement when they point on the human factor as the crucial difference between them and African nations. China, in comparison with all the other Less Developed Countries (LDCs), received the smallest amount of foreign assistance and very little World Bank's financing. Its recent fast economic growth and extraordinary development, spring mostly from the government and the people's intrinsic drives to proceed. The Chinese, the Japanese and the Koreans, live within a culture that drives everyone to achieve, pushes to excel. They teach people from their early days, to work hard and pursue education. In conclusion, it is the government responsibility to establish a supporting atmosphere and creating an encouraging environment, so that citizens will be encouraged to think creatively and act constructively. Within such a supporting environment, individual entrepreneurs are driven by the following urges:

I. **Dissatisfaction from the current situation and an urge to search for a change**. In difficult times many people feel bad but only some are willing to express their frustration. Fewer are ready to do something in order to improve the conditions. Very few only are capable to initiate or introduce a change that will cause an improvement. These few individuals, who see the potential in every complicated situation and who see challenge in every obstacle, these are the desired innovators and the progress's agents. These individuals frequently have a strong self-esteem and courage to initiate the change and to lead the advancement. This sense of a positive discontent and a continuous search for a constructive solution emerges from appropriate education, culture and social environment.
II. **Willingness to dare and readiness to take risks**. The readiness to dare is the father of accomplishment and the willing to take risk is the mother of success. Remarkable achievers must be

serious challengers. The number of challengers and risk-takers vary from one nation to another, but all together they are relatively few in any place. Social and organizational environments must build and maintain surrounding conditions that will encourage the emergence and the activity of risk-takers and will secure innovations. As a rule of thumb it is safe to say that as much as the social surrounding provides more supporting for entrepreneurs, so their achievements are more remarkable and they can contributes more to society. Bureaucrats and civil servants usually, all over the world, incline to act routinely and to run their business in accordance with written procedures. By their nature they are not built to take risk and to adopt revolutionary ideas. In many cases they say, "what work well for the past fifty years will also be good for the next ten". Besides common people that not always understand the necessity of innovations, these bureaucrats are the greatest opponents for progress. How to cope and attain success in the struggle with those people is the major challenge of the innovators.

III. **Ability to convert ideas into actions and having skills of implementing**. As previous mentioned only few people can find and offer ways to improve a given system. However, the number of individuals who are capable to implement ideas is even smaller. One thing is to come with a bright idea or an excellent concept, but quite another story is the executing of these great ideas. People who are really competent in doing are relatively rare and valuable. Many theoreticians are not aware of the implementation's hardships, and one should be smart as Einstein to confess as he did: "
I wish I were a doer".
Implementation costs money. Introducing a new machine requires a running-in period and a grace period until full benefits are attained. An organization that wishes to advance must find the appropriate funds and give enough time to its advancement's agents to execute their program. The best innovator and the most creative inventor cannot function in a social vacuum. They need a social environment, public or private, that will be ready to invest in their ideas and paying the expenses of making them work. Since the world today is opened and people can move from one country to another, nations that will not understand this reality, and will not invest in Research and Development (R&D) will lose many talents and entrepreneurs.

IV. **Feeling of preserving individuality and respecting privacy.** Innovators, entrepreneurs and creative thinkers are usually very aware to their personal freedom and very keen about their privacy. They dislike bureaucracy and hate too much red tape. Because drives of creativity and entrepreneurship are intangible, nobody can say what is the appropriate range of personal freedom these people need in order to maximize their contribution. Similarly, they also differ from one country to another and from one individual to other. Management and government should recognize how crucial and critical are creativity and entrepreneurship and they must support it properly.

V. **Enabling fair and generous materialistic compensations.** Although innovators and entrepreneurs are driven mostly by their internal need to create and innovate, materialistic compensations should not be forgotten. Idealism is important and patriotic feelings can play an important role in encouraging young people to dedicate their competence to the country's needs. But, somebody, or the system, must think and also provide proper rewards to the creative individuals. As long as a private or a business entity provides the benefits, they have their ways of doing it. This problem of proper compensation is much more complicated in large organizations, in Not Governmental Organizations (NGOs) and in the public sector. Up to now little attention was given to this issue and therefore many organizations are stuck with an old and less productive bureaucracy.

Governments and large organization must find sound and proper compensations in order to keep competent people otherwise they will be attracted by foreign firms.

5. Conclusion

In today's globalize economy a nation that want to elevate its economy must find ways to deepen its participation in the globalization process. For that reason it should maintain a free, safe and steady social environment, which will enable executing the following strategy:

- Finding a proper niche for its products and services
- Investing in both physical and cultural infrastructures
- Promoting and strengthening its export-oriented industries
- Encouraging and leading a national creative and entrepreneurial spirit.

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The Prohibition of Bribery of Foreign Public Officials under the South African Legislation and the African Union Convention: An Examination of its Strengths and Weaknesses

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Abstract: This paper critically sets out the South African and the African Union's legal framework for the combat and prevention of bribery of foreign public officials, and the extent to which these instruments advance the African dream of combating corruption in line with international developments. In particular, the paper looks at the Prevention and Combating of Corruption Act of 2004, and the 2003 African Union Convention on Prevention and Combating Corruption. This paper examines comparatively the background to these instruments, their provisions on the offence of bribery, and their strengths and weaknesses.

1. Introduction

1.1 General remarks

The past years have seen an explosion of instruments at national, regional and multilateral levels designed to promote and strengthen the development of mechanisms necessary to prevent, detect, punish and eradicate corruption in its various forms. Particularly interesting in these instruments is their proscription of bribery of foreign public officials, a measure which has long been established in the United States. [1]

On 11 July 2003 the African Union established the Convention on Preventing and Combating Corruption (AU Convention) in Maputo, Mozambique. [2] The Convention is a regional instrument that was precipitated by many events, including the Washington Principles. A group of African countries met in Washington, DC and committed themselves to combating corruption and later working towards the creation of an African anticorruption convention. [3] The Parties to the Convention undertook to adopt legislative and other measures designed to proscribe corruption and other related activities. [4]

On 28 April 2004 the new South African anticorruption law, the Prevention and Combating of Corrupt Activities Act (PCCAA) of 2004, [5] was promulgated to replace the 1992 legislation. [6] The PCCAA is legislation designed to implement the AU Convention. The PCCAA is modelled partly on the Organization for Economic Cooperation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Convention). [7]

The PCCAA is quite an extensive piece of legislation. In addition to providing for the offence of corruption, it expressly proscribes ancillary offences of conspiracy, incitement, aiding and abetting, inducing or instigating an offence, and instructing another to commit an offence [8] related to the main corruption offences. It also provides for the offence of obstruction of the investigation, dealing in or concealing the proceeds of corruption and/or of corrupt activities [9]

1.2 Issue addressed

This article presents a detailed and comparative examination of the strengths and weaknesses of the PCCAA and the AU Convention. The examination will revolve around the offence of bribery of foreign public officials. In particular, Part 2 and Part 3 set out and appraise the elements of the offence as dealt with by the PCCAA and the AU Convention respectively. Part 4 looks at the possible sanctions for committing the offence. Part 5 of this article outlines preventative measures incorporated in the PCCAA and in the AU Convention. In particular, it considers measures such as accounting and reporting; the protection of whistleblowers; public education; and the regulation of political funding and campaigns contributions. In part 6 we deal with enforcement measures including extradition; and mutual legal assistance and cooperation. Part 7 gives a summary of the strength and weaknesses of the AU Convention and the PCCAA. The article is concluded in Part 8.

2. The Offence

2.1 South African legislation

The PCCAA contains far-reaching and interrelated provisions which signal the commitment and the intention of the Government of South Africa to unbundled [10] corruption by defining and prohibiting various corrupt actions and related practices. Most importantly, South Africa follows international trends by extending its national law to address bribery of foreign public officials by its nationals for the first time after 46 years of the country's anticorruption legislation. This has been a major development in the criminal justice system in light of the fact that corruption of national public officials has been an offence for a period of 46 years.

Section 5 of the PCCAA creates an offence of bribery of a foreign public official by stating that:

Any person who, directly or indirectly gives or agrees or offers to give any gratification to a foreign public official, whether for the benefit of that foreign public official or for the benefit of another person, in order to act, personally or by influencing another person so to act, in a manner -

That amounts to the -

Illegal, dishonest, unauthorized, incomplete, or biased; or

misuse or selling of information or material acquired in the course of the exercise, carrying out or performance of any powers, duties or functions arising out of a constitutional, statutory, contractual or any other legal obligation;

That amounts to -

(i) the abuse of a position of authority;

(ii) breach of trust; or

(iii) the violation of a legal duty or a set of rules;

(iv) designed to achieve an unjustified result; or

that amounts to any other unauthorised or improper inducement to do or not to do anything, is guilty of the offence of corrupt activities to foreign public officials.

Without derogating from the generality of section 2(4), "to act" in subsection (1) includes -

the using of such foreign public official's or such other person's position to influence any acts or decisions of the foreign state or public international organization concerned; or obtaining or retaining a contract, business or any advantage in the conduct of business of that foreign state or public international organization. [11]

Section 5 of the PCCAA in essence mirrors Article 1(1) of the OECD Convention. The Parties to the Convention committed themselves to do the following:

> [T]ake such measures as may be necessary to establish that it is a criminal offence under its law for any person intentionally to offer, promise or give any undue pecuniary or other advantage whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business.

The textual reading of the AU Convention does not expressly point to the proscription of bribery of foreign public officials. However, the provision of the AU Convention may by mutual agreement between States be applicable to bribery of foreign public officials in terms of Article 4(2).

2.2 The African Union Convention

The AU Convention deals primarily with bribery of national public officials in almost identical terms as the UN Convention. Article 4(1) (a) of the AU Convention describes the act of corruption of a public official as follows:

> the solicitation or acceptance, directly or indirectly, by a public official or any other person, of any goods of monetary value, or other benefit, such as a gift, favour, promise or advantage for himself or herself or for another person or entity, in exchange for any act or omission in the performance of his or her public function.

3. Analysis of elements of the offence

3.1 The offender

According to section 5(1) (a) of the PCCAA "any person" can commit the offence in question. Person is not defined in the PCCAA. Be that as it may, by "persons" in the South African law reference is to both natural (human) and juristic (corporate) persons. The PCCAA uses primarily nationality as a basis for jurisdiction over an offence or accused persons. Section 5 of the PCCAA primarily regulates the bribery of foreign public officials by South African citizens. In accordance with what is known as prosecution *de dere aut judicar*e [12], South Africa prosecutes its nationals for corruption and bribery committed anywhere in the world, even if committed wholly outside its territory (Sibanda, 2005).

The PCCAA also applies to people who are resident or domiciled in South Africa [13], foreign juristic persons incorporated or registered in South Africa [14] and to any other persons who, although they may not be regarded as resident or domiciled in South Africa, or as registered or incorporated in South Africa, have committed the offence whilst in South Africa. [15]

3.2 Mens rea

The type of *mens rea* required for the commission and prosecution of the offence is not expressly stated in the PCCAA. The courts will have to read in and interpret the appropriate *mens rea* in accordance will the prevailing principles of criminal culpability. To begin with, the PCCAA does not expressly make reference to intention as the required *mens rea* for the *offence.* Be that as it may, intention has always been a requisite *mens rea* for the offence of bribery of national public officials under South African law. In my opinion no different approach should be taken when dealing with the offence of bribery of foreign public officials under the PCCAA. Intention should still be the requisite *mens rea* for the offence of bribery of foreign public officials.

Whether or not the South African courts are to follow the stricter *mens rea* test or the less stringent test employed in the United States is another matter that will have to be addressed. The text of the PCCAA itself is not clear in this regard. Under the United States *Foreign Corrupt Practices Act* (FCPA), it is sufficient to show that the accused person acted corruptly. [16] Acting corruptly would cover individuals who plead ignorance to the circumstances of the bribery [17], or who consciously disregard [18] the *indicia* of questionable payments such as abnormally high commissions; payment of unusual bonuses to managers of foreign operations; and doing business in a country with a history of bribery problems or corrupt practices. [19]

The textual reading of the PCCAA suggests that South African courts might not follow the United States' less strict *mens rea* test of wilful blindness or conscious disregard, except in cases of prosecuting the offence of failing to report knowledge or suspicion of corruption or corrupt activities to the police. [20] Central to the *mens rea* inquiry here is that the accused purposely committed an act which the law forbids as tending to corrupt with the intention of gaining an improper advantage.

3.3 Actus reus

3.3.1 … directly or indirectly giving, agreeing or offering …

Both the AU Convention and PCCAA prohibit both the "direct" and the "indirect" acts of bribery. [21] The proscription of indirect acts of bribery is important given the fact that intermediaries like agents and consultants are often used in securing bribes. Extending the offence to agents or other intermediaries has been a major development in both the AU Convention and the PCCAA. These individuals play a critical role in international business marketing, sales or distribution of a corporate body, and are susceptible to bribery. [22]

3.3.2 … any gratification …

The PCCAA refers to giving, promising or offering "gratification" to a foreign public official. "Gratification" is explained broadly in the PCCAA as including pecuniary advantages, such as money, and other non-pecuniary advantages, such as sexual gratification, property or interest in property. [25]

Although the wording with regard the items of bribe payment in the AU Convention and PCCAA differs to some extent, the two prohibit almost the same corrupt activities. Like PCCAA, the AU Convention proscribes corrupt solicitation, acceptance, offering or granting of "any goods of monetary value" (pecuniary advantage)

and other benefits such as gifts and promises (non-pecuniary advantages). [23] However, the PCCAA provision in this regard is preferable. It is broadly couched to even cover requests for sexual gratification as a corrupt activity. [24]

3.3.3 … to a foreign public official …

A curious and conspicuous omission in the AU Convention is the proscription of bribery to a foreign public official. Curious in a sense that corruption is endemic in Africa and one would have expected all the major forms of corrupt activities to be dealt with in the Convention.

"Foreign public official" is broadly defined in the PCCAA [25] as including any person holding a legislative, administrative or judicial office of a foreign country, whether appointed or elected; any person exercising a public function for a foreign country, including a public agency or public enterprise; and any official or agent of a public international organization formed by governments or by other public international organizations. By foreign public officials reference is to all the levels and the subdivisions of government, be it either national, local, regional or federal, or an agency or political subdivision of a country.

A glaring omission in both the AU Convention and the PCCAA is the exclusion of political candidates and other officials of international institutions under the auspices of a state or public international organization [26] from the definition of foreign public official. It has been argued that the inclusion of these parties is important given their "great influence not only in international socio-discourse but also in international trade and business transactions" (Low et al, 1998). However, the exclusionists argue that the proscription of payment of bribes to political parties and candidates have the potential to criminalize even legitimate political campaign contributions. And that in any event such an inclusion is unnecessary if the law covers corrupt acts done through intermediaries (Low et al, 1998).

3.4 Unlawfulness

3.4.1 … in order to act, personally or by influencing another person ... to act …

Section 5(i) of the PCCAA requires that a bribe payment be made in order to induce a foreign public official to neglect (or omit to act in terms of his/her assigned duties) or to act in a manner contrary to and in violation of his/her normal official duties. The phrase "in a manner contrary to and in violation of his/her normal official duties" should be read to include several actions, such as acting dishonestly, acting in a biased manner, abusing a position of authority, acting in breach of trust, or acting in a manner which is designed to achieve an unjustified result. [27]

According to the PCCAA it is also unlawful to ask a foreign public official to use his/her position to influence to your own advantage the acts or decisions of the foreign state or of a public international organization. It is further unlawful to ask such an official to use his or her position of authority to enable you to obtain or retain a contract or any form of business with the foreign state or with the public international organization. [28]

4. Sanctions

It is important that an instrument outlawing corruption provide for measures or for the adoption of such measures to enable the establishment of liability and set effective, appropriate and dissuasive sanctions. Unfortunately, the AU Convention does not have a provision dealing with sanctions or penalties in case of the commission of the offence or in case of non-compliance with prescribed preventative measures. On the other hand, the PCCAA provides specifically for criminal and non-criminal sanctions which are dealt with hereunder.

4.1 Criminal sanctions

4.1.1 Fine or imprisonment

In terms of section 26(1) of the PCCAA the possible criminal punishment(s) for bribing a foreign public official is a fine or imprisonment. The High Court of South Africa may impose a fine or life imprisonment, the regional courts may impose a fine or imprisonment of up to 18 years, and a magistrate's court may impose a fine or imprisonment of up to five years. Unfortunately, the PCCAA does not specify the amount of the fine to be

imposed by the courts. In my opinion the PCCAA should have at least set a minimum fine. Alternatively, it should have set guidelines on how the courts should proceed in determining the applicable fine on a case by case basis.

4.2 Non-criminal sanctions

4.2.1 Blacklisting, exclusion from state subsidies, public tenders and procurement

Non-criminal sanctions that may be imposed under the PCCAA include measures such as the exclusion from public and state subsidies, and exclusion from public tenders and procurement.

With regard to corruption relating to tenders, section 28 of the PCCAA requires the Minister of Finance to create a Register of Tender Defaulters. If a person or business is convicted by a court of law of crimes involving contracts or tenders, the names of such persons or businesses and details, including the names of directors, and the details of the crime are recorded in this Register. Registration in the tender defaulter register may result in existing government contracts or tenders by the defaulter being cancelled immediately. The names of defaulters remain on the Register for between 5 and 10 years. Defaulters are blacklisted from taking part in any new contracts or tenders while their names are on the Register.

4.2.2 Confiscation and forfeiture

Article 16(1)(a) of the AU Convention enjoins each State Party to adopt legislative measures as may be necessary to enable the seizure of the instrumentalities and proceeds of corruption pending the finalization of the case. The Convention further makes provision for the confiscation of proceeds or property gained from corrupt activities. Moreover, Article 6 of the Convention calls for the establishment of the offence of laundering proceeds of the corruption activities, and it also calls for the law making it possible to repatriate proceeds of corruption. [29]

The PCCAA contains no provision for the confiscation and forfeiture of proceeds of corruption. Since the PCCAA is not a stand-alone statute, it is assumed that the confiscation and forfeiture of proceeds of corruption may be ordered through other legislation such as the Prevention of Organized Crime Act 121 of 1998 and through chapter 4 of the International Co-operation in Criminal Matters Act 75 of 1996 dealing with confiscation and forfeiture orders by foreign states.

5. Preventative measures

5.1 Accounting and reporting system

The State Parties to the AU Convention had undertaken to adopt among others, measures designed to "create, maintain and strengthen internal accounting, auditing and follow-up systems in particular, in the public income, custom and tax receipts, expenditures and procedures for hiring, procurement and management of public goods and services". This is probably one of the commendable undertakings by the AU Convention given the positive role accounting and reporting requirements play in combating corruption and money laundering as shown in jurisdictions such as the United States. [30] Accounting and reporting requirements serve both as additional deterrents to bribery and the strengthening of the effective enforcement of anti-bribery laws. The reporting and accounting practices would, amongst others, enable a proper investigation and conclusion of the investigation. Reasonably detailed books and records should be maintained in which the acquisition and disposition of assets is accurately reflected to enable the detection of acts of corruption by law enforcement agencies.

The PCCAA does not contain a similar accounting and financial reporting provision. The closest the Act comes to accounting and reporting requirements is the provision that persons who hold positions of authority must report any knowledge or suspicion of corrupt transactions to the police. [31] Though the duty to report and account in terms of the PCCAA is imposed expressly on people in authority, other people may also be obligated to report any demand, solicitation or acceptance of an undue benefit contrary to the provisions of the PCCAA in terms of other laws such as the Financial Intelligence Centre Act (FICA) 38 of 2001.

Though FICA was enacted to deal specifically with money-laundering issues, its reporting and accounting provisions are equally applicable to corruption investigations as the latter is treated as a predicated offence for money laundering. Section 28 of FICA enjoins juristic persons to report to the Centre all cash transactions which are above the predetermined limit. The reporting requirement is further imposed under section 29(1) of FICA on

a person who carries on a business or is in charge of or manages a business or who is employed by a business to report suspicious and unusual transactions – transactions involving proceeds or unlawful activities; or transactions designed to use such business to launder money.

Section 22(1) of FICA obliges accountable institutions such as banks to keep records of business relationships and transactions. Where money is involved, the record in the custody of such institution should reflect, for example, the amount of the money involved and the parties to the transaction. [32]

5.2 Protection of whistleblowers

In South Africa the protection of whistleblowers is contained generally in the Protected Disclosures Act of 2000. Protection is offered to those who report corrupt practices, particularly involving their employers, institutions or corporate bodies, against any prejudice or detriment. [33] Similarly, the AU Convention calls for measures designed to "protect informants and witnesses in corruption and related offences, including protection of their identities". [34]

5.3 Public education

Promoting public education and awareness is vital in the fight against corruption and related activities. Article 5(8) of the AU Convention calls for State Parties to adopt and strengthen mechanisms for promoting the education of the public to "respect the public good and public interest, and awareness" in the fight against corruption and related offences. This, according to the AU Convention, can be done through measures including school educational programmes and media activism on corruption issues including but not limited to the existence, causes and the seriousness of and the threat posed by corruption. Importantly, Article 12(4) calls for the media to be given access to information in cases of corruption and related activities provided such access does not adversely affect the investigation process and the right of the accused to a fair trial.

There is no similar provision in the PCCAA relating to the adoption of mechanisms for promoting public education and awareness in the fight against corruption. One will have to look outside the Act for similar provisions. The South African National Anti-Corruption Forum (NACF) -- comprised of the civil society, business and government -- was set up **to, among others,** raise awareness of corruption and related activities. Information on cases of corruption may be accessed through the *Promotion to Access to Information Act* 2 of 2000 in order to satisfy the prescript of Article 12(4) of the AU Convention.

5.4 Regulation of political funding and campaigns contribution

In 2.3.3 above it was mentioned that there has been a concern that the proscription of payment of bribes to political parties and candidates may lead to the criminalization of legitimate political campaign contributions. Perhaps we should concede that one has to walk a very delicate and fine line in determining if a political contribution is legitimate or not. This is the major reason why it has become relevant that the possible connection between political contributions and corruption should not simply be dismissed without further action. In order to address this concern, the AU Convention enjoins State Parties to adopt legislative and other measures proscribing the use of proceeds of corruption to fund political parties, [35] and to put in place transparency and accounting measures in relation to funding of political parties. [36]

Unfortunately the South African law does not incorporate any reference to funding of political parties, nor is there in existence a law on the regulation of political funding and contribution. In the absence of the regulation of political finance, the current South Africa anticorruption law is largely restricted, particularly in respect of public officials. Political funding may be misused to gain a comparative advantage in government procurement and tendering, and in order to influence policy-making decisions.

6. Enforcement measures

The fast growing global trend in legal frameworks pertaining to corruption and money laundering is to have additional enforcement measures such as extradition; mutual legal assistance; and the disregard of bank secrecy. These measures are discussed hereunder.

6.1 Extradition

Corruption is explicitly an extraditable offence in the AU Convention. In terms of Article 15(2) of the AU Convention offences falling under the Convention are extraditable and should be included as extraditable offences in extradition treaties between or among State Parties. Where compliance with a request for extradition is made conditional on an extradition treaty and such a treaty in not in force between the requesting and the requested State Party, Article 15(3) provides that the Convention may be treated as the legal basis for the request.

The PCCAA is silent on the issue of extradition. That notwithstanding, extradition issues are governed generally by the Extradition Act 67 of 1962. The process for the surrender of the offender in the context of extradition is primarily an executive process. It involves the minister of justice receiving a request and determining whether the extradition process should proceed. The extradition request is then heard before a magistrate's court to only determine if the person is extraditable. The question of extradition itself is to be decided by the minister of justice.

Extradition in South Africa, in terms of the Extradition Act, is conducted on a dual-criminality basis. This means, for example, that a requesting country's domestic laws must be similar to those of South Africa and those that penalize a particular act of corruption. In this regard, Article 15(2) of the AU Convention satisfies the requirement of State Parties such as South Africa that makes extradition conditional on dual criminality by deeming the offence of corruption to be included in the national laws of State Parties as crimes requiring extradition.

6.2 Mutual legal assistance and international co-operation

The AU Convention encourages regional, continental and international cooperation to "prevent corrupt practices in international trade transactions". [37] In this regard, Article 19(5) of the AU Convention provides that the State Parties shall "cooperate in conformity with relevant international instruments on international cooperation in criminal matters for purposes of investigations and procedures". The State Parties should provide the necessary legal assistance to each other in connection with criminal investigations and proceedings. Practically this means that when evidence material to the institution of criminal or other proceedings related to the offence in one State Party or necessary for completion of the proceedings is located in the jurisdiction of another State Party, the latter may be requested to submit the evidence to the former. An important aspect to legal assistance and co-operation is that Article 7(5) of the AU Convention provides that immunity to public officials shall not be an obstacle to investigating and prosecuting such public officials for corruption.

On the other hand, the PCCAA does not incorporate a provision on international cooperation. However, the preamble to the PCCAA acknowledges that "regional and international cooperation is essential to prevent and control corruption and related corrupt activities". Mutual legal assistance and cooperation is an already well-established practice in South Africa. Mutual legal assistance and cooperation can be requested under the provisions of the International Co-operation in Criminal Matters Act of 1996. There are other instruments that may be used to facilitate legal assistance and cooperation. For instance, since South Africa is a party to the United Nations Convention Against Trans-national Organised Crime, negotiated in Palermo, Italy (at the Palermo Convention), South Africa and other State Parties to the Palermo Convention may use it as the basis for requesting legal assistance, particularly the exchange of information and gathering of evidence, to combat transnational organized crimes.

6.3 Disregarding bank secrecy

In terms of Article 17(3) of the AU Convention, State Parties can not plead bank secrecy in order to contest a judicial order for the confiscation or seizure of banking information which is important in the investigation and prosecution of acts of corruption and related offences. Article 17(4) further provides that State Parties should, in terms of bilateral mutual legal assistance agreements, waive banking secrecy. In brief, bank secrecy may not be used to decline a request for assistance in criminal matters. Put differently, banking secrecy and confidentiality shall not be a defence when invoking measures intended to implement the AU Convention. This is an important development given the tendency and practice of persons committing bribery and laundering proceeds thereof to jurisdictions because such jurisdictions mandate strict bank secrecy.

The PCCAA contains no such provisions on bank secrecy. Instead, bank secrecy issues in relation to corruption are dealt with under the provisions of FICA. Section 41 of FICA permits the disclosure of

confidential banking information obtained and held by the Financial Intelligence Center [38] pursuant to section 26(1) of FICA, in several cases including for the purposes of legal proceedings and in terms of a court order. Furthermore, the South African common law has always permitted the disclosure of confidential banking information when a crime has been committed.

7. Summary of Strengths and Weaknesses

From the above discussion the following strengths and weaknesses are identified in both the AU Convention and the PCCAA:

7.1 The AU Convention

7.1.1 Weaknesses

- No provision on the bribery of foreign public officials – except by mutual agreement between governments.
- No provision on sanctions
- No provision on corporate liability
- Contains a provision allowing reservations

7.1.2 Strengths

- Establishes a broad range of corruption related offences
- Contains requirements for whistleblower and witness protection
- Sets a precedent among regional anti-corruption convention by requiring the regulation of and transparency in political party funding
- Requires important preventive measures in the public service such as declaration of assets by designated public officials; creation of code of conduct and monitoring body; ensuring proper management of tendering and hiring procedures
- Provides for restrictions on immunity for public officials during investigations
- Public education and awareness regarded important in the fight against corruption
- Encourages regional cooperation and judicial assistance, including in extradition, investigations, as well as confiscation, seizure and repatriation of proceeds of corruption
- Imposes restrictions on use of banking secrecy

7.2 The South African Legislation

7.1.2 Weaknesses

- No provision on the regulation of political funding.
- Lack of clear definitional elements of the offences created
- No provision on public education and public awareness of corruption
- No accounting and reporting requirements, except reporting under the whistle blowing provision
- No provision on bank secrecy
- No confiscation and forfeiture provision
- No incorporation of the requirements of extradition and judicial cooperation, despite the latter's importance being acknowledged in the preamble of the Act

7.1.2 Strengths

- Establishes a comprehensive and broad range of corruption offences
- Broad coverage of offenders
- First time punishment of extra-territorial acts of corruption
- Provides for harsher criminal and non-criminal sanctions including banning offenders from government business.

8. Conclusion

The AU Convention and the PCCAA are important and significant anticorruption instruments signifying a commitment by African countries to deal aggressively with the ever growing incidence of corruption and its related activities. The introduction of the offence of bribery of foreign public officials in the South African legislation, and the regulation of corruption in general by the AU Convention is a commendable attempt to level the playing fields in a manner comparable to that of jurisdictions like the United States. It is expected that these instruments will respectively be pivotal in the fight against corruption that is consuming the African continent like a malignant tumour. By establishing the convention against corruption, the African Union was brought in line with international developments such as those of the OECD and the United Nations. Africa now has a comprehensive regional anti-corruption framework, which will set common standards for State Parties.

As noted in 7.1 and 7.2 above, there are clearly challenges, strengths and weaknesses in both the African Union and the South African anticorruption frameworks that need some attention so as to maximize the efficiency and effectiveness of the anticorruption measures. Particularly in need of urgent attention is the regulation of political funding in South Africa; and the incorporation of bribery of foreign public officials in the AU Convention. The regulation of political contribution and funding is an important step towards the culture of political accountability in South Africa. The regulation is particularly important in the wake of the decline of reliance by political parties of the traditional means for party finance such as membership dues, and fundraising events. The lack of political funding regulation has resulted in some innovative ways by political parties to source funding to stay financially afloat, some of which are questionable when judged against the current corruption law.

Political will is also one of the ranges of factors that can be used to contribute to the effectiveness of anti-corruption measures in South Africa. There unfortunately seem to be not a strong and clearly visible political will and leadership from our public officials and the government in the fight against corruption. The country has also been slow in implementing the PCCAA.

The lack of resources for follow-up mechanism, and capacity and expertise for peer review processes is also a major hindrance in achieving the aims and objectives of the AU Convention.

Notes:

[1] The United States *Foreign Corrupt Practices Act* (FCPA) of 1977 codified at 15 U.S.C. 78 became the first and the only statute or law of its kind in the world for almost 20 years to proscribe bribery of foreign public officials by American persons. The FCPA has been amended by the *International Anti-Bribery and Fair Competition Act* of 1998, 105 P. 366 [S. 2375] to conform to the requirements of and to fulfil the United States obligation to implement the Organization for Economic Cooperation and Development (OECD) *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* (OECD Convention).

[2] See AU: Convention on Preventing and Combating Corruption (AU Convention) (2004) 43 *ILM* 5.

[3] The 25 Washington Principles were drawn up and agreed to at a meeting held in Washington DC on 23 February 1999 under the auspices of the Global Coalition for Africa by eleven African countries. The Washington Principles take cognizance of the global and regional efforts like those of the OECD to combat corruption. See "Africans Make Major Gains in Fighting Corruption" *Africa News*, March 2 (1999), for more information on the Washington Principles

[4] See Article 5.1.

[5] The Prevention and Combating of Corrupt Activities Act 12 of 2004 (PCCAA). The PCCAA is an extensively reconsidered version of the Prevention of Corruption Bill 19 of 2002.

[6] Corruption Act 94 of 1992.

[7] See note 1 above.

[8] See PCCAA s 21.

[9] See PCCAA s 20.

[10] See PCCAA Preamble par 14.

[11] My emphasis.

[12] See C Enache-Brown & A Fried "Universal Crime, Jurisdiction and Duty: The Obligation of *Aut Dedere Aut Judicare* in International Law" 43 *McGill L J* 613 (for an extensive note on the principle *aut dedere aut judicare*).

[13] See PCCAA s35(1)a&(b)

[14] Ibid s 35(1)(d).
[15] Ibid s 35(1)(e).
[16] 15 USC'78dd-1(a).
[17] Sibanda O "The South African Corruption law and bribery of foreign public officials in international business transactions" (2005) 1 SACJ1, at 11.
[18] In terms of the United States' corruption legislation history, the knowing standard was enacted into the FCPA to replace the reason to know standard in order to include a conscious purpose to avoid learning the truth that there is a violation of the FCPA. *H.R. Conf. Rep. No*. 100-576 at 919-920 (1988). See also L Baum "Foreign Corrupt Practices Act"(1998) *35 Am Crim L. Rev 830.*
[19] See *H.R.Conf.Rep.*No. 100-576,nl4
[20] In *S v Deal Enterprises (Pty) Ltd* 1978 (3) SA 302 (W).
[21] See generally Art. 4 of the AU Convention and section 5(1) of PCCAA
[22] See PCCAA six.
[23] See AU Convention Article 4.
[24] See PCCAA s ix.
[25] See PCCAA s v.
[26] The PCCAA s xxiii and the *Commentaries* clause 17 define "public international organization" to include any international organization formed by states, governments or other public international organizations, whatever the form of the organization and scope of competence
[27] See PCCAA s 5(1)(i)(ii)(iii)&(iv)
[28] See PCCAA s.5 (2)(b)
[29] Article 16(1 c)
[30] In 1994 the FCPA was amended to include accounting and financial reporting requirements -- 15 USC section 78(*b*)(1994), the purpose among others being to prevent falsification of records to conceal improper transactions. In the United States the compliance procedures are used as guidelines for public companies involved in transnational businesses not to fall foul of the FCPA. A company or business institution is required to report any act or incidence of unfair business practice by third parties in trying to secure business with it or by any of its management or persons involved in the procurement of businesses for it. A failure to comply with this obligation would result in delisting of the company and criminal liability.
[31] See PCCAA s 34(1)
32] Financial intelligence Centre Act (FICA) 38 OF 2001, section 22(1)(f).
[33] See, generally, O Sibanda, "Unplug your ears and speak out: Protected Disclosures Act 26 of 2000" (2003) 5 *The Judicial Officer* 149, for a critical analysis of the Protected Disclosures Act
34] Article 5(5).
[35] Article 10(a).
[36] Article 10(a).
[37] Art 19.2, read with Article 18 entitled *Cooperation and mutual legal assistance*.
[38] The Financial Intelligence Centre is established as a juristic person under section 2 of FICA as an institution outside the public service but operating within the public service. The objectives of the Centre include assisting in the identification of the proceeds of unlawful activities and combating money laundering; and to collect and make available financial information on persons to investigating authorities. See FICA section 3.

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Structuring Money Laundering Control as Mechanism for Controlling Corruption in Nigeria: Need for Enhanced International Cooperation

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Abstract. Corruption like money laundering is a plague threatening development and enthronement of good governance in most developing countries, including Nigeria. Nigeria is a word that is almost synonymous with corruption, and the determined effort of government to fight the scourge of corruption has revealed that international cooperation and support is crucial to its success. This paper explores the structuring of money laundering control as a mechanism for effective control of the corruption pandemic in Nigeria and other developing countries of the world, through enhanced international cooperation, towards the enthronement of good governance.

Keywords: Money laundering control, corruption, enhanced international cooperation, good governance.

1. Introduction

Nigeria [1]was under military rule for over thirty years, and on return to democratic governance on May 29, 1999, determined to fight corruption, the government of President Olusegun Obasanjo, barely on assumption of office established the Independent Corrupt Practices and other related Offences Commission (ICPC) in 1999 to deal with the problem of corruption and corrupt practices. In year 2001, the listing of Nigeria as one of the countries considered to be inadequately participating in the fight against money laundering by the Paris based Financial Action Task Force (FATF), [2] led to the establishment of the now Economic and Financial Crimes Commission (EFCC), (hereinafter called 'the Commission') in 2002, although the National Drug Law Enforcement Agency (NDLEA) (hereinafter called 'the Agency'), has been the body combating money laundering during the military regimes since 1989. The achievement of the Commission so far in its bid to fight corruption is not unconnected with the level of international cooperation given to it, via money laundering control mechanism. Otherwise Nigeria's determination to fight corruption would have been grossly ineffective if confined to national borders only.

Wining the war against corruption by Nigeria and indeed large number of countries in developing and post-communist worlds, where corruption represents a major impediment to economic growth, foreign investor confidence, and democratic stability, remains areas of critical concerns.[3] The President of the Financial Action Task Force (FATF), has noted that an issue that is important to developing countries in all regions of the world, is the devastating effects of money laundering linked with corruption.[4]Thus this paper canvasses the need for enhanced international cooperation in fighting the scourge of corruption in Nigeria and indeed in other developing countries of the world, using the global network and mechanism for combating money laundering.

2. Money Laundering

The offence of money laundering is still basically that of attempting to disguise the proceeds of illicit activity or illegal acts. It has been described as a process that includes the placement of the illicit proceeds in the financial system, subjecting the funds to a number of processes or manoeuvres in an attempt to disguise their origin and the re-emergence of the funds as apparently legitimate money.[5]

In Nigeria the crime is governed by both the Economic and Financial Crimes Commission (Establishment Act) 2004 and the Money Laundering (Prohibition) Act, 2004, but under Section 7 (2) of the Economic and Financial Crimes Commission (Establishment Act) 2004, the Commission is now the coordinating agency for the enforcement of the provisions of the Money Laundering Act, 2004; and any other law or regulation relating to

economic and financial crimes, such as the Advance Fee Fraud and Other Fraud Related Offences Act 1995 etc. including the Criminal and Penal Codes. Both laws did not define the words 'money laundering' per se, but only prescribes acts that constitute the offence of money laundering. In order to prevent money laundering, section 1 of the Money Laundering Act provides that 'Except in a transaction through a financial institution, no person or body corporate shall make or accept cash payment of a sum exceeding (a) #500,000 (about $3,333) or its equivalent, in the case of an individual (b) 2million naira (about $13,333) or its equivalent in the case of a body corporate.' Under Section 2(1) 'A transfer to or from a foreign country of funds or securities of a sum exceeding $10,000 or its equivalent must shall be reported to the Central Bank.' In section 14(1), any person who transfers resources or property derived directly or indirectly from illicit traffic in narcotic drugs or psychotropic substances or any other crime or illegal act, with the aim of either concealing or disguising the illicit origin of the resources or property or aiding any person involved in such acts to evade the legal consequences, is guilty of an offence and liable on conviction to imprisonment for a term of not less than 2years or more than 3years. In the case of a body corporate, the court may order that it be wound up and all its assets and properties forfeited to the Federal Government. (Section 18 (1) and (2)).

Important duties imposed by the Act on financial bodies, are the identification and verification of customers' identity in transactions of $100,000 and above, preservation of such record and other required records for at least 10years, identification of suspicious transactions of less than #500,000, mandatory disclosure etc. These are contained in Sections 3-5, 9 and 10 and the Agency was given wide surveillance powers under Section 12. Section 9 (2) of the Act empowered the Governor of the Central Bank to impose a penalty of not less than 1 Million Naira (about $6,666) or the suspension of any licence issued to a financial institution for failure to comply with the provisions of subsection (1) of this Section (i.e. dealing with arousing awareness among employees of a financial institution on the battle against money laundering).

The objective of making money laundering an offence therefore is that if criminals are deprived of the proceeds of their illicit activities, the various economic and financial crimes the world over, will be less attractive and thus thin out or be greatly reduced. The case of one Felix Enwerem was cited, who in a single day lodged the sum of N70 Million (about $466,666) in his account with a financial institution, being the proceeds of an international advance fee fraud scam. He was reported to have visited the bank 24 times in a single day to cash remittance from abroad, paying a small amount into his account each time to avoid being noticed. [6]

Although Nigeria had been accused in the time past of paying lip service to the battle against money laundering, without any meaningful prosecution or recoveries having been made in this regard. The establishment of the Commission by the current government has changed this opinion, as the Commission has successfully prosecuted advance fee fraud scam perpetrators, while some are still being prosecuted.

The Commission has been commended home and abroad for its unprecedented efforts at combating economic and financial crimes, and has returned over $750 to foreign victims of Nigerian fraudsters. [7]

However, Nigeria's money laundering law needs to be reviewed, especially in the area of punishment, because the punishment of between 'not less than 2 years or more than 3years' if anything, is like a slap on the wrist for such a serious offence. In the $242m advance fee fraud cited below, the perpetrators got between 2 and 3years jail terms. Also, definition of the offence of money laundering is ambiguous, owing to lack of definition of the word itself. Our Criminal Procedure Act and Evidence Act needs to be reviewed to incorporate the admission of digital evidence, in view of the advancement in science and technology. Judges need to be exposed to further training in trying such cases. Nigeria also needs to build capacity in investigation and prosecution of money laundering and financial crimes (this handicap is not peculiar to Nigeria as there is generally shortage of expertise in prosecuting money laundering), although current efforts are commendable.

2.1 Consequences of Money Laundering

The consequences of laundering proceeds of illicit or illegal activities in any economy, especially of a developing country such as Nigeria can be quite debilitating, some of which are as follows:

It also erodes the confidence of the international banking and financial institutions in that country's financial industry.

The influx of large volume of laundered money in an economy can lead to a distortion or failure of the economic, monetary and fiscal policy and planning of government and inhibit them from having desired effects and may also lead to a devaluation of the country's currency. Since such influx of money cannot be controlled by the appropriate regulating agencies of government.

The consequence of a country being regarded as a money-laundering haven is that of bad reputation and of shutting the country out from new bona fide investors. [8]

Proceeds from illicit activities are often used by criminals to corrupt public institutions and officials and may also be used to finance other crimes such as political insurgencies, illegal take over of government by rebels, violence, terrorism etc, with the consequences of threatening the peace and security of a country and rendering its political landscape unstable [.9]

The vast accumulation of assets and enormous wealth through economic and financial crimes bestows powers, privileges and veneration by the populace and provides the criminals with easy access to political power and affords them the exercise of subterranean influence over state policies and officials. [10]

It can inhibit economic growth as the government will lose revenue which will otherwise be payable on such laundered money as tax, the money laundered not being legitimate money.

The serious concern pose by this scourge stems from the fact that the amount usually lost by Nigerians and foreigners alike worldwide to such crimes is quite enormous and the cost of preventing/controlling and prosecuting them is also high. Nigeria is believed to have lost over $72billion in potential investments and goodwill since June 2001 when she was placed on the FATF's list of Non-cooperative Countries and Territories on money laundering, and June 2006 when she was removed from it; [11] while the estimated money laundered worldwide annually in economic activity according to the International Monetary Fund (IMF) has been put at between $600billion and $1.6trillion. [12]

This greatly stresses the need for enhanced international cooperation both in combating money laundering and corruption, notwithstanding the international and regional instruments and initiatives designed to tackle this scourge. [13]

3. The corruption pandemic in Nigeria

The country was under military rule for over thirty years, during which it was widely believed that corruption was institutionalized in the foundation of governance. The factor responsible for this primarily was that military regimes were unaccountable, so opportunities were privatized by the powerful and due process was submerged. The military and their collaborators massively looted the nations' treasury and stashed the stolen money in foreign banks. As at 1999, it was estimated that Nigeria had lost during the past 20 years, over US$75.18billion to corruption, out of which US$65billion was believed to have been transferred abroad, an amount which was twice the total of Nigeria's external debt of about US$30billion as at 1999.[14]

Transparency International (TI), corruption survey also declared Nigeria as either the most corrupt or the second most corrupt nation in the world for years 2000, 2001 and 2002. Over $6billion was believed to have been stolen by the late military ruler, General Sanni Abacha, [15] out of which $2billion has been recovered. There are also various allegations of embezzlements of huge public funds against former military rulers in Nigeria. Since the return to democratic governance in 1999, various public office holders, political leaders and their cronies have been accused of corrupt practices, some of them have been prosecuted, while others are still facing prosecutions. These include a former chief of police, from whom over US$150million was recovered (this was a celebrated case), [16] a government minister and an impeached state governor.

In the past four years, the Commission has recorded an impressive performance in combating financial crimes, as it has successfully prosecuted over 120 people for corrupt practices and recovered over US$5billion.[17] The most celebrated case was the conclusion of trial in 2005 of the world's biggest advance fee fraud case, involving the sum of $242m from a Brazilian bank Mrs. Amaka Anajemba, Mr. Emmanuel Nwude (a former Bank director) and others pleaded guilty as charged and were appropriately convicted and sentenced to various terms of imprisonment, for duping the Brazilian banker, Mr. Nelson Sakaguchi. They are also to forfeit all their ill-gotten wealth. Nwude is to refund over $110m and pay $10m as fine while Anajemba is to forfeit $45.45m and pay $5m as fine to the Federal government. The Commission has made significant progress in the assets recovery drives ordered by the court as part of the sentencing of convicts, and have obtained court orders to enable the recovery of much of the $242m. As directed by the court, the Commission has recovered assets running into billions of naira from the 419 convicts. As at November, 2005, the first instalment equivalent of $17m (N2.3b) was returned to the victim of the scam. [18] Several other cases are currently pending in court.

A former governor, currently standing trial for corrupt practices while in office, is accused of having 18 properties in three countries, six companies, and more than $6 million in banks in four countries and shares in an oil refinery abroad.[19] In a 2006 report of investigations by the Commission, twenty-three State Governors were found to have perpetrated various acts of corruption including stashing of State funds and acquisition of assets abroad, diversion and stealing of State funds etc.[20]The Vice President of Nigeria has been accused of abuse of office by aiding and abetting the diversion of public funds in the sums of US$125 million and US$20 million respectively, approved for specific projects,[21] an allegation which he has however denied.

According to the United Nations office on Drugs & Crimes (UNODC) in Nigeria, Nigeria has lost over US$1 trillion to corruption. [22] This clearly indicates the negative effect of corruption on a nation.

3.1 Significant impact of corruption on Nigeria

3.1.1 Poverty

The World Bank Report: Attacking Poverty for 200/2001 indicates that 70.2 percent of the Nigerian population survives on less than US$1 per day, with a poverty gap of 34.9 percent. [23] In his address at the opening ceremony of the 24th African Parliamentary Union (APU), (held in Abuja in October, 2001) President Olusegun Obasanjo identified corruption as the major factor responsible for Africa's woes and mass poverty. The President said, 'Contrary to some schools of thought that reported global recession as the factor responsible for our poor continents poor economic showing over the years, a major and perhaps the root cause of its economic malaise is corruption.'[24]

These various acts of large scale and wanton corruption have snowballed into misery and poverty for millions of Nigerians more than anything else, where majority of the people are living in obvious want or squalor, and frightening conditions, despite the fact that the country had earned over US$300billion from crude oil in the 20 years preceding the return to civil rule. [25]

There is a stunning irony with the case of Nigeria, as the World Bank (1996) puts it, 'Nigeria presents a paradox; the country is rich but the people are poor.' This paradox perhaps stems from the fact that Nigeria is the largest producer of crude oil in Africa, and the fifth largest in the world. Yet, the country remains poor and its population is one of the poorest in Africa, [26] a factor deeply rooted in corruption.

3.1.2 Lack of good governance and political participation

There is generally no enthronement of good governance in Nigeria, and the little gains of democratic government are wiped off by corruption. Almost after eight years of democratic rule in Nigeria, the country is still confronted by severe development challenges such as weak governance, limited administrative capacity, persistent social tensions and violence. The present political landscape in the country is heated and volatile, and characterized by money politics, acrimony, politically motivated assassinations, etc. There is thus lack of popular participation in the democratic process. President Olusegun Obasanjo has however declared that he will use all legal means to stop "criminals and crooks" from taking the reigns of power in Nigeria. [27] It is hoped that this will become a reality.

3.1.3. Effect on democratic institutions and human rights

Corruption undermines democratic institutions all over the word, but its effect in developing countries can be more disastrous, especially in the absence of mechanisms, both legal and institutions that effectively tackles the scourge and bring perpetrators to book. It encourages organized crimes and a subversion of the rule of law. Human rights culture cannot effectively take root in the atmosphere of corruption. Law enforcement agencies and the court cannot protect rights in a country where corruption is endemic, such that human rights will suffer a great deal. Human rights can only germinate fully in an environment free of corruption.

4. The Need for and areas where enhanced International Cooperation is needed

If the battle against corruption in Nigeria and other developing countries is to be successful, there is need to seriously explore the money laundering control mechanism as an effective means of fighting corruption. Members of the international community must form a synergy and ensure that adequate and effective money laundering control measures (both legal and institutional) are put in place in their respective countries, to track laundered funds. Strict compliance by financial and other related institutions in member countries with such control measures must be effectively supervised and ensured. This is because ordinarily financial institutions have penchant for cheap funds and there is tendency for them not to easily cooperate with regulatory authorities in this regard. Key among financial institutions' role are, identification of customers, avoidance and reporting of suspicious transactions, and compliance with internationally recognized best practices. Adequate sanction should be provided for defaulting institutions, to serve as deterrence.

It is essential that countries should not allow their financial institutions to be used as conduit pipes or haven for illegal funds or let such funds lubricate their economies. Hence, necessary machinery must be put in place to repatriate illegal funds to the country of origin, once it has been clearly identified. Putting legal or diplomatic obstacle in the way of such repatriation will be counter productive as a result of the consequences of keeping looted funds in one's economy already outlined above. The United Nations have put in place two model treaties to facilitate issues on extradition and mutual assistance in criminal matters. These should be of great assistance. For instance Nigeria has bilateral agreement with United Kingdom on mutual legal assistance in criminal matters, [28] although the workings of this cannot be said to be very satisfactory, but the situation is improving.

However, the political will of countries to fight money laundering and corruption is central to the level of cooperation to be given at any material time, with or no bilateral agreement. This is because despite bilateral agreements, some countries are hypocritical and do not give necessary cooperation in fighting corruption, and are too eager to throw request for assistance in recovering stolen money back on one ground or the other. Even when such requests are processed after a long delay, what would be given is mass of irrelevant information, thus frustrating the country making the request. On the other hand some countries provide safe haven for the criminals, from where they use the stolen money to fight against their being brought to book. [29] The chances of wining the war against corruption or money laundering will be slim, if there are safe haven for stolen money, and criminals are protected from the arms of the law. This is the underpinning issue in this paper.

There is no reason why a country should not ordinarily give mutual assistance to another on criminal matters. Notably the Swiss, American and British governments have supported Nigeria's efforts in combating corruption either by detecting money laundered by corrupt Nigerians into their economies or by assisting in repatriating looted funds, but they can do better. There should be cross-border sharing of intelligence and members of the international community, in order to track laundered funds and perpetrators. However, for too long members of the international community have been enmeshed in unnecessary rivalry, divide of religion and tribe, conflicting national interests and negative international politics, instead of fighting common enemies such as money laundering and corruption, which damaging impacts are no respecter of continental or national boundaries.

5. Conclusion

The level of success recorded so far under the Vienna Convention can be largely attributed to enhanced mutual cooperation in legal, extradition processes and cordial/improved bilateral and multilateral relationships among countries. In fact, there are various platforms for co-operations, among countries of the world, e.g. as members of United Nations need to co-operate on the 2003 UN Convention against Corruption which has the desire for international cooperation on corruption and in prevention and asset recovery as its focus, and under similar regional instruments, and at FATF's membership or regional anti-money laundering bodies' level among others. The current government of Nigeria for instance had extradited Nigerians to the United States to face drug charges. There is also the need to build capacity in this regard (investigation and prosecution), as this is a general problem in most cases. Enhanced cooperation by members of the international community on crimes will be mutually beneficial, and also send clear message that there would be zero tolerance for corruption around the world. Money launderers take advantage of differences in countries anti-money laundering mechanism by moving funds into jurisdictions with weak or ineffective mechanisms. If corrupt people have no hiding place for their loot, and huge funds realized from crimes cannot easily be moved from one place to another, such acts will be significantly reduced in the world. The need to strengthen the global network to combat money and corruption are key challenges, towards the enthronement of good governance in the developing countries of the world.

Notes

[1] Nigeria is the most populous black nation in sub-Saharan Africa, according to the latest results of the population census conducted in year 2006, the country has a population of approximately 140,000,000 **[**one hundred and forty million**]** available at <http://www.odili.net/news/source/2007/jan/10/399.html> The country is the tenth largest in Africa, lies on the West coast of Africa and occupies approximately 923,768 square kilometers of land bordering Niger, Chad, Cameroon, and Benin. Nigeria is made up of 36 States and Abuja, the Federal Capital Territory.

[2] An international body established to oversee the implementation of the principle of the Vienna Convention of 1988, made up of 31 member countries and governments. Members of the FATF are: Argentina; Australia; Austria; Belgium; Brazil;
Canada; Denmark; Finland; France; Germany; Greece; Hong Kong, China; Iceland; Ireland; Italy; Japan; Luxembourg; Mexico; the Kingdom of the Netherlands; New Zealand; Norway; Portugal; the Russian Federation; Singapore; South Africa;
Spain; Sweden; Switzerland; Turkey; the United Kingdom; and the United States.
Republic of China became an observer on 21 January 2005.
[3] See The Human Rights Law Service, (2005) Controlling Endemic Corruption in Nigeria. Paper on controlling endemic corruption in Nigeria's Public Service, 1.
[4] See Financial Action Task Force Annual Report 2005- 2006 p. 5, where it was stated that a Project Group has been established to explore ways in which these links can be taken into account more systematically in FATF's work. <http:///www.fatf-gafi.org/dataoecd/38/56/37041969.pdf>
[5] See Paul M. Salay. (2002) Money Laundering and Trans-National Crimes, Modus International, Law and Business Quarterly vol. 7, (No 2), 63.
[6] See Insider Weekly December 30, 2002 P. 40
[7] See Remi Emeka Njoku, World Bank President Praises Nigeria's anti-corruption campaign, Businessday , 05 January, 2007 <http://www.efccnigeria.org/index.php?option=com_content&task=view&id=1169&Itemid=2>; The US has expressed satisfaction with Nigeria's strides in the fight against corruption and related offences. See Collins Edomaruse, Thisday 13 April 2006
<http://www.efccnigeria.org/index.php?option=com_content&task=view&id=864&Itemid=2rage the country (Nigeria)>; FATF has also acknowledged the strong progress made by Nigeria in combating money laundering, See FATF Annual Report 2005-2006, p5 <http://www.fatf-gafi.org/dataoecd/38/56/37041969.pdf >
[8] See Paul M. Salay. (2002) Money Laundering and Trans-National Crimes, Modus International, Law and Business Quarterly vol. 7, (No 2), 64.
[9] A clear example in this regard is that of Colombia, which is the No. 1 drug producing country in the world, where despite long history of democratic government, the drug barons use the proceeds from their illicit trade to finance rebels, which has made the political landscape in that country volatile and unstable. See Colombia, Microsoft Encarta ® 2006.
[10] The case of a re-elected member of the Federal House of Representatives, said to be an advance fee fraud kingpin, died in detention while standing trial (with others) for allegedly defrauding a German of $300,000 and 75,000 DM. He had easy access to power because of his enormous wealth and was said to be in politics in order to cover up his shady past; Adekoya, C.O. (2006) An Appraisal of the Renewed Battle Against Money Laundering in Nigeria, 3 (forthcoming 2007, copy on file with author.)
[11] See– Ayo Olesin, Nigeria lost $72bn to Money Laundering, The Punch, August 14, 2006, 27.
[12] See The IMF and the Fight Against Money Laundering and the Financing of Terrorism. IMF Factsheet, April 2003. <http://www.imf.org/external/np/exr/facts/aml.htm>
[13] Notable among these are The Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances ("the Vienna Convention") of 1988; the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime. Regional initiatives are The Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), the Eurasian Group on Money Laundering (EAG), the Grupo de Acción Financiera de Sudamérica (GAFISUD), the Middle Eastern and North African FATF (MENAFATF), the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL) and the Offshore Group of Banking Supervisors (OGBS). With the recognition accorded the Intergovernmental Action Group against money laundering in West Africa in June 2006, these regional bodies are now 9. See FATF Annual Report 2005-2006, p10 <http://www.fatf-gafi.org/dataoecd/38/56/37041969.pdf>
[14] See Levi Anyikwa, Masari seeks experts' help to recover stolen funds, The Guardian, November 11, 2003, 3.
[15] See Ribadu accuses French banks of keeping Nigeria's loot Tue, 28 Nov 2006 <http://www.efccnigeria.org/index.php?option=com_content&task=view&id=1125&Itemid=2>; About $693million alone was recovered from Swiss Banks had been returned to Nigerian government, See Nnanna Okere, April poll: Switzerland to expose corrupt candidates, <http://odili.net/news/source/2007/mar/1/503.html >
[16] See Segun Olatunji, Our leaders are corrupt- Ribadu, The Punch, July 19, 2006, 7.

[17] See Alex Last, The Politics of Nigeria Corruption 13 September, 2006 <http://news.bbc.co.uk/2/hi/africa/5339030.stm>; Oscarline Onwuemenyi, EFCC has convicted 120- Ribadu, The Punch, 15 November, 2006 <http://www.efccnigeria.org/index.php?option=com_content&task=view&id=1106&Itemid=2>

[18] See Text of a Media Conference by Mallam Nuhu Ribadu, Executive Chairman, EFCC, 21 November, 2005. <http://www.efccnigeria.org/index.php?option=com_content&task=view&id=716&Itemid=2>

[19] See No big deal amassing wealth while in office –Alamieyeseigha, Vanguard, March 17, 2007, <http://odili.net/news/source/2007/mar/17/300.html >

[20] See Senan John Murray, EFCC Probes 23 governors, The Punch, September 28, 2006, 1.

[21] See Alifa Daniel, Senate Panel indicts Atiku on PTDF, chides Obasanjo, Guardian, February 28, 2007 < http://www.guardiannewsngr.com/news/article01>

[22] See Clement Idoko, Nigeria loses $1 trillion to corruption- UN, Nigerian Tribune, December 6, 2006. <http://www.tribune.com.ng/06122006/news/news4.html>

[23] See Animi Awah & Dele Peters, (2002, April) Poverty Alleviation and the Control of Public Revenue: Legal and Equitable Issues. Paper presented at the Nigerian Association of Law Teachers Conference, at Lagos State University (LASU), Ojo, Lagos, 4.; World Bank (2001): World Bank Development Report 2000/201: Attacking Poverty, .280-281

[24] See The Human Rights Law Service, (2002) The Governance Scorecard, HURILAWS Publications, Lagos, Nigeria .9. Lagos, Nigeria.

[25] See Emeka Anuforo, Past govts mismanaged oil revenue, says Okonjo-Iweala, The Guardian, November, 30, 2004, back page.

[26] See Nigeria: Country Strategy Paper 2000-2002 by the United Kingdom's Department for International Development (DFID), Sept. 2000, 1-2.

[27] See Alex Last, The Politics of Nigeria Corruption 13 September, 2006 <http://news.bbc.co.uk/2/hi/africa/5339030.stm.>

[28] See Bilateral Agreement on Mutual Legal Assistance in Criminal Matters, Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Federal Republic of Nigeria, concerning the Investigation and Prosecution of Crime and the Confiscation of the Proceed of Crime, signed and dated 18/09/1993 Ref. TS 018/1994 Cm 2497, entry into force 30/10/1993 <http://www.fco.gov.uk/Files/KFile/MLA%20bilats%20criminal%20web%20doc,0.pdf>

[29] For instance, France has been said to be the residence of the number one promoter of corruption in Africa and the biggest money launderer in the world and that efforts to get him has not enjoyed the best of cooperation. See 'Ribadu accuses French banks of keeping Nigeria's loot' Tue, 28 Nov 2006 <http://www.efccnigeria.org/index.php?option=com_content&task=view&id=1125&Itemid=2> An allegation which France was said to have denied.

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International Human Rights Law: Providing Measurement Tools for CSR

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Abstract: Corporate Social Responsibility (CSR) is talked about a great deal in contemporary academic as well as corporate and commercial circles. This paper argues that despite, or perhaps because of, its fashionable status, CSR is an ill-defined concept which has consequently been interpreted and implemented in numerous different, and even conflicting, ways. It is demonstrated that currently there is no clear and unanimous definition of what CSR is, or should be. Importantly this means that there are also no clear and unanimous guidelines of how companies or private organisations should adopt CSR. The paper contends that this problem is further amplified through the lack of one single mechanism to measure a firm's CSR performance - there currently exists a multitude of different tools and strategies which pertain to serve this purpose, however, the lack of consistency or consensus between these mechanisms means that it is impossible to draw valid comparisons between the data they provide. Further, it is noted that this lack of consistency not only makes it hard to measure or compare firm's progress, but makes it difficult for firms to know how to comply with CSR, or what it is that they should be complying with. The paper therefore argues that there is a need to develop one single standardised mechanism for measuring CSR performance so as to eliminate the current confusion and uncertainty that exists. It is contended that through a clearer picture of what is required of firms it would no longer be necessary for them to spend time and resources defining or interpreting the concept of CSR, rather they could instead focus on making valuable progress towards meeting the goals of CSR. Finally, the paper suggests that international law, and in particular human rights law, provides a strong basis from which to develop the required single, standard mechanism for measuring CSR performance.

1. Introduction

The importance of Corporate Social Responsibility (CSR), which this paper proposes, derives from its role in meeting the goals of sustainable development. The concept of sustainable development became well-known in 1987 through the World Commission on Environment and Development's (WCED) report 'Our Common Future', (often referred to as 'The Brundtland Report'). The central premise of sustainable development is that economic and ecological goals are not necessarily oppositional and can in fact complement one another, (however, it is widely acknowledged that economic goals are prioritised over ecological goals). The highly important Brundtland Report (WCED 1987) defined sustainable development as the right of the present generation to meet its needs for development with respect for, and without compromising future generation's rights and opportunities to develop. We argue that CSR is essentially committed to a similar goal. The Brundtland Report called for the expansion of international institutions for cooperation and legal mechanisms to confront common concerns, and in particular for increased cooperation with industry. As such, business plays an important role in achieving sustainable development. Participation and responsibility on the part of society as a whole are key elements in making sustainable development a reality; thus social responsibility is itself closely connected with this concept (Rudnicki 2000). This paper therefore proceeds based on the supposition that CSR should be considered as a tool for sustainable development.

However, in order for CSR to play a meaningful role in sustainable development, a means of ensuring that CSR activities and commitments represent *real* efforts to make firms more socially responsible, as opposed to merely giving the firm a more socially responsible public image, are much needed. This paper demonstrates the need for a clear conceptual framework for measuring CSR. It is shown that whilst there is currently much talk and activity relating to CSR in academic as well as corporate circles, measuring strategies which serve to evaluate companies' CSR performance are based on diverse and dissimilar subject matters (standards) and as such the results that they provide are unable to be compared. Hence valid conclusions relating to the current state of CSR are not able to be made. The system, therefore, is unreliable and needs to be redesigned. Developing a

consistent and standardised means of measuring CSR performance is essential in order to achieve a well-founded picture of the current state of play in CSR.

This paper will begin by outlining the main debates which currently exist in the CSR literature, (which typically relate to companies' motivations for committing to CSR, and the financial benefits of doing so), and will then go on to demonstrate the need for a reliable means of measuring CSR performance. Most of the currently recognised measuring strategies will then be discussed in order to show their diversity and the problems that this causes. The paper will then conclude by outlining a potential way forward in developing a standardised mechanism for measuring CSR. This, it is felt, can appropriately be based in international law, particularly human rights law. It is not possible to construct a theory which focuses on the rights of persons without referring to international human rights.

2. Background – defining CSR

In recent times, CSR has come to be somewhat of a buzzword in academic (as well as corporate and commercial) circles. As was the case with sustainability discourses in the decade following the publication of the highly influential Brundtland Report (WCED 1987)**,** there is now a burgeoning literature surrounding, and emanating from, the discourses of CSR. This is not, of course, an entirely new phenomenon; some thirty years ago Holmes (1976) noted the importance of morals or ethics to the firm in arguing that part of the role of business was to assist in solving social problems; and twenty years ago Aupperle *et al* (1985:446) referred to 'an enormous body of literature concerning corporate social responsibility'.

Recently this trend towards CSR has become far more pronounced, as Tsoutsoura (2004:3) observes: 'The field of corporate social responsibility has grown exponentially in the last decade'. An unfortunate inevitability of the increasing volume and diversity of articles, research papers and other literature now focusing on and making references to CSR, is the diversity of, and disparities between the available definitions and interpretations of the concept of CSR. In some cases such disparities are vast.

Numerous definitions of CSR have been proposed and often no clear definition is given, making theoretical development and measurement difficult. CSR activities have been posited to include incorporating social characteristics or features into products and manufacturing processes (e.g. aerosol products with no fluorocarbons or using environmentally-friendly technologies), adopting progressive human resource management practices (e.g. promoting employee empowerment), achieving higher levels of environmental performance through recycling and pollution abatement (e.g. adopting an aggressive stance towards reducing emissions), and advancing the goals of community organizations(McWilliams *et al* 2006)

Aupperle *et al* (1985) commented that studying CSR was problematic given the 'value laden' nature of the concept and since it is 'susceptible to particular ideological and emotional interpretations' (p446). Carroll (1999) provides an interesting historical account of the evolution of the concept of CSR from as early as the 1950's – it is evident that despite (or perhaps because of) the many decades that the concept has existed there is little consensus as to its precise meaning or implications. Sommer (1980:52-53) observed that while some commentators use the term CSR to 'mean simply that corporations should abide by the law… others contemplate corporations' voluntary actions that are uncommanded by the law and that serve goals other than profit making for the benefit of the shareholders.' Clarkson (1995:92) argues that:

A fundamental problem in the field of business and society has been the lack of definitions of Corporate Social Performance, Corporate Social Responsibility, or Corporate Social Responsiveness that provide a framework or model for the systematic collection, organization, and analysis of corporate data relating to these important concepts. No theory has yet been developed that can provide such a framework or model, nor is there any general agreement about the meaning of these terms from an operational or a managerial viewpoint.

The problems associated with the lack of a clear definition or understanding of the notion of CSR are not merely linguistic or academic (Margolis & Walsh 2001). Given that evidence of CSR's appeal is present not just in academic but also commercial and corporate arenas, there are very real consequences attached to the ways by which it is defined and implemented. A vast array of companies and organisations now have publicly available CSR policy statements and the ways by which such companies and organisations define the concept of CSR will inevitably inform the decisions they make regarding their commitments and activities.

3. Why CSR? – Separation Thesis and Stakeholder Theory

This paper will now briefly describe the two central theories which underpin much of the current CSR literature and thinking and thus set the background for the central problem of this paper (the need for a reliable measurement strategy). A great deal of the CSR literature focuses on motivations or incentives for companies to take up principles of CSR: 'the business case for CSR'. Issues such as CSR's role in sustainable development are largely overlooked and instead the emphasis is on the financial aspects of CSR (for example see; McGuire *et al* 1988, Aupperle *et al* 1985, Schiebel & Pochtrager 2003, Tsoutsoura 2004, Carlisle & Faulkner 2004, among many others). Nevertheless, Cannon (1992) argues that the debate cannot only focus on financial aspects and instead points out that the primary role of business is to produce goods and services that society wants and needs. However, in practice, it may be easy to take the cynical approach and conclude that companies will only adopt CSR where they perceive benefits to themselves or their shareholders. Burke and Logsdon (1996) note that the 'classic literature in business and society asserted that while CSR might entail short-term costs, it paid off for the firm in the long run.' It was contended that 'firms would benefit from greater social legitimacy with less government regulation, and that a better society was simply good for long-term profitability' (p496).

Much of the CSR literature takes a similarly managerial approach with the focus being on how CSR can benefit firms and disregards the impacts of business on society. Indeed, it could be argued that unless CSR makes financial sense for companies there is no reason that it would be of interest to them. The 'Separation Thesis', for example, maintains that the central concern of business is maximising shareholder profit (Friedman 1970), and hence generating financial returns – not protecting, or serving the interests of (non-shareholder) stakeholders. However, the 'Stakeholder Theory' challenges this proposition and instead asserts that ethical and moral considerations should play a key part in business practices, while 'Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business… The separation thesis begins by assuming that ethics and economics can be neatly and sharply separated' (Freeman *et al* 2004:364).

Freeman (1994) suggested that stakeholders have all too often been treated as mere entities; not individual people with moral rights, obligations and lives beyond the interests and powers of the firm. Thinking of stakeholders in this way allows their concerns to be discounted and for them to be treated in ways which may result in unethical and potentially harmful actions and outcomes. It is for this reason that Freeman (1994) and others have called for the personalisation of the way in which stakeholders are perceived and treated. McVea and Freeman (2005:61) call for a 'names-and-face approach to stakeholder management' which would incorporate 'the idiosyncratic knowledge of individual stakeholders' into the running and decision-making of organisations.

Marquez and Fombrun (2005:306) comment that 'It is clearly in a company's interest to earn a favorable CSR rating. A good rating brings awards, applause, sales and reputation. It reduces the likelihood of 'churn' — when consumers, investors or employees mobilize against the company.' Further, negative perceptions of the firm by host communities will affect what companies call "licence to operate". The risk of this view, however, is that a significant number of firms will invest in society as far it buys them a "license to operate" (Walsh 2004), as such philanthropic investment may function as merely an insurance mechanism.

As a consequence, stakeholder theory has largely come to take on a managerial or instrumental role. Freeman provides excellent accounts of what stakeholder theory *should* mean – putting ethics into business and ensuring fairness and equity for *all* stakeholders - however, in practice it has come to mean something entirely different. Stakeholder theory as discussed by Mitchell *et al* (1997) among many others, and as has influenced much management practice (for example see Deegan 2001 or Scholes 1998), is now a highly manipulative tool which managers use to understand and consequently control stakeholders who are all too often viewed as opposition and as obstacles to be tackled. The ethical motivations behind considering stakeholders have in many instances been lost – it no longer serves to maximise value and benefits for all concerned parties but rather as a power-grabbing exercise which allows managers and decision-makers to 'manipulate all other stakeholders in Machiavellian ways to ensure the best possible chances of successful implementation of a strategy' (Scholes 1998:168). Katsoulakos and Katsoulakos (2006:24) point out that:

Instrumental approaches are aimed at maximising shareholder value *paying attention to stakeholder relationships*. The basic assumption in this model is that stakeholders control resources that can facilitate or slow down the implementation of strategies and therefore must be managed to create competitive advantage to maximise profits and ultimately returns to shareholders. Clearly, in all cases, instrumental stakeholder management is a means to an end which may have nothing to do with the welfare of stakeholders

As such, whilst instrumental stakeholder management is a visible part of corporate strategy it clearly does not drive strategy. However, corporate approaches, which are endorsed solely by concerns surrounding the mere viability and sustainability of the corporation, undermine the social responsibility of business. Therefore, an

instrumental approach is not sufficient to drive CSR, what is required is a normative approach which acknowledges the firm's stakeholder relationships and networks. Mutually beneficial, trusting and long-lasting relationships can only be built upon ethical commitments, principles and the rule of law.

In sum, there are substantial reasons to conclude that business and society are inter-dependent. From a theoretical perspective these two managerial approaches result in making CSR a self-contradicting notion, and practically the two approaches are equally of little use to society, other than shareholders. What we argue is that underneath CSR, there is a normative assertion that overrides any other theory; sustainable development, which includes the protection of human rights. There is, then, a stronger foundation for CSR. Clearly, companies, as active members of society, can/should contribute to the achievement of sustainable development via CSR. Here CSR is understood as a win-win situation which is mutually beneficial for society and business alike.

4. Moving away from why and what, and towards how and how much

For the purposes of this paper it is not worth examining further the precise meanings of CSR or who it is said to involve. If, as is proposed by this paper, the meaning of CSR is the participation of business as part of society in order to achieve sustainable development via long-term economic success then it is vital to consider how we can measure CSR in order assess progress towards this goal.

Given the disparities in definitions of CSR mentioned above, it is clear that companies are able to adopt CSR in very different ways and with a great deal of flexibility and interpretation. Hence, measuring CSR helps us to know that it does not merely represent an exercise in PR for companies and organisations hoping to benefit from a socially, or environmentally clean image. It is important to consider what the outcomes of this action are and what impact these may be perceived to have. Assessing the CSR performance of a company can provide us with the means to discern whether the company is in fact meeting social and environmental expectations. This essentially leads us to the central problem of this paper.

The key focus of this paper is measurement, particularly the conceptual framework for the measurement of CSR, as opposed to the operational qualities of CSR measurement tools. This is based on our assertion that if measurement strategies come from dissimilar conceptual origins then the results will naturally be different and incomparable thus rendering the system unreliable.

Firstly it should be acknowledged that it is extremely problematic to assess the CSR performance of a company or organisation, or to know that their actions reflect the commitments set out in CSR policy. Aupperle *et al* (1985:446) commented that 'The problem in assessing levels of corporate social responsibility is objectively determining appropriate criteria and standards of corporate performance, a kind of difficulty typical of the labyrinthine problems confronting social audits.' The problems of measuring CSR are well-acknowledged in the literature, (see for example; Swanson 1995; Carroll 1999; Hopkins 2005; Peloza 2006; Marquez & Fombrun 2005), however as yet no solution has been found. Currently, there exists a great variety of internal and external organisational strategies/approaches for measuring CSR, however, there is little consistency between these strategies/approaches, and it is clear that presently there is no agreement regarding the perfect model.

Consequently, a key problem associated with CSR is the absence of a valid mechanism for measurement. It is true that measurement systems do exist and are available; however the proliferation of these systems, particularly for measuring corporate performance on social issues, while encouraging, does not provide a systematic conceptual basis. The measuring systems lack a theoretical framework and indicators are often chosen on the whim of the moment (Hopkins, 2005) with clear bias and subject-preference depending on the assessment body/person (for example environmental factors are often given prominence). Therefore any CSR comparative rating is inadequate and claims of validity are misleading.

5. Measurement Approaches

The paper turns now to reviewing the different measurement approaches currently available. It is strongly argued that the use of a single conceptual framework for measurement would facilitate company compliance with CSR principles since it would give them a clearer picture of what is expected of them. Furthermore, society would have a clearer picture of what to demand of companies. The following section illustrates the discrepancies of the different methods used today and demonstrates that measurement of corporate social responsibility is so inconsistent that it has become meaningless.

Orlitzky *et al* (2003) argue that there are four measurement approaches, which are broadly associated with the construct of corporate social performance (CSP)

(a) CSP disclosures;
(b) CSP reputation ratings;
(c) Social audits, CSP processes, and observable outcomes; and
(d) Managerial CSP principles and values (Post 1991)

5.1 CSP Disclosure

Typically, attempts to measure CSR have focussed on the production of annual reports and other public corporate disclosures created by the firms themselves; this method is referred to as CSP disclosure. This strategy of measurement commonly consists of 'content analysis' of annual reports. Content analysis is used to compare components of text against particular CSP subject matters in order to draw inferences about the organisation's underlying social performance (Wolfe 1991).

5.2 CSP Reputation Ratings

There is also a long history (from the late 1970s) of reputation ratings produced by CSR/Sustainable agencies (see below), businesses and knowledgeable observers (Alexander & Buchholz 1978; Heinze 1976) independent of the accountable firms and based on one or more dimensions of social performance. In particular these aim to measure the performance of companies that meet globally recognised corporate responsibility standards (Cochran & Wood 1984, Maignan & Ferrell 2000, Abbott & Monson 1979). The reputation index method is based on the assumption that CSP reputations are good reflections of underlying CSP values and behaviours (Orlitzky *et al* 2003).

5.3 Social Audits, CSP processes, and observable outcomes

Orlitzky *et al* (2003:408) refer to social audits as 'a systematic third-party effort to assess a firm's 'objective' CSP behaviour, such as community service, environmental programmes, and corporate philanthropy.' Orlitzky *et al* observe that this strategy normally results in a sort of rating, and for this reason this is considered as a CSP reputation rating for the purposes of this paper.

5.4 Managerial CSP principles and values

The fourth strategy may be used either internally by firms or externally and involves assessing the firm's compliance and progress in relation to certain key CSR values and principles. These values and principles would be expected to be built into a company's culture. Models for this purpose have been developed by both Carroll (1979) and Wood (1991). The last strategy of measurement creates a conceptual model based on questions of whether a company has a clear statement of principles, whether the principles generate processes for their implementation and which outputs can be measured. The approach is systematic and descriptive; however, measurement varies according to business needs and as such lacks consistency, further, as with the earlier mechanisms, it does not have a pre-established conceptual framework.

6. Measurement Problem

As discussed above, there are four broad approaches to measuring CSR, all producing different results as a consequence of the fact that they cannot be linked theoretically. This paper will now focus briefly on the two most popular methods: a) CSP disclosure and b) CSP reputation ratings, in order to demonstrate the stated problem.

6.1 CSP Disclosure or Content Analysis

At the end of the 1970's Abbott and Monsen (1979) attempted to develop a social involvement disclosure scale based on a content analysis of annual reports and found that there were significant advantages to using this technique for measuring corporate social responsibility. Shortly after Ingram and Frazier (1980) used content analysis to measure the content of each firm's environmental disclosure in the 80's and since this time content analysis has come to be regularly used for measuring social performance. This strategy of measurement today

commonly consists of 'content analyses' of annual reports. Content analysis is used to compare components of text against particular CSP subject matters in order to draw inferences about the organisation's underlying social performance (Wolfe 1991).

CSR Reporting as a manifestation of corporate social performance is confusing; a significant amount of data is presented without any contextualisation or explanation of its significance for the users or readers of CSR reporting.(1) To date, more than 3,000 corporate environmental, social or sustainability reports have been published voluntarily, yet despite this CSR Reporting still has no clear patterns. One could argue that a certain degree of similarity must exist for the sake of transparency, clarity and validity. Furthermore, reporting ought to be straightforward and tangible focusing on all stakeholders, such as employees, host communities and business partners.

Today there are more companies than ever before producing social and environmental reports. A report by AccountAbility (2002) concluded that companies lack an understanding of certain aspects of the impacts of social and sustainability reporting. In particular many companies are still unclear about their key stakeholders, thus the materiality of their reports and boundaries are seriously affected. The report points out that the "lack of clarity on the audience can pose additional difficulties in selecting the right content" (p,49). This publication is based on 32 interviews with 11 large corporations from a variety of sectors and different geographical regions of operation. One of the aims of AccountAbility's study is to establish a distinction in the purpose of reporting between what it calls 'transformational' reporting and 'classical'. The 'classical' view holds that the purpose of reporting is changing the perceptions of the report's readers. The 'transformational' view, however, holds that reporting is primarily a device to drive change within the company. Therefore it impacts on business decisions and outcomes.

To conclude, measurements based on different components will indubitably provide differing and inconsistent results (between as well as within companies). Clearly this strategy for measurement is making it very difficult to gain an accurate impression of CSR progress, and particularly of how companies compare with one another, thus, it largely serves an internal purpose or as PR.

6.2 CSP Reputation Ratings

The aim of this strategy is to measure the performance of companies that meet globally recognised corporate responsibility standards (Maignan & Ferrell 2000, Cochran & Wood 1984, Abbott & Monson 1979). There are an increasing number of agencies and companies providing ratings today based on the CSP of businesses. Their methodologies vary from indexes that merely consider the firm's CSR policies to others that analyse how well they have integrated these policies into their overall business operations.

In theory, CSR indexes serve basically two purposes: a) as tools for companies and society to compare their social, environmental or ethical performance, and b) as a tool for potential investors to analyse companies. In general indexes rate the company management practices that impact on the community, environment, marketplace and workplace. As will be discussed below, this measurement approach is unreliable and does not allow factual company comparison (Global Finance 2006). To demonstrate this problem this paper will now focus on the two most important market indexes: DJSI & FTSE4Good.

Whilst the DJSI and FTSE4Good indexes may be perceived to serve the same purpose, there are some striking conceptual differences between the two. For example, whilst the FTSE4Good index measures companies according to a variety of criteria (environmental impact and management, human rights, stakeholder issues) and excludes companies from certain sectors, (i.e. tobacco producers, nuclear weapons companies and defence companies), the DJSI does not exclude specific sectors but instead adopts a 'best-in-class' approach. With regards to the human rights criteria the FTSE4Good takes into account, only for the global resource sector, the UN Basic principles on the Use of Force and Firearms by Law Enforcement Officials or the Code of Conduct for Law Enforcement Officials or alternatively signatories to the Voluntary Principles on Security and Human Rights. Conversely, the DJSI does not make use of the UN Basic principles on the Use of Force and Firearms by Law Enforcement Officials or the Code of Conduct for Law Enforcement Officials or alternatively signatories to the Voluntary Principles on Security and Human Rights in its assessment criteria.

The reputation approach postulates a reputational effect on CSR rather than giving an authentic picture of the social responsibility of the firm. Thus the result of index ranking will be inaccurate and liable to inconsistencies, as is demonstrated in the following example: In September 2005 DJSI and FTSE4Good announced the results of their annual reviews. Taken together, these results produced some interesting contradictions within particular sectors:

Fully half (11 of 22) of the companies deleted for failing to meet FTSE4Good's Environmental Criteria inhabit the banking and financial services sector, including AmSouth Bancorporation (ASO), Bank of New York (BK), Charles Schwab (SCH), Fifth Third Bancorp (FITB), Keycorp (KEY), National City (NCC) and US Bancorp (USB).On the other side of the same coin, banks and financial services companies account for more than a quarter (15 of 57) of the DJSI additions list, including Bear Stearns (BSC), Goldman Sachs (GS), H&R Block (HRB), Nomura Holdings (NMR), the London Stock Exchange (LDNXF.PK), and Provident Financial (PFG.L).Baue 2005.

Therefore whilst half of the companies deleted from the FTSE4Good index were banks and financial services, companies from this sector accounted for more than a quarter of the companies *added* to the DJSI list. So given that the two lists pertain to represent the same phenomena, why did they provide such seemingly contradictory findings? A possible explanation is the different methods used by the two index providers (outlined above); whilst DJSI utilises a best-in-class approach, rewarding best practice in sustainability issues, FTSE4Good utilises negative screening whilst also employing an approach of raising the bar on social and environmental performance criteria incrementally to promote gradual and achievable improvement from companies.

Examples such as these provide illustrations of how the current array of numerous differing CSR measurement strategies is making it very difficult to gain a clear impression of CSR progress, or to make comparisons between companies and judge the reliability of measurements. As they stand today, without a common theoretical framework, none of the methods outlined above provide a wholly adequate means of measuring CSR.

If it is true that the diversity of reputation ratings provide options for investors across a broad spectrum of ideological beliefs, they lack a common conceptual framework which would permit corporate comparison. For example, some social investors prefer screens that exclude 'sin' sectors such as gambling, while others prefer best-in-class screening that includes companies in all sectors, including 'sin' sectors. This may be, *prima facie,* good for investors' decision-making, but for other stakeholders the measurement of CSR becomes meaningless. A study undertaken by the Stockholm School of Economics and the Nordic Partnership on sustainability indexes showed similar conclusion: Socially Responsible Investment (SRI) products and instruments are hard to compare due to the lack of standardised screening methods for evaluating companies' performance (Sjostrom 2004). The report notes that SRI mutual funds have no common standards, definitions, or codes of practices and there is a clear need for standardised methods and criteria to draw meaningful conclusions.

7. CSR Measurement

The current collage of measuring initiatives highlights that one of the biggest problems creators of measurement systems face, is what conceptual basis to use (Marquez & Fombrun 2005). This is no different to the problem faced by creators of codes of conduct or principles of behaviour; in fact it is intrinsically related due to the fact that measurement relies on the standards chosen for CSR. With the explosion of interest in CSR, and what could be seen as a bandwagon effect, there now exists hundreds of forms to measure corporate performance in societal terms. However, such mechanisms are dissimilar and complex. In current commercial practice, different levels of CSR and strategies for measurement are grouped together creating greater confusion as to what is being talked about, (*i.e.* policies, implementation and measurement, or reporting). The measurement systems rarely define concepts, and indicators and data are seldom given. A possible reason for this, as suggested by Hopkins (2005:226), is that the schemes used today are commercially oriented and so 'one can wonder what is really being measured'. The systems utilised do not show an analogous stated performance criterion, which enables an objective assessment of CSR. In addition, such exercises tend to hurt the credibility and certainty of the CSR system as a whole.

Without a consistent pattern of measurement the uptake of CSR by private firms and organisations is questionable. Since there is no single standard by which to measure and report a firm's CSR progress and since there is instead a vast array of mechanisms to choose from it is possible that a firm could manipulate this situation so as to gain the best CSR report not through making the best commitment or acting in the best way, but rather by measuring and reporting its progress through the most accommodating method. In order to enable a fairer picture of CSR progress in and between firms and organisations, it is therefore necessary to develop one standard instrument of measurement, which will facilitate reporting and by which all firms and organisations can be tested according to similar, if not the same, bases. Further, the creation of one standard mechanism for measuring and reporting CSR would enable firms and organisations to improve CSR policies in response to benchmarking. It must be noted that the discrepancies between current levels of CSR commitment (discussed

above) are not necessarily a sign of varying dedication on the part of firms but may quite fairly be seen to represent the inevitable confusion caused by the huge variety of measuring strategies which now exist.

When one combines this variety of measuring strategies, with the confusion surrounding definitions and interpretations of the concept of CSR, it is clear that firms attempting to make a meaningful CSR commitment currently have to fight their way through a jungle of perplexity and ambiguity. Defining one clear, and ideally universal set of CSR standards would not only make it easier to measure companies' compliance and commitment but would also make it easier for companies to know exactly what it is that they should be committing to. More importantly, it would no longer be necessary to debate the precise meaning of CSR as a concept, and firms would no longer have to waste resources determining *what* they should be complying with – this is a particularly important point for SME's attempting to adopt CSR – rather there would be a clear set of standards which all firms, regardless of size or geographical location could aspire to meet. The focus therefore needs to shift away from *what* CSR is, or should be, and instead towards *how* we can measure individual firms' progress.

As noted above, there is a need to develop a standard model which can be used by businesses (not just large enterprises but also SME's), irrespective of their operative location or type of industry. This leads us to the final part of the paper: how can we measure CSR? For that purpose, the model ought to be underpinned by set standards which provide an impartial and universally applicable assessment of corporate performance so that the outcomes of CSR may be fully comprehended.

A single standardised approach would eliminate the possibility of such confusions and contradictions and better enable a clear assessment of companies' CSR progress. In order to construct the necessary efficient and detached scheme for measuring CSR this paper therefore suggests that international standards are required. A structural framework to facilitate analysis of corporate social activities should have at least the following two properties: First, categories for classifying corporate activities should be stable over time making historical comparisons possible. Second, the definitions of various categories should be applicable across firms, industries, or even social systems, making comparative analysis possible (Sethi 1975). Taking these properties (which reflect consistency and universality) into consideration the authors see international law, and human rights law in particular, as providing a way forward for measuring and reporting CSR.

8. International Standards for Measurement

Most available standards do not relate to measurement directly, but rather serve as guidelines for CSR as a strategy. However, in practice standards provide a benchmark against which CSR can be measured. There are a number of standards available such as those provided by the ISO family of standards (for example, ISO14001), the ILO (International Labour Organisation), the OECD, the UN Global Compact, the Global Reporting Initiative or Amnesty International's Human Rights Guidelines for Companies. It is clear that companies who follow recognised standards can be compared more easily than if the company employs individual measures and criteria.

No organisation has contributed more to the development of social standards, or has wider legitimacy than the United Nations (UN). There are a variety of international instruments adopted under the auspices of the UN dealing with human rights, corruption, the environment and labour conditions which delineate the standards of conduct for persons and states. Therefore, we propose that the best standards for CSR measurement are clearly provided by human rights law. In fact, such instruments are already used by several companies, rating agencies, investors, NGO's and governments as minimum levels for acceptable performance in these areas[(2)].

Dunphy *et al* (2003) note that there are no universal values for implementing CSR, thus there are always diverse philosophical grounds that lead to difficulties in the implementation and measurement. In other words, people differ in how to interpret reality and therefore it is often difficult to find a consensus on values. It is precisely here that we find the utility of international human rights. In a more specific sense, the recognition of individual rights has a long history, but it has evolved considerably in the post-1948 era. This approach has led to standard setting, on the universal level via treaty law or custom and is particularly oriented towards protecting the human rights regardless of the source of violation. This international system has sprung in different generations of rights; first (civil & political rights), second (economic, social and cultural rights) and third (collective rights). It can be said, then, human rights law is *per se* universal. This expansion of rights also shows the legal competence of international law to deal with corporate behaviour.

International human rights law "is the only existing internationally-agreed expression of the minimum conditions that everyone should enjoy if they are to live with dignity as human beings"(International Council on Human Rights Policy 2002:15). Human rights, encompassing the international bill of rights, are the most

fundamental rights of the person. Nicholas Howen (2005) argues that human rights condenses what is common across all cultures and adds advocacy power to those who are marginalised. Aspects of consumer law, criminal law, environmental law or even corporate law can all help companies decide what they should and should not do. However, only human rights standards provide the comprehensive normative guide about how human beings should be treated.

If one of the major social concerns is how corporate conduct impinges on the environment, life, dignity and freedom of persons, the regulation of corporate behaviour is a direct matter for international law. It would make little sense to consider an act as a human rights violation when performed by a state agent but not when it is performed by a private person [natural or legal]. In fact, regional courts have already acknowledged the horizontal effect of international human rights law. In sum, the standard-setting is not only appropriate for CSR but a set of this obligations are binding on persons (e.g. *jus cogens).* We propose to borrow human rights norms so as to enable a level playing field for CSR measurement.

Human rights law enables international adherence to social issues due to its normative character and creates general standards that are in fact widely accepted and consistent. Other alternatives such as ethics or local customs lack the binding character, which requires (almost) identical application of norms for most countries around the globe. International standards would thus be objective, expressed in terms of a combination of process, management and performance criteria, rather than designed by companies or being descriptive according to characteristics of local customs. Human rights law will set the precise framework, (as environmental law will do for measuring environmental performance) for dealing with individuals and local communities.

The International Social and Environmental Accreditation and Labelling Alliance (ISEAL Alliance 2004) notes that all standards should be structured and use a common language to support consistent interpretation, which is exactly what human rights instruments provide. Furthermore, ISEAL recommends that standards should only include criteria that contribute to the achievement of the stated objectives (which we argue is sustainable development), that is precisely the nature of human rights: "the ideal of free human beings enjoying freedom from fear and want can only be achieved if conditions are created whereby everyone may enjoy his economic, social and cultural rights, as well as his civil and political rights" (Universal Declaration of Human Rights).

Using international human rights as universal standards will facilitate the development of a consistent pattern of measurement, data collection, presentation, auditing and comparability not only between companies but also across jurisdictions because of their multi-stakeholder membership and consistency. Additionally, human rights pave the way forward due to the fact that it enables the realisation of all other rights.

In sum, we advocate a measurement approach for social performance which would be based on human rights law and most likely include basic management requirements pertaining to:

a) Compliance with all rules and regulations of the country jurisdiction;
b) International norms concerning environmental and human rights[4] including labour standards and
c) Agreed standards based upon a meaningful stakeholder engagement process.

9. Conclusions

CSR is an important area of consideration for sustainable development with much potential, however the current bandwagon of academics as well as corporate and commercial actors pertaining to be working in or concerned with the area of CSR has led to a complex and almost meaningless array of differing interpretations and implementations of the concept. Since there exists such a range of interpretations of, and means for measuring, CSR it has become possible for companies to comply through any number of different means. As such compliance does not necessarily equate positive or meaningful action or commitments on the part of the company. It is, therefore, more than apparent that the current systems for measuring and reporting companies' CSR performance are inadequate and in need of an overhaul.

We argue that given CSR's important role in sustainable development it is necessary to radically rethink the ways in which it is discussed in order to ensure that meaningful and comparable progress can be made in accordance to standardised principles and goals. It is argued is that underneath CSR, there is a normative assertion, which gives a stronger foundation to corporate responsibility, that overrides any other theory; sustainable development, which includes the protection of human rights. As is suggested in this paper, academic debates about CSR should move away from exploring the reasons *why* companies commit to CSR principles and instead should focus on the important questions of *what* such a commitment should entail and *how* we can measure this.

Such a conceptual move would not only enable a clearer insight into the real progress of CSR, but would also create clearer guidelines for companies wishing to comply with CSR. The current varying levels of commitment and the differing actions that are taken by companies can be seen to represent the confusion which exists around what CSR actually means and what compliance to this concept actually entails. A standardised mechanism for measuring CSR performance would provide companies with clear parameters as to what they should aim to achieve.

The tri-dimensional adherence and compliance of business enterprises with social, economic and environmental standards is, *inter alia,* a key component of sustainable development. This paper has suggested that the integration of these three dimensions of sustainable development is found within the concept of CSR. Furthermore, we argue that human rights law, due to its universal, horizontal effect and consistent character, provides the best standards for CSR and thus the most appropriate framework for (corporate) social performance measurement. However, we have to remember that human rights are minimal standards and it is expected CSR moves beyond "corporate accountability" to "social responsibility". It is clear that much remains to be done in the area of performance measurement and human rights, and this paper represents the early ideas of a work in progress however it is hoped that it will serve to indicate new areas of thinking in the field of CSR and some important directions for future developments.

Notes

|1**|** For example, see, Nike, Co-operative group, Novartis, BC Hydro, Pepsico, BASF, Dofasco and CIBC reports
[2] For a discussion of companies using international human rights instruments for CSR policies see UN 2006
[3] A concrete example in this line is international environmental law and its effect on adopting global environmental performance measures.
[4] Here we refer to the International Bill of Rights

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Legal and Technological Developments Concerning eGovernment Services in Poland

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Abstract. Adoption of electronic services in the public sector in Poland is still in its infancy, despite success stories such as the launch of Public Information Bulletin or social security and customs applications. Important services that need to be developed include a centralized eGovernment platform as well as numerous specific applications dealing with, for instance, the provision of certificates, enrolment in higher education, social contributions for employees, and submission of data to statistical offices or customs declarations. Only a small fraction of the services are accessible online. The aim of this article is to present the emerging electronic services in Polish public administration. The present contribution is of informative nature and will focus on two areas of interest: a legal framework for eGovernment adopted by Polish Parliament and the most important technological developments.

1. Introduction

In the early 1970-ties, economists and information theorists argued that companies that do not adopt information technologies will be disadvantaged and might disappear from the market. With the advent of the Internet and global electronic commerce in the 1990-ties, market analysts anticipated that lack of adoption of e-commerce might not only lead to a company failure but can also affect its business partners. In other words, information technology was viewed as a fundamental tool with respect to the competition between different supply chains.

In the beginning of the XXI century, one can argue that the rapid adoption of information technology by government sector can turn out to be a crucial factor that will affect the competitiveness of a country. States should replace their old ways of governing the public affairs with modernized, interlinked information systems that will allow savings in public and private budgets alike and facilitate everyday existence. Modern computerized states will simply act more efficiently and effectively than traditional, paper-based government structures.

The transition from traditional to electronic government is obviously a huge challenge. The scale of informatisation is enormous in comparison with the effort required to develop and implement early company-wide information systems, or even modern inter-organisational information systems such as collaborative platforms or electronic marketplaces. Although modern governments can draw upon lessons learnt by the precursors of electronic commerce, the change in the mindset of public officers can be much more difficult to achieve. Furthermore, governments must act on the basis of law; therefore development of a coherent and comprehensive legal framework is another serious challenge.

Adoption of electronic services in the public sector in Poland is still in its infancy, despite success stories such as the launch of Public Information Bulletin, social security and customs applications. Although 36% of households and 90% of businesses have Internet access [2], important services need to be developed, for instance, a centralized eGovernment platform or specific applications dealing with, for example, provision of certificates, enrolment in higher education, social contributions for employees, submission of data to statistical offices or customs declarations. Currently, only a small fraction of public services are accessible online.

The aim of this article is to present an overview of the developments of public electronic services in Poland. As a result, the article is more of an informative nature. The research method used involved the analysis of legal regulations and government reports concerning the state of informatisation.

The present contribution will focus on two areas of interest: a legal framework for eGovernment adopted by Polish Parliament and the most important technological developments [1]. The first part will be rather formalistic as it describes the most important legal acts that provide a regulatory basis for informatisation of

government services. The second part will present the most interesting eGovernment services that have been adopted so far. The assessment of the current state of informatisation process will conclude this article.

2. The legal framework for eGovernment services

Poland is one of the first countries that have introduced a comprehensive framework for public e-services in the European Union. There are several acts that are of importance in the area, including the Act on Informatisation of Public Sector and the Law on Public Procurement.

2.1 Act on Informatisation of Public Sector

The most comprehensive legal development with respect to eGovernment services is certainly the Act on Informatisation of Public Sector (AIPS 2005), which entered into force on 21st of July 2005 together with ten regulations that supplement it (Regulations 2005). AIPS is the first act of its kind in Central and Eastern part of Europe. It establishes minimal technical requirements for Informatisation of public bodies as well as rules for Government-to-Government (G2G) information exchange.

As a rule of thumb, AIPS does not establish rules for Business-to-Government (B2G) and Citizen-to-Government (C2G) e-services as it applies to government administration units, public healthcare institutions, state control and law enforcement authorities, courts, local authorities etc. The Act contains five different objectives, which can be summarized as follows.

2.1.1 Top-down informatisation plans

The drafters adopted a strategy of public informatisation based on top-down plans. AIPS introduces a State Informatisation Plan (PIP) as well as sector-specific and cross-sector informatisation projects. The 2006 State Informatisation Plan aimed to rationalise investments in public IT projects and to create a modern and citizen-friendly state. The aforementioned plan promised investments in numerous public IT projects.

The draft Plan for years 2007-2010 assumes the continuation of projects envisaged in the plan for 2006. The goals and priorities with respect to informatisation of public administration are set together with a list of the key public projects, a program for developing Information Society and a list of public activities that are to be delivered online. The goals for 2007-2013 are:

- implementation of technological neutrality in public IT systems through, e.g., use of open standards,
- development of friendly e-administration through, e.g., simplification of procedures, and
- rationalization of IT investments through, e.g., elimination of redundant public processes (PIP 2007).

It also lists a number of IT projects, such as a centralised public administration platform e-PUAP described in the second part of the article.

2.1.2 Technological neutrality

Public entities are also obliged to treat all technologies in an equal manner, thus implementing the principle of technology neutrality. In order to ensure fulfilment of this obligation, public institutions have to publish supported data formats, communication and encryption protocols as well as document structures and acceptance tests in Public Information Bulletin (Biuletyn Informacji Publicznej) or make them available in other manner. Public Information Bulletin is available online.

Furthermore, an extensive body of rules dealing with a control of the implementation of public information systems is established. A software developer is required to test his solution (acceptance tests) at his own expense, before a roll-out and after each modification. A public institution may verify developers' tests. AIPA also foresees establishment of a country-wide National Registry of Information Systems and Public Registries, which will contain data about all public information systems and public registers (whether computerized or not). It is to be managed by the Ministry of Internal Affairs and Administration (Regulations 2005).

2.1.3 Minimal standards

AIPS sets up minimal standards for public information systems, public registries and exchange of information in the public sector. These standards are described in a Regulation of the Council of Ministers on minimal requirements for teleinformation systems (Regulation on minimal standards 2005). It is interesting to note that the minimal standards are actually well-known and widely used Internet protocols and file formats. According to article 1 of the Regulation, public institutions should support the following communication and encryption protocols enabling data exchanges with other public information systems: IP v.4.0, TCP, UDP, ICMP, HTTP, SMTP/MIME, POP3, IMAP, SSL v. 3.0, TLS, S/MIME, DNS, FTP, SOAP, WSDL.

Furthermore, the Regulation specifies which formats public institutions should support. One may find here the following list of widely used document formats: .txt, .rtf, .pdf, .doc and Open Document. Pictures should be sent using .jpg (.jpeg), .gif, .tif, .tiff, .png or .svg format. On the other hand, web applications should support HTML, XHTML, CSS, WAP, XML, XSD, GML, XSL and XSLT. The regulation also specifies compression standards as well as information coding and encryption formats.

Public institutions are required to meet minimal requirements and support at least one of the above technical standards for data processing. Similar requirements have to be fulfilled by electronic registries, which have to enable access to and submission of information by electronic means, respect minimal technological standards and comply with additional set of minimal requirements for public registries. These minimal requirements are enlisted in a separate regulation, which contains a list of data structures (fields and their lengths) that should be adhered to by public institutions when collecting and exchanging information (Regulation on registries 2005). However, only public institutions are guaranteed free access to electronic registries (art. 15)

2.1.4 Submission of electronic documents (G2G)

The Act on Informatisation of Public Sector obliges public bodies to enable exchange of electronic documents via teleinformatic systems or data carriers (art. 16). Consequently, public institutions, even if they do not have information systems in place but exchange information with other public bodies, should develop ones.

The obligation to ensure electronic communication is further expanded in a Regulation of the President of the Council of Ministers on organizational and technical conditions for submission electronic documents between public bodies (Regulation on submission of electronic documents between public bodies 2005), which sets out the conditions for submission of electronic documents between public institutions (G2G). The technical framework deals with data structures and formats of electronic documents that ought to be supported by public institutions. As a rule of thumb, the documents should be submitted to public institutions using document structures and data formats listed in the Regulation on minimal standards. Public bodies should therefore accept documents sent in .doc or .pdf format provided that the required structure of a document is ensured. It is important to stress that public bodies have to establish definitions of data structures and make them available online in Public Information Bulletin.

The Regulation on submission of electronic documents also sets out the organizational framework for submission of electronic documents. Electronic documents can be submitted in a variety of modes i.e. either via computer networks or on data carriers such as a floppy disk. Public institutions should establish electronic contact points for the purpose of network-mediated data delivery. Online submission of electronic documents is simpler as it requires automatic transfer of data from an electronic document to an information system and then the automatic generation and delivery of receipt confirmation via the network. On the other hand, electronic documents saved on data carriers must be manually keyed into a public information system and a confirmation receipt must be generated and saved on the data carrier on which the document was submitted. Public bodies are obliged to store generated receipt acknowledgments for the period for which electronic documents should be stored. It is important to stress again that the aforementioned obligation is limited to G2G data exchange, although similar rules were recently adopted for B2G and C2G communication

2.1.5 Submission and delivery of electronic documents (C2G and G2C)

As it was mentioned earlier, the Act on Informatisation deals only with rules for G2G data communication. However, it has changed the most important statute dealing with the administrative procedure, namely the Code of Administrative Procedure (CPA 1960). Accordingly, an individual (C2G) or a company (C2B) can submit an application to the public administration using electronic mail or web form. However, two conditions must be fulfilled. Firstly, such application must be written on a specified application form and use required data formats.

Secondly, it must be signed using an advanced electronic signature based on a qualified certificate (art. 63 CPA). The problem is that the required document formats have not yet been published. Until then, citizens and businesses will not be able to submit their application in an electronic way.

On the other hand, a public body can only deliver administrative decisions in an electronic manner if an individual (G2C) or a company (G2B) has made such request or has accepted this form of communication (art. 39^{1} § 1 CPA). The delivery of documents between administration and individuals is considered effective provided that an addressee (citizen, business) confirms the receipt within 7 days (art. 46 § 3 CPA). Regulation on generation and delivery of electronic documents from public bodies to individuals and businesses sets out the conditions for such deliveries (Regulation on delivery of electronic documents 2006). An electronic document should meet minimal data formats, signed using an advanced electronic signature and be written on a standard application form (§3). These standard forms are to be made available in an electronic repository of standard application forms.

The regulation also contains a rather obscure procedure of delivering electronic documents. A sender (a public body) should inform an addressee (individual, business) about sending an electronic document, an electronic address where it is to be deposited (which means that it will not be a simple email attachment) and instruct how to authorize and confirm receipt of such communication using secure electronic signature. Ministry of informatisation or other public authorities may create electronic mailboxes for the purpose of electronic deliveries (§5). Access to a mailbox will involve the authorization by means of passwords or secure electronic signatures. However, for a delivery to be effective, the addressee must sign an official receipt acknowledgement with a secure electronic signature (§4). The date of signing the electronic receipt acknowledgement will be the date of document delivery (§5).

The new framework also contains several provisions relating to network and information security (§4). For instance, public administration is required to use encryption protocols such as Secure Sockets Layers. However, public information systems are obliged to use encryption keys not shorter than 2040 bits, which seems excessive in comparison to trade usages developed by, for example, electronic banks (Polanski 2006, 2007). Furthermore, in order to provide effective management of date and time of electronic submissions, public bodies will have to make available tools enabling ascertainment of universal time. Public information systems will also have to ensure that digital certificates are valid. In general, these systems will have to meet latest standards issued by European Standards Organisations, for instance, a general norm CEN-CWA 14167-1 as well as norms concerning the use of secure cryptographic modules (HSM) - norm FIPS 140-2 level 3 or norm CEN-CWA 14167-2.

Finally, the regulation on delivery of electronic documents contains some provisions relating to the functionality of public administration systems (§5). For instance, such systems must enable access to documents and receipt acknowledgements sent by public authorities to citizens and businesses. Furthermore, users should be able to ascertain the date and time of document submission and signing off the receipt acknowledgement. In addition, public information system should notify officers which addressees did not confirm electronic receipt within 7 days, in order to deliver such documents in a traditional manner.

2.2. Public Procurement

The Law on Public Procurement (LPP) broadly speaking applies to the procurement of goods, services and construction contracts by public administration and healthcare institutions above €60.000 (LPP 2004). Tenders can be submitted online and are published in Public Procurement Bulletin (PPB). The Act permits submission of requests, specifications and information by electronic means. As a rule of thumb, electronic confirmations and advanced electronic signatures are not mandatory (art. 27). There are some important exceptions, however. For instance, an offer must be signed using advanced electronic signatures based on qualified certificates (art. 82.2).

In line with the Directive 2004/18/EC, LPP permits electronic auctions but for standardized services or supplies worth below a certain threshold. What follows is that electronic auctions are forbidden for more expensive, non-standard public contracts of supply or services. Furthermore, parties to electronic auctions must communicate using electronic means. An offer must be signed using an advanced electronic signature based upon a qualified certificate (art. 78.1). However, the offer ceases to bind as soon as another participant makes a lower bid. In consequence, price is the sole determinant and contracting authority must select a bidder who offered the lowest price (art. 80.3.0). Electronic auction can have many phases, but a contracting authority must inform a winner and other participants about the outcome of the electronic auction immediately after it is closed.

When price is not the sole determinant, contracting authorities can employ dynamic purchasing systems, which are allowed for contracts of limited duration (max. 4 years) and based on indicative offers. Again, indicative offers must employ advanced electronic signatures based upon a qualified certificate (art. 103.2.)

2.3 Summary of legal framework

Polish law described so far contains quite an extensive body of important rules necessary for the development of effective eGovernment services. There are numerous other legal acts of relevance to the topic, but space limitations do not permit to discuss them here. AIPS is especially important because it creates standards for G2G, and indirectly, also for C2G and B2G data communication. However, the problem concerns enforcement of these rules. For instance, public administration was obliged to enable submission of electronic documents to public authorities by August 2006 (ESA 2001) but the deadline had to be postponed for another two years. The reason was simple – the majority of public administration was still unprepared for the adoption of modern ICT technologies. As the section below will demonstrate, e-services in Poland have not yet become a reality.

3. Technological developments

There are numerous eGovernment projects currently underway. The following section will briefly present the most interesting ones including Gateway to Poland, e-PUAP, STAP, Payer, Celina, eDeklaracje and PESEL 2. Most of these projects are in the planning phase and are included in the draft State Informatisation Plan for 2007-2010 (PIP 2007). Some of them, however, are already in the production phase, e.g. Payer or Celina.

3.1 General (cross-sector) projects

The draft State Informatisation Plan for 2007-2010 (PIP 2007) envisaged five cross-sector projects: e-PUAP, e-PUAP II (for years 2008-2013), STAP, pl.ID and the Polish part of SIS II. Due to space limitations only first two developments will be outlined.

3.1.1 e-PUAP (ang. Electronic Platform for Public Administration Services)

Despite comprehensive legal framework and interesting regional developments such as Małopolska Gateway described below, Poland still does not have a central e-governmental portal that would enable personalized access and communication with administration. The development of such platform became the cornerstone of the State Informatisation Plan (PIP 2007). The central portal is planned to be accessible to every citizen and company through a central Internet-based platform known as e-PUAP (ang. Electronic Platform for Public Administration Services), also known as "Wrota Polski". The aim is to increase the effectiveness of public administration through the development of electronic equivalents of administrative procedures and processes.

e-PUAP is not going to replace existing legacy systems owned by various administrative units. Instead, the idea is to connect these platforms and enable citizens and companies to communicate with them from one place. In other words, e-PUAP is meant to be a transparent gateway to the world of public administration that provides a catalogue of services accessible to citizens, business and other governmental agencies. Certain services, such as authentication module, payment system or certification services will be accessible to everyone interested. The platform is going to evolve with time, therefore it has to be based on open standards and use scalable, easily upgradeable technologies.

The central portal will be first accessible to business and only later to ordinary citizens. The rationale behind this approach is that business interact with public administration more frequently, therefore higher savings can be generated. Therefore businesses will be able to lodge tax forms, register companies, transfer social security documentation or interact with the customs office. On the other hand, ordinary citizens will be offered a greater range of electronic services such as taxes, social security, job search, processing of personal documents such as driver licenses, personal IDs, car registrations etc (MNII 2005).

However, e-PUAP platform is still in the planning phase. There are four forms that this platform can take. The development of e-PUAP will probably start from a simple form of "directory", which will provide a search engine and hyperlinks to websites of various administrative bodies. As a rule of thumb, information systems of public bodies will handle all the requests – not the portal itself. This form will offer the basic functionality provided by typical portals found on the Net. The second stage of progress will involve the development of a "gateway", which will enable personalised and secure access to online services. A user will be able to fill in

various forms, which will be sent to an appropriate destination and processed there. The architecture can be classified as a more advanced portal that passes information to other information systems (hence gateway). A third stage of complexity will involve the implementation of what is known as a "notifier" model. In consequence, a user after successful login will be informed about various events such as overdue taxes. In this model, e-PUAP platform will aggregate and prioritize information sent by administrative information systems. These notifications will have to be sent in an appropriate format, which has to be enforced country-wide. Finally, the system is planned to evolve into a "coordinator" model that will not only manage events sent by administrative systems but will also direct responses to these systems. Therefore, e-PUAP will assume the role of an information broker that will pass information back and forth between information systems of different public bodies. However, as in the case of directory, gateway or notifier – the task of handling the request will be done by a local information system (Bednarski 2005).

From the technological perspective, the platform will consist of the front-end portal and the integration platform. The portal will be a directory visible to end-users whereas the integration platform will provide all the value added services of the gateway, notifier and coordinator models described above. The project is planned to be completed in two stages by the end of the year 2013 (PIP 2007).

3.1.2 Wrota Polski (ang. Gateway to Poland)

"Wrota Polski" (ang. Gateay to Poland) is a term used to describe the original idea of a centralised, Internet-based portal accessible to individuals and businesses, now known as e-PUAP. Originally, the project was expected to handle tax declarations, social security payments and public procurement of goods and services and, to bring 1, 5 billion, 240 millions and 12, 5 billions of budget savings annually (KBN 2002).

However, the idea has actually been implemented in a limited form and on a local level so far. The regional governments of several regions, including Podlasie, Małopolska, Opolszczyzna and Pomerania, have signed agreements to develop regional gateways that were meant to form the Gateway to Poland in the end. The regional platforms offer e-services of various degree of complexity ranging from provision of information or forms to download to one-way or two-way transactions.

The most advanced regional platform – the Małopolska Gateway offers two major functionalities: the Digital Office (Cyfrowy Urząd) and the Public Information Bulletin (Malopolska Gateway, 2007). The Digital Office currently offers 52 online services that are then handled by numerous local authorities. At the beginning of 2005 it implemented advanced electronic signatures. The citizens and businesses can find the necessary information online, download, fill out and submit forms, order documents, find out about the processing stage of procedures and submit them using secure electronic signature. On the other hand, Public Information Bulletin offers access to public information generated by local authorities.

The second platform – the Opolszczyzna Gateway – presently offers 24 services, yet without the ability to use of electronic signatures (Opolszczyzna Gateway 2007). The procedures listed in the catalogue can only be initiated online but their completion via Internet is not possible. To facilitate the search the services are both listed alphabetically and divided in two groups: for citizens and for businesses or institutions. Each service is described in detail and the necessary form is attached. There are plans to create a platform, common to the regions that would enable online procurement.

So far, the e-services offered for businesses are further down the track than those for ordinary citizens. The latter in most cases have to rely on one-way services. But this approach is fully justified as business interacts with public administration more frequently than ordinary citizens and has greater willingness to test new solutions. The same approach was taken by the authors of e-PUAP platform that will offer the benefits of regional Gateway to Poland to the whole country.

3.1.3 STAP (ang. Teleinformatic Network of Public Administration)

STAP (Sieć Teleinformatyczna Administracji Publicznej) is actually a separate project that will lead to the development of the country-wide public network enabling organisational integration of public administration (MNII 2005). The aim is to create common computer network infrastructure for public administration in Poland in order to reduce costs and provide better security of electronic communication. This telefinformatic network will also serve as the backbone of the e-PUAP platform.

STAP network will reuse existing IT infrastructure to create a common technological platform for basic back-end services such as electronic signatures, exchange of documents between public institutions, Internet

telephony and videoconferencing. STAP and SIS II are the two most important ICT projects that the government has promised to complete by 2008 (PIP 2007).

3.2 Sector-specific projects

The draft State Informatisation Plan for 2007-2010 (PIP 2007) envisaged 22 sector-specific public administration projects. This section will present two projects (Payer, Celina) that are already in production phase, and two others (eDeklaracje, PESEL 2) that are included in PIP 2007.

3.2.1 Płatnik (ang. Payer)

Payer (ang. Complex Information System for Social Security Agency) is an example of a sector-specific eGovernment application that is already in the production phase and is actually being widely used. The aim of this system is to process pension information of all citizens of Poland. The system permits companies who are usually the social security payers to submit social insurance declarations by electronic means. Furthermore, the system also allows bidirectional exchange of information so that users can not only submit documents to the Social Security Office but also request statements about individuals they insure (Podrecznik 2007). Recently, it was reported that the system has successfully processed social security data of 12 millions of people insured (Computerworld 2006).

3.2.2 Celina

CELINA – a web-based information system used for processing of customs declarations is another existing and widely used public information system "Governmental Customs Gateway" consists of two applications: CELINA OPUS and CELINA Web-Cel (Celina 2007). The latter is used for processing standard customs applications, whereas the former is used for simplified procedures. In order to use the system, the users must first apply for a username and password to a relevant customs authority. The submission procedure requires the use of advanced electronic signatures based on a qualified certificate generated by the system. Having such electronic signature, a user can electronically sign XML-based customs declaration and submit it using one of the systems.

3.2.3 eDeklaracje

One of the most interesting projects started recently will enable companies to file tax forms using ICT technologies. eDeklaracje has already been offered to 7500 larger corporations that will test this information system. Beneficiaries of this system can submit tax forms either using a web form available on https://e-poltax.mf.gov.pl website, or using a separate application available free of charge, or using a customized modules developed according to XML template published by a Ministry of Finance. Notwithstanding the choice of mode of delivery, all of the submitted documents have to be signed using an advanced electronic signature.

In the next phase, more entrepreneurs will be allowed to use the system. The project is planned to be completed in two phases. In the first stage, a registry of tax payers and a central repository of tax forms will be built. The second phase will focus on broadening access to the system to ordinary citizens and on integration of the registry with other public services. The draft informatisation plan for 2007-2010 anticipates completion of the project in 2009 (PIP 2007).

3.2.4 PESEL 2

PESEL is a unique number assigned to every citizen of Poland and printed on his or her ID card. The aim of the program is to modernize existing electronic registry of PESEL numbers and to streamline the operation of other systems that require access to such information (PESEL 2 2006). Development of PESEL 2 will offer basic authentication services in the context e-PUAP platform, STAP, eDeklaracje and other major projects that will need access to personal data of ordinary citizens. Another major cross-sector project known as pl.ID will also rely on this system to create polish multifunctional eID card (PIP 2007).

There are several benefits of the proposed system. Firstly, the Internet based PESEL registry will allow to minimise costs associated with printing and distribution of public certificates through the creation of central depository of such data accessible only to certain public bodies (G2G) and other institutions. Secondly, the new

system will permit ordinary citizens to obtain e.g. certificates of civil status in any local council rather than only in the one where he or she is officially registered. Thirdly, taking into account the cooperation of PESEL 2 with other public information systems, ordinary citizens will not have to worry about updating their personal data in other public bodies as the system will do it for them. Finally, the system will permit only one identification number to develop which will allow to communicate electronically with any administration office in Poland.

4. Conclusion

Poland is one of the first countries in Europe that has developed a comprehensive legal framework for public electronic services. Although the necessary legal reform is still far from completion and existing legislative acts are sometimes imprecise or flawed, this approach shows that Polish government seems to understand the central role of information and communication technologies in the process of modernisation of public administration and a tool to gain competitive advantage in the region. It is important to stress the necessity of a sound legal framework because of the constitutional principle, which states that public administration must act on the basis of law and within its limits. As a result, the path to informatisation of public services necessitates the journey through a complex legislative process.

There are several interesting features of the informatisation process in Poland. Firstly, public electronic services are still in the early stage of development characterized by a disintegrated approach to their development. One can speak of the bottom-up growth of "islands of automation" such as Gateway to Małopolska, which are supposed to be integrated at a later stage under the umbrella of the e-PUAP platform.

Secondly, Polish government undertook a truly massive informatisation task. There are four major cross-sector projects (e-PUAP I & II, STAP, Polish ID card and SIS II) and numerous sector-specific IT initiatives (e.g. CEPiK, PESEL 2, e-Deklaracje and 19 others). So far, the realisation of informatisation plans were delayed in practice (Kulisiewicz 2007) and it is highly likely that it is going to be very hard to finish all of these projects by the end of 2013. Part of the delay can be attributed to the change of philosophy, which goes away from the tenet of the informatisation of public offices and stresses the need to exchange information with the users. As a result, a citizen and not a public office is at the centre of informatisation reform (Iszkowski 2006).

Furthermore, services offered to businesses (G2B) are far more developed than those for ordinary citizens (G2C). For instance, as it was mentioned earlier, only businesses can use social security system Payer or customs gateway CELINA. In general, G2C applications provide primarily informational services whereas G2B services are more advanced, although rarely equipped with functionalities such as online payment systems. In fact, one can speak of a growing divide in terms of access to these services by the households. Such approach can be justified on the basis that businesses need to report to public administration more information and more often than ordinary citizens. But the provision of useful electronic services to households is a crucial stimuli to the progress of democracy and the development of the Information Society.

In addition, online services are usually limited to the provision of information and sometimes web-forms. Households and business users can usually download only certain documents or send applications, but this only triggers the administrative machine that processes the application in a traditional manner. In consequence, one-way services (public-to-individual) are far more widespread than two-way services. Since the introduction of two-way services requires a sophisticated software infrastructure and a better organization and cooperation of administrative bodies, introduction of such services has been very slow so far and is unlikely to change in the near future. Additionally, country citizens are definitely favoured in comparison to non-citizens. It is mainly due to lack of resources necessary to translate services into the foreign language.

Undoubtedly, the informatisation of public services requires a high-quality, committed management and coordination at all levels of public governance. This seems to be a major challenge, much greater than in private companies. A highly bureaucratic nature of public administration requires the communication of decisions and the enforcement at all levels of public domain. The lack of a necessary expertise, trust and willingness particularly inside the public administration is another problem. Public officers do not seem to be keen to actively participate in the informatisation process as it requires changes in the long established canons of behaviour and introduces "an unnecessary burden" for always busy public officers. For instance, electronic services are usually treated only as a mere invitation to commence the administrative procedure, which has to be continued in a traditional manner.

The aforementioned problem is related to the poor adoption of electronic signatures by businesses and citizens alike. Since the legal framework for eGovernment services requires the usage of qualified digital certificates, very low adoption rates make the development of public e-services a very challenging process. One of the reasons for the lack of adoption of advanced electronic signatures is a high cost of qualified digital

certificates. Another reason, is a perceived lack of benefits that an ordinary citizen (as opposed to companies) sees in such certificates. It is especially so taking into account that many administrative units are not prepared to use PKI infrastructure.

Another major obstacle is a poorly developed technical infrastructure. Out of 36% of households connected to the Internet, only 22% have a broadband access [2]. On the other hand, nearly 90% of businesses have Internet access, but only 46% of them use a high-speed connection [2]. Furthermore, existing applications such as Payer continue to be publicly criticised for software bugs and a lack of interoperability with operation systems other than Microsoft. Last but not least, one of the major challenges continues to be the lack of a legal framework for the informatisation of courts. For instance, Polish courts cannot accept documents in an electronic format, utilise technologies to record the hearings or to remotely question the witnesses (Gołaczyński et al. 2006; Kotecka et al. 2006).

The resolution of the problems mentioned above is going to be a lengthy process and requires not only a commitment on the side of public administration but also an involvement of the society. In order to increase the level of expertise and trust into public electronic services the government would have to popularise advanced electronic signatures. Furthermore, the government has to continue a battle with telecommunication providers in order to decrease the cost of broadband Internet. All of these efforts should be supplemented with a continuous education of ordinary citizens.

In summary, the informatisation of administration is planned to increase the actual effectiveness of public administration by 10% and the potential effectiveness by 40% (KBN 2002). If these goals are to be achieved, the process of informatisation will require fundamental organizational, technical and legal changes. Without the physical integration of numerous public legacy systems under the umbrella of central, Internet-based platform such as e-PUAP and the sustaining changes in the actual functioning of public administration, Poland will not benefit from the early adoption of the necessary legal framework. One the other hand, the commitment of the government to the rapid adoption of planned eGovernment projects could quickly secure enormous financial savings, greatly facilitate everyday contacts of individuals and businesses with administration, and equip entrepreneurs with powerful tools to better compete on and beyond the unified European Union market.

Notes:

[1] This article is partly based on data gathered during the process of writing a report „Next Steps in Developing Information Society Services in the New Member States: The Case of eGovernment and eHealth" (still in preparation) by Transformation, Integration and Globalization Economic Research Institute commissioned by the European Commission.
[2] http://www.stat.gov.pl/dane_spol-gosp/spoleczenstwo_informacyjne/2006/index.htm, last access: 8/04/2007.

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Democracy and Human Rights: Reappraising the Rhetoric of "Interdependence and Mutual Reinforcement"

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Abstract: The relationship between democracy and civil and political rights is often assumed to be self-evident. What is often less obvious is that between democracy and economic and social rights. The emergence of China and India (two countries with divergent attitudes to democratic governance) as global economic powers has revived the debate about the relationship between democracy and both human rights categories. This short article is thus an attempt at assessing the strength of these relationships.

1. Introduction

For most observers, the relationship between democracy and civil and political rights is self-evident – so much so that the traditional references to "democratic governance" in the global media are often assumed to be synonymous with this category of rights. What is often less obvious is the relationship between democracy and the less "photogenic" aspects of the Universal Declaration of Human Rights, namely, economic and social rights. This, to be sure, is not to suggest that the debate about the latter is new. Indeed, because economic and social rights are inextricably associated with the subject of economic (under)development, it is, at the very least, as old as the emergence of certain Asian economies from a state of economic underdevelopment within a relatively short time frame, even though these countries have been ruled by semi-authoritarian regimes. In the meantime, it was even possible to point to the fact that countries such as India (universally acknowledged as the world's largest democracy) and Bangladesh (another Asian democracy) appeared unable to achieve development.

Of late, China (a totalitarian "People's Republic), and India have emerged as global economic giants, and (if it could be assumed that economic growth is the essential catalyst for the realization of these rights) should soon be in a position to realize them. Meanwhile, although much of sub-Saharan Africa has embraced multiparty democracy since the 1990s, its people have in fact become poorer – their prospects of realizing these rights increasingly gloomy. In other words, neither despotism nor democracy has made much difference in the region. Yet, human rights advocates and policy makers continue to affirm what has become an article of faith: "democracy, development and respect for human rights and fundamental freedoms are interdependent and mutually reinforcing." [1]

This short article seeks to determine the extent to which this rhetoric is sustainable in light of these emerging realities. It begins with a definition of the notion of democracy, before exploring the relationship between it and the two human rights categories. The role of economic development is also discussed. The conclusion is that contrary to what might seem obvious, the emerging realities (like the old) have not undermined the validity of the notion of interdependence.

2. Democracy Defined

It is almost customary practice to trace the origins of democracy to the Ancient Greek practice of demokratia or "rule by the people" (Marks & Clapham, 2005:62). Indeed, so established is this definition that it finds further elaboration under Article 21(3) of the Universal Declaration of Human Rights (UDHR) which proclaims: "The will of the people shall be the basis of the authority of government; this will shall be expressed in periodic and genuine elections which shall be by universal and equal suffrage and shall be held by secret vote or by equivalent free voting procedures."[2] The elegant simplicity of this definition is obviously based on the supposition that there is universal agreement as to what constitutes "the will of the people," how it is obtained, or indeed, what is entails. Indeed, as the eminent social scientist, David Held points out, every component of the concept raises its own definitional questions. For example, the very term "the people" raises questions about precisely who these are, what kind of participation is envisaged for them, as well as whether the incentives and disincentives (or costs and benefits) of participation can be made equal amongst all participants; while the term "rule" raises

questions regarding how broadly or narrowly it is to be construed, whether it is to be restricted to the "political" sphere, or should be defined to cover areas such as law and order, international relations, the economy, the domestic or private sphere (Held, 1987:2). Indeed, even the phrase "rule by" seems equally problematic, as it raises further questions such as the extent to which the people's "rules" must be obeyed (or to put it differently, whether there is room for dissent), what mechanisms are to be created for those who choose to be "non-participants," as well as whether the State is entitled to resort to coercion against "those outside the sphere of legitimate rule." (Held, 1987, ibid).

It should come as no surprise, therefore, that virtually every regime in the world – no matter how obnoxious – has claimed to draw its legitimacy from "the will of the people." Thus, far from being a useful definitional guide, it is, at best (and *on its own*), a meaningless slogan, and otherwise, a mere legitimizing façade behind which many regimes have committed grave human rights violations against their citizens: The one-man Stalinist dictatorship of North Korea, for example, formally calls itself the "Democratic People's Republic of Korea." The apartheid regime in South Africa would clearly have preferred to be judged on the basis of how it responded to the needs of its white population – rather than on its vicious and pernicious racism against its black population. Most governments in Africa are now "democratically elected;" yet the continent remains a cesspit of political repression and economic underdevelopment. Indeed, as noted below, even the established democracies of the Western world cannot always be trusted with the basic rights of their citizens. For example, recent developments in the United States and the United Kingdom have shown that it is not only the "usual suspects" that have become adept at exploiting the façade of democracy: In a statement attributed to a former senior CIA officer responsible for preparing President Bush's daily intelligence briefs, he reportedly responded thus to a suggestion that America was *becoming* a fascist State:

> [T]here are others saying we are already in a fascist mode. When you see who is controlling the means of production here, when you see who is controlling the newspapers and periodicals, and the TV stations, from which most Americans take their news, and when you see how the so-called war on terror is being conducted, you begin to understand where we are headed…(Pilger, 2007)

In the United Kingdom, the "mother of Parliaments" proved powerless to prevent the Blair government from undermining such ancient right as those relating to *habeas corpus* and jury trial. [3] Indeed, long before Prime Minster Blair decided to support President Bush in his "war on terror," a former Conservative Lord Chancellor, Lord Hailsham, had famously described British democracy as "an elective dictatorship," in recognition of the unfettered dominance of the Executive in the legislative process – not to mention the notorious absence of formal checks and balances within the British constitutional arrangement. Thus, appearances can be very deceptive indeed.

These, however, do not mean that the above definition is inherently flawed; indeed, any definition that excludes the people's will or authority is inherently flawed. Neither do they suggest that there are no core considerations to be borne in mind when articulating the concept of democracy; indeed, as already indicated, the UDHR stipulates that the will of the people should be evidenced by: periodic and genuine elections (through secret ballot or by equivalent free voting procedures), conducted on the basis of universal and equal suffrage – factors the importance of which is evidenced by their subsequent incorporation into treaty law. [4] On the contrary, what is being suggested here is that democracy must always be defined in relation to these core factors.

3. Democracy and Civil and Political Rights

As already indicated, the relationship between democracy and civil and political rights is often taken for granted, and rightly so, not least because certain rights are an absolute necessity for exercising popular control over those in power through familiar democratic means such as criticisms, mass protests, or other forms of agitation aimed at effecting change. The defunct United Nations Commission on Human Rights recognized this relationship by declaring that:

> [T]he essential elements of democracy include respect for human rights and fundamental freedoms, *inter alia* freedom of association, freedom of expression and opinion, and also include access to power and its exercise in accordance with the rule of law, the holding of periodic free and fair elections by universal suffrage and by secret ballot as the expression of the will of the people, a pluralistic system of political parties and organizations, the separation of powers, the independence of the judiciary, transparency and accountability in public administration, and free, independent and pluralistic media.[5]

> To these might be added the right to equality and the prohibition of discriminatory treatment, [6] which are essential in ensuring popular participation. So strong is this interrelatedness that the defunct Commission on Human Rights affirmed the existence of a "right to democracy." [7]

It is pertinent to note, however, that some commentators do not see this relationship in absolute, unqualified terms. For example, while acknowledging that "[d]emocracy and human rights share a commitment to the ideal of equal political dignity for all [and that] international human rights norms...require democratic government," one eminent political scientist argues that the link need not run in the other direction (Donnelly, 1999: 619). One of his arguments is that because human rights are merely a small aspect of international human rights norms, the struggle for human rights is much broader than the fight for democracy. Indeed, he argues that even where both are not in direct conflict, they "often point in significantly different directions" (Donnelly, ibid). This, he asserts, is because democracy aims to empower "the people," whereas human rights aim to empower the individual "thus *limiting* rather than empowering the people and their government [emphasis unchanged]. Much, he further contends, also depends on the nature of the "democracy" in question: a liberal democracy will tend to reinforce human rights because it is "a very specific kind of government in which the morally and politically prior rights of citizens and the requirement of the rule of law limit the range of democratic decision-making." By the same token, a "consociational democracy" will protect the rights of established social groups such as Catholics and Protestants in Holland, or Walloons and Flemish in Belgium, he further observes. On the contrary, electoral democracies, it is believed, tend to protect only the interests of those that are part of the majority – or whatever group exercises the power of the people (Donnelly, ibid, *et seq*).

There can be no doubt that at first sight, such observations are quite persuasive indeed, at least as analytical exercise. It is, however, doubtful whether it adds much more to the debate than highlight the difference between democracies (as envisaged under international human rights instruments) and non-democracies. The secret lies in the examples used: At one extreme are the liberal and "consociational" democracies which presumably include Western democracies generally, and on the other are the "peoples" or the "electoral" democracies of the developing world. Yet, even such simple categorizations can be quite misleading: as indicated earlier, even the established democracies cannot always be trusted to respect the rights of their citizens. What this means therefore, is that any debate on the relationship between democracy and human rights must not be allowed to stray too far from the main human rights instruments.

4. Democracy and Economic and Social Rights

As mentioned earlier, the relationship between democracy and economic and social rights is not as straightforward as might be expected. The traditional discriminatory treatment of the two human rights categories aside, it is pertinent to note that economic and social rights, to begin with, are inherently intertwined with economic development – at least insofar as development can be defined as "a comprehensive economic, social, cultural and political process, which aims at the constant improvement of the well-being of the entire population and of all individuals on the basis of their active, free and meaningful participation in development and in the fair distribution of benefits resulting therefrom"[8] – a definition which extends the notion of development beyond the narrow, market-oriented model. Moreover, ever since their proclamation under the International Covenant on Economic, Social and Cultural Rights (ICESCR) [9], there have been trenchant criticisms mainly surrounding their conceptualization, *justiciability* and *realizability*.

While it is beyond the scope of this critique to explore these in any depth, it is pertinent, at the risk of oversimplification, to point out that these criticisms are no longer sustainable. For example, whatever one might think of their conceptualization, the fact that they are enshrined in a treaty which has received near-universal ratification puts the matter beyond debate.[10] Secondly, their inherent justiciability is evidenced by the growing body of case law that is emerging at the international and municipal levels[11]. Thirdly, their realizability (which is closely associated with the problem of resource constraints) has received so much critical attention (and clarification) that the UN body responsible for monitoring its realization has been able to identify what have, in effect, become non-derogable rights amongst them [12]. It thus becomes necessary to outline the nature of these rights before attempting to explain their relationship with democratic governance.

4.1. The Nature of Economic and Social Rights

Without wishing to delve into the history of economic and social rights (for which, see Steiner & Alston, 2000:242), it is necessary to note that many scholars often trace their modern evolution to the Treaty of Versailles which established the International Labour Organization, aimed at abolishing the "injustice, hardship and privation" of workers, as well as guaranteeing "fair and humane conditions of labour" (Leary, 1992:582). Some of the rights proclaimed under the ICESCR are thus labour-related. But this is not the full picture, for it was the experience of the Great Depression that provided much impetus to the realization that economic deprivation was an impediment to the very notion of freedom – hence, the incorporation of economic and social rights into the UDHR which was later to form the basis of the ICESCR (Steiner & Alston, 2000:243-244). Indeed, the ICESCR itself begins by recognizing that "the ideal of free human beings enjoying freedom from fear and want can only be achieved if conditions are created whereby everyone may enjoy his economic, social and cultural rights, as well as his civil and political rights."[13]. The main substantive rights proclaimed under the ICESCR range from self-determination, non-discrimination, employment and labour rights, social security, family rights, as well as a full range of what might be termed cultural rights. At the core of these rights are those relating to: food, healthcare, education and housing, to which have been attributed the status of non-derogability by the Committee for Economic, Social and Cultural Rights – the UN body charged with monitoring their realization [14]. It is the very nature of these rights, therefore, that makes it possible to associate them with the known ramifications of economic (under)development – at least insofar as their non-realization constitutes a desecration of human dignity as proclaimed under various international human rights instruments.

4.2. The Role of Economic Development

Very few concepts are as controversial as economic development, and much depends on one's ideological inclination. Hence, a liberal economist might define it simply as "[t]he growth of national income per capita of developing countries," (Bannock, Baxter & Davis, 1998:117) while those on the political left might define it as "the sustained elevation of an entire society and social system toward a 'better' or 'more humane' life" (Todaro, 2000:16). The former thus clearly places much emphasis on growth in national productive capabilities, based on the supposition that this will invariably "trickle down" to the poor, while the latter identifies the poor as the primary and sole objects of development. The merits of each of these are beyond the scope of this short critique. What is indisputable, however, is that although both models are still evident in development literature and rhetoric, there has been a noticeable departure from these narrow, ideological conceptions of development towards a comprehensive, rights-based approach (Wolfensohn, 2005:19), which was defined earlier. A rights-based approach is therefore one that seeks to strike the right balance between growth on the one hand, while taking due account of basic human needs. This is the sense in which development is virtually synonymous with the realization of economic and social rights. But even these do not fully explain the role of development in the democratic process – a role that needs to be seen in terms of its empowering features. A World Bank report puts it thus:

> Poor people often lack legal rights that would empower them to take advantage of opportunities and protect them from arbitrary and inequitable treatment. They, more than any other group in society, are adversely affected by laws permitting discrimination, deficient laws and institutions that fail to protect individual and property rights, and insufficient enforcement of these laws, as well as other barriers to justice...The rule of law requires the existence of an appropriate legislative framework and predictable and fair enforcement by independent judiciaries, and it calls for accountable and legitimate governments to maintain order, promote private sector growth, and fight inequality (World Bank, 2002:59).

4.3. Making Sense of a Mixed Picture

As already indicated, the relationship between democracy and development (and by extension, economic and social rights) is somewhat complex. At the level of theory, it is often presumed that democracy is the catalyst for development. Indeed, Western policy towards sub-Saharan Africa since the end of the Cold War (when entrenched ideological calculations trumped every other consideration) has been based on this supposition. Yet, as noted at the outset, the region's prospects for realizing these rights have in fact become gloomy, even though much of it is now ruled by "democratically elected" governments. Indeed, as also noted, until fairly recently, India had remained largely underdeveloped in spite of being the world's largest democracy. In contrast, the semi-authoritarian regimes in Southeast Asia have famously succeeded in lifting their peoples from poverty. But

the contradiction does not end here: Whereas authoritarianism appears to have enabled other East Asian countries to achieve development, it has clearly kept North Korea in poverty. Even in sub-Saharan Africa – the region most synonymous with underdevelopment – the picture does not lend itself to easy conclusions: post-apartheid South Africa, Botswana and Mauritius continue to achieve development while remaining democratic, while Nigerians remain trapped in economic misery regardless of what regime has been in place. Nor does the experience in Latin America offer a less complicated picture: On the one hand, decades of military rule had generally failed to reduce poverty in that region, although authoritarianism has not impeded the realization of healthcare and educational rights in Cuba, and, of late, in Hugo Chavez's Venezuela. The emergence of China and India as economic giants (with their opposing attitudes to democratic governance), has therefore merely served to highlight the complexity of this interconnectedness.

What, then, should human rights advocates make of these inconsistencies? One obvious response is to avoid reading too much into what are, by their very nature, inconsistent anecdotal indicators. Or as one eminent economist puts it:

We should not take the high economic growth of South Korea or Singapore in Asia as proof that authoritarianism does better in promoting economic growth any more than we should conclude the opposite on the basis of the fact that one of the fastest growing countries in the world – Botswana – with the best consistent record of economic growth in Africa has been a real oasis of democracy in that continent. The selective anecdotal evidence goes in contrary directions, and the general statistical picture does not yield any clear relationship at all (Sen, 1999a: 91).

More specifically, there is a need to avoid the simplistic assumption that democracy (however defined) automatically engenders economic development. To begin with, this would ignore the role of economic policy (itself a function of democratic governance) in bringing about development. For example, it is well known that a variety of policy choices played a crucial part in the East Asian developmental process, including the use of international markets, economic competition, high literacy rates, land reform, and interventionist policies aimed at encouraging growth and exports – factors which, as noted by Amartya Sen, are not in any way incompatible with democratic governance (Sen, *ibid*: 92). Conversely, a development model which focuses merely on statistical indicators without broader democratic imperatives such as the rule of law or due process rights is unlikely to guarantee an equitable distribution of its benefits. Or as a World Bank report noted some years ago:

The Asian financial crisis of the late 1990s demonstrated not only that a sound financial architecture is essential for growth but also that an effective legal and judicial system is paramount for growth to be equitable and sustainable. The transition in Eastern Europe has shown that market forces alone, without transparent laws and fair enforcement, can lead to uneven economic growth and increased poverty. (World Bank, 2002: 59)

5. The Two Rights Categories and the Notion of Interdependence

The relationship between the two human rights categories is one that is often overlooked, at best, or rejected by commentators and policy makers. This is due, in large measure, to the apparent differences in their very conceptualization – even though both share a common legal basis. The arguments are as varied as those who make them. Hence, for example, some have argued that economic and social rights are not rights in any sense (Cranston, 1973:65 *et seq*; Vierdag, 1978:103) while others believe that civil and political rights are an impediment to the realization of economic and social rights - a view reiterated by certain governments from the developing world at the Vienna World Conference on Human Rights in 1998 (Sen, 1999b:147 *et seq*), the result of which was the following inherently contradictory proclamations:

All human rights are universal, indivisible and interdependent and interrelated. The international community must treat human rights globally in a fair and equal manner, on the same footing, and with the same emphasis. While the significance of national and regional particularities and various historical, cultural and religious backgrounds must be borne in mind, it is the duty of States, regardless of their political, economic and cultural systems, to promote and protect all human rights and fundamental freedoms. [15]

The inherent contradiction aside, questions remain as to the extent to which both rights categories can be said to be interdependent, not least because on the surface, these rights differ significantly from each other. Yet, these apparent differences often conceal the fact that both rights categories were designed to preserve the inherent dignity of the human person as proclaimed under the various international human rights instruments. The right to housing, for example, can hardly be said to have any direct correlation with the right to freedom of thought, conscience and religion, except that the sense of despair engendered by homelessness, if nothing else, can seriously impair the victim's ability to enjoy a wide range of civil and political rights, including freedom of

thought. Neither does the right to vote have any meaning to those too ill to visit the polling station. Nor does freedom from torture mean very much to someone already enduring the pangs of starvation. By the same token, the denial of freedom of expression directly impedes the victim's ability to participate in the democratic process, and by extension, his ability to exercise influence over policies that directly affect his well-being (such as healthcare or housing needs). Indeed, as the Nobel Laureate, Amartya Sen insightfully points out, famines do not occur in democracies (including those with underdeveloped economies) because of an entrenched culture of political scrutiny. (Sen, 1999b:179). These, and many more reasons, explain why the ICCPR "[recognizes] that the ideal of free human beings enjoying civil and political freedom and freedom from fear and want can only be achieved if conditions are created whereby everyone may enjoy his civil and political rights, as well as his economic, social and cultural rights."[16]

6. Conclusions

This short article was an attempt at reassessing the relationship between democracy and the two human rights categories, at a time when two economic powers have appeared on the global stage with opposing attitudes to democracy. In the course of the critique, the picture that emerged was, on the surface, quite mixed and confusing. However, it soon became clear that too much is often read into what are essentially unique circumstances which have no universal application. Indeed, it became clear that although the connection between democracy and civil and political rights is much easier to articulate, its relationship with economic and social rights is no less symbiotic. It thus becomes possible to conclude that the interdependence thesis remains valid, not least because of the inherent ability of democracy and human rights (of both categories) to empower the individual, thus enabling him to preserve his dignity as envisaged in the various human rights instruments.

In regard to the two human rights categories, the conclusion is that although the realization of one does not invariably result in another, the extent to which both are mutually reinforcing cannot be overstated. It is, however, important to note that the realization of both categories of human rights is dependent not merely on the democratic process per se. Indeed, as the experience of sub-Saharan Africa demonstrates, democracy can be abused in a way that undermines its liberating and empowering features. Much, therefore, depends on how the mandate so obtained is exercised by way of policy choices and priorities.

NOTES

1. See United Nation General Assembly, Vienna Declaration and Programme of Action, World
2. Conference on Human Rights, Vienna, 14-25 June 1993, UN Doc. A/CONF.157/23, 12 July
3. 1993, para.8
4. See Universal Declaration of Human Rights, adopted 10 December 1948, G.A. Res. 217A (III), UN Doc. A/810 (1948)
5. See Amnesty International, United Kingdom: Human Rights: A Broken Promise, AI Index: EUR 45/004/2006, 23 February 2006, available at http://web.amnesty.org/library/index/engeur450042006 (visited 30 March 2007)
6. See Art.25 of the International Covenant on Civil and Political Rights, adopted 16 December 1966, entered into force 23 March 1976, G.A. Res.2200A (XXI), UN Doc. A/6316 (1966), 999 UNTS 171, reprinted in 6 ILM 368 (1967) [hereinafter, ICCPR]
7. See Office of the High Commissioner for Human Rights, Interdependence Between Democracy and Human Rights, Commission on Human Rights resolution 2003/36, UN Doc. E/CN.4/RES/2003/36, 59th Session, 23/04/2003, para.1
8. See Article 26 of the ICCPR
9. See UN Commission on Human Rights, Promotion of the Right to Democracy, Commission on Human Rights resolution 1999/57, 55th Session, UN Doc.E/CN.4/RES/1999/57, 28/04/1999
10. See UN Declaration on the Right to Development, G.A. Res. 41/128, Annex, 41 U.N. GAOR Supp. (No.53) at 186, U.N. Doc. A/41/53 (1986), at Preamble
11. See International Covenant on Economic, Social and Cultural Rights, adopted 16 December 1966, entered into force 3 January 1976, G.A. Res. 2200A (XXI) UN Doc. A/6316 (1966), 993 UNTS 3, reprinted in 6 ILM 360 (1967)
12. As of 9 June 2004, the Covenant had been ratified by 149 countries (Information available via: Office of the UN High Commissioner for Human Rights, at: http://www.unhchr.ch/html/menu3/b/a_cescr.htm)

13. See, respectively: *Soobramoney v Minister of Health (Kwa Zulu-Natal)*, 1997 (12) BCLR 1696 (South African Constitutional Court, decision concerning the appellant's right to health), and *Malawi African Association & others v Mauritania* (Merits), Communications 54/91, 61/91, 98/93, 164/97, and 210/98, in Thirteenth Annual Activity of the African Commission on Human and Peoples' Rights (1999-2000), ACHPR/AHG/222 (XXXVI) Add. 136,158 (2000) (where the African Commission on Human Rights pronounced on, among other things, the right to an adequate living standard)
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15. See the ICESCR, at Preamble
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The Legal Implications of Reputation Risk Management for Franchisors

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Abstract. Franchisors in Britain face a difficult problem. If they use the techniques of reputation risk management to protect their corporate brands (which is usually their most valuable assets), they may inadvertently increase their exposure to third party tort claims. This paper explains why this may occur and how the franchisor could try to do to deal with this problem. It shall be suggested that a form of reputation risk management should be adopted by franchisors, even where the tort risk remains. This is because the franchisor has much to gain from having an efficient method of protecting the corporate brand where appropriate legal and organisational arrangements can be made to further this goal.

Key words: tort**,** vicarious liability, legal risk, reputation risk management, franchisor, franchisee

1. Introduction

The main purpose of this article is to examine a difficult problem faced by franchisors. If the franchisor attempts use the techniques of reputation risk management to protect its corporate brand (which is usually its most valuable asset), the franchisor may inadvertently increase their exposure to third party tort claims. This is because of the unusual structure of the franchised business and the problems of implementing a risk management system within this structure.

Although the franchised business has the appearance of a single business entity because it operates a chain of outlets under the same name and delivers the same, standardised, quality-assured, product and/or service, it is not one. Many of the franchised outlets are, in fact, small to medium-sized independent businesses linked together by contract with the franchisor. These businesses derive their corporate identity and working methods from intellectual property rights that are licensed to them by the franchisor. The franchisor therefore, does not have the normal, "command and control" power over its franchisees, which the management in many conventional organisations have over their employees. Therefore, the implementation and enforcement of a reputation risk management system to protect the franchisor's corporate brand is not as straightforward as it might be for companies with normal management structures. In addition, the franchisees have a degree of autonomy over how the run their businesses and they may resist the imposition of potentially costly risk management procedures by the franchisor. If the franchisor imposes a reputation risk management system on the franchisees, there may be problems over compliance and enforcement. The imposition of such a system may at the same time increase the scope of the franchisor's tortious liability.

Normally, franchisors are in a favourable position in relation to tort claims. In British law, there is a fairly clear legal boundary between the franchisor and the franchisee because they contract at arms-length to operate the franchise. This means that if a third party suffers harm as a result of the franchisee's negligence the injured person would have a claim against the franchisee as an independent contractor. The franchisor would not normally be involved. However, the franchisor's protection from such tort claims could be undermined if the franchisor introduces a reputation risk management system. Reputation risk management would require the franchisor to exercise greater influence and control over the network than has been the case in the past. One important consequence of this could be to strengthen the claims of third parties against the franchisor under the principles of vicarious liability. This could produce a paradoxical result for the franchisor. In its attempts to control the business risk of damage to its reputation, the franchisor may be inadvertently increasing the scope of its legal risk.

This article shall examine this problem. It shall be suggested in the course of the analysis that a form of reputation risk management should be adopted by franchisors, even where the tort risk remains. This is because the franchisor has much to gain from using a modern and efficient method of protecting the corporate brand if appropriate legal and organisational arrangements can be made to further this goal.

2. The value and the vulnerability of franchised brands

Most franchised businesses are built upon the concept of the brand [1] and the value of the brand to these businesses can be significant proportion of the total value of the company [2]. Indeed, in some cases the value of the brand may be the single most valuable company asset. In the case of the very large franchised businesses the brand value can be worth billions of dollars. In a recent survey of the top 100 brands in the world, the brand value of McDonald's was approximately $26 billion, the KFC (Kentucky Fried Chicken) brand and the Pizza Hut brand were worth approximately $5 billion, the Hertz car rental franchise brand was worth approximately $3.5 billion, and the Starbucks coffee shop franchise was worth $2.5 billion[3]. The world's top brand, as listed by the Interbrand Corporation, the brand consultancy, is a franchised business. It is Coca-Cola, which, like its soft drink rival Pepsi, franchises it bottling operations (Felstead, 1993: 38). According to Interbrand, Coca-Cola's brand value was $67.5 billion, while Pepsi's brand value was worth $12.4 billion.

Although many of the largest franchised brands are immensely valuable, they can also be surprisingly vulnerable. In the twenty-first century it is becoming harder to protect the brands from damaging publicity. For example, if a franchised business were to make a mistake that harmed human health or safety this would be quickly disseminated over the Internet and the 24-hour news channels leaving the business with very little time to investigate the cause of the accident or to respond to its critics. Under these conditions, the corporate reputation may suffer and sales may decline without the full facts of the case being properly investigated. When so much of the value of a franchised business is tied up in an intangible asset that could be affected by bad publicity, franchisors have an incentive to seek new ways to protect their brands. But this is not a straightforward matter because of the peculiar legal structure of the franchised business (examined below).

2.1 The Coke Products Case

Franchised brands can be damaged by the acts and omissions of the franchisor, but also potentially by the acts or omissions of thousands of local franchisees. It is true that in the case of the franchisees, the franchisors are able to set the standards of performance for the brand, but these standards have to be implemented properly by the franchisees to be effective. Normally most franchisees will run their businesses according to the standards set for the brand (for example, in terms of fast and friendly service, the quality of the product, clean premises, good hygiene, etc). However, because franchisees (as independent business people who have put capital into their enterprises) tend not to be monitored as closely as employee-managers running branch operations in a typical, hierarchical, unified corporate structure, there may be a greater chance for things to go wrong at the local level that could have a negative impact on the brand.[4] Furthermore, franchisors are reluctant to become too closely associated with the day-to-day operations of the franchisees' businesses because they fear the legal threat of being held vicariously liable for the defaults of their franchisees (Abell, 1989:90) So the risk to the reputation of the franchised brand can be significant.

Indeed, there have been cases where the acts or omissions of a local franchisee in one country have had a wider negative impact on the brand. For example, in 1999, the Coke brand was damaged in an incident involving 120 people in Belgium and 80 people in France who felt ill after drinking Coke. This temporary illness was attributed to the production operations of the Belgian and French franchisees and was not caused by an act of the brand-owning franchisor, Coca-Cola of Atlanta, Georgia, USA.

On investigation of this incident, it was discovered that the contamination of the Belgian-produced drinks was caused by some defective carbon dioxide being used in a small supply of bottles in the plant of the franchisee in Antwerp. Meanwhile, in France the source of the contamination arose from a fungicide that was used by the franchisee in Dunkirk to spay on wooden pallets. Yet because Coca-Cola management did not intervene either early enough or decisively enough during these crises to allay public concerns, the national media in France and Belgium could justifiably inflame public outrage in these countries. This public outrage led to an unofficial boycott of all Coke-branded drinks and ultimately to a public demand for a total product recall.

The Governments of France and Belgium succumbed to this public pressure (even when it became clear that there was no threat to public health) and they ordered a total product recall. This recall cost Coca-Cola $103 million. Coke's profits subsequently dropped by 31% in these countries and the franchisor had to spend substantial sums in a promotion campaign to restore public confidence in the product (Larkin, 2003). Risk management experts have argued that if a crisis management system (as described below) had been in place in Coca Cola as part of a reputation risk management scheme, the impact on the franchisor's brand could have been much less.

However, damaging bad publicity is not only generated by unfortunate incidents like those occurring in Belgium and France; it is sometimes created by campaigning groups as a way of bringing pressure to bear on franchisors to change their business practices and to galvanise the politicians into making laws to curb the alleged bad practices of business. Environmentalists, trade unionists and anti-corporate activists have all found something to object to in the way certain franchises conduct their businesses. In the case of McDonald's for example, various groups have attacked the reputation of the business by alleging (amongst other things) that it was selling food that may cause obesity; that it was targeting their advertising at children; that it was exploiting its workforce; that it was contributing to the suffering and exploitation of animals, and that it was adding to the environmental problems by producing packaging waste [5].

Yet whatever faults are to be found in franchised businesses, they are certainly not the "worse offenders" in the corporate world in terms of alleged breaches of social and environmental responsibilities. These businesses become targets for other reasons. For anti-globalisation and anti-corporate activists the large franchised brands are conspicuous examples of the global capitalist system. By bringing pressure to bear on them through a sustained attack on the brands, the campaigners hope to persuade other companies to change their business practices to avoid the same treatment [6]. Franchisors are therefore keen to implement risk management systems that will help to protect their valuable reputations from the various threats described above.

3. The management of the risks to reputation

Risk management consultants have identified some of the main reasons why companies have found themselves in crisis situations where their corporate reputations are seriously at risk. These companies had no effective plans in place to manage the threats to the company's reputation from the damaging incidents that occurred. In many cases the incident that damaged the reputation of the company happened because the company's decision-makers did not know what was going in the lower levels of the organisation. This is a problem that is made more difficult to solve as a company grows in size and complexity and may be particularly acute in the case of franchised networks where the franchisees enjoy a degree of autonomy.

When the damaging incidents occurred, the managers of these companies simply dealt with the problem as it arose without the benefit of effective forward planning. This perhaps explains why, to some extent, the companies' responses to these crises were so poor. This reactive management may no longer be a sensible response strategy. As Neef (2003: p vii) has pointed out "in many ways companies have a lot more to lose today than even ten years ago, simply because the potential for being caught and exposed, by activists, lawyers… government agencies and the media, is greater [now] than ever before". Therefore, companies need to be proactive. This entails identifying, analysing and implementing solutions to the foreseeable problems that may arise.

3.1 The basic principles of reputation risk management

There are a number of risk management specialists, who have written books on the subject, setting out various frameworks for reputation risk management (Sheldon Green, 1992; Jolly, 2001; Davies, 2002; Neef, 2003; Larkin, 2003; Fishkin, 2006). These vary in their details, but an overall pattern of recommendations does emerge which could be regarded as a common core of the subject. All recognise that reputation is built upon perception and that perception is vulnerable to real and imaginary threats (Larkin, 2003: 86-120). The goal of a reputation risk management system is to identify and prevent the avoidable threats and control and minimise the unavoidable threats.

The first essential step in creating a risk management system is to create a team of managers with the task of focusing on risk management and prevention. This coordinating team needs to have the full backing of the board so that it has power within the organisation to impose the controls necessary to achieve their goals. The first task of these risk managers is to identify the threats to the company's reputation from within the organisation and from outside the organisation. They then have to assess those risks by estimating their probability and their likely effect on the organisation's good name.

Clearly, the threats that are very likely to occur and are very likely to cause grave damage to the organisation are the ones that must be eliminated or at least minimised as a priority. Risk avoidance and reduction methods must be put in place for the other perceived threats to the company's reputation, especially for the low probability but high cost threats that could cause a crisis for the company. This usually involves further training for employees and the promotion of a culture where problems in the business can be reported without the employees having to fear for their jobs or promotion prospects within the company. The risk management

experts also seem to agree that the reputation risk management procedures should be accommodated within the company's wider risk management programmes [7] as it may be complementary to, and overlap with other risk management systems, such as financial risk management, health and safety risk management and the requirements of the *Turnbull Report* on the management of internal risks as part of the obligations of the Combined Code on Corporate Governance, as amended 2005 [8].

Finally, the various authors suggest the creation of a detailed crisis management procedure so that if the worst-case scenario happens, it can be dealt with efficaciously. So, for example, there should be an identifiable spokesperson ready to answer questions from the media or regulators about the crisis. There should be a system for briefing all relevant top personnel about the problems and alerting a "trouble-shooting" team. This trouble-shooting team should find out and report on the causes of the problem and the measures that may be necessary to eliminate it, or at least minimise the damage that the problem has caused. There would seem to be a consensus among the reputation risk management specialists that if a crisis were to emerge the preservation of the company's reputation will depend upon how the company is perceived to have managed the problem. This may depend upon the extent to which the company is perceived to have taken full and reasonable precautions to guard against the circumstances which threaten it; how effective the company has been in reacting to and minimising the damage caused to the public, and how far the company is seen to be genuinely concerned about what has happened at a level beyond that of purely business considerations (Sheldon Green, 1992: 171).

4. Legal implications of reputation risk management techniques for franchisors

In the franchised system, the franchisees operate as separate businesses and have a degree of autonomy over how the run their outlets, within the parameters set by the franchise agreement. Franchisors use this structure to limit the possibility of claims being made against them by victims of wrongs committed by the franchisees. The franchise agreement will make it clear that the franchisees are to be regarded as independent contractors [9] and to encourage these victims to pursue the franchisee the franchisors will usually ensure that the franchisees has the appropriate level of public liability and other types of insurance. This means that when a franchisee commits a wrong there should be insurance money available to satisfy the claim of the victim.

However, this system does not offer complete immunity to the franchisor. There have been occasions where franchisors have been found to be liable vicariously to third parties. These cases have arisen because the culpable franchisee had no suitable insurance cover or was under-insured. In these circumstances the injured party has had to resort to the "deep pockets" of the franchisor through the mechanism of vicarious liability in order to receive full compensation for the harm done by the franchised business.

In many of these vicarious liability cases, a decisive factor in establishing franchisor liability has been the degree of control exerted by the franchisor over the operations of the franchisees. This is a source of concern for any franchisor wishing to implement a reputation risk management system because such a system requires the franchisor to exercise a greater degree of control than had been the case previously. Unfortunately, the greater the degree of control that the franchisor exerts over the franchise network, the greater is the risk of vicarious liability being established against these franchisors.

5. Under what circumstances might a franchisor be held vicariously liable for the wrongs of the franchisee?

The law gives considerable scope to businesses to structure their agreements in order to reduce or minimise legal risks [10]. By contractual devices and by careful commercial arrangements regarding the operational control of the franchise, the franchisor might be able to prevent the principle of vicarious liability from applying (Collins, 1990, 731).

However, if the victim is to succeed in bringing a claim against the franchisor on the basis of vicarious liability, the victim must establish a nexus between the franchisor and the franchisee sufficient to justify the imposition of this special form of tortious liability. If the victim can show that the franchisor exercised a sufficiently high degree of influence or control over the franchisee to the extent that the franchisee's wrongs can be fairly ascribed to the franchisor, then the victim may have a case against the franchisor. Such a nexus may be established if the victim can show that the relationship between the franchisor and franchisee is analogous to that of the law on master and servant, or to that of principal and agent. However, to keep this article within the word limit only the master and servant issue will be examined.

5.1 The analogy of master-servant relationship

Over the years the British courts have developed three main tests to determine whether or not a master-servant relationship exists between two persons. These are the control test, the organisation test and the "multiple test".

Under the classic formulation of the control test by Bramwell LJ in *Yewens v Noakes,* a "servant is a person who is subject to the command of his master as to the manner in which he shall do his work" [11]. Therefore, where one company can instruct another person on what to do and how to do it, this may be sufficient to establish the existence of a master-servant relationship. If the franchisee's wrongdoing were within the scope of his "employment", a sufficient nexus would exist to make the franchisor vicariously liable to the third party for that wrong [12]. An arguable case can be made that many franchisees are subject to a sufficiently high degree of franchisor control to satisfy the application of the control test to modern circumstances. In modern times, the subordination of the franchisee is not to the direct, personal command of the franchisor, but rather to the rules of the franchisor's bureaucratic system. Most business-format franchises function by making the franchisees follow the detailed procedures set out in the operations manual [13]. These manuals are issued to each franchisee to ensure uniformity of product, process or service. The operations manual may specify the opening and closing hours of the franchisee's business, when he can take his holidays, how he should record his accounts, how he should decorate his premises and how he should dress his staff (Mendelsohn, 1999: 67). A failure to follow the instructions set out in the manual is usually treated as a breach of contract by the franchisor (Felstead 1993:117).

Further examples of the franchisee's subordination to the will of the franchisor may be found in the terms of the franchise agreement (Adams & Prichard-Jones, 1997: 357-388). In this contract the franchisor may determine the sales targets of the franchisee's business as well as what the recommended retail price for the product or service should be. Usually, the franchisee is obliged by a contractual term to share his gross revenues with the franchisor by way of royalty payments (Barrow & Golzen 1994: 70-71) and it is often the case that the franchisee is restricted to buy his supplies from the franchisor by a term in the franchise contract. Thus, the contract and the manual may be the manifestations of control.

The organisation test was created to deal with the problem of persons who appear to be independent of the employer because they are not closely monitored or controlled by the employer but are, nonetheless, essential to the operation of the business. In *Stevenson, Jordan & Harrison v MacDonald & Evans*, Lord Denning stated the control test does not cover every situation. He explained that, "it is often quite easy to recognise a contract of service when you see it, but very difficult to say wherein the difference lies. A ship's master, a chauffeur and a reporter on the staff of a newspaper are all employed under a contract of service; but a ship's pilot, a taxi-man and a newspaper contributor are employed under a contract for services [i.e. self-employed]. One feature which seems to me to run through the instances is that, under a contract of service, a man is employed as part of the business and his work is done as an integral part of the business: whereas under a contract for services his work, although done for the business, is not integrated into it but is only accessory to it" [14]. Reasoning by analogy it could be argued that although the franchisee carries out his work without the close supervision of the franchisor, he is nevertheless performing a function that could be viewed as integral to the franchisor's business [15].

5.2 The "multiple test"

The third test is the "multiple test". This is the most sophisticated test of the three. It covers the situation where the various factors that constitute the parties' relationship seem to contain contradictory elements. Some elements may point to the independence of the worker, while other elements in the agreement point to the existence of a master-servant relationship [16]. This test, when applied to the franchise agreement, would involve the courts considering and then weighing up a number of different factors governing the relationship between the franchisor and the franchisee. Factors which may incline the court towards the view that the relationship is one of employer-independent contractor may include the following: the fact that the person invested his own capital in the business (which is something all franchisees do); the fact that he hires his own workers, uses his own equipment and pays his own income tax and National Insurance contributions, etc. [17]. These factors tend to be present in the typical franchise arrangement and would seem to support the franchisor's contention that it should not be held vicariously liable for the torts of an independent franchisee.

However, the issue is not clear-cut. There are other factors that exist within the franchise relationship that indicate it might be more like an employment relationship. These factors would include the following: firstly, the fact that the franchisee is normally dependent upon the franchisor's managerial and operational knowledge to run the business. Secondly, that the franchisee is expected to follow the operational instructions set down in the Operations Manual (the document that is normally issued to franchisees at the outset of the franchise) [18].

Thirdly, that the franchisor normally ensures that the franchisee adheres to the instruction as set out in the manual by reserving the right to carry out inspections of the franchisee's business to monitor compliance. A failure to follow the instruction manual is usually treated as a breach of contract.

There has been a franchise case in the UK where this "multiple test" has been employed. This was the case of *Ready Mix Concrete v Minister of Pensions and National Insurance* [19] In this case the company dismissed its drivers, sold all its trucks to them and then re-employed them as "independent contractors" (franchisees). The contract specified that the drivers were to wear the company's uniforms, place their trucks at the company's disposal for a certain number of hours and obey orders from the company's foreman. The drivers were expected to pay their own tax and National Insurance, maintain their vehicles and pay all the running costs, and hire substitute drivers if and when necessary, to fulfil the Ready Mix contract. MacKenna, LJ held that the drivers were independent workers (outside the provisions of s1 (2) of the National Insurance Act 1965). In his judgement he noted that the obligation to do work subject to the employer's (franchisor's) control was not always a sufficient condition of a contract of service if other provisions of the contract were inconsistent with it [20]. The fact that the drivers owned their vehicles, bore the financial risk and had the power to hire substitute drivers confirmed their status as independent workers (franchisees).

It would seem therefore that the franchisor could resist the claims of a victim of a wrong on the basis of this case. However, it must be borne in mind that this case only concerned the relationship between the franchisor and franchisee between themselves for the purposes of allocating liability for National Insurance payments to the State. The case did not concern third party rights. Where third party rights have been at stake under the law of tort, the cases show that the courts are influenced by different considerations. Under English Law primacy tends to be afforded to the interests of the tort victim who needs to find a defendant with adequate resources to meet the compensation claim. [21] Thus, if the tortious act by the worker/ franchisee occurred within the scope of his or her employment, or for the purposes of the employer's business, that will normally be enough to settle liability on the employer/franchisor. As Selwyn (2004: p269) notes, "in recent years the courts appear to be gradually extending this principle of legal liability, and to that extent the distinction between an independent contractor and an employee is becoming possibly less important than before".

6. Vicarious liability of the franchisor: the American experience

Unlike other countries, franchising in the UK is not subject to special legislation [22]. Despite the size of franchise networks and their impact on jobs and the economy in Britain [23], there is relatively little case law on the specific issue of franchising, particularly concerning third party rights under tort. For this reason it may be instructive to look at a common law jurisdiction where franchising has been a frequent issue in litigation, in order to estimate how the problem of torts committed within franchised networks may be handled in this country. The obvious place to look is America. This is so for two main reasons. Firstly, because the Americans developed the concept of business format franchising that is now used throughout the world [24] and secondly, because third party actions against the franchisor for the wrongs of the franchisee has been much more common occurrence there than anywhere else in the common law world.

6.1 The use of the employment analogy in America

To impose vicarious liability on the franchisor, the American courts have accepted the franchisor -franchisee relationship may be analogous to the master-servant relationship of employment law. One of the earliest cases to establish this principle occurred in a dispute concerning a petrol station franchise. This type of franchise was granted to an individual operator, called Schneider, by an oil company in the case of *Humble Oil &Refining Co. v Martin* [25].

In 1949, the Humble Oil Company was found vicariously liable for the wrongful acts of its servant/franchisee when third parties were injured by the negligence of the petrol station staff. The facts were, briefly, these. Mrs. Love was told by garage staff to leave her car in the driveway of the garage. The garage staff said to her that they would move it from there to the workshop for repair. But they acted negligently when they failed to check that the hand break of the car was fully on, or that the gears were engaged. They were also negligent in leaving the car unattended for some time on an incline in the garage's driveway. The car rolled back down this hill on to the road, where it picked up momentum and crashed into a garden striking Mr. Martin and his two young daughters from behind just as they were walking up their garden path to their front door.

In its defence, the Oil Company contended that it was not liable for the injury to the Martin family because the franchisee of the petrol station was an independent contractor. To support its case, the Oil Company

pointed to a term in the franchise agreement that clearly identified the franchisee as an "independent contractor". The Company also established that the franchisee believed himself to be an independent businessman and that the staff of the garage considered themselves to be employees of the franchisee (who dictated their terms of employment and paid their wages), and not employees of the oil company.

The Texas appeal court accepted that there were indeed elements in this franchise agreement that seemed to support the appellant's case, but the court also noted that there were other elements in the agreement, which would indicate the existence of a master and servant relationship. What tipped the balance in favour of the respondents was the evidence of the *degree of control* that the Oil Company actually exerted over the franchisee. The franchise agreement demanded that the franchisee, "make reports and perform other duties in connection with the said station that may be required of him from time to time by the Company". The agreement gave the Oil Company the power to dictate the franchisee's hours of work, as well as the type of products he could sell at the service station. In addition, it was established that the Humble Oil Company provided all the important station equipment and was the legal owner of the garage premises. It also paid a substantial part of the operating costs of the garage. The franchisee merely leased the petrol station from the Oil Company. Indeed, the court found that the only real area of discretion that the franchisee had was in the hiring and firing of petrol station staff.

The court concluded that: "all in all, aside from the stipulations regarding [the franchisee] Schneider's assistants, there is essentially little difference between his situation and that of a mere store clerk. Schneider was Humble Oil's servant and so accordingly were Schneider's assistants who were contemplated by the [franchise] contract" (Klein & Ramseyer, 1997: 14). This extensive operational control exerted by the Oil Company over the franchisee's business justified the court's finding that the Oil Company was vicariously liable to the Martin family.

In *Billops v Magness Construction Co., the Hilton Hotel and others* [26] (a case concerning assault and defamation), an American appeal court again found a franchisor vicariously liable to an injured third party for the wrongful acts of the franchisee. The appeal court found that the terms of the agreement between the franchisor and franchisee were so detailed as to amount to the subordination of the franchisee to the will of the franchisor analogous to a master and servant relationship. The court focused on the contents of the Operations Manual of the franchise. This manual regulated very many aspects of the daily operations of the franchisee's business. It dictated the franchisee's front office procedures, and its cleaning and inspection service for guests' rooms and for public areas of the hotel. It set the minimum guest- room standard, as well as the food purchasing and preparation standards. It determined the level of "brand name" stock the franchisee should hold and the Manual laid down the franchisee's staff and accounting procedures. The Operations Manual also dictated the level of insurance cover the franchisee should have.

Furthermore, to ensure that these prescriptive rules were followed, the franchisee was required to keep detailed compliance records for the franchisor's inspection. In addition, the franchisor had the contractual right to enter the franchisee's hotel, "to inspect the hotel so as to maintain the high standards and reputation of the system, the goodwill of the public, and compliance with the provisions of this Agreement [the franchise contract] and the Operations Manual" (Klein & Ramseyer, 1997: 40). Although there were other terms in the agreement which granted the franchisee some business discretion, such as the power to hire and fire hotel staff, the appeal court took the view that the franchisor was, in reality, exercising day-to-day operational control over the franchisee's business. This made the franchisor vicariously liable for the wrongs of the Brandywine Hilton Hotel.

There are other American cases that similarly focus the extent of the operational and managerial control exercised by the franchisor over the franchisee's business as the basis for allocating liability. Thus, in *Dorsic v Kirtin (1971)* [27] , it was held that the franchisor's interference with the operational running of the franchisee's business, particularly by setting the business's hours of work made the franchisor liable to third parties. In *Drexel v Union Prescription Centres (1978)*[28] the detailed operations manual setting the methods of conducting business, including the level of inventory to be carried put the franchisor in a position analogous to a master and therefore made the franchisor vicariously liable.

In conclusion, when the American courts have used the master and servant analogy to decide whether or not the franchisor is to be held vicariously liable to an injured third party for the wrongs committed by the franchisee, the criterion of control has been crucial. It is only when the degree of control extends into the day-to-day managerial and operational functions of the franchisee's business will the franchisor be held to be vicariously liable. It is submitted that a similar approach may be adopted in Britain [29].

7. Is there scope to minimise the potential legal risks?

The problem for the franchisor in applying a reputation risk management system is that it involves extending its control over its franchisees to reduce risks. The greater the degree of the franchisor's control over the network, the more likely it is that the franchisor will be held vicariously liable for the franchisees' torts. However, it could be argued that if the risk management system is implemented and enforced correctly, it can actually reduce tort risk. If foreseeable hazards are identified and eliminated by risk management, the causes of many legal actions against the franchisee and the franchisor are thereby removed (although a low probability, but high impact wrong may still cause trouble for the franchised business).

The main issue facing franchisors is how to ensure the effectiveness of the risk management system within the federated structure of the franchise. The franchisees, as semi-autonomous businesses, may resent the extension of control by the franchisor over how they run their franchised outlets, particularly with regards to the costs and procedures associated with risk management systems. As a possible consequence, some of the franchisees may not fully cooperate with the franchisor. They may perform their risk reduction duties in a perfunctory fashion, so that there is the real probability of errors going undetected, which may give rise to legal liability later. To address this problem the franchisor may have to increase the monitoring of the franchisees and be more willing to take disciplinary action against reluctant or recalcitrant franchisees. But that would increase the costs of the franchisor and make its vicarious liability for any subsequent wrongs all the more likely.

7.1 The possible use of a management services company

One of the most promising methods by which the franchisor could attempt to introduce reputation risk management, and at the same time reduce the risk of vicarious liability, is to use a management services company to provide the risk management systems. The franchisor could contract with an existing company that offers these services or it could set up its own services company as a subsidiary company. This option offers the franchisor a number of potential advantages. The management services company could hire risk management experts to identify and quantify risks, spread best practice on risk control throughout the franchised network and monitor compliance with the rules designed to avoid or minimise risks. The management services company would therefore be able to exercise the control necessary to implement and enforce the risk management system and as a separate legal entity in law it would isolate the franchisor from the risks of vicarious liability (*Adams v Cape Industries plc*) [30].

However, there are two problems with this option. The franchisor would incur additional costs either by setting up such a company and paying for its services, or by contracting with an independent management services company for such risk management services. But this may be acceptable and a price worth paying if it protects the brand, which is the franchisor's most valuable asset. The second problem may be more serious. By creating or engaging a separate company to manage risks through external intervention, the employees of the franchisor and the franchisees may not see risk reduction as being a core part of their own activities. These employees may regard risk reduction as the responsibility of the service company's personnel and may not internalise the need to avoid or reduce risks whenever this is possible. But this is an organisational and management problem rather than a legal problem.

8. Conclusions

Reputation risk management can help to protect the brand, which is the most valuable asset of the franchisor's business. Risk management can also reduce legal risk of legal eliminating the most probable causes of legal liability. For these reasons it will be worthwhile for franchisors to introduce reputation risk management systems.

However, there are problems with such systems. In order to make the risk management system work effectively, the franchisor may have to increase its control over its franchisees. This may be resented and resisted and there is a danger that the system may be difficult to implement effectively in practice. Nonetheless, any attempt to increase control over the network (whether such attempts are efficacious or not) carries another type of risk for the franchisors. Increased franchisor control may make it easier for tort victims of the franchisees to establish vicarious liability on the part of the franchisors in those cases where there has been a failure to manage a particular set of risks.

It has been suggested that transferring the responsibility of reputation risk management to a management services company may reduce this legal risk. The services company would generally isolate the franchisor from

the risk of vicarious liability. Whilst there may be organisational and managerial problems with such a strategy, it is still a promising one for franchisors to adopt.

Notes

[1] A brand is a trade name used to identify a product or service. It serves to distinguish the goods or services of the owner from those of his competitors. Producers believe that if the invest in the quality of their brands they will build up a brand image to which consumers will respond by asking for the goods by their brand name. Customers may also be prepared to pay a premium for the branded product. See Issacs, A. (2003) "The Oxford Dictionary of Business, Oxford OUP, 43-44

[2] See Magid, J. M., Cox, A. D. and Cox, D.S. "Quantifying Brand Image: Empirical Evidence of Trademark Dilution", American Business Law Journal (Volume 43) 1 at pages 8-9. In early 2002, the Coca-Cola Company had a market capitalization of $127.4 billion, while the book value of its tangible assets was only $8.8 billion. Thus over 90% of the company's value (nearly $120 billion) could be attributed to intangible assets. While Coca-Cola has a variety of intangible assets (e.g., trade secrets, exclusive distribution contracts), most valuation experts consider the bulk of its value to be its dozens of brands and trademarks.

[3] These are the most recent figures produced by the Interbrand Corp survey of "The 100 Top Brands" as published in "Business Week" in July 2005, available at http://www.ourfishbowl.com/images/surveys/best_global_brands_2005.pdf

[4] Franchisors have to be careful how they deal with the franchisees. Heavy-handed supervision might alienate the franchisee and may cause him to leave the franchise. On the other hand, the franchisor has to be sure that the brand will not be damaged by franchisees failing to meet the set standards for service, quality and cleanliness, etc. Therefore, franchisor will inspect the performance of the franchisees in various ways (e.g. by field visits, by "mystery shoppers" who anonymously evaluate the outlet, etc). However, the emphasis is on creating incentives for the franchisee to perform effectively, so that self-control can largely replace external control. See Murray, I. (2003) "How to choose a Franchise" London, Kogan Page Ltd, 141-146

[5] The defendants, Steel and Morris, made a number of these allegations about McDonald's in the so-called McLibel trial. See Vick, D.W. & Campbell, K. (2001) "Public Protests, Private Lawsuits, and the Market: The Investor Response to the McLibel Case", Journal of Law and Society, Volume 28, (Number 2) 211-218

[6] McIntosh, M. & Leipziger, D. (1998) "Corporate Citizenship" London, Financial Times/Pitman Publishers, 257. The authors note that: "campaigners tend to target not the worse companies, but those that are most well known…McDonald's being among the most well-known fast food chains, is always vulnerable. Targeting an industry leader puts the whole industry on warning. Companies like McDonald's make good pressure points because they are industry leaders, because they have solid brands with a global identification and because people expect more from them".

[7] See Larkin op cit pages 20 -21 and Sheldon-Green op cit, Chapter 4 "The Bottom Line of Reputation Risk Management". In this chapter Sheldon-Green presents a financial case for adopting reputation risk management and one of his points is that a reasonable percentage of the cost of this programme is already in place because of the overlap between the management of reputation risk and the management of other types of risks in the company.

[8] The Turnbull Report sets out the best practice for the internal control of risk and was fist published in 1999. It has now been amended. The directors of listed companies are now required to confirm in the annual report that they have dealt with (or are planning to deal with) any significant failings or weaknesses highlighted by the internal control system. For the new guidance see the "Internal Control: Revised Guidance for Directors on the Combined Code" available at www.frc.org.uk/corporate/internalcontrol.cfm

[9] The contractual draftsmen will have made it clear by a number of devices that the two parties to the contractual agreement are separate and independent persons. These include the use of clauses declaring the franchise agreement is not a joint venture or a principal-agent relationship. Commercial practices will also be scrutinised by the franchisor's legal advisers so that the operation of the agreement will not give rise to an inference of franchisor control sufficient to bring the doctrine of vicarious liability into play. See Mendelsohn, M. (2004) "Franchising Law" (second edition) Richmond, Richmond Tax & Law Ltd, p123-124

[10] Perhaps this fact can best be illustrated by the vivid judgement of Templeman LJ in a leading case on the nature of corporate liability." English company law possesses some curious features, which may generate some curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any

liability for the debts of the insolvent subsidiary." per Templeman LJ, Re Southard & Co Ltd [1979] 1 WLR 1198 at p. 1208.
[11] (1880) 6 QBD 530
[12] The principle of the employer being vicariously liable for his employee's tort committed within the scope of his employment is well established in Employment Law. See for example, the case of Mersey Docks & Harbour Board v Coggins and Griffith [1947] AC 1 HL. The concept of the scope of employment has been developed in cases such as, Kay v ITW [1968] 1 QB 140, CA; and Rose v Plenty [1975] ICR 430.
[13] For an example of the breadth and depth of control that the franchisor may exert through the operations manual, see A. Feldstead, op cit p118, especially where the author describes how Mc Donald's, the fast food franchise issues a 600 page manual of rules and regulations to its franchisees.
[14] [1957] 1 TLR 101 (Denning LJ)
[15] Using Cassidy v Ministry of Health [1951] 2 KB 343 as an analogy for this proposition
[16] This difficulty was recognised by Lord Wright in Young v Montreal Locomotive Works [1947] 1 DLR 161 at169 where he said, "In many cases the question can only be settled by examining the whole of the various elements which constitute the relationship between the parties".
[17] Barrow, C. and Golzen G: (1994) "A Guide to Taking Up a Franchise", London, Kogan Page, p40 where the authors point out that," some contracts state that [the operations manual's] status is paramount over anything said in the agreement".
[18] Felstead, op cit, p116-121
[19] [1968] 2 QB 497
[20] Lord Justice MacKenna in the case of Ready Mix Concrete v Minister of Pensions and National Insurance set out a three- point test to determine whether or not there was a contract of service between the parties, at p515.
[21] See Selwyn, N. (2004) "Employment Law" London, LexisNexis UK at p269-270. Selwyn gives the traditional reasons for vicarious liability being imposed. He explains that the employer, having initiated or created the situation where the employee has been in a position to cause harm, should properly bear the loss. The second reason he gives is that employee will usually be unable to meet any substantial claim for damages, whereas the employer will normally have the financial resources to provide compensation, or at least will be insured against such contingencies.
[22] The subject matter of this legislation is to ensure that the franchisor discloses all the necessary information about the franchise to prospective franchisees. The legislation is not concerned with third party rights. The countries that have disclosure laws include the USA, Alberta and Quebec in Canada and France. See Adams op cit p323 to 326
[23] A survey carried out on behalf of the Franchise Association for 1999 found that franchising had an annual turnover of £57.9 billion and employed 316,900 people directly in the UK.
[24] See Felstead op cit p39 for the origins of franchising. Although he traces the origins of franchising back to the Middle Ages in Europe, he identifies the origins of corporate franchising and the business format form of franchising to America.
[25] 148 Tex 175, 222 S.W.2d 995 (1949)
[26] 391 A. 2d 196 (Del. Sup. 1978)
[27] 96 Cal Rptr 528 (1971)
[28] 582 F.2d 781 (1978)
[29] There is an interesting British case that might be of relevance. Hitchcock v Post Office [1980] ICR 100. In this case a shopkeeper running his own business had a contract with the Post Office to run a sub-post office from his premises. The Post Office exerted control over the security and financial aspects of the sub post office. Was this degree of control enough to make the Post Office the "master" and the shopkeeper, the "servant"? In this case the answer was, no. The managerial and operational functions of the business still remained with the shopkeeper. This fact confirmed that he was an independent contractor.
[30] [1991] 1 All ER 929

The New EU Services Directive: Metaphor for Europe Today, Model for Expanding International Harmonization Tomorrow

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Abstract. The recent adoption of the European Union's controversial Services Directive marks a palpable advance in the evolution of Europe's transborder collaboration and especially in its efforts to stimulate trade. The Services Directive mandates increased Member State cross-border cooperation in the economically dominant services sector, and requires the creation of trade facilitation processes and structures, with a new level of transparency and accountability. This Directive's design may serve as a model for expanding broader cooperation in promoting international trade in services. Moreover, the fierce legislative debate leading to the Directive's amendment and enactment reflects the uncertainty and conflict in today's EU regarding how to manage global trade and competitive forces, pitting market economy advocates versus opponents seeking to safeguard European social cohesion.

Keywords: EU Model Expanding Services Trade

I. Introduction

The European Union's vaunted common market has failed since its inception to include what has grown to be its most important economic sector. Today, trade in services generates sixty to seventy percent of economic activity in the EU, and seventy percent of the EU's workers are employed in the services sector (Copenhagen Economics, 2005). Yet only twenty percent of EU cross-border trade is in services (OECD, 2005). EU leaders have been unable to tear down the many national barriers that inhibit the cross-border offering of a broad range of vital services, from insurance, banking, accounting, and legal services, to real estate agency and construction. Moreover, over the past decade, services produced more than 75% of the EU's growth rate, even as productivity increases in the EU services sector have been stagnant (Delgado, 2006). Most EU leaders and economists agree that internal barriers undermine the full economic potential of the services sector, and that unleashing the cross-border services sector for development is essential to improving the European economy (Copenhagen Economics, 2005; McCreevy, 2006).

This sclerotic services market begs for liberalization. Service providers wishing to set up a business or merely to deliver services across state borders face a labyrinth of twenty-seven national and thousands of regional and local administrative legal systems Europe-wide that impose complex and varied restrictive authorization schemes, often disproportionate and discriminatory. Any business attempting only to discover the requirements from other countries and localities faces multiple searches that are burdensome and expensive. Once discovered, the licensing and other regulations often impose numerous requirements, such as conducting needs testing, producing certificates of solvency or general reliability, in certified translations, and incorporating in every place of service, further slowing the processes and increasing the costs (Practical Examples, 2004). Thus, EU service sector economic analysis and decisions are weighed against growth.

Long-awaited progress in reducing this burden was finally achieved on May 29, 2006, when a political deal was brokered in Brussels, ending years of contention. Representatives of the EU Member States agreed to a compromise version of the highly controversial Services Directive. One commentator found it "particularly appropriate" that the agreement was reached on the precise date when, one year previously, the French voters had torpedoed the Treaty for a European Constitution, this controversial directive being "a big factor in the French rejection (Peel, 2006)."

The agreement was made even more significant by its substantial and at times fierce opposition. Thousands of anti-globalization and left-wing protestors had marched in France, Germany, and Greece to oppose the reform (Deutsche, 2006). "Given the heated political debates, press articles, and even protests in the streets,

anyone inclined to betting would have got very long odds indeed on the possibility of arriving at a compromise (McCreevy, 2006)." One German minister praised the EU's "ability to act in the most difficult dossier in recent years (Deutsche, 2006)."

Once this political compromise was reached, the final steps of the codecision process followed without major incident. Parliament approved its second-reading on November 15th, and the Council adopted the final measure on December 12, 2006.

The compromise Directive accomplishes less than many had hoped. While many of its criticisms are undoubtedly accurate, the Directive will concretely introduce modest yet fundamental improvements in the regulation of the services sector. From the beginning of negotiations, the Directive had been aimed to advance two of the fundamental principles of the EC Treaty: Article 43's freedom to establish businesses in other Member States and Article 49's freedom to offer services across national borders. This Directive will not, of itself, produce a genuine internal market in services, but it mandates basic measures that will require the reduction of legal and administrative barriers for trans-border services activity, and this first, formal legislative step will likely lead to subsequent measures to further facilitate a more effective internal market.

EU Commissioner for the Internal Market and Services, Charlie McCreevy, summarized the Directive into three key elements: simplification of rules and processes for establishing businesses, facilitating freedom to provide services, and cooperation between Member States (2006). In more concrete language, the Directive's primary achievements lie in the requirements for greater transparency and cooperation among Member States, and reducing the often massive red tape required in cross-border activity. National authorities are now required to establish one central source for information providing the requirements for authorization in each Member State, and applicants for establishing new service businesses must be able to satisfy the formalities electronically on-line. The Directive flatly prohibits discriminatory, disproportionate, and unnecessary administrative requirements, specifically banning the expensive "economic needs" tests. Existing requirements that a business be formally "established" with a legal presence in a Member State, or take on a particular legal form prior to offering services there, are forbidden by this Directive. Finally, the measure mandates the creation of an EU-wide electronic system for the direct exchange of service provider information among Member States.

This legislation has already generated widespread attention on the problematic realities of the present, Balkanized system of services regulation in the twenty-seven Member States. As authorities begin the required process of examining, organizing, and publishing their rules and schemes of regulation, in their jurisdictions and among all the Member States, they necessarily will bear the burden of an unprecedented visibility. As they comply with the Directive's mandate to strike and streamline unjustified and overly burdensome requirements, service providers and the public, as well, will support the basic thrust of these internal market principles. The resultant transparency will draw attention to protectionist resistance as the liberalizing process progresses, in many cases exposing anti-competitive regimes, engendering support in both consumers and businesses seeking to expand. This will subsequently empower legislators to take further liberalizing steps in the future.

Thus, these modest yet fundamental steps are likely to strip away a layer of the opaqueness shielding protected service providers and businesses, and will release the services market to grow and begin to stimulate cross-border competition, yielding the well-known advances for consumers and the market.

II. Current regulation of the cross-border trade in services drags EU growth, inhibits competition, and deprives consumers of market opportunities.

The Commission's 2006 amended proposal for the Services Directive articulated persuasively the need for liberalizing the EU services sector (Amended, 2006). Three main deficiencies were targeted in the proposal: 1) a wide range of barriers block the internal market in services, 2) this artificially-restrained market fails consumers in numerous ways, and 3) Member State authorities do not cooperate in administering their diverse regulatory systems. The proposal provides:

> "At present, a wide range of Internal Market barriers prevent many service companies, especially SMEs, from growing across national borders and fully benefiting from the Internal Market. This also undermines the global competitiveness not only of EU service providers, but also of the manufacturing sector, which increasingly relies on high quality services. It also makes Europe a less attractive place for foreign investment.
>
> * * *

> The consumer demand for services is not being met due to considerable legal and administrative difficulties and a lack of information on, and of trust and confidence in, services from other Member States.
>
> * * *
>
> Regulatory authorities in Member States have little knowledge of, and therefore little trust in, the legal framework and supervision [of the services markets] in other Member States. This results in duplication of rules and controls for cross border activities."

These observations are explained in specific application by further Commission analysis and by independent economic studies and reports (Practical Examples, 2004; Delgado, 2006). These reports expose in clear detail markets tightly bound with layers of restrictions limiting growth. The Commission's Practical Examples study specifies the following.

> The cost merely of ascertaining the diverse legal requirements to offer cross-border services or to establish a service business in another Member State can be staggering. For example, one electronic hardware and services company spent €100,000 on legal advice to discover the applicable rules in only five Member States, while a technical engineering company estimated that it spent about 3% of its annual turnover for researching the requirements for their service to enter two other Member States.

Sometimes, sellers in one country cannot even find out what contracts are on offer in other countries (Buck, 2006). The Commission's Practical Examples continue: In cases when out-of-state providers do pursue service contracts across borders, they sometimes lose them due to delays in obtaining the required authorizations in other Member States, or in satisfying other administrative formalities, and in some cases they eventually abandon the effort as unproductive or inefficient. Some Member State authorities demand legal documents that do not exist in the provider's home country. In other cases, lengthy negotiations ensue, but with no assurance that permission ultimately will be granted.

Some authorities have required hopeful service providers to produce documents such as certificates of nationality, while not accepting passports or national identification cards, certificates of tax compliance, general reliability, or solvency, sometimes in demanding formats such as in certified copies or certified translations.

Some Member States require service providers to be legally established in that Member State before they can offer certain types of services, and things get even more complicated when a provider seeks actually to formally establish a business in another Member State. In each Member State, different authorities regulate from national, regional, and local levels, with diverse requirements and forms. Just discovering these requirements is onerous. And because many Member States do not allow the use of electronic filing for the requirements, service providers from these countries must incur the added costs of travel in person, sometimes more than once, to the physical offices of the different authorities.

Other complaints include the high degree of discretion allowed to some authorities, while criteria used in the decision making lack clarity; resultant negotiations with authorities can be lengthy and expensive. Some operators have complained that authorities make up new conditions that are not written in the regulations and laws. The Commission suggests that excessive discretionary powers vested in Member State bureaucrats can conduce hidden discrimination against outsider competition.

The often unpredictable duration of authorization procedures, sometimes many months or even years, also discourages applicants. A sub-problem during these processes is the interpretation to be given a lack of response from authorities. Applicants often cannot know if silence means a refusal to accept documents or explanations, or whether it just means the process is ongoing.

The Commission especially targets "economic needs testing," which requires applicants to finance expert market studies showing that the proposed establishment in the intended market would not destabilize local competition. "These are burdensome, costly and leave room for discretionary, unpredictable and discriminatory decisions."

Some service providers, required to provide financial guarantees as a condition of authorization, have been requested to arrange the guarantees from financial institutions established in the Member State. Some Member State quantitative restrictions on certain service activities, such as those based on population and distance between outlets are justified, while others are not, in the Commission's view. Similarly some fixed minimum pricing requirements prevent new service providers from using lower prices as a competitive tool to enter the markets.

Moreover, some national measures punish cross-border services, for example by granting favoured tax deductions or government grants only to consumers who use in-state professional or language training services. Similarly, some Member States impose discriminatory or disproportionate taxes on cross-border services, as in special taxes in some Member States on the use of satellite dishes which prevent consumers from receiving certain broadcasting services from other Member States.

Cross-border service providers also face burdens when sending workers to other Member States to help deliver the services. These include diverse requirements, such as mandating that the workers obtain prior authorizations or make certain declarations, that all workers' labour documents be posted in the new locale, and that the company designate a permanent representative in the new country.

Conversely, Member State authorities complain that other Member States cooperate poorly when asked to provide verification of an applicant's good standing in its home state. In addition, an EU company wishing to send a third country worker into a Member State, as is common in the IT and high-tech sectors due to skills shortages, again faces extra burdens, such as requirements to hold work permits. These requirements cause delays.

The Commission observes that consumers can face uncertainty about the reliability or quality of service providers in other Member States because mandatory information-requirements are not required in some sectors. This hinders consumer confidence when seeking cross-border services. The same problem arises from inconsistent regulations for professional indemnity insurance and after-sales guarantees, leaving ambiguity about what activities are covered. Access and competition are also distorted by divergent Member State regulation of commercial communication, again making entrance to new markets more difficult where such communications are banned. This same lack of information makes it more difficult for consumers to compare service offerings.

Finally, Member State authorities' lack information about each other's regulatory requirements, processes, and supervisory techniques naturally leads to a lack of confidence in one another and limits their ability to work together effectively. Member States have been under no obligation to cooperate and assist one another. The Commission goes so far as to suggest the possibility that some Member State authorities "tend to turn a blind eye when service providers based in their territory cause harm in other Member States' territories (Practical Examples, 2004)."

A recent OECD (2005) report observed that intra-EU "trade in business and transport services are comparatively underdeveloped, while the trade in personal services is almost non-existent. In business services, the Netherlands, the United Kingdom, and to a smaller extent Spain have a strong openness to trade, whereas France, Germany, and Italy appear to be rather inward-oriented – a pattern that is correlated with the regulatory environment."

The independent CPB Netherlands Bureau for Economic Policy Analysis (CPB for Central Planning Office) 2004 report *The free movement of services within the EU* substantiated the general consensus. Scientifically expressed, the report found "that the heterogeneity in regulation hampers bilateral service trade in the EU, and also bilateral direct investment." The authors estimate that an effective services directive could increase EU commercial services trade by 30-60% and foreign direct investment by 20-35%. Another independent expert study suggested that the Directive could lift GDP 0.8 percent, while creating some six hundred thousand jobs (Copenhagen Economics, 2005). These numbers illustrate how much the lack of liberalization is hurting the EU's employment. And "[h]igher growth in labour productivity in services and the convergence of service prices would help lower inflation persistence in the euro area... (OECD, 2005)." The experts' arguments in favour of service market reform are compelling.

> "Reducing barriers to service provision intensifies competition and forces firms to cut prices to the benefit of consumers, governments, and businesses both within and outside the service sectors. Barrier reductions also reduce costs and increase productivity, because barriers waste real resources. The economic effects are thus caused by both stronger competition and reduced costs in the EU services sectors.
>
> "Stronger competition will reduce artificially inflated prices and less waste of resources will lead to lower costs of services provision. This will benefit both consumers and firms using the covered services as inputs. Productivity gains enable the creation of higher value added and provide a strong stimulus to the EU economy (OECD, 2005)."
>
> "Output and value added will increase across all sectors, and services and goods markets will expand considerably. . . . The increase in economic activity will spur the creation of new jobs. . . . .[B]usinesses will experience increased opportunities in the Internal market as international expansion becomes less costly. . . . Both cross-border trade and foreign commercial

> establishments will increase. This will lead to improved availability of different service varieties and promote competition in the Internal market (Copenhagen Economics, 2005)."

One report concludes that "[s]ervices are even more important for job creation than their share of employment might suggest since the service sector has been steadily recruiting over the last three decades while the workforce has been shrinking in manufacturing and farming. Examples of the United States and the United Kingdom, where services account for an even higher share of employment, suggest that services still offer considerable job creation potential in the euro area (OECD, 2005)."

III. The Directive's Difficult Birthing

The European Commission adopted its original Services proposal in January, 2004, and sent it to the Parliament and the Council in February, 2004. The Parliament debated the proposal, often heatedly, through ten committees, making numerous amendments, and finally adopting its amended version on February 14, 2006. This was forwarded to the Council, which reached political agreement, with only a few amendments on May 29, 2006. The second reading in the Parliament began on Sept 13, 2006, and its final approval was given on November 15, 2006. The Council adopted the final measure on December 12, 2006.

This journey from original proposal to the final adoption of the heavily amended proposal was an arduous one. The original directive had generated strong opposition, and the Parliament took matters in its own hands. One critic stated that the European Parliament essentially "threw out the original version and presented its own text," which was accepted by the Commission (AFP Wire, 2006). Another flatly observed that the European Parliament had essentially "written" the final Directive (Noticias.info, 2006).

The worst fighting in the Parliament focused on two highly contentious issues: the country of origin principle (by which a service provider is broadly subject to the legislation of his country of establishment and not the country where the service is provided) and the scope of the directive (precisely which services it will cover). Ultimately, the Parliament threw out the country of origin principle and substantially reduced the scope of the Directive.

> "The directive was perceived as putting at risk the "European social model" by allowing service providers to cross borders without abiding by local labour and social regulations. Many of the wealthier member states saw in the document an open door to service providers from new member states where wages are lower and social protection systems less developed. Moreover, the state plays an important role in the provision of many services in Europe . . . and many perceived the Services Directive as an attempt to privatize such services while ignoring their social component and in the process reducing quality standards (Delgado, 2006)."

"Opponents warned that the [original] directive would lead to "social dumping" – companies and jobs relocating to eastern Europe or using low-cost labour (sic) in jobs like construction throughout the rest of the European Union. Many European countries and trade unions feared that companies from countries with fewer taxes and regulations, in particular in Eastern Europe, would be able to operate in higher cost economies without paying their employees the local rate. Anti-globalisation and left-wing demonstrators took to the streets in France, Germany and Greece to oppose the reform (AFP Wire, 2006)." One MEP estimated that 25,000 demonstrators protested in the streets of Strasbourg during Parliament's first hearing. Parliament reacted aggressively, and killed the country of origin provision and substantially narrowed the Directive's scope.

After the Parliament's amendments, more criticism flowed. Some insisted the amendments eviscerated the directive; one commentator characterized it as a "toothless Services Directive, passed after a Soviet-style anti-market campaign waged in the European Parliament (Gurdgiev, 2006)." Others offered a more a positive view. Commissioner McCreevy heralded the growing maturity of the European Parliament as demonstrated by its role in the formation of the Directive, characterizing the broad consensus it reached in this difficult sector as a "real breakthrough (2006)."

Then, the Commission and the Council acceded to most of the Parliament's demands. The deal was done.

IV. The final, amended Directive's Specifics

The final Directive's seventeen-page Preamble introduces the measure's purposes, encouraging economic and social progress in the Community's internal market with the free movement of services, referencing a dozen of the EC Treaty's Article 2 goals, from high levels of employment and social protection, to the environment and quality of life. Restating what the Commission and economists have argued for many years, "At present, numerous barriers within the internal market prevent providers, particularly SMEs, from extending their operations beyond their national borders and from taking full advantage of the internal market." The Preamble flatly states: "A free market which compels Member States to eliminate restrictions on cross-border provision of services while at the same time increasing transparency and information for consumers would give consumers wider choice and better services at lower prices." (2006)

The Preamble repeats the substance of the Commission reports cited above, regarding the need for reduced services barriers, and terms this "a basic condition for overcoming the difficulties encountered in implementing the Lisbon Strategy and for reviving the European economy, particularly in terms of employment and investment." Moreover, because direct application of Articles 43 and 49 of the Treaty on a case by case basis will not adequately effect the needed reduction of barriers, this Community legislative instrument is necessary to achieve the coordination of national legal schemes and setting up of administrative cooperation.

Next, the Preamble articulates the many exclusions from the measure, showing the Directive's limited application: financial services (banking credit, insurance, pensions, securities, investment, etc.), electronic communications networks and services, as they are the subject of other Community legislation, healthcare and pharmaceutical services, taxation, audiovisual, gambling services, as well as the provision of professional services such as notaries, social services, such as housing, child care and support of persons in need, existing Community legislation regarding professional qualifications, safety, or consumer protection, criminal law, social security law, labour law and relations between the social partners, measures to promote cultural and linguistic diversity. The Directive has no affect on international organizations on trade in services (especially GATS). Services of general interest are excluded, but services of general economic interest (those performed for an economic consideration) do fall within the scope of the Directive, except for certain areas such as postal services and transport, which are excluded. The amended Directive does not require Member States to liberalize services of general economic interest or to privatize public entities providing such services, or to abolish existing monopolies. The Directive does not aim at harmonizing national procedures, but rather at removing overly burdensome ones.

The Directive specifies examples of sectors included within its scope, such as: business services such as management consultancy, certification and testing; facilities management, including office maintenance; advertising; recruitment services; and the services of commercial agents; legal and fiscal advice; real estate services; construction, architecture; distributive trades; the organization of trade fairs; car rental; travel agencies; consumer services, such as in the field of tourism, leisure services, sports centres and amusement parks; and generally household support services, such as help for the elderly.

The Preamble continues for numerous pages, explaining its definitions and rationale, leading to the actual Articles of the Directive. The Directive's Chapter I, Articles 1 and 2 define the subject matter and scope of the Directive, including listings of the exclusions described above. Article 3 explains the relationship of the Directive with other Community measures, and Article 4 sets forth definitions.

Chapter II gets to the substance of "Administrative simplification," essential to the measure. Article 5.1 requires Member States to "examine and, if need be, simplify the procedures and formalities applicable to" providing services. Art. 5.2 permits the Commission to introduce Community harmonized forms, equivalent to certificates, attestations, and other documents required for service providers. Article 5.3 mandates that Member States must accept equivalent documents from other Member States to satisfy their requirements for certificates or other documents for service providers, when it is clear that the requirement has been satisfied. Member States may not insist that required documents from another Member State be produced in original form, or as certified copies or certified translations, except where justified by some overriding public interest. Exceptions are specified for documents recognizing professional qualifications, used in public works or supply contracts, or similar special cases.

Article 6 creates the duty for Member States to establish "points of single contact" where applicant service providers may find and complete the procedures and formalities needed for authorization to provide services, providing access for all necessary declarations, notifications, or applications for authorization from the competent authorities, as well as applications for inclusion in any register.

Article 7 sets forth the information that must be easily accessible from the points of single contact: requirements for the exercise of service activities, contact details for competent authorities, the means of accessing public registers and databases on providers and services, means of redress generally available for disputes among competent authorities, providers and or recipients, and finally contact details of associations or organizations, beyond competent authorities, that may provide practical assistance to providers or recipients. Similarly, information must be available on the way in which all the requirements are generally interpreted and applied, and all of this information must be provided in a clear and unambiguous manner, kept up-to-date, and accessible via electronic means. Finally, the single points of contact and the competent authorities must respond "as quickly as possible" to any requests for information or assistance.

Article 8 repeats specifically the obligation for Member States to provide electronic means for applicants to access all service activity procedures and formalities, and the Commission shall adopt detailed rules to insure the interoperability of the electronic systems of the Member States.

Chapter III addresses freedom of establishment for service providers. Article 9 imposes rules on Member State authorization schemes: they may not discriminate and must be justified by overriding reasons relating to the public interest that cannot be achieved by a less restrictive measure. Member States are also required in their Mutual Evaluation Reports that must be submitted to the Commission (Article 39) to identify their authorization schemes and give the reasons showing this need.

Article 10 mandates that authorization schemes be based on certain listed criteria precluding arbitrary or discretionary operation: the criteria must be non-discriminatory, justified by overriding public interest, proportionate, precise and unambiguous, objective, made public in advance, and transparent and accessible. Furthermore, conditions shall not duplicate requirements which are equivalent or essentially comparable to those to which the provider is already subject in another Member State or in the same Member State. A refusal or a withdrawal of authorization must be fully reasoned and shall be open to challenge before the courts.

Article 11 makes the authorizations of unlimited duration, except where an overriding public interest reason, or when legitimate conditions for authorization are no longer satisfied. Article 12 requires impartiality and transparency when selection must be made among several candidates, as in cases of scarcity of natural resources or technical capacity. Article 13 prescribes that authorization schemes be clear, made public in advance, and easily accessible; they may not be dissuasive or delay the provision of the service. Applicants must be given acknowledgments of receipt by the authorities of their applications, as well as given assurances that their applications will be processed within a reasonable time. In cases of a failure of an applicant to comply with required procedures, the applicant must be informed promptly.

Article 14 prohibits discriminatory requirements based directly or indirectly on nationality or location of registered office, residence requirements, prohibitions against being established in more than one Member State, economic testing making the authorization subject to proof of the existence of an economic need or market demand, or an assessment of the potential or current economic effects of the activity. Also prohibited are requirements that involve competing operators, excluding professional associations, chambers of commerce, and social partner organizations. Further banned are obligations to provide a financial guarantee or to take out insurance from a particular provider in a Member State.

Article 15 requires Member States to examine their authorization schemes to insure these rules are followed, and that their Mutual Evaluation Reports specify their requirements and explain the how they comply with these requirements. Any new requirements imposed by Member States must be notified to the Commission, which will communicate the measure to the other Member States, though the measure may be put into effect. Within three months from the date of that notification, the Commission shall examine the compatibility of the new measure with Community law, and if appropriate, shall adopt a decision requesting the requirement be abolished.

Chapter IV addresses free movement of services. Article 16 reaffirms the freedom to provide services in other Member States, with no discriminatory restrictions, repeating the rules of proportionality and necessity for all rules, as set out in previous articles for establishment. Exceptions for public policy, security, health, and the environment, are allowed. Article 17 lists the derogations: in the area of general economic interest services, for the postal, electricity, gas, water and waste water sectors. Further excluded are matters covered by the posting workers directive, data privacy directive, professional qualifications directive, and Community rules regarding free movement of persons and workers, with other exceptions listed in the Article.

Article 19 forbids restrictions on recipients of out-of-state services, such as requirements to obtain authorization, or to limit financial assistance because the service originates out-of-state, or other discriminatory or disproportionate fees on equipment needed to receive such service. Article 20 forbids discrimination based on a recipient's nationality.

Article 21 mandates that Member States must make available information on the requirements applicable in other Member States to use services, in particular those relating to consumer protection, general information on means of redress in case of disputes, and contact details of organizations for practical assistance. Information provided must be clear and unambiguous, and where appropriate, competent authorities must include step-by-step guides. Such information will be distributed by the Commission to all Member States.

Chapter V addresses quality of services. Article 22 instructs Member States to ensure that service providers make basic information available: names, legal status, address, contact details, place of registration, relevant authorization information, general conditions and clauses used by the provider, the main features of the service provided and necessary details about pricing, all supplied in good time prior to the conclusion of a contract. Article 23 requires Member States to ensure that providers subscribe to professional liability insurance or other guarantee appropriate to the nature and extent of any risk, but not in a manner discriminatory from that required for in-state providers. Such insurance or guarantee may not be required when the provider is already covered by an equivalent guarantee or insurance in another Member State.

Article 24 mandates that Member States must remove all total prohibitions on commercial communications by the regulated professions, and that all Community rules relating to such be observed. Article 26 requires Member States to encourage quality in services, by having activities certified or assessed by independent bodies or participating in quality charter groups, with options for encouraging this and voluntary European standards with the aim of facilitating compatibility between services supplied by providers in different Member States. Article 27 prescribes that Member States take numerous steps in facilitating the settlement of disputes, including those to insure prompt and effective communication between recipients and suppliers. Providers which require recourse to non-judicial settlement resolution procedures must follow rules regarding clear notification to consumers.

Chapter VI, Article 28 promulgates the general obligation for Member States to give each other administrative cooperation and mutual assistance, to cooperate in supervising providers and their services. Liaison points of contact for this cooperation must be designated and communicated to the other Member States and the Commission, a list of which shall be published by the Commission. Member State authorities must cooperate in good faith to requests for information, inspections, certificates, etc., offering responses electronically as quickly as possible. Member State failure to cooperate must be notified to the Commission, which may take appropriate steps to require cooperation. Likewise, if competent authorities learn of any conduct by a provider that may cause harm to the health or safety of persons or the environment, they must inform other Member States and the Commission promptly. Articles 29-31 place similar duties on Member States for information on providers established in them and others temporarily offering services there.

Article 32 provides the alert mechanism, whereby an authority learning of any serious acts or circumstances involving services that could cause serious harm must inform the Member State in which the provider is established, as well as other Member States involved and the Commission. The Commission shall promote the operation of a European network of Member State authorities to effectuate this alert mechanism. Article 33 requires Member States to provide to one another relevant information about disciplinary, administrative or criminal sanctions of a provider. Article 34 requires the Commission to establish an electronic system for the exchange of information between Member States, and to facilitate such exchanges with training and programs to organize them. Articles 35-36 impose obligations and limits on derogations to the Directive.

Article 37 introduces convergence measures, requiring Member States, in cooperation with the Commission, to take steps to encourage drawing up at the Community level codes of conduct aimed at facilitating cross-border services, and that these are available as other information specified in the Directive. Article 39 sets forth the mutual evaluation process whereby the Member States present their reports to the Commission, which will publish them and open a form of consultation, ultimately producing a summary report to the parliament and the Council, accompanied by appropriate proposals for additional initiatives. Article 40 calls for a Committee of Member State representatives to assist the Commission in its efforts. Article 41 calls for a comprehensive review of the Directive's workings to be presented to the Parliament and Council every three years. Finally, Article 44 obligates Member States to bring into force laws and regulations necessary to comply with the Directive, by December 28, 2009, and to communicate those provisions to the Commission.

V. Conclusion: The Directive represents a valuable step

Commissioner McCreevy recently explained: "[T]he internal market is never quite finished. It very much is a work in progress that needs continuous development and mending to ensure that businesses and consumers get the best deal possible and that attempts to shield markets are stopped (2006)." Even though the Commission's

original proposal was heavily diluted by the Parliament's amendments, the amended Directive "still represent[s] a small, but important, step in liberalizing trade in services and in countering the recent revival of protectionist rhetoric in Europe (Delgado, 2006)."

Legally, the measure strongly re-affirms the principles of the EC Treaty Article 43's freedom to establish businesses in other Member States and Article 49's freedom to offer services across national borders, and the Directive engages Community and Member State mechanisms to clarify and streamline the complex tangle of restrictions in this sector.

Practically, the new Directive will make it easier for businesses to offer services and to become established other Member States, especially in reducing the often massive red tape in different Member States. It will simplify and accelerate authorization processes, thereby lowering the economic costs; the mutual cooperation and evaluation obligations will promote "best practice" modernization among Member States, and this can only advance progress. Some unnecessary and discriminatory regulations will fall as a result of this Directive. Services competition will be increased, generally increasing consumer choice and lowering prices. The Directive also contains requirements for vital consumer information about the providers, their services, conditions of the service, and prices.

Symbolically, this compromise Directive will break the legislative impasse of opposing views about market liberalization in the services sector and the social welfare model. The modest, but real, advances that will be visible to the leaders and public alike, as the realities of the old protectionist schemes are exposed, will likely allay fears that have been so aroused by the fierce debate. The predictable benefits of competition in a more opened, expanding services market will lead to further steps in this and other sectors toward the original EC Treaty goals of a true internal market.

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Relieving the Burden of UK Capital Taxation on Business

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Abstract. Whilst UK Inheritance Tax is applied at a rate of 40% on all assets, the legislation ascribes a nil value to assets meeting the business property definition. In the absence of a statutory definition of business property, the courts and tribunals have constructed a jurisprudence for the concept, based, but not exclusively reliant, upon interpretations in other fiscal contexts. This paper analyses this approach in the broad context of statutory interpretation and extracts from the various decisions and determinations the implications for the future developmental direction.

"*I want the United Kingdom to be the obvious first choice for new investment*". Gordon Brown, Budget Speech 1997.

Introduction

According to some sources, capital taxation can be seen as an inhibitor to business succession (ACCA 2002, 2003; European Commission 2003; Federation of Small Businesses 2004; Harvey 2004). Yet the fact remains that in recent times, British Fiscal policy has aimed to facilitate the maximal retention of resources within viable enterprises with the view of business continuity. One major fiscal threat is posed by Inheritance Tax which applies at a rate of 40% on all the assets of an estate in excess of a nil rated band (£285,000 at the time of drafting but anticipated to rise to £350,000 by 2010). Whilst essentially a personal tax, its impact has a major indirect impact on business, in that the value of business falls as an asset to the charge to IHT. During Gordon Brown's reign for the last decade as Chancellor of the Exchequer (and Prime Minister in Waiting), estates falling to pay the tax has trebled to 6% (Brown 2007). However, as the tax is based upon UK domicile (or deemed domicile) it features only marginally in the standard texts on International Tax Planning such as Miller & Oats and Doernberg. Moreover, there are considerable Tax Planning opportunities for both UK and non UK domiciled entrepreneurs as transfers of businesses and business assets may legally be able to escape all burden of this tax, through the application of Business Property Relief. This prompted the Department of Trade and Industry's Small Business Service to report

> "Empirical research confirms that the current capital tax régime is more favourable than previous régimes and those of most of European countries".

It continued:

> "the present capital taxation regime, which includes … 100% business property relief within inheritance tax, eases succession planning." (DTI 2004)

Because of the attraction of extensive benefits afforded by the relief, taxpayers have sought to stretch to its far-most limits the application of the relief. A particular battle field has been identifying "business" and holding the fine line of distinction between 'trade' and 'investment': in this difficult area of fine line calls, the judicial response has been to achieve fiscal consistency.

This paper commences by describing the tenets of application and interpretation of fiscal rules, before briefly describing the capital tax regime. It then explores the Business Property Relief, and its judicial interpretation. In this context, this paper argues that the "business" tests currently used by the courts readily seem to presume, but deny, a similar definition for a word used in the different contexts; and that this is an oversimplification which risks further mudding the waters.

Fiscal Principles

The constitutional division between the creation and the application of taxation was expressed by Lord Wensleydale (and subsequently approved by Lord Halsbury in Tennant v. Smith [1892] A.C. 150):

> "It is a well-established rule, that the subject is not to be taxed without clear words for that purpose; and also, that every Act of Parliament must be read according to the natural construction of its words." In re Micklethwaite 11 Ex. 452 at p. 456

But such a simple approach of following "the natural construction of its words" belies underlying difficulties which Lord Halsbury explained:

> "This is an Income Tax Act, and what is intended to be taxed is income. And when I say "what is intended to be taxed," I mean what is the intention of the Act as expressed in its provisions, because in a taxing Act it is impossible, I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes. In various cases the principle of construction of a taxing Act has been referred to in various forms, but I believe they may be all reduced to this, that inasmuch as you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed by making such and such objects the intended subject for taxation, you must see whether a tax is expressly imposed. Cases, therefore, under the Taxing Acts always resolve themselves into a question whether or not the words of the Act have reached the alleged subject of taxation." Tennant v. Smith [1892] A.C. 150 at 154

Subsequently, Lord Donovan explained the principles of statutory interpretation in the fiscal field:

> "…it may be useful to recall at the outset some of the rules of interpretation which fall to be applied. First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices. As Turner J says in his (albeit dissenting) judgment in *Marx v. Inland Revenue Commissioner* [1970] NZLR 182, 208, moral precepts are not applicable to the interpretation of revenue statutes. Secondly, "…one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used": per Rowlatt J in *Cape Brandy Syndicate v Inland Revenue Commissioners* [1921] 1 KB 64, 71, approved by Viscount Simons LC in *Canadian Eagle Oil Co Ltd v The King* [1946] AC 119, 140. Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation that would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to its construction." *Mangin v. IRC* [1971] AC 739 at 746.

The articulation of these principles leads inexorably to two conclusions. Firstly, that no citizen is liable to taxation unless clearly falling within the statutory charge, as Walton J. observed:

> "One should be taxed by law, and not be untaxed by concession…" Vestey v. IRC [1979] Ch 177 at 197

- a view later reinforced by Lord Wilberforce:

> "Taxes are imposed upon subjects by Parliament. A citizen cannot be taxed unless he is designated in clear terms by a taxing Act as a taxpayer and the amount of his liability is clearly defined." Vestey v. IRC [1980] AC 1148 at 1172

And secondly, that any reasonable ambiguity must favour the citizen, as Lord Mackay LC observed:

> "At the very least it appears to me that the manner in which I have construed the relevant provisions in their application to the facts in this appeal is a possible construction and that any ambiguity there should be resolved in favour of the taxpayer." Pepper v. Hart [1993] AC 593 at 614.

So, it is not surprising that it was consideration of a taxation issue which prompted the extension of the right of the courts to resort to forensic materials to Hansard's record of proceedings in Parliament: as Lord Griffiths observed:

> "The days have long passed when the courts adopted a strict constructionist view of interpretation which required them to adopt the literal meaning of the language. The courts now adopt a purposive approach which seeks to give effect to the true purpose of legislation and are prepared to

look at much extraneous material that bears upon the background against which the legislation was enacted." Pepper v. Hart [1993] AC 593 at 617.

Applying these principles, it has long been accepted that the burden is upon the HM Revenue and Customs to establish that the charge falls upon the citizen but that the burden of claiming an exemption falls upon the taxpayer. However, to date, the principles adopted by the courts for statutory interpretation of provisions imposing tax and do not appear to have dichotomized from those applied to the interpretation of relieving provisions. Moreover, whilst the purposive approach may have accelerated the abandonment of strict constructionism and liberalized the application of tax laws, it risks excessive cross reliance upon extrinsic borrowed interpretations, and overweighing the value of policy against clarity.

Inheritance Tax (IHT)

Inheritance Tax is charged upon a disposition (including a 'deemed' disposition on death) where the donor does not survive seven years. Although it bites at a flat rate of 40% on estates over £285,000 (2006-7) it should not be considered a threat as there are extensive reliefs (including spouse and business asset relief). Under sections 103-114 Inheritance Tax Act, 1984, business property attracts a generous 100% reduction in value on transfers on death and *intervivos*:

"Where the whole or part of the value transferred ... is attributable to the value of any relevant business property, the whole or that part of the value transferred shall be treated as reduced-

a) in the case of property falling within section 105(1)(a), by 100%;
b) in the case of other relevant business property, by 50%"

In addition, ss. 106 - 8 require that the donor has owned the property for two years immediately preceding the transfer (or where it is replacement property or was acquired by the transferor on the death of the donor's spouse).

To qualify for this generous treatment two conditions need to be satisfied: firstly that the property meets one of the statutory definitions, and secondly that the transferor meets the period of ownership conditions.

Section 105(1) (a) divides business property into two categories: the first (attracting 100% relief) consists "of a business or interest in a business" which by (s. 105(1) (b)) includes unquoted securities of a company giving control (i.e. voting control over all matters relating to the company (except its winding up or variation of class rights) s. 269(1) (4)); and unquoted shares (but not securities) in a company.

The second (attracting 50% relief) includes controlling holdings of quoted companies (i.e. quoted on a recognised stock exchange or the Unlisted Securities Market – s. 272, Inheritance Tax Act 1984) securities of a company giving control; land, buildings, machinery or plant used mainly for the purposes of a business carried on by a company controlled by the transferor or by a partnership of which he is a partner. (Section 105(1) (cc), (d)). However, section 103(3) Inheritance Tax Act 1984 excludes from the relief"a business carried on otherwise than for gain."

'Business' defined

So, firstly there must be a "business": but British income tax law does not provide a ready definition of business. As Her Majesty's Revenue and Customs website explains, for such purposes the test is merely whether there is 'trading' as Lord Reid explained:

"As an ordinary word in the English language 'trade' has or has had a variety of meanings or shades of meaning. Leaving aside obsolete or rare usage, it is sometimes used to denote any mercantile operation, but it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services. The contexts in which the word 'trade' has been used in the Income Tax Acts appear to me to indicate that operations of that kind are what the legislature had primarily in mind." Ransom v. Higgs [1974] 50 TC 1 at 78.

In the same case, Lord Wilberforce underlined the difficulties caused by the lack of a definition of trade:

"'Trade' cannot be precisely defined, but certain characteristics can be identified which trade normally has. Equally some indicia can be found which prevent a profit from being regarded as

> the profit of a trade. Sometimes the question whether an activity is to be found to be a trade becomes a matter of degree, of frequency, of organisation, even of intention, and in such cases it is for the fact-finding body to decide on the evidence whether a line is passed … Trade involves, normally, the exchange of goods or of services for reward–not of all services, since some qualify as a profession or employment or vocation, but there must be something which the trade offers to provide by way of business. Trade, moreover, presupposes a customer (to this too there may be exceptions, but such is the norm), or, as it may be expressed, trade must be bilateral–you must trade with someone. ... Then there are elements or characteristics which prevent a trade being found even though a profit has been made–the realisation of a capital asset, the isolated transaction (which may yet be a trade)" ibid at 88.

However, 'business' is used for VAT purposes, and the principal test is that adopted by Gibson J. (as he then was) in Customs and Excise Commissioners v. Lord Fisher [1981] STC 238 which considered whether a business existed where some pheasant shooting enthusiasts had contributed to a fund to cover the cost of facilities provided for their mutual benefit. His Lordship sought positive responses to five tests to ascertain whether an activity constituted a business:

1. Is there a 'serious undertaking earnestly pursued' (as applied in *Rael-Brook Ltd v. Ministry of Housing and Local Government* [1967] 2 QB 65 at 76)?
2. Is it 'an occupation or function pursued with reasonable or recognisable continuity' (as applied in *Customs and Excise Commissioners v. Morrison's Academy Boarding Houses Association* [1978] STC 1 at 8)?
3. Did the business activities have a 'measure of substance measured quarterly or annually' (as applied in *Customs and Excise Commissioners v. Morrison's Academy Boarding Houses Association* [1978] STC 1 at 8)?
4. Had the activity been 'conducted in a regular manner on sound and recognised business principles' (as applied in *Customs and Excise Commissioners v. Morrison's Academy Boarding Houses Association* [1978] STC 1 at 10)?
5. Were the activities 'of a kind commonly carried on by those who seek profit by them' (*Customs and Excise Commissioners v. Morrison's Academy Boarding Houses Association* [1978] STC 1 at 6)?

The Partnership Act 1890 section 1(1) also uses the noun "business" in its definition of a partnership:

> "Partnership is the relation which subsists between persons carrying on a business in common with a view of profit"but the statutory definition fails to help as section 45 merely states:
>
> > "The expression 'business' includes every trade, occupation, or profession".

Secondly, the implicit requirement that the business should not be conducted "otherwise than for gain" clothes business with commerciality similar to that implicitly demanded for partnerships by the need of "**a view of profit**". It seems that our Victorian forefathers thought that there could be a business, without some view of profit, but there could not be a partnership without such a view; although they did not go so far as to predicate a partnership upon the realisation of profit.

Thus, in *Khan v. Miah* [2001] 1 All ER 20, the parties acquired and prepared premises for their anticipated restaurant business: notwithstanding that the venture folded before any diner had eaten there, the House of Lords court accepted that the activities met the Partnership Act test, and in so doing, Lord Millett distinguished "trade" from "business" in the context of the Partnership Act 1890:

> "There is no rule of law that the parties to a joint venture do not become partners until actual trading commences. The rule is that persons who agree to carry on a business activity as a joint venture do not become partners until they actually embark on the activity in question. It is necessary to identify the venture in order to decide whether the parties have actually embarked upon it, but it is not necessary to attach any particular name to it. Any commercial activity which is capable of being carried on by an individual is capable of being carried on in partnership. Many businesses require a great deal of expenditure to be incurred before trading commences. Films, for example, are commonly (for tax reasons) produced by limited partnerships. The making of a film is a business activity, at least if it is genuinely conducted with a view of profit. But the film rights have to be bought, the script commissioned, locations found, the director, actors and cameramen engaged, and the studio hired, long before the cameras start to roll. The work of finding, acquiring and fitting out a shop or restaurant begins long before the premises are open for business and the

> first customers walk through the door. Such work is undertaken with a view of profit, and may be undertaken as well by partners as by a sole trader."

Moreover, to qualify for Business Property Relief under sections 103-114 the activity must be trading (as distinct from investment), and, consequently, shares in an investment holding company will not attract the relief but shares in a trader (e.g. market maker) would do so.

Applying the Relief

A search of the Tax Tribunal database indicates several areas of dispute over the interpretation and application of the rules:

- Participation in a business: *Beckman v. CIR.*
- Distinguishing passive from active: *Brown's Executors v. CIR; Martin and Horsfall v. CIR;* and *Burkinyoung v. CIR*.
- The substantial activity test: *George & Anor v. Inland Revenue, and Seymour v. CIR.*
- The characterization for the other tax purposes: *Clark v. CIR*, *Phillips v. CIR*, and *Burkinyoung v. CIR.*
- Commercial reality: *Clark v. CIR.*
- Control of a company: *Walker's Executors v. Inland Revenue Commissioners.*

Each will now be considered.

Participation in a business

The issue in *Beckman v. CIR* [2000] STC SCD 59 SpC 226 was whether Business Property Relief applied in respect of monies left in a partnership after one partner had retired. Taking the view that this was merely a creditor / debtor arrangement, Special Commissioner M J F Palmer denied the relief:

> "in the absence of any agreement to the contrary, [the funds] were simply those of a creditor of the business, which in this case, because her daughter was the sole continuing partner, means that she was simply the creditor of her daughter."

Distinguishing passive from active

In the case of a mixture of activities, the relief can apply to the trading (but not the investment elements such as land holding); and the courts look at the activity, not at the temporary character of the assets - as highlighted in *Brown's Executors v. CIR* [1996] STC SCD 277 SpC 83. There, trading assets (a night-club called 'Gaslight') had been sold and the proceeds invested pending the selection of the next enterprise. As Special Commissioner THK Everett reasoned:

> "Looking at the evidence as a whole, I am unable to accept that the business of Gaslight from the date of the sale of the night-club to the date of Mr. Brown's death consisted wholly or mainly of making or holding investments. Although the bulk of the proceeds of sale were held in an income-producing account, they were available at short notice to be applied by Mr. Brown when he found suitable alternative premises. He intended to replace the night-club which had been sold with alternative premises and on the evidence of his brother and the evidence of Mr. Ufland, he made efforts to find suitable alternative premises for Gaslight and it would appear that those efforts would have come to a successful conclusion but for Mr. Brown's untimely illness and death in the later part of 1986."

This is particularly important when a charge is triggered (e.g. by death) after exchange of contracts. This 'dynamic of the business' approach adopted by the courts displaces the traditional view that an exchange of contracts operates the doctrine of conversion to convert assets into their net proceeds of sale.

Conversely, an incidental trading activity is insufficient to recharacterize the main activity, as a number of lettings cases illustrate. Partnership law, generally, does not recognize as 'a business' merely the holding of property in the absence of other activities; and it is unsurprising that the courts have consistently disallowed business property relief where essentially the activity is merely the letting of property and the receipt of rents whether or not via a managing agent and whether of domestic or industrial units (Martin and Horsfall v. CIR [1995] STC SCD 5 SpC2 and Burkinyoung v. CIR [1995] STC SCD 29 SpC3).

In *Martin and Horsfall*, His Honour Stephen Oliver (Presiding Special Commissioner) explained (at para 13):

> "Where the value transferred by a transfer of value is attributable to let property, entitlement to business property relief depends on the two tests in s. 105 being satisfied. The appellant has first to show positively that the let property is comprised in a business (s 105(1) (a)); then he has to establish as the second stage that that business does not consist wholly or mainly of the making or holding of investments (s 105(3)). The Revenue conceded that the property in this case consists of a business in s 105(1) (a) d. None the less, I still have to determine the essential nature of that business before proceeding to the second stage."

To draw a distinction between passively holding investments and a "trade", the Judge applied the test adopted by the House of Lords in *Fry (Inspector of Taxes) v. Salisbury House Estate Ltd* [1930] AC 432 to determine whether profits from 'service lettings' of unfurnished office space fell to be taxed under Sch D as trading income or under Sch A as rental income. In *Fry*, the Court of Appeal had earlier distinguished the activities of the landlord assumed under the lease ('mere incidents of an ordinary tenancy') from others separate from the land-owning part of the landlord's business (e. g. cleaning, heating, and lighting) which were potentially taxable as trading income. Thus in *Martin*, mere management activities were insufficient, as the Judge explained at para 22:

> "The third category covered the management activities summarised in para 8 above. The Moores were actively involved in these: and these continued after Mr. Moore's death, though at a reduced level. The purpose of these was to keep the property tidy, secure and in good repair and generally to keep up the standards of the whole investment property. But they were in no way productive of any income other than rent, nor were they designed to produce any separate income."

The judge then continued, at para 25, by quoting from Hansard:

> "The expression 'the business … of making or holding investments' has not yet been interpreted in any decisions of the courts. Accepting without conceding the point that its meaning might be obscure … the Revenue referred me to certain passages from Hansard. Paragraph 3(2) of Sch 10 to the Finance Bill of 1976 contained the wording of the predecessor of s 105(3) of the Inheritance Tax Act 1984. In the course of the debate on 17 May 1976 the Chief Secretary to the Treasury, the Rt Hon Joel Barnett MP, made a statement in relation to business property relief as then found in clause 64 and Sch 10. I quote (911 HC Official Report (5th Series) cols 1125-1126):
>
> > 'Mr. Barnett: The new relief will be extended to all genuine business assets . . The relief will apply to all assets of a farming business, including agricultural land, in so far as it does not benefit from relief for agricultural land under Schedule 8 of the Finance Act 1975 as modified by Clause 65 of this Bill. I hope that that will be considered a substantial additional relief.
> >
> > Mr. Graham Page: The business of providing tenanted property is excluded from this relief. I understand that perhaps if it is tenanted houses, but does it also apply to agricultural land? If one is in the business of providing tenanted agricultural land, does that get relief as a business?
> >
> > Mr. Barnett: If the right hon. Gentleman is referring to a landlord letting land, the answer is that the relief does not apply, but it does apply to a tenant, who would be entitled to the business relief on tenant's assets.'
>
> In my view, that ministerial answer covers the point in issue here."

In *Burkinyoung,* HH Stephen Oliver referred to the tests he had previously applied in *Martin* and observed of the property management activities of the deceased (at 14-15):

> "The construction sought by the taxpayer which seeks to distinguish between the operations of the active and of the passive landlord, is too vague and too dependent on degrees of involvement to have been what Parliament contemplated when the relief was designed.
>
> Here the whole gain derived by Mrs. Burkinyoung from the property came to her as rent. It all arose from the investment in the property and the leases granted out of it; it all arose from the making or holding investment activities carried on by her. She provided no additional services and so earned nothing from any other sources or activities. The business was, therefore, wholly one of making or holding investments and so is excluded from being 'relevant business property' by the words of s 105(3)."

The substantial activity test

The Courts eschew a minute dissection of the business activities as illustrated in the context of caravan parks in the case of *George & Anor v. Inland Revenue* [2003] EWCA Civ 1763. There, the deceased had held 85% of the shares of a company operating a residential caravan park with associated services and caravan sales, a site for caravan storage, and a club for residents and non-residents. The case turned on the correct allocation between 'non investment' (attracting relief) and 'investment' (not attracting relief) of the various activities and whether the consequentially identified 'investment' element of the business was extreme enough to deny relief. The Revenue asserted that there was an exploitation of proprietary rights over the land because it produced a profitable return and that this amounted to an investment under Inheritance Tax Act 1984 s 105(3). Special Commissioner Dr John Avery Jones had allowed the relief as because the caravan owners were paying for the site services rather than merely the right to enjoy the caravan pitch; and, thus, the holding and exploitation of the land was ancillary to the provision of services to the residents. Whilst Laddie, J. in the High Court applied *Weston v. IRC* and reversed the decision on the basis that the services to owners were merely ancillary services, the Court of Appeal took a broader view. It acknowledged there could be a wide spectrum extending from the exploitation of land by granting a tenancy coupled with sufficient services to make it a trade to mere property 'management' without additional services. The characterisation of services depended on the nature and purpose of the activity, not on the terms of the lease or site licence; and the caravan storage was investment, but only one part of the business and not the main one. As Carnwath LJ explained at paras 60 and 61:

> "[The provision] does not require the opening of an investment "bag", into which are placed all the activities linked to the caravan park, including even the supply of water, electricity, and gas, simply on the basis that they are "ancillary" to that investment business. Nor is it necessary to determine whether or not investment is "the very business" of the Company. The statutory language does not require such a definitive categorisation. In the present context, it gives insufficient weight to the hybrid nature of a caravan site business, as I have explained. The holding of property as investment was only one component of the business, and on the findings of the Commissioner it was not the main component. In my view, the Commissioner's overall approach was correct in law, and he reached a view which was open to him on the facts ... I find it difficult to see any reason why an active family business of this kind should be excluded from business property relief, merely because a necessary component of its profit-making activity is the use of land."

Similarly in *Seymour (Ninth Marquess of Hertford) v. Inland Revenue Commissioners* [2005] S.T.C. (S.C.D.) the taxpayer sought 100% relief on the whole value of the property notwithstanding that a small part was used other than for the business. Special Commissioner Judith Powell determined that in the absence of any statutory authority for an apportionment, as the property was in effect a single asset, eligibility extended to the whole value of the property.

The characterization for the other tax purposes

It is understandable that taxpayers and judges resort to definitions and principles found elsewhere despite the comment of Carnwath LJ in *IRC v George* (at para 12) that "cases relating to different taxes and different subject matter are unlikely to be helpful".

In *Phillips v Revenue and Customs Commissioners* [2006] S.T.C. (S.C.D.), the business of a company was solely the lending of money to related family companies to finance their purchase of property to be held as investments.

Special Commissioner Dr Nuala Brice noted that on 6 December 2000 the Revenue noted that 'the company's activities had changed and the company should no longer be treated as a close investment holding company.' The company was therefore treated, for corporation tax purposes, as a trading company from the tax year ending on 5 April 1998.

Finding that the activity was not of holding investments, Dr Brice emphasised that the correct test was to have regard to 'all the facts in the round', and (at para 39) that she had not been influenced by the description of the activities of the company in the directors' reports nor

> "by the treatment of the company for the purposes of corporation tax, bearing in mind the views of Carnwath LJ in *George* that cases relating to different taxes and different subject matter are unlikely to be helpful"

Commercial Reality

In *Clark v. Revenue and Customs Commissioners* [2005] S.T.C. (S.C.D.) a private company owned and managed properties in return for a management fee of which approximately 25 per cent related to building (i.e. trading) activity. In its balance sheet, the properties were described as 'fixed assets – investments.' Citing *Martin*, Special Commissioner John Avery Jones referred to his dicta in *George v IRC*, which was approved by Carnwath LJ:

> "There is a spectrum at one end of which is the exploitation of land by granting a tenancy coupled with sufficient activity to make it a business, which may be activity in granting tenancies rather than activity in relation to the tenancy once granted. At the other end of the spectrum, while land is still being exploited, the element of services means that there is a trade, such as running a hotel, or a shop from premises owned by the trader."
>
> Here one is at the former end of the spectrum. The Company's maintenance activity is not the separate provision of services; it is inherent in property ownership. As Carnwath LJ said in *George* at [27]:
>
> > "…I agree in general terms that property 'management' is part of the business of 'holding' property as an investment (cf *Webb* (*Inspector of Taxes*) *v Conelee Properties* Ltd [1982] STC 913 at 921, 56 TC 149 at 157). In the case of a building held for letting, management no doubt includes the activity of finding tenants and arranging leases or licences, and that of maintaining the property as an investment."

Accordingly, the Special Commissioner considered that in *Clark* the company's activity was principally a business of holding investments and consequently disallowed business property relief.

Control of a company

Under s. 269 Inheritance Tax Act 1984, the full 100% rate of relief is available only where the transferor has control. In *Walker's Executors v. Inland Revenue Commissioners* [2001] S.T.C. (S.C.D.) 86 the deceased had held 50 per cent of the shares in a company and, as chairman had been entitled to a casting vote at general meetings. Special Commissioner Theodore Wallace confirmed that as the deceased had 'control of the company' by virtue of casting vote 100% business property relief was available of in respect of the shareholding.

Reflections and Conclusions

The Inheritance Tax Act clearly establishes the sequence of enquiry for the application of the relief: is there a business; and if so, is it carried on for gain? But it fails to define 'business'. This has allowed the Tax Tribunals and Courts to have some considerable judicial consistency and develop a positive approach to applying Business Property Relief without any evident inconsistency with other fiscal treatment of a business. They have, quite rightly, followed the approach of Carnwath LJ in *George*: but this, in turn and rather incestuously, relied on the earlier analysis of Special Commissioner Avery Jones in that case. Moreover, despite fears that the purposive approach and reference to Hansard risked accelerating the abandonment of a strict constructionist approach and liberalizing the application of tax laws, there is ample counter evidence against excessive cross reliance upon extrinsic borrowed interpretations.

Borrowing approaches from VAT and Partnership law to resolve issues such as those raised in Beckman was sensible; but it remains to be seen whether a partnership without a trade could ever fall to be classified as a 'business'. No case (at least to date) offers a simple definition for the application of the relief, and like the "with a view of profit" in the Partnership Act 1890, cases often turn on their own particular facts – a point validly underlined by Dr Brice's "all the facts in the round" approach in *Phillips*.

Nevertheless, the generous approach to Business Property Relief does challenge the assertion of capital taxation as an inhibitor to business succession, and the author suggests that the inhibition might flow from the entrepreneurs' inadequate understanding of the relief, or possibly that the older generation deliberately characterises Inheritance Tax as a fiscal Bogeymen to delay succession. Furthermore, as the business retained by the older generation would attract the relief in contrast to the cash or paper debt flowing from a next generation buyout, it may be that the relief discourages succession. The answer thereto remains speculative ahead of any further research study!

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Auditor's Liability Towards Third Parties Within the EU: A Comparative Study Between the United Kingdom, The Netherlands, Germany and Belgium

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Abstract. Auditors' liability is a hot topic nowadays. Due to the increased risks of auditors and the lack of appropriate insurance, a limitation of auditors' liability seems appropriate. Based on the economic study of the London Economics, the European Commission issued a consultation paper to discuss a European harmonization of auditors' liability. But to harmonize a liability cap on auditors, one needs to examine not only the economic implications, but also the legal restraints and differences of auditors' liability regimes within the European Union. This paper shows that there are large discrepancies concerning auditor's liability towards third parties within the legal systems of the European Union. In Belgium an auditor is liable towards each interested party. However, the public role of an auditor is not acknowledged in the United Kingdom, the Netherlands and Germany. In those countries the purpose of audited statements is to fulfil the auditor's duty to the shareholders collectively and not to the stockholders as individual parties or third parties. In Germany, the Netherlands and the United Kingdom, an auditor has to encompass a special duty of care towards the third party to be liable. Only a special relationship of the auditor towards a third party could imply auditor's liability toward those parties. This element wasn't discussed in the London Economics Study. However, these findings could have a major impact on the debate to harmonize an auditor's liability cap because the more parties can pursue an auditor, the more damage can be claimed and the higher the liability cap needs to be fixed.

1. Introduction

Due to the increased market capitalization of companies during the last decade, the risk of auditing such companies has increased similarly. But at the same time, access to insurance for auditors has fallen sharply, especially for firms auditing international and listed companies, thus leaving partners in audit firms with an unattractive prospect of entirely supporting the liability risks themselves. Numerous financial scandals such as Enron, Worldcom, and Parmalat (etc.) underlined these issues.

This paper will show that there are large discrepancies concerning auditor's liability towards third parties within the legal systems of the European Union. To be able to litigate an auditor some legal systems require specific conditions of a third party. Four legal systems are to be compared: the United Kingdom, the Netherlands, Germany and Belgium. These findings will have serious consequences on the debate about the limitation of auditors' liability because the number of claimants and therefore the amount of damage could vary enormously.

2. A European initiative to harmonize auditors' liability cap

In pursuance of article 31 of the Statutory Audit Directive 2006/43/EC (OJ L 157, 9.6.2006, 87-107), the European Commission ordered a report concerning this debate, more specific on the economic impact of current national liability rules carrying out statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis on the limitations on financial liability. The extensive report of London Economics on the economic impact of auditors' liability regimes of September 2006 indicated that the current amount of high value actual of potential claims arising from statutory audits may entail serious financial consequences for audits firms. Since the current level of commercial insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States, the independence audit work could endangered. Within this debate, we may not forget the Enron-fraud already evolved in the elimination of one of the Big Audit Firms. Different solutions to resolve this extensive liability risk of auditors are to be debated.

In January 2007 the Directorate General for Internal Market and Services issued a consultation document on this matter, to be precise on the auditors' liability and its impact on the European capital markets. It proposes a liability cap for European statutory audit. Four options are to be considered:

(1) One single monetary cap for all EU member states,
(2) a cap depending on the company's size,
(3) a cap depending on audit fees charged to the company and
(4) proportionate liability.

Austria, Belgium, Germany, Greece and Slovenia already capped the liability of the auditors.

To harmonize auditors' liability and the limitation of auditors' liability in particular, it's necessary to study the different legal systems within the European Union. In this paper we highlight the major differences in some European legal systems on auditors' liability towards third parties. A Belgian auditor is liable towards each interested third party. In Germany, the Netherlands and the United Kingdom, an auditor has to encompass a special duty of care towards the third party to be liable. This means an evaluation will be made of two European common law systems versus two European civil law systems with some reflections to the American system, since this was an inspiration to some legal European systems. This element wasn't discussed in the London Economics Study, but is a significant issue in the liability limitation debate since the number of claimants and damage could differ enormously.

3. The United Kingdom

3.1. Liability of an issuer of a statement: *Hedley Byrne & Co v. Heller & Partners*-case

In the United Kingdom, the third party liability of an auditor is restricted. Numerous cases describe the necessary conditions for a third party in order to be able to rely on the auditors' statements.

The leading case concerning the liability of an issuer of a statement towards third parties, is the *Hedley Byrne & Co v. Heller & Partners*-case ([1963] 2 All ER 575). These third party liability principles were an inspiration for many auditor liability cases. In the *Hedley Byrne & Co v. Heller & Partners*-case the House of Lords ruled that a third party who had relied to his detriment on a negligent statement could sue the issuer of the statement, despite the absence of privity of the contract. For the first time the House of Lords recognised the possibility of liability for pure economic loss caused by a negligent statement was not dependent on any contractual relationship.

> Persons uttering statements owe a duty of care to any third person with whom a 'special relationship' exists. A special relationship requires more than a fiduciary contractual relationship. It can arise because of a voluntary assumption of responsibility by the defendant. "*All those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that, and where the other gave the information or advice when he knew or ought to have known that the inquirer was relying on him.*".

3.2. Auditor's Liability: *Caparo Industries v. Dickman and others-case*

The duty of care of an auditor to third parties was elucidated in the *Caparo Industries v. Dickman and others*-case ([1990] 1 All ER 568; AC 605).

The Court specified the necessary relationship, as mentioned in the Hedley Byrne case, between the maker of a statement or giver of advice (adviser) and the recipient who acts in reliance on it (advisee) may typically be held to exist where:

(1) *"the advise is required for a purpose, whether particularly specified or generally described, which is made known either actually or inferentially, to the adviser at the time when the advise is given,*
(2) *the adviser knows either actually or inferentially, that his advise will be communicated to the advisee, either specially or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose,*
(3) *it is known, either actually or inferentially, that the advice so communicated is likely to be acted on by the advisee for that purpose without independent inquiry and*
(4) *it is so acted on by the advisee to his detriment.*

That is not of course, to suggest that these conditions are either conclusive, but merely that the actual decision in the case does not warrant any broader propositions."

Based on this judgment a three pronged test for a duty of care is applied:

1. foreseeability of damage;
2. a relationship characterised by the law as one of proximity or neighbourhood (proximity) and
3. that the situation should be one in which the court considers it would be fair, just and reasonable that the law should impose a duty of care given scope on one party for the benefit of the other.

Proximity was the focus of the Caparo Court's legal analysis, given that foreseeability is not difficult to establish in many situations. Proximity exists when

(a) the professional knew that his or her work product would be communicated to a known third party or a known third party class;
(b) the third party suffered damage as a result of relying on the professional's work product;
(c) the work product was used for the purpose for which it was prepared.

The professional's knowledge includes not only actual knowledge but such knowledge as would be attributed to a reasonable person situated as the defendant. The knowledge requirement must be met at the time the work product is prepared.

The third requirement - that it should be fair, just and reasonable - was an additional restriction to Hedley Byrne principles. Based on this three-pronged test, the Court rejected the claim of Caparo Industries against the auditor of a company, Fidelity plc. The facts were that the plaintiff acquired shares in Fidelity based on the accounts of Fidelity as audited by the defendants, Dickman. Shortly after the plaintiff acquired the shares, it became clear that the reality of the financial position of the company was significantly worse than the audited accounts suggested. The Court ruled that in absence of special circumstances, an auditor of a public company owes no duty of care to an outside investor or an existing shareholder who buys stocks in reliance on a statutory audit.

According to the Caparo Court, the purpose of the audited statements is to fulfil the auditor's statutory duty to the shareholders collectively and not to the stockholders as individual shareholders or third parties.

3.3. The Caparo-case as a precedent

Likewise, in the *Al Saudi Banque v Clarke Pixley*- case ([1990] Ch 313), the court ruled that no duty of care is to exist of an auditor to the credit institution because the defendant/auditor had not issued his report to his client with the intention or the knowledge that the audit opinion would be communicated to the credit institution. Proximity required contemplation not only of a particular and identified recipient of the information but also of a particular and known purpose for which the defendant would foresee that the information would be relied on.

In 1991 the *James McNaughton Papers v. Hicks Anderson* Court ([1991] 1 All ER 134) narrowed the scope of the duty of care of an auditor to third parties which are directly intended by the maker of the statement to act on it. Six key elements highlight the auditor's liability to third parties:

(1) the purpose for which the information was prepared;
(2) the purpose for which the information was communicated;
(3) the relationship between the maker of the statement (the auditor), the informed (the client) and each interested third party;
(4) the size of the class to which the third party belongs;
(5) the degree of experience of knowledge of the maker of the statement;
(6) the extent of the third party's reliance.

Still, the Caparo-test is the foremost approved judgment to describe and reject the auditor's liability to third parties.

More recently, the Scottish High Court decided in the *Royal Bank of Scotland v. Bannerman Johnstone Maclay and others*-case (23 July 2002) – in the context of a strike-out-application – that in preparing audited accounts, company's auditors were legally responsible to a credit bank if they knew (or ought to have known) that the bank would rely on those accounts. In this matter, the Court rejected the auditor's (Bannerman) attempt to narrow the Caparo-test by imposing a requirement that to be liable the auditors must have intended that the

party seeking to establish a duty of care should rely on those accounts. The requirement of intent was not presented in Caparo itself.

According to this jurisprudence, an auditor can exclude his liability to all identified third parties by adding a disclaimer to his audit report. However in circumstances in which auditors are not aware that particularly identified third parties are to rely on audited accounts, such individual disclaimer will be meaningless.

4. The Netherlands

Whether third parties can rely on the information of the audit report is controversial in the Dutch jurisprudence and doctrine. Often inspired by some American principles, the public character of the audit report is not acknowledged. The purpose of the audit report is to inform the general meeting and the shareholders of the true and fair view of the financial statements as a basis to evaluate and possibly penalize the board's policy. More in particular the minority shareholders should benefit from the information in the financial statements and audit report.

But the Dutch jurisprudence and legal doctrine are not unanimous on this point. Several cases illustrate the auditor's liability to third parties.

4.1. Liability of an accountant

On the 28th of September 1983 (*NJ* 1985, 120), in a case concerning an accountant, the Den Bosch High Court recognized third party liability of the accountant based on the fact that an accountant's work covers 'the proprietary right of the company within judicial matters'. For this, an accountant accepts third party liability for his statements. Dutch legal doctrine criticizes this judgment for it's not the accountant but the (board of directors of the) company who's responsible for creating the financial accounts.

Similarly, in 1990, the Utrecht Court (Rb. Utrecht 18 April 1990, *unreported*) accepted accountant liability to third parties for the negligent composed annual account of a company. The accountant was reluctant to perform additional verifications which resulted in inaccurate financial statements. The Court based his decision on the following criteria:

(1) the accountant knew that the annual accounts were to be used to promote the company;
(2) the accountant should have realized that the annual accounts were to be used to attract financial resources;
(3) the accountant should have known that a rosy picture of the financial situation of the company could lead to transactions with third parties.

This decision is highly criticized among the Dutch doctrine: tort liability to third parties can only be derived from special circumstances such as known use of the financial statements, foreseeability, and the plausible use of the accounts for matters such as price setting of shares for a merger or acquisition.

4.2. Auditor's Liability

Especially related to audit, the Dutch jurisprudence focuses on the degree of expertise of the third party to uphold the auditor's liability.

In 1999 the Amsterdam Court decided that a credit bank can't rely solely on the audited financial accounts for it has its own, separate responsibility to lend funds to the audited company (Rechtbank Amsterdam 9 juni 1999, *JOR* 1999/195).

The Utrecht Court reached a similar decision on the first of March 2000 (*unreported*). In 1991 creditor Voorhout Beheer B.V. lent Akwarius B.V. the sum of 1.115.520 euro. However, on the fourth of December 1991 Akwarius B.V. was declared bankrupt. The credit bank tried to retrieve its losses from the auditor for his negligent statement. According to the Court's decision, the credit institution acted negligently in relying on the financial statements and the audit report to accommodate the money because it refrained from executing its own due diligence.

Only in special circumstances the auditors' liability to credit institutions as a third party is acknowledged, e.g. the explicit approval of the company to use the financial statements and the audit report.

The Zutphen judgment is equally auditor 'friendly' (Rechtbank Zutphen 12 December 2002, *NJ* 2003, 26). Only the company can rely on the audit report, which implies that the auditor mainly is liable to the company. The duty of care of an auditor to third parties can only be derived from Caparo-like criteria. One might

recognize the American *Ultramares* approach. According to the *Ultramares*-principle (*Ultramares Corp. V. Touche Niven & Co.*, 174 N.E. 441, 443 (N.Y. 1931)), an accountant is liable only for negligence to third parties who are in privity of contract (the state of two specified parties being in a contract) or privity-like relationships with the accountant. This doctrine provides the narrowest standard for accountants to be held liable to third parties for negligence.

On the 27th of June 2000 the Den Haag High Court (*JOR* 2001/70) rejected auditor liability to third parties by lack of foreseeability, similar to the American Restatement approach. The Restatement approach has been extracted from § 522 Restatement of Torts: "*One who, in course of his business, profession of employment, or in any other transaction in which he has a pecuniary intrest supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon information, if he fails to exercise reasonable care or competence in obtaining or communicating the information*." According to the Den Haag High Court an auditor has a duty of care to those third parties of which he reasonable might have foreseen that his fault could cause damage to those specified third parties.

More recently and surprisingly, on the 13th of June 2001 (*NJ* 2001, 445), the Den Haag High Court abandoned this approach by recognizing third party liability. The High Court stated that by issuing a public statement, the auditor is aware of the risks involved towards third parties. The amount of expertise of the third party was no issue in this debate.

The High Council has not decided yet on this matter. However, concerning different but similar liability matters, the court focused on the credit institutions' own responsibility to analyze the financial statements. Therefore, a lead manager may not rely on the accuracy of the financial statements of the issuer (HR 2 December 1994, *NJ* 1996, 246). Similarly, the High Council rejected the duty of care of an accountant to a third party which relied on the negligent information of the accountant (HR 9 juni 1995, *NJ* 1995, 692). The High Council stated that the third who acquired a considerable number of shares of the company, should have performed its own due diligence to examine the value of the company ('s shares).

5. Germany

The German system is similar to the approach in the Netherlands and the UK.

Based on the principles of tort law, the liability of a German auditor or Abschlussprüfer to third parties is restricted. Since no explicit regulations on auditor liability to third parties are in place, the German doctrine and jurisprudence tried to resolve this loophole in the law by applying different tort law techniques: the (bloße) Auskunftvertrag, the Vertrag mit Schutzwirkung zugunsten Dritter and the Garantievertrag.

5.1. Bloße Auskunftvertrag

The jurisprudence of the Bundesgerichtshof, acknowledges that a statement such as an advice could accomplish under different circumstances an implied agreement or bloße Auskunftvertrag to third parties. The Bundesgerichtshof decided that an Abschlußprüfer consented tacitly to the third party if the information which was issued – namely the audit report – was essential for the third party to take a certain decision. Irrelevant is the question whether both parties – the Abschlußprüfer and the third party – wanted to contract. However, special circumstances should be met to establish a (bloße) Auskunftvertrag.

First, the Abschlußprüfer should have known his report was of great importance for the third party to take his decision. Second, the issuer of the information should have a certain degree of expertise which infuses special confidence into its clients or third parties. Concerning the audit work, an Abschlußprüfer will always possess the required expertise to meet with this last condition. This legal concept, established mainly by jurisprudence, was seriously criticised by the German doctrine imposing that this mainly fictious concept doesn't comply with the consensus ad idem requirement of contract law. This consensus is not in place within the concept of the (bloße) Auskunftvertrag. To meet this criticism the jurisprudence nowadays obliges an explicit consensus for this legal concept.

5.2. Garantievertrag

Another approach to the issue of the liability of an auditor is the Garantievertrag. The Garantievertrag is a more evolved type of the above mentioned Auskunftvertrag. By issuing a Garantievertrag in the audit report, the Abschlußprüfer guarantees the content of the audit report. The basis of this legal concept is found in the special

position of the Abschlußprüfer within the legal system for he knows that his audit work will be used by interested parties because his report is to be published.

The application of this Garantievertrag is obviously more limited in comparison by the Auskunftvertrag. The Abschlußprüfer only guarantees the accuracy and correctness (Richtigkeit seiner Auskunft) of his public statement and not the carefulness of his audit work. Therefore, based on this theory, an Abschlußprüfer can limit his audit work to a strict minimum of shallow supervision and publish a condensed report. Since this isn't the purpose of an audit, this approach is not appropriate to use in the auditor's liability issue.

5.3. Vertrag mit Schutzwirkung zugunsten Dritter

Finally, the Vertrag mit Schutzwirkung zugunsten Dritter could be applied to determine the auditors' liability towards third parties. For this issue, this approach is widely accepted among the jurisprudence and the doctrine. According to the Vertrag mit Schutzwirkung zugunsten Dritter, both contractors could have accepted in behalf of third parties (some of) the implications of the agreement. Occasionally, the mutual consent to imply the agreement to third parties is contracted tacitly by means of a '*stillschweigenden Vereinbarung*'. Thus, the contract between the audited company and the Abschlußprüfer could embrace a protective function towards third parties (*Schutzwirkung zugunsten Dritter*).

The legal foundation of this approach is not to be found in the explicit consent between the contractors, but in the principle of Treu und Glauben, meaning the protective function is fair and reasonable. However, the protective function or Drittschutz is not indefinite because several requirements describe the limitations of this approach to third parties.

- Leistungs- oder Vertragsnähe: the risk of the third party should be equal to the risk the contractor – the audited company – has to endure caused by the negligent performance of the auditor's duties. Based on this requirement, individual investors or stockbrokers seem to be excluded from the protective function of the Vertrag mit Schutzwirkung zugunsten Dritter.
- Glaübigernähe: a special relationship has to exist between the third party and the audited company by virtue of which the Abschlußprüfer has a duty of care to the third party. The Glaübigernähe is at hand as soon as it is contracted between the Abschlussprüfer and the audited company. It is accepted if the contract stipulates some kind of special interest to safeguard a third party. This subjective requirement is supposed to be on hand if the Abschlußprüfer is commissioned by the company to issue a statement which will be made public to third parties.
- The Abschlußprüfer knew or had to know he owed a duty of care to a third party and vice versa, the third party had a considerable interest in the good performance of the contract between the auditor and his client, the audited company.

To apply this approach, the Bundesgerichtshof decided in 1985 that it is necessary that the third party and the contractor of the adviser have equal interests.

This approach makes it possible for third parties to compensate economic losses caused by false or misleading information and audit reports issued by the company or Abschlußprüfer. However, not even this last approach is without criticism for this artificial approach ascribes much prerogative power to the courts.

6. Belgium

6.1. The public role of a Belgian auditor

In Belgium, the liability of the auditor is not restricted towards third parties. By virtue of article 140 of the Belgian Company Code and the common liability principles a Belgian auditor is liable towards each interested party. Since the financial information and the audit report have to be published, third parties are able to rely on that information.

Since the seventies, the public role of the auditor is acknowledged. By ordering the mandatory publication of the financial information, the Belgian legislator wanted to emphasize the information is meant not only to inform the shareholders or the company, but the public in general. Similar to the publication of the financial information, due to the performance of an audit by an independent and certified professional and the publication of it's report, all parties involved are equally informed of the value of the public statement. So, the audit report is a public mechanism to inform all interested parties.

The auditor doesn't act solely in the interest of the company, but also in the general interest. This means that all users of certified financial information could found their decision on the public report. Therefore, not

only the shareholders or the company are entitled to rely on the audit report, but all stakeholders (e.g. employees, creditors, …) and other interested parties. No legal or juridical limitations are enforced: a claimant has to prove that the negligence of the auditor has caused the damage he suffered. As for the company, this implies that all third parties who relied on the financial information and the audit report to make a damaging decision could take legal action against the auditor to recuperate its economic losses.

6.2. Jurisprudence

Despite this 'tolerant' legislation, few cases of auditor liability towards third parties exist in Belgium. Three remarkable cases are to be considered.

In 1989 the liability of an auditor was upheld by the Belgian tax authorities (Rb. Brugge 6 november 1989, *F.J.F.* 1990, 44). According to article 633 of the Belgian Company Code, a general shareholders' meeting is to be convened either by the board of directors or the auditor, when, as a result of losses, the Company's equity has decreased to less than half of the Company's share capital. The general shareholders' meeting must deliberate and resolve on the dissolution of the Company or possible other measures.

The Belgian tax authorities claimed the auditor was negligent to notify the shareholders' meeting in accordance with article 633 of the Companies Code. They argued that if the shareholders meeting was convened the company wouldn't have gone bankrupt and (most of) the indebted taxes would have been paid. The ability of the tax authorities to act as a claimant in a procedure against an auditor wasn't questioned by the court. However, the Bruges Court rejected the auditor's liability uttering the causal connection between the negligence of the auditor and the economic damage of the tax authorities wasn't proved. No evidence existed that if the shareholders' meeting was convened the indebted taxes would have been paid.

Also credit institutions are acknowledged as third parties in auditor liability cases. No specific requirements e.g. expertise, as is essential in the Netherlands, exist.

In 2002, a credit institution filed a suit against an auditor to recuperate its losses due to a judicial composition (Gerechtelijk akkoord) by the company (Kh. Hasselt 25 juni 2002, T.R.V. 2003, 81). Due to this similar to the Chapter 11 in the United States-procedure, the credit institution let the company off some debts. The credit institutions wanted to recuperate its losses from the auditor as they declared that the audited financial statements were used to evaluate the company's financial situation on which basis the funds were granted. So according to the credit institution the false audit report led to the damage it endured. Similar to the tax authorities-case, the interest of the credit institution to file a suit against an auditor wasn't questioned. The Hasselt Court approved the credit institution's argumentation for it was clearly prearranged that a positive audit of the financial statements was a prerequisite for the credit institution to allow the funds.

On the 12th of December 1996, the Brussels Court upheld the auditors' liability towards a new shareholder of a company (*T.R.V.* 1997, 41). For the acquisition, the price setting of shares of the company was based upon the annual accounts, audited by the company's auditor. Within months after the acquisition, different corrections (e.g. a considerable amount was transferred as exceptional expenses) concerning the annual account were made as result of which it was obvious that the annual account did not represent a true and fair view of the company's financial situation. The Brussels Court acknowledged the claimant's argumentation that if the auditor had issued an unqualified audit report or an adverse audit opinion, the claimant would have been informed about the misleading data in the annual accounts before deciding to acquire a number of shares.

As mentioned before, according to the Belgian legal system, no additional requirements exist for an auditor to be liable towards a third party. However, only few cases exist on this matter. One of the most important motives can be found in the difficulty to acknowledge the causation between the auditors' statement and the third party's decision: one has to prove the audit report (directly of indirectly) influenced their decision: without the auditor's fault, the decision wouldn't have been taken and the damage wouldn't have occurred. For this, the claimant first of all has to prove he actually utilised the audit report before taking his decision. Secondly it must be proven that the financial information and annual accounts would have been different if the auditor had not been negligent. Thirdly, a claimant has to prove he would have taken another decision if the information had been presented correctly.

7. One single monetary liability cap for all EU member states?

Whether auditor's liability should be capped, is not the focus of this paper. Different studies, especially the London Economics report studied this question. Five EU Member States (Austria, Belgium, Germany, Greece and Slovenia) have already chosen to cap auditor liability. The UK has recently introduced a regime of auditor

liability limitation agreements into law and also the Italian and Spanish legislators are currently considering bringing in laws limiting auditor liability. In the US, the Committee on Capital Markets Regulation has expressed concern that the present level of auditor liability could result in the bankruptcy of an audit firm, with what it describes as "*devastating results to corporate governance in the United States and the rest of the world*" and has recommended that the US Congress explore protecting auditing firms from catastrophic loss.

This paper examines the question whether all EU liability regimes could be harmonized and one single monetary liability cap for all EU member states is advisable.

As mentioned, there are large differences between the legal systems of auditor liability of the studied EU Members States, especially concerning third party liability. The public role of an auditor is not acknowledged in the British, Dutch or German legal system. Only special circumstances could compromise the auditors' liability towards third parties. According to the Belgian regime, each interested third party can be involved in a liability claim towards a negligent auditor. Compared to the restricted British, Dutch or German legal regimes, potentially more parties and thus more damage, could be involved in a liability claim towards a negligent auditor. Due to these differences, one single monetary liability cap is not preferable. The cap should be adjusted to the legal regime of each EU Member State. The more parties potentially involved, the higher the liability cap should be regulated.

8. Conclusion

To discuss the harmonization of legal cap on auditor's liability, one might recognize not all legal liability systems in the European Union are equal. This paper examined the auditors' liability towards third parties of four countries: the United Kingdom, the Netherlands, Germany and Belgium. In Belgium, each interested third party, e.g. tax authorities, a credit institution etc., is allowed to pursue a liability claim against an auditor. The British, Dutch and German legal systems necessitate special requirements, e.g. foreseeability, proximity (etc.) for a third party to be able to pursue the auditor.

For two reasons, these findings are of major importance in the debate concerning the limitation of auditors' liability. First of all, a liability cap will be more appropriate in countries with a 'tolerant' legislation towards third parties because potentially more parties will be involved in a liability claim against an auditor. Secondly, the amount of liability cap should be higher in countries with a 'tolerant' legislation towards thirds as potentially more parties are implicated and as such more damage is to be recuperated from the negligent auditor.

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Recent Developments of Corporate Governance in the Global Economy and the New Turkish Commercial Draft Law Reforms

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Abstract. Corporate governance in a globalized economy has become one of the most important topics for the business environment and the governments. The proper implementation of corporate governance regulations by the companies bring out advantages for companies and the countries. High quality status of corporate governance means low capital cost, increase in financial capabilities and liquidity, ability of overcoming crises more easily and prevention of the exclusion of soundly managed companies from the capital markets. For years OECD has been working to promote use of the corporate governance principles since they were first issued in 1999 and revised in 2004 to support good corporate governance policy and practice both within OECD countries and beyond. In accordance with the developments in the global market the Capital Markets Board of Turkey issued the corporate governance principles of Turkey for the listed companies in June 2003 and amended these principles in 2005. Most recently, the new Turkish Commercial Draft Law proposes important changes and reforms for corporate governance in Turkey.

Keywords. Corporate governance, corporate law, Turkish Commercial Draft Law, Turkish trade law, corporate governance in Turkey

1. Introduction

Recently, the corporate governance in a globalized economy has become one of the most important topics for the business environment and the governments. A series of corporate scandals caused billion dollars of loss and this made a destructive effect on the investors' trust (Macavoy and Millstein, 2004, pp. 1-3). Some of the biggest companies in the U.S.A. and Europe such as Enron, Worldcom, Arthur Andersen and Parmalat, became bankrupt rapidly (Widen, 2003, p. 961; Elson and Gyves, 2003, p. 855; Enriques and Volpin, 2007, p. 123). It is widely accepted that bad management practices have triggered these company scandals. Recent developments in global economy have proved that the companies shall have more responsibility against all beneficiaries including employees, directors, shareholders, stakeholders, customers, suppliers and the society as a whole. Today there is no doubt that the companies shall be more accountable and transparent. In U.S.A. and Europe the legislators enact rules that are based on the management system having ethical standards rather than just free market principles.

For example in U.S.A., in response to these financial scandals and the demands raised by international investors to protect shareholders and the general public from fraudulent practices in the companies, a legislation called Sarbanes Oxley Act [1] has been enacted (Lander, 2004; Chandler and Strine, 2004; Ribstein, 2002). The basic aim of this Act is protecting the rights of the investors by increasing the reliability and accountability of the financial reports that are disclosed to the public by the companies. According to this Act, the enforcement to abide by these principles has been assured by the immediate threat of excluding such firms from stock exchange markets and there are serious sanctions for the directors and consultants of these companies in case of violation. Despite these, the legal regulations are not sufficient to prevent high profile scandals. It should be noted that no matter how harsh rules are set and enforced the bottom-line in the ultimate goal relies heavily on the inner dynamics of the corporations, namely good and proactive governance.

In order to prevent the above-mentioned problems and ensuring the accountability, transparency and good management of the companies, a system called "corporate governance" has been invented. The term "corporate governance" was first used in USA and afterwards has been a subject for various debates, academic works and international documents (Gilson, 1996; Longstreth, 1991; Gilson and Kraakman, 1991; Williamson, 1984).

For years the OECD has been working to promote use of the corporate governance principles since they were first issued in 1999 and revised in 2004 to support good corporate governance policy and practice both within OECD countries and beyond. [2] In light of above-mentioned developments, the Capital Markets Board of Turkey (hereinafter "CMB") issued the corporate governance principles of Turkey [3] for the listed companies in June 2003 and amended these principles in 2005. The CMB principles set forth corporate governance principles under four sections; shareholders, public disclosure and transparency, stakeholders and board of directors. For all corporations, the regulatory framework for corporate governance is in Turkish Commercial Code (hereinafter "TCC") and recent changes have been made to this regulation by Draft Turkish Commercial Code (hereinafter "The Draft Code"). This paper focuses on the developments of corporate governance in Turkey especially those made in the Draft Code.

2. Definition

Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. As a result different people have come up with different definitions that basically reflect their special interest in the field. It is hard to see that this "disorder" will be any different in the future so the best way to define the concept is perhaps to list a few of the different definitions rather than just mentioning one definition.

According to the OECD definition, corporate governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return (OECD, 2004). It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations. A similar definition is made by Monks and Minow, corporate governance is the relationship among various participants [chief executive officer, management, shareholders, and employees] in determining the direction and performance of corporations (Monks and Minow, 1995). According to Sir Adrian Cadbury corporate governance is holding the balance between economic and social goals and between individual and communal goals (Cadbury, 2000). The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economics and discourage fraud and mismanagement. Margaret Blair states that "Corporate governance is about "the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated." (Blair, 1995, p. 19)

Governance is ultimately concerned with the alignment of information, incentives and capacity to act (Monks and Minow, 1995). It involves the monitoring of the corporation's performance and the monitor's ability to observe and respond to that performance. Insufficient and/or unclear information may hamper the ability of the markets to function, increase volatility and the cost of capital, and result in poor allocation of resources (La Porta *et al.*, 2000). It is apparent that market forces for transparency would be weaker where ownership is concentrated. This partially explains the lack of strong disclosure tradition in Turkey. Weakness in standards of transparency and accountability allow corporate management (therefore major shareholders) to avoid disclosure and manipulate markets by misinformation. These weaknesses are conduit to asset transfers and asset stripping. Effective disclosure requires legally mandated disclosure requirements, good accounting standards, independent auditors, and enforcement. These standards are highly significant in ensuring that stakeholders have sufficient, timely, credible, comprehensible and cost-effective information to monitor the company's performance (Gilson, 1996).

Effective governance needs stem from the structure of these huge corporations, the fundamental conflict arising from the separation of ownership and control (Berle, 1958). Clearly, good corporate governance practices will emerge from effective application of full transparency, sound auditing and compliance mechanisms (Pound, 1993).

This shows the importance of the sound corporate management practices. Empirical studies indicate that international investors now better realize the significance of corporate governance practices on the financial performance of companies and while adopting investment decisions, international investors believe that this issue bears more importance for countries that are in need of reforms, and that they are more ready to pay higher premiums for companies having sound corporate governance practices (Lipton, 1987; Yuksel, 2004, p.38).

Several studies have been and are still being realized in the area of corporate governance. These studies emphasize the fact that no single corporate governance model is valid for every country (Roe, 2003; Roe, 1993).

Accordingly, the model to be established should be compatible with the conditions peculiar to each country (Black and Kraakman, 1996). However, the concepts of equality, transparency, accountability and responsibility appear to be main concepts in all international corporate governance approaches that are widely accepted (Shleifer and Vishny, 1997). Equality means the equal treatment of share and stakeholders by the management in all activities of the company and thus aims to prevent all possible conflicts of interest. Transparency, on the other hand, aims to disclose company related financial and non-financial information to the public in a timely, accurate, complete, clear, construable manner and easy to reach at low cost, excluding the trade secrets and undisclosed information. Accountability means the obligation of the board to account to the company as a corporate body and to the shareholders. Finally, responsibility defines the conformity of all operations carried out on behalf of the company with the legislation, articles of association and in-house regulations together with the audit thereof.

3. Corporate Governance in Turkey

In Turkey corporate governance principles are regulated in TCC and CMB's corporate governance principles. Even if the regulatory framework became satisfactory after amendments in the Draft Code some challenges still remain (Hacimahmutoglu, 2000). Family-controlled groups of companies are a common feature of the Turkish business scene, often with a high degree of cross-ownership between companies. Controlling shareholders often play a leading role in the management and strategic direction of company groups, many of which include companies that are listed on the Istanbul Stock Exchange. Without effective safeguards, however, there is potential for abuse, for example in situations where controlling shareholders impose commercial conditions that go against the interests of the company as a whole and minority shareholders. Market discipline – defined as the power of financial markets to persuade companies to meet corporate governance standards or risk public criticism, lawsuits or a sell-off in their shares – is still relatively weak. In order to solve this problem;

- the laws on deals involving related parties shall be strengthened, for example by implementing proposed amendments to Turkish company law requiring more disclosure about deals between companies that belong to a group and requiring controlling companies to compensate controlled companies for losses resulting from the exercise of control.
- Publicly held companies shall be required to give more detailed and easier-to-understand disclosure about who owns them and controls them, proposes tougher penalties for breaking the law and encourages the authorities to focus more resources on enforcing these laws.

Also in Turkey there is a need for supervisory, regulatory and enforcement authorities to have the power, integrity and resources to act professionally and objectively. Independent regulators like the CMB need stable funding, freedom to decide how they spend their budget and clear support from government. The continued strong leadership and independence of the CMB and other independent financial sector authorities are crucial for the long-term vitality of the corporate sector in Turkey and the economy as a whole.

The Turkish accounting system is not compatible with the International Accounting Standards (IAS). This discrepancy restricts investors' ability to make informed decisions about investment alternatives. A research jointly undertaken by seven major global accounting and auditing firms compares written national accounting standards of sixty-two countries and benchmarks them against IAS. It is apparent that Turkey is one of the four countries (Lithuania, Slovenia, Morocco and Turkey) where national standards have at least one major difference from IAS and it is the only country with deviation in more than one area. It is reported that in two key areas, the absence of Turkish rules leads to important differences from IAS: In addition adjusted reporting and mandatory financial consolidation for parent enterprises. This benchmark is based on the accounting standards issued by the CMB. There is no set of generally accepted accounting principles that applies equally to all companies operating in Turkey other than general rules that govern the aspects of accounting in the Tax Procedures Code and the Uniform Chart of Accounts which prescribe a code of accounts and a format for presentation of financial statements. Indeed, CMB has issued draft standards on accounting and consolidation in line with IAS requirements; however the changes required in the tax code are pending to be discussed in the parliament after several postponements (Ararat and Uğur, 2003, pp. 58-75).

In Turkey compliance with requirements is assured by internal audits, external audits and regulatory audits. The internal audit framework is denned in the TCC, but the provisions are vague. External audits are required only for listed companies. External auditors have to be certified by CMB. The Independent Audit Association founded in 1988 does not have statutory position to self-regulate the profession. It is arguable that the audits are credible and objective. In case of failures, the ISE and the CMB can issue private and public

warnings, impose penalties, suspend trading or may put the companies on a ‘‘watch list’’ (companies on watch list can trade for only 30 minutes per day). Regulatory audits are conducted by the CMB or by external auditors appointed by the CMB in case of complaints, suspects or when there is a need such as in the case of mergers and acquisitions. Although the existing regulations and the planned improvements present significant improvements, compliance is still a problem to be addressed.

In Turkey, the fundamental document governing the shareholders' rights is the company's articles of association – which should provide for the rights to participate in the general assembly, to vote and acquire information, to have the company audited, to .le a complain, and to take civil or legal action. There are no mandatory provisions in the TCC. In addition, the TCC provides for privileged shares and imposes practically no limit to the extent of privileges that may be granted – including multiple voting rights, pre-determined dividend rate, priority entitlement at the time of liquidation etc. Minority rights start from five percent for public companies and ten percent for non-public ones according to the TCC. Shareholders can vote by notarized proxy by appointing a representative through a power of attorney; however the procedure is complicated and costly.

Empirical evidence shows that based on a study of a cross sample of countries including Turkey, issues pertaining to stakeholders rights are generally covered by the relevant country's own legislation (law of obligations, law of execution and bankruptcy, law of labor, etc.). Moreover, it was generally observed that no separate division was devoted to stakeholders' rights within the principles of corporate governance. However in some other cases it was observed that stakeholders' rights were dealt with under a separate heading within the principles of corporate governance. For instance, examining the European Union reveals that, some regulations aim to increase the employee participation in the governance of companies and there is a gradual shift within companies to incorporate this issue within their principles of corporate governance. In Turkey the stakeholder's rights are not protected properly by TCC; however, the Draft Code by complying with international standards enacts stakeholder rights too.

The CMB monitors implementation of the CMB principles. In 2005 it reviewed all listed companies' 2004 Corporate Governance Compliance Reports, published a survey about listed companies' implementation and held follow-up discussions with company representatives and advisers to discuss the results. A similar review is done in 2006. The CMB has issued financial reporting standards based on the IFRS that were in effect as of January 2003. For the financial years 2003 and 2004, the CMB permitted publicly held companies to satisfy the CMB's financial reporting obligations by complying either with the CMB's new IFRS-based standards (specified in Communique XI: No. 25) or the pre-existing CMB standards (specified in Communique XI: No. 1) since 2005, all listed companies except banks have been required to publish audited financial statements prepared either in accordance with the CMB's IFRS based standards or current IFRS. On the other hand CMB issued corporate governance standards in 2003 and revised them in 2005. The CMB principles represent a statement of governance practices which reflect international good practice standards. Briefly, CMB Principles state;

Shareholders:

- The scope of the shareholders' right to obtain accurate information is extended by a recommendation on inserting a special provision in the articles of association, which would allow this right to be exercised more effectively,
- Companies should have in-house regulations consisting of provisions that would enable important decisions to be adopted at the general shareholders' meeting only,
- The effectiveness of voting rights should be increased and Principles limiting voting privileges of shares should be included,
- Principles should be adopted in order to remove any impediment to the free circulation of shares,
- Sound record keeping practices and the update of these records has strongly been advised.

Public Disclosure and Transparency:

- Shareholders and investors of a company need to have regular access to reliable and accurate information about the management and legal and financial status of the company.
- The aim of the principle on public disclosure and transparency is to provide shareholders and investors accurate, complete, and comprehensible and easy-to-analyze information, which is also accessible at a low cost and in a timely manner.

- While disclosing information, the company is recommended to use most basic concepts and terminology and avoid using vague or indefinite expressions that would result in confusion.
- Disclosed information should be unbiased. Any information disclosed to benefit the information needs of a particular group of shareholders as opposed to others is unacceptable.
- Under no circumstances should a company refuse to disclose information, which is required to be publicly disclosed, even if such information may be detrimental to the company. However this information shall not contain trade secrets.

Stakeholders:

- The stakeholders benefit from sound management and protection of the capital of the company. Disclosure of the company's operations to the public in an honest, reliable and transparent manner therefore enables the stakeholders to be informed about the status of the company. Within this context, the strict adherence to the corporate governance principles is both vital and essential from the stakeholders' point of view.
- Taking into consideration the fact that effective communication and cooperation between the company and its stakeholders is advantageous for the company in the long term, the company should respect the rights of its stakeholders that is protected by law and mutual arrangements and contracts and secure stakeholders' rights.
- To be able to minimize any possible conflicts of interest that may arise between the company and its stakeholders and within the stakeholders, well-balanced approaches should be adopted and these rights should be considered as independent.

Board of Directors:

- The board of directors should fairly represent the company within the framework of the relevant legislation, the articles of association and the in-house regulations and policies.
- In adopting and applying the decisions, the board of directors should aim to raise the company's market value to the maximum extent possible.
- While managing the company, the board of directors should ensure that the shareholders acquire long-term and stable income.
- In conducting its business, the board should pay special attention to maintaining the balance between the interests of the shareholders and the company's growth prospects.
- The board of directors should perform its functions in a rational manner and act in accordance with the rules of good faith through maintaining the balance between interests of the company and the shareholders and stakeholders.
- The board of directors should be composed in a manner to enable utmost efficiency thereof and to perform its decision-making, management and representation duties independently, free of any conflicts of interest and influence. Level of skills, experience and degree of independence of the board members will serve as a useful tool in determining the performance level and success of the board of directors and therefore directly affects the success of the company.
- The independent board members are assumed to be objective in decision-making and have the natural advantage to praise the interests of the company, shareholders and stakeholders equally.

4. Complying with Corporate Governance Principles

Compliance programs are on the priority list of leading corporations of the world. In this regard, those Turkish firms that are internationalizing can benefit largely from the application of this widely accepted risk management method. Two major factors are taken into consideration when developing such a compliance program: based on norms (written rules and law), and based on ethics (virtues) (Berenbeim, 2005). Based on norms approach is about the firms abiding by the common law. Ethics based approach, also referred to as the behaviorist approach, is about the firms' everyday actions and practices complying with the values and virtues (Worthington, 2005, p.1). In this latter approach, firm has the initiative to choose and implement among various practices not based on norms but largely on free will. An effective compliance program should entail these six factors: a) setting compliance standards by the employees, b) delegation of responsibility to top management, c) providing

effective communication among all employees, d) making rational moves to reach compliance such as controlling, auditing, and employee reports, e) standardizing the application of the program items, and f) to retaliate and to prevent wrongdoings. Designing the work according to the law in affect, setting priorities, determining responsibilities, printing handbooks and procedures, training employees, and updating programs are the main determinants of success of these compliance programs. Compliance programs will benefit firms in many ways. By detecting unlawful practices firms can help reduce responsibility for managers and other employees. Firms can resolve prior conflicts using these compliance programs. Firms can also gain from such programs by designing the underpinnings of their organizational culture and educating their employees about the risk bearing law related issues.

An effective corporate governance system is mandatory for the betterment of the markets and economic development. In the Turkish setting, even though political stability and the macro economic indicators show improvement, a fully trustworthy investment environment has not been achieved, yet. Capital markets still can be characterized to provide low liquidity, short term, limited and high cost capital. In those economies where management scandals and poor governance practices prevail, managers steal from shareholder, majority shareholders steal from minority shareholders and the public. When we look at the big picture, in such examples the resources are wasted. In the global economy, it should be noted that, those firms with good and effective corporate governance will undeniably be much more valuable than those that lack such practices. Higher standards of corporate governance combined with the accountability of those who manage the vast resources will enable trust among investors all around the world and in Turkey.

According to Schneider, there are eight steps in developing a culture of compliance (Schneider, 2006). First, establishing a vision for reasonable compliance system design is required. Having a clear and shared understanding of the reasons of such a program, its consequences and benefits is the essence of having such a vision in the first place. Second, organizing the effort by evaluating prior efforts and identifying key stakeholders is necessary. Third step is to determine the compliance requirements. For this purpose applicable laws and regulations and relevant business practices should be considered. Forth, mapping these laws and regulations to the relevant business activities and to the functional areas that are responsible. Fifth, prioritizing compliance requirements using a risk-based approach is advised. Sixth, drafting, reviewing and approving policies and procedures gives us an initial program to work with. Seventh, a company should launch and implement this compliance program by means of first training employees and then communicating this effort to investors. Lastly, an annual review comprised of self-assessment, testing, escalation, and reporting is suggested. In this comprehensive model, companies are encouraged to perform a risk-based assessment of the current state of affairs on an ongoing basis. Schneider suggests that becoming compliant is more than putting policies and procedure in place (Schneider, 2006). Truly developing a "culture of compliance" requires leaders who clearly articulate the importance of compliance to the organization and who follow through with in-depth training for everyone. Employees at all levels must understand their responsibilities and how they support the organization's compliance efforts. Training should be an ongoing effort, not just a crash course.

5. The Draft Code

The proper implementation of these regulations by the companies will bring out advantages for companies and the countries. High quality status of corporate governance means low capital cost, increase in financial capabilities and liquidity, ability of overcoming crises more easily and prevention of the exclusion of soundly managed companies from the capital markets. On the other hand, with respect to the country, sound corporate governance means improvement of a country's image, prevention of outflow of domestic funds, increase in foreign capital investments, increase in the competitive power of the economy and capital markets, overcoming crises with less damage, more efficient allocation of resources attainment and maintenance of a higher level of prosperity.

The Turkish Commercial Code was adopted in 1956 and remained in effect for fifty years. When it came to effect, it was inspired by the best codes of its age and since then, most of the provisions remained same despite international commercial improvements in fifty years. The need to regulate trade law as per, recent developments in the local and global business environment, technological and legal developments and the requirements of Turkey's integration to the European Union, was the occasion of the efforts to modernize the TCC. European Union Commission's recommendation to start negotiations with Turkey introduced the obligation of not only harmonizing Turkish commercial regulations to EU *acquis communautaire* but also following the EU's action plans with respect to the commercial law. In accordance with these, the Draft Code

shall regulate dynamic provisions to reconcile with the economic and technological developments and the commercial laws of the European Union member states.

On the other hand, extension of internet usage in every area has affected commercial law positively. Beginning with entrance into contract by electronic signatures, exchanging business documents and calling the directors, personnel, shareholders to meeting by e-mails or voting by e-mails addressed the need to change regulations in accordance with these developments. Since the beginning of 2000s, e-trade is used widely in Germany, France, Scandinavian countries and most of the other states. The Draft Code shall reflect these developments.

In light of these facts the new Draft Code shall govern social responsibility of the companies and take corporate ethical standards into consideration.

The relevant Commission of the Ministry of Justice presented the Draft Code for public opinion in late February 2005. The Commission has paid particular focus to electronic transactions, consumer protection, minority shareholders' rights and corporate governance.

The global and national developments as the reason for modernizing the Turkish Commercial Code;

- The global economic developments,
- Harmonizing Turkish commercial regulations to EU Legislation (*acquis communautaire*),
- Technological developments and the extension of e-trade,
- Growing global competition,
- Establishment of the World Trade Organization,
- Aim to play a significant role in international markets,
- Insufficiency of the Turkish Commercial Code as to the new legal needs.
- In accordance with the above mentioned developments;
- The Draft Code has been regulated in a way which helps the judges solving the new legal needs.
- The requirements of Turkey's integration to the European Union have been met,
- Corporate governance principles have been regulated in the Draft Code,
- Besides shareholders rights, the stakeholders rights have been protected in the Draft Code,
- The capital protection, public disclosure, transparency and accountability principles have been regulated in the Draft Code,
- The organs of joint stock companies have been regulated in a global view,
- The independent auditing companies have been given more efficient and active role in the Draft Code,
- Turkish Commercial Code, which is the main legislation for the Turkish companies to compete with international companies in the global market, has been modernized.

According to a Report prepared by OECD Corporate Governance in Turkey: A Pilot Study evaluates Turkish corporate governance standards and practices in light of recommendations in the OECD Principles of Corporate Governance. Turkey has a strong regulatory framework for corporate governance, according to the report. Disclosure to the market by listed companies is improving, and international standards for accounting and auditing are being introduced. The report urges the Turkish government to adopt as soon as possible proposed amendments to Turkish company law, including a proposal to centralize the process for setting accounting standards under the Turkish Accounting Standards Board. The report also examines the Draft Code about corporate governance standards.

5.1. Trade Registry and Commercial Records

Important changes are proposed in the Draft Code regarding the trade registry and the function of registrations. The authorized bodies to keep track of company records are defined exhaustively as the chambers of commerce and chambers of industry. Furthermore, the Turkish Union of Chambers and Stock Exchanges is required to establish and maintain an online data room, where any and all issues required to be registered will be stored and regularly updated.

Under the Draft Code, a plaintiff may no longer rely on the commercial books and records of a commercial enterprise as evidence to prove a claim. The Draft Code, however, stipulates that merchants must keep commercial books and must record their commercial actions and assets in their books in line with the Turkish Accounting Standards, in a manner clear enough for third parties to understand. The books may be kept in written, visual or electronic form.

5.2. Unfair Competition

The Draft Code introduces some major changes to provisions regarding unfair competition. It aims to ensure an honest and uncorrupted competition environment to the benefit of all market players. Misleading, insulting, libelling statements, sales techniques imperative to competition, actions that may lead a person to cancel or violate a contract, unauthorized exploitation of another person's work products are considered as actions and practices that violate the good faith principle. The Draft Code, among others, sets out a non-exhaustive list of actions that constitute unfair competition. These include misleading customers about the fair price of a product, limiting consumers' freedom of choice by employing aggressive sales techniques, and dishonesty in instalment sales.

5.3. Company Groups

The Draft Code introduces the concept of "company groups". Accordingly, a multi-company group is formed when a corporation, directly or indirectly, controls the majority of voting rights, or is in a position to vote for the appointment of enough members to establish a majority in the governing body, or exercises the majority of the voting rights due to contractual relations on its own or with other shareholders, or keeps another corporation under control by virtue of a contract or in any other manner. Furthermore, the Draft Code stipulates that if a real person or a legal entity or enterprise (that is not a corporation), regardless of whether its residence is in Turkey or abroad, is at the head of a multi-company group, the multi-company group principles will still be applied and the person or entity in the controlling position will be considered as a merchant. It is mentioned that the purpose of defining and regulating multi-company groups is to achieve transparency, accountability, and a balance of interests in transactions between the parent (controlling) and the affiliate (controlled) companies.

There are various duties and liabilities imposed on the members of the Board of the parent company, such as the requirement to prepare a report concerning all legal transactions with affiliates, any precautions taken or not taken, as well as the losses of the affiliate in detail within the first three months of each operational year. Furthermore, members of the Board of the parent company may request a detailed report relating to all transactions with affiliate companies, and may also request such reports to be included in the annual reports of the parent company. Additionally, according to the Draft Code, shareholders of the parent company are entitled to request reports on the financial status of affiliate companies at the general assembly meetings of the parent company. The Draft Code provides that parent companies cannot use their controlling positions to direct the affiliate to act in certain ways to the detriment of the affiliate.

5.4. Shareholders

Shareholders play a very crucial and significant role within the structure of corporations since each shareholder owns a particular portion of a company's property in real economic terms. As a result, each shareholder is entitled to both pecuniary and managing rights. When corporate governance regulations (codes, reports, guides etc.) of various countries are examined, it becomes evident that the shareholders' rights are included under the right to obtain accurate information, the right to participate actively in the general shareholder meeting, and the right for equal treatment among shareholders. In fact, regulations of various countries only include issues such as the Board of Directors' structure, accountability and responsibility without mentioning the shareholders at all. With respect to the previously applied corporate governance regulations of Turkey, it is generally accepted that shareholders are unable to exercise their rights effectively, and to communicate and interact effectively with management and that there exist various imperfections in the regulations pertaining to shareholders rights. Above-mentioned circumstances lead to deviations between Turkey's legislation and the OECD Corporate Governance Principles. Therefore, in order to ensure proper harmonization between these regulations, it has been proposed that provisions are adopted in the articles of association and in the internal regulations of a company in order to improve and protect shareholders rights.

Another major change proposed by the Draft Code concerns the number of shareholders. Under the current TCC, a minimum of five shareholders is required to incorporate a joint stock corporation and a minimum of two partners for a limited liability partnership. The Draft Code reduces this number to one shareholder both for joint stock corporations and limited liability partnerships. The Commission noted that the rationale behind this change was to avoid the presence of nominee shareholders with as little as 0.001% stakes in companies solely for the purpose of complying with the minimum shareholder requirement imposed by the TCC.

5.5. Privileged Shares

The Draft Code provides that under equal circumstances, all shareholders of a joint stock corporation must be treated equally. The Draft Code recognizes privileged shares, and a privilege is described as "a prevailing position with regard to rights such as dividends, liquidation shares, rights of first refusal and voting or other shareholder rights not foreseen in the Draft Code". Thus, "voting privileges" are recognized, whereby shares with equal nominal value are ascribed with different voting powers. However, the Draft Code limits the number of votes per privileged share to 15, unless required by the circumstances of institutionalization or a justified cause is proven. Nonetheless, the relevant commercial court must inspect the institutionalization project or the justified cause and decide in favor of one of the two exceptions being adopted.

5.6. Statutory Auditors

Another significant change is the abolition of the requirement to have statutory auditors among the statutory bodies of joint stock corporations. According to the system prescribed by the Draft Code, auditing of joint stock corporations of all sizes shall be conducted by independent auditing companies, or alternatively, in small-scale joint stock corporations, by a minimum of two independent sworn-in auditors or public accountants to ensure compliance with laws, Turkish Accounting Standards, and the articles of association.

5.7. Web Site

The Draft Code requires every company to have a Web site. Joint stock companies are allowed to hold online general assembly meetings. All administrative transactions of joint stock companies may be conducted online, which will create such options as online attendance for general assembly meetings, online submission of motions, online negotiations and online voting. People will have easy access to previously unavailable company information.

On their Web sites, companies may publish corporate information, documents, reports, statements and invitations. If they publish false information on their Web sites, they will face legal and criminal liability. Online meetings are allowed for boards of directors, executive boards of capital stock companies, board of directors or general assemblies for sole proprietorships, limited liability companies and shareholding companies. Decisions made in online meetings will be deemed valid, and it will be possible to record the decisions with secure electronic signatures or physical signatures appended afterwards. Online attendance will facilitate easy access by ordinary shareholders to general assembly meetings, creating more transparent management. The Ministry of Industry and Commerce will draft regulations for the implementation of these principles. International standards will be introduced for company inspection. The auditors system will be replaced with an "independent supervision" system for large capital stock companies. As per the Draft Code, large companies will be inspected by independent and impartial supervision companies while small companies may be supervised by at least two chartered accountants or a certified public accountant and a financial advisor. The Draft Code prohibits independent supervision companies from providing consulting to the companies they are inspecting. Independent inspection companies are responsible for reporting correctly to shareholders and the public. Otherwise, they will face criminal, indemnification and confidentiality liabilities.

In joint stock companies, shareholders are not allowed to become indebted to their own companies except for debt arising from capital subscriptions. In the legal basis section of the article, it reads this provision intends to prevent the bad and faulty practice, which is widespread in the business world. The goal is to prevent shareholders from using the company's money in various transactions, from making their personal expenditures using this channel and from drawing money from the company. Shareholders cannot be denied their rights related to their shares through general assembly decisions, other arrangements or administrative acts. Participants will be held liable for damages and losses arising from unlawful, incorrect, misleading or obscured statements in the documents or deeds concerning the establishment of a company, capital increase or decrease and issuing securities.

Consent by the CMB is required for raising funds for the purposes of, or with the promise of, establishing a joint stock company or increasing capital. Those raising funds in breach of these provisions and members of the boards of directors of companies who are aware of such acts shall be held responsible in proportion to the amount of funds raised and an action will be brought against them in six months following precautionary measures or attachments imposed.

There will be follow-up inspections to ensure that the funds raised after obtaining the CMB's consent are properly spent. This is intended to put an end to deception, particularly against Turks living abroad.

Single-partner limited liability companies. The number of partners in a limited liability companies will not exceed 50. Establishment and operation of single-partner limited liability companies are allowed. In case the number of partners decreases to one, this will be registered and published in seven days. Otherwise, managers will be held responsible for resultant damages. Single-partner limited liability company will be a subcategory of limited liability companies, not a new category of companies.

Partners will not be responsible for company debts but only for their capital subscriptions, additional payment and secondary performance liabilities. A limited liability company may be established for all economic areas of activity not specifically prohibited under laws.

The Draft Code lists the requirements that articles of association must contain pertaining to establishment of a limited liability company. Thus, founders may include any provision in the company's articles of association, provided that it does not violate mandatory provisions.

Partners shall be responsible for protecting confidential information of the company, and this responsibility cannot be eliminated through provisions of the articles of association or general assembly decisions. Partners will not act in a manner detrimental to company interests. They will not be allowed to conduct transactions that bring private gains or be harmful to the goals of the company.

6. Conclusion

The current analyses about the globalization of the corporate activities show that the national legislations have little importance in determining the management systems of the corporations (Thomsen, 2003; Gregory, 2000; Cohen and Boyd, 2000). This observation does not take into consideration the fact that national legislations have an important role in company management and activities (Black and Kraakman, 1996). Therefore, national companies' laws, capital markets laws and labor laws shall be analyzed thoroughly in respect of corporate governance systems. The globalization of corporate governance shall be the reason for amending legal regulations in accordance with the recent developments and shall not curtail the role of national governments in economy (Cioffi, 2000, p. 572).

The legislators shall consider the domestic circumstances while regulating corporate governance principles. There is consensus between all international bodies working on this subject that there can not be a uniform international corporate governance regulation and implementation and the domestic circumstances and priorities shall be taken into account.

Indeed, while improving the management of the companies based on corporate governance principles, the companies shall be informed about the importance of the subject and shall endeavor to implement these regulations. In accordance with this fact, the Draft Code will have a significant role in improving the governance of all joint stock companies by obligating them to act in conformity with these rules.

The reason of the need for effective corporate governance is separation of ownership and control in big or publicly held companies (Coffee, 2001). The transparency and adequate auditing standards shall be accompanied by compliance mechanisms in order to prevent misuse of control on the ownership (Yüksel, 2004, p. 38).

Increase in foreign capital investments has a significant effect on Turkish companies to comply with the international corporate governance principles. However, the importance of corporate governance shall be realized by local companies which are improving to become international and even global companies. It is inevitable that the companies shall analyze the improvements in the global market and take steps to comply with the developing standards of the market.

Even if the national commercial law regulations are in conformity with OECD corporate governance principles, targeted efficiency cannot be obtained because of the ineffectiveness of the compliance practices. It is stated in the survey that this ineffectiveness is especially, widespread among global companies, shareholder rights are not protected and the public is not informed properly. Generally, the features of the Turkish business scene are as follows (i) there are very few listed companies, (ii) the majority shares are held by an individual or a family, (iii) shareholding generally has a very complex structure, and (iv) the relationship between big companies and their own banks cause some problems.

In the global economy, firms and customers are becomingly demanding two things; internationally standardized trust, and application of appropriate procedures. In this respect, we see the Turkish law and its practice becoming more transparent and compatible with the international standards. Turkey's efforts to become a full member of the European Union and in this regard the praised compliance practices including the Customs'

Union depict this fact. Moreover, international foreign investment inflow to Turkey is increasing steadily. This highlights the foreign investors' increasing interest in those firms that are more compatible with the international standards (Wielan 2005).

Today's global financial market place sets the scene for outstanding and swift developments. In light of such developments and latest novelties, the competitive power of the markets is more important than ever. The global trends need to be clearly identified to ensure efficient functioning of capital markets for the purpose of the country's development. Although national borders maintain their physical existence, they are becoming less significant in today's world that is becoming a smaller place to live in. Recent trends in globalization and improvements in information technology have enabled funds to move from one market to another in just a few seconds. On the other hand, as governments across the world and international finance institutions have realized the need for closer cooperation, international standard setting is becoming a must in many areas. Companies and even governments no longer feel restricted to limit their financial capacities with their own domestic markets, but rather seek to utilize their opportunities in the international financial arena. International competition is becoming a lot more essential in order to best utilize the flow of capital movements across the world. As new funds and new innovations enter the world financial markets, investor preferences are getting enhanced with each day. In parallel with these developments, regulation of the problems and standard issues being faced in today's financial markets is becoming more complex. Due to the increase in competitive conditions within financial markets, countries are being required to harmonize their legislation with the international level and realize a set of regulations in order to attain and sustain development. Within this context, the new Turkish Draft Code is becoming highly significant especially for companies that want to become international ones in terms of providing global liquidity and expanding the fund provision capabilities of international financial markets.

NOTES

[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 from http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf
[2] OECD Corporate Governance Principles from www.oecd.org
[3] CMB Corporate Governance Principles from http://www.cmb.gov.tr/regulations/files/corporate_governance.pdf

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Financial Collateral Arrangements

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Abstract: Increasing use of securities and collaterals in transactions brings the legal ambiguity in today's financial markets which are trying to globalise. It should have been noted that without legal certainty an achievement can not be obtained in a complete manner. To solve this legal ambiguity in financial markets, reform movements have been started through out the world from different groups, institutions and communities involving both jurists and practitioners. On 19 May 1998, the Directive on settlement finality in payment and securities settlement systems and on 6 June 2002, the Directive on financial collateral arrangements were adopted. These two directives are both supplementary legislations for the Directive of the Parliament and of the Council on the reorganisation and winding up of credit institutions dated 4 April 2001. All of these directives are the circles of a chain that aim the proper functioning of the internal financial market in European Union. In this study, mainly the Collateral Directive will be taken into account. Firstly, the necessity of a harmonised collateral law and the aims of the Collateral Directive will be handled. Following, the main provisions of the directive will be analysed in details. While analysing in details, the different implementations of the directive in member states will be mentioned. Finally, the conflict of laws clause and the consequences of the directive will be explained.

1. INTRODUCTION

Reforms in insolvency law have triggered the significance of collateralisation which can be deemed as a primary risk mitigation technique gaining much importance day by day. Financial institutions carry on cross-border trading without the restrictions of exposure limits by taking and giving collaterals which cover all or part of those credit exposures. (Coiley, 2001) The value of collateral held by the European Central Bank at the beginning of the 2000 was 550 billion US dollars and nearly the 160 billion dollars of this amount was held on cross-border transactions.(Summe, 2001) These gigantic totals well illustrate the importance of collateralisation on financial markets.

Increasing use of securities and collaterals in transactions also brings the legal ambiguity in today's financial markets which are trying to globalise. It should have been noted that without legal certainty an achievement can not be obtained in a complete manner. To solve this legal ambiguity in financial markets, reform movements have been started through out the world from different groups, institutions and communities involving both jurists and practitioners. [1]

On 19 May 1998, the Directive on settlement finality in payment and securities settlement systems (Directive 1998/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement System [1998] OJ L166/45, hereafter cited as the Settlement Finality Directive) and on 6 June 2002 the Directive on financial collateral arrangements (Directive 2002/47/EC of the European Parliement and of the Council on Financial Collateral Arrangements [2002] OJ L168/43, hereafter cited as the Collateral Directive) were adopted. These two directives are both supplementary legislations for the Directive of the Parliament and of the Council on the reorganisation and winding up of credit institutions dated 4 April 2001(Directive 2001/24/EC of the European Parliement and of the Council on Reorganisation and Winding up of Credit Institutions [2001] OJ L125/15, hereafter cited as the Reorganisation and Winding up Directive). All of these directives are the circles of a chain that aims the proper functioning of the internal financial market in European Union. In this paper, mainly the Collateral Directive will be taken into account as the subject of this paper is collateral arrangements. Firstly, the necessity of a harmonised collateral law and the aims of the Collateral Directive will be handled. Following, the main provisions of the directive will be analysed in details. While analysing in details, the different implementations of the directive in member states will be mentioned. Finally, the conflict of laws clause and the consequences of the directive will be explained.

2. NECESSITY FOR A HARMONIZED COLLATERAL LAW

Collaterals have became the vital instruments for the modern financial markets as they are used nearly in all types of transactions such as; bank treasury and funding, payment and clearing systems, repurchase agreements, general bank lending and etc (Lober & Klima, 2006). It is stated in the tenth semi-annual survey of the *repo* market that the EU *repo* market size is now estimated to be in excess of Euro 5.8 trillion.[2] Creditors naturally want to obtain enforceable and valid collaterals to reduce their credit risk. In payment and securities settlement system, collateral is the major mechanism to decrease the systemic risk (Lober & Klima, 2006).

Collateral can be in the form of the cash or securities and when it comes to dematerialised securities, the problems start to emerge. In classical "direct holding systems", the owner of a security has direct relationship with the issuer. However, "indirect holding systems" which are very commonly used in nowadays transactions, consist of more then one tier of intermediaries between issuer and investor. As a result of this multiple securities and multiple layers of intermediaries occur. When a problem arises like opening of the insolvency proceedings against one of the parties, it becomes a very sophisticated issue because each state has its own law regarding to above mentioned issues. In addition to this, not only substantive laws of the states vary from each other, but also conflicts of laws approaches vary. (Einhorn & Siehr, 2004) Hence, different national laws may apply to separate parts of the transactions. For instance, assets provided as collateral may situate in one state, debtor's domicile can be in another state, debt can also be governed by a third state. Indirect holding systems make it much more sophisticated as an indirect holding system may consist of a lot of tiers like, international central securities depositories, financial institutions, brokers, individual investors and etc. [3]

The Finality Settlement Directive and the Collateral Directive have been adopted as a solution for the above mentioned situations that would probably hamper the internal financial market. Although the Finality Settlement Directive constituted a milestone for payment and securities system, it has a rather restricted scope and only covering some types of collateral arrangements. Because of this, a new action was started to create legislation on collateral arrangements that would go beyond the scope of the Finality Settlement Directive, after taking consultations from market experts and national authorities. (The Collateral Directive, recital 2)

3. FINANCIAL COLLATERAL ARRANGEMENTS DIRECTIVE

3.1 Main objectives of the Directive

The aim of the directive is to contribute the stability and cost-efficiency of financial market, so that the free movement of capital in the single market will be provided. It also aims to ease the implementation of the common monetary policy. This can be achieved by fostering the efficiency of the cross-border transactions of the European Central Bank and permitting the participants in the money market to balance the comprehensive amount of the liquidity in the market among themselves. (Asgeirsson, 2003/4) The main objectives of the directive are: (Vereecken & Sylvia Kierszenbaum,2005; Turing,2007)

- Removing certain obstacles to the efficient use of collateral arrangements by limiting the formalities for the creation or enforcement of the financial collaterals. So that the burdens in the national laws regarding to the form, validity, completion and substance of collateral arrangements would be abolished (Collateral Directive, article 1(2)(a)-(d)),
- Supporting the protection of collateral arrangements from insolvency and reorganization rules,
- The reuse of the collateral is allowed as if collateral takers owned it,
- Recognizing the title transfer of the collateral arrangements and close-out netting structures,
- Enlighten the issue of the applicable law to book-entry securities collateral by stating that the governing law shall be the law of the country where the securities account is maintained.

3.2. Scope

3.2.1. Personal Scope

Parties to agreements on financial collateral arrangements are listed in article 1(2). These parties are; specific financial institutions, namely public sector debt and account management bodies, central banks, multilateral

development banks, international financial institutions, central counterparties, settlement agents and clearing houses.(Collateral Directive, article 1(2)(a)-(d)) An additional category is also stated in article 1(2)(e) as "persons other than natural persons, including unincorporated firms and partnerships may participate in such arrangements provided that the other party is an institution defined in above articles 1(2)(a) to (d)." However an opt-out clause is stated for Member States so that they may exclude this additional category.(Collateral Directive, article 1(3)) This opt-out clause is the result of the countries which are supporting the need for stable and efficient financial market.(Lober & Klima, 2006)

Implementation of the personal scope of the directive differs between Member States mainly because of this opt-out clause. It is remarkable that except Austria , all the other Member States have not used a full opt-out clause somehow. Malta had also decided to exercise this opt-out clause when they first implement the directive on May 1 2004, however they revoked this clause after having consultations with the local financial services industry on the basis that the other persons (including unincorporated firms and partnerships) stated in article 1(2)(e) could not benefit from the advantages of directive such as remedy of appropriation.(Portanier, 2005) An extended implementation is made by Belgium that Belgium has included natural persons, however excepting the title transfer transactions from this extension.(Lober&Klima, 2006)

3.2.2. Material Scope

The Directive only covers the financial collaterals in the form of cash [4] or financial instruments [5] according to article 1(4). Two types of financial collateral arrangements are defined in article 2(1)(b) and 2(1)(c) and directive applies to both of them. First, one is "title transfer financial collateral arrangement" (Collateral Directive article 2(1)(b)) in which a collateral provider transfers full ownership of the collateral to the collateral taker (this also includes repurchase agreements). Second, one is "security financial collateral arrangement" (Collateral Directive article 2(1)(c)) where a collateral provider provides financial collateral by way of security to a collateral taker, but the full ownership of the financial collateral remains with the collateral provider when the security right is established.

Material scope of application also includes an opt-out clause stated in article 1(4)(b), that allows Member States to exclude from the financial collateral consisting of the collateral provider's own shares, shares in affiliated under takings (Within the meaning of seventh council Directive 83/349/EEC of 13 June 1983 on consolidated accounts) and shares in undertakings whose exclusive purpose is to own means of the production that are essential for the collateral provider's business or to own real property. Denmark seems to be the only Member State using this opt-out clause in full. Countries like Germany has exercised a partial opt-out clause in its implementation namely if the collateral giver is a corporate entity some limitations apply. (Lober, 2005) On the other hand, Czech Republic, Sweden and France have extended the material scope of the application for also particular kinds of receivables like bank loans or claims.(Lober & Klima, 2006)

Article 1(5) states another issue of evidencing the collateral. According to this article, the"directive applies to financial collateral once it has been provided and if that provision can be evidenced in writing". The Directive will govern the financial collateral arrangements, if it is evidenced in writing or in a legally equivalent manner (Collateral Directive, article 1(5) last sentence). What has to be understood from "writing" according to this directive is that writing also includes recording by electronic means and any other durable medium (Collateral Directive, article 2(3)).

3.3. Formal Requirements

Divergent formal requirements by Member States concerning collateral arrangements have hampered the harmonization of internal financial market. Laws which lay down a special procedure (for instance use of a defined stock transfer form) for transfer of securities do not vanish simply because the transfer constitutes a part of a financial collateral arrangement. (Turing &Lester, 2005) To overcome such procedures, thus limiting the administrative burdens for parties, the directive opted to minimize formal requirements in order to secure mutual recognition by Member States of the validity of such arrangements. (Asgeirsson, 2003/4) Formal requirements are enacted under article 3 of directive. According to article 3(1), Member States shall not require formal requirements for creation, validity, perfection or enforceability of a financial collateral arrangement (such as notarial deeds, registration requirements, notification requirements, public announcements or other formal certifications (Lober & Klima, 2006)). However, Member States shall require conclusiveness of financial collateral arrangements in writing or in a legally equivalent manner. (Collateral Directive article 3(2))

3.4. Enforcement

Article 4 which regulates the enforcement of financial collateral arrangements provides improved enforcement rights. Collateral taker shall realise security collateral arrangements by sale or appropriation of the financial instruments and by setting of their value against, or applying their value in discharge of the relevant financial obligations (Collateral Directive article 4(1)(a)). When it comes to cash collateral, collateral taker shall realise by setting of the amount against or applying it in discharge of the relevant financial obligations (Collateral Directive article 4(1)(b)). However these procedures of realisation are only possible only if these are agreed by the parties in the security financial collateral arrangement (Collateral Directive article 4(1)). When they are then accepted in the collateral arrangement, Member States have to recognize those procedures without prior notice of the intention to realise, its approval by any court (public officer or other person), public auction or waiting period(Collateral Directive article 4(4)).

The Directive allows appropriation if parties agreed on the appropriation and on the valuation of the financial instruments in the security financial collateral arrangement (Collateral Directive article 4(2)). Appropriation was a new procedure for some jurisdictions of realising the collateral, in which the collateral taker may keep assets as their own property instead of selling collateral while setting off the value of collateral against their own relevant financial obligations against the collateral giver. (Lober & Klima, 2006)Appropriation is preferable to a sale where immense mass of a particular kind of financial instruments are involved. The reliability of this method depends on the fair valuation of the collateral at the time of the appropriation; therefore the interests of the collateral giver have to be protected. (Lober & Klima, 2006) This protection of the collateral giver is provided by the above mentioned clause of the directive (Collateral Directive article 4(2)(a)) that the appropriation is only possible only if parties agreed it in the collateral arrangement.

Article 4(3) of the directive states an opt-out clause for the appropriation procedure. Member States which did not allow appropriation on 27 June 2002 were not obliged to recognize it. However, all the 25 Member States recognize appropriation and implemented it into their legislations. (Lober & Klima, 2006)

The enforcement of collateral arrangements is protected from effects of reorganization measures and winding-up proceedings with the article 4(5) of the directive: "Member States shall ensure that a financial collateral arrangement can take effect in accordance with it terms notwithstanding the commencement or the continuation of winding-up proceedings or reorganization measures in respect of the collateral provider or collateral taker".

These provisions (articles 4, 5, 6 and 7 of the Collateral Directive) shall not prejudice any requirements under national law. Hence, realisation or valuation of financial collateral and the calculation of relevant financial obligations must be conducted in a commercially reasonable way. (Collateral Directive article 4(6)) However one of the commentators has mentioned that the satisfaction of this reasonableness test is questionable as what have to be understood from the wording "reasonable" is not lucid (for details of the implementation of the Collateral Directive in Italy Lantalme, 2004).

3.5. Right of Use of Financial Collateral

According to article 5 of the Collateral Directive, a right of use [6] collateral should be available if and to the extent that the terms of a security financial arrangement so provide. In other words, it seems that the right of use collateral subject to a condition under directive. However, in UK implementation, the right of use is not attached to a condition. (Mccormack, 2003)

If a collateral taker exercises a right of use, certain obligations are imposed on that party, namely to replace the original financial collateral with equivalent financial collateral or, if the arrangement permits to set off the financial collateral against the relevant financial obligations. (Collateral Directive article 5(2)) The equivalent financial collateral shall be subject to the same terms of the arrangements as the original financial collateral was subject to under the article 5(3) of the directive. In addition to this, Member States shall ensure that the use of financial collateral by the collateral taker under a financial collateral arrangement does not render the rights of the collateral taker invalid or unenforceable. (Collateral Directive article 5(4))If an enforcement event occurs, while assets are in the process of reuse, then the obligations of the collateral taker may be brought into account in a close-out netting arrangement.(Collateral Directive article 5(5))

Contrary to the appropriation procedure, no opt-out provision was supplied for the right of use. As a result of this, almost all Member States have implemented the right of use technique into their national legislations.

German implementation of the directive does not contain a particular provision for this technique as they have had it in their customary law before the directive. (Lober & Klima, 2006)

3.6. Title Transfer

Member States must ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms according to article 6(1) of the directive. In other words the risk of being re-characterised as a security financial collateral arrangement for title transfer financial collaterals' is abolished. [7] Thus, repurchase agreements which are the best known form of title transfer collateral arrangements benefit from the same legal protection that is provided for security financial collateral arrangements that will facilitate the use of repurchase agreements by reducing the uncertainty about their performance. This is why this provision has a basic importance for institutions (for instance central banks) that engage in such transactions. (Asgeirsson, 2003/4)

Article 6(2) states that, if collateral falls to be enforced while any obligation of the collateral taker to transfer equivalent collateral remains outstanding, the obligation may be subject of a close-out netting provision.

3.7. Close-out Netting

The enforceability of the close-out netting arrangements is explicitly protected notwithstanding the insolvency of the parties to the relevant collateral arrangement. (For details, see recital 14 of the Collateral Directive that mentions the importance of protecting the enforcement of the bilateral close-out netting.) . Hence, under article 7 of the Directive, Member states shall ensure that a close-out netting provision can take effect in accordance with its terms, notwithstanding winding-up proceedings or reorganization measures in respect of the collateral provider and/or collateral taker. The Directive does not permit the attachment of a contractual right, for example, a third party creditor or competent court that may prejudice the effectiveness of the close-out netting. (Collateral Directive article 7(1)(b))

The comparison of Settlement Finality Directive and Collateral Directive is made on the close-out netting provisions that have to be taken into account. (Westerlund, 2004) Both of the directives overlap only to a specific extent. Oppose to the Settlement Finality Directive that only applies to obligations arising from securities and currency trading, Collateral Directive applies to all types of obligations. Settlement Finality Directive allows netting between multiple parties where as the Collateral Directive merely applies to netting between two parties (collateral provider and collateral taker). The commentator of this comparative analysis added that implementation of these directives raises the effectiveness of contractual close-out nettings. (Westerlund, 2004)

Close-out netting provisions can operate without being subject to the requirements stated in article 4(4) namely prior notice, approval from courts and public auction. (Collateral Directive article 7(2))

3.8. Insolvency Issues

Member states are blocked by article 8 of the Collateral Directive, which operates as an escape clause, from applying their national insolvency rules to financial collateral arrangements.(G. Gungor, 2005) The reason for this blocking is to improve the legal certainty of financial collateral arrangements and fostering a cost-effective internal financial market as applying national laws will hamper the effective realisation of financial collateral or cast doubt on the validity of current techniques like, bilateral close-out netting, top-up collateral and substitution of collateral. (Collateral Directive, recital 5)

The Collateral Directive rejects the retrospective effect of winding-up proceedings and reorganisation measures regarding to collateral arrangements by enacting article 8(1). (Sharp, 2004) Rejecting the retrospective effect can also be deemed as abolishing the zero-hour rule. According to article 8(1), financial collateral arrangements may not be declared invalid or void on the sole basis that the arrangement or obligations came into existence on the day of the commencement of winding-up proceedings or reorganisation measures or in a prescribed period prior to the commencement of such proceedings or measures.

Financial collateral arrangements are enforceable and binding on third parties, if the collateral arrangement or a relevant financial obligation has come into existence on the day of, but after the moment of commencement of winding-up proceedings or reorganisation measures, provided that the collateral taker can show that he was not aware or should not have been aware of such proceedings or measures. In addition to this if

the financial collateral is provided on the same day but after the commencement of such proceedings and measures, such arrangements shall also be binding. (Collateral Directive article 8(2))

Questioning the provision of top-up and substitution financial collateral arrangement on the sole basis that the relevant financial obligations existed before that financial collateral was provided or that the financial collateral was provided during a prescribed period is prevented by the wording of article 8(3). However the potentiality of questioning the top-up and substitution collateral under national laws is not completely rejected on the basis of misuse, for instance top-up or substitution can be done intentionally to the detriment of the other creditors. (Collateral Directive recital 16) If a financial arrangement contains an obligation of top-up collateral or provisions for a right of substitution of the collateral; then the obligation or right shall not be treated invalid or reversed on the sole basis that the financial collateral was provided on the same day at when the winding-up proceedings or reorganisation measures commenced or that the relevant financial obligations were incurred prior to the date of the provision of the collateral. (Collateral Directive article 8(3))

There seems to be a conflict in the directive between articles 4(5) and 8(4), in article 4(5) the enforcement of collateral arrangements is protected from effects of reorganisation measures and winding-up proceedings, where as in article 8(4) the general rules of the national insolvency law is left unaffected regarding to the voidance of transactions entered into during the prescribed period referred to in paragraph 1(d) and 3(i) of article 8. Therefore, it can be understood from the wording of article 8(4) that the national laws of the Member States handling the avoidance of transactions entered into during the suspect period does not want to be ameliorated by the directive (G. Gungor, 2005)). So, questioning the issues such as the top-up and substitution collateral under national laws is possible as it is mentioned at the previous paragraph.

3.9. Conflict of Laws

3.9.1. Complexity of the Book-Entry Security Collateral Arrangements - Point of Conflict of Laws View

Since it is written under the title of "necessity for a harmonized collateral law", it is very vital to ascertain which law will apply to collateral arrangements. Suppose that, an individual investor pledges the securities which are credited to his deposit account with his bank to that bank. Bank can also pledge the same securities to its own creditors or to a clearing institution in which an immense amount of these securities are being held. In this kind of a situation the parties claim regarding their rights in those securities may conflict with each other. What is more, if transferred or pledged securities represented by a global instrument and/or dematerialized and holding by a custodian in a global custody, then the situation becomes very sophisticated. (Einhorn & Siehr (eds), 2004) Hence a movement from direct holding systems to indirect holding system can be seen very clearly in recent times and this tendency threatens the certainty as to the law applicable in cross-border securities transactions. The main problem in indirect holding system is to localize the arrangement because the ownership and other proprietary rights in an indirect holding system may be held and transferred thorough several different countries as the participants of indirect holding system are generally located in different states. As a consequence, the number of national laws applicable to the situation will increase and this will shake the legal certainty of the market. (G. Gungor, 2005)

The law governing collateral security is the law of the country where the underlying financial is located under the "*lex rei sitae"* principle. However, determining the location is a very tremendous task especially in collateral arrangements consists of book-entry securities. Book-entry securities are dematerialized securities that have no physical existence and only exist as an entry on a securities account (Vereecken & Kierszenbaum, 2005). A clear definition of *"book-entry security collateral which is the indirectly held security that is taken by the creditor in financial market transactions to be enforced on the intangible collateral on default(of payment or any other relevant obligation) by debtor"* is made by G. G. Gungor.

The holding of book-entry securities "indirectly" means that, they are held on an account with an intermediary, not with an ultimate owner. Such securities will be held in turn with that intermediary and national central securities depository that may also in turn hold these same securities with an international central securities depository like Euroclear. (Vereecken & Kierszenbaum, 2005) This is why determining the location of such securities is a very tremendous task, as those securities are held by many tiers of intermediaries. The doctrine asserted that, the only common localization place can be the place of the relevant intermediary in which the existence of interest on the books of that relevant intermediary is proved. (G.Gungor, 2005) This approach seems very rational on the basis that a pool of securities of the same issue on behalf of the investor and other investors is held by an intermediary and no specific securities are distinguishable as belonging to any investor. What is more, the pools over the accounts with one or more sub-intermediaries are likewise held by

intermediaries. Hence, doctrine's assertion on the place of the relevant intermediary constitutes a common centre point regarding to the rights of the all interested parties. (G.Gungor, 2005)

3.9.2 PRIMA Principle

Before analyzing the conflict of laws provisions of the Collateral Directive, them PRIMA (Place of the Relevant Intermediary) principle has to be explained. PRIMA can be deemed as a principle of conflict of laws that apply to the security transactions with respect to their proprietary aspects which also constitutes the basis for Hague Securities Convention.[8] One of the biggest advantages of PRIMA principle is that, it subjects an investor's interest in securities to the law of a single jurisdiction (in other words localize to a one single place), even where evidence of securities is situated in several different countries which maintains certainty and clarity for all parties involved. [9]

There was almost unanimity on the acceptance of the PRIMA rule at the conferences of the Special Commission on the discussions of the Hague Securities Convention Draft that this should be the relevant connecting factor for ascertaining the applicable law to dispositions and security in securities that are held indirectly by intermediaries. (Einhorn & Siehr (eds), 2004) Although the acceptance of the PRIMA rule was very quick, defining the place of the relevant intermediary was much more diffucult and controversial. After debates, it was accepted that the law applicable would be the law of that state in which securities account is maintained subject to the agreement between the investor and the relevant intermediary if only the relevant intermediary has an office or an equivalent activity there at the time of the agreement. (Hague Securities Convention, article 4)

3.9.3 Conflict of Laws Provisions in Collateral Directive

The Settlement Finality Directive also stated a conflict of laws provision concerning book-entry securities only if that security interest was vested in favour of certain categories of parties. According to the Settlement Finality Directive, the law of the Member State in which such securities are legally recorded on a register, account or centralised deposit system will be the governing law. (Finality Settlement Directive article, 9(2))The Collateral Directive extends the rule stated in Settlement Finality Directive to financial collateral arrangements including book-entry securities provided as collateral in a cross-border context. Article 9(1) of the Collateral Directive states that any question regarding to specified matters in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. "Relevant account" is defined as a register or an account – which may be maintained by the collateral taker - in which the entries are made by which that book-entry securities collateral is provided to the collateral taker in article 2(1)(h) of the Collateral Directive.

Although both the Settlement Finality and Collateral Directive with respect to conflict of laws provisions do not overlap with the Hague Securities Convention in letter, it can be accepted that both directive overlaps with the Hague Securities Convention in spirit. Thus, article 9(1) of the Collateral Directive has to be understood in a sense that is in accordance with the PRIMA principle like; the applicable law shall be the law of the country in which the relevant intermediary has its office that provides the relevant account.

Renvoi is expressly rejected, as the reference to the law of the country is a reference to the domestic law of that country. (Collateral Directive, article 9(1)) This seems to be an appropriate provision as the localization issue would become insoluble if *renvoi* was accepted.

The law of the country in which the relevant account is maintained will govern legal matters which are listed in article 9(2) of the Collateral Directive. These are;

- the legal nature and proprietary effects of the book-entry securities collateral(Collateral Directive, article 9(2)(a));
- the perfection requirements of a financial collateral arrangement with respect to the book entry securities collateral and of the provision of book entry securities collateral under such arrangement and usually the completion of the steps essential to render such an arrangement and provision effective against third parties(Collateral Directive, article 9(2)(b));
- whether a title or interest book-entry securities collateral is overridden by or subordinated by a competing title or interest or whether a good faith acquisition has occurred (Collateral Directive, article 9(2)(c));
- requirements for the realisation of the book-entry securities collateral following the occurrence of an enforcement event (Collateral Directive, article 9(2)(d)).

3.9.4. Effect of the Divergent Implementations of Collateral Directive to Conflict of Laws

While explaining the personal scope of the Collateral Directive, it is mentioned that there is an opt-out clause (Collateral Directive, article 1(2)(e)) for Member States. In addition to this, different implementations from different Member States have also been given to illustrate the situation which shows that is a divergence of implementations through the EU.

Member States may extend the personal scope of the directive by not enacting the opt-out clause into their national laws. For an illustration, United Kingdom has extended the scope of the directive by not enacting the opt-out clause to other legal entities, where only one party falls within one of the categories listed in article 1(2)(a) to 1(2)(d)and where as the majority of Member States have limited the scope of the directive by enacting opt-out clause. (Fawcett, 2005) Suppose that the parties to a collateral arrangement involve a partnership that is subject to the opt-out clause and a central bank. According to the UK implementation of the directive this arrangement will fall under the scope of the directive, whereas it will not to Austria on the basis that enacting the opt-out clause in full. As the office of the relevant intermediary is located in Austria, according to article 9(1) of the directive, the applicable law will be the Austrian law (from the viewpoint of UK). However, when this legal matter goes to Austria, Austrians may reject to solve this issue under Collateral Directive as this arrangement does not fall under the Collateral Directive from the view of Austrian implementation. What will be done in such a situation is a question that has no answer yet. One has to bear in mind that the rise of these kinds of situations may threaten the stability and certainty of the financial markets.

4. CONCLUSION

Collateralisation which can be deemed as a primary risk mitigation technique is becoming a very vital instrument for the modern financial markets as it is used nearly in all types of transactions. The necessity for a uniform set of rules in financial markets triggered the practitioners and jurists, as a result of this, Settlement Finality, Reorganisation and Winding up of Credit Institutions and Collateral Directives were enacted.

Removing certain obstacles to the efficient use of collateral arrangements by limiting the formalities for the creation or enforcement of the financial collaterals, supporting the protection of collateral arrangements from insolvency and reorganization rules, recognizing the title transfer of the collateral arrangements and close-out netting structures, allowing the right of reuse, to enlighten the issue of the applicable law to book-entry securities collateral by stating that the governing law shall be the law of the country where the securities account is maintained are the main objectives of the Collateral Directive.

The deficiencies of the Collateral Directive have also been taken into account, like the different implementations of the directive in Member States by enacting opt-out clauses, allowing appropriation if only parties have agreed on it, or to leave the door open to Member States so that they can hamper the certainty of financial markets by applying their national laws. (Collateral Directive article 4(6))

Consequently, it seems that the collateral directive will contribute to the stability and cost-efficiency of financial market, so that the free movement of capital in the single market will be provided. Although the Collateral Directive involves some deficiencies in itself, these can not cast a shadow on the success of the directive.

Notes:

[1] For instance International Swaps and Derivatives Association(ISDA) organizes a Collateral Reform Group, European Financial Market Lawyers Group(see www.efmlg.org for the comments and statements on collateral directive), Giovannini Working Group inside EU, and UNIDROIT also working on a uniform law regarding to transactions on transnational and connected capital markets.
[2] Source:Repo market surveys of International Capital Market Association(ICMA)(http://www.icma-group.org/surveys/repo.html) last visited on 26 May 2006
[3] See www.wikipedia.org for the definition of "indirect holding systems"
[4] According to the Collatarel Directive article 2(1)(d), "cash means money credited to an account in any currency, or similar claims for the repayment of money cush as money market deposits"
[5] According to the Collatarel Directive article 2(1)(e) " financial instruments means shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments, if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to

acquire to any sucs shares, bonds or any other securities by subscription, purchase or Exchange or which give rise to a cash settlement, including units in collective investment undertakings, money market instruments and claims relating to or rights in respect of any for going"
[6] According to the Collatarel Directive article 2(1)(m), "right of use means the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangements".
[7] UK courts have also rejected the recharacterising such agreements as security financial collateral arrangements. Hence, UK law already fulfils the requirements of this provision of the directive. See "Implementing the Financial Collateral Arrangements Directive 2002/47/EC – A Transposition Note" (http://www.hm-treasury.gov.uk/)
[8] Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, signed at the Hague on December 15, 2002(http://www.hcch.net/index_en.php?act=conventions.text&cid=72) hereafter cited as Hague Securities Convention
[9] See for details, http://en.wikipedia.org/wiki/Place_of_the_Relevant_Intermediary_Approach

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Virtual Meeting of Shareholders and its Immediate Rewards

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Abstract. For corporate governance, a shareholders' meeting is the fundamental part of corporate governance. Since our society entered a new stage in its development, many scholars perceive that modern means of communication can facilitate the shareholders' participation and so may improve corporate governance. Of course, this new stage has legal considerations which have to be taken into account in advance, i.e., before conducting such a meeting. We expect that a virtual meeting of shareholders (*i.e.*, with no physical attendance) actually has immediate rewards. In this article, we determine the legal and technological issues for conducting a shareholders' meeting using such modern means of communication. We introduce a theoretical model of a virtual shareholders' meeting along with the Dutch and Delaware perceptions that are incorporated in laws. From our analysis, we may conclude that a virtual meeting of shareholders has a large prospective. For instance, we see that the use of IT will enhance corporate governance so that the latter attracts more investors, and improves cross-border shareholding.

Keywords: Corporate governance, Information technologies, meeting of shareholders, information society

1. Introduction

At the end of the 20th century, our society entered a new stage in its development and was labelled by Machlup (1962) as an "information society". The central characteristic of the information society is the significance of information, widely recognized as having a high economical and cultural value. In the 21st century, developments in information technology rapidly transformed our daily life into a "knowledge economy" and subsequently into a "knowledge society".

Of course, this transformation should be completed by a new regulatory legal framework since the technology does not take into account what is and what is not allowed. Within that process, IT is deeply rooted in various types of relationships. The developments are facing the old legislation, which is no longer applicable. Testing the legislation with respect to the new type of relationships should be executed in a different environment. For instance, there should be emphasis on knowledge items. The value of exchanged knowledge is extremely high and appreciated by the knowledge society. The productivity of the knowledge exchange is crucial for corporate governance. Therefore, many law scholars perceive that IT can facilitate and improve corporate governance (cf. Krans, 2006).

However, there are opposite views, too. In the last decade, we witnessed many corporate accountancy manipulations (e.g., Enron, Parmalat, and AHold) that roused the mistrust of corporate-governance companies and contributed to the apathy of shareholders for participation and attendance of shareholders' meetings (cf. Adams, 2004).

Below, we will demonstrate that IT as a modern means of communication will increase the shareholders' participation and enhance corporate governance. For instance, IT is a fast, efficient, and low-cost approach (compared to the other types of communication and with respect to human travelling). Nowadays, corporate governance legislation allows the communication process to be performed by electronic means of communication in all phases of the operations. Many corporations maintain websites, where they (1) provide information on their annual financial reports, (2) make announcements on their policy, (3) list their goals, and (4) announce the general meeting of shareholders. Moreover, the corporations use the communication via e-mails as a tool for a fast and efficient virtual venue of information to be transmitted to shareholders, investors, and Unions. Based on the above considerations, the problem statement of the article reads as follows:

What are the immediate rewards for no physical attendance at a general meeting of shareholders?

We believe that a virtual meeting of shareholders will lead to immediate rewards. Our ideas and observations on the application of IT for an arbitrary shareholders' meeting are given below.

In section 2, we describe a model of a virtual meeting of shareholders by listing the main points which have to be taken into account before and during a virtual meeting of shareholders. In section 3, we discuss the new Dutch law that prescribes how a virtual meeting of shareholders can be conducted under Dutch legislation. In section 4, we outline the significant amendments of the Delaware Corporate Governance Law that allowed for the first time a general meeting of shareholders to be held via remote communication. Moreover, we give an example of the first corporation that benefited from the new laws. Section 5 briefly compares and comments on these two models (Dutch and Delaware) of a virtual meeting of shareholders. Section 6 provides our future expectations. Finally, in section 7, we conclude as to what extent a virtual meeting of shareholders may improve corporate governance and subsequently list the immediate rewards.

2. A model of a virtual meeting

A virtual meeting of shareholders is on the one hand a meeting with an attendance in a virtual reality, and on the other hand, a meeting with some physical attendance. When a corporation considers conducting a shareholders' meeting assisted by IT, it is advisable to take into account some legal considerations in advance (cf. Boros, 2004). The main legal consideration is the legal admissibility of holding a meeting using an electronic means of communication. Once it has been established that the by-laws of the corporation permit such a method of conducting a shareholders' meeting, the corporation has to inquire whether the shareholders would like to attend the meeting either using an with electronic means of communication or by physical presence, since we would like to give some room for shareholders who prefer the "old fashioned" physical attendance. When the majority of shareholders prefer virtual attendance and only a minority requests for physical one, it would be considered inappropriate for the management board to organize a meeting according to the majority's preference. The corporation has to satisfy both groups and should make both possible. Every shareholder who possesses shares has to participate on the meeting of shareholders because the shares he owns give him the right to attend and participate at the meeting of shareholders.

Below, we define a model of a virtual communication. It consists of three stages: (1) pre-meeting communication, (2) organizing a virtual meeting, and (3) a voting process.

Ad 1. Before conducting actually a meeting of shareholders there is a process of pre-meeting communication. In the process of pre-meeting communication, the management board has to provide the shareholders with all necessary information, concerning annual financial reports, proposals for the agenda of the meeting, all pre-meeting requests by shareholders, and their proposals for changes in the agenda. The pre-meeting communication process can be performed (1) by revealing all the information on the website of the corporation, (2) by e-mail, and (3) by regular mail.

The web site method is the most efficient and fastest method to spread the necessary information. But here we would like to focus on the website liability. For instance, some of the information could be misleading or even wrong; or the hyperlinks to web sites of a third party may be broken. In these cases, we would like to emphasize that the corporation is obliged to provide correct and reliable information and to be able to maintain a website with reliable and correct working hyperlinks. This might technologically be difficult.

Communication by e-mails has also some disadvantages. In brief, they are: (1) the law requires a proof of receipt for any message sent and (2) the condition that an e-mail is to be reliable (what criteria should be imposed for achieving this?).

Once the shareholders have received all the information by pre-meeting communication, it is a sign that transparent corporate governance has started well. Then the management may announce how the shareholder's meeting will be conducted. Subsequently the management board has to step forward and organize the actual meeting.

Ad 2. The set-up for a virtual shareholders' meeting can be performed by using (1) satellite broadcasting, or (2) web broadcasting, or (3) a web-based channel where all shareholders can simultaneously follow the meeting. All these versions imply that every shareholder is able to communicate with the management board, with the chairman, with the supervisory, and with the other shareholders. The virtual meeting requires fulfilling the terms to provide a correct flow of communication. While providing these interactions at the same time, the corporation has to secure the flow of communication and information from third parties' obstructions and invasions.

The corporate company can secure the flow of communication by supplying all shareholders with a code, which can be also the authentication number for the shareholders. This authentication code recognizes each shareholder as owner of shares and it will protect them from aggressive violation of privacy and communication.

Ad 3. Election and votes by shareholders can be arranged by providing a special virtual ballot pool. Even if there are some shareholders who attend the meeting in person; such a ballot will not be a problem, because many corporations use a remote control at the physical meeting to vote. Once the voting process is over, the chairman of the meeting can announce the result. This result can be posted on the web site of the corporation.

A virtual meeting of shareholders with a physical venue as described above is neither a problem from a financial and technical point of view. The virtual meeting might actually wake up shareholders from their apathy and increase their attendance and participation. We perceive five advantages of the virtual meeting: (1) low-cost for a corporation (2) reducing paper work (3) efficient and easy way to set up a meeting of shareholders (4) increasing shareholders' participation and 5) sufficient communication process. All these advantages would improve the present corporate governance, the involvement of the shareholders, and the attraction for investors.

Having given our view on a virtual meeting of shareholders, we would now try to answer the following three questions.

- Is it possible to formulate an appropriate legislation for a virtual meeting of shareholders?
- What is the impact of a new legal framework of a virtual meeting of shareholders?
- What are the future expectations?

3. Dutch amendments

The Netherlands can be considered as one of the leading trading countries in Europe. It is not surprising that the Netherlands is one of the first countries to enhance its corporate governance and comply with the EU regulations, as well as with the new regulations of the other leading countries, such as the U.S., the U.K., and Japan.

In December 2003, the Dutch corporate governance committee issued the Dutch corporate governance code which was enforced in January 2004. The code is applicable to (1) all companies that have registered offices in the Netherlands and (2) all so-called listed companies. This committee has a long-term monitoring function and proposed 40 recommendations (cf. Corporate governance committee (known as the "Tabaksblat Committee", 2003)). Moreover, the committee was influenced by the Combined Code of the U.K. which was adopted in 2003. The new Dutch code is replacing the recommendations by Peter's Committee (cf. Peter's committee, 1997).

Since the beginning of 2007, a new law was enforced in the Netherlands that allows a virtual meeting of shareholders. The latest amendments of the Burgerlijk Wetboek prescribe that shareholders may request to attend a meeting using electronic means of communication. Moreover, the article 2:113 states: "Shareholders (and equals) can be called together by electronic means (which has to be eligible and reproducible) unless the statutes state otherwise. Statutes can allow shareholders to be called together through electronically published and publicly accessible means" [1].

In addition, every shareholder may decide how to attend the meeting, virtually or by physical presence. Once the shareholders have provided the management board with their consent regarding how they will attend the meeting, the management board may start to organize the meeting. In addition, in order for the Dutch legislation to be valid (i.e., in force) with respect to future shareholders' meetings conducted by electronic means of communication, it has to be precisely prescribed in the statute of the corporation. "Statutes may allow every shareholder to take part in a general meeting by electronic means, and may cast his vote as such. It is required that they can be digitally identified, and can obtain direct information on what takes place at the meeting and cast his vote. The statutes can allow the shareholder to take part in the meeting by electronic means." Statutes can restrict the above; such restrictions have to be made known in advance. A written mandate can also be given by electronic means." (Article 2:117a Wet Boek)

This adequately determines the flexibility of law. The corporation and its shareholders can decide whether they want to conduct a shareholders' meeting by electronic means of communication. This can be explicitly written in the statute, which means they know in advance what they can expect.

Such a manner of legislating a virtual meeting of shareholders shows that the State does wish to be involved and over regulate the relations. We may not conclude on the legality of this method. We have to see how Dutch corporations will benefit from this legislation. We believe that within a few years we can have some empirical data to conclude. We expect that many European countries would copy such a method of legislating a virtual meeting of shareholders.

4. Recent Delaware amendments

The Delaware legislation was the first legislation in the world to enforce a virtual meeting of shareholders. Below we do not dismiss its anguish and its consequences. However, for these specific topics we refer to the general framework of the Delaware Corporate Governance Law and focus on the recent amendments.

In general, the Delaware legislation differs from other legislations by its flexibility. Delaware is a phenomenon in the corporate world. The latest technological amendments in Delaware General Corporation Law (DGCL) show the dominance of Delaware in the U.S. One prominent aspect is the periodic evaluation and updating of Delaware's General Corporate Law (the DGCL) (cf. Easmunt, 2004).

The July 2000 amendments to the DGCL are the most important areas of the last decade, primarily owing to their practical impact. They describe the nature of the future of corporate governance by using information technologies and pursuing corporate governance (1) in a new direction and (2) in a different virtual venue. The Delaware amendments are quite significant, not only for the U.S. corporate governance system, but also for the European corporate governance. In Europe, the amendments evoked some interesting discussions on the virtual venue in corporate governance and methods of communication.

Below we discuss the alleged 'technological amendments' that bring the DGCL directly into the 21st century. The amendments enable corporations to employ modern technology supporting their corporate affairs. For example, an amendment to Section 211 (Meetings of Stockholders) places the ruling for the use of IT in the hands of the board of directors to permit shareholders to attend and participate in meetings by remote communication.

Nowadays, shareholders' meetings according to DCGL are held (1) only by remote communication, without a physical venue, or (2) only by physical presence. The board's actions may be taken by using a variety of modern technologies, such as consents of directors by means of an "electronic transmission" (cf. DCGL, 2000).

The amendment of section 211 of the Corporation Law explicitly gives the main decision in the hands of the board to decide how to hold and conduct the shareholders meeting via remote communication or only by physical attendance. Therefore, we may conclude that a shareholders' meeting can be held only in its virtual venue without any physical presence. So far, it is a matter of a choice (physical presence or virtual presence). This implies that the laws provide only one option for conducting a meeting without any possibility to combine the two venues, i.e., to combine the physical and virtual presence at one shareholders' meeting.

In section 211(a) and section 141(f), we perceive that the meeting of shareholders conducted via remote communication does not require for the participants to hear each other. We assume that the meeting may be conducted via remote communication also in chat rooms, chat sites or any type of known internet communication which does not include the venue of hearing or seeing each other, and still must fulfil the requirement for communication (cf. Goldman, Pittenger, and Salomone, 2005).

Below, we provide some history showing how these amendments were used in practice for the first time. In April 2001, a small company incorporated in Delaware, INFORTE, became the first company to benefit from Delaware's new laws to conduct an electronic shareholders' meeting with no physical counterpart. Under the new Section 211 of the Delaware General Corporation Law, the board can hold a meeting 'by means of remote communication' and allow remote stockholders/proxy holders to be considered 'present' for quorum and voting purposes, if the company has the ability to: implement 'reasonable measures' to verify that each person is a shareholder or a proxy holder. INFORTE was prepared to receive e-votes by fax.

Here we may conclude that with the amendments of the Delaware general corporate law, the corporate governance in the U.S. initiated a new direction of conducting a shareholders' meeting. The significant amendments challenged the other legislative bodies in the world. Consequently, with such amendments, it is not surprising that many legislators opine that the best facilitation of corporate governance at the moment is IT. The Delaware corporate governance clearly suggests that IT may guarantee the transparency in corporate governance along with the imposition of a new role of the shareholders and their meetings in corporate governance.

5. A comparison

Comparing the Dutch and the Delaware amendments, we have to take into account (1) the differences in the legal regimes and (2) the different corporate governances. We must position the Dutch corporate governance as an insider system and the Delaware corporate governance as an outsider. From the many main differences, we focus on the nature of the meeting. Both systems have different regimes for conducting a virtual meeting. According to the Dutch laws, a virtual meeting of shareholders can be held combining both venues*, i.e.,* the

virtual venue and the physical one. The Delaware corporate law prescribes only one venue to be used when a meeting is held. The Dutch legislation requires that every shareholder may decide which venues for attending a meeting will be used - virtual or physical. Contrarily to this, Delaware legislators gave their choice in the hand of the Board of Directors to decide which venue will be used.

6. Future expectations

Obviously, the new communication technologies facilitate the shareholders' participation. Using the new modern means of communication, the participation at the General Meeting of shareholders gives the opportunity for rational decisions made by the shareholders. It may help see the importance of exercising the shareholders' rights, avoiding the accountancy manipulations of managers and the Board of Directors, and reducing any distrust in the idea of corporate governance.

We hope that the legislators will see the importance of this new form of exercising the shareholders' rights. Clearly, the virtual meeting has also to cope with the understanding of software problems and cannot just transform the present legal requirements to a "virtual" environment. The new environment has a different understanding of the legal terms, the physical assumptions, and the physical presumptions. At first, this difference may lead to misunderstanding in the communication process. Therefore, the right direction is to reach a common meeting point of legal expertise, technical approaches and new developments. It will be a waste of time if the legislation is trying to adapt the old legislation to the new demands of the knowledge society. The corporate governance has to articulate their needs in a proper way. The following factors have to be taken into account when considering the complete revision of legislation.

- Software and hardware developments
- Monopoly on the market of some software and hardware companies
- Unification of terms
- Concentration of power in decision-making bodies
- Avoiding technical slang
- Access to the electronic facilities, proper software and hardware
- Shareholders should be able to vote in absence using modern means of communication
- Unification of legal terms
- Avoiding legal conflicts on national and international level

We definitely expect that many legislative bodies will enforce new suitable legislations on one of the first virtual meetings of shareholders. This will strengthen and improve corporate governances and also cross-border shareholding. The virtual world provides us with an inexhaustible amount of knowledge and information and participation of a meeting of shareholders is easy accessible. Therefore, IT will facilitate corporate governance.

7. Conclusions

Conducting a virtual meeting of shareholders has great potentials and benefits. Shareholders may exercise their rights from a distance and will see that it improves their participation. A virtual meeting of shareholders is a real opportunity for corporations with shareholders widely spread all over the world. Such a meeting will alert the management and the CEOs in formulating and delineating a better policy. It will also improve the communication process between shareholders and the corporation. Moreover, the virtual meetings will prevent – at least that is what we expect - previously experienced accountancy manipulations. Engaging IT will enhance the corporate governance and will attract more investors from abroad.

So, we may consider that a virtual meeting of shareholders has at least four advantages, viz. (1) low costs to organize the meeting, (2) efficient and fast communication, (3) less paper work, and (4) easy to attend. These advantages are desired by many corporations. We believe that in the future a virtual meeting of shareholders will increase the shareholders' attendance and participation. This, in turn, will lead to a better corporate governance and transparent corporate finance.

So far, we have seen how the Netherlands and Delaware enforced their legislation on the possibility of a virtual meeting of shareholders. A few Delaware corporations clearly benefited from the Delaware amendments, although some did not report a big success owing to the old fashioned method of a physical attendance- i.e. the meeting of shareholders was limited to one venue. It is interesting to see how a corporation residing in the

Netherlands will use the possibility of conducting a virtual meeting of shareholders with also a physical presence.

Acknowledgement

The research has been performed under the aegis of the ITeR programme, which is supported by the Dutch Organization of Scientific Research in the Netherlands (NWO), research number 014-38-320-A

Notes:

[1]The translation is not an official translation of the Dutch legislation.

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Possibilities of Measuring the Option Clauses' Value in Sport Contracts: Empirical Study

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Abstract: Year 2004 was influenced by the strike in the National Hockey League. The reason of this strike was the option of adoption of the wage ceiling for the NHL players. The paper stresses the attention to the problem how to account and measure the possibility of the players' contracts with options in the new model. We are dealing with the following hypothesis: 'Is possible to use the experiences of valuation of financial options not only to ROA (Real Options Analysis) but also for valuation of players' contracts with option?' The modified Black-Scholes Formula is one of the possible solutions which can be used to measure the value of the option clause.

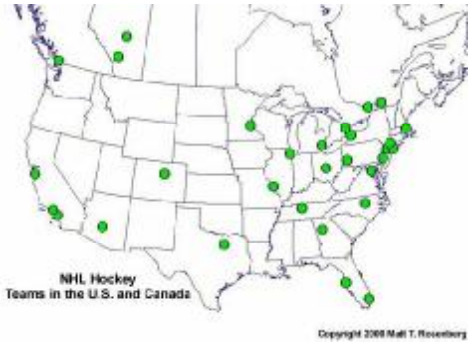
1. Introduction

1.0 History of the ice hockey and the NHL

Hockey has been played for as long as anyone of us can remember, but few can tell the date and the person who invented it because no one really knows for sure. Once a relatively obscure recreation for people who lived in the northern country, hockey is now played all over the world and has become one of the most popular winter sports. Most historians place the roots of hockey in the chilly climes of northern Europe, specifically Great Britain and France, where field hockey was a popular summer sport more than 500 years ago. When the ponds and lakes froze in winter, it was not unusual for the athletes who fancied that sport to play a version of it on ice. An ice game known as *kolven* was popular in Holland in the 17th century, and later on, the game really took hold in England. Articles in London newspapers around that time mention increasing interest in the sport, which many observers believe got its name from the French word *"hoquet"*, which means "shepherd's crook" or "bent stick".

Hockey was a strictly amateur affair until 1904, when the first professional league was created in the United States. Known as the International Pro Hockey League, it was based in the iron-mining region of Michigan's Upper Peninsula. That folded in 1907, but then an even bigger league emerged three years later, the National Hockey Association (NHA). And shortly after that came the Pacific Coast League (PCL). In 1914, a transcontinental championship series was arranged between the two, with the winner getting the coveted cup of Lord Stanley.

But after the World War I, the hockey-playing countries started a whole new organization that would be known as the National Hockey League (NHL). At its inception, the NHL boasted five franchises – the *Montreal Canadiens*, the *Montreal Wanderers*, the *Ottawa Senators*, the *Quebec Bulldogs*, and the *Toronto Arenas*. The league's first game was held December 19, 1917. The clubs played a 22-game schedule and, picking up on a rule change instituted by the old NHA, dropped the rover and employed only six players on a side. Toronto finished that first season on top, and in March 1918 met the Pacific Coast League champion Vancouver Millionaires for the Stanley Cup. Toronto won, three games to two. Eventually the PCL folded, and at the start of the 1926 season, the NHL, which at that point had ten teams, divided into two divisions and took control of the Stanley Cup. Nowadays, the NHL consists of 30 teams divided into two conferences (The Western Conference and The Eastern Conference) and into six divisions (three for both conferences).



Source: http://geography.about.com/library/weekly/aa042700e.htm

1.1 Literature Review

This paper deals with the issue of how to measure the value of the hockey player and how to calculate the value of the contract. In the sport industry, it is very popular to negotiate the contracts with the option clause. The main aim of this text is to show the importance of calculating the value of the option clause using the formula for the derivatives.

Currently, there is a lack of adequate literature; however, the author of the text worked several years as a sport journalist in the branch of ice-hockey, and had acquired the knowledge of the accounting methodology of of these contracts in the Czech Republic. The players from this country are well-known in the NHL; moreover, from the 1993, Czech Republic won 5 times the ice-hockey World Championships and the Czech players also won the gold medals from the Winter Olympic Games in Nagano, 1998. Currently, based on the world ranking of the IIHF (the International Ice Hockey Federation), the Czech Republic is the second best team in the world (after Sweden).

2. Collective Bargaining Agreement (the C.B.A.)

A principal responsibility of the NHLPA (National Hockey League Players' Association) is to negotiate, on behalf of the players, the terms of the Collective Bargaining Agreement ("CBA") with the NHL. The CBA is a document that governs all aspects of a player's rights and responsibilities relative to his employment with an NHL club. It covers such matters as entry-level compensation, free agency, waivers and grievances.

2.1 Basic Definitions

Average League Salary means the league average salary for such league year determined in accordance with the principles set forth in the decision of the Arbitrator Nicolau in the average league salary dispute dated March 20, 1995.

Compensation means any money, property, investments, loans, options or anything else of value, whether or not in cash, that a club, or any entity or person owned by (wholly or partly), controlled by, affiliated with, or related to, a club or any owner of a club, agrees to or actually pays, grants, arranges for or provides to, or is obligated to pay, grant, arrange for or provide to, a player, or is paid, granted, arranged for or provided to a third party at the request of and/or for the benefit of a player, including but not limited to, signing, reporting and roster bonuses, base salary, deferred compensation, agents fees, amounts to be paid in respect of marketing, licensing and promotional arrangements, and any reimbursement of costs or expenses in excess of the amounts specified in CBA.

Currency Exchange Ratio is the rate of exchange between Canadian dollars and U.S. dollars, as set forth in the Wall Street Journal, as of such time.

NHL Games include both NHL regular season and playoff games. For the purposes of the foregoing, the term "professional season" shall

- for a player aged 18 or 19 mean any season in which such player plays in 11 or more professional games, and

- for a player aged 20 or older mean any season in which such player plays in one or more professional games.

Player means a hockey player who is party to a player contract, any rookie, restricted free agent and unrestricted free agent, a player who having been party to a player contract has not yet achieved the experience level or age required to attain the status of a restricted free agent or an unrestricted free agent, and any entity or person owned by, controlled by, affiliated with, or related to such hockey player.

Player Contract is a written agreement between a player and a club which shall include only the standard form contract and addenda agreed to by a club and such player thereto pursuant to which such player is employed by such club as a professional hockey player.

Prior Year's Salary" is the base salary paid to such player for the last league year of such player's most recent player contract.

Unrestricted Free Agent" is a player who(a) has either never signed a player contract or whose player contract has expired, or has been terminated or bought out by a club; and (b) who otherwise is not subject to any exclusive negotiating rights, right of first refusal, or draft choice compensation in favour of any club.

2.2 Changes in the C.B.A. since 2005

The year 2004 was influenced by the strike in the National Hockey League. The reason for this strike was the option of adoption of the wage ceiling for the NHL players. The players worried about their new wages, but finally the NHLPA did not succeed in negotiating the new CBA.

The National Hockey League's Board of Governors on 22nd July, 2005, the terms of the CBA negotiated with the NHL Players' Association, ending a 310-day work stoppage, signaling a new era of cooperation and partnership, and ensuring the League will resume play for the 2005-06 season. The six-year agreement, scheduled to run through September 15, 2011, may be reopened by the Players' Association following Year Four (2008-09). The Players' Association also has the option to extend the agreement for one year at the end of the scheduled term.The Collective Bargaining Agreement includes a completely revamped economic system under which, during the first year, total player costs of the 30 NHL Clubs will not exceed 54 % of League-wide revenue. The calibration of the percentage in future years of the Agreement will be linked to a percentage of League-wide revenue, and could rise to 57 % if League-wide revenue exceeds $2.7 billion. No Club payroll for the 2005-06 season will be less than $21.5 million and no payroll will exceed $39 million – including all salaries, signing bonuses and performance bonuses. Each individual player contract currently in existence will include a 24 % reduction of NHL salary for every year of its term, and no individual player salary can exceed 20 % of a Club's Upper Limit on payroll.

The economic system also includes provisions for enhanced revenue sharing. Accounting of League-wide revenue will be monitored jointly by the NHL and NHLPA. In addition, the League and Players' Association have agreed to create several joint committees that will work together toward the advancement of the game in a variety of areas, including competition, broadcasting and marketing.The new Agreement also creates, for the first time, a joint program dealing with the use of Performance-Enhancing Substances. Per the agreement, every NHL player will be subject to up to two "no notice" tests per year. The first positive test for performance-enhancing substances will result in a mandatory 20-game suspension without pay to the player. A second positive test would result in a 60-game suspension, and a third would result in permanent suspension; however, such a player would be eligible to apply for reinstatement after two years.

2.2.1 Entry-Level Salary

Entry Level players will be subject to a maximum annual salary (plus signing and games played bonuses) of $850,000 for 2005 and 2006 draftees; $875,000 for 2007 and 2008 draftees; $900,000 for 2009 and 2010; and $925,000 for 2011 draftees. The maximum combined signing bonus will be limited to 10% of the player's maximum annual compensation in any year.

Entry Level players may negotiate for performance bonuses up to a maximum of $850,000 in individual "Schedule A" bonuses per year (maximum of $212,500 per bonus). A player may also be eligible to earn individual" B" bonuses for League-wide excellence, which will, as a general matter, be paid by the League. In addition, a player will be eligible to negotiate with his club "excess" individual "B" bonuses, subject to a maximum aggregate of $2 million in any year.

3.1.1 Minimum and Maximum Salary

The minimum NHL player salary in 2005-06 and 2006-07 will be $450,000; $475,000 in 2007-08 and 2008-09; $500,000 in 2009-10 and 2010-11, and $525,000 in 2011-12.No player may be eligible to contract for or receive in excess of 20 % of the Club's upper limit in total annual compensation (NHL salary plus signing, roster, reporting and all performance bonuses). In 2005-06, no player will be permitted to contract for total compensation in excess of $7.8 million in any year of his contract.

3.1.2 Club Payrolls

The payroll range in the Season 2005-06 will be $21.5 million (U.S.) at the lower limit and $39 million (U.S.) at the upper limit. A Club's payroll will include all salaries, signing bonuses and performance bonuses paid to players. Except in the case of bona fide long-term injury (injuries that sideline a player for a minimum of 24 days and 10 games) to one or more of a club's players, Club payrolls will never be permitted to be below the minimum or in excess of the maximum. Clubs at or near the upper limit that have players who incur a bona fide long-term injury will be entitled to replace up to the full value of the injured player's NHL salary (even if such salary would result in the club's team salary exceeding the upper limit). The" replacement salary" will not count against the club's upper limit but will count against the League-wide players' share. Upon return of the injured player, the team must come into immediate compliance with the requirements of the payroll range.

3.1.3 Renegotiation of the Contract

Player contracts will not be re-negotiated, upward or downward, during their term. Extensions may be negotiated but only in the final year of the contract and only if such extension is for an amount that can be accommodated in a Club's upper limit for the current year or as computed for future years.

3.1.4 Two-way Arbitration

Eligibility rules for Player Salary Arbitration have been modified and Clubs will now have the ability to elect Salary Arbitration for eligible Players.In general, players will be eligible for salary arbitration after 4 years in the League instead of three. For the first time, Clubs also will have the right to elect salary arbitration with respect to two categories of players. For players who are earning more than $1.5 million in their prior year, Clubs will have the right to elect salary arbitration in lieu of making a Qualifying Offer [1]. Clubs also have the right to elect salary arbitration with respect to other Group 2 players who chose not to take the Club to arbitration.

3.1.5 Unrestricted Free Agency

The age of unrestricted free agency remains 31 (with four accrued seasons of 40 or more games on an NHL Club's roster) for 2005-06. It will drop to 29 (with four accrued seasons) or eight accrued seasons – regardless of age – in 2006-07. The following season, the age drops to 28 (with four accrued seasons) or seven accrued seasons, and falls to 27 (with four accrued seasons) or seven accrued seasons in 2008-09.

3.1.6 Permission of Performance Bonuses

Performance bonuses will only be permissible for the following types of players:

- players on entry-level contracts;
- players signing one-year contracts after returning from long-term injuries[2]; and
- senior veteran players who sign a one-year contract after the age of 35.

4. Measurement of the Player's Value

The main focus of this chapter is to show how to measure the value of the player. For this purpose the author uses the framework of the IIHF and the framework of the ČSLH (Czech Ice Hockey Federation).

Principal factors affecting the player's value are as follows:

- basic ("table") value of the player,
- coefficients increasing the value.

4.1 Basic Value of the Player

The basic value of the player depends on each competition. In the NHL is given by the a) minimum salary[3], or b)the maximum entry-level salary[4] given by the Collective Bargaining Agreement corrected by the insurance coverage which is paid to the players by NHL and NHLPA.

4.1.1 Insurance Coverage

The clubs shall maintain in effect a group life insurance policy providing a face policy amount of $245,000 US per player, for all players who play in at least one NHL game during the year. An accidental death and dismemberment policy shall also be maintained by the clubs in a face amount of $245,000 US. Coverage shall continue until 1st October the following season. Claims are to be paid in U.S. Currency. The clubs shall also maintain in effect a group life insurance policy providing for a death benefit in a face policy amount of $125,000 US per spouse, for the spouse of each player who plays in at least one NHL game during the year. Coverage shall continue until 1st October the following season. Claims are to be paid in U.S. Currency. The NHLPA shall maintain in effect a group life insurance policy providing a face policy of $125,000 US per spouse. An accidental death and dismemberment policy shall also be maintained by the NHLPA in a face amount of $125,000 US per spouse. Claims are to be paid in U.S. Currency.

The clubs and the NHLPA shall also maintain in effect a career ending disability policy providing for a one-time benefit in the event a player who is on a club playing roster suffers a career ending disability. Disability must be due to an injury or illness which results solely and independently of any other cause. Disability shall be considered career-ending if the player is continuously disabled for a period of 12 months and permanently prevented from playing professional hockey. Benefit coverage is dependent upon age at date of disability, as outlined below, for the following periods:

Tab. 1: Insurance Coverage- Source: the CBA

Age	NHL Benefit	NHLPA Benefit
under 21	120	60
21 – 26	245	125
27	200	100
28	145	75
29	100	50
30 and more	50	25

4.1.2 Measurement of the Basic Value of the Player

As mentioned above, the basic value in this model is constructed as a combination of insurance coverage coefficient and the minimum salary (players in age x – 26) or the maximum entry-level salary (players in age 27 and more). The basic values are given in the following table:

Tab. 2: Basic Value of the Player – NHL © JS

Age	**Insurance coverage**	**IC/AVG**	**Basic Value**
under 21	180	0,8333	475 000 [5]
21 – 26	370	1,7130	813 675
27	300	1,3889	1 180 565
28	220	1,0185	865 725
29	150	0,6944	590 240
30 and more	75	0,3472	475 000
Average coverage	**216**		

4.2 Increasing Coefficients for Measurement of the Player's Value

Since the NHL does not have its own rules of determining the arbitration price of the player, we used the measurement of the arbitration price in the Czech Extra-League, which is the League of the world ice-hockey champions. The parameters were modified for the NHL purposes. We can construct increasing coefficient for any sport competition. The following ones are constructed on the NHL basis with the co-efficient given in percentage value:

a) number of starts in NHL

Starts in NHL	Coefficient
0	0
1 – 250	5
251 – 500	10
501 – 750	15
751 – 1 000	20
1 001 and more	25

b) position of the player in club's standings at last season

Goal	Coefficient
No. 1	20
No. 2	10
No. 3	5

The results of defensemen are based on the standings at the statistic: +/- points.
The results of forwards are based on the standings at the statistic: Canadian points.

Player	Coefficient
1st – 4th place	20
5th – 8th place	15
9th – 12th place	10
13th place and worse	5

c) position of the player in NHL's standings at last season (goals, assists, +/- points)

The results of goalies are based on the league's standings at the statistic: Received goals average per match.

Goal	Coefficient
1st – 5th place	50
6th – 10th place	40
11th – 20th place	30
21st – 30th place	20
31st place and worse	10

Player	Coefficient
1st – 10th place	50
11th – 25th place	40
26th – 50th place	30
51st – 75th place	20
76th – 100th place	10
101st – 150th place	5
151st – 200th place	2

d) number of representation starts

Starts	Coefficient
1 – 24	1 – 24
25 and more	25

e) representation start at last IIHF World Championship

Standing of the Country	Coefficient
1st place (winner)	10
2nd – 3rd place	8
4th – 8th place	5
9th – 12th place	2
13th – 16th place	0

4.3 Arbitration Price

As we are able to measure the basic value of the player and to count the coefficients, we are also able to measure the arbitration price of the player:

$$AP \quad BV + BV \cdot \sum coefficients ,$$

where:
AP… arbitration price
BV… basic value of the player

4.3.1 Illustrative Case

Let us illustrate this methodology. In Appendix 1 you can see 50 NHL contracts. In this case we will count the arbitration price of David Vyborny, the player of Columbus Blue Jackets and the captain of Czech ice-hockey team. David was born on 22nd January 1975, so for the current season he reached the age of 30. He played in the NHL 356 games. In the club standings he is the best forward, in NHL he reached the 100th position.

Tab. 3: Arbitration Price of David Vyborny

	Basic Value	Coefficients
Basic Value	***$475,000***	
Starts in NHL		10
Club standings		20
NHL standings		10
Representation starts		25
Starts at last IIHF WC		10
Total (coefficients)		***75***

$$AP \quad 475{,}000 + 475{,}000 \cdot 0{,}75 \quad \$831{,}250$$

Result: The arbitration price of David Vyborny, the player of Columbus Blue Jackets, is $831,250.

5. Measurement of the Option Clauses' Value

The special theme is the option clause in the sport branch. The option clause is the option of the club to prolong the contract with the player. So the player has in this case the obligation to sell his services to the club for next seasons. For this option clause the value of the contract is higher. In this last part of this paper, we would like to emphasize the problem of measuring the value of option condensed in the contract. Is possible to use the experiences of valuation of financial options not only to ROA (Real Options Analysis), but also for valuation of players' contracts with option?

5.1 Option Value Pricing Model (OVPM)

We use the standard Black-Scholes Formula for the valuation of the options clauses. Black-Scholes Formula is the most popular model of measuring the price of the options as a financial derivative. The price of the call option is counted as a difference between the price of the share and the present value of the realisation price of this share. Fisher Black and Myron Scholes assumed that the evolution of the price of the share can be divided to

the constant change and the random change (application of the Wiener's process). For the purpose of this model they assume the constant difference (μ) in the price of the share (S) at the time (t) $S_t \mu \Delta t$.

The random change of the price of the share is counted as

$S_t \sigma \varepsilon \sqrt{\Delta t}$, where ε is the random variable with normal distribution.

The probabilistic model of the share characteristics is as follows:

$\Delta S / S_t = \mu \Delta t + \sigma \varepsilon \sqrt{\Delta t}$

Let's construct the portfolio P, which consists of the one share trading for the price S and $1/(\partial C / \partial S)$ call options sold. The value of this portfolio is as follows:

$V_P = S - 1/(\partial C / \partial S) C$

After that the change in the value of the portfolio P in the time t is as follows:

$\Delta V_P = \Delta S - 1/(\partial C / \partial S) \Delta C$.

Using the Ito's Lemma we can construct the following equation:

$\Delta C = C(S + \Delta S, X, t + \Delta t, r, \sigma) - C(S, X, t, r, \sigma) = \frac{\partial C}{\partial S} \Delta S + \frac{1}{2} \frac{\partial^2 C}{\partial S^2} \sigma^2 S^2 \Delta t + \frac{\partial C}{\partial t} \Delta t$ When we assume the change in the above mentioned portfolio, we could count with:

$$\Delta V_P = \Delta S - 1/(\partial C / \partial S) \Delta C = -\left(\frac{1}{2} \frac{\partial^2 C}{\partial S^2} \sigma^2 S^2 + \frac{\partial C}{\partial t} \right) \Delta t / (\partial C / \partial S)$$

Let's assume that the change in the portfolio value is the same as the change in the value of the risk-free asset:

$$\Delta V_P = -\left(\frac{1}{2} \frac{\partial^2 C}{\partial S^2} \sigma^2 S^2 + \frac{\partial C}{\partial t} \right) \Delta t / (\partial C / \partial S) = V_P r \Delta t = (S - 1/(\partial C / \partial S) C) r \Delta t$$

When we reduce Δt we can construct the following differential equation:

$$\frac{1}{2} \frac{\partial^2 C}{\partial S^2} \sigma^2 S^2 + \frac{\partial C}{\partial S} Sr - \frac{\partial C}{\partial t} + Cr = 0$$

At the time of the expiration of the option t = T we should assume that:

$C(S, X, t = T) = \max[S - X; 0]$

The final solution of this differential equation with the above mentioned limiting condition is the well-known formula for the pricing of the call option:

$$C(S,X,T,r,\sigma) = S \cdot N(d_1) \quad X \cdot e^{-rT} \cdot N(d_2)$$

$$d_1 \quad \frac{\ln\frac{S}{X} - (r + \frac{\sigma^2}{2})T}{\sigma\sqrt{T}}$$

$$d_2 - d_1 - \sigma\sqrt{T}$$

$$N(d) - \frac{1}{\sqrt{2\pi}} \cdot \int_{-\infty}^{d} e^{-\frac{x^2}{2}} dx$$

, where N(d) is the distribution function of the normal distribution.

We can assume the following changes at this model, when we use it for the measurement of the value of the option clause in sport contract.

Tab. 4: Financial Option versus Options Clause

Symbol	Financial Option		Options Clause
S	strike price	→	arbitration price
X	realisation price	→	contract value
T	time to expiration	→	duration of the contract (in years)
σ	volatility of underlying asset	→	risk of injury (in %)
r	interest rate	→	age coefficient (in %)

Because the club will have the right to buy his services, we should count the premium of call option. The realisation price of the contract and the duration of the contract is the contract agreed between the player and the team. The arbitration price could be counted using the approach mentioned in the chapter 3.3., which is used in European ice-hockey competitions. The main problem of this model is measuring the risk of injury and age. These problems are very close to problems of the measurement of the financial options using this formula.

5.1.1 Age coefficient ("risk of age")

Let's assume the risk of age as an inverse function of the insurance coverage.

Tab. 5: "Risk of Age" – NHL contracts

Age	Insurance coverage	Share	Avg vs. Share	Risk of age
under 21	180	13,90 %	+ 2,77 %	19,43 %
21 – 26	370	28,57 %	- 11,90 %	4,76 %
27	300	23,17 %	- 6,50 %	10,17 %
28	220	16,99 %	- 0,32 %	16,34 %
29	150	11,58 %	+ 5,08 %	21,75 %
30 and more	75	5,79 %	+ 10,88 %	27,54 %
TOTAL	**1 295**	**100,00 %**	**x**	**100,00 %**
AVERAGE	**216**	**16,67 %**	**x**	**16,67 %**

© JS

The table of age coefficient depends on each competition.

5.1.2 Risk of Injury

Measuring the risk of injury is more difficult than determining the risk of age coefficient, because the risk of injury is definitely the random variable. Here we can see the similarity with the volatility of underlying assets measuring the value of financial options.

5.2 Accounting of the Contracts with the Option Clause

There is an official accounting formula sport contracts. The current situation in the sport clubs is following: the whole contract value (including option clause) is allocated to expenses (Services) because players are not employees of the club from a legal point of view. Being able to measure the value of the option clause is possible in reporting this amount in the balance sheet. We will assume the difference between the contract value on one side and the arbitration price and the value of the option clause s goodwill.

Tab. 6: Final Decomposition of the Contract Value

Item	Debit	Credit
Contract value	x	Liabilities
Arbitration price	Services	x
Value of the option clause (OVPM)	Option Clause (intangible asset)	x
Difference **(„goodwill of the player")**	+ Royalties	- Retained Earnings

5.2.1 Illustrative Case: Accounting of David Vyborny's Contract

David Vyborny signed a one-year contract (option clause included) for $1,140,000 (date of the agreement 1st October, 2005). As we know, arbitration price of his contract is $831,250.

1) Measuring the option clause value

Symbol	Options Clause	Parameters
S	arbitration price	$831,250
X	contract value	$1,140,000
T	duration of the contract (in years)	1
σ	risk of injury (in %)	15 % (estimation)
r	age coefficient (in %)	27,54 %
OCV	option clause' value	?

$$OCV = S \cdot N(d_1) - X \cdot e^{-rT} \cdot N(d_2),$$

where :

$$d_1 = \frac{\ln\frac{S}{X} + (r + \frac{\sigma^2}{2})T}{\sigma \cdot \sqrt{T}}$$

$$d_2 = d_1 - \sigma \cdot \sqrt{T}$$

$$N(d) = \frac{1}{\sqrt{2\pi}} \cdot \int_{-\infty}^{d} e^{-\frac{x^2}{2}} dx$$

$$OCV_{David\ Vyborny} = \$35,394$$

The value of the option clause regarding to the model is $35,394.

2) Accounting of the contract

2a – Traditional approach

Year 2005

Date			Debit	Credit
1.10.2005	Contract value	1,140,000	Deferred Expenses	Liabilities
31.10.2005	Player's services 10/2005	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
30.11.2005	Player's services 11/2005	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
31.12.2005	Player's services 12/2005	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses

Balance sheet as at 1.10.2005

Def.exp.	$1 140 000	Liabilities	$1 140 000
	$1 140 000		**$1 140 000**

Balance sheet as at 31.12.2005

Cash	-$285 000	Earnings	-$285 000
Def.exp.	$855 000	Liabilities	$855 000
	$570 000		**$570 000**

Year 2006

Date			Debit	Credit
31.1.2006	Player's services 1/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
28.2.2006	Player's services 2/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
31.3.2006	Player's services 3/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
30.4.2006	Player's services 4/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
31.5.2006	Player's services 5/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
30.6.2006	Player's services 6/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
31.7.2006	Player's services 7/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
31.8.2006	Player's services 8/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses
30.9.2006	Player's services 9/2006	95,000	Liabilities	Cash
		95,000	Expenses – Services	Deferred Expenses

Balance sheet as at 30.9.2006

Cash	-$1 140 000	Ret.earn.	-$285 000
Def.exp.	$0	Earnings	-$855 000
		Liabilities	$0
	-$1 140 000		**-$1 140 000**

2b – OVPM approach

Year 2005

Date			Debit	Credit
1.10.2005	Contract value	1,140,000	x	Liabilities
	Arbitration price	831,250	Deferred Expenses	x
	Value of the OC	35,394	Option Clause	x
	Player's goodwill	273,356	Royalties	
31.10.2005	Player's services 10/2005	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
30.11.2005	Player's services 11/2005	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
31.12.2005	Player's services 12/2005	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties

Balance sheet as at 1.10.2005

Royalties	$273 356	Liabilities	$1 140 000
Opt.clause	$35 394		
Def.exp.	$831 250		
	$1 140 000		**$1 140 000**

Balance sheet as at 31.12.2005

Royalties	$205 016	Liabilities	$855 000
Opt.clause	$35 394	Earnings	-$276 153
Cash	-$285 000		
Def.exp.	$623 437		
	$578 847		**$578 847**

Year 2006

Date			Debit	Credit
31.1.2006	Player's services 1/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
28.2.2006	Player's services 2/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
31.3.2006	Player's services 3/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
30.4.2006	Player's services 4/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
31.5.2006	Player's services 5/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
30.6.2006	Player's services 6/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
31.7.2006	Player's services 7/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses

	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
31.8.2006	Player's services 8/2006	95,000	Liabilities	Cash
		69,271	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,780	Expenses – Amortization	Royalties
30.9.2006	Player's services 9/2006	95,000	Liabilities	Cash
		69,269	Expenses – Services	Deferred Expenses
	Amortization of goodwill	22,776	Expenses – Amortization	Royalties

Balance sheet as at 30.9.2006

Royalties	$0	Ret.earn.	-$276 153
Opt.clause	$35 394	Earnings	-$828 453
Cash	-$1 140 000	Liabilities	$0
Def.exp.	$0		
	-$1 104 606		**-$1 104 606**

The difference in retained earnings (years 2005 and 2006) is given by the measurement of the option clause value. If Columbus will prolong the contract with David Vyborny, then the value of the option clause should be a part of the deferred expenses of the new period. In case the contract will not be prolonged, then we should account the option clause value to expenses.

6. Conclusion

Ice-hockey is an important player in the entertainment industry. Ice-hockey attracts not only the spectators, but also the sponsors. The history of the NHL started from the end of the World War I; the same situation is in the European continent. After that is very interesting that till nowadays there are no official rules how to account the ice hockey contracts. The purpose of the paper was to show, how to account contracts with the option value.

It is possible to use other models than the Black-Scholes Formula mentioned in this paper to measure the value of the option clause. The value of this clause is a very important part of the negotiated contract and therefore it is necessary to recognise and account it. Despite the high values of these option clauses , they are not measured and accounted separately at any of the ice-hockey competitions round the world. The author recommends further discussions on this topic.

Notes:

[1] Players earning $660,000 or less will be entitled to qualifying offers (QO) at 110 % of their prior year's salary; players earning more than $660,000 and up to $1 million will be entitled to QOs at 105 % of prior year's salary; players earning more than $1 million will be entitled to QO at 100 % of their prior year's salary.
[2] Players with 400 or more games who spent 100 or more days on injured reserve in the last year of their most recent contract.
[3] For the season 2006/2007 the minimum salary is $475,000.
[4] For the season 2006/2007 the maximum entry-level salary is $850,000.
[5] The minimum salary
[6] Only for players who played at last IIHF WC 5 and more games (goalies 3 and more).
[7] For the counting of the value of the option clause I used as a framework Black-Scholes Formula which is used on financial options. One of the variables of this model is the volatility of underlying asset (exchange rate, interest rate, price of the share). This variable is most difficult how to measure it.
To be able to use the Black-Scholes Formula on sport contracts, I should find some parallel variable with close characteristics. As a most rational I found the risk of injury of the player, because this is also a random variable. The biggest problem is how to measure this variable, as some of the players are more some are less predisposed to injury.

7. References

[1] Strouhal, J. (2005a). Options Clauses' Value in Sport: Recognition and Measurement. In: Accounting and Performance Management Perspectives In Business and Public Sector Organizations. Tartu: Bookmill Press.

[2] Strouhal, J. (2005b). Soccer and Ice Hockey Contracts: Comparative Study. In: Rimmel, G. (ed.): 28th Annual Congress of the European Accounting Association. Göteborg: BAS Publishing House.

[3] www.cslh.cz (Czech Ice Hockey Federation)

[4] www.iihf.com (International Ice Hockey Federation)

[5] www.nhl.com (National Hockey League)

[6] www.nhlpa.com (NHL Players' Association)

[7] Information about Czech icehockey Extra League are available online at the official web about Czech icehockey: www.hokej.cz.

APPENDIX – NHL Statistics

Name	Date of birth	Age	Position	Team	Compensation	Standings	
						Team	NHL
Balastik Jaroslav	28.11.1979	26	Forward	Columbus	600,000	10	286
Bonk Radek	09.01.1976	29	Forward	Montreal	2,394,000	12	263
Bulis Jan	18.03.1978	27	Forward	Montreal	1,026,000	6	152
Cajanek Petr	18.08.1975	30	Forward	St. Louis	836,000	4	135
Dvorak Radek	09.03.1977	28	Forward	Edmonton	1,596,000	12	214
Elias Patrik	13.04.1976	29	Forward	New Jersey	4,180,000	13	286
Erat Martin	28.08.1981	24	Forward	Nashville	875,000	7	125
Fischer Jiri	31.07.1980	25	Defence	Detroit	1,330,000	6	30
Hamrlik Roman	12.04.1974	31	Defence	Calgary	3,500,000	13	97
Hasek Dominik	29.01.1965	40	Goal	Ottawa	1,520,000	1	3
Havlat Martin	19.04.1981	24	Forward	Ottawa	2,600,000	14	232
Hejduk Milan	14.02.1976	29	Forward	Colorado	3,700,000	6	75
Hemsky Ales	13.08.1983	22	Forward	Edmonton	901,740	2	28
Holik Robert	01.01.1971	34	Forward	Atlanta	4,250,000	10	205
Hrdina Jan	05.02.1976	29	Forward	Columbus	1,050,000	6	183
Jagr Jaromir	15.02.1972	33	Forward	NY Rangers	8,360,000	1	1
Kaberle Frantisek	08.11.1973	32	Defence	Carolina	1,292,000	5	37
Kaberle Tomas	02.03.1978	27	Defence	Toronto	2,280,000	1	30
Klesla Rostislav	21.03.1982	23	Defence	Columbus	943,635	6	128
Kotalik Ales	23.12.1978	27	Forward	Buffalo	837,900	3	68
Krajicek Lukas	11.03.1983	22	Defence	Florida	551,000	9	110
Kuba Filip	29.12.1976	29	Defence	Minessota	1,691,000	6	97
Kubina Pavel	15.04.1977	28	Defence	Tampa Bay	2,584,000	11	110
Lang Robert	19.12.1970	35	Forward	Detroit	3,800,000	6	68
Malik Marek	24.06.1975	30	Defence	NY Rangers	2,500,000	2	12
Martinek Radek	31.08.1976	29	Defence	NY Islanders	575,000	22	196
Melichar Josef	20.01.1979	26	Defence	Pittsburgh	700,000	4	128
Michalek Milan	12.07.1984	21	Forward	San Jose	471,200	7	191
Michalek Zbynek	23.12.1982	23	Defence	Phoenix	450,000	2	30
Modry Jaroslav	27.02.1971	34	Defence	Atlanta	1,748,000	24	179
Nedved Petr	09.12.1971	34	Forward	Phoenix	2,204,000	14	286

Olesz Rostislav	10.10.1985	20	Forward	Florida	984,200	13	286
Plekanec Tomas	31.10.1982	23	Forward	Montreal	450,000	12	263
Prospal Vaclav	17.02.1975	30	Forward	Tampa Bay	1,900,000	1	15
Prucha Petr	14.09.1982	23	Forward	NY Rangers	525,000	5	117
Rozsival Michal	03.09.1978	27	Defence	NY Rangers	703,000	1	5
Rucinsky Martin	11.03.1971	34	Forward	NY Rangers	3,000,000	4	87
Skoula Martin	28.10.1979	26	Defence	Dallas	1,525,000	8	37
Slegr Jiri	30.05.1971	34	Defence	Boston	950,000	13	140
Spacek Jaroslav	11.02.1974	31	Defence	Chicago	2,250,000	3	51
Stefan Patrik	16.09.1980	25	Forward	Atlanta	1,064,000	12	232
Straka Martin	03.09.1972	33	Forward	NY Rangers	3,000,000	2	22
Svoboda Jaroslav	01.06.1980	25	Forward	Dallas	456,000	18	362
Sykora Petr	19.11.1976	29	Forward	NY Rangers	3,116,000	6	135
Varada Vaclav	26.04.1976	29	Forward	Ottawa	1,216,000	13	214
Vasicek Josef	12.09.1980	25	Forward	Carolina	1,000,000	17	362
Vokoun Tomas	02.07.1976	29	Goal	Nashville	2,280,000	1	17
Vrbata Radim	13.06.1981	24	Forward	Chicago	475,000	13	300
Vyborny David	22.01.1975	30	Forward	Columbus	1,140,000	1	100
Zidlicky Marek	03.02.1977	28	Defence	Nashville	1,140,000	7	69

Taking Patents Seriously

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Abstract. Do patents make economic sense? This question is as actual today as it was at the time of the Industrial Revolution. The Industrial Revolution changed society by introducing new manufactures and processes. The Information Revolution has changed society by introducing new technology and altering our means of communication. However, the questions that troubled the judges in the 18th century are surprisingly similar to those that perplex many judges today. It is contended in this article, that judges and lawyers generally are still struggling with patents because of two issues in particular: what is the legal status of intellectual creations and what are the economic effects of a patent system. In the 18th century, judges struggled to determine how a patent for inventions fitted within the traditional description of property. Today, judges have struggled in a similar way with the legal status of software and whether it can be protected by a patent or only copyright. In the 18th century by no means were all inventions patented; there is a discrepancy between the number of inventions and the number of patents. Nonetheless, it was an age of considerable technological advancement. Today, it is still not clear whether the patent protection of software is always useful either to the inventor himself or to society in general.

1. Introduction

In the English case of St. Albans v ICL, the High Court and then the Court of Appeal struggled with the legal status of software: was it a good or a service? In the High Court, Scott Baker J said obiter, that if called upon to decide he would probably hold that software was goods on the basis that if software was not goods he could not see what it could be "other than something to which no statutory rules applied"[1]. Sir Iain Glidewell of the Court of Appeal addressed the question of the nature of software. He held that if a disk is sold or hired by the computer manufacturer, but the program is defective, there would prima facie be a breach of the terms as to satisfactory quality and fitness for purpose implied by the Sale of Goods Act [2]. However, where there was no tangible element, such as a disk, he considered that the transfer of the program did not constitute a transfer of goods. To determine whether the implied terms as to satisfactory quality and fitness for purpose could be implied into a contract, it would be necessary to look at the common law, as the Act would not apply.

Sir Iain Glidewell's words illustrate the problems that some lawyers have with respect to software. In the first place, software is treated as an intangible. It is contended here that to do so shows a lack of scientific understanding, which in turn leads to befuddled legal argumentation. Software is not intangible. This initial mistake as to the nature of software leads to the next misconceived premise: that as software is intangible it falls outside the traditional legal definition of goods. However, software is as much goods as books and cars are goods. The matter becomes even more convoluted when the issue of the patentability of software arises. First it was assumed that patents were not applicable to software, then that patents were applicable but only if what was concerned was a software related innovation. Furthermore, these discussions on patentability seem to take it for

granted that a patent is useful in promoting technological advancement and general economic prosperity. However, that premise is open to question as well.

2. Patents in the past

The legal nature of a patent for invention is a topic that has been debated by lawyers for centuries. If a historical perspective is taken, what is striking is that the discussions that took place during the Industrial Revolution with respect to manufactures bear a remarkable similarity to the present day discussions on the patentability of software. Lawyers asked themselves then, as now, what the subject-matter of a patent could be, what manner of legal construction a patent is and whether this temporary form of monopoly was beneficial to society or a hindrance to progress.

One of the earliest laws on patents was enacted in England: the Statute of Monopolies 1624. This statute declared that all monopolies were against the laws of the realm and would be void. By the early 17th century, the patent had become tainted by its association with the misuse of monopolies. Under the Tudors and Stuarts this privilege, granted under the prerogative of the Crown, had not only been used in an attempt to promote domestic industry and trade, but also as a source of Crown patronage and revenue. Nonetheless, the Statute made an exception to the prohibition on monopolies; a patent could be granted to the 'first and true inventor' of 'the sole working or making of any manner of new manufacture' for a period of fourteen years.

The interpretation of this statutory exception was to cause considerable judicial controversy. What was a 'new manufacture'? In his examination of patents and inventive activity during the industrial revolution in Britain, Harry Dutton points out that at least some judges were keenly aware that their lack of scientific knowledge hindered their understanding of the patentability of inventions. Early in the 19th century, Chief Justice Abbot admitted to a lack of practical knowledge of machinery and declared himself 'a stranger to the exact sciences'. Nonetheless, Abbot was prepared to concede that a manufacture could encompass either a new product or a new process, an opinion not shared by all judges at that time. Galloway lamented in a letter to Brougham in 1825 that 'It is a great misfortune that there are but few persons at the Bar who have any extensive practical knowledge of machinery.' Further judicial confusion arose when judges attempted to distinguish between a manufacturing process, a method and a principle [3].

Looking at the opinions of judges during this period, it would appear that there was a certain confusion concerning what exactly a patent protected. This confusion was not limited to the interpretation of the statutory requirement of 'new manufacture' or to the analysis of the specification, which became a compulsory part of a patent application from 1734 onwards. It was connected to the legal status of a patent as a form of property. That the legal debate should be in terms of 'property' rather than in terms of 'rights' is not entirely surprising: in 18th century England the label 'property' was applied to many things which lawyers would now describe in terms of rights. For example, John Locke in his Second Treatise states that the task of the state is to protect property, being 'lives, liberties and estates, which I call by the general name property'; by this definition, liberty itself was a form of property [4]. Nonetheless, it is a characteristic of common law jurisdictions that abstract rights, such as patents, were recognised as forms of property, whereas those countries with a civil law tradition have tended to deal with the concept of property in a different way.

3. Patents as property

Defining a patent as a form of property was not without its complications. How was it possible to fit a patent into the traditional legal description of property? In his 'Commentaries on the Laws of England', published in the second half of the 18th century, William Blackstone defines the right to property as "the sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe"[5]. He may be taken as voicing a conception of property that would have been familiar to most eighteenth century lawyers. Of interest here is the phrase 'external things of the world'. That Blackstone chose to frame his definition in terms of 'external things' does not mean he rejected the concept of an intangible as the object of property. He recognised certain forms of intangible property, such as future interests in the form of reversions and remainders, and incorporeal hereditaments such as peerages, tithes and advowsons. Blackstone, however, was not comfortable with the newer abstract forms of property rights. Whereas page upon page is devoted to the intricacies of the law of real property, little more than a couple of sentences is devoted to patents, a simple acknowledgment that the patent is a temporary property granted as an exception under the Statute of Monopolies[6].

If the object of property could be an intangible, an intellectual creation, what was the nature of that intellectual creation which was protected? It is interesting to compare the opinions of two judges, Yates and Ashton, in the copyright case of Millar v Taylor 1769 in this respect. Although it is a copyright case, of significance here is that both judges took this opportunity to compare copyright for authors with the patent protection for inventors. Both deal firstly with the definition of property in general. The traditional definition of property as having as its object something tangible led Yates in this case to reject that which was not visible, which had no marks or bounds to distinguish it, as falling under the definition of property. A set of ideas cannot therefore be property. Ashton, on the other hand, shows in Millar v Taylor he is aware that society is changing and forms of property are changing too: "the written definitions of property, which have been taken notice of at the Bar, are, in my opinion, very inadequate to the objects of property at this day… the objects of property have been much enlarged by discovery, invention and arts". Ashton sees the subject-matter of copyright in the following terms: "The composition therefore is the substance: the paper, ink and type, only the incidents or vehicle."[7].

Both Ashton and Yates draw a comparison between patents and copyright. Yates remarks that invention or labour, no matter how great, cannot change the nature of things, or establish a right where no private right can possibly exist. Whereas an inventor certainly has a property in the machine which he makes, he does not gain a property in the ideas, the abstract principles upon which he constructed his machine, although these may be called the inventor's ideas and as much his sole property as the expression of the ideas of an author. "We all know that whenever a machine is published, (be it ever so useful and ingenious) the inventor has no right to it, but only by patent; which can only give him a temporary privilege."[8]. What is remarkable is that Ashton, given his opinion on the subject-matter of copyright, seems to see literary work and mechanical production as two very different "matters": 'the property of the maker of a mechanical engine is confined to that individual thing which he has made; that the machine made in imitation or resemblance of it, is a different work in substance, materials, labour and expense, in which the maker of the original machine cannot claim any property; for it is not his, but only a resemblance of his; whereas the reprinted book is the very same substance, because its doctrine and sentiments are its essential and substantial part." "The imitated machine, therefore, is a new and a different work: the literary composition, printed on another man's paper, is still the same. [9]" While both judges were of the opinion that abstract principles cannot, in themselves, be the object of a patent, what both judges fail to understand is that a patent covers more than the physical product that is the invention. The importance of a patent is the protection of the formulation laid down in the specification, the way in which ideas have been used in order to produce a new physical product. In this respect it is similar to copyright, which protects the expression of ideas.

4. Patents in the past: conclusion

There appears to have been a certain reluctance on the part of judges in the 18th century with respect to patents. Lord Kenyon, who took over from Lord Mansfield as the head of the Court of King's Bench, stated in the case of Hornblower v Boulton "I'm not one of those who greatly favour patents" [10]. He was not alone in this attitude. As Dutton points out, in this period patents were regularly set aside by judges based only upon the slightest defect in a specification. In the 18th century there were those who were firmly opposed to patents as an undesirable monopoly, forming an obstacle to technological advancement and general prosperity. The fear of monopolies still persisted well into the 18th century; illustrative of this attitude is an article in 'The Times' of June 20, 1786 that attributes "the prodigious increase in trade" inter alia to "the suppression of various monopolies". That judges' attitude towards patentees becomes more generous in the 1830s Dutton ascribes to their acceptance that inventions led to prosperity and economic growth [11]. This was, as it is now, however, a moot point. This point will be dealt with below.

5. Similar legal problems in the present: software

Bearing these points of contention in mind, it is perhaps surprising to see that these issues have never entirely been resolved. That becomes apparent if the legal attitude towards software, a new form of 'invention', is examined. As stated above, the legal status of software has been at issue. It is a matter that has come particularly to the fore where legal provisions use the terms 'goods' or 'property'. In countries with a civil law tradition an aspect of that discussion is whether a product of the intellect should be categorised as property (tangible objects) or as a right (intangibles).

That this whole discussion has arisen with respect to software rests upon a basic misunderstanding by many lawyers as to the nature of software. Just as the judges in the time of the Industrial Revolution struggled to come to terms with new machinery, so have judges today struggled to understand modern technology. Their lack of understanding has had repercussions for the legal status of software and has led to the development of specific legal measures to deal with computer technology. What then is software? Software may be defined as computer data which, when implemented in a computer system, cause the computer to perform a function. The hardware responds to the data, which represent instructions or statements. It is common to find lawyers categorising software as an intangible. Software is not intangible. It has a physical manifestation, consisting of magnetic patterns and electrical currents. These magnetic patterns are tangible objects. The very fact that data can now be manipulated by technical means implies that data are tangible and could therefore be goods, tangible property. The same is true for many forms of energy today, for example electricity.

Many lawyers are prepared to add a proviso to the definition of software as intangible by conceding that software may have a tangible form, but only when it is on a tangible carrier, for example a disk. If the logic of that argument is followed through, then a car could be described as a design plus a steel plate, an intangible 'work' plus a tangible object. Conceptually, there would appear to be very little difference. Just as a car can be stolen, so can software. Lawyers have argued that provisions in the law concerning theft, fraudulent appropriation or criminal damage would not apply to data because these provisions were concerned with physical goods. As has been shown above, data are physical. The other objection voiced by lawyers is that there is no theft because the data are not taken away because they are still there after copying. Nonetheless, a copy has been taken away. It does not matter if that data have been taken away from a physical disk or downloaded from a network. Furthermore, what has not been appreciated by those who see no change in the status quo is that a copy that has been taken away does affect the control the original possessor had over the data: the thief could, for example, decide to place the data file on the Internet. No-one denies these days that electricity can be stolen. Whether a battery containing electricity is stolen, or whether the electricity is stolen from the mains, does not matter.

6. The patentability of software

This confused approach to software has affected the matter of its patentability. In order to satisfy the requirements of patentability, there must be some physical end product constituting the subject matter of protection. It must signify a novel and inventive step and be capable of industrial application. The legal problems associated with patentability are well illustrated by the discussions that have arisen with respect to the European Patent Convention (EPC) 1973. Excluded from patentability are scientific theories and mathematical methods, schemes, rules and methods for performing mental acts, playing games or doing business, and software, 'as such'. The EPC states specifically that computer programs "as such" are not inventions for the purposes of granting a European patent [12].

Just as in the past, there is confusion as to what is the subject matter of a patent. Drafted back in 1973, Article 52 construes a computer program in terms of an abstraction, as 'instructions' or 'methods', not as a tangible object. There is, however, a physical end product. If data are recognised as physical patterns, tangible objects that can contain information, it is not an abstraction, but goods. Therefore, it is not the patenting of an abstraction, a method or instructions. As with all patentable inventions, it is the formulation from which a physical thing emerges, and hence it conforms to the requirements of patentability of other 'inventions'.

The exclusion laid down by the EPC has not meant, however, that it is impossible to obtain patent protection for computer programs. They can be patented as a method of operation or as a product but only in connection with hardware. This special exception again arises out of a legal misconception of the nature of software. A separate regime is misconceived and unnecessary.

The matter of software patentability has remained a contentious legal issue. Again, this is shown very clearly by the discussions that have taken place in Europe. In 2002, the European Commission presented a proposal for a Directive to the European Parliament and the Council on the patentability of computer-implemented inventions. [13] The aim of this Directive was to prevent different interpretations of the provisions of the European Patent Convention concerning the limits of patentability. [14] In 2005, the European Parliament rejected the proposal. What are of interest here are the arguments that were advance for and against the patentability of software. These arguments had little or nothing to do with software itself but were in fact arguments for or against patent law in general. The supporters of patents - lawyers specialized in patent law, large electronics companies and software multinationals – emphasized the importance of innovation. Their opponents – small and medium sized software developers primarily organized in interest groups [15] - voiced

their concerns about the future of small software developers. The latter argued: "From 1997, the European Patent Office has initiated and generalised the granting of patents for algorithms, software ideas, data structures and information processing methods. In a directive proposal on 20 February 2002, the European Commission proposed to officialise this abuse, presenting it as a status quo. In fact, this is a considerable extension of the scope of patentability, in breach of the spirit of the European Patent Convention that excludes from patentability mathematical methods, computer programs and presentations of information."[16]

7. Arguments for and against patents in general

Legal and economic arguments seem to be inextricably linked when it comes to the matter of patents. In the early days of the Industrial Revolution in Britain, the patent had not yet recovered from the popular hostility to monopolies. The patent, as an undesirable monopoly, often on commodities, had led to the Statute of Monopolies under James I and had played no insignificant part in damaging the reputation of Charles I in the eyes of his subjects. There were incidents of intense opposition by manufacturers to patents, for example that of the textile industry in northern England to Arkwright's patent on his cotton spinning machine, and to the extension of Watt's patent on the steam engine by Act of Parliament in 1775. However, where an inventor needed investment in order to develop his 'new manufacture', there seems to be little doubt that few were prepared to invest without the protection of a patent. If Watt had not secured the extension to his steam engine patent, it is unlikely Boulton would have advanced the capital Watt needed. As to the impact of patents, research has shown that only about 30% of patents effectively survived longer than seven years, and even successful patents had a long pay-back period: on average a successful patent would yield no profit until its 7th or 8th year. Watt's steam engine did not begin to make profits until the 1790s [17].

This raises two questions; how valuable is a patent to the inventor and is a patent useful from a macro economic perspective? With respect to the first of these questions, Christine MacLeod points out that at the time of the Industrial Revolution, to a large extent the patent system created its own market: " as its existence became more widely known, not only were inventors and manufacturers more willing to use it, they also became more fearful of not using it."[18] Whether an invention was patented varied from industry to industry, the major deterrents being the expense and the anxiety and cost of enforcing patent rights. Trade rivalry in the second half of the 18th century stimulated patenting, but the patent was a better investment in some enterprises than in others. It was of particular use to the newcomer to manufacturing, the inventor who needed to attract partners and yet keep them from stealing his invention. While MacLeod is of the opinion that a patent could be of economic value to a patentee, the protection of an invention and the prestige that a patent bestowed were closely linked motivations [19].

From a macro economic perspective, the role of the patent led to sometimes quite heated debate during the Industrial Revolution. There were those who rejected the idea of a patent system on ethical grounds: an invention should be for the benefit of the community at large, and should not reward the individual at the expense of the community. It is this approach to intellectual creations that finds expression in Lord Justice Grey's words in the copyright case of Donaldson v Beckett 1774: "They forget their Creator, as well as their fellow creatures, who wish to monopolize his noblest gifts and greatest benefits. Why did we enter into society at all, but to enlighten one another's minds, and improve our faculties, for the common welfare of the species?"[20] Others were prepared to acknowledge that an inventor should be rewarded for his ingenuity and hard work. The classical economist Adam Smith was not against the grant of a patent, although he considered privileges and monopolies to be prejudicial to society. The privilege of a patent was harmless: if the invention was good and profitable to mankind the patentee would reap the financial benefits. If the invention was of no value, the inventor would reap no benefit. Therefore it could do no harm yet may also bring some good[21]. Dutton contends that during the Industrial Revolution, except for the attitude of some judges, abolitionist views are rarely encountered; protest was not against the patent system in itself but its expense, inefficiency and its failure to give adequate protection. It is only around the middle of the 19th century that the patent abolition movement reaches its peak; its main arguments being for free trade and the emancipation of industry. Taken as a whole, Dutton concludes that the patent system during the Industrial Revolution approached the ideal, ironically because it was not a perfect system: "a slightly imperfect system, where patents still provide some security for the inventor, or a degree of protection at least in excess of the next best alternative, will tend to accelerate the process of innovation and technological change…. this would be the most conducive to economic growth".[22]

8. Arguments for and against the patentability of software

If we turn to software, the nature of the arguments for and against patents have changed but little. Whether a patent is useful to the patentee, whether the patentee will be able to reap the rewards he seeks within the twenty year period now allotted to patents, depends on the nature of the invention just as much as it did several hundred years ago. With respect to the patentability of software, one argument that has been advanced against patentability is that software becomes too quickly out of date. With the speed of technological advancement in this sector, protected software could become irrelevant in months rather than years. The patent is therefore pointless. This, however, is more a matter that should be taken into account when the application for the patent is made than as an argument against software patentability in general.

Similarly, the argument that a too wide interpretation of the requirement of producing a technical contribution will eventually lead to business methods being patentable is a matter for the examination of the patent at the time of the application. More generally, there is the argument that warns against "trivial patents". This is a different argument from that which contends that a software patent is pointless or becomes outdated too soon. Here the danger is that a monopoly will be established on the basis of trivial technology, which is undesirable because such a monopoly does not contribute to technological progress.

Another objection to the patentability of software has been that software is already adequately protected by the copyright regime and therefore the matter of patentability is irrelevant. This is a very strange argument indeed. It accepts that there should be legal protection for software but fails to take into account the very different nature of the protection awarded by a grant of patent. Copyright law will only prevent the copying of a particular expression of an idea. It can be used to prevent the total duplication of a software program, as well as copying a portion of the software code. It will not prevent the creation of a competing program that uses the same ideas as an existing program. If the software is patented, then the patentee could prevent others from using a set of instructions without his permission, or that others create software programs that perform a function in a certain way.

Today, economic theory has still not conclusively determined the macro economic effect of patents. The costs and benefits are not always obvious, and furthermore they can change over time. It is still difficult to determine conclusively whether patents encourage technological advancement, and hence economic prosperity. Although England never abolished its patent system, several other countries did. One of those countries was the Netherlands in 1869. It would be another forty-three years before the Netherlands re-established its patent system. It used this period to catch up with the more advanced industrial nations, and from that point of view the abolition of patents was not perhaps unfavourable. This piracy, however, won the Netherlands few friends amongst the more developed nations. In 1912 it reintroduced patents partly because of foreign pressure, but by this time the process of catch up was well advanced and the Netherlands had inventions of its own that it wanted protected[23]. A patent system, now the Netherlands was no longer simply an underdog, was much more attractive.

9. Conclusion

In conclusion, many of the issues regarding patents that troubled lawyers during the Industrial Revolution have remained. Judges often simply do not have the understanding of science and technology that is required in order to apply legal principles to inventions properly. Although there were judges who were conscious of this limitation over two hundred years ago, legal education has done little to remedy this defect. There is much to be said for teaching new generations of lawyers to comprehend technology; these lawyers are the ones that will have to continue to deal with such matters as chips protection, software, databases, data protection, peer to peer file sharing and the Internet in general.

Just as during the Industrial Revolution, lawyers today struggle to fit new technological developments into definitions that were drawn up long before such developments could be conceived of. In the 18th century, many English judges regarded intellectual products with suspicion because they did not fit easily into the traditional definition of property. Nonetheless, patented inventions became accepted in the common law systems as a form of property. They were absorbed into the pre-existing structure. What is strange is that software is often approached as something entirely different, something anomalous. This is to a large extent the reason for the whole confused discussion as to whether software is goods or a service, and partly because so many lawyers fail to appreciate that what is being dealt with here is not an intangible. It has led to separate regimes being established to deal with software, when this was entirely unnecessary. What is also clear is the continued

confusion over what constitutes an invention. This has important legal repercussions because if it is not an invention, it cannot enjoy patent protection. Legal confusion is also socially undesirable.

In general, it would seem that technological innovation does not always develop along a steady, unbroken curve, but rather exhibits a pattern of jumps, of short curves connecting each other. It would be interesting to investigate whether the absence of patents would produce a steadier and longer growth curve because of the possibility of recycling and continued development. However, is it the presence of patents that stimulates the jumps themselves, because that is the only way in which competition is allowed?

Finally, there is still no conclusive evidence to support the premise that patents either harm or promote technological inventions and in turn general economic wellbeing. Certainly in the time of the Industrial Revolution, there were many more inventions then the patent roll would suggest. The importance of a patent also depended to some extent on the type of activity involved. The award of the patent, however, became increasingly important as a means for the inventor to attract capital and to send out the signal that this invention had to be taken seriously; the patent gave it status. Today, the speed of technological innovation renders long term protection for some inventions irrelevant. However, during the Industrial Revolution a patent was not suitable for all forms of innovation either. Perhaps the value of the patent is the stimulus it gives to competition. Of certain value is the status it provides. That was as true at the end of the 18th century as it is today.

Notes

[1] St Al[1]bans v ICL[1995] FSR 686
[2] [1996] All ER 481
[3] Harry Dutton, The patent system and inventive activity during the industrial revolution 1750-1852, (1984) p. 73 and 82.
[4] John Locke, The Second Treatise, s.123 (chapter IX)
[5] William Blackstone, Commentaries on the Laws of England, II.2
[6] idem II. 409
[7] Millar v Taylor (1769) 4 Burr. p.2338-9 and p. 2349. Today's copyright lawyers still use the terms "corpus mysticum" for the composition and "corpus mechanicum" for the paper and the ink.
[8] idem p.2357, 2361
[9] idem 2349
[10] R. Godson, A practical treatise on the law of patents, 1823, p. 204
[11] Dutton, p.79
[12] EPC Article 52 (2) and (3)
[13] Proposal for a Directive of the European Parliament and of the Council on the patentability of computer-implemented inventions COM(2002) 92 final.
[14] Common Position (EC) No 20/2005 adopted by the Council on 7 March 2005 with a view to adopting Directive 2005/…/EC of the European Parliament and of the Council of …on the patentability of computer-implemented inventions (2005/C 144 E/02), consideration (8).
[15] Such as FFII en NoSoftwarePatents.com.
[16] http://www.softwarepatenten.be/doc/prof_petitie.pdf
[17] Dutton, p.151-2 and 159
[18] Christine MacLeod, Inventing the Industrial Revolution: the English patent system 1660-1800, (1988) p. 75
[19] idem p. 88, 95
[20] See the report of this case in Cobbett's Parliamentary history of England, (1813) vol. XVII, p. 953
[21] Adam Smith, Lectures on jurisprudence, Report of 1762-3, ii 30-33 (Ofxord reprint of 1978) p. 83
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Intellectual Property Rights from an Islamic Perspective

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Abstract: This paper seeks to answer the following two questions. What is the stand of Islamic Jurisprudence with regard to regulating Intellectual Property Rights and its protection? Has this matter ever been tackled by any of the earliest or recent Islamic Jurisprudents?

1. Introduction

The issue of intellectual rights is as old as man himself. He recognized and developed it over the years (Omar, 1993). But its tangible emergence had, however, come into sight in the wake of the Industrial Revolution, and crystallized further, during last decades, to become one of the main outstanding features and progress dimensions of our age. Indeed, the European states showed earlier interest in intellectual rights, adopted laws for their protection (Ladas, 1975), and introduced them as a subject matter of learning at institutes and research centres. So did, though somewhat late, most of the Arab countries (Abbas, 1971).

Hence, we may not avert the truth if we say that humanity owes the emergence of intellectual rights – with technology at its core – to consecutive civilizations, given that the latter naturally interlock, interact, and interconnect over the time. In fact, civilizations are a common heritage of all nations, and it is totally unfair to attribute them to a single one. Rather it is quite just to acknowledge that certain nations have enjoyed distinctive factors of civilizations more than others, and thus their contributions to human civilization were subsequently more effective and outstanding.

There must be a concrete faith that the human intellect is just the interaction of multi-cultural elements of different civilizations whether they were correlated or alternated.

In this light, it can be safely said that intellectual rights have become part and parcel of our modern age vocabulary, though definitely not any of its product. Moreover, they haven't come out of the blue, but are a fruit of man's development in all walks of life, a result of experience accumulated by people and communities, and an offspring of the unremitting progress that has been realized in various fields of science throughout the world. Historically, humanity initiated the agricultural revolution first, launched the industrial revolution that was followed by the information revolution, and nobody knows exactly what comes next.

This paper aims to explore the view of Islamic Jurisprudence in organizing and protection of Intellectual Property Rights. It will focus on views of previous and current Jurisprudence on this regard, and will consider the state of Qatar as an example among other Islamic countries in this concern.

2. Intellectual Rights

2.1 The Definition of intellectual rights

Financial rights are usually divided by Jurisprudents into two exclusive categories: real rights and personal rights (Abdel Baqi, 1984).At a later stage, they have come to refer financial rights to either category (Al- Sanhuri, 1954).

Yet the advancement experienced by man in the various fields of life has ensued new and unprecedented rights, such as the property rights of inventors, explorers, designers, painters and authors on their scientific, epistemic, literary and arts works, whether appearing in a form of script, sound, drawing, movement or figures. Hence it is quite obvious that the new category of rights takes its pictorial expression in those forms which fall under "morale", i.e. "rights attached to a non-material thing"(section 67 Jordan Civil Code) as they are related to the production or innovation of thought, and have assumed a different and more popular term called: "Intellectual Property Rights".(Zaineddin, 2006)

2.2 Scope of Intellectual Property Rights

The scope of intellectual rights is fairly wide, because they simply deal with all sorts of mental work. So their main venue is knowledge, or the means of expression mastered by its owner. Nonetheless, they can be specified into three major classifications:
1. Industrial Rights, which include patents, industrial models and drawings.
2. Commercial Rights, which include trade marks, and trade names.
3. Copyrights: which include works in science, literature and arts, appearing in forms of books, novels, poetry, sound, sculpture, drawing, photographing or movement.

The common denominator among these rights is that they are all perceptions, i.e. mental pictures created by man's intellectual endowment and have been employed in one of these fields or the other. Subsequently, the creator has obtained one of those rights which finds its exposure in a form of exclusive power of possession that gives him a kind of a moral right that acknowledges his fatherhood of that particular right on the one hand, and entitles him to a financial access of legal investment of this right on the other.

2.3 Significance of Intellectual Rights

Intellectual rights significance involves protection, for they lead to:
1. Encouraging legal and fair competition.
2. Prohibition of illegal, unfair competition.
3. Prevention of sorts of fraud and passing off.
4. Anti-forgery and Anti-infringement.
5. Encouraging creativity and innovation, as well as knowledge-making.
6. Stimulating the nation's taking up with development, progress and prosperity through creativity but not through imitation.
7. Access to technology and high techniques rather than being dependent on old fashioned means and methods.

No wonder then that paying greater attention to intellectual rights has become an urgent need, especially in an age of advanced industry, commerce and agriculture that is fed by intellect, run by machine, and controlled by technology. At the end of the day, the main goal of the intellectual property system is to enhance the society's socio-economic and cultural progress through the development and management of international laws and conventions that deal with this issue.(Amin, 1992) Hence most nations of the world have launched, individually and in groups, legislation that govern and regulate intellectual rights, to the extent that they have become among the latest juristic disciplines, especially as they deal – from the law point of view – with the new aspects and achievements of science and technology which constitute the backbone of any nation's development and progress.

2.4 Legal Regulation of Intellectual Property Rights

On the International Level:
World legislator has demonstrated great concern about intellectual property rights, and thus adopted treaties, Agreements and conventions in patents, trade marks, industrial designs, appellations of origin, new varieties of plants, the Olympic Symbol, copyrights, neighbouring copyrights, such as, Paris Convention, for the Protection of Industrial Property (March 20, 1883),Madrid Agreement Concerning the International Registration of Marks (1891), the Protocol Madrid agreement concerning the international registration of marks (June 27, 1989), Trade Marks Law treaty (T L T) (1994), Hague Agreement, Concerning the International Deposit of Industrial Designs (November 6, 1925), The Geneva Formulation of The Hague Agreement on International Registration of Models and Industrial Designs, (Geneva, 1999), Madrid Agreement, for the Repression of False or Deceptive Indications of Source on Goods (April 14, 1891), Lisbon Agreement, for the Protection of Appellations of Origin and Their International Registration (October 31, 1958), International Convention for the Protection of New Varieties of Plants, (UPOV) (December 2, 1961), Nairobi Treaty, on the Protection of the Olympic Symbol, (September 26, 1981), Berne Convention, for the Protection of Literary and Artistic Works (September 9, 1886), World Agreement on Authors Copyrights, signed in Geneva (November 06, 1952), Washington

Agreement on the Protection of Integrated Circuits, signed (May 26, 1989), WIPO Treaty on the Authors Copyrights, signed (December 20, 1997), Rome Convention, for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations (October 26, 1961), Geneva Convention, for the Protection of Producers of Phonograms against Unauthorized Duplication of Their Phonograms (October 29, 1971), Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (1995).

On the domestic level (e.g. Qatar):
As the state of Qatar is a member in most of the above mentioned, treaties, Agreements and conventions (since 1995) The Qatari legislator has issued some laws to protect Intellectual Property Rights, such as, Law No.2 of 1999 for Anti-passing off, in commercial transaction, Law No.7 of 2002 for Copyright Protection and Related Rights, Law No 9 of 2002 for Trade, Merchandise Marks, Trade Names, Geographical Indications, Industrial Designs and Models, Law No.30 of 2006 for Patents.

3. Islamic Jurisprudents and the Regulations of Intellectual Rights

3.1 The stand of protecting intellectual property rights

From the heated debate that took place on the intellectual rights on the world scale, two main trends have emerged (Khalil, 1983). **The first** advocates the need for due regulation and legal protection of these rights as a basis axiom of justice on the one hand, and as a factor that involves fair competition, attracts foreign capital, and promotes investment and prosperity on the other. **The second** trend opposes on the basic that it hampers the development and growth of national economy, especially industry, and leads to monopoly, inflation, high production costs, and, finally, affects people.

It seems that by way of preference, the first trend seems to be more appropriate, and coincides with the premises of logic and human nature. It also involves mutual benefits and saves money and effort, provided that of course, it does not lead to monopoly and dependence, but ensures genuine equality among nations, so that no state comes to being on the account of another, namely through brain drain, capital flight or immigration.

Apparently, the first trend has gained momentum and prominence, especially in the capitalist, free market economies, whereas the second, which prevailed in the countries of socialist (centralized) economies, continues to maintain a faint echo.

It should, however, be noted that the second trend started to fade away in the aftermath of the collapse of the Soviet Union. Subsequently, the world fell under US hegemony, induced by the transport and communications revolution, which constitutes the core of the globalization phenomenon that has shaken state borders and established the "Global Village", a fact that is felt by all.

3.2 Stand of Traditional Islamic Jurisprudents of Protecting Intellectual Property Rights

This section seeks to answer the following two questions, what is the stand of traditional Islamic jurisprudents with regard to intellectual property right? Has this matter ever been tackled by any of the earliest or the recent Islamic Jurisprudents?

As for the Islamic jurisprudence and whether it ever tackled this issue, Dr. Fathi Al Duraini (Al-Duraini, 1987) asserts that no eminent figure of the Islamic schools of jurisprudence has ever objectively investigated or comprehensively traced this topic, save some concise statements by Emam Al Qurafi (in his book, titled Alfrooq, vol.1 p. 208) , and sporadic comments of a few young scholars (Sheikh Ali Al-Khafeef, in his book, titled Property in Islamic Sharia and Sheikh Mustafa Al-Zarqa in his book titled Introduction to Theory of obligation). In fact, the latter relegated thorough examination to the private rights-related interest, which falls short of the indispensable comprehensive and detailed analysis for shaping an overall accurate and realistic perception of the matter's jurisprudence, taking into account its theoretical and experimental impact on the one hand, and the scientist's rights on his/ her production on the other.

The reason behind that is probably the fact that this matter didn't persist in the past centuries (in the Muslim World) as we see it today, thanks to the scientific advancement that has developed in the agricultural, commercial, industrial and social aspects of life. Moreover, intellectual creativity has never had such an impact, progression and maturity in comparison with what we have today at universities, cultural centers and scientific laboratories throughout the world.

As for its definition of the concept of intellectual right, Islamic jurisprudence says, according to Al Duraini, it is "the intellectual forms that are first contrived by a scientist or a literary author's inherent talent, and was not preceded in this endeavour by anybody else" (Al-Duraini, 1987).Indeed, an invented production is the intellectual form, not the final sample, in which its substance has been shaped, e.g. a book, since that substance is actually a revelation of those reflections and a means to realize the benefit of that production. It also affirms its quality and appeal. So, as they are abstract, moral forms and incidental benefits, intellectual (mental) pictures can only be felt by mind, and not by any of the senses. Meanwhile, an invented production must be creative too, and distanced from recurrence, imitation or plagiarism.

It should, however, be noted that no invented work needs to be entirely new, as every intellectual work is unavoidably originated in a culture where other innovations and scientific heritage have already contributed to its overall build up. Hence an innovation differs in quality and impact from another in as much novelty it involves and in the volume of work exerted there in. Innovation is at the end a relative, not absolute matter. In relative terms, though, intellectual forms are taken as an effect, not a substance-of, a resultant and an offspring of the inherent talent. Innovation is, indeed, a mental image.

Scientists and literary authors, etc. are terms of generalization inclusive of all theoretical, applied and experimental sciences, and all those of literature and arts as well. It is, therefore, the quality of the intellectual work that establishes the criterion of differentiation among individuals and nations alike (*Surat Al-Zumr, Verse 9*).

In this respect the Quran tells us of stories of ancient nations who inhabited this land for long and left their imprints there, such as the Ad and Thamud people (*Surat Al-Fajr, Verse 6*), the tale of Pharaoh and Moses (*Surat Al-Qassass, Verse 9*) and that of Zhul-Qarnayn. (*Surat Al- Kahf, Verse 3*) Moreover, there are ample works of fine arts around the world, (e.g. Taj Mahal and other works of the Seven Wonders of the World), which demonstrate distinction among nations and civilizations. In their wonderful art, manifest science, evident ability, marvellous skill and powerful might, the Seven Wonders are indicative of nations who once ruled, then perished, after having acquired epistemic expertise, industrial techniques, commercial means, technical skills and all other forms of intellectual creativity. (Eid, 1998)

These manifestations indeed confirmed experience of the world's communities and peoples, and the incessant progress achieved in all fields of knowledge. Certainly, civilizations interlock, interact and inter-communicate over the years, and thus constitute a common heritage of all nations. Therefore, and in terms of its impact on directing human life, the quality of an intellectual work is rightly considered one of the most tacit scientific means of utility from the world's beneficial sources. Otherwise we would have turned back to the state and conditions of primitive man, where resources and land remain as they are. But it is the "mind" that has changed so has the organization; then civilization began to rise. (Al-Durini, 1987)

Intellectual and literary works are thus the means of human, cultural, material and moral progress. It is a well-known fact that all aspects of advanced material civilization are, actually, substantiated forms of complementary applied scientific theories, where the precedent introduces the subsequent, and the latter rectifies the former.

3.3 Stand of Contemporary Islamic Fiqh of protecting intellectual property right

Whatever, at present the issue of intellectual property has been on the agenda of the Saudi-led Pan-Islamic Fiqh Academy? (In its ninth annual session, convened in Mecca in March 1986), the Fiqh Academy noted that the copyright piracy, i.e. the unauthorized duplication of original work, in the Muslim Middle East, had resulted in the unscrupulous generation of wealth by those who abuse the duplication facilities. Since this practice adversely affected the initiative and innovative enthusiasm of authors and scientists, the Fiqh Academy decided that the concept of intellectual property be recognized save in circumstance where the sole purpose of duplication was to disseminate knowledge.

The Islamic Fiqh Academy definitely approved of the principle of intellectual property legal protection in its Resolution (No. 43 (5/5) adopted at its session in Kuwait in December 1998), without discrimination between nationals and foreigners. Islam acknowledges that learning is a requisite of sound human nature, as God Almighty says in the Holy Quran: "(God) Most Gracious! It is He Who has taught the Quran. He has created man: He has taught him speech (and Intelligence)". There is no intelligence without thought, as God Almighty says: "(He) Taught man that which he knew not", by creating the thinking power in man. At the same time, God decides the kind of "learning" that should be sought, learned and innovated, in that it should be "beneficial learning", as prophet Mohammad (peace be upon him) says: "O God, bestow upon me a beneficial learning".

This is in general, for the scholar and for others. Also, God Almighty says: "Do not mischief on the earth, after it has been set in order….". Here the meaning goes to the material and moral setting in order, in all life affairs, and not only to the contractual setting in order.

This may not be achieved without the learning and the production of thought. It is concluded from the above that Islam is keen to achieve "the moral existence" of mankind, on the highest level, and at all times, with ascendance in the degrees of perfection. As the material existence, though important, is not the most important and the sought goal. Otherwise, there would have been no messengers, or prophets sent down or shari'a laws revealed by God. The destructive and harmful learning has no sense in this significant meaning.

In fact the intellectual work is certainly a more arduous and exhausting work than any muscular or physical work. If the latter duly deserves compensation, it is much more worth for the former.

4.Conclusion

Intellectual Property Rights constitute a vital issue with an apparent effect on the economic, scientific and cultural life, on both the local and international levels, and, indeed, imply an impact on civilization as a whole.

Regulation and legal protection of Intellectual Property Rights as a basis axiom of justice on the one hand, and as a factor that involves fair competition, attracts foreign capital, and promotes investment and prosperity on the other.

The Quran tells us of stories of ancient nations who inhabited this land for long and left their imprints there, such as the Ad and Thamud people, the tale of Pharaoh and Moses and that of Zhul-Qarnayn. And There are ample works of fine arts around the world, (e.g., Taj Mahal and other works of the Seven Wonders of the World), which demonstrate distinction among nations and civilizations

Intellectual Property rights are the outcome of man's overall development, accumulated experience of the world's communities and peoples, and the incessant progress achieved in all fields of knowledge. Certainly, civilizations interlock, interact and inter-communicate over the years, and thus constitute a common heritage of all nations.

The tradition Islamic Schools of jurisprudence has ever objectively investigated or comprehensively traced the topic 0f Intellectual property Rights, save some concise statements by Emam Al Qurafi, and sporadic comments of a few young scholars. The latter relegated thorough examination to the private rights-related interest.

Intellectual property Rights has been on the agenda of the Saudi-led Pan-Islamic Fiqh Academy. The latter decided that the concept of intellectual property be recognized save in circumstance where the sole purpose of duplication was to disseminate knowledge.

The Islamic Fiqh Academy definitely approved of the principle of Intellectual property Rights legal protection in its Resolution (No. 43 (5/5) adopted at its session in Kuwait in December 1998), without discrimination between nationals and foreigners.

Islamic jurisprudents has acknowledge the Intellectual property Rights. It advocates the restitution of these rights to their owners so that the latter be treated just and fair and thereby encouraged to go ahead with research and innovation, and finally achieve a legal interest. In that sense, the people concerned, and humanity as a whole, would not be deprived of a real, public and proven interest emanating from inventions produced by the operating mind and intellect of man in the different fields of life.

Intellectual property Rights are certainly a more arduous and exhausting work than any muscular or physical work. If the latter duly deserves compensation, it is much more worth for the former.

There is no harm, from the Islamic Fiqh point of view, that special acts on Intellectual property Rights be adopted with a view to regulating its rules and protecting their owners as implied by justice and interest.

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19. Verse 9, Surat Al Qassass (The Narrative): The wife of pharaoh said: "(Here is) a joy of the eye, / for me and for thee:/ Slay him not. It May be/ that he will be of use/ to us, or we may adopt/ Him as a son. And they/ Perceived not (what they/ were doing).
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I™: Avatars as Trade Marks

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Abstract. Virtual worlds may be the future of e-commerce. The game designers who created these thriving virtual worlds have discovered a much more attractive way to use the internet: through an avatar. This avatar is your identity. It will be your trade mark. Trade marks, more than other species of intellectual property, are one step further from tangible property. Stephen Carter has called trade marks "owning what doesn't exist." Every kind of intellectual property requires participants, users, to acquire value. What makes trade marks different is that they require participants to acquire meaning. This article deals with the complex problem of creating intangible property interests (i.e., trade marks) in what does not exist except in virtual reality. How do two parties with competing interests (game developers and the players) work to create trade marks within pre-trade marked worlds?

1. Introduction

Virtual worlds may be the future of e-commerce. The game designers who created these thriving virtual worlds have discovered a much more attractive way to use the internet: through an avatar. (Morningstar and Farmer, 1991)[1] These avatars, unlike previous video game alter-egos, can be richly customized and are designed primarily for social interaction. (Lastowka and Hunter , 2004) The typical user devotes hundreds of hours (and hundreds of dollars, in some cases) to develop the avatar. This avatar is your identity. It will be your trade mark.

Trade marks, more than other species of intellectual property, are one step further from tangible property. Peculiar to trade marks, the communicative sign is a placeholder for a robust but intangible cultural relationship between producer and consumer. The very existence of this relationship begs the question of the consumer's creative role. Stephen Carter has called trade marks "owning what doesn't exist." (Carter, 1990[2]; Ackerman, 1992; Reich, 1964) This article deals with the complex problem of creating intangible property interests (i.e., trade marks) in what does not exist except in virtual reality. How do two parties with competing interests (game developers and the players) work to create trade marks within pre-trade marked worlds?

2. What is an Avatar?

To enter a virtual world, the user is first connected to the server via the internet. Once the connection is established, the user enters a program that allows them to choose an avatar for themselves. In all of the major virtual worlds, one can spend an extraordinarily long time at this first stage, choosing the appearance of the avatar as well as its abilities. Avatars, like their human counter-parts, express themselves through appearance and body language. [3]

Depending on the game universe, the player can freely, within the confines of the world's 'realities', select sex, appearance, profession, and physical features. (Damer, 1998) The initial choice of character occurs under a budget constraint of these attributes that ensures equality of opportunity in the world: Your mace-wielding ogre will be dumb, and your brilliant wizard will have a glass jaw. At the same time, the budget constraint ensures equality among avatars along dimensions that most people think should not matter for social achievement. In particular, male and female avatars have the same initial budget of skills and attributes. Avatars whose physical characteristics (i.e. skin tone, size) are associated with any benefit in the game must accept some compensating disadvantage. Any inequality in the virtual world can only be due to one of two things: a) a person's choices when creating the avatar, or b) their subsequent actions in the virtual world. (Filiack, 2003; Castronova, 2003)

Once the avatar is created, she needs a name. So the player must choose one. If they cannot think of one which matches the game's universe, an automatic name generator can be used. This name will become your

identifier; your identity, in fact. Your name will be on what you build your reputation. This will become your trade mark. (Walsh, 2004; *Marvel Enterprises, Inc. et al v NCSoft Corporation, et al*[4])

As defined above, the avatar is the representation of the self in a given physical environment. This environment creates an idealized situation in which a player may freely shape her own "self". She has full control over her own image. It is significant to note that people talking about their activities while in the game world use the pronoun "I", each identifying his or her "self" with their avatar they have created. (Filiack, 2003)

As virtual worlds support rich social interaction, many of those who have chosen to visit virtual worlds remain residents of them. The average EverQuest player and Norrath avatar, for instance, spends about twenty hours a week within the virtual world. (Yee, 2005) Virtual world users design costumes, furniture, and houses for their avatars, and sell their creations to others. (Dibbell, 2003 and Damar, 1998) They buy and barter virtual chattels on eBay. (eBay listings, Internet Games at http://listings.ebay.com/pool2/listings/list/all/category4596/index.html).They form clubs and organizations devoted to mutual aid and protection. Massive Multiplayer Online: Clans and Guilds, Open Directory Project at http://dmoz.org/Games/Video_Games/Roleplaying/Massive_Multiplayer_Online/Clans_and_Guilds See also, Allakhazam's Magical Realm at http://links.allakhazam.com/Everquest/Guilds) . Notwithstanding substantial investments of time and creativity, and in light of the emergence of new virtual social orders, the activities within virtual worlds are viewed still by some as games and diversions, not worthy of serious attention. (Lastowka and Hunter , 2004)

3. Identity and Reputation

In a universe that offers hundreds of virtual worlds, the virtual body becomes a vessel of choice, and the thinking part of humanity – the Self – will find it convenient to slip into and out of avatars as economic, social, and political circumstances dictate. (Huhtamo, 1995) At first glance, this may seem to pose a distinct challenge for legal theory. Law is built on the idea that the self is a unitary, rational actor. Rational choice theories of social effects emphasize the importance of information for the maintenance of social norms. Norms can only be enforced if it is possible to impose some kind of punishment on the violators. In a virtual community, the real self behind the avatar is generally hidden. As a result, any punishments the community may dictate can only be imposed on the avatar, not the self, and the self is free to simply exit the avatar and escape unscathed. (Mnookin, 1996; Lessig, 1999)

The combination of team production and level-based advancement seems sufficient to support very strong social norms in the game, and such norms do seem to be present. The broader implication is that the diversity of avatar attributes is useful not only as an end in itself, but also as a means to encourage agents to develop and maintain good reputations for their avatars. Specialized attributes allow systems of joint production, which can have the side effect of inducing conformity to social norms. Avatars tend to mimic their players as they develop personality, individuality, and an ability to act within the virtual world – as any person on their way to maturity. (Rehak, 2003)

At the same time, no norm system in cyberspace can be truly oppressive. Anyone who wishes to live under a certain set of norms, or under no norms at all, is free to inhabit avatars in the appropriate worlds. It should be noted that the same systems that encourage norm formation will also tend to slow down the shifting of populations that leads to equality of opportunity. Equality of opportunity emerges because dissatisfied agents can develop capital in different kinds of avatars; it will emerge more quickly if the switch from one powerful avatar to another can be accomplished rapidly. Yet a system that encourages reputations will also require that it is *not* easy to develop capital rapidly in another avatar. If it were easy to do so, anyone could ruin their reputation with one avatar, destroy it, and then simply reappear with another avatar of similar powers. The credibility of social norm enforcement depends on the degree to which an agent has a vested interest in the fate of the avatar. If agents are deeply invested in their avatars, and are hesitant to start new ones, it will take more time for the levelling process of population shifting to occur. There is a trade-off between equal opportunity and social order; agents will choose worlds based on their relative tastes for both. (Johnson & Post, 1996; Castronova, 2003)

Of course the natural laws of earth need not apply in a world that exists entirely as software, and much of what defines an avatar's uniqueness is its ability to bend or break some of these laws and not others. Depending on the skills chosen, an avatar might be able to fly, see for miles, hypnotize, heal wounds, teleport themselves, or shoot great flaming fireballs at other avatar's heads. However, a budget constraint applies: those who can heal or hypnotize often have difficulty summoning a fireball worthy of mention. As a result, avatars come to view themselves as specialized agents, much as workers in a developed economy do. The avatar's skills will

determine whether the avatar will be a demander or supplier of various goods and services in the virtual world. (Damer, 1998) Each avatar develops a social role. This is an important consideration for trade marks.

4. Trade Marks and Authors

"The use of authorial marks in relation to the sale of creative works, like the use of business trade marks in relation to the sale of goods and services, creates social benefits that deserve legal protection. Authorial attribution acts as an incentive to authorial production, provides valuable information to consumers, and provides additional social benefits that go beyond issues of market efficiency. However, the use of authorial marks, like the use of trade marks, can also create social harm." (Lastowka, 2005)

No other intellectual property regime poses so many legal tests that depend upon public consciousness yet provides so little corresponding recognition of the public's contribution. By associating a symbol with an object, the public contributes to the authorship of trade marks. This associative power grants a word or icon meaning as the representation of a particular object. (Wilf, 1999) Society as a whole benefits from the trade mark holder's vested interest in maintaining quality across numerous transactions. Since the trade mark holder both invents and sustains the worth of the mark, it is his or her claims to private ownership that must be protected. (Schechter, 1927; Beebe, 2004)

The issue of player entitlement is noteworthy for trade marks. Unlike copyright, there is no set limit to the time to which the privilege extends. (Hughes, 1998) [5] And, unlike copyright, trade mark lacks a broad doctrine of fair use. Copyright fair use has been eroded through the courts' tendency to immunize creators from responding to even compelling public interests. (Gordon, 1990; Fisher, 1988; Patterson, 1987; Bonito Boats, Inc. v Thunder Craft Boats, Inc., 1989) [6] Therefore, a fair use doctrine extended to trade marks will not be suggested. Instead, the focus will be upon the player's authorial role in associating a symbol with an object.

The Lockean model seeks to limit those rights and privileges of trade mark owners that intrude upon the public right to either a linguistic or cultural commons. (Gordon, 1990; Carter, 1990) Private trade mark privileges are constrained in order to prevent harm to the commons. In virtual worlds, players want to be able to create their own marks out of the virtual cultural commons; while, on the other hand, the game developers want to limit players' use of the company's real world trade marks. The balancing test is not only between virtual private rights and virtual public good, but also between corporate private rights and players' public good. Thus, a major concern is that both the personality theory and Lockean paradigms begin with the premise that through sole creation of the trade mark, its holder has established ownership. In the original position, according to these models, all property rights belong to the trade mark holder. It is only second-in-time concern with the making of individual selves or common good that legitimizes limiting those rights. (Wilf, 1999)

The model posited here is an alternative in which private game developer trade mark rights are limited from the very beginning and players virtual marks are allowed to flourish. This model is founded upon both a personality theory and a labour theory for creating intellectual property. But there is a major point of departure. Even as these other paradigms limit certain private entitlements they remain highly individualistic: it is the individual identity at stake in the personality theory and the first-in-time individual acquisition in the Lockean labour theory. The player authorship model, however, addresses the question of collective identity. It is the collective personality of culture that participates in the authorship of trade marks and that act of collective labour establishes a stake to trade mark symbolism contemporaneous with any private claims. (Wilf, 1999)

This is noteworthy for a number of reasons. First, it recognizes an overlooked role of the public, i.e., game player, in creating property rights. Proprietary rights of tangible goods such as manufactured objects are usually assigned to the person who controls the means of production. In intellectual property, the stakes are cultural and more personal; and it may make a more convincing argument about the costs of property alienation. Second, a public authorship model transfers the burden of claims. No longer is it on the public (game player), but rather, back on the private enterprise who is seeking trade mark protection. Under a personality theory of property, an individual must demonstrate the personal loss entailed as a result of deprivation of certain kinds of property. A Lockean labour model limits ownership only through demonstrable disadvantage to the commons. Here, however, the public does not have to prove harm. Instead, it is the trade mark holder's proprietary claims that are limited from the start because of the public (game players') contribution in creating the mark.

The third reason for a public authorship model is practical. The model carves out a public stake in all trade marks. Not simply those marks that are charged with status/personal meaning or those that might threaten the cultural or linguistic domain, but the over-all regulation of trade marks by the public is justified as a compelling public purpose. The creators of virtual trade marks must be able to have some control over their marks. Even according to classical trade mark doctrine, public regulation of trade marks varies with the

distinctiveness of the mark. There is always a core public interest that cannot be lost. Nor should this core interest disappear in virtual worlds.

5. Is There an Author for a Trade Mark?

The question of trade mark authorship has often gone unnoticed through cultural routine. Trade marks are bound to a commercial context, functional (identifying a product) rather than primarily creative, and practical rather than an expressive elaboration of ideas and sensibilities. Just as one imagines an author writing in a picturesque Edinburgh cafe rather than in the Mall of America, Nebraska, such authorship seems an unusual question for commercial language such as trade marks. Yet a trade mark is a creature of symbolic language. Like any other symbol or text, trade marks do not simply appear out of thin air. They are authored. But what does that mean for a mark rather than a book?

Authorship is not a simple concept for either trade marks or the literary realm of copyright. Take the debates currently raging in copyright scholarship. Authorship, they argue, is a cultural construction.[7] What makes an author? Do not some "authors" (even Shakespeare) stitch together texts from pre-existing plots? Or even borrow characters and scenes whole cloth from other narratives? Why should certain kinds of expression, like literary production, be privileged above other types? (Jaszi, 1988)

These questions strike at the heart of assigning special legal privileges that restrict the use and distribution of written texts. If authorship is elusive in copyright, however, it is even more so in trade mark. While copyright has its classic image of the literary author and patent law its notion of an inventor, trade mark is established simply through commercial use.

However, one should compare the role of authorship in trade mark and copyright. Peter Jaszi, in his critique of the pervasive copyright doctrine that the author is central role to copyright, traced the rise of this privileged concept to the eighteenth-century origins of copyright doctrine. (Jaszi, 1988) The Romantic Movement was noted for emphasizing the understanding that individual works are the expression of an individual self. It created the myth of the author as transformative genius. (Woodmansee, 1992) Jaszi has argued that such a notion of the author is a stalking horse for economic interests that dominate intellectual production at the expense of the public. (Jaszi, 1991; Rose, 1988)

Contrary to Jaszi's article *Toward a Theory of Copyright*, this article looks ‘to re-spawn’ the idea of the author in trade mark and to infuse a greater role for the public (game player) domain. The idea of authorship presented here differs considerably from the traditional Romantic understanding of the author as dominant creative force. Trade mark cannot be lumbered with mythic notions of authorship in the same way as a great work of literature or art. As Justice Holmes remarked, a trade mark cannot be compared to Milton's *Paradise Lost.* (*Chadwick v Covell*, 23 N.E. 1068, 1069 (Mass. 1890)) Indeed, the public authorial role in trade mark is much closer to the Court's definition of authorship as enumerated in *Burrow-Giles Lithographic Co. v. Sarony*, 111 U. S. 53 (1884): "he to whom anything owes its origin ...."(see also, *Feist Publications v Rural Telephone Service Co, Inc*., 499 U.S. 340 (1991)) Trade mark originates from a linguistic partnership of consumer/interpreter as well as producer/writer.

5.1 Author as Creator

Trade mark has become less a matter of invention or design of a sign than the association of a mark with a particular object. Association occurs in two stages. The first stage involves a producer connecting a sign with an object. It may be placed upon the object as a label or incorporated into its over-all design. The second stage occurs when that association is recognized and invested with meaning by the public as an interpretive community.[8] Following association of the object with the sign there is a third stage where the object-sign association is contextualized within a broader cultural context. As will be examined below, the public power of association plays a pivotal role in a number of trade mark doctrines such as the establishing of secondary meaning.

Who makes a mark is not an idle question. Intellectual property rights are often founded upon a right to the product of one's own labour that begins with an act of creation. The Lockean notion that creators should be rewarded with just desserts has been enshrined in natural rights arguments for the protection of intellectual property rights against free riders. In the words of Justice Brandeis, a person or corporation should not "reap where it has not sown."(*International News Service v Associated Press*, 248 U.S. 215, 239 (1918) (Brandeis, J., dissenting)) Ownership of intellectual property generally relies upon claims to creation or the transfer of those claims. Regardless of whether the writings remain locked away in a study drawer, like those of Kafka, or lack

any economic utility whatsoever, intellectual property rights are linked to authorship. (Becker, 1977; Waldron, 1988; Port, 1993; Landes & Posner, 1987; Denicola, 1984 (asserting that the collection of information warrants copyright because of a labour theory of just desserts); Brennan, 1993) (For an attempt to construct an economic fair use rationale, see Gordon, 1982).

A redefinition of the public role in making trade marks is needed in order that interpretation will be incorporated into the act of creation. There are two approaches: (1) new understandings of the meaning of authorship found in reader-response theory, and (2) new understandings of the meaning of consumption and language drawn largely from the work of Pierre Bourdieu. (Bourdieu, 1991) These approaches perceive cultural forms as constructed through interpretive interaction. Reader-response criticism emphasizes the convergent relationship between the beholder and the work. It views readers as actualizing a text and becoming co-producers of that text through interpretation. The idea of the text encompasses its reception as well as the language composed by the writer.

Here it will be argued that the public, both the virtual businesspeople and the virtual consumers, form an interpretive community whose reading of trade mark symbolism casts it in the role of creating authorial-like meanings about the mark itself. Bourdieu positions language within a social context. All language consists of words and a linguistic context which informs how those words are defined. For Bourdieu language is contextualized meaning. It is not static nor an idealized dictionary full of words, but a dynamic exchange of signs, interpretations with its meaning shifting from one context to another. (Id.)

5.2 Investing in a Symbol

Authorship in trade mark can be redefined to include a public act of interpretive association precisely because it lacks the idea of individual authorial/inventive production that lies at the centre of other intellectual property regimes. The U.S. Constitution established federal regulation for patent and copyright "to promote the progress of science and useful arts by securing ... authors and inventors the exclusive right to their respective writings and discoveries." (U.S. Const. art. 1, cl. 8) While acknowledging the practical need to encourage investment in literary and scientific expression, this provocative use of the possessive pronoun implies that copyright and patent may protect intellectual creations for the sake of the creator himself. (Wilf, 1999)

With a looser connection to authorship, trade mark is not mentioned with patent and copyright. Instead, the U.S. Supreme Court in the *Trade-Mark Cases* (100 U.S. 82 (1879)) ruled that federal power to regulate trade marks fell solely under the Commerce Clause: "The ordinary trade mark has no necessary relation to invention or discovery." (Id. at 94) In its decision, the Court made a clear distinction between trade mark law and the author-driven doctrines of patent and copyright. It held that trade marks are established often as the result of accident, not of design; that trade marks take root over a considerable period, not as a result of sudden invention; and that they are not the "fruits of intellectual labour," unlike copyrights or patents. (Id.)

This notable admission of the problem of authorship in trade marks has gone largely unnoticed. The dilemma comes from two customs. First, there is the identification of right to ownership with creativity. How much creativity is enough to warrant protection?[9] Nobel Prizes and Oscars are not awarded for trade marks. Despite Madison Avenue's self-promotion about creative advertising, no one speaks of a trade mark artist. Fabricating symbols seemed to the Supreme Court in the *Trade-Mark Cases* as requiring "no fancy or imagination or genius" (*Trade-Mark Cases* at 94) and as too simple a task to "legitimize an entire intellectual property regime."(Id.)

The second rights argument justifying intellectual property is based upon labour. A large expenditure of intellectual labour is not required to design a label. Here, too, the *Trade-Mark Cases* Court seemed sceptical, stating that trade mark is "simply founded on priority of appropriation." (Id.) How much "sweat of the brow" is needed to establish proprietary rights?[10] Taking a natural rights approach, however, trade mark must be justified by some form of labour.

If not intellectual labour, then what kind of labour can serve as the foundation for proprietary privileges? How can the rights of the trade mark holder be predicated upon investing labour in symbolic production? The solution has been to shift the notion of labour investment from the actual sign to the good will embodied by that sign. Good will is defined as the willingness of a customer to continue doing business after the first transaction. It is a bit of a semiotic shell game: the consumer object is signified by good will which, in turn, is signified by a trade mark. (McCarthy, 1984)

Is it possible to argue that trade marks are institutional publicity rights? (Denicola, 1984; Pollack, 1993) Just because individuals have the right to control the commercial use of their identity, should the identity of products be protected? The identity for trade mark reflects the product itself and the feelings it generates (i.e.,

good will). Is this an important distinction between publicity rights and trade marks? Publicity rights depend upon the identification of the persona. A celebrity expends considerable efforts to make his or her self distinct. Elton John wears peculiar glasses, Madonna can often be found in lingerie. No prior commercial exploitation of that self is necessary. Good will, however, depends upon the reputation of a product with consumers in a commercial setting. It requires consumer consciousness. This explains why there is a confusion rationale for trade marks but not for publicity. Good will is an identification created by the public.[11]

On the other hand, is good will authored in the same way as more tangible symbols? The classic understanding of good will is as reputation. While trade mark serves as the marker for how a potential consumer might identify a product, the good will itself is seen as emerging from care in maintaining quality and marketing.

6 The Public Role in Trade Mark Doctrine

Trade mark doctrine demonstrates a notable reliance upon public perception. The power invested in the public is largely associative: the power to identify a sign with an object to the exclusion of others. The following is divided in two sections. The first section, "Making and Unmaking through Association," discusses establishing meaning for trade marks and how that meaning might be lost. The second section, "Meaning in Context," explores how associative meaning changes in different linguistic markets.

6.1 Making and Unmaking through Association

6.1.1 Making Trade Marks

"Recognition and association are the cornerstones of secondary meaning." (*SmithKline Bechman Corp. v Pemex Prods. Co*., 605 F. Supp. 746, 750 (E.D.Pa. 1985) "Secondary meaning," wrote one appellate judge "has been defined as association, nothing more." (*Carter-Wallace, Inc. v Proctor & Gamble Co*., 434 F.2d 794, 802 (9th Cir. 1970). See also *The American Angus Ass'n v Sysco Corp*., 829 F. Supp. 807, 827 (E.D.N.C. 1993) (stating that "the prime element of secondary meaning is association between the alleged mark and a single source of the product"); *Visser v Macres*, 29 Cal. Rptr. 367, 370 (1963) (holding that secondary meaning is acquired when the public "submerges the primary meaning of the name ... in favor of its meaning as a word, identifying that business."); McCarthy, 1984) In the United Kingdom a trader would have to show that the word has become 'distinctive in fact' or has taken on a 'secondary meaning'. (*Reddaway v Banham,* [1896] AC 199; Wadlow, 1999) Almost no other element of trade mark doctrine so embodies the idea of establishing text through association and so underscores the public role in authorship. Unlike distinctive marks like "Kodak," suggestive marks require secondary meaning to become descriptive marks. For example, a dish washing soap called "Pleasant detergent" requires further association to transform the descriptive term "pleasant" into a particular product name. (See *Clinton Detergent Co. v Procter & Gamble Co*., 302 F.2d 745 (C.C.P.A. 1962) It may be defined as the association by the consuming public of a once independent word/symbol with a product that transforms the word/symbol into a distinctive mark. Producers must speak to the consumer through associative language of symbol/object. The consumers must see the disassociated symbol as invested with meaning, even where the object is not present. (*Levi Strauss & Co. v Blue Bell, Inc*., 632 F.2d 817, 820 (9th Cir. 1980); *Edge & Sons v Gallon & Sons* [1900] RPC 557; *Peter Waterman v CBS* [1993] EMLR 27) British examples of descriptive words that have acquired secondary meaning would include: "Flaked Oatmeal" (*Parsons v Gillespie* [1898] AC 239 (PC)); "Malted Milk" (*Horlick's Malted Milk Co. v Summerskill* (1916) 33 RPC 108); and "Mothercare" (*Mothercare v Penguin Books* [1988] RPC 113, 115) for clothing for expectant mothers and children.

Trade mark creation is a two-step process. First, a producer affixes a symbol to the product. In the virtual world, it may be that Jedi Joe affixes two swooshing Js to the light sabres he produces. Second, the public associates the symbol with the product. All the superior Jedis want to acquire a light sabre with the swooshing Js because they are better made light sabres. They would then be called JJs. The producer affixing a symbol might be called primary meaning while secondary meaning embodies the idea of public association. This association takes place in the midst of a market where linguistic exchange parallels the transfer of goods. (*Coca-Cola Co. v Seven-Up Co*., 497 F.2d 1351 (C.C.P.A. 1974) (holding that "Uncola" lacks linguistic meaning until acquired in marketplace)). Both the producer and the consuming public are joint authors.

Although recognition in addition to first-in-time use by a manufacturer or marketer should be necessary to establish the suitability of a trade mark, secondary meaning does not address utilitarian rationales for trade mark doctrine including commercial regulation and potential injury coming from the use of the mark. (Carter, 1993)

Traditional fraud or passing off claims can be used to regulate commerce while misappropriation doctrine would grant relief for injury to the trade mark holder. An argument can be made that secondary meaning demonstrates a trade mark's worth to the public and, therefore, justifies the cost of employing legal resources to protect it. But why, then, is it not a requirement for fanciful marks. There is no reason why a product called "Xystal" should not warrant the same protection as one labelled "Mr. Clean."[12]

A return to natural rights theory is needed to explain the doctrine of secondary meaning. Secondary meaning recognizes that the public is granting a right through its creative association of the object with the mark. As Justice Stevens has stated, "language, even in a commercial context, properly belongs to the public ...."(*Park'N Fly, Inc. v Dollar Park and Fly, Inc*., 469 U.S. 189, 215 (1985) (Stevens, J., dissenting)) On the whole, the association must be in the mind of the general public, so that it is not normally legitimate 'to slice the public into parts.'(*Peter Waterman v CBS* [1993] EMLR 27) This solution assumes a substantial permanent alienation of part of the public's linguistic-symbolic heritage. It would be difficult to later return and claim harm due to loss of that piece of common culture.

Secondary meaning might also be seen as the construction of a new word from a number of sources including a pre-existing English word, a product with its affixed label fabricated by a producer, and the interpretive associational power of the public. (Wilf, 1999) According to Locke, if language is a symbolic representation of an idea, then descriptive trade marks do not take language but draw upon it for marketing. The "pleasant" of the dish detergent company simply looks like the common word "pleasant" in English. But pleasant may evoke very different images, from a Sunday dinner to a ride in the country. Prior to the introduction of this particular dish soap, no one would associate pleasant with washing dishes. But that is precisely the point. The mark is really a newly created symbol constituted by a tightly bound sign-product association. (*Antec International v South Western Chicks (Warren)* [1997] FSR 278; [1998] FSR 738, 734-4)

The two words, then, are "pleasant" (English term representing enjoyment) and "Pleasant-detergent" (commercial term for a particular kind of dish soap). The sign "Pleasant-Detergent" would be conjured up in advertising, attached to a product, or tossed about within market settings. This suggests the limits of public alienation of its creation. "Pleasant Detergent" is not a Lockean res nullius, an un-owned piece of property. It was created by the public association of a pre-existing word and an already owned object. Unlike fanciful or arbitrary names like "Kodak" or "Exxon," it was not the result of a sole party's labour. Thus, under Lockean natural rights theory, public entitlement of this newly coined phrase should be retained for use outside of its single commercial association. On occasion, courts have employed arguments that resonate with Lockean logic. *Otto Roth & Co. v Universal Foods Corp*., 640 F.2d 1317 (C.C.P.A. 1981) recognized the importance of "free use" of language. Whereas the court in *Bada Co. v Montgomery Ward & Co*., 426 F.2d 8, 11 (9th Cir. 1970) held that one "competitor will not be permitted to impoverish the language of commerce by preventing his fellows from fairly describing their own goods". Every kind of intellectual property requires participants, users, to acquire value. What makes trade marks different is that they require participants to acquire meaning.

Compare the linguistic association devised for descriptive marks with suggestive marks. Descriptive marks convey an immediate idea of the product. "Wheaties" consists of wheat, "Oatnut" is bread made of oats and nuts. (*In re Entenmann's Inc*., 15 U.S.P.Q.2d (BNA) 1750 (P.T.T.A.B. 1990)) "Oven Chips" is for potato chips to be cooked in the oven rather than fried. (*McCain International v County Fair Foods* [1981] RPC 69) "Pentomino" is a domino with five sides. (*Golomb v Wadsworth*, 592 F.2d 1184 (C.C.P.A. 1979)) Suggestive marks require "'thought and perception to reach a conclusion as to the nature of the goods.'" (*Abercrombie & Fitch Co. v Hunting World, Inc.,* 537 F.2d 4, 11 (2d Cir. 1976) (quoting *Stix Prods., Inc. v United Merchants & Mfgs., Inc*., 295 F. Supp. 479, 488 (S.D.N.Y. 1968))) The inquiry in relation to used marks is exclusively concerned with customer perception: the needs of other traders are irrelevant. (*Windsurfing Chiemsee Produktions v Attenberger*, C-108 and 109/97 [1999] ECR I-2779, I-2829 (para. 48)) "Chicken-of-the-Sea" is only suggestive because one might not necessarily conjure up an image of tuna without a leap of imagination. It might be expected that greater imagination would lead to a larger public role in the creation of suggestive marks.[13] The imaginative leap then is really made by the producer, and the public simply follows suit. The producer is the one who calls suntan lotion "Coppertone," creating a linguistic association that might enrich the cultural commons. (*Douglas Lab. v Copper Tan, Inc*., 210 F.2d 453 (2d Cir. 1954)) It follows according to Lockean natural rights to reward the suggestive mark with stronger initial protection against other commercial entities than a descriptive trade mark.

Association still needs to be recognized by the public, and the public should retain its entitlement for non-market uses. Descriptive marks borrow heavily from the linguistic commons and require public recognition through secondary meaning before warranting commercial protection. On the other hand, suggestive and arbitrary marks warrant early protection from commercial interference because they are based upon either

linguistic (arbitrary marks) inventiveness (Nynex for New York Telephone) or imagistic inventiveness. (associating the colour of tanned skin with the burnished colour of metal that is reminiscent of the Bronze Age) Arbitrary or suggestive marks take on additional cultural meanings through use. In no cases can the public fully alienate linguistic creation from the Lockean cultural commons once it has entered common usage.

Public entitlement for trade mark is based upon two principles. First, certain public traditions, like descriptive marks, take on commercial meaning through public association. Second, in arbitrary or suggestive marks, producers take upon themselves a larger role in their commercial creation. After being exchanged as commercial entities, these become part of the Lockean cultural commons. The fanciful mark "Oreo" was introduced into the commercial sphere as the name of a cookie. But African-Americans adopted it to refer to those who are black on the outside, white on the inside. In that form, the word is fully part of the cultural commons.

Finally, there are marks which cannot be made commercial because their cultural meaning is either collective or their use would be so offensive to the collective. Both the Lanham Act (15 U.S.C. §1052-72, 1091-96, 1111-27 (1994)) and the Trade Mark Act of 1994 s 3 prohibits registration of a number of types of trade marks on the basis of content. These prohibitions include purely descriptive marks, (§1052(e)(1) (1994); TMA s 3(1)(b)) and marks that are primarily surnames (§1052(e)(4) (1994)). In the UK, traditionally surnames have been considered to be non-distinctive and thus unregisterable. (*Elvis Presley Trade Marks* [1997] RPC 543, 558). The OHIM has not adopted the practice of objecting to surnames as being 'devoid'. This is changing. Now when determining whether a surname is distinctive, the Registry and courts have taken into account how common the surname is. (*Fantastic Sam's Service Mark* [1990] RPC 531, 532) Sam which appeared only 13 times in London Telephone Directory was considered not a surname. (see also, *Nichols Plc v Registrar of Trade Marks* (C-404/02) (Unreported, September 16, 2004) (ECJ)) and geographic names if the secondary meaning exception cannot be met. (§1052(e)(3) (1994); TMA s 3(1)(c)) Moreover, both Acts exclude registration of "immoral, deceptive, or scandalous matter; or matter which may disparage or falsely suggest a connection with persons, living or dead, institutions, beliefs, or national symbols, or bring them into contempt or disrepute." (§1052(a); see also TMA s. 3(3)(a); see also, the mark "Tiny Penis" was refused in *Ghazilian's Application* (2001)) These limitations express the problem of associating a symbol/name with meaning if meaning already exists. For example, surnames are arbitrary designations for an individual. This person is called Abercrombie rather than Fitch. In a sense, then, Abercrombie is a trade mark for persons, shared within an exclusive semi-public domain by everyone named Abercrombie. The number of people with that name may increase (Abercrombies pass down the mark to their children or share with a spouse or Fitches may change their name to Abercrombie) but it is applied solely to this limited set of individuals. Different Abercrombies are distinguished in a variety of ways. There is Alexander Abercrombie, Bertram Abercrombie, the Abercrombie from New York, the Abercrombie from Glasgow, Abercrombie the professor, and Abercrombie the insurance salesman. Because human beings are singular and found within local settings there is little confusion (though occasionally one has to resort to middle names for someone with the common appellation of Smith). (Wilf, 1999)

The association is between person and name. By using it as the designation for a product requires taking it away from its sole connection to individual identity and attaching it to a physical object. Such a re-association is legitimate because the naming of the self is really one communicative channel and the association with a commercial product is another. In the case of celebrities, however, the name has become commercialized. (Harrington, 2005) Self and the commons have intermingled. It therefore would be prohibited to name a perfume after Elizabeth Taylor while there would be no problem using a name already in currency for an ordinary individual. For ordinary persons, the name is arbitrary or fanciful (this individual is an "Abercrombie") but for products it becomes a descriptive term (Abercrombie's may be translated as the restaurant owned by Abercrombie). Consequently, secondary meaning is required to re-establish this new association.

A public role is also required because the extension of the Abercrombie name to a restaurant encroaches upon the entitlement of every other Abercrombie. Another member of the Abercrombie family would be barred from opening a restaurant with the same name in the city. For example, Joseph Gallo (brother of the Gallos who own Gallo Winery) was prohibited from using his surname on packaged cheeses). (See, *E. & J. Gallo Winery v Gallo Cattle Co*., 967 F.2d 1280 (9th Cir. 1992)) Unlike surnames, there is no secondary meaning requirement for historical names. While Michelangelo will be unaffected by a paint store named in his honour, the entitlement of everyone bearing the Abercrombie name diminishes if it is called Abercrombie. A secondary meaning requirement means that public use of language (its perception and associational power) trumps limited group entitlements to names.[14]

6.1.2 Unmaking Trade Marks

Nothing underscores the authorial power of public association more than its ability to unmake trade marks. By becoming generic, aspirin, cellophane, thermos, linoleum and other trade marks have lost their distinctive meaning. (*Bayer Co. v United Drug Co*., 272 F. 505 (S.D.N.Y. 1921); *DuPont Cellophane Co. v Waxed Prods. Co*., 85 F.2d 75 (2d Cir. 1936); *Linoleum Manufacturing Company v Nairn* (1878) 7 Ch D 834, 836; Stern, 1983) Thermos, once a specific trade mark, was applied to other vacuum-sealed containers that keep liquids at a constant temperature. (*King-Seeley Thermos Co. v Aladdin Indus., Inc*., 321 F.2d 577 (2d Cir. 1963) Public association of a mark with a broad variety of similar products means that a sign or symbol becomes part of a public domain. But it is not a sudden transfer of rights from a private holder of the trade mark to a linguistic commons. For example, the first holder of "Shredded Wheat" only had "de facto secondary meaning." (*Kellogg Co. v National Biscuit Co*., 305 U.S. 111, 119 (1938); *Canadian Shredded Wheat Co. Ltd v Kellogg Co of Canada Ltd* (1938) 55 RPC 125; *Shredded Wheat Co Ltd v Kellogg of Great Britain* (1940) 57 RPC 137) The Supreme Court held that the mark was generic. (*Kellogg* at 117) This means that the public never associated the symbol with the object of a particular producer but merely with the general type of goods. At the time Shredded Wheat was produced by just one company, the name referred to that company alone. As other companies began to produce similar cereal biscuits, there was no particular or distinct association with the producer to prevent that association from spreading to all makers of the same sort of products. (Id. at 120; *DuPont* at 81 (holding that no matter how much money was spent in marketing to ensure that cellophane would not be deemed generic, "so far as it did not succeed in actually converting the world to its gospel, it can have no relief").

6.2 Meaning in Context

This article has argued that the authorial role of the public has created a public domain. Authorship legitimizes the public power to determine what will or will not be a protected trade mark. It is established through association. This section will contrast competing doctrines being developments in trade mark law. One development challenges the emphasis on public-derived meaning and the other seeks to deepen that meaning through contextualizing it within a linguistic market.

The creation of secondary meaning and the use of inherently distinctive trade dress have both come under attack. Sometimes secondary meaning cannot be proved because a product is in an early stage of marketing. (*Marcus Publishing v Leisure News* [1990] RPC 576, 584) Holders of trade marks have argued for secondary meaning in the making in order to claim injunctive relief. Secondary meaning in the making is defined as a presumption that meaning will develop in the future. (Id.; *National Lampoon, Inc. v American Broadcasting Co*., 376 F. Supp. 733 (S.D.N.Y. 1974); McLean, 1993; Bryant, 1989) There is no requirement to demonstrate how the mark is presently perceived by the public. Secondary meaning in the making is largely based upon the intent of the person who seeks exclusive use for a trade mark. (*Salvatore Ferragamo Italia SpA*, R 254/1999-1 (14 Apr 2000)) Salvatore Ferragamo sought registration of a bow which it had used on its shoes for the previous twenty years. While there was plenty of evidence of use, and of advertising in elite magazines, it was by no means evident that the ordinary purchasers of shoes would have been familiar with the mark. (Id)

As one judge has pointed out, secondary meaning in the making is "focused solely upon the intent and actions of the seller of the product to the exclusion of the consuming public." (*Black & Decker Mfg. Co. v Ever-Ready Appliance Mfg. Co*., 684 F.2d 546, 550 (8th Cir. 1982)) Secondary meaning in the making relies upon the intent of the producer. Are there plans to invest in advertising? Will the product be marketed soon? A large chasm stands between marketing and public cultural meaning.

The second doctrine I wish to discuss, inherently distinctive trade dress, relies upon a reading of the product itself. In the case of *Two Pesos v. Taco Cabana Int'l Inc*., 505 U.S. 763 (1992), the Supreme Court examined whether trade dress infringement could be found without a determination of consumer confusion. Two Mexican eating establishments shared a similar menu, floor plan, and interior decor. The restaurants were built around patios and were decorated with murals. Both used bright, festive colours. Finding that the decor of the first restaurant was "inherently distinctive," the Court held that the first restaurant was unique enough that questions of secondary meaning were irrelevant. (Id.) Such analysis reduces secondary meaning into something of contingent importance. *Chevron Chem. Co. v Voluntary Purchasing Groups, Inc*., 659 F.2d 695 (5th Cir. 1981), required a demonstration of secondary meaning only when it was determined that the trade dress was not sufficiently distinctive. How distinctive is distinctive enough is hard to show as seen in *Publications Int'l, Ltd. v Landoll, Inc.,* No. 98-1490, 1998 U.S. App. LEXIS 31382 (7th Cir. 1998). "Courts have struggled to articulate a

standard for when a trade dress is sufficiently distinctive to be entitled to the prima facie protection of the Lanham Act." (Id.)

A similar but slightly different phenomenon has occurred in the United Kingdom, the problem of look-alikes. The British Producers and Brand Owners Group (destined to become known by the unattractive acronym, BPBOG)[15] mounted a powerful lobby for the inclusion in the Trade Marks Bill of specific protection against look-alikes. [16] The British Retail Consortium (BRC) joined forces with the National Consumer Council and the Consumers' Association to mobilize the opposition.[17] J. Sainsbury plc., the United Kingdom supermarket giant, seized the opportunity to launch its own "Classic Cola" in red and white cans retailing at a price a quarter less than "the real thing." The mighty wrath of The Coca-Cola Company was incurred,[18] but Sainsbury had succeeded in significantly increasing its market share of cola sales in-store.[19] The Trade Marks Bill, originally described as "technical and not at all party political,"[20] captivated the public interest on soap opera scale.

Despite the remarkable level of support commanded by the brand owners' plight, especially in the House of Lords, the United Kingdom Government remained steadfast in its rejection of the desired look-alike amendment to the Trade Marks Bill. Instead, the increased scope for protection of trade marks under the new Act must be given a chance to work. The issue of look-alikes might have to be revisited at a subsequent time, but the government refused to be drawn on the questions of when and how.[21]

This decision places at risk the traditional public role in making trade marks. Both secondary meaning in the making and inherently distinctive arguments have been questioned by courts and scholars. They are seen as handing advantages to existing trade mark holders that crowd out new entrants. (Carter, 1993; *Black & Decker* at 546) More importantly for the argument here, they strip away the public role in making trade marks. These doctrines see the trade mark holder as the sole author. Yet the idea of assuming public reaction based upon marketing is very troubling. Without the association of the trade dress with a symbol identifying the source, how can there be secondary meaning and, consequently, likelihood of confusion? (*Laureyssens v Idea Group, Inc*., 768 F. Supp. 1036 (S.D.N.Y.), aff'd in part, vacated in part & rev'd in part, 964 F.2d 131 (2d Cir. 1992))

In *Two Pesos*, Justice Thomas claimed that "the first user of an arbitrary package, like the first user of an arbitrary word, should be entitled to the presumption that his package represents him without having to show that it does so in fact." (505 U.S. 787. Sainsbury averted litigation by changing the script on their cola cans.) Yet as has been shown above, trade mark common law has commonly held that representation of descriptive marks requires the acknowledgment of an outside viewer. As Locke suggested, a person can claim to invent a word but unless that linguistic change takes hold, it is meaningless. Justice Thomas confused claims and meaning.

Secondary meaning in the making and inherently distinctive arguments are non-contextual. These doctrines understand trade marks or trade dress as symbols outside of a context of communication between producer and consumer. Focusing upon intent of the producer (secondary meaning in the making) or distinctiveness of product (inherently distinctive) is tricky. Just because a producer intends or even takes action to market a product does not mean that this attempt will be successful. The doctrine of generic trade marks is an example of the thwarting of producer intent. (TMA s 3(1)(d); Article 7(1)(d) CTMR)

The Court in *Two Pesos* did not examine the differences that might arise from trade dress for a service (where face-to-face contact takes place) as opposed to an object nor did it ask whether Mexican decor is not a logical direction for any Mexican restaurant to follow. Without reference to the public, the decision in *Two Pesos* only protects the holder of the mark, not the public, from commercial confusion. The intent examined should be that of the individuals seeking to follow the lead of the first holder. Is this a conscious attempt to copy a successful business venture? Is free-ridership intended? If this was the case, a bad faith action could be initiated. (TMA s3(6); §1051(d)(1)) For questions of distinctiveness, the understanding of the public should determine whether products are distinctive enough, not an objective standard. The objective standard of *Two Pesos* concentrates on the "total image of the business." (*Two Pesos* at 765)

Yet distinctiveness for an interpretive community might very well lie in the details. Perhaps the wearing of large Sombreros by waiters or even serving a dish as a specialty of the house is sufficient to set off one restaurant from another. There is no objective standard for the cultural distinctions found by consumers. (Compare id., with *Haagen-Dazs, Inc. v Frusen Gladje, Ltd*., 493 F. Supp. 73 (S.D.N.Y. 1980). In *Haagen-Dazs*, the court stated that the plaintiff did not have an exclusive right to a unique marketing theme. These cases constitute inherently distinctive approaches to the copyright doctrine of substantial similarity.) Not only has this article tried to argue for a broader understanding of authorship (including the public as well as the producer who determines the packaging), but also for a more dynamic definition of a trade mark.

A trade mark is not simply a phrase or symbol or trade dress. It is not what might be thought of as a word of sorts. Instead, it is the product of an act of dynamic communication. Two types of association have been

described above: (1) initial meaning, where the producer affixes a sign to a package, and (2) secondary meaning, where the public associates sign and product as connected. What will be proposed now is a third kind of association: Tertiary meaning. The tertiary meaning is the placing of a sign-symbol in a context. (Wilf, 1999)

A publisher could affix the phrase "red book" to a particular work. When a reader sees a reference to this red book, the reader only thinks about Chairman Mao. Yet much later that reader comes across a plum book. The Plum Book describes legal jobs available in the federal government. This book has little to do with Mao's reference (he might even be horrified by any suggestion of similarity) other than perhaps playing on the idea of a coloured cover. The plum is a pun on plum jobs. In the context of tertiary meaning the Plum Book is completely distinct from Mao's Red Book. (Id.)

Contexts come in a variety of forms. It is possible to divide the contextual use of language into three kinds: (1) to whom said? (2) about what said? (3) how said? (The question of multiple linguistic markets based upon differing sophistication and expertise has not been addressed here. Children, for example, are much more susceptible to confusion. Professional, well-educated consumers are less likely to blur distinctions. See *Mead Data Central, Inc. v Toyota Motor Sales, U.S.A., Inc.,* 702 F. Supp. 1031 (S.D.N.Y. 1988)) When someone says "how are you" to a critically ill friend it has a very different meaning than when it is said to a stranger in passing. When speaking about a coffee as robust, it means something very different than talking about an Olympic athlete. Or, finally, when someone says "you need killing," it means something very different if said in a context of humour or anger. The lion of Dreyfuss investment services is not the same as the cowardly lion of the Wizard of Oz. (*Dreyfus Fund Inc. v Royal Bank of Canada*, 525 F. Supp. 1108, 1117 (S.D.N.Y. 1981); see also, *General Motors Corporation v Yplon*, Case C-375/97 [1999] 3 CMLR 427, 443 (para. 22 & 23) (regarding the Chevy symbol)) All this seems obvious. But it has been difficult for courts to contextualize language in quite this way.

Some decisions have moved in this direction. The question in *Nike v. "Just Did it" Enterprises*, 6 F.3d 1225 (7th Cir. 1993), is "to whom said?" A mail-order entrepreneur parodied the Nike t-shirt reading "just do it" with an emblem saying "Mike."(Id. at 1226. In *Anheuser-Busch, Inc. v Florists Ass'n of Greater Cleveland*, 603 F. Supp. 35 (N.D. Ohio 1984), florists used the advertising phrase "this bud's for you," with strong references to a Budweiser Beer slogan. The court decided that the difference between flowers and beer markets argued against trade mark confusion.) Advertisements for the shirt were sent only to people with the first name of Mike. Even though the word Mike looked very much like Nike from a short distance, the court held there was no confusion. Writing only to a discrete population and only through the mail, trade mark as contextualized language was spoken only to certain people. (*Nike*, 6 F.3d at 1230) The trade channels were substantially different. (Id.)

On the other hand, courts confuse the "to whom said?" For example, in *Playboy Enterprises v. Chuckleberry Publishing*, 486 F. Supp. 414 (S.D.N.Y. 1980), Playboy required an injunction against the publishing of a voyeuristic magazine entitled "Playman." (Id. at 418) Playboy had failed to act against other publishing ventures like Playgirl, an analogous erotic magazine directed towards women. (Id. at 421) The case could have been adjudged applying the crowded field doctrine wherein surrounded by numerous similar marks, a trade mark cannot be very distinctive. However, the court concluded that Playboy was aimed at a heterosexual market and would be recognized amongst competing signs meant for heterosexual men. (Id.) Here, unfortunately, context was drawn in a terribly narrow fashion.

Scottish Whisky Ass'n v. Watson, 958 F.2d 594 (4th Cir. 1992), tackled the question of "about what said?" Black Watch Scotch was produced in America but every attempt was made to associate it with Scotland. (Id. at 598) Its label bore the regimental badge of the Scottish Black Watch Regiment, thistles, and the word "Highlands." (Id. at 595) It spelled "whisky" without an "e" as is the case for Scottish whiskeys, not with an "e" as is the usual usage for American produced liquors. It was alleged that the product caused deceptive confusion, and consumers would think that the liquor actually came from Scotland. (Id. at 596) Yet the context (and the tertiary meaning) was meant to be evocative of Scottish liquor, not Scotland itself. The court decided against confusion. (Id.)

A third case, *Jordache v. Hogg Wylde, Ltd*., 625 F. Supp. 48 (D.N.M. 1985), deals with the context of "how said?" The court concluded that humorous speech was different from serious speech even if both were commercial. (Id. at 50) Jordache designer jeans, intended for those with skinny figures, were parodied by a company manufacturing jeans for fat women. (Id.) These pants were called "Lardashe." The delicate horse insignia of Jordache was replaced with a garish pig-pocket. Swine, in general, were the theme of this company's marketing. (Id.) The court found that the use of humour established a completely different context. (Id. at 51) The humorous quality of parody created an associational rift between Jordache and Lardashe so that the use of a mocking trade mark was "not likely to create in the mind of consumers a particularly unwholesome, unsavoury, or disagreeable association." (Id. at 57) It dismissed claims of misappropriation or dilution. The association of lardashe-to-humour was greater than that of lardashe-to-Jordache. (*Toho Co. Ltd. v Sears, Roebuck & Co*., 645

F.2d 788 (9th Cir. 1981) (allowing use of garbage bags called Bagzilla after the lizard character Godzilla); *Universal City Studios, Inc. v Nintendo Co., Ltd*., 746 F. 2d 112 (2d Cir. 1984) (allowing the game Donkey Kong as a parody of King Kong); *John W. Carson v Here's Johnny Portable Toilets, Inc*. 698 F.2d 831(6th Cir. 1983) (allowing the parody use of identifying phrase for toilets); *Girl Scouts of the United States of America v Personality Posters, Mfg. Co*., 304 F. Supp. 1228 (S.D.N.Y. 1969) (allowing a poster of a pregnant Girl Scout with the Girl Scout phrase "Be Prepared"))

Association means authorship and context points to meaning. Within trade mark doctrine, the material to construct a public domain is possible. During the moment of associational creation, the public allows for certain kinds of trade mark privileges. The public never alienates symbols or words from the Lockean commons because to do so would be to lose touch with a collective self.

7 We Have Met the Author and She is Us

This article has set forth a characterization somewhat different than the usual depiction of trade marks. Trade marks viewed not as a word or symbol but as an association of an object with a sign. Trade marks authored not by the production/marketing of an object in its package but by a joint interpretive enterprise between author and public. Trade marks not interpreted alone but in a linguistic context. The purpose behind this reinterpretation is to carve out a public entitlement for trade marks.

This reinterpretation requires a rethinking of the very definition of intellectual property. The accent has been placed on the "intellectual," rather than the "property". The public should (and some would argue, must, as a political imperative) retain a robust role in shaping expression. If, as Jennifer Nedelsky suggests, legal notions of property have created the bounded self, (Nedelsky, 1990) then intellectual property can serve as a model for an unbounded, collectivist self. This is an important position with regard to virtual worlds and the collectivist self found in them. Trade marks, as signs of a material culture embedded in everyday life, are clearly found in these virtual worlds; probably more so than in the real worlds. Its abstraction of symbol as representing a relationship, its reliance upon public readings, its ability to seep into the many corners of our lives makes trade mark, as paradigmatic of intellectual property as a whole, a means for connecting disparate selves. (Wilf, 1999)

New Republican legal theorists have struggled with the problem of what constitutes a community, often seeking to locate community in discourse. (Ackerman, 1984; Fiss, 1982) The argument has been made here for a linguistic or interpretive community. Virtual worlds are foremost linguistic and interpretive communities. These communities should have the collective rights over its cultural creation. The question, ultimately, is one of legal authority. "When I use a word," said Humpty Dumpty in Through the Looking Glass, "it means just what I choose it to mean - neither more nor less. The question is which is to be the master - that's all." (Carroll, 2000)

Notes

[1] This usage of the term was coined in 1985 by Chip Morningstar, a user of the first avatar environment created by LucasFilm called Habitat. (Morningstar and Farmer, 1991) Habitat lacked many of the features we have in today's games such as quests and puzzles. It was more similar to a social MUD in which the interactivity between avatars was the ultimate goal.
According to Encarta: *Avatar* [Sanskrit]: 1. incarnation of Hindu deity: an incarnation of a Hindu deity in human or animal form, especially one of the incarnations of Vishnu such as Rama and Krishna. 2. embodiment of something: somebody who embodies, personifies, or is the manifestation of an idea or concept. 3. image of person in virtual reality: a movable three-dimensional image that can be used to represent somebody in cyberspace, for example, an Internet user.
[2] Arguing that this non-tangible quality makes it hard to apply classic utilitarian analysis to trade marks. A number of scholars have seen intangible property rights in government licenses. Scholars have also recognized individual liberties to do as one wishes with one's body. Here it will be suggested that the intangibility of trade marks, and the way they are summoned into existence, invests interpretive powers in the players that create these public property rights.
[3] "Ultima Online gives you the option to choose your character from a set of templates of traditional professions. You're certainly not required to build your character from a template, but we highly recommend it for the first-time player. You may create multiple characters on each shard (except the Siege shards), so don't worry about creating a character you may not like. Using a template for your first character is an excellent way to get a feel for Ultima Online.

To create a character from a template, choose the 'Samurai', 'Ninja', 'Paladin', 'Necromancer', 'Warrior', 'Mage', or 'Blacksmith' option. The 'Advanced' option is for those comfortable enough with the UO skill system to build a character from scratch.
Once you have chosen a starting profession, you'll need to customize the 'look' of your character. The image you create will be visible to other players in the game whenever they double-click on you. This image is also known as your 'paperdoll.' You can specify gender, skin colour, hair style and colour, shirt colour, pants/skirt colour and, if you've chosen to play a male character, facial hair style and colour.
Your first character will show up with defaults for all of these options, to change them, simply click on the corresponding part on your character. If you click on an item of clothing, you will then be able to select a colour by clicking anywhere in the palette box to the right of your character. If the selected item is a hair-style, you will see a drop-down menu appear to the left of your character listing all of the style options. Clicking on one will apply it to your character.
When you are satisfied with your appearance, click the small green arrow to continue."
http://www.uo.com/newplayer/newplay_0.html

[4] *Marvel Enterprises, Inc. and Marvel Characters, Inc. v NCSoft Corporation, NC Interactive, Inc. and Cryptic Studios, Inc.*, Case No. CV 04-9253-RGK in US District Court for the Central District of California. Marvel claims that NCSoft's computer game 'City of Heroes' infringes their trade marks with their character creation system which allows and encourages players to create heroes that are similar to, or identical in appearance to Marvel's well-known comic book characters. In the U.K., the courts have found these types of characters ineligible for copyright protection, but have not been presented with the trade mark question. (See e.g., *King Features Syndicate Inc v O&M Kleeman Ltd.*, [1941] A.C. 417, [1941] 2 All E.R. 403 regarding the character of Popeye).

[5] Hughes (1988) argues that "the greatest difference between the bundles of intellectual property rights and the bundles of rights over other types of property is that intellectual property always has a self-defined expiration, a built-in sunset." This statement is rather puzzling since trade mark doctrine lacks such a restriction. Yet, it is possible to apply this notion of sunset and non-sunset restrictions to differentiate trade mark from other intellectual property regimes.

[6] The Supreme Court asserted the need to recognize an intellectual property public domain. See *Bonito Boats, Inc. v Thunder Craft Boats, Inc.*, 489 U.S. 141, 151 (1989) "Free exploitation of ideas will be the rule, to which the protection of a federal patent is the exception." Nevertheless, the court's emphasis upon the diffusion of ideas (rather than symbols) suggests that copyright and patent have more compelling claims for free exploitation. Id. at 157-60.

[7] Jaszi, (1991); Jaszi, (1992); Rotstein, (1993); Woodmansee, (1992); Boyle, (1992)(arguing that copyright protection is often predicated upon a distinction between public and private information informed by the stereotype of the Romantic author).
See also, Sherman and Stowel (1994); Woodmansee and Jaszi, (1994). For a related philosophical inquiry, see Waldron, (1993) (noting that cultural assumptions about authorship inform how we think about the legal issues of copying).
Among the historical studies of authorship are Woodmansee, (1984); Rose, (1988); Rose, (1993); Hesse, (1990) (tracing the alternative political meanings of authorship in Revolutionary France, from Ancien Regime individual creator to Revolutionary actor in a broader project of public enlightenment); Price & Pollack, (1992) (discussing the plasticity of the notion of authorship in copyright). For a comparative perspective, see Saunders, (1992).

[8] By the word "sign," I mean a fundamental element of communication. A sign has various expressions in trade mark law. It may be either linguistic (words as found on a label) or non-linguistic (pictorial representation or trade-dress). According to the widely accepted semiotician Ferdinand de Saussure, the sign has two intertwined characteristics: (1) signifier (the tangible expression of communication) and (2) signified (its conceptual meaning). See De Saussure, (1974). I am suggesting an application of these two ideas to trade mark doctrine. The first stage is the creation of a signifier (the making of the tangible mark itself). The second stage is that of the signified (the investing of the mark with meaning). I will use these terms from semiotics, sign and signifier, throughout the article.

[9] Even with copyright, there is a concern that the act of creation be original and independent enough. See Jaszi, (1988)(noting that Shakespeare's dramas, written prior to the rise of authorial dominance, are a pastiche of material from other sources and demonstrate the difficulty of determining originality standards); VerSteeg, (1993)(attempting to determine thresholds of creativity that might warrant protection); Wang, (1990) (explaining

that the multiplicity of modern art media often entails reproduction, making it difficult to determine originality in traditional ways).

[10] Courts have come to differentiate between creativity and hard work. See Ginsburg (1990) (recognizing the need to protect "high authorship," such as literature, justified through creativity and "low authorship," such as maps and computer databases, justified through labour arguments). Justice O'Connor recently stated that "copyright awards originality, not effort." *Feist Publications, Inc. v Rural Tel. Serv. Co*., 499 U.S. 340, 364 (1991); see also, Ginsburg (1992)(arguing that the Feist decision fails to fulfil the Constitutional mandate promoting the creation of intellectual property).

[11] See McCarthy, (1984); Post (1986)(referring to reputation as property because it reflects exertion of labour or talent to create self).

In *Zacchini v Scripps-Howard Broad. Co*., 433 U.S. 562 (1977), an analogy is made to the goals of patent and copyright that protects creative labour. Interestingly, the Supreme Court does not make a comparison to trade marks where, as discussed above, it is more difficult to make an argument founded upon notions of creative labour. Yet, publicity rights are also very much a creature of legal making. See Gaines (1991); Madow, (1993) (illustrating how Melville Nimmer, who frequently represented Hollywood interests, worked to create a tort distinct from a privacy tort).

[12] It might further be argued that secondary meaning is necessary because if the mark had no meaning it would simply be Babel and, as such, unworthy of protection. However, we do protect Babel in copyright. It is possible to copyright utter nonsense, poorly crafted or even unintelligible expression. If trade mark is not *Paradise Lost*, not every copyrightable nonsense tale is *The Walrus and the Carpenter*.

[13] Two tests exist for distinguishing between descriptive and suggestive marks, the Competitors Needs Test and the Competitors Use Test. The Competitors Needs Test evaluates the amount of imagination required to interpret the trade mark. The more imagination required, the less likely the words or symbols will be needed by competitors. See *Union Carbide Corp. v Ever-Ready, Inc*., 531 F.2d 366 (7th Cir. 1976). The Competitors Use Test asks whether competitors employed these words or symbols when describing their product. See *Shoe Corp. of Am. v Juvenile Shoe Corp. Of Am*., 266 F.2d 793 (C.C.P.A. 1959); *Firestone Tire & Rubber Co. v Goodyear Tire & Rubber Co*., 186 U.S.P.Q. (BNA) 557 (1970); McCarthy, (1984)

[14] The bar against using national or religious symbols and immoral marks, however, underscores the limits of mark making. It prohibits registration for trade marks which "falsely suggest a connection" with such public symbols as flags, religious images, or national emblems and seals. (15 U.S.C. 1052(a); TMA s 3(3)(a)) The language of the Lanham Act is telling. All connections are false because it is problematic to associate national or religious symbols with private commercial ventures. While public association at times trumps limited group entitlements, the public is unwilling to make private its own linguistic and cultural commons.

[15] BPBOG re-launched itself as a new body under the name the British Brands Group (BBG) in mid-October 1995, Marketing Week, October 20, 1995.

[16] First, by extending the definitions of infringement (Hansard, HL/PBC, January 18, 1994, cols. 26-28); second, and in the alternative, by introducing an action for unfair competition based on Article 10bis of the Paris Convention (Hansard, HL Report, February 24, 1994, cols. 750-52). With hindsight, the proposed amendments were ill-timed and inappropriately drafted.

[17] It was argued that the introduction of specific protection against look-alikes would restrict product choice and increase prices for the United Kingdom consumer by an estimated £628 million a year (British Retail Consortium Press Release, July 5, 1994).

[18] Legal action was averted by Sainsbury agreeing to alter the style of lettering on their cans.

[19] According to The Scotsman, March 10, 1995, "Classic Cola" now accounts for 65% of Sainsbury cola sales and 11% of United Kingdom sales. Marketing Week, May 5, 1995, announced a Sainsbury deal to sell "Classic Cola" through 25 hospitals in the United Kingdom. See also, The Times, June 7, 1995.

[20] Lord Peston, Hansard, HL Second Reading, December 6, 1993, col. 755.

[21] Mr. Patrick McLoughlin, Parliamentary Under-Secretary of State for Technology, Hansard, HC Third Reading, June 20, 1994, col. 82.

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The Purpose of Copyright Protection in Jordan & Canada: A Brief Comparison

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Abstract. A just copyright model can only be found where copyright protection is provided according to the principle of "balance", a human rights-related principle that equally considers the interests of authors to receive a just reward for the products of their intellect and the interests of the public in accessing and laboring upon those products. This principle is not well-acknowledged in Jordan, for the second element thereto – the public users – is not placed on the general agenda of the Jordanian copyright policy makers, and has been replaced with the goal of luring Foreign Direct Investment ("FDI") to the country through excessive copyright protection. The practical divergence away from balance of the Jordanian *Copyright Law* is also inferred from the Jordanian *Copyright Law*'s rejection of the first sale doctrine and adoption of anti-circumvention provisions. Canadian copyright law, on the other hand, not only deals with these two issues conversely, but also articulates balance as its sole purpose.

1. Introduction

This paper compares and contrasts the purpose of copyright protection in both the Hashemite Kingdom of Jordan ("Jordan") and Canada and the impact on the equity of both systems. The paper argues that a just copyright model can only be found where copyright protection is provided according to the principle of "balance", a human rights-related principle that equally considers the interests of authors to receive a just reward for the products of their intellect and the interests of the public in accessing and laboring upon those products. The paper further argues that this principle is not well-acknowledged in Jordan, for its second element – the public users – is not placed on the general agenda of the Jordanian copyright policy makers, and has been replaced with the goal of luring Foreign Direct Investment ("FDI") to the country through excessive copyright protection.

The practical divergence of the Jordanian *Copyright Law* from balance is also inferred from the Jordanian *Copyright Law*'s rejection of the first sale doctrine and adoption of anti-circumvention provisions. Canadian copyright law, on the other hand, is in direct opposition with these two issues. More importantly, balance is the sole purpose of the Canadian *Copyright Act* as interpreted by the Supreme Court of Canada.

In conclusion, the paper recommends that the Jordanian *Copyright Law* should reconsider its purpose for providing copyright protection and provide it according to the principle of balance.

2. Balance: The Ideal

With the advent of the printing press in the mid of the 15th century, stationers felt that their economic rights over intellectual works became vulnerable in England.[1] Therefore, stationers started to seek parliament's action, through a series of petitions, not only to restore the protection they had enjoyed prior to that technological advancement but also to strengthen this protection. Influenced by those petitions, the British parliament enacted the *Statute of Anne: An Act for the Encouragement of Learning, by vesting the Copies of Printed Books in the Authors or Purchasers of such Copies, during the Times therein mentioned.*[2] The *Statute of Anne* did not satisfy the demands of authors; on the contrary, it abolished their common-law right over copyrighted works.[3] The *Statute of Anne* was intended to play a social role that was embodied in the encouragement of authorship and publication in order to educate the public. One can note this instrumental role through the wording of the Statute's preamble, [4] the temporary duration of copyright protection stated therein, [5] and the requirement to deposit copies of the copyrighted works in some major libraries in the United Kingdom. [6]

Frustrated by the implications of the *Statute of Anne*, publishers saw courts as their next remedy. They hoped to get a judicial precedent characterizing their rights over published books as common-law rights, which would result in rendering those rights perpetual.[7] They achieved these rights in the landmark case of *Millar v. Taylor*[8] in which the majority of the court embraced the natural law theory to justify copyright protection. A

few years later, in a case involving the same disputed copyrighted work in *Millar v. Taylor*, the House of Lords held in *Donaldson v. Beckett*[9] that copyright protection had become the creature of the Statue rather than the common law, since the enactment of the *Statute of Anne*. In addition to the emphasis on the positive nature of copyrights, the House of Lords emphasized that under the umbrella of copyright protection authors and users are both important stakeholders whose interests need to be balanced against each other in order to achieve the ultimate value – the public interest in the production, dissemination, and use of knowledge. Using terminology full of humanitarianism, Lord Camden delivered the paragraph that included the principle of balance. The learned Justice wrote:

> *Why did we enter into society at all, but to enlighten one another's minds, and to improve our faculties, for the common welfare of the species?* … We know what was the punishment of him who hid his talent, and Providence has taken care that there shall not be wanting the noblest motives and incentives for men of genius *to communicate to the world those truths and discoveries which are nothing if uncommunicated. Knowledge has no value or use for the solitary owner: to be enjoyed it must be communicated*… . Glory is the reward of science, and those who deserve it scorn all meaner views. I speak not of the scribblers for bread, who teaze the press with their wretched productions; fourteen years is too long a privilege for their perishable trash… . Some authors are as careless about profit as others are rapacious of it, and what a situation would the public be in with regard to literature, if there were no means of compelling a second impression of a useful work to be put forth, or wait till a wife or children are to be provided for by the sale of an edition. *All our learning will be locked up in the hands of the Tonsons and the Lintons of the age, who will set what price upon it their avarice chooses to demand, till the public become as much their slaves as their own hackney compilers are.[*10] [Emphasis added]

A close look at this landmark case reveals the two main characteristics of the principle of balance. First, balance functions under the umbrella of the dual-facet utilitarian justification of copyright protection to which public utility is the core.[11] Under the first facet of this theory, copyright protection is the incentive by which copyright holders are induced to *produce* and *disseminate* intellectual works.[12] Without this incentive no author or publisher would sacrifice his/her mental effort or invest his/her capital in the production, improvement and/or dissemination of intellectual works, given the ease by which intellectual works are pirated.[13] Clearly the highest interest to be attained is the public welfare rather than the author's interest.[14] The other facet of the utilitarian theory provides that copyright protection is granted as a reward to an author from the public for the time and intellectual effort that he/she has spent in producing the copyrighted work.[15]

Although Lord Camden recognized the copyright monopoly as a reward or incentive for authors to produce and disseminate intellectual works, he believed that the real reward was the public recognition and the immortal reputation that authors of intellectual works had enjoyed. This was an express call to avoid rewarding authors at the expense of the public's right in accessing intellectual works. Furthermore, Lord Camden noted that not every author of a merited work was expecting a reward for his/her work and, even when such expectation was available, it was not necessarily excluding others from using the copyrighted work. Finally, Lord Camden required that rewarded works meet a high threshold of originality. Not every work was entitled to be rewarded by the temporary protection of copyright.

Second, *Donaldson* linked the public interest in accessing intellectual works – the second element to the principle of balance – to human rights. The court abhorred linking the creation and dissemination of intellectual works to financial profit. Knowledge is power, the monopolizing of which would result in rendering the public, due to their need for knowledge, slaves of the stationers who possessed this power. Linking access to knowledge to human rights meant that users' rights in accessing intellectual works not only stemmed from the utilitarian theory of copyright protection but also from the human rights laws protecting humans' fundamental rights and freedoms.

Following *Donaldson,* the House of Lords continued to emphasize the importance of balance to solve the inherent tension between authors and users of intellectual works. In *Sayre v. Moore*,[16] Lord Mansfield provided a clear description of the principle of balance with its two major elements – authors' reward and stimulus and the public interest in accessing authored works. The learned Lord wrote:

> We must take care to guard against two extremes equally prejudicial; the one, that men of ability, who have employed their time for the service of the community, may not be deprived of their just merits, and the reward of their ingenuity and labour; the other, that the world may not be deprived of improvements, nor the progress of the art be retarded.

When copyright protection was sought to become universal in the last decades of the 19th century, the principle of balance, as articulated by the British House of Lords, did not find its way into the infant system, namely the *Berne Convention for the Protection of Literary and Artistic Works* of 1886.[17] This convention aimed at protecting the rights of authors,[18] and users' rights shrank to be merely exempted infringements to the rights of authors.[19] With its three principles, national treatment, automatic protection, and minimum rights,

the *Berne Convention* was the first step down the road of one-sided copyright protection.[20] Since then, authors' rights have been growing gradually and users' "exceptions" have remained frozen.[21] The ultimate growth of this protection occurred in 1994 when a marriage between the international trade system and the international intellectual property regime resulted in the **Agreement on Trade Related Aspects of Intellectual Property Rights** ("*TRIPS*") *Agreement*. *TRIPS* obliges member states, *inter alia*, to provide authors with copyright protection that is equal to or above the minimum standards of protection set out therein. *TRIPS* not only continued an international trend to protect the rights of copyright holders at the expense of users, but also sustained this trend by an effective dispute settlement mechanism as being one of the World Trade Organization ("WTO") agreements.[22] If any member state is found in a dispute infringing upon the provisions of *TRIPS*, the country will be subject to serious trade sanctions.

The one-sided nature of this agreement stimulated the need to search for other legal sources from which users' interests could extract stronger support. Fortunately, human rights law has provided this basis . The principle of balance had actually migrated from the British House of Lords to major international human rights documents, namely the *Universal Declaration of Human Rights* ("UDHR")[23] and the *International Covenant on Economic, Social, and Cultural Rights* ("ICESCR").[24]

Article 27 of the UDHR gives everyone the right to "participate in the cultural life of the community" and to "enjoy the arts and to share in scientific advancement and its benefits." On the other hand, the declaration gives anyone the right to the protection of their "moral and material interests resulting from any scientific, literary or artistic production of which he is the author." Furthermore, with similar wording to that of the declaration, article 15 of the ICESCR provides:

1. The States Parties to the present covenant recognize the right of everyone:
    a. To take part in cultural life;
    b. To enjoy the benefits of scientific progress and its applications;
    c. To benefit from the protection of the moral and material interests resulting from any scientific, literary or artistic production of which he is the author.

Examining these two instruments, along with their drafting history, leads one to four basic conclusions.

First, both international instruments emphasize the rights of individuals to participate in the cultural life and the enjoyment of the arts. Such participation and enjoyment would be a myth without real consideration of users' interests in the diffusion of knowledge that is an essential element of the principle of balance.[25] The drafting history of both instruments shows that there was virtually a consensus on the public's rights in the participation of cultural life and the enjoyment of intellectual works, while the discussion of authors' rights was controversial.[26]

Second, although both the UDHR and the ICESCR emphasize the importance of protecting the rights of authors and creators, there is no mention that this protection should be in the form of a "monopoly". Protection can take other means such as governmental subsidies, tax breaks, and/or social recognition.[27]

Third, although sometimes there is an inevitable overlap between authors' rights under the UDHR and the ICESCR and the rights granted by intellectual property regimes, whether national or international, both types of rights are not necessarily the same. This means that copyright holders under the Intellectual Property ("IP") system do not automatically qualify as human rights holders. The *General Comment No. 17* provides in this regard:

> Whereas the human right to benefit from the protection of the moral and material interests resulting from one's scientific, literary and artistic production safeguards the personal link between authors and their creations and between peoples, communities, or other groups and their collective cultural heritage, as well as their basic material interests which are necessary to enable authors to enjoy an adequate standard of living, intellectual property regimes primarily protect business and corporate interests and investments. Moreover, the scope of protection of the moral and material interests of the author provided for by article 15, paragraph 1(c), does not necessarily coincide with what is referred to as intellectual property rights under national legislation or international agreements.[28]

Finally, and most importantly, both instruments address the tension between authors and users by emphasizing the rights of the two conflicting extremes over the protection of and access to intellectual works. The two instruments do not consider any of the conflicting interests inferior or superior to the other, but look at them equally.[29] In other words, they acknowledge the need to balance the interests of both parties. The *General Comment No. 17* does support such interpretation and it expressly highlights the importance of balancing the rights of authors, as spelled out in article 15, paragraph 1(c), and the public interest in accessing those works. The *General Comment No. 17* provides:

> 22. The right to the protection of the moral and material interests resulting from one's scientific, literary and artistic productions *is subject to limitations and must be balanced with the other rights recognized in the Covenant.* … [Emphasis added]
>
> 35. […] States Parties are therefore obliged to *strike an adequate balance* between their obligations under article 15, paragraph 1 (c), on one hand, and under the other provisions of the Covenant, on the other hand, with a view to promoting and protecting the full range of rights guaranteed in the Covenant. *In striking this balance*, *the private interests of authors should not be unduly favored and the public interest in enjoying broad access to their productions should be given due consideration.* … States Parties should also consider undertaking human rights impact assessments prior to the adoption and after a period of implementation of legislation for the protection of the moral and material interests resulting from one's scientific, literary or artistic productions. [Emphasis added]

It should be mentioned, however, that neither instrument tried to illustrate how this principle of balance can be applied. Some argued that the principle of balance was a utopia that intellectual property regimes should achieve, even though those regimes themselves lacked the balancing qualities.[30] However, the next section argues that this principle is attainable and the Canadian copyright system is an example. Therefore, when the Jordanian policy maker is called upon to apply this principle, he/she is not being asked for the impossible.

3. Balance Between the Jordanian and Canadian Copyright Laws: A Comparison

By comparing the purpose of copyright protection in Jordan and Canada, this section attempts to show the deviation of the Jordanian copyright system from the principle of balance, which has expressly been articulated as the sole purpose of the Canadian *Copyright Act*. Further this section discusses the impact of the absence or presence of such a purpose in Jordan and Canada on the public interest of accessing intellectual works as a fundamental element of the principle of balance.

3.1. The Purpose of Copyright Law in Canada and Jordan

(a) Canada

Since the Canadian *Copyright Act* does not disclose its purpose, the Supreme Court has frequently taken up the challenge of determining this purpose. The first express articulation occurred in *Bishop v. Stevens*,[31] wherein Madame McLachlin J., writing for the court, asserted that the *Copyright Act* "was passed with a single object, namely, the benefit of authors of all kinds, whether the works were literary, dramatic or musical." In the early years of the 21st century, however, the Supreme Court radically departed from the author-oriented purpose earlier identified in *Bishop*. In *Théberge v. Galerie d'Art du Petit Champlain Inc*.,[32] the Supreme Court made it clear that the principle of balance, under which users' rights are considered equal to authors', is the sole purpose of the Canadian *Copyright Act*. Justice Binnie, writing for the majority of the court, drafted this purpose as follows:

> 30. The Copyright Act is usually presented as a balance between promoting the public interest in the encouragement and dissemination of works of the arts and intellect and obtaining a just reward for the creator (or, more accurately, to prevent someone other than the creator from appropriating whatever benefits may be generated)… .
>
> 31. The proper balance among these and other public policy objectives lies not only in recognizing the creator's rights but in giving due weight to their limited nature. In crassly economic terms it would be as inefficient to overcompensate artists and authors for the right of reproduction as it would be self-defeating to undercompensate them... .
>
> 32. Excessive control by holders of copyrights and other forms of intellectual property may unduly limit the ability of the public domain to incorporate and embellish creative innovation in the long-term interests of society as a whole, or create practical obstacles to proper utilization… .

Balance, as articulated in *Théberge*, is similar to the principle of balance highlighted by Lord Camden and Lord Mansfield in the British House of Lords two centuries earlier. Balance in the 21st century is still utilitarian oriented, and at its core is the public's interest in having a robust and accessible public domain. In *Théberge,* the Supreme Court looked equally to the two main stakeholders, copyright holders and public users, between whom balance must be struck. Here, unlike the teachings of *Bishop*, authors' interests are merely one value that needs

to be considered in light of another, which is the public interest in accessing and laboring upon copyrighted works. The court emphasized the limited nature of copyright protection, and warned against over-compensating authors by excessive copyright protection, for that would negatively impact the public domain.

Since its decision in *Théberge,* the Supreme Court of Canada has reaffirmed balance as the purpose of the Canadian *Copyright Act* in many leading cases.[33]

(b) Jordan

Jordan's *Copyright Law*[34] does not disclose its purpose and, unlike Canadian courts, Jordanian courts have never dealt with the issue of determining the purpose thereto. Therefore, when one needs to deduce this purpose, if there is any, studying the reforming process through which the Jordanian *Copyright Law* has gone is essential.

Copyright protection is not a newly arrived concept to the Jordanian legal system; it dates back to 1910 when the Ottoman *Copyright Law* was in force in Jordan as part of the former Ottoman Empire. This law remained in force in Jordan till 1992, when it was repealed by the Copyright Protection Law No. 22 of 1992. Since then, however, the latter law has undergone multiple revisions to ease Jordan's journey toward entering the global economy.[35]

During the last decade, Jordan entered into a bundle of bilateral and multilateral trade agreements that have restructured not only its economy but also a wide range of its law. For instance, in 1997 Jordan signed an Association Agreement ("AA") with the European Union ("EU");[36] in 2000 Jordan managed to access the WTO;[37] and a year after, Jordan signed a free trade agreement with the United States ("Jordan-US FTA"),[38] being the first Arabic and second Middle-Eastern country to do so. Reaching those three agreements was in part paved by and led to a dramatic increase of the levels of intellectual property protection generally and copyright specifically in Jordan. As a result, most of the amendments to the *Copyright Law*, brought about between 1992 and 1999, were intended to increase the levels of copyright protection in Jordan to satisfy the intellectual property-related conditions with which Jordan needed to comply in order to qualify for the WTO membership or to satisfy its obligations under the bilateral trade agreements.[39]

For Jordanian policy makers, Jordan has achieved unprecedented success by joining the WTO and signing the bilateral trade agreements, regardless of how strong copyright protection has become consequently. The prominent belief is that increasing copyright protection will attract FDI to the country, which will result in more economic prosperity.[40] The argument continues that without this protection, foreign businesses would not invest in research and development in Jordan since their resulting intellectual property would be vulnerable to piracy.[41] Dr. Mohammad Halaiqah, then secretary general of the Ministry of Industry and Trade and chief negotiator to accession to the WTO, stated:

> There is a *great* cost to joining the WTO, but if we do not join, the cost will be higher... our industries will no longer be competitive, they will lose markets and foreign investment in Jordan will be jeopardised.[42] [Emphasis added]

The Head of the National Library, Dr. Mamoun Talhouni, strongly agreed. He said:

> IP experts agree that intellectual property protection promotes domestic economic activity, attracts foreign investment, facilitates the transfer of technology and creates confidence in Jordanian industries worldwide. These are the messages the National Library will be seeking to get across in the coming months.[43]

In unofficial circles, the story is told similarly. Some intellectuals agree on Jordan's steps toward globalization despite the negative ramifications resulting therefrom. For instance, Dr. Fahed Fanek, a Jordanian economist, believes that Jordan is already paying high prices because of the International Monetary Fund reform package assigned to Jordan, so joining the WTO would entail only a few more sacrifices that would, at the same time, generate significant rewards to the Jordanian economy.[44]

It is clear that the public interest in accessing intellectual works is not envisaged in Jordan at either the official or unofficial levels. It seems that Jordan's goal to attract FDI to foster the country's economy has rendered copyright holders, at least in the eyes of the copyright policy maker, the only stakeholder worthy of protection, and any detriment to the interests of any other affected group, namely users' interest, are merely *acceptable "costs or prices"* for joining the global economy. In short, the principle of balance seems a strange concept for the Jordanian copyright policy makers.

While the economic argument of Jordanian policy makers appears persuasive on the surface, the core is wanting.[45] First, this argument views low levels of intellectual property generally and copyright protection specifically as the sole hurdle against FDI in Jordan while the truth is that many other reasons such as high levels of bureaucracy and the lack of cyber laws are major impediments facing FDI in Jordan.[46] Second, while

increasing the levels of copyright protection was sought to stimulate FDI in the Jordanian information and communication sector, this purpose has not yet materialized;[47] FDI in this field has underperformed compared to the general inflow of FDI to the country.[48] It is true that since 2000 Jordan has experienced steady economic growth and the percentage of FDI has increased significantly; however, most FDI was targeting the industrial and real estate sectors.[49] This shows that the premise that increasing copyright levels would foster FDI in information and communication sectors is merely a myth. It is worth mentioning also that most FDI inflowing to the country is native to the Gulf region, and statistics show that the percentage of FDI coming from the US and EU, strong proponents of high levels of copyright protection in Jordan, is shockingly low.[50]

Third, it is the norm that when a country is a net importer of copyright-based products, the country tends to set the levels of copyright protection at the minimum levels allowed by the international copyright law. However, when the country is a net exporter of such works, the levels of copyright protection are much higher. When we applied this rule to Jordan, the irony is conspicuous. Jordan lacks a copyright-based industry; on the other hand, 27 per cent of the population is students – users of copyrighted works. Therefore, by limiting the scope of accessing copyrighted works, Jordan is harming one of its major economic assets – its human capital. Jordan has been famous for its high-quality education and well-qualified graduates. With excessive copyright protection, however, availability of educational and research materials would be hindered and educational expenses would increase dramatically, given that, for instance, 85 per cent of the software sold in the country is pirated.[51] This would stifle the enlightening movement in the country, and stop the wheel of development by creating educational dualism[52] in which the rich can learn while the poor can not. To overcome such a problem, Jordan has to pick one of two options, both of which are directly or indirectly economically harmful. First, if the government chooses to subsidize education, which is very unlikely since this contradicts the economic reform policy going on in Jordan, the budget of the country would owe foreign copyright holders exhausting high bills. If this does not happen, the quality of education in Jordan will suffer major backlashes, and consequently Jordan will not be able to develop a strong industry that can effectively compete in the international market for which Jordan strived to enter. Jordan also would lose the foreign currency flowing into the country from its citizens working abroad, for Jordanians, lacking good quality education, would find it difficult to secure jobs abroad.

Finally, it is well-acknowledged now that if Jordan had been more deliberate in negotiating the conditions of joining the WTO, and if such conditions had gone under parliamentary scrutiny and been subject to public consultation, Jordan could have reached a better deal.[53] At the very least, such democratic processes could have alerted Jordanian officials that they were giving up important values embodied in the users' rights of access to knowledge as illustrated under the principle of balance.[54]

To sum up, unlike the copyright regime in Canada, the Jordanian *Copyright Law* tends to consider copyright holders as the main and only stakeholder worthy of protection, and any unpaid access or use to their works is merely theft, piracy, and crime. With this clear policy, it is fair to conclude that the principle of balance is a stranger to the Jordanian copyright policy.

3.2. The Impact of the Absence or Presence of Balance on the Public Interest

I have concluded that, unlike in Canada, the principle of balance is not a goal that the Jordanian *Copyright Law* tries to achieve. This principle is not even envisaged by the copyright policy makers in Jordan since the focus there is only on authors' rights. This section, therefore, shows the adoption of the first sale doctrine and the rejection of anti-circumvention provisions as two examples through which the practical impact of the presence of balance in Canada can be seen. However, the situation under the Jordanian *Copyright Law*, due to the absence of the principle of balance, is the reverse.

(a) First Sale Doctrine

Copyright laws grant authors a bundle of exclusive rights, subject to some limitations, over their intellectual works. They place constraints on the scope of control that an owner has over a tangible object to which a copyright is attached. Put differently, the owner of a tangible object possessing intellectual content does not own the intellectual content contained therein. This content usually remains controlled by the author according to the copyright law. To alleviate some of the tension between the property rights of owners and the copyrights of authors caused by this formula, some copyright regimes developed a specific exception called "first sale doctrine"[55] according to which a purchaser of a particular copyrighted work can transfer it to someone else

without the need to acquire the permission of the copyright holder. In other words, the distribution rights of a copyright holder become exhausted on that particular copy once the copy is sold.

The Canadian *Copyright Act* does not have a provision materializing the first sale doctrine. In *Théberge*, however, the Supreme Court of Canada endorsed the first sale doctrine for the first time. The court pointed out that this principle is needed to guard against excessive control of copyright holders over sold copyrighted works that would contradict with the principle of balance. The court used the first sale doctrine as a balancing valve between the property rights of owners of tangible objects and the copyrights of authors residing therein. In this regard Justice Binnie wrote:

> The proper balance among these and other public policy objectives lies not only in recognizing the creator's rights but in giving due weight to their limited nature. In crassly economic terms it would be as inefficient to overcompensate artists and authors for the right of reproduction as it would be self-defeating to undercompensate them. *Once an authorized copy of a work is sold to a member of the public, it is generally for the purchaser, not the author, to determine what happens to it…* .[Emphasis added]

In Jordan, on the other hand, the *Copyright Law* rejects the first sale doctrine. This can be inferred from reading both article 9 and article 15 of the *Copyright Law* No. (9) of 2005:

> 9. The author shall have the right to financially exploit his work in any way he chooses. No other person may engage in any of the following conducts without the author's written permission, or the permission of his successors: (A)...(B)...(C) Commercial leasing of the original work or a copy thereof to the public. (D) Distribution of the work or a copy thereof through sale or other disposition of ownership.
>
> 15. The transfer of the title of the original copy of the work or the only reproduction or a number of reproductions thereof to others shall not include the transfer of the copyright of this work to same… .

When read together, articles 15 and 9 show that the Jordanian *Copyright Law* rejects the principle of first sale doctrine since article 9 includes the right of permitting the distribution through further sales in the bundle of rights afforded to authors which, according to article 15, are not transferred to purchasers of the copyrighted work. If article 9 embraced the first sale doctrine, it would give authors only the right of "first" distribution; however, the right of distribution as mentioned therein is not limited or qualified.

(b) Anti-Circumvention Law

When the purpose of the Canadian *Copyright Act* was merely the protection of authors, the public interest in accessing intellectual works was merely embodied in the infringement exceptions provided by the Act in Part III thereof, which was titled "Infringement of Copyright and Moral Rights and Exception to Infringement". Canadian courts also were very proactive when they tackled this part of the *Copyright Act*, and rejected any liberal interpretations to the infringement exceptions that may have led to a better consideration of users' interests in accessing copyrighted works. In this regard, Justice McLachlin wrote, "[c]opyright law is purely statutory law which simply creates rights and obligations as set out in the statute" and "[a]n implied exemption to the literal meaning of s. 3(1)(d) is all the more unlikely." With such a positive and narrow interpretation to the infringement exceptions, *Bishop* was the shield copyright holders employed to resist any unpaid access to their works.

However, in addition to reaffirming balance as the sole purpose of the *Copyright Act*, the Supreme Court in *CCH* interpreted the infringement exceptions afforded by the *Copyright Act* very liberally, finding them to be "users' rights" integral to the *Copyright Act*. Writing for the court, the Chief Justice stated:

> Before reviewing the scope of the fair dealing exception under the *Copyright Act*, it is important to clarify some general considerations about exceptions to copyright infringement. Procedurally, a defendant is required to prove that his or her dealing with a work has been fair; however, *the fair dealing exception is perhaps more properly understood as an integral part of the Copyright Act than simply a defence.* Any act falling within the fair dealing exception will not be an infringement of copyright. *The fair dealing exception, like other exceptions in the Copyright Act, is a user's right. In order to maintain the proper balance between the rights of a copyright owner and users' interests, it must not be interpreted restrictively.*[56]

The court here put the principle of balance in action by qualifying users as rights holders, not merely exempted infringers. The nature of users as rights holders was used effectively in the battle against introducing an anti-circumvention law in Canada that would have paved Canada's path toward ratifying the *WIPO*

Performances and Phonograms Treaty and *WIPO Copyright Treaty* (**"**WIPO Internet treaties")[57] that oblige member states, i*nter alia*, to provide legal protection to technological protection measures ("TPMs") by outlawing the circumvention thereof.[58]

In this battle, proponents of author-oriented copyright law were arguing that Canada needed to comply with WIPO Internet treaties and, without such law, compliance would not be possible. On the other hand, aided by the Supreme Court's decision in *CCH* describing users as rights holders, espousers of a balanced copyright system were rejecting an anti-circumvention law, arguing that such a law would have undermined many users' "rights" under the Canadian copyright law, such as fair dealing and private copying by creating the so-called "multi-layer copyright protection".[59] The end result of such debate was *An Act to Amend the Copyright Act*[60] that, although it tried to make Canada comply with the WIPO Internet treaties, was impliedly considerate of users' rights.

Bill C-60 entitles copyright holders, *inter alia*, to seek legal remedies from anyone circumventing a technological protection measure, facilitating such circumvention, or knowingly dealing with a work that the TPM thereto has been circumvented.[61] *Bill C-60*, however, was reasonably successful in considering the principle of balance when protecting TPMs. Foremost, it did not consider circumvention *per se* an infringement; therefore, where the circumvention was not intended to commit copyright infringement, the circumvention would not be illegal. This leads one to conclude that circumvention for the purpose of private copying was impliedly approved under *Bill C-60,* as was the circumvention for the purpose of fair dealing. Furthermore, this means that no threat to the public interest in research and development in the field of cryptography or digital locks technologies was raised by this Bill. *Bill C-60* did not prohibit dealing with the technologies or devices that are used for circumvention. This shows a real consideration of other interests, such as the ones related to the freedom of trade.

The situation in Jordan, in contrast, is the opposite. Articles 17, 18, and 19 of the Jordanian *Copyright Law* No. (9) of 2005 enumerates the fair uses that can be made of published works without the permission of the author. Such uses include, for instance, using a work for educational, cultural, religious, vocational training, social, criticism, review, and news reporting purposes. Article 17 also embodies a private copying clause, although Jordan does not have a private copying levy imposed on blank audio recording media.

Users under those articles, however, enjoy merely infringement exceptions that are subject to other limitations. For example, the private copying exception must not interfere with the normal exploitation of the work and must not cause unjustified damage to the legitimate interests of the rights holder.[62] The use of the work for educational, cultural or social purposes must not result in any financial gain, and the names of the work and author must be mentioned. Finally, the use of the work for criticism and review must be within the limits needed to achieve such goals and must include the names of the work and author.

Article 20 of the of the Jordanian *Copyright Law* No.(9) of 2005 also allows Public libraries, noncommercial documentation centers, educational institutions and scientific and cultural institutions to reproduce any work, without the consent of the author, as long as the number of copies is limited to the needs of these institutions and provided that these actions do not lead to damaging the copyright of the author and do not interfere with the normal exploitation of the work.[63] Finally, Article 11 allows any Jordanian to apply to obtain a non-exclusive license from the Minister of Culture to allow the translation of a work into Arabic and/or to allow the reproduction and the publication of any of the published works. The licensing, however, is subject to a bundle of conditions stated in Article 11 of the law.[64]

The fair use provisions, along with the licensing mechanisms described in Article 11 of the *Copyright Law* No. (9) of 2005, when read on their face appear to be an illustration of Jordan's effort to protect the interests of public users in accessing intellectual works by utilizing the exceptions and limitations articulated in Articles 10 and 10*bis* of the *Berne Convention*, and the *Berne Annex* related to developing countries. Therefore, it might be argued that a balancing scheme is actually taking place under the Jordanian *Copyright Law*. Such argument, however, experiences a sever backlash when the anti-circumvention provisions spelled out in Article 55 of the law are considered.

Article 55 of the Jordanian *Copyright Law* prohibits not only circumventing TPMs but also the manufacturing, importing, selling, and offering for sale, renting, possessing for commercial purposes, distributing or advertising in connection with the sale and rental of circumvention devices. Anyone who infringes this provision would be subject to a penalty of imprisonment for a period not less than three months and not more than three years and a fine of not less than 1000 Dinars and not more than 6000 Dinars, or one of those two penalties shall be applied to.

When Article 55 of the Jordanian *Copyright Law* is examined some conclusions can be drawn. First of all, TPMs play an infamous role in blocking any unauthorized uses of works regardless if those accesses are justified

as fair dealing or any other exception or limitation such as the ones spelled out in Articles 11, 17, 18, 19, and 20 of the Jordanian *Copyright Law*.[65] At the same time, the Jordanian *Copyright Law* does not provide any express exception in Article 55 by which circumvention may be allowed to give those "public interest" articles their effect. With the one-sided nature of Article 55, Jordan provides authors of digital works not only copyright protection, but more importantly absolute property rights.[66]

Second, the *Copyright Law* does not even require the intention to infringe copyrights in order to outlaw the activity of circumvention; this activity is criminalized *per se*, regardless of the scientific importance or research value resulting from such circumvention. Such attitude will likely hinder research and innovation in the field of cryptography and regulating access technologies in Jordan. Finally, the law lacks any safeguards against the abuse of the use of TPMs although it is now internationally known that TPMS have serious drawbacks on the rights of free speech,[67] security and privacy,[68] anonymity,[69] and fair competition.[70]

4. Conclusion

In his study on the levels of intellectual property protection in Jordan in 1995, Lackert noticed that "the lack of understanding about the nature of intellectual property rights and their protection"[71] resulted in under-protecting intellectual works. This paper, however, concludes that the same dilemma – the lack of understanding about the nature of intellectual property rights and their protection – results in under-protecting users' rights. The Jordanian *Copyright Law* should acknowledge the fact that a just copyright system can only be founded on the principle of balance, which views the rights of both authors and users as equal, the protection of which aims at achieving the overall public good. The presence of this principle in the Canadian copyright regime sends a clear message to the Jordanian copyright system that if it decides to adopt "balance" to acquire its justice it will not be alone.

Notes:

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I would like to acknowledge the generous financial support from both the School of Law-Common Law Section and the School of Graduate Studies of the University of Ottawa. I would like also to thank Dr. Elizabeth F. Judge, my supervisor, for her invaluable teaching, guidance, and support.

[1] It is well-settled that early English laws dealing with copyright were initially tools of censorship. They were attempts by the Crown to regulate and stifle the mass distribution of books that resulted from the advent of the invention of printing press. The fear was that liberal and critical thinking resulting from unorthodox political and religious opinions would lead people into questioning the integrity of the Crown itself. See Marke, J.J. (1977). United States Copyright Revision and its Legislative History. 70 Law Libre. J. 121 at 122; Handa, S. (2002). Copyright Law in Canada. Markham, Ontario: Butterwoths at 28 [Handa, Copyright Law in Canada]

[2] *Copyright Act*, 1709 (U.K.), 8 Ann., c. 19. [*Statute of Anne*]. Before the enactment of the *Statute of Anne*, stationers enjoyed an exclusive legal monopoly over all printing licensed by the state. This was by a royal decree in 1556. An earlier statute, designated to protect English printers, was the *Statute of Henry VII* in 1534. See Magavero, G. (1978). The History and Background of American Copyright Law: An Overview. 6 I.J.L.L. 151 at 151-153.

[3] Rogers, E.S. (1910-11). A Chapter in the History of Literary Property: The Booksellers' Fight for Perpetual Copyright. 5 Ill .L.R 551 at 553.

[4] *Statute of Anne, supra* note 2, at para. I.

[5] *Ibid.*, at paras. II. & XI.

[6] *Ibid.*, at para.V.

[7] For a comprehensive discussion on the events preceding the introduction of the principle of balance, see Handa, Copyright Law in Canada*, supra* note 1 at 3-42; also Hesse, C. (2002). The Rise of Intellectual Property, 700 B.C. – A.D. 2000: An Idea in the Balance. Dædalus Spring at 1-37. Retrieved from www.amacad.org/publications/spring2002/hesse.pdf [Hesse, The Rise of Intellectual Property].

[8] (1769) 4 Burr. 2303, 98 Eng. Rep. 201 (K.B.) [*Millar*].

[9] (1774), 4 Burr.2408, 1 E.R 837 (H.L.) [*Donaldson*].

[10] (1966) The Parliamentary History of England From the Earliest Period of the Year 1803, Vol. XVII A.D. 1771-1774. Johnson Reprint Corporation, New York, at 999-1000.

[11] Hesse, The Rise of Intellectual Property, *supra* note 7, at 36-37.
[12] Easterbrook, F.H. (1990). Intellectual Property is Still a Property. 13 Harv. J. L & Pub. Pol'y 108 at 108; Lemely, M.A. (2004). Ex Ante Versus Ex Post Justifications for Intellectual Property. 71 U. Chi. L. Rev. 129 at 131; Vaver, D. (1990). Intellectual Property Today: of Myths and Paradoxes. 69 Can. Bar Rev. 98 at 104.
[13] Calandrillo, S.P. (1998). An Economic Analysis of Intellectual Property Rights: Justifications and Problems of Exclusive Rights, Incentive to Generate Information, and the alternative of A government-Run Reward System. 9 Fordham Intell. Prop. Media & Ent. L. J. 301 at 303- 310.
[14] Bently, L. & Sherman, B. (2004). Intellectual Property Law, 2d ed. New York: Oxford University Press at 35.
[15] *Ibid.,* at 34.
[16] (1785), 1 East. 361, 102 E.R. 139n.
[17] 9 September 1886, as last revised at Paris on 24 July 1971, 1161U.N.T.S. 30. Retrieved from www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html [*Berne Convention or Berne*]. *Berne* was a result of a trend that developed in the latter half of the 19th century. Europe became interested in protecting authors internationally. This trend kept developing gradually in the direction of protecting authors.
[18] Article 1 of *Berne Convention* provides: "The countries to which this Convention applies constitute a Union for the protection of the rights of authors in their literary and artistic works."
[19] See Articles 10 and 10*bis* of *Berne Convention*. See also Article 9(2) of the same convention that provides: "It shall be a matter for legislation in the countries of the Union to permit the reproduction of such works in certain special cases, provided that such reproduction does not conflict with a normal exploitation of the work and does not unreasonably prejudice the legitimate interests of the author." According to the three-step test articulated in Article 9(2), a Member State can provide in its national law exceptions to the reproduction right provided in *Berne* in *certain special cases that do not conflict with the normal commercial exploitation of the work, and do not unreasonably prejudice the Legitimate interests of the author*. The said test is now used as a model to determine the scope and extent to which a given Member State can create exceptions to the intellectual property rights provided in The Agreement on Trade-Related Aspects of Intellectual Property Rights. See *General Agreement on Tariffs and Trade, Annex 1C Trade-Related Aspects of Intellectual Property Rights (TRIPS)*, 30 October 1947, 55 U.N.T.S. 187, 1948 Can T.S. No. 31 (provisionally in force 01 January 1948) [*TRIPS*], Article 13; see also Gervais, D.J. (2005). Towards A New Core International Copyright Norm: The Reverse Three-Step Test. 9 Marq. Intell. Prop. L. Rev. 1 at 13-14.
[20] Vaver, D. (1998 November). Internationalizing Copyright Law: Implementing the WIPO Treaties. Paper presented at a seminar in the Programme in Comparative Media Law & Policy, Centre for Socio-Legal Studies, Wolfson College, Oxford. Retrieved from OIPRC Electronic Journal of Intellectual Property Rights at http://www.oiprc.ox.ac.uk/EJWP0199.html
[21] In the 2001 WTO panel decision on Section 110(5) of the U.S. Copyright Act, the panel stated: "At any rate, in our view, a non-commercial character of the use in question is not determinative provided that the exception contained in national law is indeed *minor* [Emphasis in the original]." See United States, Section 110(5) of the US Copyright Act, June 15, 2000, WTO Doc. No. WT/DS160/R, paragraph 6.58. The panel added in paragraph 6.97 that "[a]rticle 13 of the TRIPS Agreement requires that limitations and exceptions to exclusive rights (1) be confined to certain special cases, (2) do not conflict with a normal exploitation of the work, and (3) do not unreasonably prejudice the legitimate interests of the right holder". Ruth Okidiji comments on the three-step test with the following statement: "[T]he three-step test is not a public interest limitation to exclusive rights. . . . [W]hat appears to be a limitation to copyright, is actually a limit on the discretion and means by which member states can constrain the exercise of exclusive rights." See Okidiji, R. (2006). The International Copyright System: Limitations, Exceptions and Public Interest Considerations for Developing Countries. UNCTAD – ICTSD Project on IPRs and Sustainable Development, Issue Paper No. 15 at 13-14. Daniel Gervais, commenting on the meaning of "special" in the three-step test, states

> The meaning of 'special' in this context can be interpreted in two ways. Based on the history of the Berne Convention, it seems to mean that the exception must have a (special) public policy purpose. Another view is that it must apply to a fairly well delineated area (with or without specific public policy objective). The latter view reflects the normal 'dictionary' meaning of the term and was adopted by the panel in the above-mentioned case.

See Gervais, D. (2003). The Trips Agreement: Drafting History and Analysis. London: Sweet & Maxwell at 146.
[22] Helfer, L. (2003). Human Rights and Intellectual Property: Conflict or Coexistence? 5 Minn. Intell. Prop. Rev. 47 at 54-55.
[23] GA Res. 217(III), UN GAOR, 3d. Sess., Supp. No. 13, UN Doc. A/810 (1948) 71.

[24] 16 December 1966, 993 U.N.T.S. 3, Can T.S. 1976 No. 46 (entered into force 03 January 1976, accession by Canada 19 May 1976; acceded by Canada 19 May 1976; acceded by Jordan 28 May 1975.
[25] Drahos, P. The Universality of Intellectual Property Rights: Origins And Development. Retrieved from WIPO at www.wipo.int/tk/en/hr/paneldiscussion/papers/pdf/drahos.pdf
[26] UN CESCR. Drafting History of the Article 15 (1) (C) of the International Covenant on Economic, Social and Cultural Rights. Background Paper submitted by Green, M. (2000 October). UN Doc: E/C.12/2000/15 at 3-6 [Green, M. Drafting History of the Article 15 (1) (C) of the International Covenant on Economic, Social and Cultural Rights].
[27] Intellectual property can be used concurrently and perfectly by different people, see Hettinger, E.C. (1989). Justifying Intellectual Property. 18 Philos Public Aff 31 at 48.
[28] Committee on Economic, Social and Cultural Rights – Thirty-fifth session – *General Comment No. 17* (2005), Adopted on 21 November 2005. Retrieved from Office of the United Nations High Commissioner for Human Rights at www.unhchr.ch/tbs/doc.nsf/898586b1dc7b4043c1256a450044f331/03902145edbbe797c125711500584ea8/$FILE/G0640060.pdf at para.2 [*General Comment No. 17*].
[1][29] See *contra* Green, M. *Drafting History of the Article 15 (1) (C) of the International Covenant on Economic, Social and Cultural Rights*, *supra* note 26, at 13:

> It is fascinating to note, however, that the distinguished men and women who gave us the ICESCR did not seem to deeply consider the difficult balance between public needs and private rights when it comes to intellectual property. When the question was raised, they tended to dismiss it almost out of hand. Primarily, they seem to have assumed that the goals of 15 (1) (b) were obvious and beyond discussion, the benefits of science being a fundamental human right that belongs to everyone. They seem to have seen article 15 (1) (c), however, as a smaller thing, one that served to protect several different potential interests, according to the views of the drafter.

[30] *e.g* see Nwauche, E.S. (2005) Human Rights – Relevant Considerations in respect of IP and Competition Law. 2(4) SCRIPT-ed 468 at 471. It has been argued also that the task of balance is very difficult. This difficulty will mostly lead to indeterminate answer to the balancing task; the words of Professor Lunney in this regard are very interesting:

> If the need to ensure a work's creation suggests a broad copyright, while the need to secure its wide spread dissemination suggests a narrow copyright, then incentive and access will always oppose each other with exactly equal force. As a result, if the incentive-access balance were the sole criterion for determining the proper degree of copyright protection, it would provide an indeterminate answer as to how much protection copyright should provide.

See Lunney, G. S., Jr. 91996). Reexamining Copyright's Incentive-Access Paradigm. 49 Vand L. Rev. 483 at 486.
[31] [1990] 2 S.C.R. 467 [*Bishop*], citing Maugham J., in *Performing Right Society, Ltd. v Hammond's Bradford Brewery Co.*, [1934] 1 Ch. 121, at p. 127.
[32] [2002] 2 S.C.R. 336 [*Théberge*].
[33] *CCH Canadian Ltd. v Law Society of Upper Canada*, [2004] 1 S.C.R. 339 at para.23 [*CCH*]; *Canadian Association of Internet Service Providers v. Society of Composers, Authors and Music Publishers of Canada*, 2004 SCC 45 at paras.89- 40 [*SOCAN*]; *Robertson v. Thomson Corp*. 2006 SCC 43 at paras. 69-70 [*Robertson*].
[34] Jordanian Copyright Law No.(22) of 1992, published in the Official Gazette No. (3821)(April 6, 1992), as amended by the Law No. (9) of 2005, published in the Official Gazette No. (4702) (March 31, 2005) [the *Copyright Law*].
[35] See *e.g.* amendment to the *Copyright Law* No. 14 of 1998, published in the Official Gazette No. (4304) (October 1st, 1998); amendment to the *Copyright Law* No. (29) of 1999, published in the Official Gazette No. (4383) (October 1st, 1999); amendment to the *Copyright Law* No. (88) of 2003, published in the Official Gazette No. (4634) (December 1st, 2003); amendment to the *Copyright Law* No.(8) of 2005, published in the Official Gazette No. (4702) (March 31, 2005); and finally amendment to the *Copyright Law* No.(9) of 2005, published in the Official Gazette No. (4702) (March 31, 2005); for more on Jordan's journey to the WTO and the impact of this journey on the levels of intellectual property generally, see Said, M.E. (2006). The Evolution of the Jordanian TRIPS-Plus Model: Multilateralism Versus Bilateralism and the Implications for the IPRs Regime. International Review of Intellectual Property and Competition Law 37(5) 501.
[36] Euro-Mediterranean Agreement establishing an Association between the European Communities and their Member States, of the one part, and the Hashemite Kingdom of Jordan, of the other part, signed on (24 November 1997), in force since (01 May 2002). Retrieved from www.mit.gov.jo/PORTALS/0/Jordan-EU_Association_Agreement.PDF

[37] *Protocol of Accession of the Hashemite Kingdom of Jordan to the Marrakech Agreement Establishing the World Trade Organization,* signed in Geneva on 17 December 1999 and in force since 11 April 2000. Retrieved from Jordan's Ministry of Industry and Trade at www.jftp.gov.jo/Docs/PROTOCOL%20OF%20AC.pdf
[38] *Agreement between the United States of America and the Hashemite Kingdom of Jordan on the Establishment of a Free Trade Area* (24 October 2000). Retrieved from Jordan-US Free Trade Agreement at www.jordanusfta.com/documents/textagr.pdf; for a discussion of Jordan's IP protection obligations under Jordan-US Free Trade Agreement, see Malkawi, B.H. (2006). The Intellectual Property Provisions of the United States-Jordan Free Trade Agreement: Template or Not Template. The Journal of World Intellectual Property 9(2) 213.
[39] Before this reforming process, the level of intellectual property protection in Jordan was described as follows:

> If WTO standards can be viewed as 100 per cent, then current patent protection in Jordan stands at 70 per cent, current trade mark protection in Jordan at 80 per cent, current trade secret protection in Jordan at 60 per cent (if trade secrets are understood as being protected under general tort law), and current copyright protection is at 20 per cent.

See Lackert, C.W. (1996). Intellectual Property Rights Reform In the Middle East. 3 MECLR 74 at 75 [Lackert, Intellectual Property Rights].
[40] Taher, G. (April 1999). Jordan's WTO accession bid held up by needed reforms, business opposition. *Jordan Times*. Retrieved from Embassy of the Hashemite Kingdom of Jordan-Washington D.C. at www.jordanembassyus.org/041499005.htm [Taher, Jordan's WTO accession].
[41] Policy Reform: Intellectual Property Rights Reforms & Consumers. Retrieved from Jordan's Foreign Trade Policy at www.jftp.gov.jo/pdf/pol_e4.pdf
[42] Quoted in Taher, Jordan's WTO accession, *supra* note 40. On another occasion, Dr. Halaiqah reaffirmed Jordan's commitment to strong IP levels of protection and provided a bundle of justifications not all of which will actually result in increasing the levels of IP. He stated:

> By staying committed to protecting intellectual property rights, encouraging knowledge transfer and fostering a thriving IT industry that is second to none, the government foresees Jordan's role in the regional, as well as in the international community, as an influential force in empowering its people with the skills, expertise and resources that they require to excel in today's digital economy.

Quoted in Microsoft Press Centre, News Release. (11 December 2000). Microsoft Announces Operations in Jordan. Retrieved from Microsoft at www.microsoft.com/middleeast/press/presspage.aspx?id=200082
[43] Quoted in AGIPNEWS, News Release. (2 October 2005). The Launch of a Six-Month Public Awareness Campaign on IPR Protection in Jordan. Retrieved from AGIP at www.ag-ip-news.com/getArticle.asp?Art_ID=1883&lang=en
[44] Quoted in Taher, Jordan's WTO accession, *supra* note 40.
[45] Interestingly, Dr. Halaiqah sometimes used a natural law argument to support his strong support to strong levels of IP generally and copyright specifically. He said, "We need to inform students that when they buy original software instead of illegal copies they are paying for somebody else's hard work," Quoted in Rami Abdelrahman. (24 August 2004). Intellectual Property Week 2004 opens. *Jordan Times*. Retireved from Embassy of the Hashemite Kingdom of Jordan-Washington D.C. at www.jordanembassyus.org/08242004005.htm
[46] Peppers & Rogers Group. (2006). The e-Readiness Assessment of The Hashemite Kingdom of Jordan. A report prepared for the Jordanian Ministry of Information and Communications Technology at 24. Retrieved from Ministry of Information and Communications Technology at www.moict.gov.jo/moict/e_readiness/Jordan%20e-Readiness%20Assessment%20Final%20Document_V3.0_Final_MoICT.pdf [Peppers & Rogers Report].
[47] Peppers & Rogers Report, *ibid.,* at 24.
[48] Peppers & Rogers Report, *ibid.,* at 23.
[49] (01 August 2005). A boom for the bold. *FDI ForeignDirectInvestment*. Retirieved from FDI ForeignDirectInvestment at www.fdimagazine.com/news/fullstory.php/aid/1381/A_boom_for_the_bold.html; Petra, News Release. (17 July 2005). Direct investments rise by 125% to JD456m. Retrieved from JIC-Jordan Information Center at www.jordan.jo/en/en-news/wmview.php?ArtID=3292; see also Azzam, H.T. (Winter 2005). Another Year of Strong Economic Growth Expected in 2005. Jordan Embassy Newsletter Washington, D.C. (6) 4 at 4. Retrieved from Embassy of the Hashemite Kingdom of Jordan-Washington D.C. at www.jordanembassyus.org/new/nl/Winter2005.pdf

[50] (30 November 2006). FDI hitting new levels in Jordan. AME Info. Retrieved from AME Info at www.ameinfo.com/103831.html

[51] Taher, Jordan's WTO accession, *supra* note 40; see also Peppers & Rogers Report, *supra* note 46, at 14. Jordan's population is 5,473,900; Number of students enrolled in the basic education cycle: 1,268,200; Number of students enrolled in secondary education cycle: 184,100. See The Hashemite Kingdom of Jordan Department of Statistics (DOS). (May 2005). Jordan in Figures. (7). Retrieved from Department of Statistics, Jordan at www.dos.gov.jo/dos_home_e/main/index.htm

[52] See Anani, J. (2001). The Political Sociology of Jordan: An Analysis for the Map of Gains and Pains. In Al-Said, H., & Becker, K. (Eds.), Management and International Business Issues in Jordan (p. 191). New York: International Business Press, 163..

[53] (8 October 2003). The Challenge of Political Reform: Jordanian Democratisation and Regional Instability: ICG Middle East Briefing at 7.

[54] Jordanian officials now confess that they were hastily jogging toward globalization. However, they try to justify that by saying that without such speed Jordan could have been subject to tougher conditions. They also argue that they wanted to take advantage of the international sympathy for Jordan after the death of King Hussein to ease Jordan's accession into the WTO. See Orme, W.A., Jr. (21 May 2000). Jordan's Long Road to the Free-Trade Club. *New York Times* at BU4, Quoting Dr. Halaiqah.

[55] *e.g* section 109 of the US Copyright Act. Retrieved from U.S. Copyright Office at www.copyright.gov/title17/92chap1.html

[56] *CCH*, *supra* note 33, at para.48.

[57] *WIPO Copyright Treaty (WCT) (adopted by the WIPO Diplomatic Conference on Certain Copyright and Neighboring Rights Questions in Geneva, on December 20, 1996)*, 20 December 1996, 2186 U.N.T.S. 152 [*WCT*], and *WIPO Performances and Phonograms Treaty (WPPT) 1996 (adopted by the WIPO Diplomatic Conference on Certain Copyright and Neighboring Rights Questions in Geneva, on December 20, 1996)*, 20 December 1996, 2186 U.N.T.S. 245 [*WPPT*] – [hereinafter *WIPO Internet Treaties*].

[58] TPMs can be defined as "[A] technological method intended to promote the authorized use of digital works." See Kerr, I., Marushat, A., & Tacit, C.S. (2002-2003). Technological Protection Measures: Tilting at Copyright's Windmills. 34 Ottawa L.Rev.7. It is clear from this definition that the main use of TPMs is providing authors and creators of digital works with concrete control over their works regardless of their legal status under the Copyright Act. Simply put, this technology promotes only the permissible access, use, and/or distribution to a given technologically protected copyrighted work. Passwords, Content Scramble System (CSS,) cryptography, Asymmetric Application Segmentation (AAS), and Digital Tickets are examples of TPMs. See Kerr, Technological Protection Measures, *ibid*., at 13. Circumvention can be defined as " [t]he breaking of or avoidance of the use of the protection measures to prevent unauthorized access to a system or mechanism or database satellite, satellite system or security mechanism attached to DVD movies." See *ibid*. at 23.

Article 11 of the WCT provides:

> Contracting Parties shall provide adequate legal protection and effective legal remedies against the circumvention of effective technological measures that are used by authors in connection with the exercise of their rights under this Treaty or the Berne Convention and that restrict acts, in respect of their works, which are not authorized by the authors concerned or permitted by law.

Similarly, Article 18 of the WPPT provides:

> Contracting Parties shall provide adequate legal protection and effective legal remedies against the circumvention of effective technological measures that are used by performers or producers of phonograms.. .

[59] See DeBeer, J.F. (2005) Constitutional Jurisdiction over Paracopyright Laws. In M. Geist (Ed.), In the Public Interest: The Future of Canadian Copyright Law (89 at 90). Toronto: Irwin Law.; Geist, M. (2005). Anti-Circumvention Legislation and Competition Policy: Defining Way? In M. Geist (Ed.), In the Public Interest: The Future of Canadian Copyright Law (211 at 240). Toronto: Irwin Law; Kerr, I. (2005). If Left to Their Own Devices: How DRM and Anti-Circumvention Laws Can Be Used to Hack Privacy (167 at 169). In M. Geist (Ed.), In the Public Interest: The Future of Canadian Copyright Law. Toronto: Irwin Law [Kerr, If Left to Their Own Devices].[60] 1st Session, 38 th Parliament, 53-54 Elizabeth II, 2004-2005, (First Reading, June 20, 2005) [*Bill C-60*]. *Bill C-60* died when the Liberal government collapsed in 2005.

[61] This is expressly stated in section 34.02 of *Bill 60*.

[62] Those conditions are an embodiment of the three-step test articulated in Article 13 of TRIPS, see *supra* note 19.
[63] *Ibid.*
[64] *e.g* a translation license is subject to the following conditions established in Article 11 (A)(C)(D) of the Copyright Law No. (9) of 2005.
[65] It has been argued, on the other hand, that fair dealing exception will lose its importance once people switch to use content stored in centralized locations and only transmitted to authorized devises. In other words, exceptions afforded to users under the copyright law stem from the physical nature of the content's source; however, once this source is digitized, there would be no need for such exceptions. Bechtold, S. (2003). The Present and Future of Digital Rights Management. In E. Becker, W. Buhse, D. Gunnewig & N. Rump (Eds.), Digital Rights Management: Technological , Economic, Legal and Political Aspects. Berlin: Springer. Retrieved from University of Tubingen Law School at www.jura.uni-tuebingen.de/bechtold/pub/2003/Future_DRM.pdf To overcome the negative impact that a legal protection to TPMs may have on the exceptions presented in the *Copyright Act*, Professor Kerr suggested that a positive obligation on copyright holders to ensure fair access to technologically protected content could be legislatively imposed. See Kerr, Technological Protection Measures, *supra* note 58, at 46.
[66] It has been argued that when TPMs protect works effectively and those works are stored in centralized locations and only transmitted to authorized devises, those works can meet the conditions of property. Strong protection through TPMs will achieve the rivalrous characteristic; storing in centralized locations will achieve persistence, and transmission to authorized devises will achieve interaction, see Fairfield, J. (2005). Virtual Property. 85 Boston L. Rev 1047 at 1053-1054. Bechtold, S. (2003). The Present and Future of Digital Rights Management. In E. Becker, W. Buhse, D. Gunnewig, & N. Rump (Eds.), Digital Rights Management: Technological, Economic, Legal and Political Aspects. Berlin: Springer. Retrieved from University of Tubingen Law School at www.jura.uni-tuebingen.de/bechtold/pub/2003/Future_DRM.pdf; Professor Cohen argues that by using TPMs copyright holders are resorting to technology rather than to the *Copyright Act*, which means that they are opting out of the Copyright system; therefore, it should not be provided by protection justified under the *Copyright Act*. If this protection is afforded, however, balance would be missed. More importantly, they would be protected under a system from which they departed, see Cohen, J.E. (1998). Copyright and the Jurisprudence of Self-help. 13 Berkeley Tech. L. J. 1089 at 1118, 1142, & 1143.
[67] Bailey, J. (2005). Deflating the Michelin Man: Protecting Users' Rights in the Canadian Copyright Reform Process. In M. Geist (Ed.), In the Public Interest: The Future of Canadian Copyright Law (125). Toronto: Irwin Law.
[68] Kerr, If Left to Their Own Devices, *supra* note 58.
[69] Cohen, J.E. (1996). A Right to Read Anonymously: A Closer Look at "Copyright Management" in Cyberspace. 28 Conn. L. Rev. 981.
[70] Geist, Defining Way, *supra* note 58, at 211.
[71] Lackert, Intellectual Property Rights, *supra* note 39, at 74.

Consumer Protection and Commercial Transactions in Malaysia

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Abstract: This paper analyses the various approaches to ensuring consumer protection in commercial transactions in Malaysia. The transactions in question include that of the sale of goods and property, hire-purchase of goods. The paper focuses on the three approaches namely, the enactment of consumer protecting provisions in statutes governing specific commercial transactions, the enactment of a general law relating to consumer protection and the approach taken by the courts in construing agreements emanating from such commercial transactions. It also highlights one of the major issues arising out of the introduction Islamic financing and banking principles in a system thus far dominated by a conventional financing and banking one.

1. Introduction

The objective of this paper is to highlight the various approaches in which the law seeks to protect the rights of consumers in commercial transactions, particularly that of sale and purchase of goods and the hire-purchase of goods. These include providing for consumer protection provisions in specific statutes governing the relevant commercial transaction, the enactment of a specific law meant primarily for the protection of consumers and last, but by no means the least, the judicial attitude of the courts in ensuring the rights of consumers are guarded.

1.1 The various approaches

The most common form of commercial transactions engaged by the Malaysian consumers is that of the sale and purchase of goods as well as the hire-purchase of goods. Thus, the main legislation identified for the purpose of this paper would be the Sale of Goods Act 1957 and the Hire-Purchase Act 1967. These Acts attempts to protect consumers by providing specific provisions to ensure that consumers engaging in transactions falling within the scope of the Acts are given some form of protection.

However the protection of consumers, or the lack of it, in these statutes are sufficiently lacking for the legislature to deem it necessary to introduce the Consumer Protection Act 1999. This Act contains a wide range of provisions for the protection of a consumer in transactions that comes within the scope of the Act.

There are also some situations where written law is still not sufficient to fully protect a consumer, and this paper will highlight some relevant issues of consumer rights and the consequent judicial treatment of these issues in the realm of the yet to be adequately legislated area of Islamic financing, and in particular, the apparently Islamic-compliant Islamic Home financing facility, the Al-Bai Bithaman Ajil.

2. Protection afforded by the Sale of Goods Act 1957 and the Hire-Purchase Act 1967

As mentioned earlier, the most common form of commercial transaction engaged by the Malaysian consumer is the sale and purchase of goods and the hire-purchase of goods. These transactions are governed by the Sale of Goods Act 1957 and the Hire-Purchase Act 1967 respectively.

2.1 The Sale of Goods Act 1957

The Sale of Goods Act 1957 seeks to protect the rights of the consumer, who is the buyer of goods within the definition of the Act by making provisions for terms that are to be implied in a contract of sale under the Act. These implied terms are in the form of conditions and warranties. A breach of the implied term which is a condition entitles the innocent party to treat the contract as repudiated. On the other hand, section 12(3) of the Act provides that a warranty is merely a stipulation collateral to the main purpose of the contract, and that the

breach of warranty only gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated.

2.1.1 The Implied Conditions

The conditions implied in a contract of sale of goods under the Act may be stated as follows. Firstly, that the seller has a right to sell the goods in question (section 14(a)). Secondly, where goods are sold by description, the goods shall correspond with the description (section 15). Thirdly, that the goods shall be reasonably fit for the purpose for which it was bought (section 16(1) (a)). Fourthly, that the goods bought must be of merchantable quality (section 16(1) (b)) and fifthly that where goods are sold by sample, they should correspond with the sample in quality (section 17).

2.1.2 Right to Sell

The seller impliedly contracts that he has the right to sell the goods. A person who is not the owner or does not have the owner's consent to sell the goods will breach this implied condition. Where a buyer of goods buys from a person who has no right to sell them, the buyer may repudiate the contract and recover his purchase price in full: Rowland v Divall [1923] 2 KB 500; Lian Lee Motor v Azizuddin [2001] 5 MLJ 334. Mere suspicion that the seller has no title is insufficient: Ahmad Ismail v Malayan Motor [1977] 2 MLJ 66.

The implied term is not restricted to cases where the owner has no title to the goods or the consent of the owner to sell the goods. In Niblett v Confectioner's Materials Co Ltd [1921] 3 K.B 387 it was held that the implied condition applied where the owner of goods sold the goods in a form which contravened another person's trade mark.

2.1.3 Description

By virtue of s.15 of the Act where goods are sold by description there is an implied condition that the gods shall correspond with the description which was applied. There are many leading cases on the subject but the modern approach is found in Harkingdon & Leicester Enterprises Ltd v Christopher Hall Fine Art Ltd [1990] 1 All ER 737. In this case the Court of Appeal held that to be a sale by description it had to be shown that the buyer relied on or was influenced by the description that was applied. It appears that reliance or influence it is now a requirement and the older cases must now be read in this light.

Sometimes the contract may describe the method of packaging of goods. May the method of packaging also amount to description for the purpose of s.15? The Court of Appeal decided in the affirmative in Re Moore & Co Ltd v Landaver & Co [1921] All ER 466. In a later case Reardon Smith Lines v Hansen Tangen [1976] 1 WLR 989 Lord Wilberforce in the House of Lords stressed his doubts on this case but the case itself has not been overruled.

2.1.4 Fitness

The general rule in a sale of goods is caveat emptor: let the buyer beware. There is no implied duty to supply goods which are fit for the purpose they are bought unless four requirements are met. The four requirements stated in s.16 (1) (a) are as follows:

(a) "the buyer, expressly or by implication makes known to the seller the particular purpose for which the goods are required." In many cases this requirement will be met by implication and, not by express words. In Grant v Australian Knitting Mills Ltd [1936] AC 89 (which involved a sale of an underwear) Lord Wright said,' There is no need to specify in terms the particular purpose for which the buyer requires the goods, which is nonetheless the particular purpose within the meaning of the section, because it is the only purpose for which anyone would ordinarily want the goods'.
(b) "so as to show that the buyer relies on the seller's skill or judgment". This requirement too may be satisfied by implication. However a duty to make express disclosure may arise in certain circumstances. Such a duty was recognized in Griffiths v Peter Conway [1939] 1 All ER 685 where a purchaser of a Harris tweed coat did not inform the seller that he has sensitive skin.
(c) "goods are of a description which it is in the course of the seller's business to supply "This means this seller must run a business of selling goods of type sold to the buyer. Thus the implied term does not apply to private sales between individuals.

(d) "under its trade or patent name". If a person buys goods by relying on the trade or patent name he does not rely on the seller. This was a nineteenth century concept. The courts have interpreted this proviso in such a way that it has limited effect. First, the proviso does not apply where the buyer buys from a manufacturer because he relies on the manufacturer. Secondly it does not apply where the buyer has in fact relied on a seller who is not a manufacturer. The modern approach is reflected in the local case of Medicon Plastic Industries Sdn Bhd v Syarikat Cosa Sdn Bhd [1995] 2 MLJ 257. In this case there was a sale of a machine by trade name for the manufacture of plastic bottles. V.C. George J said,

> 'Clearly the plaintiffs had relied on the seller's skill resulting in there being an implied condition that the machines would be reasonably fit for the purposes for which they were required. The situation here was a far cry from a purchase of a bottle of patent medicine or some common article like an electric iron or even a television set, sold under a popular brand name where you pick it off the shelf as it were, which is the sort of situation where the proviso could be successfully invoked. In our judgment the learned judge was wrong in applying the proviso to s 16(1) (a) on the facts of the case.'

Two further points must be noted.

- The words "good supplied" in s.16 (1) (a) have been interpreted to include goods that contain or enclose the goods bought. In Geddling v Marsh [1920] 1 KB 668 it was held that when mineral water is purchased the bottle containing it must also be fit, even if the contract states that the bottle belongs to the owner.
- If the four requirements of fitness are fulfilled the liability of the seller is strict. In Frost v Aylesbury Dairy Co Ltd milk sold was found to be contaminated. It was held that, that the seller took adequate care to ensure that the milk was safe was irrelevant.

2.1.5 Merchantable Quality

Section 16(1) (b) reads as follows:
Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not) there is an implied condition that the goods shall be of merchantable quality: Provided that, if the buyer has examined the goods, there shall be no implied condition as regards defects which such examined ought to have revealed.

At the outset it must be noted that the general rule is still caveat emptor. The implied term only arises if the goods are bought "from a seller who deals in goods of that description." This means that the implied term does not arise in private sales. What is the test of merchantable quality?

There is no definition for 'merchantable quality' in the Act. Two tests (the 'acceptability test' and 'usability test') are commonly used to determine whether particular goods comply with the requirement for merchantable quality. According to the House of Lords in the case of Henry Kendall & Sons v William Lillico & Sons Ltd [1969] 2 A.C. 31, the test is that the goods 'should be in such a state that a buyer fully acquainted with the facts, and therefore knowing what hidden defects exist and not being limited to their apparent condition would buy them without abatement of the price'.

The second test used (see Cammell Laird & Co Ltd v Manganese Bronze & Brass Co Ltd [1934] A.C. 402 at 430] is that the goods is not of merchantable quality if 'it is of no use for any purpose for which goods which complied with the description under which those goods were sold would normally be used.' This test was adopted in the case of Seng Hin v Arathoon & Sons Ltd [1968] 2 MLJ 123.

The courts have also decided that the description applied to the goods and the price is also relevant.

A car described as second-hand may not be entirely free of all defects: Bartlett v Sydney Marcus Ltd [1965] 1 WLR 1013. If the price paid for goods are very low this is a factor to be taken into account.

The proviso to s.16 (1) (b) stated that where the buyer has examined the goods he is bound by defects which such examination ought to have revealed. First, the proviso only applied where the buyer has examined the good. Secondly it only applied where such examination ought to reveal the defects. What is the position if the buyer makes a cursory examination or an examination which is not a full examination? In England in Thornett & Fehr v Beers & Sons [1919] 1 KB 486 a cursory examination was deemed to be a full examination but this case has not been followed in Australia.

2.1.6 Sale by Sample

Under s.17 (2) where goods are sold by sample there is an implied condition that the bulk when delivered shall correspond with the sample in quality.

In E & S Ruben Ltd v Faire Bros & Co Ltd [1949] I All ER 215 vulcanised rubber was sold by sample. The sample was flat and soft but the bulk delivered was crinkled and folded. It was held that this amounted to a breach of s.17 (2).

2.1.7 The Implied Warranties

Apart from the above implied conditions, the Act also provides that there are implied warranties that the buyer will enjoy the goods bought free from any encumbrances (section 14(c)) and also be able to enjoy quiet possession of the goods (section 14(b)).

2.1.8 The Shortcomings of the Act

Although it seemed that legislation intends to protect the rights of the consumers by making for provisions to that effect as mentioned above, a major shortcoming of the Act is that the Act also permits the parties to contract out of any or all of the implied terms discussed above. According to section 62 of the Act, 'where any right, duty or liability would arise under a contract of sale by implication of law, it may be negative or varied by express agreement or by the course of dealing between the parties, or by usage, if such usage is such as to bind both parties to the contract.'

This represents a major disappointment to the consumers, because although section 62 could only be invoked upon agreement by both parties to the contract, the unequal bargaining power between the parties may not guarantee that any such agreement would be with the genuine consent of the consumer.

2.2 The Hire-Purchase Act 1967

The Malaysian Hire-Purchase Act is based on the Hire-Purchase Acts of 1960-65 of New South Wales. The Act has several provisions for the protection of the hire, ranging form formalities that need to complied with during the formation of the contract of hire, the implied terms of the contract, the regulations pertaining to term charges as well as the rights of the hirer in the event of repossession, early determination or early completion of the contract of hire.

Section 4 of the Act requires the owner to give a prescribed notice to prospective hirers as to his financial obligations were he to enter into the contract of hire-purchase for the goods in question. A failure to comply with this requirement would render the contract void and the defaulting party would also be liable to a criminal prosecution.

Section 4A requires all contract of hire to be in writing and of a prescribed size of print. Again failure to comply would render the contract void and the owner liable to a criminal prosecution. Other formalities prescribed by the Act include the requirement that the contract may only be signed after the form have been 'duly completed', therefore prohibiting the owner from making the hirer sign blank forms. It also makes mandatory for certain details regarding the hire-purchase to be included in the written contract and that separate agreements must be signed for separate goods.

The hire-purchase price must also be calculated based on the prescribed formula given by the Act. This includes the requirement of a minimum deposit as well as the rate for term charges.

Not unlike the Sale of Goods Act 1957 above, section 7 of the Hire-Purchase Act 1967 also provides for certain terms to be implied in the contract of hire. These terms are similar too to the ones provided for by the Sale of Goods Act. They are the terms relating to quiet possession, the right to sell, freedom of the goods on hire from encumbrances, merchantable quality and fitness of the goods.

A major difference from the Sale of Goods Act 1957 as far as the implied terms are concerned is that section 34 of the Hire-Purchase Act prohibits the parties from contracting out of the obligations arising from the implied terms. According to section 34, 'any provision in any hire-purchase agreement whereby, except as expressly provided by this Act, the operation of this Act is excluded, modified or restricted, shall be void and of no effect.'

The Act also protects the hirer in a tripartite agreement which normally involves a dealer of goods (usually a motor vehicle), the owner (usually a bank or other financial institute) and the hirer. The most

important of this protection is the provision that the dealer is assumed to be the agent of the owner in negotiations with the hirer leading to the entry of the contract of hire between the hirer and the owner, and therefore making the owner liable for misstatements and misrepresentations by the dealer.

Other rights of the hirer that are protected by the Act includes the rights of the hirer to assign his rights to a third party (section 12), the right to a rebate when making an early settlement of the hire-purchase agreement (section 14) the prohibition of a minimum payment clause and other rights when making an early determination of the contract (section15) and also certain rights when he defaults and the owner wishes to exercise his right of repossession of the goods on hire (section 16).

The Hire-Purchase Act thus gives a considerable amount of protection to the hirer consumer and these rights could not be diminished by agreement of the parties, unlike that under the Sale of Goods Act 1957. However, it must be pointed out that the protection afforded by the Act is only applicable if the contract comes within the scope of the Act, and particularly, if the goods on hire come within the goods mentioned in the Second Schedule to the Act.

A popular form of hire-purchase, (although it may not be a true hire-purchase transaction) is that which involves the 'hirer' obtaining financing facilities under the Islamic Banking system. The issues arising under this transaction are not dissimilar to that discussed in the fourth part of this paper and will not therefore be discussed here.

3. The Consumer Protection Act 1999

A major development in consumer protection laws in Malaysia came in 1999 with the coming into force of the Consumer Protection Act 1999. This Act applies to protect a 'consumer' where goods are supplied to him in 'trade'. A consumer is defined as a person who 'acquires or uses goods or services of a kind ordinarily acquired for personal, domestic or household purpose, use or consumption. "Trade' is defined as any trade, business, industry, profession, occupation, activity of commerce or undertaking relating to the supply or acquisition of goods or services. The Act applies to goods or services in a transaction that includes a sale, lease or hire.

Section 6 of the Act prohibits the relevant parties from contracting out of any provision in the Act, and non-compliance is a criminal offence.

The most important provisions of this Act relating to the protection of consumers' right are the provision of implied guarantees in any agreement that comes within the scope of the Act. These implied guarantees (provided for in sections 31, 32, 33, 34, 35 and 37 are similar to the implied terms discussed above in the Sale of Goods Act 1957 and the Hire-Purchase Act 1967. New terms relating to the obligations of the supplier of goods and services to provide adequate repair services and availability of spare parts are introduced.

A radical move by legislation was to introduce in the Act provisions making the manufacturers liable for certain obligations to the consumer although there is no privity of contract between the parties. These include the obligation of a manufacturer to provide goods of acceptable quality (section50 (a)), that the goods must correspond to the description given (section 50(b)) and to provision of adequate service facilities and spare parts.

4. The Courts

As have been pointed out, the above mentioned Acts of Parliament are not all encompassing and there are certain transactions which the consumer may find himself not being able to seek protection under the written laws. It is therefore left to the courts to attempt to afford the consumer the necessary protection. In this respect, it must be mentioned that the Malaysian courts do not shy away from its duties. In this paper, particular emphasis is put on the rights of consumers in relation to the fast-growing realm of Islamic Financing, particularly that of home financing. In a country where the majority of the citizens profess the Islamic faith, and where the nation's Constitution have declared Islam to be the State Religion it is not surprising that commercial transactions which claims to comply with the religion's laws is becoming ever so popular.

The question that arises is whether these Islamic Financing facilities are genuinely in accordance with not just the form but also the spirit of an Islamic financing and monetary system. In other words are these transaction Islamic merely because no interest is charged, although in other respects may seem harsh and unjust on the consumer. As revealed in the Qur'an, amongst others,

'That which you give as interest to increase the people's wealth increases not with God; but that which you give in charity seeking the goodwill of God, multiplies manifold' (Surah al-Rum, verse 39)

4.1 Al-Bai Bithaman Ajil

One of the most popular forms of Islamic financing is that of home financing and the facility for this is known as the Al-Bai Bithaman Ajil. It is well known that Islam prohibits the charging of interest or riba' on loans. The essence of this system of financing needs to be explained. It has been described as 'a buy and sell transaction under which the customer pays the selling price of the bank by instalments over an agreed period of time. In this financing transaction, the bank buys the property from the customer pursuant to the Property Purchase Agreement at the property purchase price, which is usually the amount of facility required by the customer, say, RM150,000.

The bank then sells the property back to the customer immediately after the purchase pursuant to the property sale agreement at the property sale price, which is the sum of the property purchase price (RM150,000 in the example taken) and the bank's profit for the entire tenure of financing required (say RM150,000 profit for 15 years). The sale price which the customer agrees to buy from the bank will therefore be RM300, 000 which the customer will repay by monthly instalments of an agreed figure over 15 years. By way of security for the repayment the customer will provide such securities as the bank may require. This is usually a land charge over the property, the subject matter of the transaction.' (Of Islamic Loan and Other Matters of Interest [2000] INSAF XXVIX No 3, 91).

It is important to note here that the 'essence of the profit rate is that it is based on an agreed real or actual profit of the provider bank expressed as a percentage, and not an interest rate that is being charged. The profit margin is a function of the bank purchase price, the agreed profit rate on a constant rate of return and monthly rests, and the agreed tenure of the facility. It must be borne in mind that profit margin is calculated with the profit rate applied to the full tenure of the facility during which the instalments are to be made. The sale price is then paid by monthly instalments according to the number of months in the tenure of the facility.' (Wahab Patail J in Affin Bank Bhd v Zulkifli Abdullah [2006] 3 MLJ 67)

At first blush, there appears to be nothing unusual about this form of financing, when compared to a conventional banking financing facility. However, in the event the customer defaults in the agreement, the agreement between the parties apparently entitles the bank to claim not just the sum in the facility plus the profit at the point of default, but also the full sale price, including the profit calculated for the entire tenure of the facility. Under a conventional loan, the defaulting customer would only be required to pay the loan amount plus accrued interest and other charges, including late payment interest. The reason for this difference is explained as follows,

'…in the event of a default before the end of tenure, the sum the borrower in a conventional loan has to pay over and above the sum borrowed, that is the interest and late payment interest, is limited to the period from release of the loan until full settlement and not for the full original tenure of the loan; while the bank in a Al-Bai Bithaman Ajil facility claims the 'bank selling price' which is the sum of the facility given out as the 'bank purchase price' and the profit margin thereon for the full tenure of the facility. In other words, while in a conventional loan no interest is applied upon the unexpired tenure, the bank in an Al-Bai Bithaman Ajil facility seeks to claim a profit on the unexpired tenure also.'(Wahab Patail, p72).

This clearly seemed to be an unfair practice as far as the consumer is concerned. The courts had opportunity to adjudicate on these issues in a number of recent cases.

4.2 Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd [2005] 5 MLJ 210

In *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2005] 5 MLJ 210, it was argued, amongst others by the defendant that the contract is void because the repayment amount is higher than the principal amount and therefore a form of interest had been charged. His Lordship Suryadi J rejected this argument. According to his Lordship,

'…I reject any argument that injects the argument that it is not permissible to buy on credit, especially when there is mutual consent. Even Prophet Muhammad had occasion to buy some grain from a Jew to be paid at a specific time, with his coat of mail as security. I am unable to acquiesce to any argument too that, just because a larger sum is agreed to be paid back founded on a buy back concept, with the defendant openly having requested for deferred payment, and with the differential sum resembling interest, the agreement must be void. I am unable to acquiesce to such a suggestion as there is no clear text that prohibits such a transaction entrenched with all those ingredients. Even the followers of the Shafii and Hanafi schools and the majority of Muslim scholars consider it lawful, calling it Shifa al ilal fi hokum ziyadat al-thamam li mujarrad al-ajal(translated: The reason for increasing the price due to lapse of time)'(The Lawful and Prohibited in Islam by Yusuf al-Qaradawi). I

therefore reject the argument of the defendant that, just because the defendant pays more than what was needed to buy the impugned property, such sum (here called profit) must be interest per se.'

4.3 Affin Bank Bhd v Zulkifli Abdullah [2006] 3 MLJ 67

In this case,the defendant bought a double story house and secured financing for the said purchase under the Al-Bai Bithaman Ajil facility amounting to RM346,000 from the plaintiff bank who was also the defendant's employer at that time. The loan was to be repaid over an 18 year tenure by 216 monthly installments. Soon after this, the defendant left the employment of the plaintiff and upon the defendant's request, the facility was restructured, whereby under the revised facility, the bank selling price of the house was RM992,363.40, payable over a period of 25 years. The defendant defaulted on his repayments and the plaintiff commenced action in the High Court of Malaya to auction the property and recover a total sum of RM958,997.21, being the bank selling price lees the amount of already repaid by the defendant thus far. Inter alia, the issue before the court was whether the bank was entitled to recover a sum inclusive of the profit margin over the entire tenure of the facility.

The learned judge held that the bank was not entitled to do so. According to his Lordship, if the customer is required to pay the profit for the full tenure, he is entitled to have the benefit of the full tenure. It follows that it would be inconsistent with his right to the full tenure if he could be denied the tenure and yet be required to pay the bank's profit margin for the full tenure. His Lordship opined that 'the profit margin that continued to be charged on the unexpired part of the tenure cannot be actual profit. It was clearly unearned profit. It contradicted the principle of Al-Bai Bithaman Ajil as to the profit margin that the bank was entitled to. His Lordship felt that the actual profit could be calculated in the event the tenure was shortened. In coming to this conclusion, his Lordship also expressed his shock that in a pious attempt to avoid financing containing the elements of riba' (interest) the borrower under the Islamic facility could find himself far worse off than a borrower under a conventional loan in the event of default.

4.4 Malayan Banking Bhd v Marilyn Ho Siok Lin [2006] 7 MLJ 249

This case contains substantially similar facts with the above Affin case. The court however took a slightly different approach on the issue of whether the bank in question is entitled to recover the profit margin over the unexpired tenure of the Al-Bai Bithaman Ajil facility. According to the High Court, although the words in the agreement entitling the bank to recover the said full amount, under the Sarawak Land Code, the law under which the bank is making an application for an order for sale ,the court has a discretion to make an order after hearing the evidence 'as in the circumstances seems just'. According to the learned judge in this case, David Wong J, those words under the Code 'empower the court with the flexibility to make an order even if it means ignoring the terms contained in the Al-Bai Bithaman Ajil agreement provided it is just in the circumstances.'

4.4.1 Application of Equitable Principles

In deciding what is 'just in the circumstances of the case', the court would consider amongst others, public interests, the peculiarities of the contract, and the compliances by the parties of the agreed terms contained in the agreement. It is also a question of whether equity should intervene. According to his Lordship, although the Al-Bai Bithaman Ajil documents are drawn based on Islamic principles, the court is entitled to apply the common law principle of equity in construing the documents because the principle of equity is consistent with Islamic teachings. Although the judge in the Affin case above had apparently based his decision purely on the construction of the contract, and in particular, on the meaning of the term 'sale price' and 'unearned profits', David Wong J expressed his opinion that the route taken by the judge in that case was merely a creative way of applying the equitable principle of unjust enrichment. Thus, in the view of David Wang J, it would not be equitable to allow the bank to recover the sale price which includes the profit margin for the unexpired tenure in the event the facility is terminated prematurely.

4.4.2 Public Interest

His Lordship further opined that the adopting of the principles and decision in Affin, would encourage the Islamic Banking industry to flourish in Malaysia and abroad, and which would be in the public interest.

It has to be noted that both the decisions in Malayan Banking and Affin did consider the views of writers on Islamic Financing but chose to not follow the views of amongst others, Norhashimah Mohd Yasin (Norhashimah) and Mohd Illiayas (Mohd Illiayas). What the above cases have shown is that when the Islamic financing system is applied only in its form, but not with its genuine object and spirit in tandem, the courts would be willing to use various approaches to ensure that the consumer would not be unjustly treated. After all, 'among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions is the prohibition of all sources of 'unjustified' enrichment or akl amwal al-nas bi al-batil'.(M. Umer Chapra (1995 at p55).

5. Conclusion

It can be observed thus, that consumer protection could be achieved through various approaches. The Sale of Goods Act 1957 and the Hire-Purchase Act does it through making provisions in the respective laws governing the respective transactions. This approach is however limited in its scope, either because it is only limited to transactions within the intended scope of the legislation, or as somewhat disappointingly so in the case of the Sale of Goods Act 1957, the protection afforded could be contracted out of by the parties. A more all encompassing effort was found in the enactment of a specific statute aimed at the protection of consumers, as was the case of the Consumer Protection Act 1999. This piece of legislation, though providing for improved protection for consumers and providing for quite radical extension of that protection, also has its shortcomings, because again, in order for the protection to apply, the transaction or matter must be within the intended scope of the legislation. It is pleasing to note thus, that even where it seemed that there is no written law to protect the consumer in certain transactions, and despite clear and unambiguous words in the agreement between the parties, the courts are still prepared to approach the important issue of consumer protection in a creative and innovative way where the court thinks that it is 'just in the circumstances of the case' to do so.

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Current International Trends in International Product Liability Law

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Abstract: Product liability in the past half century has been a popular and important law issue in substantive laws. As well as its significance in substantive laws, product liability is also recognized as being an important subject in international law. With the increase in industrialization and the improvements in international trade, product liability disputes have become a frequently encountered matter in international law. In addition to being popular, product liability has also been a dynamic legal issue. Consumer protection ideas have been the most efficient factor which shapes the substantive rules of product liability and triggers the dynamism in product liability laws. Striking a reasonable balance between the parties also emerged as an effective factor in the dynamic structure of product liability law. This paper will address how these different concerns affect the product liability regimes in substantive laws and what are the reflections of these concerns to the international law today. First the rules of substantive law in product liability will be examined in the frame of Hague Convention on the Law Applicable to Products Liability and the Proposal for the European Parliament and Council Regulation on the Law Applicable to Non-Contractual Obligations ("Rome II").

1. Introduction

"Product liability" is the term that is used to explain the "liability of a professional supplier of a product for damage caused by that product" (Tebbens, 1979). Whilst previously product liability has been handled as a contractual obligation (Parkinson & Senders, 1959), later product liability has been accepted as an important tort law problem (Nimtz, 1953-1954) in substantive laws [1].

Parallel to the increase in industrialization and the developments in manufacturing techniques, the number of the disputes regarding the injuries which a defective products cause have risen gradually [2]. Since, the industrialization started from the western European countries and US, it is not surprising that the product liability has been a debated concern in these countries from early 1990s. Today, with the industrial growth in developing countries product liability has also emerged as an important concern in these countries [3]. Therefore product liability has been regarded as an important legal issue in all over the world, which can be called as a "global phenomenon" (Reimann, 2003).

Product liability has been established itself as a special subject in substantive laws from the early twentieth century and has started to be regulated in separate status (Reimann, 2003). Today it is generally accepted that product liability has its own special features that distinct it from other tort law issues. Therefore the current tendency in product liability law is to impose special rules by taking into account the peculiar characteristics of product liability.

Through the development of the international trade and the free movement of people and goods beyond the borders of the countries, the number of the product liability cases involving more than one country has grown very rapidly (Kühne, 1972). After a long debate, law applicable to product liability has been the subject of an international convention in 1973 by Hague Convention on Law Applicable to Product Liability. The second attempt to regulate law applicable to product liability comes after thirty years by the Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Non-Contractual Obligations (Rome II) (2003/0168 COD).

To evaluate the current developments in international product liability law, it is vital to examine the substantive rules in product liability and the law making policies underlying the rules of substantive law. In this study firstly, product liability in substantive law will be examined in terms of its dynamic structure and the reasons that trigger that dynamism. Secondly international product liability law will be explained in the frame of relevant international regulations. Finally the reflection of the substantive law to the international product liability will be evaluated in terms of consistency.

2. Product Liability in Substantive Laws

2.1. Product Liability as a Dynamic Law Issue

Product liability in past half century has been a dynamic and popular legal issue. Product liability has been an important political and legal agenda of particularly in industrially and economically developed countries (Reimann, 2003). In 1960s and 1970s, many countries reformed their product liability laws toward stricter standards. In American legal system product liability which was handled as a contractual liability until 1965, was accepted as a strict liability in Restatement II (Sec. 402A, 402B) [4].In American legal system[5] product liability standard go a step further in several cases and product liability was handled as an enterprise liability[6].At this point reached in favor of the consumer, enterprise liability that based on no fault liability particularly criticized in terms of its functioning in developing countries and revised by the legislation and courts in 1990s (Owen, 1992).

Similarly, it was possible to see the increasing standards of product liability in various nations in Europe. A number of European countries have adopted the strict liability standard in their product liability law. Parallel to this movement in European countries, EC Directive on Product Liability imposes strict (no-fault) liability standard (OJ No. L 210, 7. 8. 85). In 1985 after more than eight years of talk, the European Community took a step in harmonization of product liability laws and adopted EC Directive. Although the aim of the Directive was the uniformity, it could not been succeeded for a period of time because of the 10 year transitional period that permits variations in national laws (Mottur, 1993-1994). Even today the lack of uniformity in product liability law persists [7]. Although the lack of uniformity in product liability law even persists today in some respects, the EC Directive on Product Liability constitutes uniformity on strict liability.

Although it seems like the general tendency in product liability law is toward the strict liability, it has always been a debated subject whether it is proper to adopt strict liability as a liability standard in product liability. American approach to the liability standard has been moved swiftly through the negligence after the liability crisis of late 1980's[8].The approach accepted in American legal system in the Restatement Second which was based on strict liability (Sec. 402A, 402B) revised again by Restatement of the Law Third, Torts: Products Liability in 1997. Restatement of the Law Third represents a thorough reformulation of Section 402A and related sections of Restatement Second. Instead of strict liability, Restatement of the Law Third imposed fault based liability by accepting the concept of "defective product" and separating the product defect into distinct categories (Conk, 1999-2000).

Considering the developments in product liability law all around the world, it is possible to say that the product liability is a field of law which still keeps changing. The dynamism of product liability definitely has fundamental effects on consumer, industry, economy and nations. At this point, the answer will be given to the question of "what is the real reason behind this transformation in product liability law" will shed light on law making policy that lies under the product liability rules and the future trends in product liability laws.

2.2. What Triggers the Dynamism in Product Liability Law

Although not being the only rationale, the impacts of product liability law on the trade and economy have been a noteworthy explanation for the dynamism in product liability law. Particularly for the highly industrialized countries as US, the most important reason that makes the product liability law a dynamic field seems like that it's being geared to economic development of countries. The turbulences, such as macro economic disturbances in the economic systems and its influence to the industrial performance, are directly reflected in the law making policy of the governments (Moore & Viscusi, 2001).

Strict liability, particularly the enterprise liability was one of the important reasons for the crisis in US economy. The need for the funds in the innovation of the new products is one of the most fundamental rationales for the opponents of strict liability [9]. Vagueness and harshness of these standards have been shown as other reasons that were grounded in the criticism of the strict liability standard (Porter, 1990). According to this approach, to support the industries for the innovations, governments have to impose fault-base liability standard instead of strict liability (Horwitz, 1979) (Worthington, 1995). According to this view, in this system all costs of production are borne by the industry and this reflect to consumer eventually (Worthington, 1995) (Presser, 2002). Based on this approach, in *Brown v. Superior Court*, the California Court concluded that producers of pharmaceuticals should be liable according to their negligence because of the disastrous effects of strict product liability on availability of drugs to consumers[10].In this case, the court stated that "because of the public interest in the development, availability and reasonable price of drugs" the possibility that the cost of insurance

and of defending against lawsuits will diminish the availability and increase the price of pharmaceuticals" negligence standard was accepted by the court.

Other factors that have been effective in the dynamic structure of product liability law are the social concerns as consumer protection and the political atmosphere of the time. Besides the number of the elements in a product liability dispute, consumer protection concern is an essential theme which makes product liability disputes more complex. In several kinds of disputes such as consumer contracts or employment contracts, the weaker party's interests are protected by special rules. Proponents of strict liability argue that in substantive laws product liability disputes plaintiff has been accepted as a weaker party and protected by special regulations. Based on this approach, product liability has been regulated in different jurisdictions by taking into account the consumer protection concern (Reimann, 2003).

In the preamble of the EC Directive, protection of the consumer has been shown as a preliminary concern of the Directive. The imposition of the strict liability under the Directive constitutes changes in the legal systems of some of the member states as England on the favor of consumers. On the other hand some of the members of EC as German and France had already imposed strict liability under their law of product liability and had been implementing much more strong protection for the consumers at the time. Therefore, it is difficult to say if the provisions of the Directive produced same consumer protection effect in each member state (Fawcett, 1993). But still uniformity on strict liability in EC Directive was evaluated as a victory for consumers (Freedman, 1988).

The US product liability regime of fault-base liability would lead us incorrect conclusion of consumer protection is not a necessary concern in US anymore. At this point, it seems important to emphasize that the reason for the diversity between US and European approach in product liability is not only due to the weight given to the protection of consumer ideas. Consumer protection has been also an important concern in American legal system as well as Europe. On the other hand, the impact of the product liability standards on the economy has been different in Europe than it was in US. Despite the fact that in US product liability has enormous effects on trade (Moore & Viscusi, 2001), there were no such an effect in economic system in Europe. It was expected that there would be no considerable increases in the product liability claims after the EU Directive (Reimann, 2003). As well as Europe, in a number of Asian countries as Japan, Twain or other countries as Australia[11] or Israel[12] who have adopted strict liability, product liability does not really matter in grand scale as it does in US (Reimann, 2003). The essential reason for the differences in the number of the claim in different jurisdiction lies in the structural systems of legal procedure (Hodges, 2000-2001). Besides the differences in the structural system of legal procedures, legal traditions and cultural differences [13] also have been shown as the reason for the diversity in the application of product liability regimes of these legal systems (Reimann, 2003).

To conclude, it is possible to say product liability has been one of the battle fields that economy, politics and social concerns get involve in very close terms. When we compare the different legal systems it is possible to see that these elements have all different effects on the legal systems depends on the law making policy of the governments. However, the movement of the legal doctrine in product liability law from fault-based liability to strict liability or vise- versa has been criticized for the reason that not having a firm foundation in social or moral theory (Owen, 1991).

2.3. Future Trends in Product liability law

The answer to the question of "what will be the future trends in product liability law" seems like an important determining factor that has to be evaluated in terms of the reflection of the substantive law to the international law regime.

Although product liability is not always predicated on strict liability, the majority of the nation's liability regimes are based on strict liability (Reimann, 2003). Today, the point reached by the European countries in the product liability standards seems like as strict liability. As well as developed countries [14],strict liability has been an acknowledged standard for product liability[15] in several developing countries

In Europe recently, the necessity to revise some issues as the burden of proof for defectiveness and changing prescription periods had been considered by European Commission (Green Paper) although no action was taken. While at least for European model the move through to strict liability seems to have settled, it is difficult to say the same for the US. In contrast to the tendency of the majority of the legal systems, the US product liability system has turned back to fault-based liability (Moore & Viscusi, 2001).

Consequently it is possible to say in contrast to last three decades or so, American substantive product liability law seems less strict than European approach. However, considering the movement of liability standard toward one way to other, it is difficult to say that the future trend will definitely be fault-based liability or strict liability (Reimann, 2003).

3. Product Liability in International Law

3.1. Law Applicable to Product Liability

Today, transactions between parties go beyond the borders of countries with the growth of international trade. Consumers are continually exposed to foreign products. We are all using foreign products, such as cars , computers and drugs. Because of the increasing volumes in international commerce, e-commerce and international travel today consumers from all around the world purchase products which have been removed from their original place of manufacture. Parallel to the increase of the use of internationally distributed merchandise is the risk of being injured by a product which is produced in a jurisdiction other than the one that he resides (DeMent, 1972). Thus the number of the disputes involves a foreign element increases day by day. For this reason today in a product liability dispute it is more possible to encounter a foreign element besides the domestic product liability disputes.

In an international product liability dispute, foreign element could appear as a product manufactured in a foreign jurisdiction. However, the international dimension of a product liability is not restricted in this element. The place of purchase of defective product or the place where the damage occurs could be in all different jurisdictions. For instance, a product may be bought by a traveller and carried back to traveller's home country: or an import product may be bought by a foreign traveller or a native: the product sold in one country may have been assembled in another county. Besides the place of production, the place of purchase and the place of harm could be the foreign element in a product liability dispute. And the fact that these places rarely coincide with one another makes product liability disputes more complex (DeMent, 1972).

Lex loci delicti (law of the place of wrong) has been accepted as the rule governing the choice of law in tort actions. Law applicable to the product liability determined according to the lex loci delicti when there is no special rules for product liability. The application of lex loci delicti has been severely criticized for being too mechanical and underlying the ethical and social considerations [16]. The adequateness of lex loci delicti in product liability has pushed many legal systems to discard the lex loci delicti in favor of special rules which were regulated by analyzing the factors involved in a product liability dispute [17].

However, determining a rule to the law applicable to the complex product liability disputes has been considered as a complicated concern (Fawcett, 1993). Instead of predicating on one particular connecting factor, choice of law rules based on combination of different connecting factors. Therefore, when we examine the particular rules devised for product liability, it is possible to see countries all adopt different solutions for product liability [18]. The diversity between the rules of law applicable to product liability triggers the need for uniform rules in this field of international law.

In contrast to the development in the substantive law of product liability, private international law aspects have been ignored for a while [19]. Law applicable to product liability has been a matter of international regulation for the first time by the Hague Convention on Law Applicable to Product Liability. The most recent is the Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Non-Contractual Obligations (Rome II) (2003/0168 COD) which is still a proposal.

3.2. International Regulations on Law Applicable to Product Liability

3.2.1 Hague Convention on Law Applicable to Product Liability

The first regulation dealing specifically with the law applicable to product liability is the Hague Convention on Law Applicable to Product Liability. Because of the complexities arising from the elements included in a product liability disputes, the need for a single rule governing the law applicable to product liability seemed so urgent in late 1960s (Bourke, 1968). Hague Convention was drafted to develop a predictable, uniform, easily understood choice of law rule in international product liability (Reese, 1974). After more than five years of talk, Hague Convention was signed in 1973.

The Special Commission on Products Liability of the Hague Conference on Private International Law was motivated by the need of protecting the consumer. With this idea, the Commission considered a choice of law rule that would allow the consumer to specify one of the alternative legal systems that would govern the dispute (Bourke, 1968). The proposed rules were obviously favouring consumer by giving consumer a choice between several legal systems (Reese, 1972). Considering that the consumer protection aspect of product

liability was standing at the forefront of the substantive laws of the many counties in 1960s and 1970s, the approached adopted in favor of the consumer by the commission was not surprising.

However, in contrast to substantive laws, ongoing debates on the rules of Convention adduced that concerns other than consumer protection have also been equally effective in the formulation of Hague convention. The economic considerations became more apparent in the debate to prevent the adoption of the choice given to consumer (Bourke, 1968). Finally, in the "Text Adopted by the Special Commission (DeMent, 1972)" the rule that allows the consumer to specify the applicable law has been amended in favor of the manufacturer (Fawcett, 1993). Suggestions for choice of law rules which involve elective solution whereby the plaintiff was allowed a choice between two or more laws were dropped in the proposal. Instead of giving consumer the right to specify the applicable law, conflict of law rules were determined by using several connecting factors in various combinations. In this set of rules, the Convention establishes a hierarchy of connecting factors and a combination of combinations (Fawcett, 1993)[20].

As it is seen from the process, consumer protection had been an important concern in the adoption of convention (Reese, 1972). However in the final text adopted by the Convention, the natural stance of the Convention was emphasized to establish a balance between the parties shown among the objectives of the Convention (Reese, 1974). According to Hague Convention, a neutral stance was adopted by giving plaintiff the power to choose between two laws under just limited circumstances and enable the defendant the foreseeability safeguard, which would cause the plaintiff to base his claim on the state of principle place of the defendant even though he has no connection with that state (Reese, 1974).

Although the Convention intended to state a balance between parties, the system that was accepted in the convention is criticized for being in favor of defendant. According to this view, particularly the foreseeability clause was criticized in terms of failing to operate equitably (DeMent, 1972). The Hague convention by adopting Article 7 was in direct contradiction to the consumer protection concerns a stance adopted in favor of defendant (Fawcett, 1993). According to this approach, the only regulation that would be evaluated in favor of plaintiff is Article 6[21] of the Convention, which gives the power of election to the plaintiff (Fawcett, 1993). But this article could rarely be applied because of the principle of foreseeability which is used in certain circumstances to deny the application of what would otherwise be the applicable law. Therefore in the application of Articles 4 to 6 plaintiffs, one has to keep in mind the possibility of the application of the other laws which would cause difficulties for him.

When the Hague Convention is carefully examined, it is possible to say that the consumer protection concern had lost its priority, in contrast the trend in the substantive laws of product liability which had been in favor of the consumer in late 1960s. The majority of the nations of the world, which have specific rules on product liability, imposed strict standards of liability upon defendant at the time (Szladitz, 1966). Therefore there is an apparent diversity between the objectives of the substantive and international law rules in product liability in respect of Hague Convention.

One of the reasons for the disapproval of the proposal rules by the Commission was shown to be the notion of choice-of-law rules, which requires being objective and not favoring one part over another (Reese, 1972). This notion which the disapproval of proposal based on criticized for the inconsistency in the law making policies between substantive law and international law. While in substantive laws, it is possible to design protective rules in favor of weak party in certain areas, it is hard to understand why it would be improper for choice of law rules to apply the same policies underlying the substantive field of law (Reese, 1972). Fairness to the parties involved, attaining the uniformity of result and the ease of application are definitely important features for being an acceptable choice of law rule. However being in line with the trend in substantive law also seems like an important criteria, particularly in terms of the integrity of law.

3.2.2 Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Non-Contractual Obligations (Rome II)

Another international regulation on law applicable to international product liability is the "Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Non-Contractual Obligations" (Rome II) (2003/0168 COD). Today, the choice of law rules on product liability differs from one country to another in Europe despite the Hague convention. Due to its excessive complexity, the Hague convention is just in force only in a few EC countries (Graziano, 2005).

The proposal was adopted by the Commission on 22 July 2003 (2003/0168 COD). The European Economic and Social Committee adopted its Opinion on the Commission proposal on 30 June and I July 2004 (OJ C 241, 28.9.2004). In May 2002, the Directorate-General for Justice and Home Affairs of the European

Commission published a "Consultation on a Preliminary Draft Proposal for a Council Regulation on the Law Applicable to Non-Contractual Obligations".

In the Preliminary Draft Proposal for a Council Regulation on the Law Applicable to Non-Contractual Obligations, product liability was handled in Article 5[22]. In the draft), the habitual residence of person directly sustaining the loss which is accepted to be favouring the consumer was adopted as the main connecting factor (with the combination of others. The most criticized part of the draft was the lack of a foreseeability clause in the draft. After the industry organization's and Members of the European Parliament's [23] request to revise the draft thoroughly, the draft had been changed according the stated concerns.

After several varying draft reports promulgated, the actual proposal for Rome II of July 2003 differed substantially from the preliminary draft. In the actual proposal, product liability is regulated in Article 4[24]. According to Article 4 of the Proposal, the applicable law is basically the law of the place in which the person sustaining the damage is habitually resident. But instead of requiring a combination of this connecting factor with others as was in the Draft, the habitual residence of person directly sustaining the loss is accepted as the only and determining connecting factor. So far commission seems like it achieved the objective of protection of costumer. Since consumer would know his habitual residence law or could easily obtain information about the content of this law (Graziano, 2005).

On the other hand, the consumer protection effect of Proposal has some limits. First the standards of consumer protection in the country of consumer's habitual residence would be lower than any other possible applicable laws (Graziano, 2005). At this point, to give a full protection to consumer, to adopt a choice of law rule which gives consumer a choice to specify applicable law between two or more options (Reese, 1972) or to apply the law of the county where the product is acquired (Graziano, 2005) are the alternative rules offered to protect consumer.

The protection of costumer has also been limited by the foreseeability clause of the Proposal. According to Article 4, in order to enable foreseeability for producer, defective product has to be marketed in that country with the consent of the person claimed to be liable. The most important difference between the Draft and Proposal rises in that foreseeability clause. Business groups and academics proposed to include a foreseeability-clause as adopted in Article 7 of the Hague Convention.

When we look at the recent substantive product liability law rules of the Europe which were harmonized in the EC Directive, it is possible to say there is an apparent tendency towards the protection of the consumers. In contrast, this approach has replaced with other concerns the ideas of strike a balance between parties and predictability in international regulations in product liability. Therefore, based on this inconsistency, the sensitivity shown to the social concerns seems forgotten when it comes to international law.

4. Conclusion

Product liability has been an important and popular issue in both substantive and international law regimes. While product liability has been examined for many decades in highly industrialized countries such as the US and European countries, it has also been recently in the legal and political agenda of the developing countries.

Considering the current developments regarding to product liability in substantive laws, it is hard to say that there is a stabilized approach in this field of law. While product liability is often controlled by strict liability today, fault-base liability has returned as a product liability standard again in the US.

The reason behind the dynamism going on for many decades in product liability law has been the conflict between the economic and social concerns. The importance given to these concerns has changed from time to time and county to country depending on the social and political atmosphere of the countries. As well as substantive laws it is also possible to see the clash between these different approaches in international product liability. In identifying the direction of the developments in international product liability law, substantive law background composes significant information.

International product liability has been the issue of an international regulation for the first time in The Hague Convention of 1973. The fallowing regulation is the EC Proposal for the Directive on Product Liability (Rome II). When comparing these regulations with their preliminary drafts, it is obvious that both of them have changed dramatically from the start point. Whereas in the drafts consumer protection concern was at the stake, in final regulations to strike a balance between the parties has shown as the main purpose. The importance given to the adoption of the "foreseeability" clause is the most obvious example showing the protection of the defendant is also the one of the main objectives of the regulations. From this point of view, law making policies underlying these international regulations do not match with the ones regarded in the substantive laws. For instance, while the EC Directive on Product Liability, which regulates the current European substantive rules of product

liability, obviously favours plaintiff by adopting strict liability standard, in international law consumer protection aspect of the product liability seems like to take a back seat. Although it is an unquestionable truth that the product liability is a field of law where many considerations has to be taken into account, consistency between substantive law and international law does not seems to be expecting much, at least in terms of the integrity of law.

Notes:

[1] While some countries apply the tort law regulations to product liability disputes, the others have special regulations for product liability. If a county has a special rule regulating the product liability disputes then these regulations are to be applied to the dispute. However if there is no special rule for product liability the general tort law rule have to be applied in a product liability dispute.
[2] For the increase of case filing in the product liability see. (Moore & Viscusi, 2001).
[3] In Article 4 of Turkish Consumer Protection Act, product liability has been regulated for the first time in Turkish law (O.G. No: 25048, 14 March 2003). In Argentina and Venezuela product liability seems as a new theme (Miller, 1985). Korean product liability regulation was entered into force in 2002 (Lee, 2003).
[4] The advance in technology cause problems as inability to identify the manufacturer of the defective fungible product which caused the consumers injury as required in tort law and lack of fault in the situation of the development risks (Redemann, 1980-1981). It is not possible to held one particular producer liable when these kinds of products injure the consumer. According to this principle, without specifying which producer's product in the market cause the injury, all producers that have a market share in the sector held liable according to their market share in the sector.
[5] Since 1985 a number of states enacted some forms of tort reform in US. For the review of these legislations see. (Priest, 1987).
[6] Sindell v. Abbott Laboratories, 26 Cal. 3d 588, 607 P 2d 924, 163 Cal. Rptr. 132 (1980).
[7] For example while some of the EC members hold producers liable for development risks which is a term used to describe the defects in the product which were not discoverable during manufacturing operations in light of current scientific knowledge); some EC members do not hold producers liable for this kind of risk.
[8] For a research on the effects of the product liability standards to the American economy and industry see. (Moore & Viscusi, 2001).
[9] For the criticism of the effects of strict liability on the pharmaceutical industry in US see. (Worthington, 1995).
[10] Brown v. Superior Court, 44 Cal. 3d. 1049, 751 P 2d. 470, 479.
[11] In 1992 based on the EC Directive, Australian product liability standard has changed to strict liability by the reforms done in the Part VA of The Trade Practices Act 1974 (CTH). For detail see. (Kelam &Arste, 2000-2001).
[12] With the section 2(a) of the Liability for Defective Products Law – 1980 strict liability adopted as a liability standard in product liability law.
[13] (Easton, 1999-2000) Argues that although Japan operates strict liability standard as well as several other countries, differences between these countries legal system bar them from being identical.
[14] In Japan's Product Liability Act 1994 strict liability has been imposed as the product liability standard. For a detailed evaluation see. (Cohen, 1997-1998)
[15] In the Article 6 of the Turkish Directive on Liability from Defective Products, strict liability standard has been imposed in product liability law (O.G. No: 25137, 13 June 2003); for the tendency toward the protection of consumer and the reform legislations in several jurisdictions parallel to this approach see. (Reimann, 2003). In Argentina's product liability law strict liability standard has been applied in product liability (Miller, 1985). Mexican product liability directive also adopted strict liability standard. Ley Federal de Protection al Consumidor D.O. 22 December 1975.
[16] For the criticisms see. (Note, 1971); (Tobin, 1979-1980).
[17] See the Article 135 of Swiss Private International Law Act; Article 63 of the Italian Private International Law; Article 63.
[18] For the comparison and criticism of these solutions see. (Graziano, 2005).
[19] While the rules on jurisdiction contained in several international regulations as EC Brussels Convention (OJ No. L 304, 1968) or Lugano Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters (OJ No. L 319, 25/11/1988), applicable law aspect is less well advanced.

[20] To enable the foreseeability and diminish the harsh results that single contact rule would create coinciding contacts were combined in conflict of law rules. See (Cavers, 1977).
[21] Article 6, provides:
"Where neither of the laws designated in Articles 4 and 5 applies, the applicable law shall be the internal law of the State of the principal place of business of the person claimed to be liable, unless the claimant bases his claim upon the internal law of the State of the place of injury."
[22] Article 5- Product liability provides:
"1.The law applicable to a non contractual obligation arising out of damage caused by a product shall be that of the country in which the person directly sustaining the loss is habitually resident or has his main establishment, if that country is also the country where:
- the person alleged to be liable has his main establishment; or
- the product was purchased."
2. In all other cases, the applicable law shall be that of the country where the tort or delict is committed."
[23] In 31 January 2003 industry organizations and Members of the European Parliaments wrote a letter to the Commission, highlighting the concerns and called for a thorough impact assessment and research before the Commission makes a proposal. For the letter see. http://www.aig.org/r2g/vitorinoletter310103.pdf .
[24] Article 4 – Product liability provides:
"Without prejudice to Article 3(2) and (3), the law applicable to a non-contractual obligation arising out of damage or a risk of damage caused by a defective product shall be that of the country in which the person sustaining the damage is habitually resident, unless the person claimed to be liable can show that the product was marketed in that country without his consent, in which case the applicable law shall be that of the country in which the person claimed to be liable is habitually resident."

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Waiver of a Right to Arbitrate by Resort to Litigation, in the Context of International Commercial Arbitration

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Abstract: This paper examines the circumstances in which a party to an arbitration agreement may be deemed to have waived its right to arbitrate a dispute comprehended by the agreement, by involvement in litigation concerning this dispute. The focus is on the law in common law jurisdictions, particularly Australia and the United States of America. United Kingdom law will also be briefly surveyed. The paper focuses on the 2006 decision of the Australian Federal Court in *Comandate Marine Corp v Pan Australia Shipping Pty Ltd*, which afforded the topic significant treatment. The theoretical bases for sustaining waiver claims are analysed, including waiver as a discrete doctrine, abandonment, estoppel, election, repudiation of contract and variation of contract. The policies that underlie and inform the development of principles for testing waiver submissions are noted.

Key words: waiver, election, estoppel, arbitration

1 Overview

This paper examines the circumstances in which a party to an arbitration agreement may be deemed to have waived their right to arbitrate a dispute comprehended by this agreement, by involvement in litigation concerning this dispute. This involvement may consist of commencing the subject action, or defending against it. The focus will be on the response of courts to this issue in three representative common law jurisdictions, Australia, the United States of America (where there is considerable case law), and the United Kingdom.

In particular, the recent decision of the Australian Federal Court in Australia in Comandate Marine Corp v Pan Australia Shipping Pty Ltd ([2006] FCAFC 192) which afforded the issue significant treatment, will be examined. The decision clarifies the circumstances in which Australian courts will recognise whether a party to an international commercial dispute has by involvement in litigation, waived their right to have the dispute arbitrated pursuant to an arbitration agreement. It is potentially of interest in other jurisdictions. The decision will be considered in some detail, below.

The issue of waiver will usually arise when a party seeks a stay of litigation and a reference of the subject dispute to arbitration. Commonly, the issue arises in the context of international commercial disputes, but in principle the same principles govern cases of alleged waiver in the context of domestic arbitration.

Before discussing the case law, it will be convenient to comment on the concepts of waiver and such related (and often overlapping) concepts as abandonment, election and estoppel. All of these doctrines, if indeed these concepts have attained the status of a doctrine, are potentially relevant to explaining in the jurisprudential sense how it is that a party may be prevented from enforcing their right of arbitration.

2 Waiver, Abandonment, Election and Estoppel – General Principles

It has been commented that (in common law jurisdictions) the term **waiver** is often used imprecisely (see *ACD Tridon v Tridon Australia* [2002] NSWSC 896 at [55]). It has been said that most of the cases which purport to apply the doctrine of waiver are really cases of contract, estoppel or election (see *ACD Tridon*, ibid, citing McHugh J in *Commonwealth v Verwayen* (1990) 170 CLR 394,491). There may not be a unified doctrine of waiver at common law. There are many instances where the general law or statute or a contractual provision may operate to deem a person to have waived a legal right. For example, Article 4 of the UNCITRAL Model Law on

International Commercial Arbitration provides in substance that a party may waive a right accruing under the Law by remaining silent. This waiver which potentially can be raised in litigation at any point along the spectrum from a party's attempt to invoke arbitration, to proceedings involving enforcement of the award. A party may waive performance of a contractual right by another, such as by extending the time for performance. In principle, a waiver would need to be intentional.

The term "waiver" is routinely used in alleged waiver of arbitration cases. When examined it will frequently be found that they are instances of election or estoppel. As it will be noted in **3.2** below, there is some authority for the proposition that an independent principle of waiver exists in this context (as it does in other contexts), independently of the doctrines of election and estoppel. In this primary sense waiver is "constituted by the deliberate, intentional and unequivocal release or abandonment of the right that is later sought to be enforced" (*Zhang v Shanghai Wool and Jute Textile Co Ltd* [2006] VSCA 133, [14]). An instance where a party to an arbitration successfully submitted that the other party had waived the arbitration right is the Victorian case of *La Donna Pty Ltd v Wolford AG* ([2005] VSC 359), where a Supreme Court trial judge held that a party to an arbitration agreement had, by involvement in litigation concerning the dispute comprehended by the arbitration agreement, waved its arbitration right. The decisive act was an application by this party for security for costs. The case will be reviewed in some detail below at **3.2**.

The concept of **abandonment** centres on the unqualified forsaking or abandonment of a legal right or claim, as in this case where a party establishes by extrinsic evidence that a contract purporting to be wholly in writing has in fact been abandoned by conduct of the parties. As in the case of waiver, there may not be a general doctrine of abandonment, as distinct from a plethora of situations where a discrete legal principle or statutory or contractual provision invests abandonment with legal significance. In principle, a waiver would need to be intentional. Typically "waiver" and "abandonment" are used synonymously.

The doctrine of **election** is well recognised in various legal systems including the common law: pursuant to it a party may be required to elect between two mutually inconsistent legal rights each of which has different consequences. An example would be the obligation of a party to a contract in a common law jurisdiction, who when confronted with a breach of condition, must within a reasonable period decide whether to terminate or affirm the contract. The doctrine of election has not commonly been evoked in arbitration waiver cases, but as it will be seen in the analysis of *Comandate Marine Corp v Pan Australia Shipping* (op cit), below at **3**, it was employed in a decision that held that for a party to commence litigation collateral to the dispute comprehended by the arbitration agreement, did not amount to an election to litigate and not to arbitrate.

Various doctrines of **estoppel** are recognised in common law and other legal systems. The common feature of these doctrines is that a party to litigation may be prevented (estopped) by their prior conduct from relying upon a legal right on the basis that to do otherwise would produce an injustice. United States case law dealing with waiver of the right to arbitrate identifies estoppel and prejudice as the core tests for determining a waiver submission. Thus, a party who resisted arbitration with the consequence that the other party fully litigated the subject dispute, was estopped from seeking the post-litigation arbitration of the dispute, on the basis that this would represent a prejudice to the other party (see the discussion of *Menorah Insurance Company Ltd v INX Reinsurance Corporation* (72 F 3d 218 (1st Cir, 1995), below at **4**).

These doctrines or principles overlap – their common feature is that they involve the relinquishing or divestiture of a legal right or claim by a party, which conduct binds the party. The subject conduct may fall within two or more of these categories.

Another possible basis for waiver is that a party has by litigating a dispute that is comprehended by an arbitration agreement, committed breach or anticipatory breach of a core term (a condition) in this agreement, thereby **entitling the other party to rescind**. Caution would need to be exercised in applying this analysis – it could represent a quite low threshold for waiver. In the English decision of *Downing v Al Tameer Establishment* (2002] EWCA Civ 721) the Court of Appeal held that a party had by its conduct repudiated the arbitration agreement, with the consequence that the other party had been entitled to rescind it and to litigate. The first party had by this conduct waived its right to arbitrate.

A further theoretical basis for determining that an arbitration waiver has occurred is contractual – can the parties by litigating be viewed as having **contracted to vary or annul** the arbitration clause or agreement? This analysis was employed in the English decision of *The Elizabeth H* ([1962] 1 Lloyd's Rep 172), where a submission of waiver was made by a party a year and a half after the commencement of litigation by one of the parties. The court considered that the parties had by their conduct agreed to accept the court's jurisdiction and to vary the arbitration clause (ibid at 179).

3 Australian Authority

3.1 *Comandate Marine Corp v Pan Australia Shipping Pty Ltd*

3.1.1 The Course of Litigation

A core issue in the 2006 decision of *Comandate Marine Corp v Pan Australia Shipping Pty Ltd* (op cit) (*Comandate v Pan*) was whether a party to an arbitration agreement had waived its right to have the subject dispute arbitrated, because prior to the commencement of arbitration it had resorted to litigation. Comandate Marine Corp (Comandate Marine) and Pan Australia Shipping (Pan) were parties to a contract for the time charter of a ship, the *Comandate*. Pan had chartered this ship from Comandate Marine. Pan had also chartered a ship, *Boomerang I*, from a third party.

The Comandate Marine - Pan charter included a clause for the arbitration of any disputes arising from the charter, in London. In time, both parties alleged breaches of the charter. Pan commenced *in rem* proceedings against the *Comandate* in the Australian Federal Court, and arrested the ship. Comandate Marine wished to arbitrate the dispute in London. Pan wanted to litigate in Australia. Pan got an order from the Federal Court (an anti-anti-suit injunction) restraining Comandate Marine from instituting anti-suit proceedings in an English court.

Comandate Marine instituted arbitration proceedings in London, and sought a stay of Pan's injunction in the Federal Court. Concurrently it commenced *in rem* proceedings against *Boomerang I*, and had the ship arrested. Its purpose, it later submitted, was to obtain security for the arbitration.

Comandate Marine's application for a stay of Pan's injunction was dismissed by a judge of the Federal court**.** Pan submitted that the injunction should not be lifted, relying on a number of grounds including that Comandate Marine had waived or elected to abandon the London arbitration by its conduct. The other grounds are not relevant for present purposes. On appeal, a Full Court of the Federal Court decided that the primary judge had erred in his conclusion that Comandate had waived or elected to abandon its right to have the matter referred to arbitration, and dissolved the anti-anti-suit injunction with the consequence that Comandate was free to have the matter arbitrated in London.

The trial judge found that Comandate Marine had elected not to arbitrate, by its conduct in commencing *in rem* proceedings against *Boomerang I* without placing on the writ its intention to seek a stay under s29 of the *Admiralty Act* 1988 (Cth) or otherwise indicating on the writ that the action was commenced solely for the purpose of obtaining security for the London arbitration. He also was of the opinion that the conduct of both parties in litigating manifested an intention to abandon the arbitration. Accordingly, the arbitration agreement was either "incapable of being performed" or "inoperative" under s7(5) of the *International Arbitration Act* 1974 (Cth) (ibid at [53]. (This provision mirrors Article 8(1) of the UNCITRAL Model Law on International Commercial Arbitration).

3.1.2 Reasons for Determining that there was Not an Election to Abandon Arbitration

An election must be intentional (although this intention is to be assessed on an objective basis). If there is no intention, then in the normal case there will be no election (except where the law or a contractual or other legal obligation effects a constructive election after the passage of an interval of time, such as a reasonable time).

Prima facie, if indeed the evidence was consistent with *Comandate Marine's* claim that its *in rem* action was for the purpose of obtaining security for the London arbitration, in a situation in which the other party was adverse to arbitration, the action was not inconsistent with an intention to invoke the arbitration clause. There have been many cases where a party that wants to arbitrate, has taken court action to facilitate this arbitration.

The principal judgment of the Full Court was that of Allsop J (with Finkelstein J concurring in respect of all issues, and Finn J concurring with respect to the waiver issue). Allsop J was of the view that there had been no election to repudiate the arbitration agreement.

The resort to litigation was not as a matter of law, per se an election to litigate and not to arbitrate. The selection of a method of dispute resolution was not an election between mutually inconsistent rights (ibid at [62] citing Austin J in *ACD Tridon Inc v Tridon Aust Pty Ltd* [2002] NSWSC 896 at [58]). Rights are only inconsistent if neither may be enjoyed without the extinction of the other (as where a party rescinds a contract for breach of condition at common law – the party no longer has the legal right to affirm). Allsop J noted that

> Here, the filing of the writ did not extinguish the rights under the arbitration agreement; it may or may not have constituted, or formed part of, an inconsistent course of conduct; it may or may not

> have amounted to a breach of contract; but it did not cause or presuppose the extinction of rights under the arbitration agreement (ibid at [62]).

That is, the *in rem* action did not extinguish the other party's legal right to arbitrate (had it been minded to arbitrate). Allsop J noted (ibid) that for there to have been an election, the situation must be one where the "elector has the power to change the legal rights and duties of himself and another with a corresponding liability in that other to submit to the change" (ibid, citing Handley, K, *Estoppel by Conduct and Election*, Sydney, Thomson/Sweet & Maxwell, 2006, at 230-231).

Allsop J considered that on the evidence Comandate Marine had consistently maintained an intention to arbitrate, a position which was inconsistent with an intention to elect otherwise, or to waive or abandon its right to arbitrate. Nine days before arresting *Boomerang I*, Comandate Marine had sought assurances that Pan would submit to arbitration, in default of which it would apply for an anti-suit injunction in the London High Court of Justice (ibid at [68]). Two days before this arrest, Comandate Marine had applied for a stay of Pan's anti-anti-suit injunction in the Federal Court (ibid at [20]). There was noting in the evidence of the communications between the parties "to suggest that Comandate Marine ever evinced an intention to abandon the arbitration… "

> The action against Boomerang I was capable of being prosecuted as a means of obtaining security for the arbitration. The parties had discussed Pan's provision of security and Comandate Marine had obtained orders for maritime attachment in New York plainly for that purpose. A strong, indeed strident, body of communication made plain Comandate Marine's insistence on arbitration (ibid at [91]).

The commencement of the *in rem* action was in the context of a continuing insistence upon arbitration. The filing of this writ did not unequivocally signal abandonment or change in this position: "At most, it can be seen as the making of a tactical move to obtain an advantage in a litigation landscape which was unfolding and which was uncertain". (ibid at [91]; and note the comment at [93] that the litigation landscape was less than clear and that the *in rem* action "can be seen as one designed to advance its position whatever the outcome of the interlocutory debate in this Court").

The failure to endorse the writ with an intention to seek a stay of the anti-anti-suit was not decisive. It was of no more than evidential significance, and did not convert a position consistently maintained (in favour of arbitration) into an abandonment of this position.

The evidence showed that for its part Pan had not in the course of communications disputed the validity of the arbitration agreement (ibid at [77], [86]).

To reiterate – the pivotal test governing the determination of claims of election, waivers or abandonment, is the objective intention of the subject party.

3.1.3 Prejudice - Role of Estoppel

The issue of whether Pan had suffered such prejudice by Comandate Marine's *in rem* action so as to raise an estoppel against the latter was not raised in the case (indeed, Pan had commenced earlier *in rem* proceedings against Comandate Marine). Allsop J noted, however, in an obiter comment that legal proceedings may "be conducted to such a point that the only conclusion is that the party can be taken to have waived or abandoned the right to arbitrate" (ibid at [65]). Consistently with this analysis, even where a party does not make an election between mutually inconsistent rights, it may by its subsequent conduct be estopped from arbitrating the dispute. It follows that what has been broadly characterised as a waiver of the right to arbitrate, may be sourced from an election between inconsistent rights, or an estoppel. In the latter case necessarily, the party pleading waiver will need to demonstrate that it has been prejudiced. The analysis recognises that an estoppel can ground a waiver; but it also by implication recognises that something falling short of an estoppel – such as an operative election (with or without proof of prejudice) will ground a waiver.

3.1.4 The *in rem* Action – Did it by its Nature Preclude Election?

Pan submitted that Comandate Marine had by waived its arbitration right by the commencement of *in rem* proceedings. Technically, the *in rem* proceedings were against the ship, not Pan, and thus this litigation was not one between the two parties to the arbitration agreement. On one analysis, therefore, there was no basis for saying that Comandate Marine had elected not to arbitrate by litigating against Pan.

Given his view that the litigation undertaken did not amount to an election between mutually inconsistent rights, Allsop J considered it to be unnecessary to stress the *in rem* character of the action (although he did make extensive obiter comments on this matter). Even if the action was considered to be one between Pan personally and Comandate Marine, there was no election between mutually inconsistent rights (ibid at [60]). For one party to arbitration agreement to litigate a dispute does not extinguish the other party's right to resort to arbitration.

3.1.4 Consolidating Comandate v Pan

To consolidate this aspect of the judgment in *Comandate v Pan*, Comandate Marine had not intended to elect in favour of litigation nor waived nor abandoned its right to arbitration. The discrete and separate nature of the *in rem* action fortified this conclusion, but it was not a sine qua non of it. The judgment recognises that a waiver may be effected in the absence of a detriment to the party claiming waiver, sufficient to raise an estoppel. Equally, it recognises that an estoppel may ground a waiver, although none operated in the instant fact situation.

3.2 Other Australian Cases

Several other recent Australian decisions, both pre-dating *Comandate v Pan* may be briefly noted.

In the 2005 decision of *La Donna Pty Ltd v Wolford AG* (op cit) the court ruled that the defendant had waived its right to arbitrate after it had participated to some extent in litigation instituted by the other plaintiff in the Supreme Court of Victoria. Both parties had taken interlocutory steps in the proceedings, and participated in court-instigated mediation. The defendant had acquiesced in or agreed to certain court directions. Further, the defendant had sought security for its costs in the litigation, submitting that the plaintiff's financial position justified this. It had not reserved its position when making this application. In the court's view, the application for security was decisive. None of the antecedent acts would have constituted a waiver, but the security application evidenced an intention to see the litigation through to conclusion in the absence of a settlement. This was "an unequivocal abandonment of the alternative course, being an application for a stay and a consequent arbitration" (ibid at 31 [26]). This language is suggestive of the notion of election between mutually inconsistent rights. It contends that a waiver can occur at an early stage in litigation. (Similarly, see the Alberta case of *Millennial Construction Ltd v 1021120 Alberta Ltd* (2005 ABQB 533, [2005] AWLD 2960), which held that once a party had filed its defence to an action, both parties are to be taken to have waived arbitration).

The facts in *La Donna* parallel those in the 2002 decision in *ACD Tridon v Tridon Australia* (op cit). The defendants sought a stay of litigation commenced against them so that the matter could be arbitrated pursuant to an arbitration agreement. They had participated in pre-trial proceedings. The plaintiffs did not plead prejudice (save that which could be remedied by costs), so that the issue of estoppel did not arise. Austin J was of the view that there had been no election between mutually inconsistent rights. Selection of a method of adjudication could not per se amount to such an election (ibid at [58]). The case therefore was to be resolved as one of an alleged waiver – waiver in the sense of

> the abandonment of a right in such a way that the other party is entitled to plead the abandonment by way of confession and avoidance if the right is thereafter asserted, and is either express or implied by conduct. It may sometimes resemble a form of election, and sometimes be based on ordinary principles of estoppel, although unlike estoppel, waiver must always be an intentional act with knowledge (ibid at [58], citing Toohey J in *Commonwealth v Verwayen* (1990) 170 CLR 394, 472, quoting from *Halsbury's Laws of England* 4 ed (1976), vol 16 [1471]).

In the instant case, there had been no "irrevocable abandonment" of the right to arbitration (ibid at [83]). In contrast to the determination in *La Donna*, involvement in early stage litigation by the parties did not preclude reference to arbitration.

Given his determination that no estoppel was raised in this case, and that the defendants did not make an election, Austin J by implication contended for a robust doctrine of waiver which – whatever the limitations on its broader role – is applicable in the context of arbitration waiver. This doctrine was not dependent upon any requirement of an underlying estoppel.

A claim of waiver of arbitration was also rejected in the 2002 Victorian Supreme Court of Appeal in *Zhang v Shanghai Wool and Jute Textile Co Ltd* (op cit). The court reversed the primary judge. The dispute concerned performance of a contract for the purchase of worsted fabric by the Australian appellants (who will be referred to as "Zhang") from the Chinese respondent ("Shanghai"). The contract provided for the arbitration of disputes in China. Zhang wanted the dispute arbitrated. Shanghai wanted to litigate the dispute, and instituted

proceedings in the Victorian County Court. The trial judge determined that Zhang had by its conduct in the litigation, waived its right of arbitration. Among matters seen to be significant, were Zhang's filing of a defence without reserving its position, and Zhang's application for security for costs.

Paralleling *ACD Tridon*, the Court of Appeal (Chernov JA, with whom the other members of the court concurred), considered that there was a discrete doctrine of waiver operating independently of the doctrines of election and estoppel, applicable in this class of case. Waiver requires "the deliberate, intentional and unequivocal release or abandonment of the right that is later sought to be enforced (ibid at [14], citing *Commonwealth v Verwayen*, op cit at 423-424,473,482, and 497). The time when waiver occurs depends on the relationship between the possessor of the right and the party liable to be affected by its exercise.

> When the party possessed of the right knows that a new legal relationship is to be constituted between him and the party whose interests are liable to [be affected] by the exercise of the right and that the right, if exercised, might affect the new relationship, the party possessing that right must enforce the right before the new relationship is constituted or he will be held to have waived that right (Brennan J in *Commonwealth v Verwayen*, ibid at 427, cited in *Zhang*, ibid at [14]).

The court noted that Shanghai was not submitting that Zhang had made a waiver by election between mutually inconsistent rights, and such a submission would be unlikely to prevail "given that a choice between curial and arbitral disposition of the dispute does not seem to constitute an election between inconsistent rights" (ibid at [15]).

There was not a waiver in the sense that Zhang had intentionally and unequivocally abandoned their right of arbitration, and it was not open for the primary judge on the evidence to have concluded otherwise (ibid at [16]). Zhang had consistently pressed for the dispute to be submitted to arbitration, and indeed had submitted it to arbitration in China pursuant to the arbitration clause. The mere filing of a defence did not per se constitute a waiver, especially given that it was filed with a view to identifying the correct contractual parties (in this case, that the agreement was made with one of the appellants and not the other) rather than with a view to proceeding to a full trial on the merits. The claim for security for costs was not pursued and as such was not decisive (ibid at [16] ff) (the question of what the consequences would have been had it been pursued did not need to be resolved).

In summary, *Zhang* recognises a discrete doctrine of waiver as being applicable in the waiver of arbitration context. It does not condition application of this doctrine on proof of prejudice to the party contending for waiver. It recognises that the litigation of the subject dispute can go some distance without necessarily triggering waiver. In particular, it recognises that an application for security for costs is not per se an act of waiver.

The Queensland Court of Appeal's decision in the arbitration waiver case of *Australian Granites Ltd v Eisenwerk Hensel Bayreuth GmbH* ([2001] 1 Qd R 461) relied upon election analysis. The dispute between the parties was governed by a clause in the underlying contract providing for the arbitration of disputes through the agency of the International Chamber of Commerce. The appellant Hensel wished to arbitrate. The respondent Australian Granites instigated proceedings in the Supreme Court of Queensland. Hensel filed a defence. The primary judge determined that this was a waiver of the right to arbitrate, a decision reversed on appeal. The Court of Appeal considered that the delivery of a defence did not per se amount to an act of waiver, especially having regard to Hensel's need to avoid imminent default judgment, and to its continuing insistence upon arbitration (ibid at [25]). The court (per Pincus JA) considered that there had been "no unequivocal election" between inconsistent legal rights (ibid).

3.3 Consolidating Australian Authority

Australian authority will ground waiver of a right to arbitrate in circumstances where the dispute has been litigated in whole or part, on a number of alternative grounds, including election, estoppel, and waiver/abandonment as a discrete doctrine. (A given waiver submission may of course be able to be tested by reference to more than one of these analyses.) It follows that Australian case law has not identified a unified waiver doctrine. The courts do not require that the person contending for waiver in every case show that they would suffer a detriment (or at least one not able to be remedied by costs) should a stay of proceedings be granted. On balance, the courts have not seen participation in early stage litigation by a party as constituting waiver. The question of whether the right of arbitration survives mature stage litigation has not been tested, but given the operative waiver grounds identified – including waiver/abandonment and estoppel – it must be doubted that the arbitration right would survive very far into the litigation.

4 United States Authority

There have been a considerable number of US decisions dealing with the question of whether a party who is seeking to invoke an arbitration agreement, has waived their right to arbitration by concurrent or antecedent litigation. They appear to found the waiver on the notion of estoppel – an estoppel described as an equitable estoppel in a Supreme Court of Ohio case, *MRK Technologies Ltd v Accelerated Systems Integration Inc* (2005 WL 23359 (Ohio App 8 Dist), [3], citing *Cleveland Thermal Energy Corp v Cleveland Elec Illuminating Co*, Cuyahoga App No 80312, 2002-Ohio-3904). In this respect the waiver doctrine may be narrower than that identified in Australian case law. Two representative decisions will be examined.

The principles governing the determination of an arbitration waiver claim in the United States are set out in the decision of United States Court of Appeal for the Eleventh Circuit in *Ivax Corp v B Braun of America Inc* (286 F3d 1309 (11th Cir 2002)) (*Ivax v Braun*). The decision dealt with a domestic arbitration issue, but the reasoning is equally applicable to the circumstances of international commercial arbitration. The court stated the test thus:

> In determining whether a party has waived its right to arbitrate, we have established a two-part test. First, we decide if, "under the totality of the circumstances", the party "has acted inconsistently with the arbitration right", and second, we look to see whether, by doing so, that party "has in some way prejudiced the other party" (ibid at 1315-1316, citing *S & H Contractors, Inc v AJ Taft Coal Co,* 906 F2d 1507,1514 (11 Cir 1990)).

The requirement of inconsistency is in substance one that the party who is alleged to have waived its right to arbitrate have acted with an objectively determined intent to arbitrate; and the requirement of prejudice is consistent with a requirement that the circumstances be such as to raise an estoppel against this party.

The case centred on performance of a contract for the sale of a business by Braun to Ivax. The contract provided for the making of contingency payments after settlement by Braun, depending on the business's performance. Provision was made for the arbitration of any dispute concerning these payments. Pursuant to a contractual power, Ivax appointed a firm of accountants, Arthur Anderson (AA) to examine relevant records. Braun subsequently sued AA for breach of a confidentiality agreement between it and AA.

Ivax then sued Braun for breach of contract, in relation to the contingency payments. The court held that Braun had not, by its litigation against AA, waived its right to arbitrate (thereby reversing the district court). Arthur Anderson was not a party to the arbitration agreement. Suing a non-party "cannot express an intent to forego the arbitration of a dispute against Ivax" (ibid at 1316). The rights and liabilities inter se between Braun and AA on the one hand, and Braun and Ivax on the other, were distinct, separate and not inconsistent (see ibid at 1317, citing *Usher Syndicate Ltd v Figgie Int'l, Inc*, 1987 US Dist LEXIS 10340, No 87-1079, Oct 22, 1987 (SD Fla 1987). Braun sued AA to protect its confidential information. This action could not have sabotaged the verification and dispute resolution process because the arbitrator would have unlimited access to it pursuant to the arbitration agreement (ibid at 1319).

This consideration aside, the issue of how far a party proceeds along the litigation path is highly relevant to assessing whether they have manifested an intention to waive or abandon arbitration (ibid, citing *Morewitz v West of Engl Ship Owners Mut Prot & Indem Ass'n* 62 F3d 1356 (11 Cir 1995)).

Because Braun had not acted inconsistently with the arbitration right, it was unnecessary to discuss the prejudice test. The decision parallels that in *Comandate v Pan,* in that the subject litigation was collateral to the matter sought to be arbitrated and could not in itself be inconsistent with the arbitration of this more central dispute.

In the US Court of Appeals for the First Circuit 1995 decision in *Menorah Insurance Company Ltd v INX Reinsurance Corporation* (op cit) the subject dispute had been litigated before the appellant sought to invoke the arbitration clause. Proceedings, that is, had been pursued fully along the litigation pathway, in contrast to the fact situation in *Braun v Ivax.*

Menorah Insurance Co Ltd (Menorah) had entered into certain reinsurance treaties with INX Reinsurance Corp (INX). The parties had agreed in each contract that disputes arising from the contract should be arbitrated. A dispute occurred and Menorah sought arbitration. INX refused, on the grounds that its financial situation precluded it from doing so. Menorah obtained default judgment in an Israeli court and sought to enforce it in Puerto Rico, where INX was domiciled. At this point INX sought to have the dispute arbitrated. A district court held that it had waived its right to arbitrate.

This decision was affirmed on appeal. INX when asked to arbitrate, had explicitly refused. Thereafter, its whole course of conduct constituted an implicit refusal to arbitrate. The first test (of the two-part test noted in the

analysis of *Braun v Ivax*, above) was fulfilled. The prejudice test was also met. INX had delayed for over a year before seeking arbitration, during which time the other party had been compelled to litigate. Menorah had incurred costs thereby and this was sufficient prejudice (ibid at 222, noting that delay per se did not always result in prejudice, as where a party resorts to court to obtain information that would in any event be needed in a contemplated arbitration, and citing *J & S Constr Co, Inc v Travelers Indem Co*, 520 F2d 809 (1st Cir 1975); *Van Ness Townhouses v Mar Indus Co*, 862 F2d 754,759 (9th Cir 1988).

The policy considerations underpinning resort to arbitration justified this conclusion: in "the context of international contracts, the opportunities for increasing the cost, time and complexity of resolving disputes are magnified by the presence of multiple possible fora", and create "the very problems the [New York] Convention sought to avoid (ibid at 223).

To permit a party to arbitrate after litigation had been completed (this case) or after it was well progressed, would be to increase the costs, time taken and complexities of dispute resolution, considerations that commonly motivate parties to enter into agreements for binding arbitration. Moreover, to accede to INX's arguments would produce a regime where a party who suffered an adverse outcome in litigation, or who sensed an adverse verdict during litigation, would be able to resort to the arbitration agreement, compounding delay and expense (ibid at 221, citing *Jones Motor Co v Chauffeurs, Teamsters and Helpers Local Union* No 633, 671 F2d 38,43 (1st Cir), (1982)).

5 United Kingdom Authority

Several representative decisions may be noted. Scottish authority as does some Australian authority, recognises a discrete doctrine of waiver in the arbitration context. The Court of Sessions' 1996 decision in Presslie v Cochrane McGregor Group Ltd ([1996] SC 289) held that parties to a domestic arbitration agreement had not waived their right to arbitration on the basis of their involvement as defendants in litigation concerning the subject dispute. The litigation was in an early stage. The court conceived of "waiver" as connoting "the abandonment of a right which may be express or inferred from the facts and circumstances", to be determined objectively on the evidence (ibid at 3, citing Armia Ltd v Daejan Developments Ltd [1979] SC (HL) 56, 72). A binding waiver did not require proof that the party resisting arbitration had been prejudiced by the litigation. This principle or doctrine of waiver, was then, not dependent upon an estoppel. The same analysis was applied in the later Scottish decision of La Pantofola D'Ora SpA v Bane Leisure Ltd ((2000) SLT 105).

As noted in 2 above, the English Court of Appeal decision in Downing v Al Tameer Establishment [2002] (op cit) resolved a claim of waiver by reference to a repudiation of contract analysis. The parties were involved in a contractual dispute. The contract had an arbitration clause. The claimant had sought arbitration. The defendants refused, claiming that there was no contractual agreement between the parties. The claimant treated this assertion as a repudiation of contract and purported to rescind the contract for breach of condition. The claimant commenced litigation of the dispute, at which point the defendants then sought a stay and a reference to arbitration. The trial judge held that there had been repudiation, but that the claimant had not accepted this repudiation. The Court of Appeal rejected this finding, holding that there had been an unequivocal acceptance of repudiation that had been communicated. Proceedings were not very far advanced. The trial judge had been wrong in not viewing the commencement of litigation by the claimant, in a context in which the defendants had renounced arbitration, as a clear acceptance of their repudiation (ibid at [29]). The court noted, however, that the commencement of litigation per se, in a circumstance where the other party had repudiated, was not always to be viewed as a clear intentional acceptance of repudiation – much would depend on the background of communication between the parties (ibid at [35]).

The case inferentially raises the broader issue of whether the commencement of litigation dealing with the subject dispute, by a party to an arbitration agreement comprehending this dispute, amounts to a repudiation. The overwhelming weight of authority (for example, Comandate v Pan and Zhang v Shanghai Wool) is of course inconsistent with such a principle. To routinely treat the commencement of litigation as repudiation would result in a very low threshold for waiver, were the other party minded to accept it. A party can only be viewed as repudiating if (on an objective view) it intends to repudiate. Perhaps out of caution, US authority does not countenance the repudiation analysis, requiring instead a situation of estoppel. The repudiation analysis has not been canvassed in Australian case law. In principle, however, a waiver submission should be upheld in the case where a party has repudiated the agreement (whether the repudiation takes the form of commencement of litigation or otherwise), and the other party has accepted this repudiation. In respect both of repudiation and acceptance, both parties must on the evidence be shown to have acted with the clear and unequivocal intention to repudiate and to accept repudiation, respectively.

As noted in 2 above, English case law has also employed another contractual analysis to test a submission of waiver, pursuant to which a waiver issue can be resolved by asking whether the parties have entered into a contract varying (or by parallel reasoning annulling) the arbitration agreement, in favour of litigation: the Elizabeth H ([1962] 1 Lloyd's Rep 172, op cit).

These decisions reflect the same eclectic approach to waiver of arbitration questions in the United Kingdom as is encountered in Australian case law. That is, there is no one unified doctrine operating to test waiver claims. In these decisions waiver submissions were tested by reference to waiver/abandonment as a discrete doctrine (the preferred Scottish analysis), and contractual analyses.

6 Conclusion

What principles govern arbitration waiver, and what principles ought to govern resolution of the issue?

United States authority is straightforward – waiver of the right to arbitrate ultimately is grounded on the doctrine of estoppel. There must be conduct inconsistent with the arbitration right, viz, an objective intention to waive, but this alone is insufficient. There must as well be proof that the party pleading waiver has suffered prejudice as a result of the litigation.

Australian (and UK) authority is more eclectic, in recognising a number of independent grounds for waiver. Australian case law in theory at least, sets the threshold for an operative waiver somewhat lower, in that it does not demand proof of detriment sufficient to ground an estoppel. A waiver may be able to be sourced from several different (if sometimes overlapping) principles or doctrines. The first is **waiver** per se, a concept that appears to be synonymous with the notion of abandonment. According to *ACD Tridon v Tridon Australia* and certain other decisions, waiver/abandonment functions as a discrete doctrine grounding a right of waiver, and is not dependent on proof that the party pleading waiver suffered prejudice. The second is the doctrine of **election.** Again, there is no reason to think that the party contending for an election not to arbitrate must be shown to have suffered a detriment. In the case of waiver/abandonment, and election, the party alleged to have so acted must have had the objective intention of relinquishing the right of arbitration.

Comandate v Pan offers a useful reminder that the alleged election must be scrutinised closely. An election between litigation and arbitration is not one between mutually inconsistent legal rights, and will not in itself ground a waiver. *Comandate v Pan* is authority that merely to commence litigation, or to engage in collateral litigation, will not per se amount to a waiver or abandonment. To the extent that the decision in *La Donna v Wolford* was inconsistent with *Comandate v Pan*, the latter is to be preferred.

Clearly, **estoppel** will also ground a waiver of the right to arbitrate. This was recognised in the obiter comment in *Comandate v Pan* that notwithstanding that the commencement of litigation had not amounted to an election to litigate, if the party pleading non-waiver were to conduct the litigation to a (by implication) mature stage they might properly be viewed as having waived or abandoned the arbitration right. Unlike US authority, however, Australian authority recognises explicitly (for example, *ACD Tridon*) and implicitly (for example, *Comandate v Pan* and *La Donna v Wolford*) that waiver may be effected in the absence of prejudice sufficient to raise an estoppel.

In all of these cases, the real question is – at what point in court proceedings is the conclusion to be drawn that the subject party is to be deemed to have waived their arbitration right? Different tests have been propounded in case law, but are there any practical differences in their application? In practice there may not be any substantive differences.

It is submitted that both Australian and United States law, or at least the courts applying this law, in practice permit a party to participate in the early stages of litigation without losing their right of arbitration. United Kingdom case law is similar in this respect. It follows that the courts are cautious in too readily arriving at a waiver finding. (The Victorian decision of *La Donna* represents an exception to this approach.) On the other hand, it is likely that in both countries waiver will readily be inferred, when the parties have gone beyond the preliminary stages. When the party contending for waiver has suffered a detriment because of time and or costs, US authority will ground an estoppel against the party seeking a reference to arbitration. There is no reason to think that Australian authority is any different. Australian authority does not require proof of estoppel. On the other hand, significantly, it does not preclude application of estoppel doctrine, as *Comandate v Pan* confirmed. Likewise, where the matter is analysed in the alternative in waiver terms, the more mature the litigation the more readily it would be inferred that the party claiming right of arbitration, has by clear and unequivocal conduct, abandoned this right. There is little authority on mature phase waiver, no doubt for the practical reason that when parties participate in litigation to a mature stage neither has any interest in going to arbitration (cf the comments

in *Menorah Insurance Co* on opportunistic resort to an alternative mode of dispute resolution by a party who apprehends or suffers an adverse result in court proceedings).

In summary, there may be little practical difference in the application of waiver doctrine in the common law jurisdictions reviewed.

What principles ought to govern waiver determinations? In answering this question, regard must be had to the underlying policies sought to be served by these principles.

When the parties enter into an agreement to arbitrate, it is reasonable that a presumption in favour of arbitration should be recognised. This is explicitly recognised in the US cases dealing with waiver, although Australian authority is less emphatic (indeed Austin J was of the opinion in *ACD Tridon v Tridon Aust*, op cit, [136] that there was no presumption in favour of arbitration; cf *Australian Granites Ltd v Eisenwerk Hensel Bayreuth*, op cit at [3]). This presumption would favour preservation of the arbitration right further along the litigation spectrum, with a determination of waiver being less readily made. It would (consistently with US case law) lend support for a requirement that a positive determination of waiver should be conditioned by a requirement that real prejudice to the other party be demonstrated, prejudice not remediable in by a costs order.

On the other hand, when parties enter into an arbitration agreement, they are seeking to limit the resolution of the subject dispute to one adjudication in one forum only. To permit a party who has initiated and/or participated in litigation to a substantial extent, to then enforce the arbitration agreement does, as noted, necessarily then leads to involvement in multiple fora. As this is inconsistent with a core consideration underlying the arbitration agreement, its prospect paradoxically may be viewed as rebutting the presumption in favour of arbitration.

It is submitted that the present balance achieved by case law in the several jurisdictions is correct. A waiver of arbitration ought not to be too readily inferred. Participation in the early stage of litigation ought not readily to ground a waiver determination. To the extent that Australian law countenances this (as reflected in *La Donna*) there is something to be said for conditioning waiver with a requirement of detriment in the manner of US authority. On the other hand, the progress of the litigation with the willing participation of both parties to an intermediate or mature stage should ground a waiver. To permit one of them to then shunt the dispute off to arbitration creates obvious potential for detriment to the other party – it exposes this party both to a potential for compounding costs and delays, and to an opportunistic change of forum by a party dissatisfied by the course of litigation. Authority is soundly based in precluding such a tactic. It could only be justified by the theoretical consideration that to abort mature litigation and to then arbitrate the dispute, would be quicker and less expensive than to continue with the litigation. This may be true in some cases, but to preclude abuse a reference to arbitration in this circumstance should be consensual, rather than engineered by waiver.

Finally, where each of the disputants has on the evidence clearly and unequivocally waived their right of arbitration then, whatever analysis is adopted (waiver, abandonment, variation of contract), and whether or not the matter has proceeded some distance along the litigation spectrum, a determination of waiver should be made. The arbitration mechanism was the product of their agreement, and they must have the power to vary or annul this agreement. But, to reiterate, this inference of intention to waive ought not lightly to be drawn.

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Integrating 'Equity' and 'Mediation' into International Commercial Arbitration to make it More Economical and Just

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Abstract. International commercial arbitration has acquired nearly every negative element that it came to rectify. It has now become as costly, protracted and rigid as litigation. By integrating 'equity' and mediation into arbitration, it may be made economical, quicker and just.

1. Introduction

Some legal pundits claim that international commercial arbitration suffer from some of the same problems, which characterizes international commercial litigation, such as rigidity, *excessive cost* and *protractedness.*
Some seventeen years ago, Lord Mustill (1989) expressed his grave concern about numerous problems, other than the ones mentioned above, confronting international commercial arbitration, and the urgent need for effecting necessary reforms. [1] Otherwise he feared it will be overtaken by competitors like mediation. "Arbitration," he said "can and should grasp the opportunities which stand before it (to bring reforms). There is no room for complacency". [2]

It appears that little has been done to correct this malaise. This paper proposes that a step towards reformation and revitalization of international commercial arbitration may consist of integrating and amalgamating into it 'equity' and 'mediation' in order to make international commercial arbitration cost-effective, speedy and just.

2. The Meaning of Equity in the Context of this Paper

'Equity', in the context of this paper, does not mean a body of rules, formulated and administered by the Court of Chancery, to supplement the rules and procedure of the common law. 'Equity' herein refers to the principle which confers on the arbitrator the discretionary power for the liberal construction or application of a contractual obligation, in order to avoid *excessive hardship* and *injustice.*

The 'equity', suggested in the context of this paper, carries a narrower meaning than amiable composition, which confers on the arbitrator broader powers allowing him to apply his own sense of fair play, justice and good conscience. Where parties have empowered the arbitrator to act as amiable compositeur, they have indeed conferred on him a very wide discretionary power. This is not the meaning in this paper. The suggested integration of equity would amount to empowering an arbitrator, in his own right and without being so empowered by the parties, to liberally interpret the contractual obligation of a party to arbitration in situations where strict compliance appears to bring injustice. The suggested 'equity' is contemplated to form part of the law of arbitration. Its meaning is not the same as the expression – amiable composition, and which depends wholly on the permission of the parties. In case of 'equity' suggested here, there is no need of the consent of parties, because it forms an integral part of the law governing arbitration. As in the case of equity in common law, a judge needs no authorization or consent of anyone for applying equity where he thinks fit. Equity is built into law and cannot be detached from it. It provides occasions to interpret the law liberally in situations where liberal interpretation is called for. It may serve to fulfil law and, not to destroy it.

3. Not the 'Equity' Opposed by English Courts

A point worth clarification is that the 'equity' suggested in this paper for arbitration is different from the one opposed by the English courts. The suggested equity carries a restricted meaning wherein an arbitrator is allowed to give a liberal interpretation only to a contractual obligation clause which if literally interpreted and applied may produce unjust and harsh results. English courts, on the other hand, show their opposition to a

situation which "purported to free arbitrators to decide without regard to law and according, for example, to their own notions of what would be fair". [3] The nature of this opposition is explained by Megraw J in the following words:

> "(It) is the policy of the law in this country (U.K) that, in the conduct of arbitrations, arbitrators must in general apply a fixed and recognizable system of law, which primarily and normally would be the law of England, and that they cannot be allowed to supply some different criterion such as the view of the individual arbitrator or umpire *on abstract justice or equitable principles,* which, of course, does not mean 'equity in the legal sense of the word at all'. [4]

In numerous other similar judgments, [5] the English courts have expressed their opposition to "abstract justice" or 'home-made laws', which attempt to replace the whole corpus of the law of the land. [6] Apparently, the resistance and hesitation showed by the English courts against the application of equity in arbitration is due to this possibility of investing a virtually unfettered power of discretion to an arbitrator. However section 46 (1) (b) of the (English) Arbitration Act 1996 now provides that "the arbitral tribunal shall decide the dispute, *if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the (arbitral) tribunal".* This amounts to importing *amiable composition* into the Act without saying so. [7]

4. Case For 'Equity'

Common law has always taken pride in introducing to the world the concept of equity, which confers on law its vitality and enables it to meet the demands of justice.

In the task of defining the scope of 'equity clause', a term used for *amiable composition* or *ex aequo et bono*, English law has not achieved a unanimous verdict. Their interpretations fluctuated [8] until the enactment of the Arbitration Act 1996. Beginning two centuries ago and until recently, some of the English courts were very clear that arbitrators need not apply strictly the law if the latter produced harsh results. [9] Back in 1791, it was held in an English case:

> "(The) arbitrator has greater latitude than the court in order to do complete justice between the parties. For instance, he may relieve against a right which bears hard upon one party, but which having been acquired legally and without fraud, could not be resisted in a Court of Justice". [10]

4.1 French, American and Islamic Approaches

This approach is also found extensively in the Islamic, French and American Legal Systems. *Quranic* emphasis on doing justice (Quran: 4:58) is the basis of *amiable composition* in the Islamic law of *tahkim* (arbitration). [11] Upto 18th century, French law allowed arbitrators to decide in accordance with justice, equity and good conscience. The Code of Civil Procedure 1806, however, subjected the application of *amiable composition* to the consent of the parties. [12] In USA, arbitrators are empowered to apply *amiable composition* by virtue of Title 9: United States Code: Arbitration Act 1947, C 3932 SI, 61 State 669.

> The American courts have repeatedly upheld the validity of liberal construction and laid down the policy that "an arbitration clause in contract, such as charter party, must be given broadest possible interpretation as to subject-matter", [13] and that the "Federal policy is to construe liberally arbitration clause, to find that they cover disputes reasonably contemplated by language, and to resolve doubts in favour of arbitration". [14] And "Courts should not, by hair-splitting decisions, hamstring (arbitration) operation". [15]

In a Report of the International Court of Justice, the contours of "equity" came to be defined in the following words:

> "The justice of which equity is an emanation is not abstract justice but justice according to the rule of law: which is to say that its application should display consistency and a degree of predictability; even though it looks with particularity to the peculiar circumstances in an instant case, it also looks beyond it to principles of more general application. This is precisely why the courts have, from the beginning, elaborated equitable principles as being, at the same times, means to an equitable result in a particular case, yet having a more general validity and hence expressible in general terms". [16]

Equity becomes necessary to ensure justice between the parties, so that one party is not allowed to take advantage at the expense of the other. There is indeed no justice possible without allowing equity to play its part.

4.2 When an 'Equitable' Construction Becomes Necessary?

Sometimes, natural causes beyond the control of humans create undue difficulties for a party to a business contract. In applying the principle of law, equity ought to be allowed to ensure justice. The basis of equity is not intuition taken in the abstract. Equity neither represents the precision of Mathematics or Physics, nor is it a work of fiction, "but creates a link between the law as a letter and life as a phenomenon of nature". [17]

The complexities of contemporary life and commercial transactions may give birth to situations, which if tackled by law alone, may produce unjust results. Such situations may include – a change in the economic condition of a country or party to an extent where a strict performance of a contractual obligation may appear as unduly harsh and unjust; a diligent, though not strict, performance of a contractual obligation; adverse effect on the best interest of a party, of things done in good faith; etc. An arbitrator's authority to apply equity in such circumstances should be recognized, and should not be dependant on the authorisation by the parties. The arbitrators, in their own right, should be allowed to apply equity wherever it appears necessary to do so. This should and could never be interpreted as empowering an arbitrator to select and apply 'any rule' in accordance with his whims and fancies. On the contrary, it simply amounts to empowering him with the discretion to refrain from enforcing a contractual obligation, which if applied blindly, may cause hardship and injustice. [18]

The occasions to do so may indeed be rare and far in between, but empowering an arbitrator to do so would certainly add a new meaning to international commercial arbitration, making it more humane and just. Till now, the world-wide use of *amiable composition* has given no occasions for complaint of either miscarriage of justice or arbitrariness on the part of the arbitrator. This is indeed a verifiable fact if we look at the experiences of all those countries, which have adopted UNCITRAL Model Law. Thus, if the arbitrators are allowed to apply equity in their own right, it may not create any problem. Recognition of *amiable composition* will in fact facilitate the adoption and acceptance of equity.

5. Integrating Mediation into Arbitration

My second suggestion to enhance the efficacy and cost-effectiveness of international commercial arbitration is to integrate mediation into arbitration. It is not Med-Arb that is suggested. Here mediation becomes part and parcel of arbitration. It is with compulsory mediation that the process starts and to be finished in as short a time as possible. Where mediation fails, then it should be left to the parties to avail of arbitration using either the same person who acted as mediator, or a new person to act as arbitrator who must also be empowered to go on trying to bring settlement between the parties during the entire course of arbitral proceedings.

Integration of mediation into arbitration may bring great saving of cost and time, and may also help to keep intact the friendly relationship between the parties. The positive results gained in the US after the enactment of the Federal legislation – Alternative Dispute Resolution Act 1998 (HR 3528) - are well known. In high-value disputes where stakes are very high, no party may like to go straight to arbitration, which is costly, protracted and acrimonious, if an easier speedier and cheaper option like mediation is compulsorily made available. On the basis of success achieved by mediation in settling dispute, it may be safely assumed that a good percentage of disputes may end up in settlement and may never proceed to arbitration.

5.1 Combining Mediation with Arbitration is Widely Recognized

Numerous jurisdictions mention the combination of mediation with arbitration. In Islamic countries, *Ayat* 35 of *Surah Al Nisa* of the *Quran* mentions conciliation *(sulh*) along with arbitration. From this verse it is inferred that the arbitrator has to try reconciliation. This may be made subject to the consent of the parties, as done in the Ottoman Code, but it is not mandatory to do so. Article 1850 of the *Mejelle (Majallah Al-Ahkām-I-Adliyyāh),* the Ottoman Civil Code*)* provides: "Should the parties have authorized the arbitrators….to conciliate then, the agreement of the arbitrators is deemed to be a compromise…which the parties must accept". The role of the arbitrator is to act as the agent of the parties who, instead of negotiating directly, have entrusted this job to their agent in order to obtain a compromise. Article 1851 of the *Mejelle* echoes this when it provides: 'If a third party settles a dispute (put to arbitration) without having been entrusted with this mission by the parties, and if the latter accept his settlement, the award shall be enforced by application of Article 1453" (Art 1453: ratification is

equivalent to agency). There appears a clear leaning in favour of mediation, mainly due to cost factor and the discovery process. In Japan, the use of mediation during the arbitral process is regarded 'as a better way of resolving disputes'. [19] "The Arbitral Tribunal may, at any stage of the arbitration proceedings, mediate between the parties for the whole or a part of the disputes". [20]

The Chinese law of Arbitration (Art 51) firmly encourages combining mediation with arbitration. In CIETAC (China International Economic and Trade Arbitration Commission) arbitrations, "conciliation has been conducted by the CIETAC arbitrators during arbitration proceedings in almost 50% of the cases under their cognizance. The success rate is 40%-50%. So far, no complaint and dissatisfaction can be traced from the parties and their lawyers who have participated in the combined arbitration – conciliation process". [21]

The laws in many other countries including Sri Lanka, India, Singapore, Australia, Canada, the Netherlands, etc. and Rules governing arbitration in South Korea, Germany, Slovenia, Hungary, Croatia, Austria, Switzerland, France, former CMEA countries and Rules of WIPO Mediation, recommends the combination of mediation and arbitration. [22]

5.2 The Nature of Suggested Amalgamation of Mediation and Arbitration

The proceeding must start with mediation. Where parties fail to succeed in mediation, they should be given an option to try mediation again anytime during the arbitration proceedings. The arbitrator should help them in their mediation efforts throughout the arbitration proceedings.

If the parties so wish, they should be allowed to mediate some issues and arbitrate others; or, mediate, then arbitrate some unresolved issues, then return to mediation; or, mediate, if unsuccessful, ask for an "advisory opinion" by the mediator which is binding as an award unless either party vetoes the opinion within a limited period of time. Another med-*arb* variation which is growing in popularity is mediation, if unsuccessful, is followed by a final offer by each side, one or other of which the mediator turned arbitrator must choose. [23]

There could be other models to suggest the form of the possible integration of mediation into arbitration. This is something that may be worked out in detail later on. Either of the parties is given the choice to opt for any out of numerous alternatives, or the choice may be limited to one or two models. Consideration of certainty demands limiting of the choice to a single model.

In an amalgamation of mediation and arbitration, if parties do not wish to accept the same person who acted as mediator to continue acting as arbitrator too, a time limit should be prescribed within which each party should give notice to reject the nomination of this person. A different person may be appointed as arbitrator once the mediation part comes to an end. [24] However, a better option would be to go for the same person, as this may bring in savings in time and cost and the advantage of familiarity with facts. Only in cases where either party has expressed reservations about the neutrality of the mediator, should a different person be brought in to serve as arbitrator.

6. Conclusion

The law often needs the assisting hand of equity and the discretion that accompanies it, to do justice in some cases where strict application of law may cause hardship or even injustice. Terms of a contract formulated to deal with situations existing at a given time may work unfairly where circumstances drastically change. 'Equity' may come handy in such situations to mitigate the severity of contractual obligations. Let arbitrators apply equity in such situations. The long history of the application of equity by the courts shows that its application is not an unfettered discretion. Where parties wish to allow an arbitrator to act as *amiable compositeur,* they may so allow; thereby empowering him to apply his *personal sense of fair play and justice.* It is a very wide discretionary power which the parties may not always wish to give to the arbitrator. What is suggested here is to take out equity from this list of powers because the basis of equity is not pure discretion, as is the case with 'fair play' and 'personal sense of justice.' Inducting it into arbitration will not affect the certainty of the law of arbitration, as may be argued in case of *amiable composition.* Integration of equity into arbitration will help to make it more just and equitable, and will give a humane face to arbitration. It is left to the parties to use the arbitrator's personal discretion and sense of fair play, by allowing him to decide *ex aequo et bono.* By integrating equity into arbitration, it becomes part of arbitration law.

Countries all over the world have embraced mediation, incorporating it into their laws, combining it with arbitration and making it legally possible to do so by enacting laws to this effect. [25]

There is a need to embrace mediation as an integral part of arbitration. Such a move would be part of the reform in arbitration law which is perceptible in every part of the world. Med-arb. is now part of the legal framework in India, Hong Kong SAR of China, Singapore and Sri Lanka and others. It reflects the philosophy of introducing a more simple, and cost effective means of resolving disputes. Section 30(1) of the (Indian) Arbitration and Conciliation Act 1996, for example, says that it is not incompatible with arbitration proceedings for an arbitral tribunal to encourage settlement of the dispute, at any time during the arbitral proceedings. My suggestion is to take a step further and integrate mediation into arbitration.

> According to P.G. Lim, former Director of the Kuala Lumpur Regional Centre for Arbitration:
> "There seems to be a convergence of attitudes in the Asia Pacific region with regard to combining mediation with arbitration in the same dispute. There is a leaning in favour of mediation/conciliation brought about in the main by growing dissatisfaction with arbitration mainly because of the cost factor and the discovery process… the combination of the two procedures (mediation and arbitration) has more advantages than keeping them apart…"[26]

Notes:

[1] See, Michael John Mustill, (1989) "Arbitration: History and Background", Journal of International Arbitration, vol. 6, p. 43 at 55.
[2] Ibid.
[3] Home Insurance Co. and St. Paul Fire and Marine Insurance Co.V. Administration Asigurarilor de stat, 2 Lloyd's L.R. 674 at 677 [1983].
[4] Orian Compania Esponla de Seguros v Belfort Maatschppij voor Algemene Verzekgringeen 2 Lloyd's Rep. 257 at 264 [1962]. David Taylor Son Ltd. V Baruet Trading Co., 1 WLR 563 at 568[1953].
[5] For example, See, David Taylor & Son Ltd v. Barnet Trading Co. 1 WLR 563 at 568 [1953] and Home and Overseas Insurance Co. Ltd V, Mentor Insurance Co. (U.K) Ltd. (in liquidation) 1 WLR 153 [1990].
[6] Czarnikow v. Roth Schwidt & Co., 2 KB 478 [1922].
[7] There is a view that "the reason why term amiable composition or deciding the Case ex acquo et bono is not used is because 'the expressions do not derive from English law or arbitration practice and it was felt inappropriate to incorporate them into the Act'…". Rutherford and Sims, (1996) Arbitration Act 1996: A Practical Guide, para 46.4, cited in Hong-Lin Yu, (2000) "Amiable Composition – A Learning Curve", Journal of International Arbitration, vol. 17(1), 79-98 at 95.
[8] For judicial views expressed against amiable composition, See, for example, Czarnikow v. Roth Schmidt & Co. [1922] 2 K.B. 478; David Taylor & Son Ltd. V. Barnett Trading Co. [1953] 1 W.L.R. 562 at 568; Orion Compania Espanola de Seguros v. Belfort Maatschappij voor Algemene Verzekgringeen 2 Lloyd's Rep. 257[1962]; Home & Overseas Insurance Col. Ltd. V. Mentor Insurance Co. Ltd. [1989] 1 Lloyd's L.R. 473.
[9] See, for example, Knox v Symmonds 1 Ves. Jun 369 = 30 English Reports 390 (1791); Rolland v Cassidy 13 AC 770 (1888); Jager v Tolme and Runge 1 KB 939 [1916]; Board of Trade v Cayzer Irvine & CoAC 610 at 628-629 [1927].
[10] Knox v. Symmonds 30 English Reports, 390 at 391[1791].
[11] See, El-Ahdab, Abdul Hamid, (1999) Arbitration With Arab Countries, 2nd ed p.1 (Kluwer Law International, The Hague).
[12] R.H. Christie, (1992) "Amiable Composition in French and English Law", Arbitration, p. 259At 263.
[13] Fox v. The Giuseppe Mazzine, D.C. N.Y. 110 F. Supp. 212 (1953).
[14] Metro Indus. Painting Corp. v Terminal Const. Co. CA 2 287 F. 2d 382 (1961).
[15] Insurance Agents' Intern. Union A.F. of L.V. Prudential Ins. Co., D.C. Pa 122 F. Supp. 869 (1954). See also, Lundgren v Freeman, C.a. Or. 307 F. 2d. 104 (1962).
[16] (1985) International Court of Justice (ICJ) Report, p. 39 (para 45).
[17] Arbitral award of Judge Manfred Lachs in the arbitration between Guinea v Guinea Bissau, p.124, given in Supra n. 13 at 130.
[18] See, Syed Khalid Rashid, (2005) "Some Contentious Issues In International Commercial Arbitration", 13 International Islamic University Malaysia Law Journal 147 at 159.
[19] Kenji Tashiro, (1995) "Conciliation or Mediation During the Arbitral Process – A Japanese View", Journal of International Arbitration vol. 12 No. 2 at 120
[20] Section 28 of the Rules of the Maritime Arbitration Commission of the Japan Shipping Exchange Inc.
[21] Tang Houzhi, (1996) "Is There an Expanding Culture that Favours Combining Arbitration With Conciliation or other ADR Procedures?", ICCA Seoul Arbitration Conference, p. 101 at 102.

[22] Id at 102-108, where some details of the various enactments and rules could also be found.
[23] David C. Elliott, (1996) "Med-Arb: Fraught With Danger or Ripe withOpportunities", 62 Arbitration, 175 cited in Haig Oghigian, (2002), "Discussion On Arbitrators Acting as ediators", 68 Arbitration, 42
[24] Christian Buhring-Uhle (1996), Arbitration and Mediation in International Business :Designing Procedures for Effective Conflict Management, (Kluwer Law International, The Hague)
[25] See, PG Lim (Ms), (1998) "The Growth and use of Mediation Throughout the World: Recent Developments in Mediation/Conciliation Among Common Law and Non-Common Law Jurisdictions in Asia", 4 Malayan Law Journal, cv.
[26] Id. at cxi

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Recognition & Enforcement of 'Foreign Arbitral Awards' -A Comparative Study

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Abstract. A success, commercial in nature, in a global economy entails creativity and flexibility, which needs to be appearing enthralling in both, the working machinery, and arbitration. International commerce transactions often engross cultural differences, unfamiliar philosophies, differing traditions, and the use of foreign legal systems. These can give rise to complex legal challenges with important commercial consequences. The fast-paced, technology-driven, cross-border world of the twenty-first century makes these challenges ever more demanding. The purpose of this article to discuss the bundle of procedural laws and the judicial response in the respective countries like India and U.S. The Comparative Study involves inspection as well as reflection of International Conventions, respective State Legislations and Judicial Response thereto of Laws relating to Recognition and Enforcement of foreign arbitral awards in India and US.

1. Introduction:

Since last two decades, governments in Asia and other third-world areas have embarked on and initiated bold reforms to liberalise their economies. This has meant larger and keener interaction by local businesses with their counterparts in the industrialised nations for cross-border trade and investment.

The seller, manufacturer, supplier or agent in any part of the world, when dealing with a counterpart outside his country, keeps three issues in mind:

- that both parties perform their respective contractual obligations;
- that no disputes arise between the parties and if they do, with all commercial adjustments, they are amicably resolved; and
- in a worst-case scenario, he/she is able to retain the right to have the dispute determined by a court/tribunal at home, as against in a foreign country.

On the international plane, therefore, nations attempt to project their "investor-friendliness' by enacting local legislation aimed at easing the enforcement of foreign judgments and awards -- impartially, promptly and at a reasonable expense. As a vital emerging market, India has also such legislation in place in comparison to other developed countries like U.S.A. It is the purpose of this article to discuss this bundle of procedural laws and the judicial response in the respective countries.

2. The Enforcement Paradox:

The jurisdiction of an arbitrator is created by the consent of the parties. Unlike a judge, an arbitrator has no recourse to the authority of the state to enforce his award. Unlike a judge, he has no enforcement power available to him. The arbitrator has completed his mission and becomes *functus officio* on the issuance of his award. The enforcement of the award rests in the hands of the successful party.

In many international disputes, there is, however, a point at which the successful party irrespective of whether the matter was arbitrated or litigated is faced with the same problem, i.e. it must go to a foreign jurisdiction to enforce its award or its judgment. This is, of course, the situation where the successful party has a judgment or award but it seeks enforcement, for example, against assets located outside of the state in which the judgment or award was rendered. It is at this point that the enforcement paradox arises. [1] One might well conclude a priori that sovereigns would be more generous in enforcing foreign judgments than they would be in enforcing foreign arbitral awards. [2] Would their common interest in enforcing the judgments of the courts of another state not be greater than their common interest in enforcing awards of arbitrators who have derived their authority from the agreement of private parties and issued their awards outside the framework of a state-created system of dispute resolution?

These questions were resolved in favour of the private non-state system of arbitration by the New York Convention of 1958. That Convention generally speaking makes it far easier to enforce arbitral awards than it is to enforce judgments. Indeed, there is no comparable international convention dealing with the enforcement of foreign judgments.

3. State legislation(s) in India & US:

3.1 Position in India:

Earlier, the Indian law of arbitration was available in the form of three different enactments. They were: the Arbitration Act, 1940, The Arbitration Protocol and Convention Act, 1937 and The Foreign Awards (Recognition and Enforcement) Act, 1961. Thereafter, to consolidate and amend the outdated law relating to domestic arbitration, international commercial arbitration and for enforcement of foreign arbitral awards and for other matters connected therewith or incidental thereto, the Indian parliament adopted the UNCITRAL model law on international commercial arbitration to enact the 1996 Act.

3.1.1 The Arbitration (Protocol And Convention) Act 1937:

The laws in India enforced and legislated are shadow of common law which reflects a greater relevancy to any other law, rule or convention. For the purpose of giving effect to the Arbitration (Protocol) 1923 and enabling the Arbitration (Convention) 1927, the legislature made certain further provisions respecting the law of arbitration in India -The Arbitration (Protocol and Convention) Act 1937. The First schedule reproduced clauses of the Arbitration (Protocol) while the Second Schedule set forth the Arbitration (Convention) on the execution of foreign arbitral awards. Section 2 defined a 'foreign award' for the purposes of this Act to mean: An award on differences relating to matters considered as commercial under the law in force in India[3] made after the 28th day of July, 1924. Further, Section 7 set forth the conditions for enforcement of foreign awards.

3.1.2 The Foreign Awards (Recognition And Enforcement) Act 1961

This legislation was enacted to give effect to the New York Convention 1958, to which India is a party and for purposes connected therewith. In s 2 of the Act it defined a foreign award, unless the context otherwise required, to mean:

An award on differences between persons arising out of legal relationships, whether contractual or not, considered as commercial under the law in force in India, made on or after the 11th day of October, 1960. This definition is *pari materia* with the definition of a foreign award under s. 2 of the Arbitration (Protocol and Convention) Act 1937. Section 7 of this Act sets forth the conditions for enforcement of foreign awards as defined in this Act. The Schedule to this Act reproduced the text of the New York Convention.

3.1.3 The Arbitration And Conciliation Act Of 1996

Part II of the 1996 Act, in chapters I and II deals with the provisions relating to enforcement of foreign awards in India. A foreign arbitration award is consequently enforceable in India under the respective multinational conventions to which India is a party as per the respective details given hereunder:

i) Under Sections 44 to 52 in chapter I, Part II of the 1996 Act, if a foreign award has been made in a country which has ratified the New York Convention of 1958 (contained in the first schedule of the 1996 Act), the award can be enforced in India under the said provisions.

ii) Under Sections 53 to 60 in chapter II, Part II of the 1996 Act, if a foreign award has been made in a country which has ratified the Geneva Protocol (contained in the second schedule of the 1996 Act), or the Geneva Convention of 1927 (contained in third schedule of the 1996 Act), the award can be enforced in India under the said provisions.

Therefore, a foreign award can be enforced in India depending on the multilateral international convention sought to be enforced by the foreign litigant who is a party to the said convention. Section 85 of The 1996 Act, repeals both the abovementioned Acts and provides a composite legislation which contains the provisions of the aforementioned three schedules i.e. The New York Convention in schedule I, Geneva Protocol

in schedule II and Geneva Convention in schedule III. Thus, India continues to be a party to three important international instruments for the recognition and enforcement of foreign arbitral awards.

3.2 Position in the US:

In the United States, the recognition and enforcement of foreign arbitral awards are governed principally by the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "Convention"). [4] The Convention was adopted in 1958 by 26 of the 45 states participating in the United Nations Conference on Commercial Arbitration held in New York.[5] It superseded the Geneva Convention of 1927.[6] The Convention was intended to liberalize procedures for enforcing foreign arbitral awards. For example, the Geneva Convention had placed the burden of proof on the party seeking to enforce a foreign arbitral award, and it did not limit the range of available defences. [7] The Convention shifted the burden of proof to the party opposing enforcement and limited its defenses to those enumerated in the Convention. [8] At present, the Convention has been ratified by over 130 States.[9] The United States, which initially declined to participate in the Convention, acceded to the Convention in 1970.[10] The Convention is incorporated into United States federal law by the Federal Arbitration Act ("FAA").[11]

The 'Domestic' Federal Arbitration Act, 1970:
It is worth briefly mentioning the 'domestic' Federal Arbitration Act, [12] (FAA) which may be invoked in enforcing a foreign award in the United States. The implementing legislation of both the New York Convention[13] and the Panama Convention[14] provides that the 'domestic' FAA will apply to the enforcement of foreign awards under each Convention, except to the extent that the FAA conflicts with the relevant Convention. Section 1 of the FAA extends the Act to the enforcement of awards affecting interstate or "foreign commerce."[15] This means that when an award does not come within either the New York or Panama Conventions (for example, if not made in another contracting state or if not based on a "commercial" transaction) the domestic FAA will often apply. Section 9 of the FAA provides that, within one year after the award is made, any party may apply to court for an order confirming the award, and the court must grant such an order unless the award is vacated, modified or corrected as prescribed in Sections 10 and 11. [16] This section is usually applied to international awards not subject to the New York or Panama Conventions, but it is available as an alternative means of confirming awards that are subject to the Conventions. [17] Section 10 of the FAA provides that a party may apply to have an arbitral award vacated on grounds which are regarded as grounds for refusal for enforcement of foreign Awards. [18]

4. Judicial Responses in India & US:

In the US, in addition to grounds mentioned under section 10 of FAA, it is well settled that a court may vacate an award when the arbitrators 'manifestly disregarded' the law in reaching their decision. [19] The showing required to avoid confirmation of an arbitration award is very high. [20] This limited judicial review reflects the desire to avoid undermining the twin goals of arbitration, namely, settling disputes efficiently and avoiding long and expensive litigation. [21]

The defence of 'manifest disregard' of the law is not a license to review the record of arbitral proceedings for errors of fact or law.[22] In most U.S. jurisdictions, the 'manifest disregard standard' requires a showing either that the arbitrator simply ignored the applicable law, or was aware of the content of governing law, but refused to apply it.

4.1 CRUCIAL QUESTION IN US:

Will the defences of the FAA apply to the New York Convention (and presumably the Panama Convention)? [23]

In the case of *International Standard Electric Corp. v. Bridas Sociedad Anonima Petrolera Industrial Y Comercial*, [24] the court declined to hold that "manifest disregard" of the law was a defence under the New York Convention. [25]

In *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier ("RAKTA"),* [26] overseas attempted to apply the defense of manifest disregard in the international arbitration context. The court held that the facts did not establish the defence and, therefore, the issue of whether the defence was applicable under the New York Convention was avoided.[27] This result was repeated in many cases.[28] It has been

suggested that, in keeping with the pro-enforcement policy of the New York Convention and Congress, Section 208 should be amended or a new section added which clearly states that no defences outside of those enumerated in the Convention are available in a foreign arbitration enforcement proceeding. [29]

4.2 CRUCIAL QUESTIONS IN INDIA:

Whether there should be no two stages for deciding enforceability and execution under section 49 for enforcement of foreign awards?

This aspect is covered by the recent judgment of the Supreme Court in *M/s Fuerst Day Lawson Ltd. v. Jindal Export Ltd.* [30] Therefore, no fresh amendment is necessary. In the same application, both enforceability and execution can now be decided. A problem under section 49 has been raised. Section 49 which refers to enforcement of 'foreign awards' says: "Where the Court is satisfied that the foreign award is enforceable under the chapter, the award shall be deemed to be a decree of that Court".

First, we shall refer to the change in the statutory provisions on this question. We shall then state why, in spite of the change, the suggestion is not feasible. Under section 6 of the Foreign Awards (Recognition and Enforcement) Act, 1961, the Court had to first pass an order directing the filing of the award and the Court had, therefore, to pronounce judgment in accordance with the award and then draw a decree. There were different stages under the 1961 Act. [31]

There is no doubt a clear departure under section 49 of the Act from that procedure. According to Justice Mohta's Commentary, [32] the present section 49 is a departure from section 6 of the 1961 Act.

Whether procedure under section 49 of the new Act is to be altered? The answer can only be in the negative.

In *Western Shipbreaking Corpn. Vs. Clare Haven* [33], it was held by the Gujarat High Court that there was no difference between 'enforcement' and 'execution'. It was said that once the Court declared that the award was enforceable, separate proceedings were to be taken under the CPC for execution. This must obviously be so.
It is well settled that jurisdiction of Indian Court in regard to foreign decrees is to first to find out if the foreign decrees are enforceable. Sub-clause (3) of section 44A of the Civil Procedure Code (CPC) requires the Court to be satisfied that the decree conforms to clauses (a) to (f) of section 13. [34] Foreign awards cannot be placed on a higher footing and they must also pass the test of enforceability as specified in section 48 before they are sought to be enforced or executed. However, enforceability and execution can be dealt with by the court in the same application and two applications are not necessary. [35]

The Bombay High Court in *Tueplas International Aria Pvt. Ltd. vs. Thaper Ispat Ltd*, [36] held that there is a lacuna in the Act inasmuch as if the award does not provide for interest 'after the date of award', the Court cannot grant interest and that this 'lacuna has to be cured by the legislature' or that otherwise rules have to be framed by the High Court under section 82 of the Act.

The Bombay view is not correct. In the case of ordinary suits, section 34 CPC enables the court to provide for interest from the date of judgment till payment. In a case where the Court is silent as to the grant of interest from the date of judgment till date of realization, it is deemed to be refused and the 'commercial contracts', trade usages do have great significance.[37] These principles arising from 'trade usages' are part of the 'lex mercatoria'.

5. The Machinery for Enforcement:

In India, a Foreign Award cannot be enforced in India straightaway. The machinery for enforcement of such awards has been provided under Part II of the Arbitration and Conciliation Act, 1996. Sections 47, 48, 49 cover the entire gamut of enforcement process. If on compliance of the requirements of these provisions the Court is satisfied that the award is enforceable under this Chapter, it will enforce the award as a decree of the Court. First, the successful party seeking enforcement of a ‘foreign award’ is required to apply to the court along with the evidence as set forth in s.47. Then the Court will give notice of the application to the party or parties against whom the award is invoked. If the award is not contested by such party or parties and on examination of the evidence before it, the Court is satisfied under s.49 that the award is enforceable under this chapter, it shall proceed to enforce the award as if it were a ‘decree of the Court’. It is in this context that Section 44 A of the Civil Procedure Code (CPC) lays down the provisions for execution of decrees passed by courts in reciprocating territories and Order XXI of the CPC prescribes the procedural provisions relating to execution of decrees and orders in India.

While, in the US, with respect to the formalities of enforcement, U.S. district courts have original jurisdiction over actions or proceedings falling under the Convention. A party seeking recognition and enforcement is required to produce the authenticated original award or a certified copy, as well as the original arbitration agreement or a certified copy. [38] If these documents are not in English, certified translations are also required. [39]Also, the Convention applies only to "foreign" awards, meaning awards made in countries other than the place of enforcement.

6. Limitations:

In India, Part II of the Act of 1996 does not contain any provision prescribing the time limit for enforcement of an award. In the absence of any provision, the provisions of the Limitation Act 1963 will come into play. [40] In this connection, the Delhi High Court has held that in the absence of any specific provision prescribing time limit, Art.137 will apply. Accordingly, the period of enforcing a foreign award in India will be three years from the date on which it became binding under the law of the Country where it was made. Similarly, in US, enforcement action in the U.S. must be brought within three years of the arbitral award. [41]

7. Grounds for challenging Recognition and Enforcement of Foreign Arbitral Awards:

Enforcement of a foreign award is mandatory except in cases where it may be refused by the Court on any of the ground set forth in s. 48. The grounds for challenging Recognition and Enforcement of Foreign Arbitral Awards in almost all the countries which have accede to the New York Convention, 1958, i.e. India, US are same. They are as follows:

7.1 Incapacity of the Parties: [42]

In India, the first ground contained in s.48 (1) (a) provides that the Court may refuse to enforce a foreign award if the arbitration agreement referred to in s.44 is not valid under the law to which the parties have subjected it. While it is obvious that substantive validity must be determined according to the law chosen by the parties or, in the absence of a choice, by the law of the place of arbitration, different views exist as to the relevant form requirements.[43] The step which comes into play when the law applicable to the arbitration agreement cannot be ascertained is to ask whether the award was valid in the place where it was made-that place, as far as India is concerned, is the place where arbitration has its seat. An arbitration agreement can be invalid under its applicable law either because it is not recognised by that law, or because under that law, there was no agreement between the parties.

In the US, Parties resisting enforcement have attempted to demonstrate the invalidity of arbitration agreements by relying on the reference in Article II of the Convention to an agreement "in writing."[44] No reported U.S. judicial decision has vacated an arbitral award because of either lack of capacity of one or both of the contracting parties or invalidity of the agreement to arbitrate under the applicable law. There have, in fact, been relatively few U.S. decisions [45] concerning the application of Article V (1) (a).

7.1 Party not given Proper Notice or Unable to present its Case: [46]

In India, Procedural fairness is one aspect which seeks the compliance of the rules of natural justice. The most important issue is whether the notice served was timely and appropriate. However, often a more liberal interpretation of national law requirements is needed. Not only must notice of proceeding be proper, but also other notices, such as disclosure of the names of arbitrators must be such that none of the parties are prejudiced.

The Indian courts are concerned to discover whether each party has been treated equally and has been given fair opportunity to present his case. Fair opportunity means that a party should be able not only to present his case but also to rebut the opposite party's case without any hindrances. The key phrase 'otherwise is unable to present his case' is of a residuary nature. It covers various situations, where the party resisting the enforcement of a foreign award, was unable to present his case, for any reason whatever, other than the lack of proper notice, resulting in injustice to him. [47]

In the US, in a leading decision, *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier* ("RAKTA") [48] the court observed: "This provision essentially sanctions the application of the forum

state's standards of due process." The due process guarantee incorporated into Article V(1)(b) requires that "an arbitrator must provide a fundamentally fair hearing," which has been described as "one that meets the minimal requirements of fairness - adequate notice, a hearing on the evidence and an impartial decision by the arbitrator." Hence, as a practical matter, only serious breaches of fairness which actually prevent a party from presenting its case rise to the level required to deny enforcement.

7.1 Arbitration in Excess of Jurisdiction [49]

In India, The first part of this ground for refusal of enforcement under s. 48(1)(c) of Act of the 1996 contemplates a situation in which the complaint is that the arbitral tribunal has acted in excess of its authority, i.e. *ultra petita and* has dealt with a dispute that was not submitted to it. This defence is based on the premise that the arbitral tribunal derives its jurisdiction or competence from the arbitration agreement under which the parties agreed to submit the dispute to arbitration. [50]

The U.S. courts have displayed a reluctance to second-guess arbitrators' exercises of their jurisdiction, holding that the burden of proof required to establish a defence under Article V (1) (c) "is substantial," and that the provision should be construed narrowly. Accordingly, this has been a difficult defence to establish. [51]

7.2 Arbitral Authority and Arbitral Procedure [52]

As far as position in India is concerned the first part of this ground relates to the composition of the arbitration tribunal. The parties are free to choose as to how the arbitral tribunal is to be composed with respect to the number or qualifications of the arbitrators. The second part of this ground rests on the departure from a procedure agreed upon by the parties. The parties are free to choose the procedure governing arbitration proceedings, and, in the absence of such choice, the proceedings are governed by the law of the country where the arbitration takes place-the forum country.[53] Now as far as burden of proof is concerned in case of *Transocean Shipping Agency(P) Ltd v. black Sea Shipping,*[54] the appellants did not furnish proof to the Court that the appointment of the arbitrator or the arbitration procedure followed by the arbitral tribunal was not in accordance with the law of Ukraine. On the other hand, the respondent had filed an affidavit affirming that the award had been made in conformity with the law of Ukraine, and it was binding on the parties under the law of Ukraine. In this fact situation, the Court rejected the objection.

The most important U.S. decision on the question of arbitrator bias is *Commonwealth Coatings Corp. v. Continental Casualty Co*.,[55] which concerned a review of an award under 9 U.S.C. § 10. There, the presiding arbitrator conducted business in Puerto Rico where one of his customers was the respondent in the case. The relationship was sporadic, and there had been no dealings between them for about a year prior to the arbitration. The business connection between the arbitrator and the respondent were unknown to the petitioner and were never revealed by the arbitrator, the respondent, or anyone else until after an award had been made. The petitioner did not charge that the arbitrator was actually guilty of fraud or bias, but challenged the award on Section 10 grounds. The court held that arbitrators should be required to disclose to the parties any dealings that might create an impression of possible bias, but that this would not automatically lead to disqualification. The court noted that "any tribunal permitted by law to try cases and controversies not only must be unbiased but also must avoid even the appearance of bias." Because the tribunal might reasonably have been thought biased against one party and favourable to another, the Supreme Court set aside the award.

7.3 Non- Binding, Suspended and Annulled Awards [56]

The Indian Supreme Court in *Oil and Natural Gas Commission v. Western Co. of North America,*[57] held that under s. 48(1) of this Act, a foreign award will have to be tested on the touchstone of the phrase of not yet become binding on the parties'. It means only that, in the presence of such proceedings, an award may not be treated as binding, not that in their absence it is necessarily binding. An award in some cases may become binding on the mere making of it, and in some cases may become binding only at a later stage.

The award that can be enforced must be an 'arbitral award'. The definition of an arbitral award includes an 'interim award', [58] but it does not include an 'annulled award'. A priori, when an award is set aside by a 'competent authority of the country in which or under the law of which that award was made', its life force is extinguished. It follows that if and to the extent that, the award has been struck down in the local court, it should as a matter of theory and practice, be treated, when enforcement is sought, as if to that extent it did not exist. [59] It is a nullity, and nullity cannot be enforced. [60]

The U.S takes a similar position, like in the case of *Chromalloy Aeroservices v. Arab Republic of Egypt,* [61] The United States District Court took the view that the award was enforceable and if it was a mistake at all, the mistake of the arbitrator was a mistake of law, which was not a ground recognized for setting aside the award under the United States law. Furthermore, the respondents could not rely on the appellate decision of the Supreme Court of Egypt because they had expressly waived the right of appeal and by bringing the appeal, they had repudiated their promise to abide by the result of the arbitration. Irrespective of the position under art V, the United States Court had jurisdiction to grant enforcement in view of the provisions of art VII of the Convention. [62]

7.4 Non-Arbitrarily of Subject Matter of the Dispute [63]

The New York Convention 1958,[64] the model law,[65] and the Indian Act of 1996, all authorize the relevant court to refuse recognition and enforcement of as foreign award ex officio where if finds that 'the subject matter of the difference is not capable of settlement by arbitration under the law of that country'. Each state has its own idiosyncrasies and predictions as to what disputes should be reserved for the courts of law. The concept of arbitrability has expanded considerably in recent decades as consequences of a general policy favouring arbitration, such as the USA, the courts have repeatedly noted this policy. Ultimately they exercise their discretion not to refuse enforcement of awards on ground of non-arbitrability under the law of the USA, if the case has an international element.

7.5 Conflict with Public Policy [66]

In India, in the seminal decision of the Supreme Court in *Renusagar Power Co Ltd v. General Electric Co.,*[67] an ingenious argument was canvassed before the Supreme Court - that by using the phrase 'public policy' in s. 7(1) (b) (ii) of the foreign Awards(Recognition and Enforcement) Act 1961 instead of the words 'public policy of India' as used in the Act of 1937, the parliament had deliberately deviated from the purport of art V (2)(b) of the New York Convention which provides, 'Recognition and Enforcement of arbitral awards may also be refused if the competent authority in the country where recognition and enforcement is sought, finds that the recognition or enforcement of the award would be contrary to the public policy of that Country.

Subsequently, in *ONGC v. SAW Pipes Ltd*, [68] another two judge Bench of the Supreme Court added one more point viz '*patent illegality'* to the three points set forth in the *Renusagar* case for refusing enforcement of a foreign award on the ground that the enforcement would be in conflict with the public policy of India. Consequently, a domestic award may be annulled and enforcement of a foreign award may be refused if such award is contrary to: (i) fundamental policy of Indian law; or (ii) the interest of India; or (iii) justice or morality; or (iv) if it suffers from a *patent illegality*.

In the US, this ground has generated the most discussion and litigation, and often overlaps with there grounds such as Article V (1) (b) (due process), Article V (1) (d) (improper procedure or composition of tribunal), and Article V (2) (a) (non-arbitrability). One of the leading U.S. cases discussing this defence is *Parsons & Whittemore Overseas Co. v. RAKTA*. [69] There, Parsons sought to have the U.S. courts refuse enforcement on the ground that the award was contrary to U.S. public policy. The court reviewed the history of the Convention, noting that "extensive construction of this defence would vitiate the Convention's basic effort to remove pre-existing obstacles to enforcement." The court concluded that the Convention's public policy defence should be construed narrowly and that enforcement of foreign arbitral awards may be denied on this basis only when enforcement would violate the forum state's most basic notions of morality and justice.

7.6 Forum non Conveniens:

In India, the basic principles which the Courts would follow in staying proceedings in India, because of rule of *forum non conveniens* and granting of anti suit injunction restraining the commencement or continuation of foreign proceedings are the same. [70]

The settled position in US is that *forum non conveniens* is a procedural doctrine that applies in domestic arbitration cases under the Federal Arbitration Act, and this rule may also apply to cases under the Convention. [71]

8. Conclusion:

In brief, as the biggest developing country, India has absorbed a huge amount of foreign investment. It really needs to further improve the Indian legal environment for foreign investment, bettering its related measures on the enforcement of foreign awards. Enacting the Arbitration Act, 1996 is a fair and significant way to accelerate mutual benefits between foreign investors and the host country, and to promote the common prosperity of the world. Indeed, the same is the Case with US and UK especially with regard to application of UNCITRAL Model Law of 1985 and the New York Convention of 1958. But the main hindrances arise in application of grounds for refusal of enforcement of foreign arbitral awards *i.e.* the Courts of each country have given different interpretation to these grounds depending upon varying respective socio-economic circumstances. Finally, seven enumerated defences mentioned under Conventions continue to be applied narrowly and in general, courts have resisted allowing defences beyond those specified in Article V, although, in US, arguments based on "procedural" consideration such as forum non conveniens has met with some success, while the most varying interpretation has been given to ground of 'Public Policy'.

Hence, arbitration does not necessarily end with the award. Within the differing domestic legal frameworks, the approaches adopted by individual jurisdiction toward the grounds of opposition under the New York Convention (also provided in Geneva Convention, 1927 and UNCITRAL Model Law of 1985) cannot be the same. It is thus necessary and prudent to go through a checklist of pre-requisites each time when recognition or enforcement of arbitral awards under the New York Convention is sought.

END NOTES:-

[1] See, Reisman et al., International Commercial Arbitration (Foundation Press, 1997), p. 1215:
"It may seem odd that awards--the results of a voluntarily agreed process pronounced by persons having no official judicial standing--should be more readily enforced around the world than judgments. With the exception of intra-European agreements, the international network of treaties for the recognition of foreign judgments is notoriously deficient. Arbitral awards, in contrast, may in principle be enforced practically anywhere in the world under the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The New York Convention has been ratified by some 100 countries (some Latin American countries remain the principal group of remaining holdouts). It makes it obligatory for the courts of signatory States to recognize and enforce foreign awards (irrespective of the nationality of the parties) unless the party opposing enforcement establishes the existence of one of the grounds provided by the Convention."
[2] See, Gary Soo, *International of Foreign Arbitral Awards*, ICCCLR 2000, 11(7), 253-259.
[3] Substituted by Act 3 of 1951, s 3 and Schedule for 'the States'.
[4] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38.
[5] Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier (RAKTA), 508 F.2d 969, 973 (2d Cir. 1974).
[6] *Id.*; Geneva Convention of 1927, 92 League of Nations Treaty Ser. 302.
[7] *Parsons*, 508 F.2d at 973.
[8] *Id.*
[9] The Institute for Transnational Arbitration, Scoreboard of Adherence to Transnational Arbitration Treaties (October 15, 2002)
[10] Parsons, 508 F.2d at 973.
[11] 9 U.S.C. § 201.
[12] 9 U.S.C. §§ 1-16.
[13] 9 U.S.C. § 208.
[14] 9 U.S.C. § 307.
[15] 9 U.S. C. § 1.
[16] 9 U.S.C. § 9.
[17] See *Bergesen v. Joseph Muller Corp*., 710 F.2d 928 (2d Cir. 1983).
[18] See, Art.V, New York Convention, 1958.
[19] *Spector v. Torenberg*, 852 F.Supp. 201, 206 (S.D.N.Y. 1994)
[20] *Id*. at 206, *citing Ottley v. Schwartzberg*, 819 F.2d 373, 376 (2d Cir. 1987).
[21] *Id*.. at 209, *citing Folkways,* 989 F.2d at 111.

[22] *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier* ("RAKTA"), 508 F.2d 969, 975 (2d Cir. 1974).
[23] Robert S. Matlin, *The Federal Courts and the Enforcement of Foreign Arbitral Awards*, 5 PACE L. REV. 151, 178 (1984).
[24] 745 F. Supp. 172 (S.D.N.Y. 1990).
[25] See, *supra* at 20.
[26] 508 F.2d 969 (2d Cir. 1974).
[27] *Id.* at 977.
[28] *York Hannover Holding, A.G. v. American Arbitration Association*, No. 92 Civ. 1643 (CSH), 1993 U.S. Dist. LEXIS 6192, at *11 n. 4 (S.D.N.Y. May 5, 1993). in which then court decided that it was unnecessary to determine whether allegations of bias fell within Article V of the Convention.
[29] Robert S. Matlin, *The Federal Courts and the Enforcement of Foreign Arbitral Awards*, 5 PACE L. RE 215, 179 (1984).
[30] 2001 (3) SCALE p.708
[31] See, s.6, The Foreign Awards (Recognition And Enforcement) Act 1961.
[32] See, JUSTICE MOHTA, COMMENTARY ON THE LAW OF ARBITRATION, p. 332
[33] 1997(3) Guj. LR 1985.
[34] See, para.2.40.7, Chapter 2, *A Report on the Arbitration and Conciliation (Amendment) Bill, 2001*, 176th Report, The Law Commission of India, available at www.lawcommissionofindia.nic.in., accessed on March 12, 2007 at 20:00 hrs.
[35] *M/s Fuerst Day Lawson Ltd. v. Jindal Exports Ltd.*,2001(3) SCALE p.708
[36] AIR 1999 Bom 417: 2000(1) Arb. L.R. 230.
[37] See, para.2.40.8, Chapter 2, *A Report on the Arbitration and Conciliation (Amendment) Bill, 2001*, 176th Report, The Law Commission of India, available at www.lawcommissionofindia.nic.in., accessed on March 12, 2007 at 20:00 hrs.
[38] Convention, Article IV.
[39] *Id.*
[40] *Orient middle East Lines Ltd v. Brace Transport Corp,* AIR 1986 Guj 62.
[41] 9 U.S.C. § 207.
[42] S.48 (1)(a), The Arbitration and Conciliation Act, 1996; Article V (1)(a), The New York Convention, 1958.
[43] *State of Uttar Pradesh v. Kanhaiya Lal Makund Lal Sarraf*, AIR 1956 All 383.
[44] For example, in *Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Def. Sys., Inc.*, 29 F. Supp.2d 1168, 1173-74 the respondent argued that the parties' arbitration agreement was invalid as a result of oral amendments to the arbitration provisions in the parties' contract. The court rejected this challenge to the enforcement action on factual grounds and found that respondent failed to demonstrate that there had been oral amendments.)
[45] For Example, *Buques Centroamericanos, S.A. v. Refinadora Costarricense de Petroleos, S.A.,* No. 87 Civ. 3256 (DNE), 1989 U.S. Dist LEXIS 5429 at * 1 (S.D.N.Y. May 18, 1989). *American Construction Machinery & Equipment Corp. v. Mechanized Construction of Pakistan Ltd.*, 659 F. Supp. 426 (S.D.N.Y.), aff'd, 828 F.2d 117 (2d Cir. 1987).
[46] S.48 (1)(b), The Arbitration and Conciliation Act, 1996; Article V (1)(b), The New York Convention, 1958.
[47] *Renusagar Power Co Ltd v. General Electric Co.*, 1994 Supp (1) SCC 644.
[48] 508 F.2d 969, 975 (2d Cir. 1974).
[49] S.48 (1)(c), The Arbitration and Conciliation Act, 1996; Article V (1)(c), The New York Convention, 1958.
[50] See also *Deutsche Schachbau v. Shell International petroleum Co Ltd,*[1988] 2 All ER 833(HL).
[51] *See, e.g.,* Parsons, 508 F.2d at 976 (party opposing enforcement failed to overcome presumption that arbitrator acted within its powers in awarding $185,000 for loss of production, notwithstanding provision in underlying contract reciting that "neither party shall have any liability for loss of production; court would not engage in "second-guessing the arbitrator's construction of the parties' agreement"); *Fertilizer Corp. of India*, 517 F. Supp. at 958 (in case where arbitrators awarded consequential damages even though they were excluded by the parties' contract, the court refused to vacate the award because "the Convention does not sanction second-guessing," and the arbitrators provided "at least colorable justification" for their result).
[52] S.48 (1)(d), The Arbitration and Conciliation Act, 1996; Article V (1)(d), The New York Convention, 1958.
[53] See, also Dicey and Morris, the conflict of laws, thirteenth edn, 2000, p39, para 16-116.
[54] AIR 1998 SC 707, 711-12, (1998) 2 SCC 281
[55] See, 393 U.S. 145 (1968).

[56] *Refer,* S.48 (1) (e), The Arbitration and Conciliation Act, 1996; Article V (1) (e), The New York Convention, 1958.
[57] AIR 1987 SC 674,684. The Court was dealing with the construction of the phrase in s. 7(a)(v) of the Act of 1996.
[58] *Refer,* The Arbitration and Conciliation Act 1996. S. 2(c)
[59] *Refer,* Mustill and Boyd, *Commercial Arbitration,* companion volume to the second edn, 2001, p.90.
[60] See, *Sunder Das v. Ram parkash* (1977) 2 SCC 662.
[61] 939 F Supp 872 (1996).
[62] *Baker marine (Nig) v. Chevron (Nig*), 191 F 3d 194 (1999).
[63] S.48 (2)(a), The Arbitration and Conciliation Act, 1996; Article V (2)(a), The New York Convention, 1958.
[64] Article V (2) (a)
[65] Article 36 (1) (b) (i)
[66] S.48 (2) (b), The Arbitration and Conciliation Act, 1996; Article V (2) (b), The New York Convention, 1958.
[67] AIR 1994 SC 860,883,888
[68] (2003) 5 SCC 705,709.
[69] 508 F.2d. 969 (2d Cir. 1974).
[70] ONGC v. Western Co. of North America, AIR 1987 SC 674.
[71] Monegasque *de Reassuarances S.A.M. (Monde Re) v. Nak Naftogaz of Ukr.*, 311 F.3d 488, 495 (2d Cir. 2002).

Annex

	INDIA	US
PARTY TO CONVENTIONS (RELATING TO ARBITRATION AWARDS)	1. THE GENEVA CONVENTION OF THE EXECUTION OF FOREIGN ARBITRAL AWARDS, 1927. 2. THE NEW YORK CONVENTION, 1958.	1. THE GENEVA CONVENTION OF THE EXECUTION OF FOREIGN ARBITRAL AWARDS, 1927. 2. THE NEW YORK CONVENTION, 1958. THE PANAMA CONVENTION, 1990
DOMESTIC LAWS ON ARBITRATION	The Arbitration & Conciliation Act, 1996	Federal Arbitration Act, 1970
LIMITATION FOR ENFORCEMENT	3 Years	3 Years
GROUNDS FOR REFUSAL TO ENFORCEMENT OF FOREIGN ARBITRAL AWARDS	1. Incapacity of the Parties. 2. Party not given Proper Notice or Unable to present its Case. 3. Arbitration in Excess of Jurisdiction 4. Arbitral Authority and Arbitral Procedure 5. Non- Binding, Suspended and Annulled Awards 6. Non-Arbitrarily of Subject Matter of the Dispute 7. Conflict with Public Policy Forum non Conviniens	1. Incapacity of the Parties. 2. Party not given Proper Notice or Unable to present its Case. 3. Arbitration in Excess of Jurisdiction 4. Arbitral Authority and Arbitral Procedure 5. Non- Binding, Suspended and Annulled Awards 6. Non-Arbitrarily of Subject Matter of the Dispute 7. Conflict with Public Policy 8. Forum *non Conviniens*

Mediation in an IP context: WIPO or ICC?

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Abstract. The role of mediation in international IP disputes is significant. The paper draws attention to this role and highlights the similarities and differences between two different sets of rules regulating international mediation of IP disputes.

1. Introduction

"Cutting the cake, splitting the baby and compromising somewhere in the middle is not the key objective of mediation, but rather refashioning the structure of the relationship – or of several relationships involved in the dispute – in order to create additional value then available for distribution between the parties" [1]. However, mediation is not yet familiar to most international business executives. The most widely accepted definition of mediation is "a voluntary process in which a neutral third party, who lacks authority to impose a solution, helps participants to reach their own agreement for resolving a dispute" [2].

Mediation is a highly confidential and relatively unstructured and informal procedure in which the participation in the process as well as the acceptance of any outcome depends on the parties' agreement. The main feature of mediation, as opposed to arbitration and court action, is its lack of any means of compulsion [3]. In this respect, sets of rules play a fundamentally limited role in mediation compared to binding arbitration. Mediation as a negotiation process emphasizes the 'interests' and 'needs' of the parties [4] as opposed to their 'rights' and 'obligations'. In mediation more possibilities are available for conflict resolution, particularly with regard to the structuring and framing of the parties' future business relationship [5].

Mediators are expected to do at least three things during the proceedings: assist the parties to find a negotiated solution; sometimes to give an objective opinion on the reasonableness of each party's position privately to each party or openly to all parties; change the frame of reference of the dispute from a zero-sum, "I win, you lose" situation to a positive-sum, "I win, you win" situation [6].

In this paper we compare the operation of the rules established by the two leading institutions on mediation: ICC and WIPO.

2. Mediation of IP disputes

One of the main issues often arising in the context of arbitration is the arbitrability of IP disputes, *ie,* whether IP disputes can be resolved by arbitration. To very few exceptions most IP disputes are arbitrable. There is not, therefore, any doubt that the same disputes can be also resolved by mediation.

However, there are a few IP disputes which are unlikely to be successfully settled by mediation. Given that mediation requires the cooperation of both sides, it is not hard to imagine that such cooperation will not be easily attained in disputes involving deliberate, bad-faith counterfeiting or piracy [7]. As a general rule, however, IP disputes are now being mediated on a regular basis and the trend is growing, encouraged mostly by clients irritated by the costs and delays associated with other dispute resolution methods and frustrated by its inflexible remedies [8].

Another reason is the particular confidential nature of mediation. Arbitration proceedings are usually confidential in the sense that arbitrators and parties are expected to keep all information disclosed in the course of arbitration confidential. Mediation disputes can be confidential in another way. In patent infringement disputes, for instance, parties will reveal their respective information to the mediator , who will try to encourage them to reach a solution without necessarily disclosing to the parties the information he has received. Should this attempt fail, the parties will only then share their respective information so that both of them will eventually derive some gain.

3. A comparison between ICC ADR Rules and WIPO Mediation Rules

Alongside the traditional, well-respected arbitration services the current ICC ADR Rules (2001) offer a framework for the amicable settlement of commercial disputes with the assistance of a neutral. Under the ICC ADR Rules, parties may choose different methods of dispute resolution such as mediation, mini-trial or neutral evaluation of a point of law or fact. Article 5 (2) ICC ADR Rules regards mediation as the default resolution mechanism of the ICC. Decisions made in the process of ADR are not binding upon the parties, unless the parties have otherwise agreed.

The WIPO Arbitration and Mediation Centre established in 1994 has received so far 55 Requests for Mediation in disputes that related exclusively to IP disputes [9]. The success of the WIPO Centre in the field of alternative resolution of IP disputes is attributed to two factors: a) the active involvement of many ADR and IP practitioners and scholars in the creation of the Rules; and b) the fact that the WIPO Centre is the only international provider of specialised IP ADR services [10]. As in the case of the ICC ADR Rules, mediation under the WIPO Mediation Rules is a non-binding procedure. It is therefore interesting to juxtapose and compare the basic provisions of the two sets of rules in order to identify their similarities and differences in the treatment of mediation.

3.1 Types of disputes: domestic and/or international disputes

Both sets of rules apply to international as well as domestic disputes. According to article 1 ICC ADR Rules both domestic and international disputes can be submitted for settlement to the Dispute Resolution Services of the ICC. WIPO Mediation Rules on the other hand do not make any reference to the international character of the dispute. In principle, purely domestic disputes can also be submitted to WIPO

3.2 Conduct of the procedure of mediation

In principle, mediation is a flexible procedure and the rules set by the institutions are not binding. However, the ICC ADR Rules provide that an agreement of the parties modifying them needs to be approved by the ICC. On the other hand, article 9 WIPO Mediation Rules allows the mediator to determine the manner in which the mediation will be conducted without any further interference of the institution.

3.3 Request for mediation: submission and content

Mediation proceedings start with a request for mediation submitted by a party to the ICC and WIPO respectively. There are two main differences at the stage of the submission: first, where there is no prior agreement to refer the mediation to the ICC ADR Rules the ICC informs the other party; second, an assessment of the value of the dispute does not need to be included in a WIPO request.

In all other instances, the party initiating mediation proceedings sends a copy to the other party (article 3 WIPO Mediation Rules and article 2 ICC ADR Rules as long as there is an agreement to refer the mediation to these Rules).

Further, the content of the request varies in ICC mediations depending on whether or not there is an agreement of the parties to refer the mediation to the ICC ADR Rules. In instances where the parties have not already agreed to refer the mediation to the ICC ADR Rules the Request includes the names and contacts of the parties and their representatives, a description of the dispute including an assessment of its value and the registration fee for the ADR proceedings. Where the parties have agreed on a clear reference to the ICC ADR Rules the Request should additionally include the designation of a neutral or the qualifications required for the appointment of a neutral as well as a copy of any written agreement under which the request is made. On the other hand, the WIPO Mediation Rules provide that the Request shall only include the names and contacts of the parties, a copy of the mediation agreement and a brief statement of the nature of the dispute.

3.4 Commencement of the mediation proceedings

In both institutions the receipt of the Request for mediation by the respective centre triggers the commencement of mediation proceedings. Articles 4 and 5 WIPO Mediation Rules, for instance, clearly stipulate that on the day of receipt of the Request, the Centre informs the parties of the receipt of the Request and the commencement of the mediation.

However, the ICC rules distinguish here as well between cases where there is a prior agreement to submit the dispute to these rules and cases where such agreement does not exist. In the former case, the request should include a proposal for the designation of a neutral or the parties will jointly appoint a neutral and notify this to the ICC. In the latter instance, the mediation can start upon the ICC informing the other parties in writing of the Request for ADR and giving 15 days deadline to these parties to agree or decline their participation in the ADR. If they agree to participate, they should designate or agree on a neutral

3.5 Administration fees

Payment of administration fees is a formal, but indispensable requirement for the management of a mediation by the institutions. If payment is not performed, the request is considered withdrawn. The main difference between the two sets of rules is that the WIPO Mediation Centre sends two reminders for the payment of the administration fees before deeming that the request has been withdrawn (article 21 WIPO Mediation Rules and compare to articles 4 (1) seq. in connection with 6 (1) (f) ICC ADR Rules).

The maximum amount of administration fees is currently 10,000 USD. The registration fee is 500 USD less in WIPO (: 1000 USD) compared to the ICC (: 1,500 USD). Further, the mediator's fees are fixed in more precise hourly terms in WIPO mediations as opposed to the ICC which merely refers to a reasonable hourly rate in view of the complexity of the dispute and all other relevant circumstances.

3.6 Appointment and selection of neutral

Appointment of the neutral is by agreement of the parties in both institutions (articles 6 and 7 WIPO & article 3 ICC ADR rules). However, the ICC can appoint the neutral and notify this appointment without any prior consultation with the parties.

Further, both sets of rules provide that the neutral shall be independent. The WIPO Rules require that the neutral should also be impartial.

Finally, the ICC Rules allow the raising of an objection to the notification of the appointment of a neutral (15 days upon receipt of the notification of such an appointment). Such objection is not possible according to the WIPO Mediation Rules.

3.7 Confidentiality

Confidentiality appears to be one of the major attributes of mediation in the field of IP disputes. Confidentiality is a common consideration of both sets of rules, though there exist some differences in the extent of the duty.

The WIPO Mediation Rules provide that mediators are bound to keep confidential all information given to them by the parties and reveal it only if a party expressly authorises them to do so. Such information includes any information given at meetings with the mediator (11 WIPO Mediation Rules), written information and materials that parties regard as confidential (12c WIPO Mediation Rules). The issue of disclosure here refers to the other party to the mediation proceedings. It makes sense, though, to interpret the prohibition of disclosure as addressing third parties as well.

Article 7 (1) ICC ADR Rules, on the other hand, provides that not only the procedure (and most likely the exchange of information during the procedure, see article 7(2) ICC ADR Rules) but also the outcome of the mediation proceedings is kept confidential. The ICC ADR Rules recognise, further, the possibility to disclose such information, namely if it is required by the applicable law or has been agreed by the parties.

More specifically, article 17 WIPO Mediation Rules lists the aspects of the mediation that cannot be adduced as evidence in judicial or arbitral proceedings. This rule corresponds to article 7 (2) (b) – (e) ICC ADR Rules and both provisions read almost identical. The mediation-related information that needs to be kept confidential includes: views and suggestions made by the parties regarding a possible settlement of the dispute, admissions made by the parties during the mediation proceedings, proposals made by the mediator(s), responses of the parties to the settlement proposed by the mediator(s). The only difference appears in 7 (2) (e) ICC ADR Rules as opposed to article 17 (iv) WIPO Mediation Rules where the fact that a party was not willing to accept a proposal of the arbitrator is mentioned. The respective ICC rule refers to the instance where a party merely accepts a proposal for settlement.

Finally, article 16 WIPO Mediation Rules corresponds to article 7 (2) (a) ICC ADR Rules where all documents and materials exchanged or used during the mediation are confidential. The WIPO Mediation Rules

go a step further and they provide that materials should be returned to the party producing them and that all notes taken by the mediator should be destroyed at the end of the mediation.

3.8 Termination of mediation

In both sets of rules (article 18 WIPO Mediation Rules and article 6 ICC ADR Rules) the making of a settlement agreement terminates mediation. Similarly, mediations are terminated also pursuant to the notification by the neutral that the ADR/mediation procedure will not resolve the dispute and/or the notification by one of the parties after the first meeting that they do not wish to continue the proceedings.

Article 6 ICC ADR Rules includes additional grounds for the termination of a mediation, namely: the expiration of any time limit set for the ADR proceedings, the notification of the failure to pay the administration fees and any other amounts due (similar provision is included in 21 WIPO Rules where failure to pay amounts to withdrawal of the Request for mediation) and finally, the failure of the parties to designate or agree on the appointment of a neutral. Such a failure is not provided for, nor is it foreseen in the WIPO Rules.

3.9 Exclusion of liability

Both article 25 WIPO Mediation Rules and article 7 (5) ICC ADR Rules provide for the exclusion of liability of the centres, their employees or the mediators for any act or omissions. The exclusion of liability is absolute in the ICC ADR Rules. In the WIPO Mediation Rules, on the other hand, liability can be excluded as long as there has not been any deliberate conduct on behalf of the employees of the centre or the mediators.

4. Conclusion

The main conclusion that can be drawn from the above comparison is that both sets of rules create a flexible and suitable framework for the mediation of IP disputes. The differences that have been identified between the two systems can have a marginal influence on the decision of the parties to choose one of the two institutions. Having said that, the WIPO Arbitration and Mediation Centre has received since 1994 fifty-five Requests for Mediation in disputes that related exclusively to IP disputes while the ICC has a far less impressive record of IP mediations [11]. This clear preference should not be attributed to the operation or suitability of the rules established by the ICC. It can be rather explained by the specialised focus of WIPO in the area of resolution of IP disputes.

Notes

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[2] Leonard Riskin, *The Special Place of Mediation in Alternative Dispute Processing* in (19) U. Fla. L. Rev.(1985), p. 24.
[3]Vincent Fischer-Zernin and Abbo Junker, *Arbitration and Mediation: Synthesis or Antithesis?* in (5) Jl. Int'l. Arb. (1988), p. 25.
[4]William Ury, Jeanne Brett and Stephen Goldberg, Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict (1988), p. 3; Richard Hill, The theoretical basis of mediation and other forms of ADR: Why they work in (14) Arb. Int'l (1998), p. 174.
[5] Klaus-Peter Berger, Integration of Mediation Elements into Arbitration - 'Hybrid' Procedures and 'Intuitive' Mediation by International Arbitrators in (19) Arb. Int'l (2003), p. 390.
[6] Richard Hill, Non-Adversarial Mediation in (12) Jl. Int'l. Arb. (1995), p.137-138
[7] Guide to WIPO Mediation published by the WIPO Arbitration and Mediation Center, p.6, available at: http://arbiter.wipo.int
[8] For a thorough presentation of IP disputes that have been mediated under the WIPO Mediation Rules see: http://www.wipo.int/amc/en/mediation/case-example.html.
[9] Source: http://www.wipo.int/amc/en/center/caseload.html
[10] Guide to WIPO Mediation published by the WIPO Arbitration and Mediation Center, p.3, available at: http://arbiter.wipo.int
[11] Source: http://www.wipo.int/amc/en/center/caseload.html. ICC-related information provided by Ms Melanie Meilhac.

Towards Privacy-Preserving Data Mining in Law Enforcement

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Abstract. For law enforcement to be effective, it needs to extract previously unknown knowledge from large amounts of different types of data. Data mining is the most compelling tool for this task as it is motivated by successful applications in numerous domains. Therefore, many believe that data mining can significantly improve the execution of law enforcement. However, a severe problem occurs when data mining is applied: many inevitable mistakes result in privacy violations. Recently, we developed a new approach to data mining, called the ROC isometrics approach, which is proven to produce reliable outputs in the sense that we can set the number of mistakes before the data mining is actually applied. In the paper, we determine the implications of the approach to law enforcement and we propose several recommendations for legislations that try to deal with data mining. As a result, we may conclude that the ROC isometrics approach allows for privacy-preserving data mining so that law enforcement becomes more effectively and efficiently than so far.

1. Introduction

Recent advances in information and communication technology have made data easy to use and cheap to store and exchange. Databases across the world contain large amounts of data of various types. We mention digitized text documents, video and audio files, and financial transactions. The so-called data explosion is also apparent in the domain of law enforcement. After new knowledge has been extracted from data, an information position can be established by which a more effective and efficient execution of law enforcement is possible than before. The new form of law enforcement guided by means of data analysis is known as intelligence led policing (Cope, 2004; Tilley, 2005).

It is non-trivial to extract knowledge from data. Yet, many believe that data mining will enable us to obtain new knowledge in a reasonable amount of time, so that law enforcement can be adequately executed on a tactical, strategical, and operational level (Yen & Popp, 2005). Obviously, data mining provides a variety of tools designed to analyze the available data automatically, i.e. by computer. However, we argue that a serious problem arises when data mining is applied in law enforcement: the output of data mining is not reliable in the sense that mistakes are made. These mistakes may have serious consequences, e.g., violations of privacy when personal data are involved. Clearly, the legal consequences of mistakes are severe and therefore not affordable. To make the problem even worse, it is unknown how many mistakes will be made before the data mining is actually applied. Since the output of data mining cannot be shown to be reliable, there is no ground for making legally correct decisions (Groothuis & Svensson, 2000). It follows that it is important to consider the reliability of the data-mining output in legislation.

The remainder of this paper is organized as follows. In Section 2 we discuss the necessity of knowledge in law enforcement and we introduce two types of investigations that we use throughout the paper. In Section 3 we focus on data mining and we comment on the problem of inevitable mistakes. In Section 4 we review a recently introduced approach for data mining, called the ROC isometrics approach, that is proven to produce reliable outputs in the sense that we can set the number of mistakes before the data mining is actually applied (Vanderlooy *et al*., 2006). In Section 5, we use a juridical framework to discuss the implications of the approach. Consequently, we provide several recommendations for upcoming legislations that try to reach a balance between new possibilities of automatic data analysis and the protection of civilians' privacy. In Section 6 we give our conclusions.

2. Knowledge in Law Enforcement

Law-enforcement agencies store large amounts of data that need to be analyzed in order to find previously unknown and relevant knowledge. This knowledge is used to establish and maintain an information position. However, obvious legal questions arise concerning (1) which data may be analyzed, (2) in which situations, and (3) for which goals.

In Subsection 2.1 we show that knowledge is a necessity for law enforcement in order to fulfil its tasks appropriately. In Subsection 2.2 we distinguish two types of investigation by means of data analysis. We provide a systematic comparison of the investigation types, relate them to different law-enforcement tasks, and focus on some legal questions that will naturally arise.

2.1. Necessity of Knowledge

The main task of law enforcement is to secure legal order and to provide assistance to civilians in need (Shavell, 2003; Newburn, 2005). Securing legal order implies two subtasks. First, public safety should be established and maintained to reduce the growing unsafe feelings of civilians. Second, crimes should be tracked down and the offenders should be prosecuted subsequently. Executing the second subtask significantly contributes to executing the first subtask, e.g., terrorism aims at causing fear and disruption, and therefore unravelling upcoming terrorist plots strongly increases public safety.

One of the most important activities of law-enforcement agencies is the investigation of suspicions and clues about persons and events. Investigation can result in the prevention of crime in two distinct ways. First, the suspicions and / or clues are correct and the law-enforcement agency responded sufficiently fast to stop the crime before it has been committed. Second, the investigation did not lead to an early termination of the specific crime, but it resulted in new knowledge that is used to manage activities more efficiently and effectively than was previously possible. The latter is called proactive investigation and assumes that sufficient data is available to be analyzed (Thibault *et al.*, 2006). Analysis has to be done automatically due to the large amounts of data. The obtained knowledge is necessary to establish and maintain a good information position. This is the motivation behind intelligence led policing: a good information position enables law enforcement to prevent crimes and reduce risks of potential dangers (Cope, 2004; Tilley, 2005).

2.2. Investigation by means of Data Analysis

Knowledge extraction by means of automatic data analysis can be performed (1) in various ways, (2) using various types of data, and (3) for various investigation goals. With respect to the investigation goals, we distinguish between investigation aimed to obtain knowledge for solving specific cases and investigation aimed to obtain any knowledge that leads to new investigations or contributes to the execution of current specific investigations. We call the former goal-oriented investigation and the latter global-oriented investigation.

Table 1 summarizes the differences between both types of investigation. A goal-oriented investigation takes place when there are strong suspicions or clues concerning a specific event, person, or small groups of events and / or persons. Hence, this type of investigation has a temporary character. It aims at improving a specific information position and it is clearly most useful on the operational level of law enforcement. An example is the investigation of a murder case. The available data to be analyzed naturally consists out of relevant facts for the specific investigation and therefore disproportional privacy violations are not likely to occur. This is in contrast to the global-oriented investigation where such privacy violations are likely to occur. The global-oriented investigation has a permanent character since it aims at improving and maintaining a general information position. The investigation is not oriented towards a specific case or person, and therefore there are no strong suspicions and clues that can be verified. Consequently, the available data to be analyzed contain facts about persons and events that are not related to known crimes. For example, assume for a moment that the global-oriented investigation resulted in knowledge about an organized network of human smugglers. Persons involved in such networks operate across the borders of nations and take advantage of economic corruptibility and conflicts in certain regions. There are almost no reports about human smuggling filed in law-enforcement agencies due to the secrecy of human smuggling and the intimidation of victims (Dutch Upper Chamber, 2007c). So, specific data is not available and knowledge about human smuggling networks should therefore be extracted by analyzing a wider range of data. Care is nonetheless necessary since the legal question arises whether it is allowed to analyze the data for general law-enforcement purposes. This is a difficult but important question to answer since without global-oriented investigation it is virtually impossible to establish and maintain a good

information position. Finally, we note that the results of a global-oriented investigation can lead to a goal-oriented investigation.

It follows that it is challenging to protect the civilians' privacy right, in particular if a global-oriented investigation takes place. Hence, legislation should find the ideal balance between (1) an effective automatic data analysis and (2) the protection of the privacy of civilians. In the next section we focus on data mining to analyze data and emphasize that the reliability of the data-mining output is most important to consider in legislation.

3. Data Mining

The collection of data and the extraction of new knowledge from data is a significant economic and political activity. The most compelling and promising tools for knowledge extraction are data-mining tools. However, up to now the use of data mining is scarce in the domain of law enforcement.

In Subsection 3.1 we propose a definition of data mining that is suitable for legislation. In Subsection 3.2 we give some applications of data mining and in Subsection 3.3 we analyze why data mining is not used much in the real-life practice of law enforcement.

3.1. Definition

Data mining is an interdisciplinary field mainly consisting of research in applied mathematics and computer science (Han & Kamber, 2006). Various definitions of data mining have been proposed. With respect to legislation it is important to use the most general definition so that (1) unwanted exceptions and backdoors are prevented, and (2) legislation will also apply to future data-mining tools. Brevity and clarity should also be promoted by focussing on the goal of data mining and not on how the data analysis is performed. After all, various data-mining tools often use different analysis methods.

For the aforementioned reasons, we propose to define data mining as follows: "data mining is the analysis of data by automatic means in order to discover previously unknown knowledge in data". The proposed definition is general in the following three ways. First, the data can be of any kind and can be stored in one or more databases in any format of choice. Second, automatic data analysis can be performed in various ways, e.g., by only comparing the data as in a hit / no hit situation or by performing complex mathematical operations on the data. Third, the output of data mining can be anything as long as it provides new insights into executing law enforcement more efficiently and effectively than was previously possible.

3.2. Applications

The number of potential data-mining applications in law enforcement is growing and researchers are publishing empirical results [1]. In this subsection we give a brief review of five interesting applications that cover a wide range of law-enforcement investigations.

First, data mining can be used to analyze cases of armed robberies such that ten times as many links between the cases are found in comparison with a team of human law-enforcement officials (Dahbur & Muscarello, 2003). Useful information to find links includes physical characteristics of victims and offenders, type of weapon used, and location. Second, in a similar vein, data mining can analyze data of crime offenders in order to construct a typical profile of repeated offenders (Blokland *et al*., 2005; De Bruin *et al*., 2006). Useful information here includes marital status, conviction history, and drugs and alcohol addiction. Third, data mining to detect credit card fraud using financial transaction data is gaining interest because a high level of organized crime activity is involved (Kingston *et al*., 2004). Fourth, data mining to reveal links between crimes and offenders has shown to be promising (Goldberg & Wong, 1998; Oatley *et al*., 2004). Fifth, grouping sex offenders that have common characteristics is also an interesting application (Adderley & Musgrove, 2001).

The aforementioned applications illustrate that data mining can be used to find links and patterns in the available data. Investigating these links and patterns results in a better understanding of a group of persons and / or events. In addition to this use of data mining, data mining can be used to construct a classifier. The data to be analyzed then consist of objects and corresponding labels, e.g., objects are persons and the label indicates if the person is a human smuggler or not. The classifier is then a profile used to predict whether persons are human smugglers, e.g., a (completely hypothetical) classifier can be: "If $23 < \text{age} < 27$ and number of prior convictions $= 10$ and involved in prostitution = yes, then human smuggler = yes". We note that data mining to construct classifiers is considered as a further analysis of data mining to find links and patterns.

In the remainder of the paper we focus on data mining to construct classifiers because many applications can be written as problems for which one has to predict labels for objects.

3.3. Problem of Inevitable Mistakes

Despite the numerous data-mining possibilities in law enforcement, almost no data mining is applied in real-life practice (Oskamp & Lauritsen, 2002). We illustrate the main problem by the following example. Assume for a moment that data mining is used to construct a classifier that reveals the profile of persons who are connected to a network of human smugglers. The available data that are analyzed consist of characteristics of persons, their conviction history, and other personal and legal information that is available. The amount of data is high and it is unknown whether persons involved in human smuggling share a well-defined profile.

Data mining will fail due to an inevitable large number of false positives and false negatives. A false positive is a person incorrectly predicted as a human smuggler. A false negative is a person incorrectly predicted as not a human smuggler. Both types of incorrect predictions have undesired legal consequences. The main undesired legal consequences of a false positive are a privacy violation and a waste of limited human and financial resources. An undesired legal consequence of a false negative is not reducing crime and therefore a failure of the law-enforcement task. In addition, the number of false positives and false negatives is not known before the data mining is actually applied. It is thus not possible to obtain a classifier that is reliable in the sense that we can trust its predictions.

In the next section we review a new approach to construct classifiers that guarantee a preset number of incorrect predictions. For example, if we preset that at most five percent of all predictions may be incorrect, then the classifier will produce at least ninety-five percent correct predictions. This implies that we can preset the reliability of the data-mining output in such a way that (1) the number of undesired legal consequences is still acceptable and (2) a more efficient execution of the law-enforcement task is possible (Vanderlooy *et al*., 2006).

4. Privacy-Preserving Data Mining by the ROC Isometrics Approach

A recently introduced data-mining approach, called the ROC isometrics approach, makes it possible to preset the number of incorrect predictions that we allow a classifier to make. Hence, we know the number of false positives and false negatives before the classifier is actually applied. The abbreviation ROC stands for Receiver Operator Characteristic and it refers to a collection of tools that are used in data mining for various purposes. As is the case with most data-mining approaches, the ROC isometrics approach is defined and proven to work by means of mathematics. A definition of ROC isometrics and consequently an in-depth discussion of the ROC isometrics approach are beyond the scope of this paper. Therefore, we illustrate the idea and working of the approach on a conceptual level that is comprehensible for law enforcement officials, legislators, and privacy watchers. We again consider our example of predicting persons as human smugglers or not.

We slightly enhance our idea about classifiers such that they do not predict the label of a person, but they assign a number to each person. This number is called the score of a person and the higher the score is, the more likely it is that the person is a human smuggler [2]. The classifier is applied to eight test persons for whom we want to know whether they are human smugglers. The result of applying the classifier to the eight test persons is given in Table 2. In an ideal setting we have that all test persons who are indeed human smugglers have a higher score than the other test persons. However, this is not the case in our example; and not in real-life applications.

The combination of scores and labels provides us with useful information on how to find incorrect predictions. More specifically, a threshold on the scores is used to predict labels for persons. For example, we can say that persons with a score higher than five are human smugglers. This gives us the result as given in Table 3 which shows that persons P4 and P6 are predicted incorrectly as being a human smuggler and not being a human smuggler, respectively. Note that a different threshold leads to incorrect predictions as well. However, if we construct a classifier that uses two thresholds on the scores, then we can significantly reduce the number of mistakes. In our example we can construct such as a classifier as follows: “if score > 6 then human smuggler = yes and if score < 5 then human smuggler = no”. It follows that we do not make incorrect predictions by refusing to say something about persons P4, P5, and P6. Refusing to say something about persons does not imply that we cannot learn anything about these persons. A refusal to produce output in fact indicates that (1) the amount of data is not sufficient to construct a classifier that is able to predict labels for all persons with a high reliability, and / or (2) the reliability of the available data is questionable, e.g., too many data are left unspecified, some data contradict each other, or some data are simply incorrect. Obviously, in these cases of uncertainty, the output of

data mining cannot be considered as reliable. Therefore, the option to refuse to predict some labels is considered as an advantage of the ROC isometrics approach.

The approach is able to find automatically the thresholds that are needed in such a way that the number of incorrect predictions equals a preset value. Thus if we preset zero incorrect predictions, then the approach will find the classifier in the previous paragraph. If we preset that one incorrect prediction is allowed, then the found classifier will be: "if score > 4 then human smuggler = yes and otherwise human smuggler = no". It is easily verified that this classifier only predicts person P6 incorrectly. Since the number of incorrect predictions is preset, we also preset the number of privacy violations as well as human and financial resources that were lost by chasing dead-ends. Hence, dependent on the necessity of the data-mining application and the societal and legal context, we have to determine the number of mistakes we are willing to allow for a reliable detection of persons involved in human smuggling. We note that the lower the preset number of mistakes is, the more likely it is that the classifier refuses to say something.

5. Juridical Embedding

In the previous section we showed that the ROC isometrics approach allows presetting the reliability of the data-mining output in such a way that (1) the number of mistakes is acceptable and (2) law enforcement is executed efficiently. In this section we determine the implications of the approach to legislation and we discuss these implications with respect to the Dutch Police Data Bill.

The Police Data Bill was received by the Dutch Lower Chamber on October 17, 2005 and is now examined by the Dutch Upper Chamber (Dutch Upper Chamber, 2007a). The goal of the proposed legislation is to allow for automatic and non-automatic data analysis while trying to protect the civilians' privacy. We restrict ourselves to automatic data analysis and consequently to the use of data mining [3].

In Subsection 5.1 we examine how data mining for goal-oriented investigation is regulated and we determine which privacy problems may arise. In Subsection 5.2 we focus on global-oriented investigation and in Subsection 5.3 we provide insights into how new legislations can deal with data mining as best as possible. The insights are accompanied with five recommendations for new legislations that try to deal with automatic data analysis.

5.1. Goal-Oriented Investigation

The use of data mining to maintain the legal order in specific cases is allowed on the basis of article 9 juncto 11 Police Data Bill. The provisions allow goal-oriented investigation by analyzing large amounts of police data for a specific case, even if personal data are involved of persons for whom the exact involvement is not yet known. This is in correspondence with Recommendation R (87) 15 of the Council of Europe which states that there are no limitations concerning the status of the persons involved provided that the purpose of the investigation is served (purpose-binding principle). The data that was analyzed as well as the data-mining result may, after the purpose is served and after approval of an authorized official, be put at disposal for further analysis. Disposal of the data for further analysis occurs when this is believed to be necessary with respect to four goals of which the following two are of interest in this paper: (1) the goal to execute another goal-oriented investigation and (2) the goal to develop insights into the involvement of persons who cause serious threats of the legal order. Article 9 juncto 11 mentions privacy safeguards of which the principle of purpose binding is most convincing. However, this principle alone is not sufficient to prevent privacy violations since the provisions allow personal data to be analyzed and they seem to believe that the result of data mining is mostly correct; otherwise it is unsafe to use the new knowledge in other investigations. However, we argued in Subsection 3.3 that data mining fails due to an unknown number of inevitable mistakes. The ROC isometrics approach is thus needed.

Next to article 9, section 1 of article 8 regulates goal-oriented investigation in order to execute the daily law-enforcement task. The type of data mining that is considered here is rather primitive: data analysis is restricted to a simple search in databases such that a hit / no hit situation occurs. In case of a hit it is allowed to analyze the data further when the data are of a type as defined in the Police Data Decree (in preparation). The proposed hit / no hit situation can be seen as a privacy safeguard.

5.2. Global-Oriented Investigation

Global-oriented investigation by means of data mining for the execution of the daily law-enforcement task is regulated by sections 2 and 3 of article 8 Police Data Bill. The article allows analyzing data for a permanent

execution of the daily law-enforcement task in order to establish a global information position. Data mining may be applied on data one year after registration and this for a maximum of five years. In Subsection 2.2 we argued that the data to be analyzed for a global-oriented investigation typically need to contain facts about persons for whom there are no strong suspicions or clues of involvement in crime. Article 8 acknowledges our argument since no distinction is made with respect to the status of the persons concerned, including non-suspects. The legislator claims that article 8 provides sufficient privacy safeguards because it is in accordance with the principles of the European legal framework, in particular article 8 of the European Convention on Human Rights, the Data Protection Convention, and Recommendation R (87) 15 of the Council of Europe (Council of Europe, 1950; 1981; 1987). These legal instruments provide four principles. The four principles are as follows:

- necessity principle: data analysis should be necessary to execute the law-enforcement task;
- purpose-binding principle: data analysis should occur with respect to the purpose of the investigation;
  proportionality principle: data analysis should be in balance with the possibility of privacy violations;
- subsidiarity principle: data analysis should only be used when less intrusive methods are not effective.

Despite the accordance of article 8 with these principles, it remains that data mining makes mistakes. Without knowing the mistakes it is impossible to judge whether the data-mining output can be used to make legally correct decisions. It follows that the legislator has to consider the reliability of the data-mining output as a major concern in automatic data analysis. Without taking reliability into account there is no legally correct execution of global-oriented investigation, although this type of investigation is necessary to establish and maintain a global information position. The ROC isometrics approach is clearly needed to secure civilians' privacy.

In addition to article 8, article 10 juncto 11 Police Data Bill also regulates data mining for global-oriented investigation. The distinction between articles 8 and 10 is that article 10 emphasizes on analyzing links between crimes and offenders in order to obtain new insights into anything that may be of interest. The provisions allow data mining for any purpose as long as a serious threat of the legal order exists. The Minister of Justice remarks with our consent that analyzing data about persons with no clear connection with the crimes is needed to find the desired links (Dutch Upper Chamber, 2007c). In Subsection 2.2 we already gave the example of unravelling organized networks of human smugglers. Two similar examples are unravelling terrorist plots and tracking down persons located in some region or building using the log data of mobile phone operators. Unfortunately, privacy violations are now far more likely to occur than before. This means that data mining becomes impossible, unless the ROC isometrics approach is used.

5.3. Five Recommendations

Subsections 5.1 and 5.2 show that it is difficult to regulate data mining in such a way that (1) the execution of law enforcement becomes more effectively and efficiently than before, and (2) privacy violations are reduced to a minimum. The ROC isometrics approach makes it possible to preset the number of mistakes and therefore also the number of privacy violations. The approach facilitates the use of data mining and it helps to formulate clear legislation. In addition, and most importantly, the approach enables the safe use of automatic data analysis for global-oriented investigation. This makes it possible to establish a good information position. So, we recommend that the reliability of the data-mining output needs to become an important issue in future legislation.

The number of allowed mistakes should be preset in such a way that the number of privacy violations is in accordance with the principles of necessity, proportionality, and subsidiarity. For example, in case of serious threats of the legal order, we may believe that the number of allowed mistakes becomes higher than usual since law-enforcement officials are eager to have much data-mining output at their disposal. In case of non-serious threats and a low crime rate for a sustained time period, we may assume that securing privacy will become more important. The number of allowed mistakes will therefore become lower than before and consequently the ROC isometrics approach is restricted to produce outputs that are correct with a higher probability. So, we recommend that the reliability of the data-mining output is preset as the result of evaluating the principles of necessity, proportionality, and subsidiarity.

Once privacy-preserving data mining is implemented in law-enforcement practice, it might be necessary to adapt the European and national data protection legislation with a view to the privacy-preserving safeguards provided by the data-mining approach. Therefore, we recommend the data protection working groups within the Council of Europe and the European Union as well as the national legislators to take this into account.

Moreover, we recommend taking notice of the provisions of the Police Data Bill with respect to the sensitivity of data, the availability of data, and the duration of the data analysis. A discussion of these provisions is outside the scope of this paper, although they can clearly serve as an example for other European countries.

Finally, we recommend more interdisciplinary research between the field of law and that of computer science. Only then it is possible to formulate legislation that (1) fits the requirements and possibilities of data mining to improve law enforcement and (2) protects civilians' privacy.

6. Conclusions

To establish and maintain a good information position we argued that goal-oriented investigations and global-oriented investigations need to be performed successfully. Goal-oriented investigations aim to obtain knowledge for solving specific cases and global-oriented investigations aim to obtain any knowledge that improves the information position in general. Due to the large amounts of available data, law-enforcement officials are eager to apply data mining in order to find new knowledge. We gave several example applications of data mining.

Conventional data-mining approaches make inevitable mistakes. These mistakes are unaffordable in law enforcement, e.g., because they may result in privacy violations. The ROC isometrics approach makes it possible to set the number of allowed mistakes before the data mining is actually applied. Hence, we can also preset the number of allowed privacy violations. If this preset number is chosen to be in accordance with the principles of necessity, proportionality, and subsidiarity, then we may conclude that the ROC isometrics approach enables a safe application of data mining in law enforcement. The approach guarantees that we can trust the data-mining output and therefore legally correct decisions are made. This is even the case for the important global-oriented investigations. So, we may conclude that a major achievement is presented towards the use of privacy-preserving data mining.

Finally, we have argued that the ROC isometrics approach cannot be applied in law enforcement without clear legislation that considers the ideal balance between (1) an effective automatic data analysis and (2) the number of legally allowed privacy violations. For this argument we have determined the implications of the data-mining approach to legislation. Here, we may conclude that legislation has to pay much attention to the reliability of the data-mining output. This is currently not the case in the Dutch Police Data Bill that thus falsely claims to provide sufficient privacy safeguards to account for more data-mining possibilities. For a proper treatment of the claim we refer to our five recommendations.

Acknowledgements

The first author is supported by the Dutch Organization for Scientific Research (NWO); the research is part of the ToKeN programme, viz. the IPOL project, grant no. 634.000.435.

Notes

[1] Conferences that publish data-mining applications in law enforcement are JURIX, AAAI Symposium, and industrial tracks of data-mining conferences such as ICDM, KDD, and ACM SIGKDD. Two interesting journals are journal of artificial intelligence and law, and journal of information, law and technology.
[2] Assigning scores to persons instead of labels can be seen as being more careful. The score reflects the degree of what is believed to be true. How a score is computed is technical and beyond the scope of this paper.
[3] The Dutch Police Data Bill does not mention data mining. It uses the term automatically processing data which is defined in article 1 as any act or series of acts with regard to police data. This includes among others gathering, registering, updating, improving, comparing, and joining data. Our notion of data analysis and data mining clearly falls within the broad scope of the definition.

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Appendix

Table 1: a comparison of global-oriented investigation and goal-oriented investigation.

	Goal-Oriented	*Global-Oriented*
Goal	Specific knowledge	General knowledge
Cause	Strong suspicions or clues	No specific cause
Endurance	Temporary	Permanent
Type of Data	Detailed data concerning the specific persons and / or events	Variety of data, possibly concerning persons not related to the obtained knowledge

Table 2: the result of applying the data-mining classifier to eight test persons. The output of the classifier is the score and we ranked persons by their scores. The label of a person is said to be positive if the person is a human smuggler, and negative otherwise. This is analogue to the definition of a false positive and a false negative.

Person	*Score*	*Label*
P1	10	Positive
P2	8	Positive
P3	8	Positive
P4	6	Negative
P5	6	Positive
P6	5	Positive
P7	2	Negative
P8	1	Negative

Table 3: the result of applying a threshold of value five to the eight test persons. Incorrect predictions are given in boldface. Clearly, person P4 is a false positive and person P6 is a false negative.

Person	*Score*	*Label*	*Prediction*
P1	10	Positive	Positive
P2	8	Positive	Positive
P3	8	Positive	Positive
P4	**6**	**Negative**	**Positive**
P5	6	Positive	Positive
P6	**5**	**Positive**	**Negative**
P7	2	Negative	Negative
P8	1	Negative	Negative

Erroneous Execution of Payment Transactions: What Will be New in the Future?

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Abstract. When a payment transaction is executed incorrectly, one has to determine who will be liable for the damages caused by the wrongful execution. Today, binding European legislation relating to the erroneous execution of payment transactions is scarce. Only if a cross-border credit transfer is executed incorrectly specific rules apply. Apart from that, there is only a non-binding Recommendation which is applicable to electronic payment transactions. However, all of this will probably change in the future as the European Commission has proposed a Directive containing a new legal framework for payments in the internal market. This paper will show that the proposed Directive has a scope of application which is broader than both the existing Directive on cross-border credit transfers and the Recommendation on electronic payment instruments. It will also analyse the rules relating to an erroneous execution incorporated in the proposed Directive and evaluate these rules by comparing them with existing legislation.

1. Introduction

In December 2005, the European Commission enacted a Proposal for a Directive on payment services in the internal market (COM (2005) 603 final, 2005/0245 COD). The proposal contains rules on a variety of subjects, including clear rules on the core rights and obligations of payment service users and payment service providers in case of erroneous execution of payment transactions. First, this paper will briefly recall some basic principles of the existing legislation. Secondly, it will discuss the scope of application and the rules on erroneous execution incorporated in the proposed Directive. In a final section the proposed rules will be compared to the existing legislation since this will enable us to evaluate the proposed legislation.

2. The existing legal framework

2.1 Directive 97/5/EC on cross-border credit transfers

2.1.1. Scope of application

The Directive of 27 January 1997 (*OJ.L.* 43, 14 February 1997, p. 25) only applies to cross-border credit transfers *in euro or in the currency of a Member State*, up to the equivalent of 50.000 euro (art. 1). A credit transfer is a transaction carried out on the *initiative of an originator* via an institution with a view to making available an amount of money to a beneficiary at an institution. The originator is the person that orders the making of a credit transfer to a beneficiary. The definitions in the Directive (art. 2) illustrate that it only applies to credit transfers and not to other cross-border payments, such as checks, debit or credit cards (Favre-Bulle, 1998).

To determine whether a credit transfer has a cross-border nature, one has to look at the place where the institution (or the branch) of the originator and the institution (or the branch) of the beneficiary are established. Only when the institutions of the originator and beneficiary are established in different Member States will the Directive apply (art. 2, f). The residence or nationality of the originator or beneficiary is not relevant.

It is clear that the Directive is not applicable to all cross-border credit transfers. It only applies to cross-border credit transfers in the European Union. The originator and beneficiary must hold their account at a financial institution that is established in a different Member State. So, if a client, who holds his account at a Belgian financial institution, instructs his bank to credit the account of a person, holding his account at a bank in the US, the regime incorporated in the Directive is not applicable.

Apart from this, it is not relevant whether the credit transfers are initiated in writing or electronically (art. 2, g) or whether the order is given by a consumer or a professional (art. 2, h).

2.1.2 Late execution

According to article 6 of the Directive on cross-border credit transfers, the originator's institution must ensure that the account of the beneficiary's institution is credited at the end of the time limit agreed with the originator, or in the absence of such agreement, at the end of the fifth banking business day following the date of acceptance of the order. It is the beneficiary's institution that must ensure that the beneficiary's account is credited within the time limit agreed with the beneficiary or, in the absence of such agreement, at the end of the banking business day following the day on which the funds were credited to the beneficiary's institution.

In case of late execution due to the originator's institution or an intermediary institution, the originator's institution must pay interest to the originator. If late execution is due to the beneficiary's institution, the beneficiary's institution must pay interest to the beneficiary.

2.1.3. Defective execution

If the amount of a cross-border credit transfer - which has been accepted by the originator's institution – is not credited to the account of the beneficiary's institution, the originator's institution must credit the originator with the amount of the cross-border credit transfer plus interest and charges relating to the transfer. The amount shall be made available to the originator within fourteen banking business days following the date of the originator's request, unless the funds corresponding to the cross-border credit transfer have in the meantime been credited to the account of the beneficiary's institution (art. 8).

It is clear that the originator's institution must credit the originator's account whether or not it (or an intermediary) has made a mistake. However, it is important to stress that according to the Directive on cross-border credit transfers, the liability of the originator's institution is limited to 12.500 euro (art. 8). If the originator suffers additional damages (for example if the amount of the transfer exceeds 12.500 euro), he can only recover these additional losses based on civil law principles. In such situation, the originator will have to prove that his institution, the beneficiary's institution or an intermediary institution has been negligent. Moreover, when the non-execution of the credit transfer is not due to the originator's institution, the originator will (in most jurisdictions) not have a claim against his own institution. It is obvious that the originator will then find himself in a difficult situation.

Furthermore, it must be emphasized that the originator's bank is not liable in case of *force majeure* (art. 9).

2.2 Recommendation 97/489/EC on electronic payment instruments

2.2.1. Scope of application

The Recommendation of 30 July 1997 (*OJ.L.* 208, 2 August 1997, p. 52) applies whenever a holder obtains an electronic payment instrument from an issuer.

An electronic payment instrument is an instrument enabling its holder to transfer funds, to withdrawal cash and to load an electronic money instrument (art. 1). The term covers both "remote access payment instruments" (e.g. payment cards, phone-, home- and internet banking applications) and "electronic money instruments" (reloadable payment instruments on which value units are stored electronically such as Proton, Mondex and the Geldkarte). The Recommendation does not apply to payments by check (art. 1, 3), nor to credit transfers initiated manually and processed electronically.

The Recommendation protects the holder of an instrument, i.e. every person who holds a payment instrument, pursuant to a contract concluded between him and an issuer (art. 2, f). So, even a professional or a legal person enjoys the protection that is incorporated in the Recommendation.

2.2.2. Erroneous execution

Article 8 of the Recommendation determines that the issuer of an electronic payment instrument is liable for the non-execution or defective execution of a transaction with an electronic payment instrument. The issuer can only escape liability: 1) when the holder has initiated the transaction at a device or terminal or through equipment, which is not authorized for use by the issuer (for example when the holder uses a cellular phone that is not on the list of phones one can use in order to initialise credit transfers), and 2) when the holder has not fulfilled his obligations (for example when the holder has filled in a wrong account number).

In all other cases, the issuer remains liable even when the defective execution is due to *force majeure*. Furthermore, it does not matter whether the issuer himself or a third party (e.g. intermediary financial institution, telecommunication operator) caused the defective execution (Thunis, 1996) or whether or not the terminal is under the issuer's direct or exclusive control (so it is irrelevant whether the holder initiates the transaction on a terminal in the office of the issuer, on a terminal in a shop or on his personal computer) (Favre-Bulle, 1998). The issuer is even liable if the wrongful execution is due to the transmission of the payment order from the personal computer of the holder to the computer of the financial institution.

3. The proposed Directive

3.1 Scope of application

The proposed Directive applies to business activities, listed in the Annex, consisting of the execution of *payment transactions* on behalf of a *natural or legal person*, where at least *one of the payment service providers is located in the Community*.

3.1.1. Scope ratione materiae: payment transactions

The proposed Directive applies to payment transactions consisting in the act of depositing, withdrawing or transferring funds from the payer to the payee. Transfers initiated by the payer (e.g. credit transfer), as well as transfers initiated by the payee (e.g. direct debit) fall under the scope of application of the proposed Directive (art. 2.1).

The proposed Directive will, in principle, apply to payment services made in any currency (art. 2.2). Thus, the proposed regime will even be applicable if the order is given in US Dollar or Japanese Yen.

The rules incorporated in the proposal concerning transparency and information requirements and the rights and obligations in relation to the provision and use of payment services only apply in case the amount of the payment transaction does not exceed 50.000 euro (art. 2). According to the Commission, it is not necessary to apply the proposed regime to transfers exceeding 50.000 euro as payments above this amount are not generally processed in the same way, are often channelled through different networks and are submitted to different technical and legal procedures that should be maintained (consideration nr. 15).

Looking at the definition of a payment transaction (art. 1.1), it is clear that in principle one must not distinguish between orders initiated electronically and orders initiated in writing. However, the proposed Directive does not apply to all transactions that are initiated in writing, as some transactions are excluded explicitly from the scope of the proposed Directive (art. 3). More specifically, it concerns payment transactions based on any of the following documents drawn on the payment service provider with a view to placing funds at the disposal of the payee (art. 3 (f)): Paper cheques in accordance with the Geneva Convention of 19 March 1931 providing for Uniform Law for Cheques, paper cheques similar to those and governed by the law of the Member States which are not a party to the 1931 Geneva Convention, paper-based vouchers (e.g. transactions with a credit card, in which the credit card is not identified electronically and the holder simply is asked to sign a voucher), paper-based traveller cheques and paper-based promissory notes.

3.1.2. Scope ratione personae: the proposed regime protects the payment service user, the payer or the payee

The payment service user is a natural or legal person, who makes use of a payment service in the capacity of either payer or payee (art. 4.6). So if the term "payment service user" is used, the rule aims at protecting the payer as well as the payee. On the contrary, when a provision only concerns one of the parties of the underlying relation, the proposed Directive uses the term "payer" (i.e. the natural or legal person who has the right of disposal of funds and who allows them to be transferred to a payee (art. 4.4)) or "payee" (i.e. the natural or legal person who is intended to be the final recipient of funds which have been the subject of a payment transaction (art. 4.5)). So, the proposed regime basically protects natural persons, as well as legal persons (the rules allocating liability in respect of unauthorised payment transactions are not applicable when the payment service user is an enterprise exceeding the size of a micro enterprise within the meaning of Articles 1 and 2(1) and (3) of Title I of the Annex to Recommendation 2003/361/EC (art. 51.1)).

3.1.3. Scope of application *ratione loci*

The proposed regime does not require that all payment service providers involved in the execution of a payment transaction are located in the Community. It is sufficient that one of the payment service providers is located within the European Union. So if a German payment service user instructs his financial institution, located in Germany, to credit the account of a creditor maintaining his account at a financial institution in the United States, the proposed Directive applies. However, as will be illustrated later, the proposed Directive contains some important exceptions to this basic principle, for example in case of late and defective execution (infra).

Furthermore, the scope of application of the proposed Directive is not limited to cross-border credit transfers, involving financial institutions located in different Member States. Domestic payment transactions taking place within one Member State are also covered by the proposed Directive.

3.2 Late execution of a payment transaction

The proposed Directive contains specific rules relating to the execution time of a payment transaction. First, it is important to emphasize that the section relating to the execution time only applies when the payment service providers of both the payer and the payee are located in the Community. Thus, in order to apply these rules it is not sufficient that one of the payment service providers is located in the European Union. Moreover, the section is not applicable to payment transactions that are considered micro payments (art. 59). The term refers to payment systems where no individual payment can exceed 50 euro.

3.2.1. Payment transactions initiated by the payer

According to article 60 of the proposed Directive, the payer's payment service provider must ensure that, after the point in time of acceptance, the amount ordered is credited to the payee's payment account at the latest at the end of the first working day following the point in time of acceptance. However until 1 January 2010, a payer and his payment service provider may agree on a longer execution time, which may however not exceed three days.

First, it is important to emphasize that this rule applies to cross-border payments as well as domestic payments. However, for purely national payment transactions, Member States may provide for shorter maximum execution times (art 64). For example, they can determine that, as for as domestic payments are concerned, it is not possible to agree on a longer execution time up to 2010.

As the execution time is calculated in function of "the point in time of acceptance", it is important to determine this point in time. Article 54 of the proposed Directive states that the point in time of acceptance occurs when the following three conditions are met: 1) the payment service provider has received the order, 2) the payment service provider has completed authentication of the order, including a possible check on the availability of funds and 3) the payment service provider has explicitly or implicitly accepted the obligation to execute the payment transaction ordered. In any event the point in time of acceptance cannot be later than the moment in time when the payment service provider starts to execute the payment transaction.

When the payment transaction is initiated electronically, the payment service provider must inform the payment service user of acceptance of the order for execution. He must do so without undue delay and, in any case, before the end of the next working day after the point in time of acceptance, referred to above.

As indicated above, the account of the payee must be credited at the first working day following the point in time of acceptance. However the proposed Directive does not define the concept of a "working day". One could argue that only the days on which settlement of payments between banks can take place can be considered as working days. Anyhow it would be useful to define the term "working day" explicitly.

3.2.2. Payment transactions initiated by or through the payee

When a payment transaction is initiated by (e.g. direct debit) or through the payee (e.g. card payment), the payment service provider must ensure that, after the point in time of acceptance, the amount ordered is credited to the payee's payment account ultimately at the end of the first working day following the day on which the point in time of acceptance falls. So basically the rule is the same as the one applying when the order is initiated by the payer. However the proposed Directive enables the payee and the payee's payment service provider to explicitly agree otherwise (art. 61.1).

Once again, this rule applies to cross-border payments, as well as to domestic payments. However for purely national payment transactions Member States may provide for shorter maximum execution times (art 64). This implies that Member States also can restrict the possibility to agree on longer execution times for domestic payments.

If the payer's payment service provider refuses to release the funds that are the subject of the payment transaction, the payee's payment service provider must, within the period specified in article 61.1, inform the payee, using means of communication agreed for that purpose by the parties (art. 61.2).

3.2.3. Liability without fault - Force Majeure

It is important to emphasize that the cause of the late execution is completely irrelevant. More specifically, the payment service provider will not be able to escape liability by proving that it did not make a mistake or that late execution was due to another institution. Even when the payment service provider can prove that late execution was due to *force majeure*, he will not be able to escape liability.

3.3. Non-execution and defective execution

3.3.1. The payment service provider must ensure the payee's account is credited

According to article 67 of the proposed Directive, the service provider is strictly liable for the non-execution or defective execution of a payment transaction. Defective execution will, for example, occur whenever the payee's account is not credited with the amount of the payment transaction or not credited at all.

The payment service provider is only liable after the point in time of acceptance, i.e. after the point in time on which he has completed authentication of the order and accepted the obligation to execute the payment transaction ordered. This implies that the service provider can not be held liable in case something goes wrong before he has accepted the order, for example, during transmission of the order from the payment service user's computer to the payment service provider.

Although not determined explicitly, it is clear that the payment service provider must ensure that the account of the payee itself is credited and therefore, it is liable for everything that goes wrong until the payee's account is credited. So, the payment service provider will not only be liable when it or an intermediary institution chosen by it caused defective execution, but even when defective execution is due to an intermediary institution chosen by the payee's institution or is due to the payee's institution itself.

3.3.2. Escaping liability

First, it is important to emphasize that the payment service provider cannot escape liability by proving that it (or an intermediary institution) did not default. Neither is it possible to invoke contractual clauses, limiting the liability of the payment service provider, as the regime incorporated in the proposed Directive is mandatory (art. 78.3).

However, there are some exceptions to this basic liability of the payment service provider. The first exception relates to the situation in which the payment service provider of the payee is not located in a Member State of the European Union. In such situation the payment service provider of the payer is only liable for the execution of the payment transaction until the funds reach the payee's payment service provider. If defective execution is due to the payee's payment service provider, located outside the Community, the payer can not hold his payment service provider liable.

Secondly, the payment service provider – contrary to the rule concerning late execution - can not be held liable in case defective or non-execution is due to *force majeure* (art. 70). Although not defined explicitly, it is clear that the concept of *force majeure* relates to abnormal and unforeseeable circumstances beyond the control of the person pleading *force majeure*, the consequences of which would have been unavoidable despite all efforts to the contrary.

Particularly interesting is the question whether system malfunctions can be regarded as *force majeure*. Regarding system malfunctions, it is accepted that a mere system malfunctioning can not be seen as *force majeure*. The payment service provider invoking *force majeure* will have to prove that the malfunctioning was beyond its control and that it was impossible to avoid the consequences of the malfunctioning, *although it had sufficient back-up procedures in place*. Indeed, the question whether a system malfunctioning constitutes *force*

majeure must be determined by analyzing the measures a payment service provider has taken to avoid damages resulting from a system malfunctioning (Berkley, 1987, Reed, 1991 and Einsele, 2000).

Finally, a specific rule applies when defective execution is due to an incorrect unique identifier provided by the payment service user. A unique identifier refers to the information specified by the payment service provider and to be provided by the payment service user to identify unambiguously the other payment service user involved in a payment transaction. More specifically, it consists of the IBAN (International Bank Account Number), the BIC (Bank Identifier Code), a bank account number, a card number or a name (art. 4. 15).

If a payment order is executed in accordance with the unique identifier provided by the user, the payment order is deemed to be executed correctly with regard to the payee specified. So, where the IBAN was specified as the unique identifier, it takes precedence over the name of the payee, if it is provided additionally. Although not explicitly determined it is clear that the same rule will apply in case the bank account number is specified as the unique identifier for domestic transactions. However, in order to be able to escape liability by invoking the incorrect unique identifier, the payment service provider must prove that he has informed the payment service user in the contractual conditions in easily understandable words that identification takes place on the basis of the unique identifier (see article 26). The payment service user thus must be informed about the way the other payment service user is identified.

Although the IBAN thus in principle takes precedence over the name of the payee, the payment service provider must, where possible, still verify the consistency of the IBAN and the payee's name (art. 66.1). This provision is not very clear. What is the meaning of the words "where possible"? More specifically, the question arises whether such verification is necessary when it is technologically possible to verify the consistency of IBAN and the payee's name.

Although the payment service provider is not liable for the non-execution or defective execution of the transaction, due to an incorrect unique identifier, the payment service provider must make a *bona fide* effort to recover the funds involved in the payment transaction (art. 66.2). This implies that the payment service provider must contact the institution of the person that was mistakenly credited as a result of the incorrect unique identifier. If there are sufficient funds available on that person's account his institution will normally be able to correct the error by debiting his account and wiring the amount to the payer's institution.

3.3.3. Compensation to be paid

The payment service provider who executed the transaction defectively can not escape liability. It will be held liable for the full amount of the payment transaction. In addition he is strictly liable for any charges and for any interest charged to the payment service user as a consequence of the non-execution or defective execution of the payment transaction (art. 67). So, if the payment service provider has debited the payer's account and the payee's account was never credited, the payment service provider will have to credit the payer's account with the amount of the transaction, the costs related to that transaction and any interests charged as a consequence of the defective execution. Whether the payment service provider is liable for consequential damages (e.g. compensation the payment service user must pay to the beneficiary because he has not paid in due time) has to be determined according to the law applicable to the contract concluded between the payment service user and the payment service provider (art. 69). Most countries do not hold the payment service provider liable for consequential damages.

The fact that payment service providers are – according to the proposed Directive - not liable for consequential damages is a good thing. If payment service providers would be liable for all consequential damages, this would probably lead to an important increase of the costs of payment transactions for all customers. Therefore, one could argue that it is probably best to leave it to the payment service user to determine in his relationship with his payment service provider whether he wants the payment service provider to be liable for consequential damages (as is the case in the United States (Article 4 A-305 (d) Uniform Commercial Code) (Patriks, Bhala & Fois, 1994). That way, only payment service users choosing for such a liability regime should then pay the additional cost.

3.4. Burden of proof

As far as the burden of proof is concerned, one needs to distinguish between the situation in which the payment service user claims that a payment transaction is executed belatedly and the situation in which a payment service user claims a payment transaction is not or defectively executed.

In case of late execution, one has to take into account article 61.2 of the proposed Directive, determining that the payment service provider is deemed to have fulfilled its obligation to credit the payee's account in time. However, it is important to emphasize that this rule only applies to payment transactions initiated by or through the payee. Indeed, the proposed Directive does not contain an explicit rule as for as payment transactions initiated by the payer are concerned. Does this mean that for those transactions the burden of proof is imposed on the payment service provider? General principles incorporated in the applicable national legislation will apply, which will in principle imply that it is still up to the payment service user to prove that the account of the payee was credited too late.

If a payment service user claims that a payment order is not accurately executed, the payment service provider must show, without prejudice to factual elements produced by the payment service user, that the payment order was accurately recorded, executed and entered into accounts (art. 67.2). When the payment service provider wishes to escape liability by invoking *force majeure*, he must prove that defective or non-execution was due to abnormal and unforeseeable circumstances beyond the control of the person pleading *force majeure*, the consequences of which would have been unavoidable despite all efforts to the contrary.

4. Comparison with existing legislation

4.1. Scope of application

The scope of application of the proposed regime is broader than the scope of both the Recommendation concerning electronic payment instruments, as well as the Directive on cross border credit transfers. Whereas the Recommendation cannot be applied to credit transfers initiated in writing and the Directive on cross-border credit transfers only applies to cross-border credit transfers (in euro or in a currency of a Member State) within the European Union, the proposed regime essentially – regardless of some important exceptions to this regime, as indicated - is applicable to domestic and cross-border payment transactions in any currency, initiated electronically or in writing, as soon as one of the payment service providers is located in the Community.

4.2. Late execution

The rules incorporated in the proposed Directive relating to late execution differ at several point from the rules laid down in the existing Directive on cross-border credit transfers.

Whereas the existing Directive on cross-border credit transfers obliges the payer's institution to credit the account of the *beneficiary's institution* in due time, the proposed Directive determines that the payer's institution must ensure that the account of the *payee itself* is credited in due time. Therefore, in order to escape liability it will no longer be sufficient to prove that the account of the beneficiary's institution has been credited in due time. The rule proposed is probably better compatible with the expectations of many payment service users.

Another major difference relates to the timeframe within which the execution must take place. It will no longer be sufficient to credit the account of the beneficiary's institution within five banking business days following the date of acceptance. On the contrary, unless otherwise agreed, the account of the payee itself must be credited at the end of the first working day following the point in time of acceptance. Moreover, derogations by agreement will only be possible up to 1 January 2010; and for transactions taking place before 1 January 2010 contractual conditions must still guarantee that the payee's account is credited at the end of the third working day following the point in time of acceptance. There is a huge difference, taking into account that the existing Directive on cross-border credit transfers even allows for contractual clauses extending execution time above five working days (Favre Bulle, 1998).

It is clear that the proposed Directive will decrease execution times dramatically, as from 1 January 2010 cross-border payments within the Community initiated by the payer will have to be processed as quickly as domestic payments. In practice such decrease will only be possible when efficient settlement systems are employed which make it possible to process cross-border payments in the same way as domestic payments. More specifically, it will no longer be possible to execute payment transactions using several corresponding banks, which is common today (Brindle and Cox, 1999). That's also why the rules relating to the execution time only apply when all payment service providers are located within the European Union.

At first sight, these rules seem very interesting for the individual consumer. However, one must take into account that the installation of efficient cross-border settlement systems will create a lot of costs which will eventually have to be borne by the payment service user. Taking into account the small amount of cross-border payment transactions that are performed by consumers today, such stringent rules seem to imply more

disadvantages (higher cost of payment transactions) than advantages for consumers (in most cases consumers don't care whether the account of the payee is credited within one or four banking days). The most important for consumers is that they are informed about the execution time, so they are able to initiate the transaction in due time.

Looking at article 54 of the proposed Directive (section 3.2.1), it is clear that the payer's payment service provider is not obliged to execute the order immediately, for example on the day on which he receives the order. Not only must the payment service provider complete authentication of the order, he also must explicitly or implicitly accept the obligation to execute the order. The proposed Directive does not determine explicitly the time frame within which acceptance must take place. It only states that notification of refusal must be made without undue delay and, in any case, within three working days of *the point in time of acceptance* as defined in article 54 (art. 55). Therefore, the moment the acceptance or refusal takes place is determined by the payment service provider itself. The proposed Directive differs at this point from the Directive on cross-border credit transfers. According to article 2 (l) of the Directive the date of acceptance is the date of fulfilment of all conditions required by the institution as to the execution of the cross-border credit transfer order and relating to the availability of adequate financial cover and the information required to execute that order. It is clear that the 1997 Directive does not define the date of acceptance as the date at which the institution indicates its intention to accept (Hance and Dionne Balz, 1999).

Finally, contrary to article 6 of the Directive on cross-border credit transfers the proposed Directive does not contain a specific sanction in case the payee's account is credited to late. In order to determine the compensation to be paid, general principles incorporated in the law applicable to the contract must be applied. In most European countries the payer's institution will only be liable for interests. Other, consequential damages (for an example: Evra Corp. v. Swiss Bank Corp. 673 F.2d 951 (7th Cir. 1982) (Felsenfeld, 1993)) must, unless agreed otherwise, not be compensated, since payment service providers are usually not aware of the underlying obligation they are executing, which implies they cannot foresee the possibility or extent of consequential damages.

4.3. Erroneous execution

Whereas the existing rules differentiate between different types of credit transfers, the rules laid down in the proposed Directive basically apply to all credit transfers and all other payment transactions. It is irrelevant whether the order is initiated electronically or in writing and whether it has a cross-border or domestic nature. This can be considered as one of the main advantages of the proposed Directive, since today it is necessary according to EU law (and for example in Belgium) to distinguish between cross-border credit transfers within the European Union, domestic payments which are initiated electronically and all other payment transactions. Whereas the first fall under the scope of the Directive on cross-border credit transfers and the second under the scope of the non-binding Recommendation on electronic payment instruments, the latter are governed by civil law principles (Steennot, 2003). Not only is it easier and more transparent that there is one single regime, also there are – as far as liability in case of erroneous execution is concerned - no good reasons to differentiate between several payment transactions.

Also the content of the liability regime proposed differs from the regime incorporated in the Directive on cross-border credit transfers. Whereas the Directive on cross-border credit transfers holds the payer's institution only liable until the account of the payee's institution (or the account of the intermediary institution chosen by the payee's institution) is credited, the proposed Directive holds the payer's payment service provider liable until the payee's account itself is credited. So when the payee's account is not credited, the payee does not have to claim the money from his own institution, not even when defective execution was due to his institution or the institution chosen by his institution. It is up to the payer to claim the money from his own institution and to wire the amount again to the payee. This rule is extremely useful, especially in those countries where it is accepted that payment only takes place when the account of the payee is credited.

As mentioned, the Directive on cross-border credit transfers limits liability for wrongful execution to 12.500 euro. Such limitation is not incorporated in the proposed Directive. By eliminating this liability limitation one of the major disadvantages of the system incorporated in the Directive on cross-border credit transfers is solved (Favre-Bulle, 1998 and Steennot, 2003). Indeed, there are no good reasons for limiting liability beneath the amount of the transaction, especially since the proposed regime does not apply to transactions exceeding 50.000 euro. More specifically, the proposed rules imply that a payer of a transaction of for example 35.000 euro, no longer needs to invoke civil law principles to recover the damages exceeding 12.500 euro (22.500 euro).

According to the European Recommendation concerning electronic payment transactions, the issuer of an electronic payment instrument is liable for the non-execution or defective execution of a transaction with an electronic payment instrument, when the transaction was initiated at a device or terminal or through equipment, authorized for use by the issuer (art. 8). Contrary to what is the case according to the proposed Directive the issuer can not escape liability by invoking *force majeure*. Further it is accepted that the issuer, according to the Recommendation, is liable for everything that goes wrong after the point in time on which the transaction was initiated (Van Esch, 1998). So, contrary to the proposed Directive, the Recommendation does not enable the issuer to escape liability by proving that the order was changed during transmission from the payment service user's computer to the issuer.

It is clear that the proposed Directive offers the payment service user more protection than the Directive on cross-border credit transfers, in particular by eliminating the limitation of liability to 12.500 euro. However it is regrettable that the payment service provider still has the possibility to escape liability for the amount of the transfer by invoking *force majeure* (Favre-Bulle, 1998 and Steennot, 2003). In the United States for example, Article 4A of the Uniform Commercial Code does not enable the originator's institution to escape liability by invoking *force majeure* (Clark and Clark, 2000). This rule favouring the payment service user must be seen as the application of the general principle "*genera non pereunt*" (Dal, 1994).

5. Conclusion

Although the regime which is proposed by the European Commission relating to erroneous execution of payment transactions is clearly inspired by the rules incorporated in the Directive on cross-border credit transfers, it differs at many points from these rules (and from the rules laid down in the Recommendation on electronic payment instruments). The main advantage of the proposed regime is that there will be only one (binding) liability regime which is applicable to most payment transactions (not exceeding 50.000 euro). Equally important is that liability is no longer limited to 12.500 euro, so that payers who have initiated a transaction not exceeding 50.000 euro no longer need to invoke civil law principles to recover damages exceeding 12.500 euro.

However, some issues remain. For example it is regrettable that payment service providers – in case of defective execution - can escape liability pleading *force majeure*. Furthermore, some rules are not very clear. For example, the payment service provider must verify the consistency between the IBAN and the payee's name whenever this is technologically possible. But what does this mean? Finally, the cost of installing cross-border settlement systems enabling settlement of transactions within one banking working day will have to be borne by persons that in most situations don't care whether the account of the payee is credited within one, two or three days.

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	Directive 97/5	Recommendation	Proposed Directive
Scope of application (way of initiating)	Writing / Electronic	Electronic (and payment card)	Writing / Electronic
Scope of application (domestic / cross-border)	Cross-border	Domestic and cross-border	Domestic and cross-border
Scope of application (currency)	Euro / Currency of a Member State	No requirements	No requirements
Scope of application (maximal amount)	50.000 limit	No limitation	50.000 limit
Liability late execution (specific rules)	Yes	No	Yes
- liability originator's institution	Until credit account of beneficiary's institution	-	Until credit of beneficiary's account
- timeframe	5 banking business days	-	1 working day (until January, 1st 2010 max. 3 working days)
- compensation	Interest	-	Civil law
Liability defective execution (specific rules)	Yes	Yes	Yes
- liability payer's institution	Until credit account of beneficiary's institution	Not determined explicitly (probably credit of the beneficiary's account)	Until credit beneficiary's account
- liability in case of force majeure	No	Yes	No
- compensation	Limitation 12500 euro	No limitation	No limitation

Table: Some differences between the existing Directive on cross-border credit transfers, the Recommendation on electronic payment instruments and the proposed Directive.

Spam, Spamdexing and Regulation of Internet Advertising

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Abstract. The European Union has developed a rather comprehensive regulatory framework concerning advertising on the Internet. However, these developments have had an impact primarily on the European Economic Area and the candidate countries, such as Turkey. On a global level, there is no international regulation dealing with questions as to how to advertise in cyberspace. As a result, these matters are primarily governed by international trade usages or cyberspace customs. The aim of this article is to present certain practices that have emerged in Internet industry, which supplement the Community regulatory framework.

1. Introduction

Electronic commerce continues to evolve without a detailed set of laws on a global and regional level. It is visible in the area of Internet advertising, which remains completely unregulated. So far, international community has only managed to adopt a general framework concerning copyrights in the Information Society (WIPO 1996a; WIPO 1996b) and the Convention on Cybercrime (Council of Europe 23 November 2001). All of these instruments have had a very limited impact on the functioning of the Internet and online advertising. In 2005 United Nations adopted a Convention on the Use of Electronic Communications in International Contracts (United Nations 23 November 2005), but it has not entered into force yet. Besides, it is not concerned with Internet advertising at all (Polanski 2006b).

On the other hand, Internet merchants continued to trade and develop new marketing techniques. The lack of clearly defined legal framework could not stop them from entering the new marketplace. Despite the initial strong resistance of Internet community to commercial advertising, electronic marketing of goods and services soon became a commonplace. One of the earliest technologies employed to advertise online was electronic mail. Soon, mass marketing followed. Some of the marketers decided to conceal their true email addresses, therefore engaging in what is now known as a malicious spam. Such unsolicited commercial communication became a true plague on a global scale. Soon spamming affected other Internet applications, particularly discussion forums, guestbook and recently, blogs and wikis. The lack of a legal framework forced companies, Internet Service Providers and Internet users to fight spam using filters and blocking their content – without a success, though. The new wave of graphical spam followed, which lasts till today.

At the same time, web companies decided to fight for a high listing on popular engines by resorting to other dubious practices. For instance, metatags became overloaded with references to competitors' trademarks and websites, in order to be listed higher. Hidden texts describing competitors' products or services were used as a technique to boost search results. Numerous "junky" websites were created in order to create millions of links pointing to a target website with a hope of increasing the position of such a site. None of these techniques are forbidden or permitted by international law, although there is some case law in this area. However, search engines decided to self-regulate and to block websites that engage in such practices.

The aim of this article is to discuss spam and spamdexing practices that have emerged in Internet industry. Furthermore, issues that arise in the context of interactive advertising will also be highlighted. However, it is not intended to cover the whole spectrum of all legal issues that arise in the context of online advertising. For instance, problems associated with a right of an online company to accept or reject an advertisement will not be covered. Similarly, problems that arise with respect to context-based advertising, click frauds or linking to copyrighted or controversial materials will not be discussed. Furthermore, the conflicting judicial decisions with respect to whether a name used in a metatag violates trademark laws will not be analysed. The present contribution will focus on spamming, spamdexing and interactive advertising practices associated with promoting goods and services via websites and email. The first part will briefly outline European Community legal framework concerning advertising. Then, potential trade usages or customs will be analysed, followed by a conclusion.

2. EU regulation of Internet advertising

The European Union has developed a comprehensive framework concerning misleading and comparative advertising (OJ L 149/22 11.06.2005; OJ L 250/17 19.09.1984) and unfair commercial practices (OJ L 149/22 11.06.2005). In addition, there are sector-specific regulations concerning commercial communication with respect to, for example, tobacco products (OJ L 152/16 20.06.2003) or pharmaceuticals (OJ L 311/67 28.11.2001). As far as e-commerce is concerned, tobacco products cannot be advertised online unless such communication is intended exclusively for professionals in the tobacco trade or an online communication has been published in third countries and targeted there (art. 3). However, there are only few rules specifically devoted to electronic commerce.

Among those specific rules of Internet-based commercial communication, one should mention the Directive 2000/31/EC on electronic commerce (OJ L178/1 12.11.2000). It supplements the aforementioned regulations. The directive treats advertising as an information society service (OJ L204/37 21.07.1998), which must be provided at a distance, by means of electronic equipment (practically limited to the Internet) and at the individual request of a user. Activities of search engines or online portals are examples of information society services. To describe Internet advertising the directive uses the term "commercial communication", which is defined as „*any form of communication designed to promote, directly or indirectly, the goods, services or image of a company, organisation or person pursuing a commercial, industrial or craft activity or exercising a regulated profession*." The drafters were aware that commercial communications are essential for the financing of information society services and for developing new ones. Hence, it does not seem erroneous to equate commercial communication and advertising.

However, this instrument does not go beyond few general requirements such as- that a commercial communication and an advertising company be clearly identifiable. Therefore, online entrepreneurs are required to identify themselves and to clearly inform about the fact that a given communication is, in fact, advertising. Promotional offers (discounts, gifts, premiums) and promotional competitions or games shall contain conditions, which should be easily accessible and presented in a clear and unambiguous manner (art. 6).

On the other hand, art. 8 introduced a very important rule permitting the regulated professions to advertise online. In numerous European countries advertising by, for instance, a lawyer was prohibited. The newly adopted directive on services (OJ L 149/22 11.06.2005) abolished this restriction and extended the protection offered by the directive on e-commerce to all media (art. 24). As a result, Member States shall remove all total prohibitions on commercial communications by the regulated professions and ensure that such communications comply with professional rules, in conformity with Community law, which relate, in particular, to the independence, dignity and integrity of the profession, as well as to professional secrecy, in a manner consistent with the specific nature of each profession.

As far as email advertising is concerned, the Directive on electronic commerce introduced a rather unfortunate provision permitting the so called unsolicited communication or spam. The obligation put on spammers to identify their emails and to consult *opt-out* registers simply did not work. It took European institutions two years to realize that opt-out registries serve mainly as a source of confirmed email addresses for spammers and therefore, the Directive 2002/58/EC introduced the so called *opt-in* model (OJ L201/37 31.07.2002).

According to the new model, the prior consent of a natural person is required: "*The use of automated calling systems without human intervention (automatic calling machines), facsimile machines (fax) or electronic mail for the purposes of direct marketing may only be allowed in respect of subscribers who have given their prior consent*" (art. 13 (1)). The technologies covered embrace not only electronic mails or faxes but also SMS messages (recital 40). However, „*other forms of direct marketing that are more costly for the sender and impose no financial costs on subscribers and users, such as person-to-person voice telephony calls, may justify the maintenance of a system giving subscribers or users the possibility to indicate that they do not want to receive such calls*." As a result, certain technologies, such as, Internet telephony can be used for the purposes of direct marketing, although member states may uphold existing rules requiring the prior consent irrespective of the technology used.

The new system, however, contains some important exceptions. For instance, it is legal to send unsolicited emails, provided that a sender received a recipient's email address in the context of the sale of a product or a service (art. 13 (2)). Furthermore, the old *opt-out* system might apply in B2B transactions, because article 13 of the directive applies to subscribers who are natural persons (art. 13 (5)). As it was stated above, certain technologies can still be used without a user's prior consent. On the other hand, email messages that

conceal the identity of the sender or do not use a valid email address are prohibited (art. 13 (4)). Therefore, the malicious spam is prohibited irrespective of a legal status of a sender or a recipient. Unfortunately, introduction of the new model did not stop it.

In summary, the EU regulatory framework concerning advertising on the Internet has had an impact primarily on the European Economic Area and the candidate countries, such as Turkey. On a global level, there is no international regulation dealing with questions on how to advertise in cyberspace. As a result, these matters are primarily governed by international trade usages or cyberspace customs.

3. Trade usages in online advertising

Unwritten customs or usages play a significant role in regulating transnational trade and international relations. For instance, the 1980 Vienna Convention on Contracts for the International Sale of Goods explicitly recognizes their binding nature in article 9 (2), which states: "*The parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned*." As a result, trade usages that are widely known and regularly observed are binding irrespective of the knowledge of a given merchant. Trade usages are sometimes referred to as *lex mercatoria* (Mustill 1987).

As far as inter-state relations are concerned, international custom is equally important source of law as a treaty. Article 38 of the Statute of the International Court of Justice defines international custom as "*evidence of practice accepted as law*" (UN 26 June 1945). There are, therefore, two elements that must be ascertained: practice and its acceptance as law (*opinio iuris*). ICJ recognized numerous international customs, for example, in the area of treaty law, diplomatic relations, environment protection or the law of the sea (Wolfke 1993).

Similarly, there are numerous customs or trade usages that have emerged on the Internet, particularly with respect to online advertising. This area is particularly interesting because revenue that is generated by online marketing is the cornerstone of the majority of business models encountered on the Net (Polanski 2007, p.337). For instance, information portals or search engines rely mostly on advertising revenues to support their operations. These revenues come from, for example, online banners, sponsored links and to lesser extent from pop-up screens.

Internet trade usage can be defined as "*a legally relevant practice of trading on the Internet, which is sufficiently widespread within a given timeframe as to justify the expectation that it should be observed*" (Polanski 2007, p.9). As in the case of international customs, it can develop quite rapidly. Usually it takes few years for a usage to be established but in certain case scenarios they can develop much faster (Polanski 2006a). The practice is widespread if it has a global, regional or even a local character (widespread in space) and if it is followed intensively in time (widespread in time). In Internet advertising, the practice has a global character if it is observed by the majority of online advertisers or publishers (arguably 75% or more). It can also exhibit a particular character if it is peculiar to a number of companies exhibiting some commonality, for example, companies that are confined to one or several industries (e.g. search engines) or to one or several geographical regions.

Courts and arbitrators should recognize widely known practices as trade usages and apply them to clarify contractual provisions or to fill in gap resulting from an absence of binding regulations or contractual provisions (Goode 1997). In Western legal tradition, trade usages usually have interpretative and supplementary functions. In certain countries, however, custom is an independent source of law. For instance, in Switzerland, a judge should apply customary law in the absence of relevant statutory law (Gutteridge 1971). Similarly, in Spain, custom operates in the absence of written law provided that it is proven and not contrary to morality or public order. On the other hand, English customs have to be immemorial (dating back to 1189), continued, peaceable, not unreasonable, certain, compulsory and consistent and proven as a fact (Blackstone 1783 reprinted 1978). American trade usages, in turn, must be regularly observed but do not have to be immemorial, reasonable or local (De Ly 1992 p.138).

Taking into account the potential role of unwritten customs, it is particularly important to observe certain practices that have emerged in the area of Internet-based advertising. These usages could fill in gaps resulting from a lack of international framework concerning advertising on the Net. The section below will present potential customs that have emerged in this field.

3.1 Email spam

In the early days of the Internet, sending commercial emails was unthinkable [1]. When in 1994 a Phoenix law firm Canter & Siegel posted an immigration law advertisement on bulletin boards, the community of users reacted furiously and effectively blocked their email account by sending thousands of email messages. The law firm's account was soon revoked on the grounds that the company abused its privileges. As the system administrator of a company providing Internet access to Canter & Siegel explained: "*They took 15 or 20 years of Internet tradition and said the hell with it.*" (Bodansky Fall 2004).

The early customary norm prohibiting commercial use of the Internet proved transitory. Commercial advertising was finally accepted by the Internet community. "*Although violators suffered sanctions, these sanctions ultimately proved insufficient to serve as an effective deterrent. Instead, over time, the non-compliant behaviour established a new custom permitting advertising on the Internet, and by now this behaviour no longer entails any penalties*." (Bodansky Fall 2004). This does not mean that all forms of commercial advertising have been accepted.

Certain advertising practices are still not tolerated. It is particularly so with respect to spam or unsolicited, bulky email advertising that is difficult to block (Edwards 2000, p.309). In general, the rules of Netiquette justify this prohibition in the following words: "*The cost of delivering an e-mail message is, on the average, paid about equally by the sender and the recipient (or their organizations). This is unlike other media such as physical mail, telephone, TV, or radio. Sending someone mail may also cost them in other specific ways like network bandwidth, disk space or CPU usage. This is a fundamental economic reason why unsolicited e-mail advertising is unwelcome (and is forbidden in many contexts)*." (Hambridge and Lunde June 1999; Hambridge October 1995). The status of the Netiquette as a basis for adjudication of disputes has been confirmed in *Christophe G. v. Société France Télécom Interactive, S.A.* [2], where a French court recognised the prohibition of spamming as a binding custom (Polanski 2007 p.138-139).

One of the most evident examples of unwelcome (and forbidden) spam is bulky email advertising that contains arbitrary sender addresses. It is difficult to fight this kind of spam, because a sender address keeps changing every time in order to avoid simple text filtering. Such examples of spam have never been tolerated by Internet users and this attitude is common worldwide. It has also been recognized in Article 13 of the European directive on privacy and electronic communications, which outlaws this kind of spam in the following manner: "*4. In any event, the practice of sending electronic mail for purposes of direct marketing, disguising or concealing the identity of the sender on whose behalf the communication is made, or without a valid address to which the recipient may send a request that such communications cease, shall be prohibited.*" (OJ L201/37 31.07.2002) Similarly, section 5 of the American 2003 CAN-SPAM Act prohibits false or misleading transmission information: "*It is unlawful for any person to initiate the transmission, to a protected computer, of a commercial electronic mail message, or a transactional or relationship message, that contains, or is accompanied by, header information that is materially false or materially misleading.*" (15 USC 7704) This Act also prohibits deceptive subject headings, emails that do not contain a functioning return electronic mail address and commercial advertising after objections.

However, there are spam messages that are even more difficult to fight, for instance, emails that contain advertisements in graphical format. Marshal estimates that in April 2007, 42% of spam was image spam [3]. The reason for embedding advertisement in a graphical image is to circumvent the operation of email filters that can only operate on text. As a result, it is virtually impossible to stop companies that utilize this technique to advertise their products. Unless advanced techniques are applied in the area of information filtering, Internet users will have to bear graphical spam. One such technique, known as the Optical Character Recognition (OCR), has been used by scanning software to translate pictures of characters into computer fonts. However, even this technology has its limitations if the background and font colors of an advertisement are similar.

Another type of email advertising that is particularly unwelcome and very hard to fight is spamming in order to undermine the network security. For instance, bulky email messages are often used to spread viruses, Trojan horses or other dangerous software. Fortunately, nearly all email server administrators use anti-virus software that deletes dangerous attachments before they reach client computers. One can therefore argue that it is a customary obligation of email service providers to use anti-virus software on their servers in order to reduce the amount of spam and to fight the spread of viruses and other forms of malicious software. However, it is not the end of serious security issues posed by spam. Bulk electronic messages are also often used in order to forge Distributed Denial of Service (DDoS) attacks (Hambridge and Lunde June 1999, p.3), which result in temporary unavailability of Internet services such as a website or an email server. Hackers spam target servers in order to hack into computer systems. This use of spam is probably the most dangerous but is much harder to stop.

It is difficult to provide reliable estimate of email spam as available statistics lack clearly defined methodology. Some authors argued that in 2006 40% of emails were spam (Evett 2007). As far as the type of spam is concerned, nearly 45% of spam messages were related to health. Other spam messages advertise certain financial deals, products, adult content, phishing, education and scams [3]. A lot of spam messages, though, contains randomly assembled content and is therefore completely useless.

For years almost all the spam originated in the United States (Edwards 2000, p. 310). However, recent statistics show that spammers look for other countries to continue their activities. According to the Spamhaus Project, as of April 2007, the United States remains the worst spam origin country, but China, Russia and United Kingdom are becoming increasingly more popular. Other spam havens include Japan, South Korea, Germany, Netherlands, Canada and Taiwan [4]. On the other hand, Marshall suggests that most spam originates from Europe "thanks largely to increasingly strong showings from Italy and Poland" [3].

The Spamhaus Project researchers also demonstrated that nearly 80% of spam targeted at North American and European population is generated by a group of around 200 known professional spam gangs, listed in Spamhaus' Register Of Known Spam Operations (ROKSO) database. On a weekly list of the top ten worst spammers and spam gangs dominate individuals or organisations from Russia and Ukraine, followed by Israel, Australia, Hong-Kong and United States [5].

Spam has not been accepted by international community. The negative attitude or *opinio iuris* towards spam is visible in the works of international organisations that try to fight it. As an example, the Declaration of Principles adopted at the World Summit on the Information Society underlies the importance of fighting spam. "*Spam is a significant and growing problem for users, networks and the Internet as a whole. Spam and cyber-security should be dealt with at appropriate national and international levels*." (WSIS 12 December 2003, # 37) The Internet Research Task Force (IRTF) has established the Anti-Spam Research Group in order to investigate tools and techniques to mitigate the sending and effects of spam. In particular, the research group focuses on anti-spam tools and techniques that "*include those to prevent spam from being sent, to prevent spam from being received, to distinguish spam from legitimate mail, to facilitate management responses to spam activity, and to ensure that legitimate mail is delivered in the presence of other anti-spam measures*." [6]

Furthermore, the continuous development of technologies targeted at fighting spam is another proof of the common intention to get rid of it. The vast majority of Internet users and probably all email server administrators use spam filters in order to block the flood of unwanted electronic communications. This argument can serve as another proof of the customary nature of prohibition in respect to commercial spam.

In summary, there are plenty of legal, technical and organisational efforts to remove spam. These undertakings clearly signify the intention of the majority of users to block spam advertising that is generated by a very small fraction of the Internet community. One can therefore argue that it is customary for online business to refrain from sending spam. It is a global customary obligation.

3.2. Spamdexing

Successful advertising on the WWW involves an appropriate modification of a webpage so that search engines would list it highly. A typical Web user would not read beyond the first ten to twenty search results. In consequence, a high ranking within the results of a search engine is critical for the success of an online business.

Spamdexing (or web spam) refers to spamming the index of a search engine. In other words, web spam refers to "*actions intended to mislead search engines into ranking some pages higher than they deserve*" (Gyongyi and Garcia-Molina 2005, p.1). Although the term spamdexing is similar to spam, these two practices should not be confused. According to Wikipedia "*spamdexing refers exclusively to practices that are dishonest and mislead search and indexing programs to give a page a ranking it does not deserve*."[7] Unfortunately, because of the financial gain in achieving a high search engine rank, the amount of spamdexing has increased dramatically, leading to a degradation of search results (Gyongyi and Garcia-Molina 2005).

In the early days of WWW, search engines relied on matching queried keywords in available electronic documents. Such simple text searches were especially vulnerable to manipulation by repetition of targeted keywords on a page. Consequently, search engines abandoned this philosophy and the next generation of search engines used more sophisticated techniques. Lycos was first to develop the concept of "implicit voting", which treated a link to a page as a "vote" for it (Jones 2005). As a result, a webpage with many links pointing to it would be more "important" than pages with few links.

Google's PageRank algorithm has improved this concept with the notion of the "importance" of a page. In consequence, pages that are referenced from often cited pages such as Yahoo would be given higher ranking than pages that might have more links but from more obscure places (Page, Brin et al. 29 January 1998, p.3).

Therefore, "*for a page to get a high PageRank, it must convince an important page, or a lot of non-important pages to link to it*." (Page, Brin et al. 29 January 1998, p.12) However, despite its apparent immunity to manipulation, this concept has not turned out to be entirely bullet-proof. Google bombing [8], which involves creating pages that directly affect the rank of other sites is used particularly in non-commercial settings, e.g. to ridicule political leaders (BBC News 7 December 2003). Furthermore, web spammers often create links from blogs, wikis or guestbook in order to increase the position of their sites [9].

Spamdexing can take multiple forms. Common spamdexing techniques are classified into two broad classes: content spam and link spam [10] (Gyongyi and Garcia-Molina 2005, p.3-4). With respect to content spam, keywords can be placed in various so called "text fields": a body of a page, its title, meta tags, URL or anchor text. Depending upon the aim of a web spammer, a specific term can be repeated numerous times in these text fields or a great variety of words can be placed there. The content spam category includes techniques that place keywords as a hidden text (e.g. font colour is the same or similar to background colour). If such keywords are repeated in the body of a webpage one speaks of keyword stuffing. On the other hand, repeating keywords in meta tags is referred to as a meta tag stuffing. Other techniques include doorway pages, which contain very little content but are "stuffed" with keywords and redirecting sites that redirect a user to a different website, without showing him the spammed website.

Link spam embraces even more techniques. A web spammer will be primarily interested in using his own pages and other accessible pages to link to. It is fairly easy to use a spammer's own sites to link to a target website to boost its ranking. However, web spammers will also try to link from pages maintained by others e.g. to link from a popular blog to a target website. As a result, spamdexing is closely associated with blog spam. The most common linking technique is link farm (or spam farm), which involves any group of web pages that all hyperlink to every other page in the group [11]. By creating large spam farms with all the pages pointing to the target, a spammer can boost Google's PageRank (Gyongyi and Garcia-Molina 2005, p.5). Web spammers may also use invisible links in order to increase the importance of a page. Sometimes spamdexers purchase expired domains in order to replace the pages with links to their pages. There are also other techniques such as cloaking, which refers to presenting a different page to a web crawler than will be seen by human users (Jones 2005). As with other practices, cloaking can be used for legitimate and illegitimate purposes.

Gyöngyi and Garcia-Molina estimate that 10-15% of the content on the Web is spam (Gyongyi and Garcia-Molina 2005, p.8). Spamdexing decreases the quality of search results and inflates search engines with useless pages therefore increasing the cost of processing queries (Gyongyi and Garcia-Molina 2005, p.1). Furthermore, it forces some honest webmasters to spamdex in order to be found. However, there is still a lack of technical measures for combating this. For instance, "Search engine SPAM detector" tries only the three most common spamdexing methods: keyword stuffing, doorway farms and hidden text [12].

One of the major problems associated with spamdexing is that these techniques can be used for both legitimate and illegitimate purposes. There are numerous techniques that have been accepted in the industry as procedures for making a website indexable by search engines, without misleading the indexing process (known as search engine optimization or SEO). SEO is a legitimate practice, however, most companies providing search engine optimization services engage in spamdexing (Gyongyi and Garcia-Molina 2005, p.2).On the other hand, the most dangerous forms of spamdexing involve repeated use of certain keywords such as registered trademarks, brand names or famous names in one's webpage to take advantage of their goodwill. Such practices have been tested in courts worldwide and a consensus has emerged that they violate either competition laws (in Europe) or trademark laws (in USA) (Nathenson Fall 1998, Part II). In other cases, however, there is no law that explicitly deals with spamdexing.

In consequence, search engines have established and enforced their own web spam policies. Webmasters are usually provided with detailed guidelines that explain how to structure a webpage. For instance, Google specifies quality guidelines and warns that if a site doesn't meet them, it may be blocked from the index [13]. Similarly, Yahoo has designed Content Quality Guidelines "*to ensure that poor-quality pages do not degrade the user experience in any way*." [14] The company has reserved "*the right, at its sole discretion, to take any and all action it deems appropriate to insure the quality of its index*."

Based on the evidence of positive actions taken by Internet users to fight spamdexing, one can argue that a new customary right has emerged permitting search engines to block web spam. It is too early, however, to speak about a customary obligation to refrain from spamdexing, because techniques such as cloaking or hidden text can be used for both legitimate and illegitimate purposes. However, this area is evolving rapidly and such customary obligation might emerge soon. Clearly, more research is required, particularly with respect to unfair competition laws and trademark laws, which seem most suitable to tackle some of the highlighted problems.

3.3 Web-based interactive advertising

With the advent of web-based advertising, new marketing practices have emerged. From the very beginning cookies were used to gather information about a user in order to deliver a personalized commercial content. Cookies are invisible files containing user's profile, which are sent by a web server and stored on the user's hard disk. A website then "knows", for example, what username and password does a user have, what products were put in a shopping cart or which colours did a user select as a "skin". As directive 2002/58/EC stated in recital 25 "*...'cookies' can be a legitimate and useful tool, for example, in analysing the effectiveness of website design and advertising, and in verifying the identity of users engaged in on-line transactions*."

Cookies are very important tools facilitating online interactivity, which raise serious privacy concerns. Technically, they are created, stored and transmitted to a web server without user's knowledge or consent and might contain sensitive data [15]. The aforementioned directive on privacy and electronic communications states that where cookies "*... are intended for a legitimate purpose, such as to facilitate the provision of information society services, their use should be allowed on condition that users are provided with clear and precise information in accordance with Directive 95/46/EC about the purposes of cookies or similar devices so as to ensure that users are made aware of information being placed on the terminal equipment they are using*." As a result, an online entrepreneur should inform a user about the purposes of the cookies. Furthermore, website operator should give users the opportunity to refuse to have a cookie. Taking into account that modern browsers enable effective management of cookies, including deletion, one can argue that a customary norm has developed, which gives information society service providers a right to explore user's behaviour using cookies (Polanski 2007, p.323)

On the other hand, in the early days of web marketing pop-up windows were often used that contained simplified animations and graphics. However, introduction of pop-up blockers diminished the significance of this form of online marketing. As a result, the market self-regulated this form of marketing and no intervention of legislator was necessary. However, with the widespread adoption of Macromedia Flash software that is being used to create animated introductions, ad banners and transparent animations similar problems have appeared. The latter form of multimedia advertising is particularly intrusive when the animation is very loud, occupies the whole screen and it is hard to find a way to get rid of it. However, the majority of such advertisements usually contain a "close" button or similar means that allows the user to close the animation. It is therefore possible that a customary norm requiring online entrepreneurs to allow for closure of interactive advertising has emerged. However, at this stage it is too early to speak about a general custom requiring such behaviour. In addition, it is very difficult to say what remedies Internet users would have, if a given online business decided not to provide such functionality.

There are numerous other practices and issues that should be covered under the heading of web-based interactive advertising. For instance, one should investigate the legality of sponsored links, which do not differ from "normal" hyperlinks in a technical sense. Sponsored links have emerged relatively recently and proved to be very effective both for the advertiser and the site owner. Although they are widely used, their usage might conflict with trademark laws or unfair competition laws. However, the space does not permit to investigate all of these issues in depth.

4. Conclusion

There is no international law on advertising on the Internet. Despite a well-developed regulatory framework in the European Union countries, certain Internet practices are not covered by the legislation. The most important example is a practice of spamdexing or web spam, which is an extension of the "traditional" spam found in email messages. With respect to the latter, it is argued that online businesses are legally bound to refrain from spending spam based on a widely known and accepted Internet custom. This statement is reinforced by legislation on a regional or country level. As far as spamdexing is concerned, it is argued that search engines have a right to block websites that contain web spam based on a widely followed trade usage. This right clearly supplements existing rights and obligations under the applicable law.

Furthermore, information society service providers have the right to explore the user's behaviour using cookies. This marketing practice has been accepted by the Internet community, despite some privacy concerns. It is a very important trade usage concerning online marketing because modern WWW is dependant upon customisation and interactivity. Finally, it is customary for online entrepreneurs to provide means of closing interactive advertising such as pop-up screens or Flash animations. All of these trade usages supplement existing legal framework on a national, regional and international level but need to be tested in courts.

Notes:

[1] Section 3 of this article is based on P.P. Polanski (2007) *Customary Law of the Internet: In the Search for a Supranational Cyberspace Law*, p. 337-345.
[2] Christophe G. v. Société France Télécom Interactive, *S.A.* [28.02.2001] JGT: 64/2001, RG: 00/106
[3] http://www.marshal.com/trace/spam_statistics.asp, last visited: 7/04/2007.
[4] http://www.spamhaus.org/statistics/countries.lasso, last visited: 7/04/2007.
[5] http://www.spamhaus.org/statistics/spammers.lasso, last visited: 7/04/2007.
[6] http://www.irtf.org/charter?gtype=rg&group=asrg, last visited: 28/03/2007.
[7] http://en.wikipedia.org/wiki/Spamdexing, last visited: 28/03/2007.
[8] http://en.wikipedia.org/wiki/Google_bomb, last visited: 28/03/2007.
[9] http://chongqed.org/, last visited: 28/03/2007.
[10] http://en.wikipedia.org/wiki/Spamdexing, last visited: 28/03/2007.
[11] http://en.wikipedia.org/wiki/Link_farm, last visited: 28/03/2007.
[12] http://tool.motoricerca.info/spam-detector/, last visited: 28/03/2007.
[13] http://www.google.com/support/webmasters/bin/answer.py?answer=35769, last visited: 28/03/2007.
[14] http://help.yahoo.com/help/us/ysearch/indexing/indexing-14.html, last visited: 28/03/2007.
[15] http://www.cookiecentral.com/c_concept.htm, last visited: 28/03/2007.

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Some Remarks on the Jordanian Electronic Transaction Act

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Abstract: With the advent of the internet as a medium for forming commercial contracts, Jordan is one of the first countries in the Arab world to enact a legislation to regulate online contracting, with the Electronic Transaction Act 85 of 2001. Even this act may be considered as a first step in regulating the online environment it creates some confusion regarding the application of this act and in respect to its coherence with the Jordanian Legislation regarding regulating online contracting. Given that Jordan is a civil law country, and contract law rules are embodied in the Jordanian civil code, this paper examines whether the act creates new rules for online contracting or whether the civil law rules are still sufficient to be applied in the electronic environment. In addition, this paper summarizes two of the obstacles that the application of this Act in Jordan might encounter. The first is the need for providing rules to protect consumers in the online environment, since the internet is a place where fraud and mistakes can easily happen. The need for consumer protection rules becomes more necessary because neither the Act nor the civil code nor, indeed any other regulations in Jordan, provide safeguards to consumers from the abuse and risks existing in the online environment. The second hindrance is that the internet technology infrastructure is not regulated with standards that achieve stability and trust for consumers in Jordan.

Keywords: E-commerce, Electronic Contracting, Civil law, E-Consumer protection, Jordan

1. Introduction

The twenty- first century has brought with it a new electronic environment for forming commercial contracts and with this new environment have emerged new methods of making contracts. The use of Email and websites are now popular methods for forming valid contracts, but these new ways of making contracts are not without legal concerns. Many issues may arise in online contracting. Deciding when and where online contract is formed and the interaction of electronic agent are the best examples of legal concerns that arise in online contracting. The question that arises here is how we should regulate the legal problems occurring in online contracting. Another way of asking this question is whether we need new rules to govern the issues arising in online contracting or whether the traditional civil law rules are sufficient to regulate these issues (By traditional contract rules, we mean the rules that embodied in the Jordanian Civil Code 1976. This Code is the main legislation in areas of private law in general and law of obligations in particular in Jordan. This Act was enacted in 1976 and came into force in 1/1/1977. It replaced and superseded the previous Ottoman Civil Code (Al- Majalah) of 1877)

The method of answering this question will be by analyzing the impact of the Jordanian Electronic Transaction Act with respect to harmonizing the contracting rules in the electronic and the offline environment. The law of contract in Jordan is governed by the Jordanian civil law (No.43/1976) rules. Although many of the rules seem archaic by comparison to the current technologies, many principles remain true in the electronic environment. This will be discussed in the first part of this paper. The second part explains two main remarks which have been ignored to be dealt with the Electronic Transaction Act. The first observation is the absence of consumer protection instruments either in the Electronic Transaction Act or in the Civil Code to protect online consumers. The second is a lack of an established legal framework for internet technology infrastructure in doing business through online stores and for regulating the internet service providers (ISPs) as it is the case in Europe for example.

2. The Application of the Electronic Transaction Law

Like most countries all over the world that have enacted legislation in respect to Ecommerce, Jordan has introduced the Electronic Transaction Law (ETL) to regulate electronic commerce. This Law is considered as a

special legislation that applies to transactions conducted by the internet. Courts should govern online contracting issues according to this Act. However, this does not necessarily mean the exclusion of the application of other laws. Traditional contracting rules in the Jordanian Civil Code can still be applied where there is no provision to regulate the issue in the ETL (Art. 3/a).

The Electronic Transaction Law has a broad application in respect to transactions carried out over the internet, applying to all kinds of transactions. Transactions ,such as computer information transactions or those related to the sale of goods and services, are regulated under the scope of this Law. Also the scope of the Act applies to all the parties that make online transactions. This means that this Law governs consumer to consumer contracts (C2C); business to consumer contracts (B2C) and business to business contracts (B2B) (Art.4/a). In addition, the Act governs Transactions "approved by any governmental department or official institutions, in whole or in part"(Art 4/B).

Nonetheless, this act like the UNCITRAL requires explicit consent from both of the parties that they are going to conduct their transaction using the internet. Article 5/A of the Electronic Transaction Law states that "Unless a provision in this Law states otherwise, the provisions of this Law shall apply to the transactions on which the parties thereto agree to implement the transactions thereof through electronic means."

This scope, even it gives the act the merit for regulate all the commercial activities on the net, but it goes far from the essential goal of its application. The Act should essentially govern electronic contracts formed essentially between two main parties at the commercial context especially in respect to business to consumer contracts. This is because most commercial activities occur between a business firm on one side and a consumer on the other. This requires a legal framework that facilitates this kind of activity, especially with respect to consumers. However, the application of this act does not exclude the application of any act relevant to the transaction (Art 3/a). This non exclusion implies that the Civil Code in Jordan is still applicable to transaction carried out through the internet.

Returning back to the main question of this part - which is whether the legislative approach in Jordan aims to provide new electronic contracting rules as a reflection of the emergence of electronic interaction, or whether these rules are comported with the general approach in the civil code in unifying the rules- it can be said that the legislation for electronic transaction in Jordan neither creates new rules for electronic contracting nor excludes the application of the traditional contracting rules in the civil law. This gives us a clear indication of the main aim of the legislation in unifying the contracting rules in the online or offline environment. Even this Law is considered as a special legislation for electronic commerce, but the contracting rules are the same. The adoption of this method of analysis is attributed to two main reasons. Firstly, before the emergence of internet technology, the Civil Code policy implied that the application of the embodied contracting rules should be extendable to new methods of communication. The provision of the Civil Law gives us a clear indication that new methods of communications such as the phone or any similar method are under the scope of the Civil Law application. This is clear from the Article 102, which indicates that "Contracting by telephone or any similar method shall in respect of the place be considered as if it has been completed between two contracting parties not present when the contract was made."

Secondly, an analysis of the Electronic Transactions Law provisions, gives us a clear indication of the aim of unification between the contracting rules whether they are for the physical world or for the online world. There are no new rules that create or establish legal positions different than that in the Civil Code. For example, within the few contracting rules in the Act (Art 7-19) none of them regulate the mechanism of forming contracts through the net or the moment of conclusion online contract. On the contrary, the provisions of the act aim principally to clarify legal issues surrounding electronic contracting rather than establishing new rules. For example Article 15 clarifies the controversial problem of determining when and where the message is deemed to be sent or received. This article, however, does not establish the rules of contract conclusion, but merely explains the time of sending or receiving the message.

The aim of unification of the contracting rules in the ETL points to the main source of this Law. The ETL relies to large degree on the Model Law (UNICITRAL). This is clear through the provisions of the law which are to some extent similar to those in the Model Law. This is due to the influence of the UNCITRAL in electronic commerce legislation in Jordan. The Law in Article 3 aims to facilitate the use of electronic means. This is a general goal for the Law. This has been done by adjusting contracting rules to cope with the electronic environment and removes obstacles that face online contracting in general and regarding electronic contracting rules particularly. Many examples in the act show the trend towards unification of the rules in Jordan. Providing details provisions for electronic contracting rules will affect the main goal for that unification. Therefore, the electronic agreements should be given the same legal effect as traditional paper based contracts. This principle is

clear in most legislation around the world. But this aim is not the entire story. This Act can be described as a first step in regulating electronic commerce in Jordan, which requires further steps in two areas.

Firstly, the Model Law as a source for this Law does not succeed in answering several questions relating to online contracting, such as providing trust and transparency to the actors in the electronic environment. This is because the UNICTRAL is a Model Law aiming to provide general provisions without interfering in of the national legal system of any country, as any legal system has its own policy which comports with the economic, social and cultural nature of that country. Appling this reasoning in the case of Jordan, we do not find any provision reflecting the policy behind some commercial parties concerns in the online environment, such as providing rules regulating the consumer or the business rights and obligations. Especially one when considers that the online environment is a place where many mistakes and errors and some times even fraud, can happen easily. There is a particular need for legislative action to provide trust to the participants.

Secondly, the Jordan legislature has not taken advantage of the opportunity to consider some of the e-commerce legislation in the modern countries in regulating the establishment of online stores and the activities of Internet Service Provider, as is done in the UK or at the European level. These two criticisms are the major obstacles facing online contracting in Jordan as we will discuss in the following section.

3. Obstacles that Face Online Contracting in Jordan

Here in this part, two of the main criticisms that face the E-commerce legal framework in Jordan will be discussed in the following:

3.1 Consumer Protection:

In general, there is no comprehensive consumer protection legislation in Jordan. Most of the consumer protection rules are embodied in the general rules of the Civil Code or in the Commercial Law. For example, any action brought for damage caused by defective products will be primarily premised on the law of tort or contract (According the Civil Code Art (512/1), the sale of goods contract "shall be deemed to be made on the presumption that the sold property is free of defects except for what is customarily allowed". In paragraph2, the law gives the buyer the option to return or accept the sold property).Also in the case of a claim for personal injury under the tort of negligence, or a claim for breach of contract, or misrepresentation, the case will be governed by the general principles of these Acts. Also, most of the rules regarding forming contractual relations in the traditional way can be governed by Civil law rules. Some of these rules themselves embody a kind of consumer protection such as those related to duress or mistake while forming the agreement (Mohammad Obeidat 2001)

The rules which can be described as consumer friendly rules are applied in the physical world of contracting where the parties are in the presence of each other and the consumer can touch, feel, even in some cases taste, the product. But in the online environment, the situation is different in two ways. Firstly, the transaction in the electronic setting is carried out at a distance, and there is no physical presence of the parties. This absence of physical presence has given rise to some concerns that policy makers must protect the actors engaging in such activities (.Johnson and Post, (1996) Saami Zain (2000). So, in order for e-commerce to achieve its full potential, consumers must feel that online transactions are safe, trustworthy and fair.

Secondly, online sales often involve increased risk and uncertainty over that present in similar transactions in a traditional medium, thereby requiring increased protection (Saami Zain 2000).

This is a result of such transactions being so revolutionary both in the manner in which they occur, as well as a failure to fit within common conceptual paradigms. For instance, in the traditional sale, a consumer will go to a physical store to purchase the item. He can try, see and touch the item which is not possible in the online environment.

Therefore, any legislature aiming to provide clarity and trust in the electronic setting will try to reframe the actor's rights in the context of the electronic environment, especially with regard to the consumers. This goal requires rules that can protect consumers within the electronic medium. There was a call for adopting consumer protection rules in the electronic environment before the enactment of the ETL (U.S.-Jordan Joint Statement). Unfortunately, the ETL does not contain any explicit consumer friendly rules in the electronic environment. There is also no equivalent of the UK Consumer Protection Act in Jordan (Ian Walden 2000). Neither is there legislation that regulates distance contracted such as the distance selling regulations in the UK, nor provisions protecting consumers from the abuse of sellers and suppliers in the online environment.

However , the Jordanian legislature introduced a new bill for consumer protection in the beginning of this year, which represents a legal framework for consumer protection in Jordan. Even this Bill may be a first step to protect consumers from abuses that may occur in the online environment; this Bill does not examine distance contracting or gives new instruments for protecting online consumers. It is true that this Bill has some provisions which may provide some new rules which imply that any merchant should offer some essential information about his trade such as the name and the registration of his store, his address and the purpose of the goods and services offered to sale (Art 3, 4, 5); but these information may still insufficient especially in the online environment. Any legislature should provide transparency and trust to consumers in the electronic environment. It is therefore necessary in Jordan to enact a proper legislation to address all the issues necessary to give proper protection to consumers in the online environment. This can be either through the new Consumer Protection Bill or by amending the ETL. The latter does not have any new rules that afford consumers with protection in the case of mistakes or wrong order such as those available to consumers under the Ecommerce Directive. This is as we explained above returns to the adaptation of UNCITRAL rules in the ETL. Of course this does not conform to a national legislation that reflects the policy behind this act. The consumer bodies felt that e-commerce needed a more comprehensive set of regulations in order to ensure orderly development of e-commerce in the country.

Consequently, this factor demands greater protection for the consumer. In order to achieve this protection, Jordan's legislature should ensure that the consumer should feel that online contracting is as fair and safe as traditional contracting and can do this by enacting consumer friendly rules in the electronic environment.

3.2. Establishing a framework for internet technology infrastructure

Another important neglected aspect of regulation in Jordan is the ignorance of providing a legal framework for establishing online stores. The way of providing online activities should be governed to allow online commercial activities to flourish. From one side, it is difficult to trust online stores without knowing the origin and registration number of these stores. From another side, the application of the rules cannot be done unless there is requirement that Internet Service Providers comply with the regulations. For example, there is no equivalent article to that in the UK which stipulates "the service provider has not made available means of allowing [the individual] to identify and correct input errors" (The Electronic Commerce (EC directive) Regulations 2002)

It is true that in December 2000, regulations were promulgated under the ETL to govern the operation and licensing of internet cafés, but these regulations do not regulate online contracting in any way. They require only that all the internet cafes be licensed by the government, and that owners and managers must record the names of all names of all users and the sites they visit (Internet Café Regulations).

4. Conclusion

Jordan has missed a great opportunity to provide a complete legislation for regulating online commercial activities. The enactment of Electronic Transactions Law is only the first step. The country needs further steps to allow the online commercial activities in Jordan to flourish. The electronic commerce sector should have different instruments to encourage users, consumers and businesses to go online without any fear. Clarifying the rights and duties for the parties is very important. Besides, actions should be taken from the private sector to carry activities and encourage consumers to do online business. These tasks should be taken not only from legal point of view but also from the commercial sectors themselves. For example, through provide trust and transparency instruments either to the business firms or to the consumers. This needs special attention especially as this sector is still new to all participants in online commercial activities.

Jordan has also missed a great opportunity by ignoring the general principles of the Jordan-US Statement on Electronic commerce which stress the importance of providing consumer protection instruments. It would be much better if Jordan incorporates these principles into its Electronic Transaction Law, since such principles include an important provision regarding security, transparency, and consumer protection for actors in the online environment.

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The Importance of Live Link in Child Abuse Cases (Incest)

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Abstract: Child abuse was recognized as a social problem in Malaysia in 1991 with the passing of the Child Protection Act 1991. In 1995, the Malaysia ratified the Convention on the Rights of the Child (CRC). Pursuant to the ratification of the CRC, a great deal of time was spent discussing how to implement this treaty in order to protect and advance the position of children. In line with the ratification of the CRC, the Child Act 2001 was introduced. In the same year, incest was introduced for the first time as an offence in the Penal Code. In 2006, the Criminal Procedure Code (Amendment) Act 2006, introduced evidence by live link. The Act gives the court discretion to allow any evidence to be given via live link if it is expedient in the interest of justice. The issue which will be discussed in the paper is whether child abuse cases should automatically qualify for live link.

1. Introduction

Article 3 of the United Nation's Convention on the Rights of the Child (CRC) places emphasis on the best interests of a child. The Convention provides for the state to take appropriate steps for the protection of children (Article 19). When a government ratifies the Convention, it is obliged to examine closely the implications of such ratification from aspects of law, policy and practice currently in place concerning children. The government then has to propose measures to guarantee compliance with the Convention. As a further precautionary measure, the government has to submit a full report to the appropriate committee that oversees the implementation process of the Convention. Malaysia ratified the Convention on 10 February 1995. Going on 12 years, it is time for us to examine the extent of Malaysia's commitment and progress in promoting the objectives of the Convention. The area which commands much interest is that pertaining to child abuse.

Much has been said about the problem of rape and incest in this country and the ever increasing incidences of these acts of violence on children. It is sad to see that in a modern society, an increasing number of children become victims of such abhorrent offences.

2. Promoting Child Protection

Child abuse became a social problem in Malaysia only in 1991 with the passing of the Child Protection Act 1991(Act468). Although long before 1991 the Children and Young Persons Act 1947 (Act282) had made provisions for the offence of cruelty to children, and the Department of Social Services Malaysia commenced a registry record of child abuse and neglect, all these measures however, did not indicate that child abuse was a social problem that deserved to be addressed by the government. For instance, legislation was not available then to protect or support victims of abuse.

Concern over child abuse, neglect, child labour and other related matters concerning children were brought to the attention of the public through the mass media, seminars and round table discussions throughout the 1980's, brought about the introduction of the Child Protection Act 1991. The Act was a special Act which ensures the protection and care of children. Various forms of abuse was defined in the Act which includes amongst others, a child who had been or was at substantial risk of being physically or emotionally injured or abused by the guardian (Norbani M Nazeri, 2006).

A more focused effort on child protection was made after the ratification of the CRC, in 1995 and in 2001, the Child Act 2001(Act611) was passed. The Act was seen as an accomplishment for those who had for years advocated the rights of children in this country. The Act gave child abuse a wider meaning under the ambit of a child in need of care and protection, and provided for a place of safety for these children. The effort did not

stop there. In August of 2002, incest was made an offence for the first time under the Penal Code (Act 574). From then, efforts were made to introduce video evidence with the setting of the Child Protection Unit cum Victim Care Centre by the Royal Malaysian Police in 2003.At the same time, the victim support services was set up in courts in Malaysia, a service which gives support to child witnesses. .

3. Incest

Incest in Malaysian context is committed when sexual intercourse takes place between very close members of the family, which a person is prohibited from marrying under the law, religion, custom or usage unless the parties did not know of their relationship. This is provided by section 376A Penal Code, and section 376B Penal Code provides for a mandatory custodial sentence for the offence. If convicted, the accused shall be punished with imprisonment for a term of not less than six years and not more than twenty years and with whipping. Section 288 of the Criminal Procedure Code (Act 593) provides for a maximum of twenty four strokes of the whip for an adult male and ten for youthful offender. Before the introduction of incest, charges for incest were made under the offence of statutory rape for girls under the age of sixteen years.

To date, there are no reported cases of incest between adults. Cases reported are incest committed on children. Perhaps this is because the offence was introduced against the background of an increasing awareness of the prevalence of incest and a desire to protect children from sexual exploitation by their parents and those they trusted (Hansard Malaysia 2001). Prior to the introduction of section 376A Penal Code, a vast majority of prosecution for incest were made under section 376 Penal Code (offence of statutory rape) which relate to acts of sexual intercourse between fathers and daughters (Hansard Malaysia 2001). The court in sentencing perpetrators where incest is committed on children imposes a deterrent sentence, taking into consideration the element of public interest. It is viewed that the sentence should not only deter the perpetrators from committing the offence again, but also to deter others from committing the same type of offence (PPv Lee Tak Keong [1989] 1 MLJ 307).

In *Ismail Rasid v Public Prosecutor* [1999] 4 CLJ 402, the accused pleaded guilty on two charges of raping his own daughter aged 14 years. He was sentenced to 12 years imprisonment and 3 strokes of whipping for each of the charges. He appealed to the High Court for the sentence to run concurrently. On appeal it was discovered that the accused had also been convicted of rape of another daughter aged 12 years, and was sentenced to 15 years imprisonment and six stokes of whipping. In dismissing the appeal, KN Segara J viewed that;

> Incest is a sin that can hardly be forgiven. Therefore, when a father rapes his daughter and is convicted in court, any sentence passed must reflect the abhorrence of society to such a heinous and despicable act. A sufficiently strong and effective signal must also be sent out to would-be rapists of this species that the court would not hesitate to come down hard on them, in order to protect those naïve, helpless and innocent children who had placed unquestioning trust, faith, loyalty and confidence in their fathers to be role model as well as pillars of strength and protecting at all times, only to see their lives shattered, humiliated and traumatized by an act of lust that could have easily been curbed and controlled by any self-respecting human being.

It was also held by the court that discounts on sentences should not automatically be given to the accused just because he had pleaded guilty. In a case where public interest demands a deterrent sentence, the plea of guilty should not automatically entitle the accused for a lesser punishment. According to His Lordship;

> *Offenders think that a plea of guilty would enable them to escape the consequences of a severe penalty. It is a fallacy to think that the courts are prohibited from meeting out the maximum sentence permitted for the offence, upon a plea of guilty. Judicial officers, too, should not labour under the notion that in determining an appropriate sentence, a "discount" should automatically be given in all cases upon a plea of guilty, without prior exercise of judicial discretion to all facts and circumstances relating to the offence, the offender, the victim, the interest of the public, as well as the Malaysian culture, social behavior and propriety.*

Incest causes great impact to victims especially children physically and psychologically, who are from the very relationship is in a particularly vulnerable position, which the father is in a position to exploit due to her dependence and inexperience and, possibility fear of disrupting relations between mother and father if she lets it be known what is happening, or fear of her father if she refuses to comply with his demands (Rook&Ward, 1997,

p108). Thus it should be one of the aggravating factors that may enhance the punishment, especially if incest continued for a long period of time or that it had been committed against more than one victim.

In *Mohd Zandere bin Ariffin v Public Prosecutor* [2006] 5 MLJ 685, the accused pleaded guilty committing 3 counts of incest on his daughter aged 13 years 6 months. The daughter gave birth to a baby boy as a consequence of the incest relationship. He was convicted on all three charges by the trial judge and was sentenced to 18 years imprisonment and 3 stokes of whipping on each of the three charges. The trial judge ordered the sentences on the three counts to run consecutively where the total term is 54 year. The accused appealed to the High Court for the sentences on him be reduced or be ordered to run concurrently. In dismissing the appeal, the High Court took into consideration a number of factors, mainly;

1) The sentences passed must truly reflect the fact that in this case, the accused had committed three distinct offences of incest and that he was being duly punished for the three distinct offences.
2) Although the judge realized that the cumulative effect of the sentences would have a crushing effect on the accused, nevertheless, according to his Lordship it must be balanced against the very grave nature of the offences committed by the accused, and the demand of public interest on this type of offence. The court viewed that the case was the worst possible example of incest, and demand a stiff sentence. This is based on the fact that the accused had preyed on his innocent daughter and he had unashamedly and mercilessly abused her. The trauma, the suffering and the effects by her own father lives on for the rest of her life especially with the existing of the baby. The accused also had not given any explanation as to why he committed the offence. The facts also showed that he was still married to the victim's mother and still living with her throughout the commission of the offence.
3) The offences committed by the appellant had outraged the feeling of the community, demanding the maximum sentences to be imposed on him. Public interest demands that the sentence shows the society's abhorrent for such offence. The sentences passed must serve as a plain warning that in this country the severest possible penalty awaits any person who commits incest, and
4) Although a guilty plea had saved time and cost, this must be balanced with the grave nature of the offences committed.

Severe punishment seems to be the stand of the courts in Malaysia in dealing with cases of incest on children. Long term prison sentence is seen as the best alternative to hinder the accused for interfering with the life of a child. It was pointed out by the judge in *Mohd Zandere bin Ariffin v Public Prosecutor* [2006[5 MLJ 685, that there is nothing in the Penal Code or the Criminal Procedure Code to explain what sort of incest could be categorized as the worst possible example. Cases of incest vary from a single incident between adults to cases which are far more serious involving children. Formulating guidelines where the facts that had to be taken into consideration varied from case to case is peculiarly difficult. But it is suggested that three aggravating factor can be taken into consideration in deciding on the seriousness of the act whether committed to a child or committed by adult, that is;

a) the relationship started at a young age.
b) there was abuse by a parent of his position of trust, or an element of corruption; and
c) the incest continued for a long time and ended in tragedy (Rook & Ward 1997, p108).

Incest is viewed by the court as a very serious offence committed on children. Judges without hesitation pass deterrent sentence on perpetrators. But before this is possible, justice demands that the child appear in court as witness.

4. Child Evidence

The adversarial system which stresses on the traditional confrontation system of live evidence, examination in chief and cross examination is often stressful on children. Giving evidence against one's own relative or someone trusted or known to you in a rape or incest case is distressing indeed. Having to relate experience of a rape to strangers is embarrassing, as well as confusing. The adversarial system also unfastens another dilemma on children of the 'stage play' where advocates are free to rule the court room with their advocacy skill and 'trickery' which may leave the child tense and confused.

Stress, trauma and emotional breakdown of child witnesses in sexual abuse have been discussed as far back as 1925, when the Departmental Committee on Sexual Offences in England (Cmnd. 2561, 1925, para66) reported;

> 'We have had many cases brought to our notice in which a child or young person has been overcome with distress or fright in giving evidence at the trial and has broken down or even fainted. The result of this distress has sometimes been that no evidence could be obtained and the case has consequently been lost or has had to be withdrawn.'

These strain and difficulty is illustrated in *Yusaini Mat Adam v PP* [1999] 3 MLJ 582. The accused in this case was charged with the rape of his step daughter aged 10 years, 8 months. She was 11 when she gave evidence. Vohrah J stated the observation made by the trial judge regarding the witness;

> '.. the girl sometimes cried when she was to relate what had happened, sometimes she turned pale and sometimes she refused to speak and that the court had to adjourn the proceedings several times in order to clear her mind before she testified.'

In *Sidek bin Ludan v PP* [1995] 3 MLJ 178, a child aged nine years ten months was raped by the accused, his neighbour. The child gave evidence when she was ten years six months old. The trial judge noted that the child was under great stain while giving evidence and whenever she was asked a question or asked to relate the incident between her and her neighbour, she became uneasy and fidgety. On this point the court pointed stated that the child's;

> ' … ' gelisah' (uneasy)feeling is quite understandable . It is quite embarrassing for her to expose the sordid rape episode in court.'

The court observed that the child went through such strain in giving her evidence. The court then held that that despite going through the strain and embarrassment, the child had tremendous courage. She was able to give clear accounts of the incident and was able to respond well to cross examination by the defence. The child in this case is an exception. She was firm in her reply and was able to resist the advocate's attempts in shaking her credibility.

Observations from the cases above show that the adversarial system puts too much strain on a child in giving live evidence. It also confirms the 1925 Committee Report on Sexual Offence Against Young Persons. The judge in *Yusaini bin Mat Adam* also observed that;

> '…the child's ordeal as a witness was still made far more difficult than it should have been. Children were usually propelled unprepared and unprotected into intimidating atmosphere of a formal criminal trial….'

Strain, intimidation, and emotional distress can be eased with some change in procedure which does not at the same time compromise justice (Norbani M Nazeri, 2007). Procedure should be child-friendly to take away at least some of the discomfort of a child witness.

4. Live Link

Although great effort had been taken in the drafting of the Child Act for the purpose of protecting children, unfortunately, the Act did not provide provision on evidence. Evidence by a child is still provided for in the Evidence Act 1950 (Act 56). A child is a competent witness but corroboration is still required to convict the perpetrator. There is no special provision when a child gives evidence. But in October 2006, the Criminal Procedure (Amendment) Act was passed (the Act is not yet in operation). One main feature of the newly passed Act is the introduction of the new section 272B. The provision allows a witness with leave of court to give evidence through live link or live video link. The provision departs from the tradition rule of the adversarial system.

Section 272B reads,

> 1) Notwithstanding any other provisions of this code or the Evidence Act 1950, a person, other than the accused, may, with the leave of court, give evidence through video or a live video or live television link in any trial or inquiry, if it is expedient in the interest of justice to do so.

The amendment does not specify the application solely for child witness, but it is a still a positive move towards improving the procedure for child witnesses with the object of save guarding a child's welfare and their wellbeing throughout the trial. The court has discretion to allow a child witness to give evidence via live link. As

discussed above, child witnesses are disadvantaged when giving evidence in court with the fear, anxiety, and stress due to them being examined and asked to recall their bad experiences , as well as being challenged by the advocates with intimidating questions and sophisticated language structure which confuses them. Be that as it may, what children fear most is really a confrontation or facing the accused or the abuser, who had over powered them in many aspects of their effort to retaliate (Spencer, Flin 1990, p70-72).

Section 272B (3) provides that, the court will not give leave if in doing so, it would be inconsistent with the court's duty to ensure that the proceedings are conducted fairly to the parties to the proceedings. Meaning, the court has a duty to ensure that the system operate fairly to not only the child witness, but also to the prosecution and the accused. The provision is vague. No guideline is given for the court to refer to. This is important particularly because judges who decide on the matter are mostly inexperience as it departs from the tradition of the adversarial system of face to face confrontation with the accused.

Judges should refer to experiences from other jurisdiction in making its decision. The English courts, as far back as in 1919 has departed from the tradition of confrontation. In the case of *Smellie* [1919] Cr App.R 128, it was decided that if a judge considers that the presences of the accused will intimidate the witness, then for the ends of justice, the judge will not hesitate in removing the accused from the presence of the witness. In this case, the accused was ordered by the trial judge to sit out side, out of the sight of his eleven year old daughter who gave evidence against him in an assault case.

More recently, in *R v XYZ* [1989] 91 Cr App.R, it was held that at times, the necessity of trying to ensure that a child is able to give evidence may outweigh the prejudice towards the accused person in departing from the traditional confrontation system. This case was a case of child abuse where the judge gave permission for the child to give evidence behind a screen. This was objected by the defence counsel on the ground that the use of the screen was unfair and prejudicial which may influence the jury into believing they had already threatened and intimidated the child in some way. The court in making its decision took judicial notice that children in sexual abuse cases had been reluctant to give evidence and that in some cases they breakdown while giving evidence. The court also took into consideration the social services' view that some children would be affected if they saw the alleged perpetrator. But the court then warned the jury not to allow the presence of the screen to influence their decision. In Malaysia, following Vohrah J's observation in *Yusaini,* that since jury trials have been abolished, there is no danger of the court misunderstanding the purpose of a screen or the live link (Norbani M. Nazeri, 2007).

In the United States, the right to confront by the accused is protected by the 6th Amendment to the Constitution of the United States. In *Maryland v Craig* 497 U.S 836, the Supreme Court held that the public interest of the wellbeing of a child witness in an abuse case maybe sufficient to outweigh the accused's right to face to face confrontation. The court went on to say that the right to confront does not only mean face to face confrontation. It also means the right to examine the witness, giving evidence under oath, and observation of the demeanour of the witness. If all this have been fulfilled, the accused position has not been prejudiced.

Live link can do little to affect the trial proceedings or the way in which cross examination is conducted. It is business as usual except that the child is physically removed from the court (Jennifer Temkin, 1990, p410). As long as the accused is not prejudiced by it then public policy in ensuring a child's physical and psychological wellbeing justifies the court to depart from the tradition trial process of confronting the witness. Courts in Malaysia can follow suit in realizing the importance of protecting child witnesses from the trauma of giving evidence in court. After all since 1991, public policy demands that we protect our children from all harm and abuse.

5. Conclusion

Much has been said about child protection in Malaysia, which includes protecting child witnesses from the stress of giving evidence in court. Section 272B Criminal Procedure Code (Amendment) Act 2006 is no doubt a long awaited development. But more improvement is needed to protect the wellbeing of child witness. The corroboration rule will need to be looked into. Video evidence should be implemented since the Child Protection Unit has long been set up to accommodate the use of video technology in court. The rule on similar fact evidence should also be more accommodating in child abuse cases. Efforts must also be stepped up in implementing evidence via live link.

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Virtual Criminal Law in Boundless New Environments

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Abstract. With the growing financial importance of virtual worlds, crime spreads its wings and takes flight. This paper looks at the current status of criminal behaviour in virtual worlds, where it has increasingly become more possible. The author comes to the conclusion that real life criminal law is applicable on virtual life activities, when those activities break through the expectations participants and developers are legitimately allowed to have. Even though criminal law can be applied to virtual criminal behaviour, the question remains whether it is opportune to use criminal law and to prosecute virtual world participants. The answer to this question can, without empirical data, only be a political one and is therefore left open in the end.

Keywords: virtual behaviour, criminal liability, computer

1. Introduction and blueprint

In the beginning of the twenty-first century, a major growth seems to be visible in the digital environment. Virtual worlds that started out as computer games have become popular, as more and more people searched for something new or something different. Diverging from the earliest participants, these people are not only there for hardcore gaming, *i.e.* mainly fight or build-games, but this new generation is infused with more commercial goals. They like to share ideas, equipment and designs. People gather together to attend virtual concerts. With their in world characters or alter egos, often referred to as 'avatars', they go to virtual bars, banks and employment-agencies in new worlds as 'Second Life' [1]. In virtual worlds, the aforementioned people can buy land, houses, furniture and clothes with real life currency. The sky seems to be the limit. There are participants making their daily living by offering, for instance their services as a gardening-architect in virtual sceneries [2]. From all over the world people enter these virtual realms to start a shop or to just hang around with friends. Working in Second Life can pay a nice salary as well. There are virtual job vacancies at the moment paying up to 2750 Linden dollars per hour, being the equivalent of approximately 10 US dollars [3].

Communities like 'Second Life' were preceded by worlds that were created for gaming-purposes only. In this latter category, of which 'World of Warcraft', 'Entropia Universe' and 'Silk Road' are just a few recent top of the iceberg examples, participants can create a character (mostly called an 'avatar') with which they roam a vast virtual world. By fighting with creatures and negotiating with other members, they gain experience-points which can be used to upgrade their avatar with. In these spheres, tremendous amounts of money circulate. According to developer Blizzard's website, 'World of Warcraft' has a total subscriber-base of over 8.5 million users, paying an average of $ 13, 99 per month [4]. This comes up to a total income of over a billion dollar per year. It is not only monthly fees generating the income. In another digital realm named 'Entropia Universe', there is no fee at all. Users can participate in a virtual economy by buying and selling virtual items with currency that is connected to the American dollar. On the 'Entropia Universe'-website, it is stated that the virtual 'country' had a turnover in 2005 of 160 million dollar [5]. Considering these means, Entropia can be compared to a small real life country. Recently in January of this year, the developer of 'Entropia Universe' announced an auction of virtual bank licenses. This will bring the virtual universe even closer to become a real market that should be reckoned with.

Environments like these, which do not exist in real life but are built up out of digits only, give rise to a long list of economical, sociological and legal questions. Specified to the legal discipline, the aforementioned development does not hesitate to recently spring even more interesting questions on various issues, such as for example human rights and virtual currency (Van Balen e.a. 2006 and Franken 2006). In this paper, the criminal side will be examined. More specifically, I will be regarding the substantive part of criminal law, focusing on how criminal acts are committed in a virtual world and the preceding question concerning the mere possibility of

qualifying sheer virtual acts as legally relevant criminal ones. Other important questions that can be raised from a criminal law perspective, concerning for instance the procedural aspects as who can claim jurisdiction over crimes committed in a virtual environment, will not be discussed.

Before coming to the corporeal part of this paper, certain semantic matters ask for more explanation a priori. They will be dealt with in Section 2. In Section 3, it will be discussed whether, in abstracto, it is possible to apply criminal law on virtual environmental situations. The question concerning the mere usage and usefulness of criminal law in a pure digital context is to be examined in Section 4. In the final section, it will be stated that *in abstracto*, it appears possible to apply criminal law to virtual situations; nonetheless, the assessing of the necessity of it all is left with an open ending.

2. Semantics and limitations

Virtual worlds are experiencing a big expansion, which covers a broader public than ever before. Although definitions have been made extensively in precedent publications, matters of semantics can not be easily avoided when writing on a topic which is as changeable as the underlying one. Exposés covering virtual contexts tend to outdate rather quickly. In order to slow down this process, this paper consists of a few fairly abstract parts. In this paragraph some definitions and limitations will be given.

First the difference between real life and virtual life should be clarified. 'Real life' covers the everyday life taking place outside a computerized world. 'Virtual life' on the contrary takes place within created fictional virtual worlds. As mentioned in the introduction, those virtual worlds consist of gigantic computer animated sceneries in which members can wander around with other participants. Still, questions can be raised on everyday real life concerning computers, such as visiting websites or chatting. In between the two terms 'real life' and 'virtual life', there exists a rather grey area that regards the acts that seem virtual, but are in fact real life. In the following, acts as the just given examples of chatting and web surfing are not considered to fall within the reach of virtual contexts. Neither does the even more grey coloured example of a person using a program called a BOT to cheat in a virtual world for instance to copy someone else's Second Life assets with a CopyBot [6]. Thus virtual life as used in this paper is only about the acts being possible in the specific virtual context without additional actions being required in real life other than manoeuvring one person's virtual character.

Second, it is necessary to underline that this paper focuses on criminal law within virtual environments only. Accordingly, innumerable other interesting topics are excluded from this exposé. This is in coherence with the aforementioned point as the difference between real life and virtual life is made more concrete by the following. It is possible, for instance, to hack into someone else's computer and open, copy, and steal (etc.) that person's digital belongings. This can be called a 'cybercrime', but it is not the kind of criminal activity covered in this paper. The kinds of criminal acts that are to be covered, are the ones committed inside the virtual life in the virtual world. Whether these activities can be considered crimes and human acts will be discussed in the next section, but at this point it is of concern to explain that the deeds taken up in this text are the ones committed or omitted in a digital, not really existing, world. To commit those kinds of crimes, it is necessary to have a computer. Therefore, they can be categorized as 'cybercrimes'. It is emphasized the 'cybercrimes' taking place outside a virtual world are excluded. In this paper only (criminal) activities in virtual life are to be regarded.

The third notion is in line with the second one; as obviously inherent to a virtual world, other physical laws apply. Some things are possible in real life that are not possible in virtual life and vice versa. Accepting the fact that however even the sky seems not to form a limit in virtual worlds, some things are just impossible, leads to the conclusion that some real life crimes are not suitable for application in virtual environments. Homicide, for instance, can not be committed in a virtual context as homicide requires a dead human as an attending circumstance (Viersma & Keupink, 2006). This point will be further explained in Section 3.

Finally, it is important to mention that the aim of this text is to present some theoretical thoughts on the application of criminal law in virtual worlds. These theoretical ideas are actually meant to be open for use in nearly every legal system. With this intention in mind, it is clear that a certain amount of abstraction is inevitable. Another argument for keeping certain parts rather abstract is found in the outdating process which seems to be accelerated in the field of virtual environments, as previously mentioned above.

After making these four remarks on semantics and textual boundaries, the application of criminal law in virtual worlds will be observed in the following section.

3. Criminal law in a virtual world

3.1 General notions

This section will discuss whether it is possible, in abstracto, to apply criminal law on virtual environmental situations. When researching whether virtual acts can be deemed as legally relevant, it might be opportune to start with considering why they should *not* be regarded as such. This will be dealt in the second Sub-section of this Section. The third Sub-section will consider why acts committed in a virtual world should be acknowledged as relevant for the field of criminal law. First, some specific dogmatic reference points and assumptions will be made explicit.

General views regarding criminalization and criminal liability are assumed as follows. When regulating a society, the legislator reaches a point where he has to make a decision on whether or not certain behaviour should be pointed out as *criminal* and therefore should stand in any way open for punishment. This process of 'criminalization' may theoretically not in any way result in laws stating certain undesirable mere moral behaviour as criminal when it can not cause any objective harm. When there are only moral based arguments for criminalization, that specific behaviour should not be criminalized (Keupink 2007). As a matter of fact (and on a personal note), it should not be dealt in any field of law at all. On the other hand criminalization without any moral idea and based only on (possible) harm is neither well founded. Acts that just cause mere objectively perceptible harm should not be dealt with in criminal law, but should be based on administrative law. In brief, pure moral visions should not be expressed in, or better: through, criminal law at all when no harm is to derive from that behaviour. A certain amount of objectively perceptible harm is required for legitimate criminalization.

The fundamentals for criminal liability are in most legal systems practically and essentially the same. The requirements come in their essence down to a few abstract terms being a human act, a human will and variable circumstances laid down in specific criminal laws and throughout time improved by case-law.

Questions arise when these considerations are viewed through a scope which is aimed on virtual activities. Can the activities taking place in a virtual world be categorized as human acts? What objectively perceptible harm originates from crimes being committed in a virtual environment? In order to answer these questions and others, attention will be paid to arguments on why criminal law should or should not be applicable to virtual crimes.

3.2 Why criminal law should not be applicable to virtual crimes

Several arguments can be posed concerning why there is no room for criminal law in virtual worlds. First, it can be doubted if the activities of virtual characters can be viewed as 'human acts'. Second, it is questionable whether any real harm can arise from acts committed or omitted in a virtual world. A third argument can be found when answering the question whether certain crimes are not actually part of the game. Next to these legal based arguments, some more politically orientated objections can be presented to argue in favour of not applying criminal law to virtual crimes. In essence, they come down to the difficulty of the application, the possible refusal by the virtual community, the unwanted interference of authorities in a primarily private situation and the possibility that true crimes might not even really take place in a virtual environment. These mainly political objections will be dealt more thoroughly in Section 4. The aforementioned ones will be named first and refuted in the subsequent part of Section 3.

No human act

The possible crimes that are put central in this paper are taking place in a virtual world and are committed by creatures that are generated with a computer. The acts are only visible by using a computer. Without electricity for instance the supposed crimes would not even exist. Besides, they can only be qualified as crimes through a generous interpretation, as the actions of moving pixels on a screen do not actually mean anything. Aside from qualification issues, the virtual activities do not take place to the detriment of other people, but to computer characters which happen to be controlled by another human. Under these circumstances, it can even be possible that the character is not controlled by the human player behind the computer. In a virtual community like Second Life the participants can write their own programming scripts, meaning that in their virtual house for instance they can add a button which will manifest an action by any other player clicking it, like dancing for example. This possibility is partially responsible for some controversy in Second Life as members have also written scripts that enable characters to display sexual behaviour. This is a nice option for real life couples living at other sides of the world but for some people, it is also a source of concern.

When doubting the presence of a human act in virtual behaviour, it might rather extreme even be argued that it is the character which constitutes the criminal behaviour and not the human player behind it. This approach can be compared to the criminal liability of companies which in some countries seem not to be able to commit crimes. Without a specific basis in criminal law, one might deem it impossible for an 'avatar' to commit criminal acts. Even with a specific basis it would at least be weird to presume the character to be able to be criminally liable as itself. How could it even get punished? This would by the way also create problems concerning the required 'human will' but that is more of a side step.

No specific harm
It can be stated that no real harm can occur in a virtual society that exists of mere binary digits. Criminal law originally aims at protecting certain specific categories such as life, physical health, property et cetera. These well protected 'goods' just can not be harmed in a non-existing world. The virtual environment is purely fictional and the things happening inside do not have any actual consequence in real life. At this point, it must be remembered that this paper only covers crimes taking place within a virtual world. Activities that damage or deceive programming-codes are taking place in real life and do not fall within the range of this exposé.

Part of the game
Connected to the 'lack of harm' argument, an important point can be stated - that even if there is any objectively perceptible harm which occurs in a virtual world, that harm can not be seen in anyway way different than being part of the game. In virtual communities like 'Silk Road', an important part of all activities regards killing creatures and collecting leftover piles of coins and weaponry from other members. And even when it is not specifically created as a part of the game, participants should take into account that they enter a world which is in fact made to facilitate extraordinary occasions. A number of activities should be foreseen by the users. At this point however, a boundary becomes visible when the question is posed how far other participants are allowed to go in a virtual world when they interfere in other members' freedom to roam the virtual environment. Can and should the participants' freedom in anyway be limited when certain lines are being crossed? Where do those lines begin and where do they end? Parallels are visible with certain sports, like boxing for instance, in which 'more' is permitted without criminal law orientated repercussions than is regularly allowed outside the sports arena.

3.3 Why criminal law should be applicable to virtual crimes

In this sub-section, the arguments in favour of not applying criminal law to virtual activities are refuted. For several reasons, it can be essential to qualify certain activities in a virtual environment as relevant to criminal law. In this part the same steps as in Sub-section 3.2 are followed. After discussing the amount of human influence involved in virtual behaviour, the focus will lie on harm and the question whether (which) forms of harming behaviour should be seen as part of a virtual setting.

Human acts
Diverging from what was stated above, the activities taking place in a virtual world should be seen as 'human acts'. It is in essence a human which pushes the buttons, handles the mouse and directly controls the figure roaming through virtual sceneries. The human behind the virtual character is responsible for everything his virtual alter ego manifests. The avatar does not move by itself. It makes no difference that these movements end when the computer's power supply is switched off.

At this point it is important to distinguish between certain forms of crimes. Not every kind of real life criminal act can be committed in a virtual environment. As mentioned earlier, homicide for instance can not (for now) be committed via the mere use of a computer. Other crimes on the other hand excellently fit in the computerized worlds that generally focus on trading virtual goods and money. They involve crimes like theft, fraud and money laundering. Crimes concerning defamation and slander can also rather easily be committed in a virtual context as well. A third category concerns vice crimes. It was recently announced in The Netherlands that some test-trials might be started concerning child pornography in the virtual world of Second Life. Reasons for possibly starting these test-cases are the existing uncertainties on whether these crimes successfully can be brought to court [7].

Objectively perceptible harm
An argument for not applying criminal law to virtual behaviour is the lack of harm caused by the activities. It is, however, not true that there occurs no objectively perceptible harm. In most of the virtual environments, there exists a virtual market on which community members can trade their goods. People sell their character and equipment for hundreds of real dollars. These goods are even traded on websites like E-bay. At the moment someone is being tricked into giving his expensive magic weapon to someone else, and this other player does not return it, one might reasonably argue that the former controller of the thing has been ripped -off. These are not make-believe situations, but take place in real life. In some cases, they lead to excessive real life consequences. In China, for example, a player stabbed his friend after he sold the other players' sword to a third person [8]. The stabbing took place in real life, but the taking away and selling of the sword in question happened in the virtual world. As long as financial harm can occur, one might argue that other participants in the virtual world can in fact rather easily be harmed. An important question still remains: whether, and if so to what extent, this occurring harm can not be seen as 'part of the game'.

Not part of the game
When entering a virtual realm, participants can expect certain behaviour to occur which they really did not want to be confronted with and which they would not have expected. The End User License Agreement, used by developers to restrict and regulate the behaviour of members, might not cover those specific situations. Nor, as Lastowka and Hunter (2004) mentioned, does the fact that in most of the virtual worlds, crime is inherent to an environment which facilitates a thieving class like in Ultima Online, where their statements are based on. For this type of theft, it is necessary to perform a specific action- a specific combination of buttons on a computer, which makes theft in that world legitimate. This is a type of criminal behaviour, which should be expected and accepted by Ultima Online-players as it is intentionally made possible by the developer. However, creative players will find different ways to transfer other people's belongings in to their pocket. This is not foreseen by the developer and had it been foreseen, it can hardly be stopped. The question than remains is whether this type of property crimes should not be seen as part of the game and therefore be regarded as a true virtual crime where real life criminal law can be applied.

Some crimes definitely can not be committed, such as murder: killing someone's avatar might be psychologically painful; nevertheless, it does not end a human life. Brenner (2001) describes a possible virtual rape in the early days of cyberspace. Raping, in my opinion, is like homicide not really possible in a virtual world either. Lastowka & Hunter (2004) only regarded crimes, which harm participants' virtual property. Other crimes can be committed in a virtual world too. As previously mentioned, slander and vice crimes can also be committed virtually. It is possible that a player starts spreading false stories about other players that harm their accurate and slowly established little Second Life shops. As reputation is very important in virtual communities, it can harm a person's income which he is making with a virtual shop in a virtual world. On vice crimes, it can be stated that in a world like Second Life it is possible to create every attribute thinkable. This also gives room to people with ideas that might seem perverse to others. As mentioned above, the Netherlands have considered the idea of starting a test-prosecution on virtual child pornography and sexual actions with virtual children. In Second Life, child avatars for instance rent themselves as prostitutes for only a few Linden dollars [9]. None of the sexual behaviour takes place in real life, but it is argued that the facilitation of these activities creates a market that needs to be firmly rejected by the real life society. From an abstract theoretical point of view, this way of thinking is not free of doubts. As previously stated, criminalization of mere morally unwanted behaviour should not occur in rule of law based civilizations. A financial crime that might take place in a virtual world like 'Second Life' is money laundering by shifting large amounts of money through a seemingly endless chain of untraceable avatars and letting it end on some bank account. More easily it would be to use two avatars and sell worthless objects for a very high price and then transfer the money to other real life bank accounts. Or what to think of the corruption among administrators in EVE-Online? [10] Those were crimes that were committed in real life to the detriment of the virtual world. These can not primarily be qualified as cybercrimes in the definition given in the second section. However, there are certain members in virtual environments that are given more power than others. How about participants wandering through virtual realms as some kind of God because they were given some sort of power: where there is power, there is corruption.

3.4 Conclusion: criminal law can be applied in virtual worlds

Papers on true virtual crimes and on virtual worlds, in general, have a tendency to be outdated rather quickly. Important publications, such as Brenner (2001) and Lastowka & Hunter (2004) were written on a specific

moment in time. Nowadays more is possible within the virtual worlds, as will be in a few years from now. The conclusion at this point must be that new developments in virtual worlds make it possible for criminal law to be applied on pure virtual behaviour. It is still questionable if that application is something that should be desired.

4. Some remarks on the added value of criminal law in a virtual context

The question concerning the mere usage and usefulness of criminal law in a pure digital context is to be examined in this section. Why should criminal law be applicable on activities taking place in virtual worlds? Does the application need an entire, new system of regulation and procedural prescriptions? Is it worth going through all the trouble if it is just another internet-bubble? Who needs and/or wants criminal law to be applicable? Are there any problems now? Does the application of criminal law only create new problems? The list of questions is endless and far to long to be answered in the underlying paper. More research is of course needed. On the other hand there is nothing wrong with a scholarly ex ante approach. Therefore a few notes will be made at this point. They were previously discussed in the Sub-section 3.2 and concern the unwantedness by the virtual community, the factual difficulty of prosecution, the denial of existence of pure virtual criminal behaviour and the difference between public and private virtual activities. The answers to these problems are of a certain political order and therefore can be rather arbitrary as everyone has his own ideas.

First, it is widely known that the hardcore participants of virtual worlds want to keep big commercial activities far away from their world in which they want to drift away. It is said that big companies spoil the virtual markets. Governmental involvement is also rejected by the original (native) inhabitants. Recently, when a real life community opened a virtual department of City Hall in Second Life, there were streakers disturbing the big opening by the alderman [11]. When a community member hits it big, other residents react negatively and disturb that person's public performances as well as the recent Anshe Chung Studios case shows [12].

Second, one might argue that it is too difficult to prosecute the supposed virtual criminal behaviour in real life courts. It might be seen as an acceptable academic exercise which will remain in academia. Next to it being too difficult, the question can be raised whether prosecuting adds anything valuable. In a time where authorities can not solve every crime and can not try every case in court one might wonder if there is any added value when virtual behaviour falls within the reach of criminal law.

The third note covers the denial of crime in virtual worlds. Maybe it is just a big hoax, hyped by media. Maybe criminality does not really exist in virtual environments. Empirical data is lacking so far. The collection of those numbers is, however, something to be seriously considered.

The final remark to be made regards the difference between private and public behaviour in virtual worlds. Is it not wonderful to have your own space somewhere in a harmless virtual world where you can be king and welcome guests from all over the world? Is it not great to build your own virtual skyscraper on a small piece of land that is built up out of digits? Is it not better to have people with fantasies that are commonly rejected by the real life society come together in a virtual world so they can practice their putative perversities somewhere else than in the real world? In virtual worlds like Second Life most things happen in virtual public. In some parts of virtual worlds, the entrance can be restricted. In these private areas, participants should be able to do what ever they want. The question remains if this should be bound by rules and regulated by authorities, even though it is essentially a private contract between the developer and the member.

5. Round up: an open end

In *abstracto*, it appears to be possible to apply criminal law to virtual situations. As harm can be done and the specific behaviour can easily be qualified as human, there seems to be not much problems when working with criminal law in a virtual world. Inherent however to virtual worlds, is an agreement between developers and participants. In these agreements and deductible from a virtual community's character, members should expect certain behaviour, which in real life would be qualified as criminal, to be part of the game. Nonetheless, not every criminal act has to be accepted. When harming other players by breaking the game rules with virtual activities, it is stated in this paper that criminal law should be applied. And even when one might not find it possible to apply criminal law on the current true virtual behaviour, it can be seen as an opportunity for a legal ex ante approach which economists usually blame lawyers not to be able to. What is wrong with giving some thoughts on situations that in future versions of Second Life and other virtual worlds, at least, are to be expected? Brenner states that the law is only driven by what happens (Brenner 2001 par. 127). In my opinion, that only counts from a legislator's perspective and not when approached by scholars. From a practical point of view the necessity of it all was left with an open ending in Section 4. It is really up to politics to assess whether criminal

law should be applied on virtual behaviour. In this paper it is argued that it is possible. Further empirical research, mainly data orientated, is required to achieve a proper judgement on this topic.

Notes:

[1] "Second Life is a 3-D virtual world entirely built and owned by its residents. Since opening to the public in 2003, it has grown explosively and today is inhabited by a total of 5,203,176 people from around the globe." See http://secondlife.com/whatis/, retrieved 2 April 2007.
[2] See http://www.anshechung.com/, retrieved 2 April 2007.
[3] See http://www.virtuelebanen.nl/en/browse/jobs, retrieved 31 March 2007.
[4] See http://www.blizzard.com/inblizz/profile.shtml, retrieved 31 March 2007.
[5] See http://www.entropiauniverse.com/index.var, retrieved 31 March 2007.
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[7] See http://www.netwerk.tv/archief/4037675/433/Kinderporno_in_Second_Life.html, retrieved 31 March 2007 for a Dutch television documentary. Also http://www.nu.nl/news.jsp?n=983672&c=52, retrieved 31 March 2007 and http://www.elsevier.nl/nieuws/internet_en_gadgets/artikel/asp/artnr/140183/index.html, retrieved 31 March 2007.
[8] See http://news.bbc.co.uk/2/hi/technology/4397159.stm, retrieved 31 March 2007.
[9] Supra note 7.
[10] See http://www.gamesetwatch.com/2007/02/eve_online_trouble_in_deep_spa.php, retrieved 31 March 2007.
[11] See http://www.ad.nl/denhaag/zoetermeer/article1227090.ece, retrieved 31 March 2007.
[12] See http://news.com.com/The+legal+rights+to+your+Second+Life+avatar/2100-1047_3-6147700.html, retrieved 2 April 2007.

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The *You Tube* Case: Privacy Protection or the Right to Try to Have Sex on the Spanish Public Beaches?

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Abstract. This paper addresses the limits of privacy rights considering the advance of the You Tube technology. The discussion will analyse the Brazilian You Tube case which deals with the video of a famous Brazilian super model performing love acts on a Spanish beach that was published in the You Tube website. First, we will present the most important legal provisions regarding the right to privacy in Brazil. Secondly, we will begin presenting the facts of the case and the statutory provisions that were invoked to protect the privacy of the Plaintiffs in the case. After briefly reviewing the law, we will address both the majority opinion that granted the injunction to block the access to the video in Brazil and the dissenting opinion. This article also agues against a further ruling that blocked the access to the entire You Tube web site for not complying with the injunction. Finally we will argue that the Brazilian You Tube decision sets bad policy of granting more privacy protection to the celebrities. In other words, the decision goes against the principle that public figures and celebrities should bear the burden of having less privacy protection to avoid threats to freedom of expression of the whole community.

KEY-WORDS: YOU TUBE – ON LINE RIGHT TO PRIVACY – FREEDOM OF EXPRESSION – RIGHT OF PUBLICITY – PRIVACY CASE

1. Introduction

This article is a working paper dealing with some aspects of the protection of the right to privacy online. It is a short part of a larger work in progress. It analyses a recent case decided in Brazil, where the right to privacy in the virtual world was addressed. The facts of the case were related to a video of a famous Brazilian supermodel that was published online in the *You Tube* website. The video showed her kissing and maybe even performing some love acts on a Spanish beach in Cádiz. Her images were captured without authorization and a video was created with short titles between the scenes. The paparazzi posted her video online and the video finally was available though the *You Tube* web site. The super model and her partner sued *You Tube* and asked for an injunction to withdraw the video from the internet. The first decision issued by a state single judge did not grant the injunction, but it was later overruled by a three judge panel from the São Paulo State [2] Superior Court. You Tube complied with the injunction and the video was blocked. Some time later, the video was again released in the You Tube web site. Because the Defendant violated the court order, the plaintiffs asked the judge for a permanent block of You *Tube* in Brazil. Surprisingly, the Brazilian Court ruled for the Plaintiffs.

In this short paper, we will discuss the limits of privacy rights considering the advance of the *You Tube* model of technology and the right to free speech. The discussion will analyse the Brazilian *You Tube* case. First, this article addresses the most important legal provisions regarding the right to privacy in Brazil. Then, we will begin presenting the facts of the *You Tube* case and the statutory provisions that were invoked to protect the privacy of the Plaintiffs in the case. After briefly reviewing the law, we will address both the majority opinion that granted the injunction and the dissenting opinion. Finally, we will argue that the Brazilian *You Tube* decision sets a bad policy of granting more privacy protection to celebrities. In other words, the decision goes against the freedom of expression and the principle that famous people should bear the burden of having less privacy protection.

This paper is written only for academic purposes and the author has no commercial interest in the case. The author does not endorse nor reprimand conducts described in the facts of the case. Once again, the author is interested only in the aspects of the case that are important for the science of law.

2. Brazilian Privacy Laws

The right to privacy is enshrined in the Brazilian Constitutional Law. There are federal statutes that regulate the right to privacy in Brazil. The boundaries of the right to privacy are also set by cases decided by the superior courts, especially those cases decided by the Brazilian Supreme Court.

Due to the fact that Brazil was ruled by a military dictatorship from the mid sixties to the early eighties, fundamental constitutional rights such as the right to privacy were not enforced at that time. Therefore, after twenty years of dictatorship, there was not a lot of jurisprudence from the Brazilian Supreme Court regarding fundamental constitutional rights.

In 1988, a new democratic constitution was promulgated in Brazil. The right to privacy is protected under Article five, Sections five and ten of the 1988 Constitution. It is interesting that Section five of Article five allows the courts to impose moral and actual damages for violating the right of publicity.

Brazilian civil laws were also changed after the new constitution of 1988. In 2002, a new Civil Code was enacted. The 2002 Civil Code of Brazil regulates the so called "Rights of the Personality" in Chapter Two of Title One of Book One. In that Chapter, the 2002 Civil Code establishes that the "Rights of the Personality" cannot be waived at any time by its bearer (article 11). Besides, Article 12 of the Civil Code rules that an injunction can be granted in order to stop any threats to the rights of personality. Finally, Article 21 of the Civil Code addresses specifically the protection of the right to privacy and also allows for the judge to grant injunctions against any threats that might violate someone's privacy.

It is interesting that, even though the new Civil Code of 2002 is very protective of privacy, under the "Rights of the Personality" Chapter, few cases have been decided under the terms of the Code. The reason is that the new Civil Code has been in force since 2003, in other words, a little more than four years; at this point in time, it is still a short period.

There are also privacy laws, in Brazil, such as the Federal Statute n. 9.296 of 1996 that allows the interception of telecommunications for collecting criminal evidence for both criminal investigation and criminal procedure. Only a judge can allow the interception of telecommunications in Brazil. The request for the interception of telecommunication made to a judge has to demonstrate that the interception is necessary, not only for the gathering of evidence but also what means shall be used. Among all of the legal requirements that the Federal Statute n. 9.296 has set forth, we highlight the importance of the secrecy of the discovery procedure. The collection of criminal evidence through the procedural means of the Statute has to run under judicial secrecy. This is an important topic due to two main reasons: the protection of the privacy of the offender and the production of the criminal evidence itself (because if the ones related in the telecommunication were aware that their communication was being intercepted they would not exchange any words that could be used as evidence. Nevertheless, it is important to remember that this Federal Statute n. 9.296 is applicable only for criminal evidence; therefore, a further analysis of the Statute out of the scope of this article.

There is no legal doubt that the laws addressed in this section are applicable to the regulation of the online world, including the provisions of the Brazilian New Civil Code of 2002. We will now turn to a very relevant case that addressed privacy rights on the Internet recently, in Brazil.

3. The Brazilian You Tube Privacy Case

Brazilians are, at least most of them, fanatic about football (soccer) and about their so called "best football players". Among those players, Mr. X is considered to be one of the best soccer players in the world by his Brazilians fans (even though he spent the year 2006 playing in Spain). That player got legally married to a very famous Brazilian supermodel, but after a troubled relationship, they divorced a few months later. The supermodel is very popular in Brazil, where she hosts a television show. The facts of the case involve the supermodel, ex wife of the soccer player and her new boyfriend in Spain. The reason why the case raised so much attention in Brazil is because of her previous marriage with the famous soccer player.

The Brazilian supermodel and her boyfriend (who is not a celebrity) are the plaintiffs of the case, whereas *You Tube* and another Brazilian Internet Service Provider are the defendants.

The couple were caught performing some hot love acts on the beach in Spain. Whereas the first images only showed hugging and a lot of kissing on the mouth, the rest of the scenes showed the couple getting more intimate and torrid until the couple goes into the water. From their movements, when they were filmed in the

sea, one could infer that they were having sex in the salt waters of the Spanish public beaches of Cádiz. But we don't really know, from the images, if the couple did really have sex.

The images were caught, probably, by Spanish paparazzi that edited the images and made a less than a five-minute film with the insertion of some titles of specific parts between the scenes. The titles inserted in the film are somewhat provocative as they suggest that the couple were becoming more and more sensual. The video was finally posted online and You Tube made it available to everyone.

The couple filed for an injunction to withdraw the film from You Tube on the grounds of the constitutional privacy protection, and the constitutional protection of the right of publicity (both on article 5, X of the Federal Constitution of Brazil) as well as having as a cause of action, the rights of the personality from the Brazilian Civil Code (specifically, articles 12 and 21 of the Brazilian Civil Code).

The civil action was filed before a state judge of the Judiciary of the state of São Paulo, who denied the injunction. The couple appealed to the São Paulo State Supreme Court, where a three-judge panel reversed the decision and granted the injunction. The ruling had a dissenting opinion. We will now present the most relevant arguments of the majority opinion that granted the injunction to remove the film from the You Tube web site, followed by our comments and by the dissenting opinion.

Initially, a civil procedure analysis about the legal possibility of granting the injunction without hearing the defendants of the case was made by the judge. The majority ruling says that such an injunction, without the hearing of the defendants is an extreme ruling that is legally valid under the Brazilian Civil Procedure system. The basis of such a conclusion lay in the fact that the time that would take for the summons and for the defendants to answer could increase the damages suffered by the plaintiffs. So, an urgent situation of the Plaintiffs that requires an immediate solution from the Courts is found, in the case, from the facts. There is what the judge calls a risk in the delay, the "periculum in mora". The statutory provision that is the legal basis for the injunction is basically Article 273 of the Brazilian Civil Procedure Code.

After reviewing the legality of the injunction in the case, the majority vote addressed the right to privacy of the plaintiffs. First, a question is raised: "Is it good for the society to have granted the access to the images of the couple?" The judge then answers the question with a "no". The negative answer is based on the argument that what would justify the access to the video would only be the satisfaction of the curiosity of the public- the desire to "know about the life of the others" – to know about the life of the celebrities. In this part of the opinion, the judge balanced on one hand the right of freedom of expression and, on the other hand, the right to privacy of the couple.

We argue that this decision establishes bad policy because it sets a rule that information used only to "satisfy the desire of the people to know about the life of the others" has less free speech protection then other kinds of information. Also, such a ruling sets a higher level of privacy protection for the famous. In general, the majority opinion decides for the right to privacy when it collides with the right to free speech.

As, we have seen, the female Plaintiff is a very famous Brazilian super model. Therefore, the decision rules that normal people should not be curious about the celebrities' lives. This is bad policy: the celebrities-famous are given more privacy protection, whereas if the plaintiff was a non- celebrity, the judgement would be tilted in favour of the freedom of expression because people would show no interest in seeing normal people kissing, hugging and having sex on public beaches.

The majority ruling even cited a case from the Brazilian Superior Court (Recurso Especial number 595.600, from the state of SC, published in the DJ of the 13th of September of 2004) about a top less situation. In that case, the ruling was against a female plaintiff that sued for moral damages regarding the publication of her topless photos on public Brazilian beaches. The *You Tube* majority ruling finds that the Top less case was not applicable to the *You Tube* case. When the Superior Court ruled that someone who decides to show her breasts on the beaches (something that is definitely not usual at all in Brazil) cannot claim damages against people who captured her images, it has set a parameter that should be applied to the You Tube case as well since no nudism was shown. As we have said, it was only hugging, kissing and some movements inside the water (maybe they had sex, maybe they did not have sex) but no nude bodies were shown.

Moreover, the majority opinion stated that no authorization was granted by the plaintiffs for the publication of the film and that it is widely known that paparazzi are very aggressive in their search for celebrity photos and images. Besides, the ruling also agreed with the plaintiffs, who have argued that the images presented the couple in a scandalous and pornographic way that have damaged then both in their professional lives. Finally, the majority ruling says that public display and broadcast of the images have no social importance and that the removal of the video from the You Tube web site is a deference to the protection of the dignity of the human beings.

We can identify, in the ruling, the following arguments used to grant the injunction to remove the film from the You Tube web site: lack of interest of the people in seeing the video only to satisfy one's curiosity; privacy protection of a supermodel on a video that shows a couple kissing and hugging; no authorization from the famous to capture the images and to publish them on line; the plaintiffs' right to publicity and the protection of the dignity of the human beings.

The dissenting opinion is against granting the injunction. The rationale of the dissenting opinion is based upon two arguments: first, the importance of the Internet as a source of important facts for the people that should not be restricted in order to avoid censorship; second, that a celebrity such as the female Brazilian super model that decided to engage in sensual acts on a public beach, in Spain, knowing that there are paparazzi looking for material for their work, cannot claim that she did not know that her image could be filmed. Regarding the male plaintiff, the dissenting opinion argues that he knew that his girlfriend was a famous supermodel, who would attract the interest of the paparazzi in Spain. We also add that the female plaintiff cannot argue that she was not aware of paparazzi in Spain since she was married to a very famous Brazilian soccer player who lived in Spain. During their residency in Spain, she was photographed with or without her ex-husband, the soccer player. So, the dissenting opinion concluded that if someone decides to expose himself or herself in a public place such as Cádiz, known as the "Spanish Riviera", he or she cannot complain invasion of privacy against people who capture their images with a camera or even with a cellular phone video camera.

Of course, despite the relevant arguments of the dissenting opinion, the injunction was granted, and the video was blocked in the You Tube web site system. We know that the video was also made available through other means such as and other web sites. Many people shared the video through e-mails. Accessing the images is definitely something not difficult in Brazil. This is an important point that has to be analyzed: how efficient is such a decision? Maybe David Post has an argument here when he says that the Internet should be seen as a separate jurisdiction because it is very difficult to enforce a decision in cyberspace.

Also, another legal argument against the majority ruling is that, under Article 220, section 2 of the Brazilian Constitution, all kinds of censorship regarding social communications are forbidden. Removing videos of celebrities from You Tube could be a form of censorship.

After initially complying with the injunction, You Tube uploaded the film again. The plaintiff sought a court order and this time petitioned the Court to block the entire access of the country to the You Tube. This was a gross violation of the constitutional right to free speech. Blocking the entire access to You Tube is a not a narrowly tailored ruling because it removes access to other information to which the adult public of the country have the constitutional right to access. Fortunately, this order to block the access to all videos of You Tube did not prevail for more than one week. Such an order violates two important Constitutional principles that have to be balanced whenever a constitutional fundamental right is restricted: reasonability and proportionality. It is not reasonable to block a country's access to a web site such as You Tube in order to protect the privacy of a couple who kissed in public; besides, the scope of the decision is not proportional to the damages (in other words, the decision to block the entire access is not narrowly tailored).

4. Conclusion

The case that this article presents is one of the first important cases regarding You Tube technology in Brazil. The case has not reached the Brazilian Supreme Court, but the court ruling granting injunction is final. It is an intricate case because it deals with two important constitutional fundamental rights: the right to privacy against the right to freedom of expression (and the constitutional restriction of censorship of communications in Brazil). Balancing two broad constitutional rights, such as privacy and free speech is a difficult task because the law must comply with the principles of reasonability and proportionality.

As we have seen, the injunction was granted and the video was blocked (at least, You Tube no longer allows public access to the video) We can conclude that celebrities are protected against the paparazzi under the favourable ruling rendered in the Brazilian You Tube case. One could argue that celebrities have the right to have sex inside the waters of public beaches and no one is allowed to capture their images (and, of course, parents should also bear the obligation of closing their children's eyes when couples get hot in the waters). The policy set by the majority opinion may lead to the conclusion that celebrities are entitled to more privacy protection than regular people because their images in public should not be used to "satisfy third parties curiosity".

Furthermore, the court decision basically ruled that in balancing freedom of expression on line and the right to privacy of super models, even censoring the web should be allowed.

The rationale of the dissenting opinion is interesting because it gives less privacy protection to the famous and therefore it establishes a good policy: famous people such as supermodels make money, for example, from advertising; being famous is one of the factors for raising their income, so celebrities should have to bear the burden of being famous and having people interested in knowing facts about their lives, such as who they are dating and, of course, who they are kissing when going swimming in the public beaches. Otherwise, we would reach a totally opposite policy that, on the one hand, celebrities have their right to engage in love acts on public beaches and not being bothered by the paparazzi with their video cameras (or even cellular phone cameras) but, on the other hand, regular people would not be entitled to such a right, because posting their images on line would likely be legal since such a film would not raise a lot of interest from the people to see their images.

Finally, we conclude that blocking the access of a country to the whole You Tube web site is a decision that goes far beyond the limits set forth by the constitutional provisions of the freedom of expression. Such decision sets a dangerous precedent and the injunction of blocking the entire access to You Tube is disproportionate. In other words, that second ruling is not a narrowly tailored ruling and it is against the principles of reasonability of a decision that restricts free speech.