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## Seventeenth Biennial Meeting of the International Academy of Commercial and Consumer Law

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## FOREWORD

The *Penn State Journal of Law & International Affairs* (JLIA) created this issue as a collection of papers presented at 17th biennial meeting of the International Academy of Commercial and Consumer Law. While a foreword traditionally reflects the contents of a publication, here JLIA has elected to reflect on the passing of two of the issues contributors, Louis Del Duca and Norbert Reich. In memory of these two esteemed members of the legal community, JLIA dedicates this issue. Additionally below, JLIA has included two reflections on Louis Del Duca and Norbert Reich to commemorate their meaningful contributions to law.

## IN MEMORY OF LOUIS DEL DUCA

*By Mary Hiscock*



In the 34 years of the history of the International Academy of Commercial and Consumer Law (the Academy), some colleagues stand out as exemplars and custodians of the principles and values that are the foundation of the Academy. These were summarised by Professor Don King when he wrote a Dedication at the beginning of the published Proceedings of the 4th Meeting of the Academy, which was held in Melbourne in 1989.

To the commercial and consumer lawyers of the new age, to whom national boundaries are but a useful basis for comparison, and international harmony of law is not just a dream, their knowledge is in the wisdom of the past, the development of the present, and the trends of the future; their satisfaction is in the mastery of complex subjects, the conveyance of knowledge to students, the fellowship of colleagues, the creativeness of scholarship, and the furtherance of just and needed reforms.<sup>1</sup>

Don King, Louis Del Duca, and Norbert Reich immediately come to mind as such men. Tragically we have lost the continuing presence and contributions of all three.

Louis Del Duca was a scholar of distinction on the national and international scene. His learning constantly evolved and reacted to contemporary issues in commercial law. He was actively involved in the current work of the United Nations Commission on International Trade Law (UNCITRAL) on developing a framework for dispute resolution for online cross border contracts, particularly those where

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<sup>1</sup> *Essays on Comparative Commercial and Consumer Law*, v, (ed) Donald King, Fred B. Rothman & Co, Littleton Colorado 80127 (1992).

there is high volume and low value of transactions. He was concerned with not only its implications for consumer transactions, but also for commercial transactions in domestic as well as international law. He was immersed in planning for the next Meeting of the Academy in 2016, to be held in Fukuoka, Japan. As usual, he was scheduled to contribute to this Meeting, as he had at every past Meeting.

Louis characteristically reached out and involved others in his work, regularly phoning and emailing and chivvying, where necessary. He was the most generous friends and colleague in the giving of advice and in his concern for the welfare of friends and colleagues.

Louis was a man of transatlantic culture as well as learning. He had a legendary love of opera and performance. In his youth he was torn between pursuing a life of music or of law. In the end, he had both.

Most of all, Louis was a family man. One of his gifts to the Academy was the opportunity to establish a friendship with Frances, his wife. When Frances was around, there was always an extra sparkle in Louis. This was most evident in the hospitality in 2000, when Louis hosted the 10th Meeting of the Academy at Dickinson Law at Carlisle.

Louis joined the Faculty of Law at Dickinson at the beginning of the academic year 1956-7, and “retired” 57 years later. He had completed military service in the US Navy. He had received the degrees of BA at Temple, LL.B at Harvard, and a Doctorate of Law at the University of Rome, La Sapienza. He had also briefly practised law, and taught political science in the intermezzo between Rome and Carlisle.

Throughout his long career, Louis taught generations of students Secured Transactions, Comparative Commercial Law, and European Union Law. He initiated the program for the Master of Comparative Law for overseas students and subsequently the Summer Session Abroad based in Europe. His editorial responsibilities included the Pennsylvania Bar Association Quarterly and the Uniform Commercial Code Law Journal. He was a member of the Committee of the US Secretary of State on International Trade Law, and was active in AALS.

Louis' most recent major work was "Secured Transactions under the UCC" with Edwin Smith, Marie Reilly and Peter Winship, and many many articles on online dispute resolution.

We will all miss him.

## IN MEMORY OF NORBERT REICH

By Hans-W. Micklitz



Norbert Reich 1937-2015, Professor for German and European Civil Law, co-founder of the *Journal of Consumer Policy* 1976, Director of the Centre for European Legal Policy at the University of Bremen, 1982-1991, Director of the Riga Graduate Law School 2001-2004 and a faithful member of the International Association of Commercial and Consumer Law.

Norbert Reich's understanding of law as a discipline is deeply rooted in American legal sociology and critical German and American legal theory. That is where his interdisciplinary and cross-cultural international understanding came from. Consumer law and policy became a topical issue at the right moment in Norbert's academic life. Consumer law and policy cut across thinking in boxes, in particular disciplines of social science or in national legal orders. There were two stages in Norbert's academic involvement of consumer law and policy: first, an early commitment to German consumer law and, at a later second stage, an ever stronger focus on European consumer law and policy.

Norbert Reich began research on German consumer law as early as the mid-1970s. Together with Klaus Tonner and Hartmut Wegner, and on behalf of the then social-liberal government, he published the first draft of what would later be referred to as consumer law. Yet his emphasis was rather on the derivation and creation of a critical economic law, in which consumer law played an essential and permanent role. As early as in 1974, he advocated a structural reorganisation of civil law that was based on status. He writes: "I would like to distinguish between three fields following the reflections of the

socialist theory of civil law:<sup>2</sup> a) the legal communication of businesses (in the field of production capital), i.e., *company law* (companies in terms of antitrust law and not in terms of commercial law HWM), b) the exchange of goods between businesses and final consumers (in relation to the ownership of means of production to the ownership of consumer goods), i.e., *consumer law* (in the strict sense of the term – in the broader sense consumer law refers to administrative, penal and procedural rules; see Reich 1974), c) the field of private legal communication between citizens (classification and exchange of ownership of consumption means), i.e., *citizen law*.” As a logical conclusion of the case for an autonomous consumer law, he argued persuasively for a constitutionalisation of consumer law, a reversal of the relationship of dispositive and mandatory law and a reorientation of the legal dogmatic principles towards social science.

If one looks back to the initial situation of the 1970s, it comes as a surprise that the trisection of civil law has largely become a reality – within and through the Europeanisation of consumer law. The status-based revision of private and economic law has prevailed, strongly promoted by the European Union that had gradually become the driving force of consumer legislation. Norbert Reich had prepared the shift of national consumer law towards the European level through the then nine member states reports that the European Commission (through Ludwig Krämer) had commissioned.<sup>3</sup> The country reports were published in the late 1970s with Norbert Reich as editor (Reich 1980/1981). From now on, Norbert Reich followed the creation and the development of a genuinely European consumer law in his role as managing director of the Centre for European Legal Politics (ZERP) at the University of Bremen.

His own research peaked in the monograph with the title “Civil rights in the European Union,” published in 1999. The subtitle clarifies the topic: “Subjective rights of Union citizens and third-country citizens with particular focus on the legal situation according to the

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<sup>2</sup> Norbert Reich wrote his habilitation on Soviet Civil Law. He translated from Russian to German Pēteris Stučka the second important Marxist theorist Paschukanis. Pēteris Stučka, *DIE REVOLUTIONÄRE ROLLE VON RECHT UND STAAT* (Norbert Reich trans., 1969).

<sup>3</sup> The nine country reports are available in English, the comparative analysis in English, French and German.



case law of the ECJ and the Treaty of Amsterdam.” In order to justify the necessity of the protection of subjective rights in a transnational quasi-state institution such as the European Union, Norbert Reich chose *Georg Jellinek’s System of Subjective Rights* (1892) as the starting point. There is a direct link between the ground breaking contribution on the reorientation of civil and economic law (1974), the publication on the promotion and protection of diffuse interests in the European legal order (1987), and his work on the civil rights in the European Union (1999). During a period of 25 years, Norbert Reich not only contributed to the Europeanization of civil and economic law, but also illustrated the necessity of their integration into a European constitution.

In 2001, Norbert Reich was appointed rector of the Riga Graduate Law School. He focused on the eastward expansion, especially on questions of a modernisation of consumer, civil, and economic law in the Baltic States as well as in the former central and eastern European block states, the integration of which into the EU had been agreed (and came into effect in 2004). After his retirement in 2005, he again dealt with European consumer law and union law in the shape of a conceptual and dogmatically thought-through overall presentation. It is due to his indefatigable energy and dedication that Intersentia published the second edition of the “European Consumer Law” under Reich’s overall responsibility (Reich et al. 2014). Shortly before his death, the new edition of his work “Understanding EU Internal Market Law” was published. This is not another introduction to EU law; rather, it focuses on the “internal market,” the civil and economic law of the EU that is surrounded by civil rights, and their leading principles. Although these two later works may be reason enough to trace his enormous creative power, his intellectual legacy lies in a dense monograph on the “General Principles of EU Civil Law” that was published in 2014. This book brings full circle his work on the reorientation of civil and economic law he first argued for 40 years ago. The careful choice of the title reflects the economic and socio-political significance of civil law. European Civil Law should be guided by general principles that are rooted in the constitutional order of European society.

The International Academy of Commercial and Consumer Law will remember him as a loyal participant to the biannual

conference, an inspiring mind who contributed heavily to our international community he hosted the 12<sup>th</sup> biannual meeting of the IACCL in Riga/Latvia 2004. We will miss his bright ideas and his endurance for the role and importance of consumer law in an international economy that is more guided by efficiency than by matter of social justice. We did not only lose a great scholar and one of the pillars of European consumer law, we will miss a friend who was out there with his unlimited preparedness to provide advice and support.

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## ON THE INTELLECTUAL HISTORY OF FREEDOM OF CONTRACT AND REGULATION

*Hans-W. Micklitz\**

### INTRODUCTION

Are we private lawyers not convinced that we share a common understanding of “freedom of contract,” of “freedom”<sup>1</sup> and “contract,” and of restrictions on that freedom of contract through “regulation?”<sup>2</sup> Is this common understanding not the basis on which we all operate implicitly or explicitly in our intellectual discourse cutting across different legal traditions and different legal cultures?<sup>3</sup> At the very least, is not the notion of contract freedom shared in all countries governed by a market society and even more so if the market society is embedded into the Westernized model of democracy?<sup>4</sup>

What if this common assumption turns out to be wrong or is no more than a rather superficial “gentleman’s agreement,” which allows us to communicate with each other whilst maintaining our own preconceptions? Digging deeper into intellectual history, legal theory, and legal philosophy reveals that, for example, a French lawyer and an

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\* Professor, European University Institute Florence.

<sup>1</sup> See generally UDO DI FABIO, *DIE KULTUR DER FREIHEIT* (2005) (for a German understanding of freedom of contract).

<sup>2</sup> See HUGH COLLINS, *REGULATING CONTRACTS* (1999); Gary Marks, Liesbet Hooghe & Kermit Blank, *European Integration from the 1980s: State-Centric v. Multi-level Governance*, 34 *J. COMMON MARKET STUD.* 3341 (1996).

<sup>3</sup> See Kaarlo Tuori, *Regulation Theories*, in *TRANSNATIONAL LAW: RETHINKING EUROPEAN LAW AND LEGAL THINKING* 11-57 (Miguel Maduro, Kaarlo Tuori & Suvi Sankari eds., 2014); *THE MANY CONSTITUTIONS OF EUROPE* (Kaarlo Tuori & Suvi Sankari eds., 2010).

<sup>4</sup> Gunther Teubner, *Contracting Worlds: The Many Autonomies of Private Law*, 9 *SOC. & LEGAL STUD.* 399 (2000).

English common lawyer may not necessarily be talking about the same thing when they argue about “freedom of contract.” This becomes even more complicated if we look at the limitations and restrictions on “freedom of contract,” which are set out via statutory regulation.<sup>5</sup> These lawyers might agree on what a state is by equating it with the “nation state,” but might encounter more problems in understanding and agreeing on the meaning of “regulation.” Regulation can be private or public. When created statutorily, regulation might facilitate or restrict freedom of contract. Statutory intervention, might, depending on one’s perspective (liberal or welfarist), trigger very different expectations, feelings, or sentiments. Our perception of “regulation” very much depends on what we expect as citizens from “our” state.

This paper starts with two examples that are meant to highlight deeper cultural differences in deciding conflicting contractual issues. One example is taken from the French/German context, the other example is from the German/American context. These examples serve to underpin the hypothesis that the understanding of contract and regulation in the three countries under investigation – France, Germany and the United Kingdom – differs considerably and the reasons for the differences can be found in the intellectual history of the respective states. Further, this paper continues by contrasting the three different models of freedom of contract and regulation with the emerging European model. The hypothesis is that the European Union is yielding its own model which differs from the Member States model. This is not only due to the particular legal nature of the European Union as a quasi-state, but also to the changing economic and political environment after World War II. The conclusions remain tentative. The reader is invited to stand back and carefully look at the ongoing transformations of contract and regulation. Intellectual history and comparative research are the appropriate tools for such an exercise.

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<sup>5</sup> ROLF KNIEPER, *ZWANG, VERNUNFT, FREIHEIT: STUDIEN ZUR JURISTISCHEN KONSTRUKTION DER GESELLSCHAFT* (1981).

## I. ENGLISH-FRENCH DEFECTIVE SWIMMING POOLS

A well-known pair of cases<sup>6</sup> were decided before English and French courts facing a nearly identical problem.<sup>7</sup> In *Ruxley*, a homeowner mandated a construction company to build a swimming pool in his garden.<sup>8</sup> The water depth did not comply with what was agreed upon in the contract by twenty-two centimeters. The homeowner asked the construction company to rebuild the swimming pool. The House of Lords did not grant the homeowner specific performance.<sup>9</sup> The House of Lords found that the swimming pool was usable, although not in the envisaged way; therefore, pecuniary damages sufficed to compensate the homeowner. Implicit in the House of Lords decision is the idea that it does not make sense to destroy a usable swimming pool just to satisfy the original contract. This combination of *pragmatic* and *utilitarian* considerations will be explained as the “English model.”

Similarly, in France, a home was built thirty-three centimeters lower than what was agreed upon in the contract. In contrast to the House of Lords in *Ruxley*, however, the French Cour de Cassation held that the construction company must rebuild the house because it did not deliver exactly what was agreed to between the parties. Moreover, the construction company had to bear the full cost of reconstruction, and pecuniary damages did not suffice to compensate the homeowner for the broken promise.<sup>10</sup> The “reason” behind the agreement prevailed over any other considerations one might have invoked. This “French model” will later be examined under this rationale.

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<sup>6</sup> *Ruxley Electronics and Construction Ltd. v Forsyth*, [1996] A.C. 344 (H.L.) (appeal taken from Eng.); Cour de cassation [Cass.] [supreme court for judicial matters] 3e civ., May 11, 2005, Bull. civ. III, no. 103 (Fr.).

<sup>7</sup> I have taken this example from Ruth Sefton-Green. Ruth Sefton-Green, *The European Union, Law and Society: Making the Societal-Cultural Difference*, in PRIVATE LAW AND THE MANY CULTURES OF EUROPE 37, 52 (Thomas Wilhelmsson et al. eds., 2007).

<sup>8</sup> *Id.* at 52.

<sup>9</sup> *Ruxley Electronics and Construction Ltd.*, [1996] A.C. 344.

<sup>10</sup> Cour de cassation [Cass.] [supreme court for judicial matters] 3e civ., May 11, 2005, Bull. civ. III, no. 103 (Fr.).

Comparative lawyers who study these and other similar cases are aware of the differences between English common law and the French Civil Code.<sup>11</sup> However, the fact that a layperson, had they to decide the case, would come to the same result tells us something about our legal consciousness, and the deeper assumptions we share about our own legal systems based on the expectations we have in the functioning of the courts and of society, for good and for bad. The Eurobarometer is a neat indicator that allows for a deeper look into these differing preconceptions at least between the twenty-eight E.U. Member States.<sup>12</sup> We may speculate on what courts in the United States, Canada, Brazil, Israel, Italy, or Germany would have decided in a case similar to the English or French cases. I am sure there are similar, if not identical, cases, and I assume that a survey of the citizens of these countries would lead to results similar to my English-French comparison.<sup>13</sup> If my assumption is correct, there must be a deeper layer of rationales enshrined in long-grown cultures and traditions behind the legal rules.<sup>14</sup>

## II. GERMAN TOURISTS STRANDED IN FLORIDA

My second example deals with consumer law, which restricts and limits freedom of contract via statutory intervention. In the early

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<sup>11</sup> *Ruxley* and the French example are not unique. They represent a well-established and long standing doctrine. *See id.*; *see also* Franz Werro, *Comparative Studies in Private Law: A European Point of View*, in *THE CAMBRIDGE COMPANION ON COMPARATIVE LAW* 132-33 (Mauro Busani & Hugo Mattei eds., 2012).

<sup>12</sup> Since 1973, the European Commission has been monitoring the evolution of public opinion in the Member States, thus helping the preparation of texts, decision-making and the evaluation of its work. The surveys and studies address major topics concerning European citizenship: enlargement, social situation, health, culture, information technology, environment, the Euro, defence, etc. *See, e.g.*, European Commission, *Public Opinion*, [http://ec.europa.eu/public\\_opinion/index\\_en.htm](http://ec.europa.eu/public_opinion/index_en.htm) (last visited Jan. 27, 2015).

<sup>13</sup> For example, the Trento Common Core Project is based on the idea that the same case is looked at through the eyes of different legal orders. *THE COMMON CORE OF EUROPEAN PRIVATE LAW*, <http://www.common-core.org/> (last visited Jan. 27, 2015).

<sup>14</sup> At this point in my paper, I do not argue that these rationales are “eternal” in the sense of Pierre Legrand’s argument that European legal cultures are not converging. *See* Pierre Legrand, *European Legal Systems Are Not Converging*, 45 *INT’L & COMP. L.Q.* 52 (1996).

1990s, German tourists used a tour operator to book all-inclusive trips, which included transportation, accommodations, and meals, to Florida at a favorable price. The trip operator went bankrupt, and the German tourists found themselves stranded in Florida. The tourists were forced to buy tickets at their own cost to return to Germany.<sup>15</sup>

The German tourists sued the German state under the *Francovich* doctrine.<sup>16</sup> The tourists sought restitution or compensation of the costs for their return tickets.<sup>17</sup> At the time of litigation, Germany had not implemented Directive 90/314/EEC on package tours.<sup>18</sup> This Directive obliges Member States to shield consumers from the bankruptcy of tour operators and shifts the risk of default from the individual traveler to the community of travelers. The risk is thereby socialized, as all potential travelers must cover the costs for a fund the tour operator provides.<sup>19</sup> The German state lost and its liability was later confirmed by the Court of Justice of the European Union (CJEU) in *Dillenkofer*.<sup>20</sup> This was a costly lesson for the German state which had to pay roughly 20 million German Marks (10 million Euros). Consumer organizations and consumer victims celebrated the judgment as a great success.

The societal dimension of the conflict underlying the case is of particular interest here. At the time of the intense debate on who should bear the costs of the stranded tourists, a German television

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<sup>15</sup> For the facts and the subsequent decision of the CJEU, see Joined Cases C-178, 179/94 & C-188-90/94, *Dillenkofer v. Germany*, 1996 E.C.R. I-4845.

<sup>16</sup> Joined Cases C-6/90 & C-9/90, *Francovich v. Italy*, 1991 E.C.R. I-5395. The *Francovich* doctrine creates non-contractual liability of Member States for violations of EU law: “a State must be liable for loss and damage caused to individuals as a result of breaches of [European Union] law for which the State can be held responsible.” *Id.* ¶ 35.

<sup>17</sup> *Dillenkofer*, 1996 E.C.R. I-4845.

<sup>18</sup> Council Directive 90/314 of the European Parliament and of the Council of 13 June 1990 on Package Travel, Package Holidays, and Package Tours, 1990 O.J. (L 15) (EC).

<sup>19</sup> *Id.* at art. 7; see STEPHEN WEATHERILL, EU CONSUMER LAW AND POLICY 98-101 (2005); Klaus Tönnies, *Kommentierung des Kapitel 13: Reisevertrag*, in ZIVILRECHT UNTER EUROPÄISCHEM EINFLUSS: DIE RICHTLINIENKONFORME AUSLEGUNG DES BGB UND ANDERER GESETZE – ERLÄUTERUNGEN DER WICHTIGSTEN EG-VERORDNUNGEN (Herausgeber Gebauer & Thomas Wiedmann eds., 2010).

<sup>20</sup> *Dillenkofer*, 1996 E.C.R. I-4845.

program invited several of the stranded tourists and an American lawyer to discuss the proper remedy in the case. When given the opportunity to tell their stories, the German tourists said that, since a single return ticket cost three to four times more than the package tour, they went to the German embassy asking for financial support. At some point during the television program, the American lawyer asked the stranded tourists and the listeners a simple question: why not charter a plane? The lawyer suggested that chartering a plane would have been much less expensive for both the stranded tourists and for Germany.

The lawyer's question brings to light the expectations of German citizens, particularly the economically suspect deal of two weeks holidays in Florida for 500 to 600 German Marks. The tourists trusted the contract adage that a deal is a deal. Maybe the tourists subconsciously were also convinced that the German state would bail them out if their contractual expectations turned out to be wrong. Would consumers of a state other than Germany have had the same expectations of their contract with a package tour operator and of their state? Similarly, would these consumers have bombarded their embassies with complaints, or would they have chartered a plane? I assume that the expectations differ considerably.

However, there is more at stake than the help provided by national embassies for stranded citizens. As a result of the Francovich doctrine, E.U. law equips all E.U. citizens with individually enforceable rights to force their state to pay for the transfer, provided the respective state has not implemented, or has not correctly implemented, the Directive on package tours. How is this possible? It is not that the Member States accept liability voluntarily. Instead, it is the European Union which imposes such liability on Member States via the CJEU. Thus, the regulation of package tours by the European Union not only sets boundaries for the freedom of package tour operators, who are forced to abide by the E.U. rules when exercising their economic activity, but also paves the way for more entrepreneurial freedom in a European market.



### III. THE CONDITIONS FOR A JOURNEY INTO INTELLECTUAL HISTORY

This paper will now discuss the rationales behind the notion of freedom of contract by examining the German, French, U.K., and E.U. legal systems, all of which I am familiar with from extensive training and practice.<sup>21</sup> I want to ground this discussion in my experiences with

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<sup>21</sup> A word is needed on my knowledge of foreign legal systems, especially since current comparative legal methodology is in a state of crisis. When I was educated in comparative legal research in the 1970s and 1980s, the thinking in Europe followed the ground-breaking work of Zweigert and Kötz. *See generally* KONRAD ZWIEGERT & HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW (Tony Weier trans., 3d ed. 1998); TONY WEIR ON THE CASE (Catherine Barnard et al. eds., 2012). Legal systems were grouped around “legal families”—namely the four European families, the Romanic, the Germanic, the common law, and the Nordic countries—all of which share a common European culture, i.e., Roman law and Christian canon law. *See* Franz Wieacker & Edgar Bodenheimer, *Foundations of European Legal Culture*, 38 AM. J. COMP. L. 1 (1990); FRANZ WIEACKER, VORAUSSETZUNGEN EUROPÄISCHER RECHTSKULTUR VERLAG GÖTTINGER TAGEBLATT (1985). The method applied was a functional comparison by looking for the “best solution,” or the solution that best fit the differing traditions of the states. What is more important here was the pedagogical message inherent to the idea of legal families. Engaging in comparative law and comparative legal method requires not only knowledge of the language, but also knowledge of the country and the cultural foundations of the respective societies. This kind of knowledge, however, must be gained through training and education in the country itself. In that spirit, I benefited from the opportunity to study law in Switzerland (the French speaking part), France, the United Kingdom, the United States, and Italy. Today, such a rigorous training requirement seems old-fashioned, as comparative lawyers have to engage in the comparison of countries and legal systems even if they know neither the language nor have fully experienced the country’s culture. The E.U. promoted this type of approach through its insistence on “inclusion,” which does not follow the traditional division of legal families, but converges the legal orders of twenty-eight Member States. This approach leads to a comparison of legal systems via simplistic methods, such as tables and charts. I admit that I have been involved in this more modern approach. Interestingly enough, legal origin theory (LOT) took the legal families approach seriously, which could have reinvigorated the approach of Zweigert and Kötz. *See generally* LEGAL ORIGIN THEORY (Simon Deakin & Katharina Pistor eds., 2012) (analyzing the different strains of legal origin theory). However, what actually happened was that LOT revealed the weakness of thinking in families, as it cannot do justice to the deeper traditions and cultures of the countries compared. Professor Ralf Michaels labelled LOT “comparison in numbers,” and questioned why comparative lawyers remained so speechless in their reaction and did not defend the functional method. Ralf Michaels, *Comparative Law*

the countries' culture and history. Building on previous research on social justice in private law<sup>22</sup> and the (un)systematics of European legal culture,<sup>23</sup> I seek to identify the dominating *Rechtsbewußtsein*, i.e., legal conscience,<sup>24</sup> with respect to intellectual history, legal theory, and legal philosophy. Then, I want to transpose the intellectual history to my question on the cultural and societal foundations of freedom of contract. I am fully aware that modelling by country is risky and that it might look as if traditions and cultures are not subject to political, economic, and social change.<sup>25</sup> I would defend, nevertheless, that such grouping around models is useful in identifying differences and maybe in deepening the mutual understanding of our conceptions of freedom of contract and the regulation thereof.

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by Numbers? *Legal Origins Thesis, Doing Business Reports, and the Silence of Traditional Comparative Law*, 57 AM. J. COMP. L. 765 (2009); see also Mathias M. Siems, *Comparative Law* (Oct. 21, 2014), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2512938](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512938).

<sup>22</sup> See THE MANY CONCEPTS OF SOCIAL JUSTICE IN EUROPEAN PRIVATE LAW (Hans-W. Micklitz ed., 2011).

<sup>23</sup> Hans-W. Micklitz, *The (Un)-Systematics of (Private) Law as an Element of European Legal Culture*, in TOWARDS A EUROPEAN LEGAL CULTURE 81-115 (Geneviève Helleringer & Kai Purnhagen eds., 2014).

<sup>24</sup> See Duncan Kennedy, *Three Globalizations of Law and Legal Thought: 1850-2000*, in THE NEW LAW AND ECONOMIC DEVELOPMENT 19 (David M. Trubek & Alvaro Santos eds., 2006); *The Rule of Law, Political Choices and Developing Common Sense*, in THE NEW LAW AND ECONOMIC DEVELOPMENT 95 (David M. Trubek & Alvaro Santos eds., 2006); MENTALITÄTEN-GESCHICHTE: ZUR HISTORISCHEN REKONSTRUKTION GEISTIGER PROZESSE (André Burguière & Ulrich Raulff eds., 1987); Hagen Schulze, *Mentalitätsgeschichte – Chancen und Risiken eines Paradigmas der französischen Geschichtswissenschaft*, 36 GESCHICHTE IN WISSENSCHAFT UND UNTERRICHT 247 (1985). See also Sebastian Conard & Shalini Randeria, *Geteilte Geschichten – Europa in einer postkolonialen Welt*, in JENSEITS DES EUROZENTRISMUS: POSTKOLONIALE PERSPEKTIVEN IN DEN GESCHICHTS-UND KULTURWISSENSCHAFTEN 9-49 (Sebastian Conard & Shalini Randeria eds., 2002).

<sup>25</sup> See WOLFGANG STREECK, RE-FORMING CAPITALISM: INSTITUTIONAL CHANGE IN THE GERMAN POLITICAL ECONOMY 251 (2009) (strongly critiquing that the 'Varieties of Capitalism' neglects the two major driving forces of change in capitalist societies: the fear of workers and the greed of entrepreneurs); Dorothee Bohle & Béla Greskovits, *Varieties of Capitalism and Capitalism << tout court >>*, 50 EUR. J. SOCIETY 355 (2009); Peter A. Hall & David Soskice, *An Introduction to Varieties of Capitalism*, in VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (Peter A. Hall & David Soskice eds., 2001)(a stock taking of the debate).

## IV. WHERE TO START WITH THE INTELLECTUAL HISTORY?

The analysis of the notion of freedom contract should begin with the Roman law. We can refer to the history of Roman law, and how its foundations have survived the last 2,000 years in both continental and common law countries;<sup>26</sup> however, the historical ground might be less stable and less safe than its promoters pretend.<sup>27</sup> Regulation is much more complicated. The Roman Empire used what today we call “regulation” to govern the economy. “Regulations,” whether back then or now, have almost always been associated with the existence of a state and a territory. This brings us to the Peace of Westphalia, concluded in 1648, which laid the foundations for what later became the nation state.

The benchmark for the beginning or the reinvigoration of Roman law is the foundation of the University of Bologna around 1130/1140 and the scholastic school of law. According to Harold Berman, the conflict between Pope Gregory VII and Henry IV, Holy Roman Emperor, a century earlier over the independence of the Church from the temporal power heralded and triggered the re-establishment of Roman law, private law, and contract law.<sup>28</sup> Berman argues that the separation of spiritual and temporal power not only initiated early state building and paved the way for the development of the nation state after the religious wars of the sixteenth and seventeenth century, but also led to the creation of the scholastic school of law first in Bologna and then elsewhere in Europe.<sup>29</sup> The Crusades between the eleventh and thirteenth centuries led to a stronger intellectual exchange between the West and the East through the reinvigoration of Greek and Roman philosophy, as well as through

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<sup>26</sup> See Reinhard Zimmermann, “*Heard Melodies are Sweet, but Those Unheard are Sweeter . . .*” *Conditio tacita, Implied Conditions und die Fortbildung des europäischen Vertragsrechts*, 193 ARCHIV FÜR CIVILISTISCHE PRAXIS 121 (1993).

<sup>27</sup> Thomas Duve, *Von der Europäischen Rechtsgeschichte zu einer Rechtsgeschichte Europas in globalhistorischer Perspektive*, 20 J. FOR MAX PLANCK INST. FOR EUR. LEGAL HIST. 16 (2012) (a more nuanced analysis of the transfer and re-transfer of laws between European countries and what later became their colonies).

<sup>28</sup> See generally, HAROLD J. BERMAN, *RECHT UND REVOLUTION: DIE BILDUNG DER WESTLICHEN RECHTSTRADITION* (2001).

<sup>29</sup> *Id.* at 146, 215.

commercial exchange.<sup>30</sup> Hence, there is a connection between the rediscovery of Roman law, the split of spiritual and temporal power, and the Crusades, which renders the intellectual history of Western law to that époque indispensable.

One might alternatively argue that the starting point of my undertaking could and should be the discovery of the Americas in the fifteenth century and the conflict between the Spanish and English empires, without which the deeper intellectual history of the United States cannot be fully understood. New research initiated by Thomas Duve, the Director of the Max-Planck-Institut at Frankfurt am Main, emphasizes the cultural, political, and economic interaction and interchange between Europe and the “New World,” or the two Americas.<sup>31</sup> My approach is more modest and is more closely tied to my European cultural roots, the younger history of codified continental law, and the established role of the state in the economy and society.

This paper owes its origins to an invitation to speak on social justice in private law at the Cour de Cassation in Paris.<sup>32</sup> Thinking about justice in the French academic and judicial environment must coincide—at least this is what I am convinced of—with an analysis of the connection between state-building and constitution-building, as well as private legal order building and codification in the aftermath of the French revolution 1789. Whilst such a starting point offers joint perspectives in comparing France and Germany, it falls short by not taking the United Kingdom into account. If anything, a parallel may be drawn between the French Revolution of the late eighteenth century and German state-building of the nineteenth century on the one hand, and the Civil War and the conflict between the English Crown and Oliver Cromwell in the seventeenth century on the other. This period, i.e. the seventeenth throughout the nineteenth century, is roughly the period I investigated in attempting to explain where the different patterns of freedom of social justice derive from. I use these findings

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<sup>30</sup> *See id.*

<sup>31</sup> *See Duve, supra* note 27.

<sup>32</sup> Hans-W. Micklitz, Speech at the Cour de Cassation Paris: From Social Justice to Participatory Justice (2007).

in my attempt to transfer them an understanding of the deeper layers of freedom of contract.

V. MODELING THE MANY FACES OF “FREEDOM OF CONTRACT”

Table 1 illustrates my understanding of *freedom of contract* and *regulation*, rooted in *intellectual history*. This section will first explain the categorization of England, France, Germany, and the European Union.<sup>33</sup> I will then provide a rough account of the socio-economic and political background to the different models of autonomy and regulation in those three countries and the European Union, thereby elaborating on the characteristics of the many faces of freedom of contract in a bottom-up perspective.

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<sup>33</sup> The following analysis is a developed and adjusted version of Hans-W. Micklitz, *supra* note 23.

Table 1: Understandings of Freedom of Contract, Regulation and Their Intellectual History (France, Germany, United Kingdom European Union)

<b>Country</b>	<b>Model of freedom of contract</b>	<b>Intellectual history</b>	<b>Regulation</b>
<b>France</b>	A political project Code Civil	French rationalism Enlightenment	Regulating contracts as a political counter-project
<b>Germany</b>	A liberal authoritarian/ paternalistic project Bürgerliches Gesetzbuch	German idealism Metaphysics	Regulating contracts as a technical bureaucratic exercise
<b>United Kingdom</b>	A liberal pragmatic project Common law	Empiricism and Utilitarianism Pragmatism	Regulating contracts to solve 'concrete Problems'
<b>European Union</b>	A technocratic project Regulatory private law	Instrumentalism and functionalism	Regulated freedom – enabling and shaping autonomy

A. The English Model: Liberal and Pragmatic

In English history there is no comparable event to the adoption of the Civil Code in France or in Germany. The civil war that took place in the seventeenth century in England led to major changes in society and the parliamentary system. However, the English Civil War neither yielded a constitution nor a coherent codified body of civil law; rather, it only made way for the Declaration of the Bill of Rights in 1689. The French and the German legal systems, as seen through the eyes of a common law lawyer (daring to suggest that this is possible for me, a civil law lawyer), share a relatively homogenous view on the role and function of freedom of contract in society. These legal systems are united in the idea of universal values that infiltrate legal principles and concepts. “Autonomy” or “autonomie” is at the core of these values, and this is exactly where common lawyers run into difficulties.<sup>34</sup>

The true difference between continental law and common law dates further back than the French revolution, and it was crucial to identify the point at which the continental and common law systems diverged. I considered the clash between different philosophies, and to the remaining influence of the scholastic in continental Europe and its growing critique through nominalism in the United Kingdom. I also considered that the divergence occurred during medieval times when the relative cultural unity of Europe broke into pieces.<sup>35</sup> Therefore, I think empiricism is responsible for the deep differences between continental and common law legal systems. Despite the strong intellectual exchange, especially between France and England, Hobbes imported ideas from France, Rousseau referred to John Locke, and the ideas and concepts of Francis Bacon’s empiricism became prevalent after the failure of Cromwell. Empiricism paved the way for utilitarianism—and here we have not only the key to understanding English reservations against regulatory intervention into the economy,

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<sup>34</sup> See Lord R. Goff, *The Future of the Common Law*, 46 INT’L & COMP. L.Q. 745 (1997).

<sup>35</sup> BERMAN, *supra* note 28, at 265.

but also the explanation for English pragmatism,<sup>36</sup> which allows for regulatory intervention when there is a concrete need for action.

Both historical strings, which are tied together in my discussion above, justify the assumption that the continental European understanding of freedom of contract does not comply with philosophical, historical, economic, and legal structures in England. In other words, England has paved the way for a legal system which is deeply rooted in nominalistic and utilitarian thinking. Freedom of contract lies at the crossroads of these deep roots in English intellectual history. Nominalism served to cut away the ideological barriers enshrined in the scholastic school of law and to free English contract law from the Pandectist heritage; utilitarianism went hand in hand with the rise of the English “trading state” (Handelsstaat), which has its origins in the nineteenth century.<sup>37</sup> The heart of English contract law lies in the freedom of commerce and the freedom to conclude contracts. Freedom of contract, therefore, means first and foremost the economic freedom to voluntarily engage in economic transactions without any risk of statutory interferences, with the exception of paying taxes to the Crown.<sup>38</sup>

Compared to German Idealism (Kant, Fichte, Hegel, Schelling) and French Rationalism (Descartes, Pascal, Voltaire, Rousseau), the English view of the role and function of contract law is much more economic in its basic assumptions. It is a much smaller argumentative step from utility to economic efficiency and economic effectiveness, compared with duty, reason, will, or spirit (Pflicht, Vernunft, Wille, Verstand, Geist). English contract law can be much more easily adapted to European “integration through law,”<sup>39</sup> where

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<sup>36</sup> See Goff, *supra* note 34; Basil Markesinis, *Learning from Europe and Learning in Europe*, in THE GRADUAL CONVERGENCE: FOREIGN IDEAS, FOREIGN INFLUENCES, AND ENGLISH LAW ON THE EVE OF THE 21ST CENTURY (Basil Markesinis ed., 1994); Thijmen Koopmans, *The Birth of European Law at the Crossroads of Legal Traditions*, 39 AM. J. COMP. L. 493 (1991).

<sup>37</sup> See OLIVER WENDELL HOLMES, JR., *THE COMMON LAW* (1909).

<sup>38</sup> LAWRENCE JAMES, *THE RISE AND THE FALL OF BRITISH EMPIRE* (1st ed. 1994).

<sup>39</sup> See “INTEGRATION THROUGH LAW” REVISITED: THE MAKING OF THE EUROPEAN POLITY (Daniel Augenstein ed., 2012); *Integration Through Law: Europe and the American Federal Experience*, in INTEGRATION THROUGH LAW 3-68 (Mauro Cappelletti, Monica Seccombe & Joseph Weiler eds., 1986).



the judicial system is given a major role in the realization of the Internal Market.<sup>40</sup>

What is the relationship between the particular English variant of freedom of contract and English legal culture? The English state is a liberal state. Its function is not to control economic behavior but to guarantee freedom of contract. In the seventeenth century this concerned the merchant adventurer, today it concerns the business environment at large.<sup>41</sup> Statutory intervention in the economy is feasible if there is a political need. Labor law and consumer law legislation illustrate this approach. The U.K. Parliament was at the forefront of consumer legislation. With regard to consumer credit and consumer safety, the U.K. Parliament has long set the benchmark for statutory intervention. Pragmatism is the guiding idea of statutory regulation restricting the freedom to contract.

This approach can be felt in the way in which the transposition of European consumer law directives are integrated into the English system. Directive 99/44/EC<sup>42</sup> is an example. The U.K. Parliament rejected any attempt to revise the English law on contracts. Such an attempt would have challenged the foundations of freedom of contract by creating a separate legislation to stand side-by-side with the common law on contracts on the one hand, and the Sale of Goods Act

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<sup>40</sup> No research has been undertaken as to whether there is a link between the adherence of the United Kingdom to the Europe Union and the deepening of European integration via case law. Whilst the building blocks *van Gend en Loos* and *Costa Enel* were decided before the UK joined the EU, the ground-breaking judgments of *Dassonville* and *Cassis de Dijon* paved the way for the development of the Internal Market and were made with the participation of UK judges. Today's pattern of integration might have changed. Christian Joerges, *What is left of the integration through law project? A reconstruction in conflicts-law perspectives*, in *THE EUROPEAN RESCUE OF THE EUROPEAN UNION?* 37-67 (Edoardo Chiti, Augustín José Menéndez, Pedro Gustavo Teixeira eds. 2012) (speaks of "integration without law," referring to the dominance of politics and the influential role of governance.)

<sup>41</sup> PATRICK S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* (1985); DAVID J. IBBETSON, *A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS* (1999) (showing that the real turning point was between 1790 and 1830, when the last remnants of just price were stripped away).

<sup>42</sup> Council Directive 99/44 on certain aspects of the sale of consumer goods and associates guarantees, 1999 O.J. (L 171) (EC).

on the other.<sup>43</sup> Under E.U. Directive 93/13/EEC, a similar continuity can be demonstrated in the recent decisions of the House of Lords on the control of unfair contract terms in consumer contracts.<sup>44</sup> This piece of E.U. law has led to irritation in the English system, as it submits standard terms to a general fairness test, an approach which runs counter to the ideology of the English Parliament,<sup>45</sup> where regulatory intervention is not meant to challenge the significance of freedom of contract in general but to solve concrete problems.<sup>46</sup>

In conclusion, the basic formula which lies at the heart of English legal culture can be condensed into one single formula—what is useful is right. Here nominalism, empiricism and utilitarianism come together. Freedom of contract is foundational to the common law on contracts, and statutory intervention is acceptable as long as it aims at solving concrete consumer or labor concerns.

#### B. The French Model: Rational and Political

France has a particular historical role in the legal and theoretical discourse on the interrelationship between constitution-building and the making of private legal order. The results of the French revolution are still shaping our understanding of constitutions, civil codes, “contract,” and “tort” today. In only twenty years the key events in France which would define these notions occurred. In contrast, in the United Kingdom similar notions developed from an evolutionary process, where no clear-cut moment of constitution building and private legal order making can be fixed. The French Revolution led to a break with feudalistic structures<sup>47</sup> and instituted a

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<sup>43</sup> See LUCINDA MILLER, *THE EMERGENCE OF EU CONTRACT LAW – EXPLORING EUROPEANIZATION* (2011) (analyzing the struggle in the UK over the implementation of Directive 99/44).

<sup>44</sup> Council Directive 93/13 of 5 April 1993 on unfair terms in consumer contracts, 1993 O.J. (L 95) (EC).

<sup>45</sup> See Gunther Teubner, *Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergencies*, 61 MOD. L. REV. 11 (1998).

<sup>46</sup> See *Office of Fair Trading v. Abbey Nat'l plc & Others*, [2009] UKSC 6, [2010] 1 A.C. 696 (appeal taken from Eng. and Wales); *General of Fair Trading v. First Nat'l Bank plc*, [2001] UKHL 52, [2002] A.C. 481 (appeal taken from Eng. and Wales); Hein Kötz, *Schranken der Inhaltskontrolle bei den Allgemeinen Geschäftsbedingungen der Banken: Entscheidung des britischen Supreme Court*, 25 ZEuP 332 (2012).

<sup>47</sup> See HANNAH ARENDT, *ON REVOLUTION* (1963).

bourgeois society governed by individual freedom and equality of rights, which became even more visible in the Code Civil and in the French Constitution.<sup>48</sup> The Revolution's legacy can easily be found in the German Civil Code, which was adopted a century later.

To portray the French understanding of freedom of contract and regulation, I start from two premises. First, the vision of the French revolution, which was proclaimed in the Declaration of Human Rights, pinned down in a Constitution, and later codified in the Civil Code, has deeper social, cultural, economic, and intellectual roots. I argue that today's conception of freedom of contract in France can best be understood as a political forward-looking concept, which can be traced back to French Rationalism<sup>49</sup> and Descartes.<sup>50</sup>

Secondly, French society may be characterized by the tension between intellectual projects guided by “les grandes idées,”—the French Constitution and the French Code—which strengthen the power of the Executive to the detriment of the Judiciary, and the highly politicized bottom-up resistance against an excessively far-reaching executive power.<sup>51</sup> The fight over “the Social”<sup>52</sup>—the regulatory intervention to protect workers in employment contracts and later the consumers in business to consumer (B2C) contracts—has demonstrated that setting limits to freedom of contract through statutory intervention is a highly politicized matter that is subject to potential conflicts.

Just as in England, the intellectual turning point in France can be attributed to the fading influence of scholastic thinking. Academic

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<sup>48</sup> See FRANZ WIEACKER, *PRIVATRECHTSGESCHICHTE DER NEUZEIT* 343 (1967).

<sup>49</sup> For a deeper analysis, see LAURENCE BONJOUR, *IN DEFENSE OF PURE REASON* (1998); Laurence BonJour, *A Rationalist Manifesto*, 18 *CANADIAN J. OF PHIL. SUPPLEMENTARY* 53 (1992).

<sup>50</sup> See EGON FRIEDEL, *KULTURGESCHICHTE DER NEUZEIT: DIE KRISE DER EUROPÄISCHEN SEELE VON DER SCHWARZEN PEST BIS ZUM ERSTEN WELTKRIEG* (2007) (discussing Descartes and his methodological thinking).

<sup>51</sup> This is my own interpretation of the French development.

<sup>52</sup> See Kennedy, *supra* note 24, at 19, 95 (discussing the rise of “The Social” and its intellectual origins); from a German perspective, but taking the French impact into account, in particular Duguit, Salleilles and Gény, see Wieacker, *supra* note 48, at 543 § 28 (“Der Zerfall der inneren Einheit des Privatrechts und das Sozialrecht”). In that vein, law has a particular social function to fulfill.

questioning of the spirit evolved from the methodological constraints of scholasticism and paved the way for a new rational method in philosophy. French philosopher Michel Eyguem de Montaigne (1533-1592) set long-lasting incentives for critical reflection of all existing knowledge and values, which later came to be known as “Enlightenment.”<sup>53</sup> This new method to investigate the “truth” and the concept of the truth was left in the seventeenth century to Descartes, who began with his *Discours de la Méthode*.<sup>54</sup> Descartes claimed that a particular method to acquire the truth was needed to solve all philosophical questions. Unlike utilitarianism, Descartes believed that what is true is useful. Without Descartes’s theory, it is difficult to understand the political conception of the French Civil Code. Descartes’ philosophy results in the priority of theory over practice, which is the basic thesis of French intellectualism.

Based on this premise, the link between the French political project of freedom of contract and the particularities of the French legal culture become clear. Freedom of contract is first and foremost tied to the key function of the “reason,” “raison,” or “Vernunft” in the French civil law system. The idea is that freedom of contract is more than just an exercise to maximize mutual economic benefit. More is at stake in the communication between the parties, namely, the commitment to a contract is the product of a reasonable decision. *Autonomie de la volonté* is bound in the belief or assumption (“Einsicht”) in a higher reason that is deeper than the individual transaction.<sup>55</sup> This is the Cartesian side of the concept of *autonomie de la volonté*. However, there is also the *Rousseauian* side, and it is here where the political dimension of the concept of *autonomie de la volonté* is more obvious. *Autonomie de la volonté* may not be equated with individual freedom in the meaning of German idealism, which is inward looking. To the contrary, it is outward looking toward society itself and to the embedding of reason into the political environment. This is what Rousseau called the *volonté générale* (general will). Without Rousseau’s concept of democracy and the conviction that the people will consent

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<sup>53</sup> See FRIEDEL, *supra* note 50.

<sup>54</sup> RENÉ DESCARTES, DISCOURS DE LA MÉTHODE POUR BIEN CONDUIRE SA RAISON, ET CHERCHER LA VÉRITÉ DANS LES SCIENCES (1637).

<sup>55</sup> This implies the need to look for a certain substantive equivalence in the mutual contractual relations, in German “*das materielle Äquivalenzprinzip der vernunftrechtlichen Vertragslehre*.”

to the *volonté générale*, it is not possible to understand the political dimension of the concept of autonomy in the French civil code.<sup>56</sup>

In France, there is also a peculiar understanding of the role and function of regulatory intervention in the economy to protect workers and consumers and, more in general, to restrict freedom of contract in commercial transactions through statutory regulation. Since mercantilist times, the French government played a strong role in the organization and creation of the economy.<sup>57</sup> The economy must follow political prerogatives in order to address social concerns and any other political requirements. What matters for our discussion is the strong connection between the role and function of the political, and the understanding of regulatory intervention. The political dimension must not necessarily materialize in a top-down fashion, i.e. through legislative acts on what nowadays is called social regulation or executive intervention into the management of the economy of the country. The political may also emerge bottom-up, through resistance on the streets against the supremacy of the state managed economy over politics.

To demonstrate the continuity of the French legal conscience (*Rechtsbewußtsein*) and of the breadth and depth of the political in social regulation, I will again start with reference to the implementation of E.U. Directive 99/44/EC on consumer sales. Under strong pressure from civil lawyers and civil law doctrine, the French legislature decided that, rather than integrate the rules on consumer protection into the Civil Code, it would place the respective articles in the *Code de la Consommation*.<sup>58</sup> This strategy preserved the integrity of the Civil Code as an “eternal” political project, which might be regarded as an integral part of the French identity.<sup>59</sup> However, there is one notable difference

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<sup>56</sup> I am fully aware that Rousseau differs from Descartes in his image of the person.

<sup>57</sup> See KARL PRIBRAM, *GESCHICHTE DES ÖKONOMISCHEN DENKENS*, [A HISTORY OF ECONOMIC REASONING] 194 (Erster Band ed., Horst Brühmann trans., 1998); COLIN HEYWOOD, *THE DEVELOPMENT OF THE FRENCH ECONOMY 1750-1914* (1995).

<sup>58</sup> See MILLER, *supra* note 43 (reconstructing the political fights over the correct way to implement Directive 99/44 in the French legal system).

<sup>59</sup> French scholars had a strong reaction against the idea of a European Civil Code. See YVES LEQUETTE, *QUELQUES REMARQUES A PROPOS DU PROJET DE CODE CIVIL EUROPEEN DE MONSIEUR VON BAR 2202-14* (2002); Bénédicte

to the English method of transposition. Contrary to the problem based U.K. approach on consumer protection, the French *Code de la Consommation* was originally designed according to a political model, a blueprint which was similar to the Civil Code in that it could guide the development in Europe of a consistent body of consumer law rules.<sup>60</sup>

Contrary to most other Member States in the European Union, the consumer movement in France bore a strong political dimension, at least in the 1970s and 1980s, which largely derived from politicization through integrating consumer policy into politics. Trade unions in France were tied to various left wing parties, each of which had to leave their footprint on the then new policy.<sup>61</sup> It is only because the European Union took over consumer policy in the second half of

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Fauvarque-Cosson, *Faut-il un code civil européen?*, REVUE TRIMESTRIELLE DE DROIT CIVIL 463 (2002); see also Christian Joerges, *Der Europäisierungsprozess als Herausforderung des Privatrechts: Plädoyer für eine neue Rechtsdisziplin*, in EUROPÄISCHES PRIVATRECHT IM WISSENSCHAFTLICHEN DISKURS 133, 142 (Andreas Furrer ed., 2006) (interpreting the conflict between the German professorial model of the Bürgerliches Gesetzbuch (BGB) and the democratic tradition of the Code Civil); Wolfgang Wurmnest, *Common Core, Grundregeln, Kodifikationsentwürfe, Acquis-Grundsätze – Ansätze internationaler Wissenschaftlergruppen zur Privatrechtsvereinheitlichung in Europa*, 11 ZEUP 714 (2003); Bénédicte Fauvarque-Cosson, *Droit européen des contrats: première réaction au plan d'action de la Commission*, RECUEIL DALLOZ 1171 (2003); Philippe Malinvaud, *Réponse-bors délai-à la Commission européenne: à propos d'un code européenne des contrats*, in PENSEE JURIDIQUE FRANCAISE ET HARMONISATION EUROPEENNE DU DROIT 231 (Bénédicte Fauvarque-Cosson & Denis Mazeaud eds., 2003) ; JEAN HUET, *NOUS FAUT-IL UN 'EURO' DROIT CIVIL?* 2611-14 (2002). Whether or not the French Civil Code would pass the identity test under the Lisbon Treaty is another story. See Hans-W. Micklitz, *German Constitutional Court (Bundesverfassungsgericht BVerfG) 2 BvE 2/08, 30.6.2009 – Organstreit Proceedings between Members of the German Parliament and the Federal Government*, 7 EUR. REV. CONT. L. 528 (2011).

<sup>60</sup> JEAN CALAIS-AULOY, COMMISSION DE LA REFONTE, LE DROIT DE LA CONSOMMATION EN FRANCE (1981).

<sup>61</sup> This might explain why attempts to build connections between labor law and consumer law were particularly strong in France, to some extent in Italy, and only marginal in Germany. See MICHEL MIAILLE, *UNE INTRODUCTION CRITIQUE AU DROIT* (1976); ENZO ROPPO, *VERBRAUCHERSCHUTZ UND KLASSENTHEORIE* 109 (1976); KLAUS TONNER, *VERBRAUCHERSCHUTZ ALS GEWERKSCHAFTLICHE AUFGABE* 252 (1979); KLAUS TONNER, *VERBRAUCHERSCHUTZ UND KLASSENTHEORIE – ERWIDERUNG AUF ENZO ROPPO* 241 (1976).

the 1980s after the Single European Act<sup>62</sup> that consumer policy became de-politicized in France.

### C. The German Model: Liberal and Authoritarian/Paternalistic

The German Civil Code is 100 years younger than the French Civil Code. In 1815, the aftermath of the Congress of Vienna and the scattered German regions that comprised various kingdoms and counties (earldoms) failed to unite into a German state under a common constitution. It took until 1871 before Germany managed, under the regime of the Prussian king and his chancellor Bismarck, to finally adopt a constitution. It took an additional thirty years before the *Bürgerliches Gesetzbuch* (BGB), as it is called in German, was enacted.

My arguments are built upon two major guiding assumptions. First, there is a direct line from Kant to Savigny to Weber and the formal rationality of the private law system, which serves to constitute the capitalist society. The Kantian philosophy inspired Savigny to formulate the so-called *Historische Schule* (Historical School), which was influential during the nineteenth century among private law theorists and, remarkably, continues to be influential even after the fall of the wall in 1989.<sup>63</sup> *Historische Schule* has created a particular way of thinking, favoring the transition from “The Social” to the “pure” private law system. Social issues and regulations were outsourced by a technocratic decision to specialize private law legislation outside the BGB, although adopted 100 years later than the more integrative approach of the French Code Civil.<sup>64</sup> This time period gave the German BGB a

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<sup>62</sup> Single European Act, Feb. 28, 1986, 1987 O.J. (L 169) (entered into force July 1, 1987).

<sup>63</sup> See Reinhard Zimmermann, *Savigny's Legacy: Legal History, Comparative Law, and the Emergence of a European Science*, 112 L.Q. REV. 576 (1996); Horst Eidenmüller et al., *The Common Frame of Reference for European Private Law – Policy Choices and Codification Problems*, 28 OXFORD J. LEGAL STUD. 659 (2008) (criticizing the European private law codification project, which is inspired from and based on the destruction of the common philosophical ground of private law in the civil and common law systems).

<sup>64</sup> Both the French Code Civil and the German BGB covered tenant law. In France, tenant law has remained an integral part of the civil code, whereas German tenant law has become a legal field in itself, outsourced in special acts and only partially integrated in the BGB through the modernization of the law of obligations (*Schuldrechtsmodernisierungsgesetz*) in 2002. For details on the development of

particular ideological outlook, which maintained and defended an early nineteenth century bourgeois model of society and economy against the rising political and social transformations brought about by the industrial age and the labor movement.<sup>65</sup>

Second, there is the link between Fichte, Hegel, Thibaut, German idealism, and legal naturalism, as expressed in Jhering, von Gierke, Ehrlich, Weber, and Kantorowicz wherein national ideals were tied to the social ideals of a society and a nation.<sup>66</sup> Such a vision can hardly be connected to the authoritarian Prussian state, which provided social protection to workers<sup>67</sup> only as a means to compensate workers for their exclusion from political participation (*Sozialistengesetze* 1978). The German version of legal naturalism favors an instrumental use of social regulation, but carefully avoids and downplays the political dimension inherent in “The Social.”<sup>68</sup>

The intellectual quarrel between two German law professors, Thibaut and Savigny, over the value of a codified German Civil Code is paradigmatic for tensions arising in the German legal system: Thibaut fought enthusiastically in Heidelberg—inspired by German Idealism and les *grandes idées* of the French revolution—for a genuine German Code; Savigny fought brilliantly (but not enthusiastically) for the maintenance of the old Roman law.<sup>69</sup> Law-making in Germany in the early nineteenth century was understood as an academic exercise, quite contrary to the democratic discussion that surrounded the

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tenant law in Europe, see Christoph U. Schmid & Jason R. Dinse, *The European Dimension of Residential Tenancy Law*, 9 EUR. REV. CONT. L. 201 (2013).

<sup>65</sup> There is a connection between the late industrialization relative to the UK, the labor movement, and the Bismarckian reaction. See, e.g., HUGO SINZHEIMER, EIN ARBEITSTARIFGESETZ: DIE IDEE DER SOZIALEN SELBSTBESTIMMUNG IM RECHT (1916).

<sup>66</sup> See WIEACKER, *supra* note 48. Most of the legal auxiliary sciences such as criminology and legal sociology have their origin in legal naturalism and in the Freirechtsschule (Free Law Movement).

<sup>67</sup> E.g., 1883 health insurance, 1884 accident insurance.

<sup>68</sup> See Hermann U. Kantorowicz who attacks Savigny’s influence on the construction of the Civil Code and on what I call here “Rechtsbewußtsein”. Hermann U. Kantorowicz, *Was ist uns Savigny*, 1 RECHT UND WIRTSCHAFT 47, 76 and seq. (1911).

<sup>69</sup> ANTON FRIEDRICH JUSTUS THIBAUT & FRIEDRICH CARL VON SAVIGNY, IHRE PROGRAMMATISCHEN SCHRIFTEN, MIT EINER EINFÜHRUNG VON HANS HATTENHAUER (1973).



adoption and distribution of the French Civil Code.<sup>70</sup> The outcome was a civil code that lacked the required “socialist oil.”<sup>71</sup> This defect was remedied in the twentieth century by judges through judge-made law, and by the legislator through the adoption of numerous special laws.

German legal culture has two main components: a liberal dimension, which is shared by English law and enshrined in commercial freedom to contract; and a political dimension, which is shared by French law and enshrined in the much stronger commitment to “The Social.”<sup>72</sup> The English streak dates back to the merging of the German *Länder* (states) under a tight Prussian grip, which triggered the industrial revolution and led to an amazing boost for the economy. In this context, the predominance of the market and a sense of English pragmatism can be felt. The German state, however, is not a liberal-enabling state in the Anglo-Saxon sense. The German state is rooted in the authoritarian heritage of pre-democratic times. As such, the state is seen as the key regulator to realize not only economic but also political objectives, which brings German legal culture nearer to its French counterpart. However, contrary to France where the political also bears a strong top-down dimension, the political dimension in Germany is more bottom-up as it is always connected to expectations set by the citizens of the state. Today, the early Bismarkian regulatory state and the post-World War II welfare state still bears elements of authoritarian care-taking, which is different from England due to the strong interventionist side and different from France due to the lack of an open political discourse. The tension between the liberals and the

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<sup>70</sup> See Reinhard Zimmermann, *Consumer Contract Law and General Contract Law: The German Experience*, 58 CURRENT LEGAL PROBS. 415 (2005); Harm Schepel, *Professorenrecht? The Field of European Private Law*, in LAWYER’S CIRCLES – LAWYERS AND EUROPEAN LEGAL INTEGRATION 115 (2004); Rainer Maria Kiesow, *Rechtswissenschaft – was ist das?*, 12 JURISTEN ZEITUNG 585, 586 (2010).

<sup>71</sup> OTTO VAN GIERKE, DIE SOZIALE AUFGABE DES PRIVATRECHTS 13 (1889); TILMAN REPGEN, DIE SOZIALE AUFGABE DES PRIVATRECHTS: EINE GRUNDFRAGE IN WISSENSCHAFT UND KODIFIKATION AM ENDE DES 19. JAHRHUNDERTS (2001).

<sup>72</sup> GERT BRÜGGEMEIER, ENTWICKLUNG DES RECHTS IM ORGANISIERTEN KAPITALISMUS, BAND 1: VON DER GRÜNDERZEIT ZUR WEIMARER REPUBLIK (1977); GERT BRÜGGEMEIER, ENTWICKLUNG DES RECHTS IM ORGANISIERTEN KAPITALISMUS, BAND 2: VOM FASCHISMUS BIS ZUR GEGENWART (1979).

authoritarians explains why political debates in Germany so easily turn into ideological conflicts, just as it was between Thibaut and Savigny.

What does this mean for the German variant of freedom of contract—or private autonomy (*Privatautonomie*) as phrased in the context of the intellectual history—and the limitation of freedom of contract via statutory regulation? Private autonomy centers on the individual. But who is the individual? The reasonable Cartesian French person/citizen, the utilitarian Englishman, or the idealistic Kantian/Hegelian subject? The key question in German legal theory—although not in commercial transactions, freedom of contract, the common law of contracts, or the *droit des obligations*—is how this individual can bind himself legally. The conceptual difference is visible in the comparison between the common law and the German Civil Code. Only the German BGB contains a General Part (*Allgemeiner Teil*), which not only precedes the law of contract, but also precedes family law and the law of succession. The General Part holds the entire German private law system, as laid down in the BGB, together. Its content triggers irritation and uncertainty outside Germany (what is a juridical act? *Ein Rechtsgeschäft?*<sup>73</sup>). The key to understanding the idealistic German concept of private autonomy is to appreciate its roots in the so-called “will theory” (*Willenstheorie*), which states that the individual is bound through his will, rather than through his declaration (*Erklärung*).<sup>74</sup> It is true that the Prussian legislator introduced corrections to the “will theory” into the BGB, which have been amplified by the judiciary in the twentieth century. Idealistic thinking embedded in the concept of private autonomy is still alive: it has been taken up by the Freiburg school, ordo-liberalism, and the private law society.<sup>75</sup> Its counterpart, the resistance against restrictions, more often than not bears a strong ideological bias that is outweighed

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<sup>73</sup> The Academic Draft Common Frame of Reference contains such a general part in compliance with the German BGB.

<sup>74</sup> The “will theory” is extremely helpful because it combines European legal thought with American legal thought. See Duncan Kennedy, *From the Will Theory to the Principle of Private Autonomy: Lon Fuller’s “Consideration and Form,”* 100 COLUM. L. REV. 94 (2000).

<sup>75</sup> See ERNST-JOACHIM MESTMÄCKER, A LEGAL THEORY WITHOUT LAW: POSNER V. HAYEK ON ECONOMIC ANALYSIS OF LAW 174 (2007) (responding to the critics of law and economics against ordo-liberalism).

by intense legislative activities in the twentieth century for the benefit of those contracting parties with weaker bargaining power.

Again, I will use Directive 99/44/EC as a blueprint to explain the continuity of the German *Rechtsbewusstsein* and the tension between the liberal and authoritarian views of freedom of contract. In the shadow of the so-called modernization of German contract law (*Schuldrechts-Modernisierungsgesetz*) in 2002, the executive, i.e., the Ministry of Justice, used the expiry of the two-year implementation period to complete the twenty-year long pending project of revising the German Civil Code, thereby “smuggling” the bulk of consumer contract law rules into the German Civil Code. This integration of Civil Code and consumer contract law perhaps was not an authoritarian, but a paternalistic move.<sup>76</sup> The academic debates focused almost entirely on the proposed revision of the prescription rules, in particular, on *Leistungsstörungenrecht* (law on the interference with or impairment of the performance of an obligation). This revision has been performed as a technical bureaucratic exercise.<sup>77</sup> Pragmatism might have guided German scholars to accept the development of a new sales law, as a common pattern for business to business (B2B) and B2C relations; however, contrary to France and the Netherlands, there was no deeper political discussion, especially on the possible role of consumer law as an integral part of the civil code, in the open democratic fora in Germany. Until today, consumer law has remained a foreign body in

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<sup>76</sup> There is a deeper discussion needed on the difference between (Prussian) authoritarianism and (post-Second World War) German paternalism. See ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* ch. VI (1835), for a starting point on this distinction (“[a]bove this race of men stands an immense and tutelary power, which takes upon itself alone to secure their gratifications and to watch over their fate. That power is absolute, minute, regular, provident, and mild. It would be like the authority of a parent if, like that authority, its object was to prepare men for manhood; but it seeks, on the contrary, to keep them in perpetual childhood: it is well content that the people should rejoice, provided they think of nothing but rejoicing. For their happiness such a government willingly labors, but it chooses to be the sole agent and the only arbiter of that happiness; it provides for their security, foresees and supplies their necessities, facilitates their pleasures, manages their principal concerns, directs their industry, regulates the descent of property, and subdivides their inheritances: what remains, but to spare them all the care of thinking and all the trouble of living?”).

<sup>77</sup> See, e.g., Stephan Lorenz, *Fünf Jahre “neues” Schuldrecht im Spiegel der Rechtsprechung*, 1-2 NEUE JURISTISCHE WOCHENSCHRIFT 1 (2007).

the German BGB. The integration of “The Social” has not led to an overall re-thinking of the foundations of the German BGB. Instead, the two parts, although located in the same civil code, are each rooted in their very particular intellectual history.<sup>78</sup>

#### D. The European Model: Enabling and Restricting

Over the last sixty years, the European legal order and the European constitutional charter<sup>79</sup> have yielded a genuine model of freedom of contract to protect participants in an ever-growing Internal Market. At the same time, however, the European legal order and constitutional charter have also set boundaries to this established freedom of contract.<sup>80</sup> How is it possible that the European Union is able to generate a distinct model, different from national ones? I am not so much interested in whether the emerging European model should be understood as some kind of reaction to the globalization of markets.<sup>81</sup> My focus is on the intellectual history of the European legal order that underpins Europe and the European Union. Although Europe and the European Union are intertwined, they must be kept separate in our discussion.

Perspective matters. Europe is treated as a homogenous whole by those on the outside, and particularly by U.S. legal scholars. Two examples of such over-generalized discussions about Europe include the work of James Whitman on U.S. consumerism versus E.U.

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<sup>78</sup> See HANS-W. MICKLITZ, BRAUCHEN KONSUMENTEN UND UNTERNEHMEN EINE NEUE ARCHITEKTUR DES VERBRAUCHERRECHTS? GUT-ACHTEN A ZUM 69. JURISTENTAG 129 (2012); Hans-W. Micklitz, *Do Consumers and Business Need a New Architecture for Consumer Law? A Thought Provoking Impulse*, 32 Y.B. EUROPEAN L. 266 (2012).

<sup>79</sup> Neil Walker, *Big “C” or Small “c”?*, 12 EUR. L.J., 12 (2006).

<sup>80</sup> See Guido Comparato & Hans-W. Micklitz, *Regulated Autonomy between Market Freedoms and Fundamental Rights in the Case Law of the CJEU*, in GENERAL PRINCIPLES OF EU LAW AND EUROPEAN PRIVATE LAW 121-54 (Ulf Bernitz, Xavier Groussot & Felix Schulyok eds., 2013); NORBERT REICH, GENERAL PRINCIPLES OF EU CIVIL LAW (2013).

<sup>81</sup> KARL POLANYI, THE GREAT TRANSFORMATION (1944); KARL POLANYI, GLOBALISATION AND THE POTENTIAL OF LAW IN TRANSNATIONAL MARKETS (Christian Joerges & Josef Falke eds., 2011).

producerism,<sup>82</sup> and the work of Daniel Kelemen on Eurolegalism.<sup>83</sup> In general, scholars tend to treat the south and north, the east and west, and the European Union and European Council the same. Similarly, there is little discussion in contemporary research on where Europe ends: European countries are considered a single entity, this entity is often implicitly equated with the European Union, and then the entity is compared with the United States.<sup>84</sup>

Does the conception of freedom of contract and its statutory limitation reflect a common denominator of English Utilitarianism, French Rationalism, and German Idealism? Is there a foundation shared by the English liberal and pragmatic, French rational and political, and German liberal and authoritarian? To what extent does this intellectual crossover mutually impact England, France, and Germany? Those who stress a common cultural foundation insist on an intellectual exchange between the great minds behind the concepts of empiricism, utilitarianism, rationalism, enlightenment, and idealism. For centuries, European intellectuals shared a common language, Latin, which gradually vanished between the seventeenth and nineteenth centuries. The deeper cultural foundation, however, cannot be based in language alone. For example, in the late nineteenth and early twentieth centuries, leading private lawyers from all over Europe and the United States were involved in intellectual exchange, but all wrote in their respective languages.<sup>85</sup> It seems as if the intellectual

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<sup>82</sup> James Q. Whitman, *Consumerism Versus Producerism: A Study in Comparative Law*, 117 YALE L.J. 340, 407 (2007).

<sup>83</sup> R. DANIEL KELEMEN, *EUROLEGALISM: THE TRANSFORMATION OF LAW AND REGULATION IN THE EUROPEAN UNION* (2011).

<sup>84</sup> This kind of stereotyped, over-simplified thinking has been promoted by the Integration Through Law Project by Mauro Cappelletti, Monica Secombe, and Joseph Weiler to compare the constitutional architecture of the then European Economic Community and the United States. See *INTEGRATION THROUGH LAW: EUROPE AND THE AMERICAN FEDERAL EXPERIENCE*, *supra* note 39, at 3-68; “INTEGRATION THROUGH LAW” REVISITED: THE MAKING OF THE EUROPEAN POLITY, *supra* note 39. This kind of thinking might be due to the historical circumstances in which it took places. In the mid 1980s there was still the political idea pending that the Member States of the European Union would be ready and willing to transform the European Union into a fully fledged federal United States of Europe.

<sup>85</sup> René Demogue, *La Notion de Sujet De Droit*, *REVUE TRIMESTRIELLE DE DROIT CIVIL* 611-55 (1909); *RECUEIL SIREY, ÉVOLUTIONS ET ACTUALITES CONFÉRENCES DE DROIT CIVIL* 29-51 (1936).

exchange was much more intense hundreds of years ago than it is today, since today the English language dominates the intellectual discourse and non-English contributions to the intellectual history of Europe are no longer perceived.

Wieacker is perhaps one of the few scholars who looks behind the three main intellectual historical strains and condenses the common European legal culture that unites the private law *in der Neuzeit*<sup>86</sup> (in modern times) into three invariables. The first invariable is personalism, which is directly connected to the role of the individual, autonomy, and freedom in private law. The second invariable is legalism in which decisions are bound to the rule of law. The third invariable is European intellectualism, which drives European legal thinking in the direction of thematization, conceptualization, and contradiction-free consistency of the law.

Is Wieacker's theory correct? Is the revitalization of the common European legal culture after the Second World War not guided by the political purpose it had to fulfill? Can the common European legal culture be regarded as an attempt to rewrite legal history? I fear that these questions are too broad for this paper.<sup>87</sup> The debate on the possible legal philosophical foundations of Europe<sup>88</sup> and European private law<sup>89</sup> is just about to start. The handbook edited by Julie Dickson and Pavlos Eleftheriadis<sup>90</sup> on the philosophical foundations of E.U. law mainly focuses on European constitutional

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<sup>86</sup> This is the title of Franz Wieacker's masterpiece, which was translated into English by Tony Weir. See generally WIEACKER, *PRIVATRECHTSGESCHICHTE DER NEUZET*, *supra* note 48.

<sup>87</sup> See, e.g., WOLFRAM KAISER, *CHRISTIAN DEMOCRACY AND THE ORIGINS OF EUROPEAN UNION* (2007); RAOUL CHARLES VAN CAENEGEM, *EUROPEAN LAW IN THE PAST AND THE FUTURE: UNITY AND DIVERSITY OVER TWO MILLENNIA* (2002); FRIEDRICH HEER, *THE INTELLECTUAL HISTORY OF EUROPE* (1968); see also *Kolleg-Forscherguppe Working Paper Series*, KOLLEG-FORSCHERGRUPPE: *THE TRANSFORMATIVE POWER OF EUROPE*, (2009-2015) available at [http://www.polsoz.fu-berlin.de/en/v/transformeurope/publications/working\\_paper/index.html](http://www.polsoz.fu-berlin.de/en/v/transformeurope/publications/working_paper/index.html).

<sup>88</sup> See JAMES Q. WHITMAN, *THE LEGACY OF ROMAN LAW IN THE GERMAN ROMANTIC ERA: HISTORICAL VISION AND LEGAL CHANGE* (2014).

<sup>89</sup> *THE FOUNDATIONS OF EUROPEAN PRIVATE LAW* (Roger Brownsword et al. eds., 2011).

<sup>90</sup> *PHILOSOPHICAL FOUNDATIONS OF EUROPEAN UNION LAW* (Julie Dickson & Pavlos Eleftheriadis eds., 2012).

theory, rather than European private law and European private law theory.<sup>91</sup>

To understand the European model of freedom of contract, it is helpful to look at the intellectual history, and perhaps the constitutional history, of the European Union. This understanding requires a leap to the post-war period, when the European Economic Community was launched and the European Union was created. Scholars<sup>92</sup> advocated for the revitalization and re-invigoration of a common European culture to enable a peaceful and prosperous future for the European peoples. For example, scholars advocated for peace through economic integration, and in 1986, the Single European Act added social integration to the new European legal order.<sup>93</sup>

Economic integration of the European Union is based on the free movement rights and competition. In particular, German academics in the ordo-liberal tradition have argued that private autonomy is enshrined into the free movement rights.<sup>94</sup> Economic integration aims at enabling the growth of, or paving the way for, private entrepreneurship in the ever-bigger common European market. The abundant case law of the European Court of Justice (ECJ) on the four freedoms often involves contractual disputes in which one party seeks access to the market but is barred by national statutory

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<sup>91</sup> The Oxford University Press series, where Julie Dickson and Paylos Eleftheriadis also appeared, includes an ongoing project on the philosophical foundations of private law.

<sup>92</sup> These scholars include academics such as Wieacker, Grossi, and Coing, and political scholars such as Monnet, Schuman, de Gaspari, de Gaulle, and Adenauer.

<sup>93</sup> Fritz Scharpf was one of the most influential scholars in this field. *See generally* FRITZ SCHARPF, GOVERNING IN EUROPE: EFFECTIVE AND DEMOCRATIC? (1999) (analyzing the relationship between economic and social integration in Europe).

<sup>94</sup> *See* Stefan Grundmann, *The Concept of the Private Law Society: After 50 Years of European and European Business Law*, 16 EUR. REV. PRIVATE L. 553 (2008). For a nice account of the European economic constitution and its influence on (European) private law, *see* Sabine Frerichs & Teemu Juutilainen, *Rome under Seven Hills? An Archeology of European Private Law* (Helsinki Legal Studies Research Paper Ser., Paper No. 32, 2014), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2465873](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2465873).

regulation.<sup>95</sup> Private autonomy then obtains a different meaning, namely, it is bound to trans-border business and European economic integration. The European variant is functional and instrumental.

Social regulation in European private law is very much focused on consumer protection.<sup>96</sup> The tone of such social regulation is set by the famous Sutherland Report.<sup>97</sup> Consumers and consumer protection rules are needed to complete the Internal Market (the 1986 program behind the Single European Act). Putting it differently, the price to pay for the Completion of the Internal Market is the adoption of minimum social (protection) standards.<sup>98</sup> The overall philosophy is enshrined in the wording of Article 114 of the Treaty on the Functioning of the Europe Union (TFEU), formerly Article 95 EC and Article 100a respectively, which adopted measures to complete the Internal Market in realizing social protection standards.<sup>99</sup> In the late 1970s and early 1980s, several consumer and labor protection rules were adopted under the unanimity principle, the *enabling* of autonomy and the *limitation* of autonomy go hand-in-hand. The broadening of economic freedoms, similar to common law freedom of contract, preceded the development of protective standards that limited freedom of contract, mainly through binding legal standards.

This development is by no means limited to the field of traditional private law, contract law and consumer protection, or employment contracts and labor protection. European private law is

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<sup>95</sup> Gareth Davies, *Freedom of Contract and the Horizontal Effect of Free Movement Law*, in THE INVOLVEMENT OF EU LAW IN PRIVATE LAW RELATIONSHIPS (Dorota Leczykiewicz & Stephen Weatherill eds., 2013).

<sup>96</sup> See Weatherill, *supra* note 19; HANS-W. MICKLITZ ET AL., EUROPEAN CONSUMER LAW (2d ed., 2014).

<sup>97</sup> PETER SUTHERLAND ET AL., THE FUTURE OF THE WTO: ADDRESSING INSTITUTIONAL CHALLENGES IN THE NEW MILLENIUM: REPORT BY THE CONSULTATIVE BOARD TO THE DIRECTOR-GENERAL SUPACHAI PANITCHPAKDI (2004).

<sup>98</sup> The European Commission has made an enormous effort after 2000 to transform the minimum social protection standards into maximum standards. However, this effort has largely failed. See Hans-W. Micklitz & Norbert Reich, *Crónica de una Muerte Anunciada: The Commission Proposal for a "Directive on Consumer Rights,"* 46 COMMON MKT. L. REV. 417 (2009).

<sup>99</sup> Consolidated Version of the Treaty on the Functioning of the European Union art. 114, May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].



regulatory by nature, as the European Union is and will be under constant construction. Legal rules remain a key instrument for regulation. The most prominent field of action beyond traditional private law and even traditional fields of social regulation (*e.g.*, consumer and labor protection) has been the so-called regulated markets. The liberalization and privatization policy implemented by the Single European Act in telecom, energy, postal services, transport, and financial services, the dismantling of former state monopolies, amounts to a political decision to establish markets where there were none.<sup>100</sup> This policy enabled freedom of contract with statutory limitations. Therefore, enabling and restricting are the two parameters that characterize the European model of freedom of contract.

#### E. Stand and Stare

Provided my analysis contains an element of truth—and I hope it does—what is the added value of this finding for our understanding of freedom of contract and even more so for the communication between lawyers across legal cultures and traditions, just like those lawyers in our Academy for International Commercial and Consumer Law? First and foremost, the value added is to “Stand and Stare,”<sup>101</sup> and to distance ourselves from our subjects of analysis and own cultural roots and traditions.

“Stand and Stare,” however, is just the first step. I do not want to argue that our legal cultures and traditions are set in stone and that there is no room for mutual learning and for change. Indeed, there is arguably an emerging European legal culture, certainly in key areas of

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<sup>100</sup> See Hans-W. Micklitz, *The Visible Hand of European Private Law*, 28 YEARBOOK OF EUROPEAN LAW 3 (2009); in Italian, *La mano visibile del diritto privato europeo in materia normativa – La trasformazione del diritto privato europeo dall'autonomia al funzionalismo nella concorrenza e nella regolamentazione*, in SEMINARI DEL CONSIGLIO NAZIONALE FORENSE: COLLANA “STUDI STORICI E GIURIDICI” 125-92 (Guido Alpa & Roberta Mazzei, eds. 2010); in Finnish, *Lakimies* 3/2010, 330-56; in Japanese, *Yōroppa kisei watashi-hō no mokusuteki-teki shuhō: Yōroppa watashi-hō no, kyōsō to kisei ni okeru jūritsu kara kinō shugi e no hen'yō*, 12 HOKKAIDO JOURNAL OF NEW GLOBAL LAW AND POLICY 17 (2011); in French, *La main visible du droit privé réglementaire Européen*, 28 REVUE INTERNATIONALE DE DROIT ECONOMIQUE 5-57 (2014).

<sup>101</sup> Roger Brownsword, *The Theoretical Foundations of European Private Law: A time to Stand and Stare*, in FOUNDATIONS OF EUROPEAN PRIVATE LAW 159 (Roger Brownsword et al. eds., 2011).

private law<sup>102</sup>—some would argue this legal culture has been enshrined in Europe since the *ius commune*. There is also an emerging culture of transnational law,<sup>103</sup> which is now gaining ever stronger attention with a refocused understanding and design of comparative and transnational (legal) history.<sup>104</sup> I fear, however, that we are approaching a divided legal world—a world where each state contains a national legal order in which the territory and language are transnational. There is a chance for deepening our understanding of the “many faces of freedom of contract,” for learning from each other and for developing even a common cultural ground.<sup>105</sup>

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<sup>102</sup> TOWARDS A EUROPEAN LEGAL CULTURE (Genevieve Helleringer & Kai Purnhagen eds., 2014).

<sup>103</sup> See Kaarlo Tuori, *Transnational Law: on Legal Hybrids and Legal Perspectivism*, in TRANSNATIONAL LAW, RETHINKING EUROPEAN LAW AND LEGAL THINKING 11 (Miguel Madur, Kaarlo Tuori & Suvi Sankari eds., 2014).

<sup>104</sup> See Thomas Duve, *European Legal History – Global Perspectives Working paper for the Colloquium “European Normativity – Global Historical Perspectives”* (Max Planck Inst. for Euro. Legal Hist. Research Paper Ser. No. 2013-06, 2013).

<sup>105</sup> See Hans-W. Micklitz, *An Essay on the Bifurcation of Legal Education - National vs Transnational* (forthcoming 2015).

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## INTERNATIONAL B2B CONTRACTS – FREEDOM UNCHAINED?

*Prof. Dr. Ingeborg Schwenzer, LL.M. & Claudio Marti Whitebread, MLaw\**

INTRODUCTION.....	34
I. PROTECTED PERSONS AND/OR TRANSACTIONS .....	34
A. Consumers .....	34
B. Small and Medium Size Enterprises.....	36
C. Standard Terms or Individually Negotiated Terms ..	37
II. EXCLUSION OR LIMITATION OF LIABILITY CLAUSES .....	38
A. Typical Clauses.....	39
B. Restrictions .....	39
1. <i>Reasonableness</i> .....	39
2. <i>Personal Injury</i> .....	40
3. <i>Gravity of Fault</i> .....	40
4. <i>Warranty and Guarantee</i> .....	41
5. <i>Minimum Adequate Remedy</i> .....	42
III. EXCLUSION AND LIMITATION OF LIABILITY CLAUSES IN CISG CONTRACTS .....	42
CONCLUSION .....	43
A. B2B v. B2C .....	43
B. Unified Approach in International B2B Contracts..	43
C. Criteria to be Considered.....	45

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\* Prof. Dr. Ingeborg Schwenzer, LL.M. (Berkeley) is a professor of private law at the University of Basel. Claudio Marti Whitebread, MLaw, attorney at law, is a research and teaching assistant at the University of Basel.

## INTRODUCTION

Freedom of contract is regarded to be a general core principle in international Business to Business (B2B) contractual relationships.<sup>1</sup> This is especially true for sales contracts governed by the U.N. Convention on Contracts for the International Sale of Goods (CISG), which in Article 6 explicitly provides that “[t]he parties may . . . derogate from or vary the effect of any of its provisions.”

Although domestic legal systems also recognize the principle of freedom of contract in commercial practice, they still vary considerably with regard to the extent of this principle and to its possible limitations. First, this paper will discuss how international instruments as well as domestic legal systems draw the line between Business to Consumer (B2C) and B2B contracts. Second, the validity of exclusion and limitation of liability clauses will be examined as the most prominent example for the exercise of judicial control of clauses in B2B contracts.

## I. PROTECTED PERSONS AND/OR TRANSACTIONS

## A. Consumers

It is generally agreed that consumers deserve special protection in B2C relationships.<sup>2</sup> However, the definition of who is a consumer considerably differs on both the international and the domestic level.

The most widely used definition of “consumer” is found in Article 2(a) CISG, according to which a consumer is a person who buys goods for “personal, family, or household use.”<sup>3</sup> This definition

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<sup>1</sup> M. G. BRIDGE, *THE INTERNATIONAL SALE OF GOODS* ¶ 1.28 (3d. ed. 2013); 1 CHITTY ON CONTRACTS ¶ 1-029 (H. G. Beale et al. eds., 31st ed. 2012); E. A. FARNSWORTH, *CONTRACTS* 23 (4th. ed. 2004).

<sup>2</sup> CASES, MATERIALS AND TEXT ON CONSUMER LAW 2-3 (Hans-W. Micklitz, J. Stuyck, E. Terryn, & Dimitri Droshout, eds. 2010); G. WOODROFFE & R. LOWE, *CONSUMER LAW AND PRACTICE* ¶ 1.15 (9th ed. 2013); G. HOWELLS & S. WEATHERILL, *CONSUMER PROTECTION LAW* 8-9 (2d. ed. 2005).

<sup>3</sup> United Nations Convention on Contracts for the International Sale of Goods, U.N. Doc. A/CONF.97/18, art. 2(a) (1980), *available at*

is also typically used by common law<sup>4</sup> and some Asian jurisdictions.<sup>5</sup> The emphasis here is clearly on the intended use of the goods sold.<sup>6</sup> The European Directive on Consumer Rights, which entered into force on 13 June 2014, defines consumer as a “natural person who . . . is acting . . . outside its trade, business, craft or profession.”<sup>7</sup> Thus, this approach is slightly different to the CISG’s; however, it should not yield very different results. The UNIDROIT Principles, on the other hand, do not contain a specific definition of the “consumer.” Instead, they focus on the term “commercial” contracts, which leaves much leeway for interpretation.<sup>8</sup>

In Ibero-American legal systems it is common to find references to the ultimate purchaser, which suggests a focus on the relative position of a person in the supply chain.<sup>9</sup> This definition is much broader than the ones described above. It may well lead to friction when dealing with a contract governed by an international instrument such as the CISG.

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<http://www.uncitral.org/pdf/english/texts/sales/cisg/V1056997-CISG-e-book.pdf> [hereinafter CISG].

<sup>4</sup> Business Practices and Consumer Protection Act, S.B.C. 2004, c. 2, pt. 1(1) (Can.); Unfair Contracts Term Act 1977, c. 50, § 12(1) (U.K.).

<sup>5</sup> Framework Act on Consumers, Act. No. 8372, Sep. 27, 2006, art. 2(2) (S. Kor.); Consumer Act of the Philippines, Rep. Act No. 7394, art. 4(n), (q) (July 2, 1991) (Phil.); Ordinance of Protection of Consumer’s Interest, art. 1 (Viet.).

<sup>6</sup> M. P. FURMSTON, ET AL., LAW OF CONTRACT 28 (16th ed. 2012); CASES, MATERIALS AND TEXT ON CONSUMER LAW, *supra* note 2, at 31; I. Schwenzer & P. Hachem, in SCHLECHTRIEM & SCHWENZER: COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALES OF GOODS (CISG) (3d. ed. 2010).

<sup>7</sup> Council Directive 2011/83, art. 2(1), 2011 O.J. (L 304)(EC) [hereinafter Directive 2011/83]. Art. 2(f) of the Common European Sales Law (CESL) contains a similar definition. *Commission Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law*, at art. 2(f), COM (2011) 635 final (Oct. 11, 2011) [hereinafter CESL].

<sup>8</sup> International Institute for the Unification of Private Law, UNIDROIT Principles of International Commercial Contracts (2010) [hereinafter UNIDROIT Principles], preamble, cmt. 2, available at <http://www.unidroit.org/english/principles/contracts/principles2010/integralversionprinciples2010-e.pdf>.

<sup>9</sup> Consumer Protection Law, art. 2 (Costa Rica); Consumer Code, L. No. 29571, art. 2 (Peru).

## B. Small and Medium Size Enterprises

Many legal systems broaden the scope of protection so as to also encompass certain small and medium size enterprises. In essence, there are two different approaches to extend the protection to this group. A variety of jurisdictions include into their consumer protection laws those artisans and small companies who acquire products or services to integrate them into a production process for the supply of products or services to third parties. For example, under Chinese and Mongolian law, farmers who purchase materials for production still qualify as consumers.<sup>10</sup> In other jurisdictions—especially in Ibero-America—the same result is achieved by using the ultimate purchaser approach.<sup>11</sup>

Other legal systems distinguish according to the size of the respective enterprise. With regard to the control of standard terms, the English and Scottish Law Commission suggests a revision to the Unfair Contract Terms Act to extend protection to small enterprises that do not employ more than nine persons.<sup>12</sup> A similar approach can be found in the Netherlands. There, enterprises having less than fifty employees or otherwise not obliged to publish their annual balance are put on a par with consumers.<sup>13</sup>

Another approach sets a monetary limit in distinguishing the level of judicial protection. Again, the English and Scottish Law

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<sup>10</sup> SCHWENZER, HACHEM & KEE, *GLOBAL SALES AND CONTRACT LAW* ¶ 6.25 (2012).

<sup>11</sup> Law No. 22240, Sept. 22, 1993, art. 1 (Arg.); Lei No. 8.078, de 11 septiembre de 1990, art. 2, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] 12.09.1990 (Braz.); Law No. 19496, Marzo 7, 1997, art. 1, DIARIO OFICIAL [D.O.] (Chile); Law on Consumer Protection, July 10, 2000, art. 2 (Ecuador); Ley No. 842, 10 Oct. 2013, Ley de Protección de los Derechos de las Personas Consumidoras y Usuarías [Law on Protection of the Rights of Consumers and Users] art. 4, DIARIO OFICIAL [L.G.], 10 Oct. 2013 (Nicar.); Law No. 1334, 1998, art. 4 (Para.); Consumer Protection Law, art. 2 (Uru.). *See also* E. MUÑOZ, *MODERN LAW OF CONTRACTS AND SALES IN LATIN AMERICA, SPAIN AND PORTUGAL* 47 (2011).

<sup>12</sup> The Law Comm'n & The Scottish Law Commission, *UNFAIR CONTRACT TERMS: REPORT ON A REFERENCE UNDER SECTION 3(1)(E) OF THE LAW COMMISSIONS ACT 1965* ¶ 5.40 [hereinafter *Unfair Contract Terms*], *available at* <http://www.scotlawcom.gov.uk/files/2512/7989/6621/rep199.pdf>.

<sup>13</sup> Art. 6:235(1)(a) BW (Neth.).

Commission suggests, in the course of the Unfair Contract Terms Act, to apply the same control of standard terms as for consumers to transactions involving small enterprises with a volume of less than £500.00 GBP.<sup>14</sup> The Australian Competition and Consumer Act 2010 applies to all transactions for the supply or sale of goods and services up to a limit of approximately \$40.00 AUD.<sup>15</sup>

### C. Standard Terms or Individually Negotiated Terms

The classical German approach draws a sharp line between standard terms and individually negotiated terms. In general, individually negotiated clauses are not subject to special judicial scrutiny. The picture immediately changes as soon as a clause is part of standard terms.<sup>16</sup> Judicial practice shows that virtually the same standard applies to both B2C and B2B contracts.<sup>17</sup> Recently, this approach has received severe criticism.<sup>18</sup> Anecdotally, German companies frequently opt out of German law and choose Swiss law to circumvent the German courts' scrutiny of standard terms.<sup>19</sup> Unfortunately, the German approach has made its way to the European level. The distinction between standard terms and

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<sup>14</sup> Unfair Contract Terms, *supra* note 12, ¶ 5.59.

<sup>15</sup> Competition and Consumer Act 2010 (Cth) s 4B(2)(a) (Austl.).

<sup>16</sup> BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, REICHSGESETZBLATT [RGL.] 195, as amended, § 307 (Ger.) [hereinafter BGB].

<sup>17</sup> Bundesgerichtshof [BGH] [Federal Court of Justice], May 16, 2007, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 2007 (2176) (Ger.); Bundesgerichtshof [BGH] [Federal Court of Justice], Sept. 19, 2007, BeckRS 2007 (18417); Bundesgerichtshof [BGH] [Federal Court of Justice], Mar. 3, 1988, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1785, 1988.

<sup>18</sup> C. Kessel, *Zur Frage einer Reform des AGB-Rechts im unternehmerischen Rechtsverkehrs*, in STÄNDIGE DEPUTATION DES DEUTSCHEN JURISTENTAGES 69 (2012); E.M. Kieninger, *AGB-Kontrolle von grenzüberschreitenden Geschäften im unternehmerischen Verkehr*, in EINHEIT UND VIELHEIT IM UNTERNEHMENSRECHT 179 (2013); I. Schwenzer & F. Lübbert, *Neues AGB-Recht im unternehmerischen Rechtsverkehr?*, ANWALTSBLATT, H. 4. S. 292 (Apr. 2012); K.P. Berger, *Für Eine Reform des AGB-Rechts im Unternehmerverkehr*, NJW 2010, 465.

<sup>19</sup> Ingeborg Schwenzer, in STÄNDIGE DEPUTATION DES DEUTSCHEN JURISTENTAGES 69 (2012); T. Pfeiffer, *Flucht ins schweizerische Recht*, in ZWISCHEN VERTRAGSFREIHEIT UND VERBRAUCHERSCHUTZ, FESTSCHRIFT FÜR FRIEDRICH GRAF VON WESTPHALEN 555 (F.C. Genzow, B. Grunewald & H. Schulte-Nölke eds., 2010); S. Brachert & A. Dietzel, *Deutsche AGB-Rechtsprechung und Flucht ins Schweizer Recht*, ZGS 2005, 441.

negotiated terms was first introduced into the Directive on Unfair Terms in Consumer Contracts.<sup>20</sup> It was restricted to B2C contracts;<sup>21</sup> however, the Draft Common Frame of Reference (DCFR),<sup>22</sup> and subsequently the Common European Sales Law (CESL),<sup>23</sup> which was approved by the European Parliament in February 2014, extended the distinction between standard terms and negotiated terms to the area of B2B relationships.

In many other legal systems—at least insofar as B2B contracts are concerned—the fact that a certain clause formed part of standard terms is only one criterion among many others when assessing the fairness of the respective clause. This is true for most Common law jurisdictions,<sup>24</sup> and also for Switzerland<sup>25</sup>.

## II. EXCLUSION OR LIMITATION OF LIABILITY CLAUSES

The litmus test for any approach of judicial control of freedom of contract in B2B relationships is the question how a certain system deals with exclusion and limitation of liability clauses. These clauses can be found in almost every commercial contract, especially on an international level. Together with the description of the contractual duties, they form the core part of the contract and decide whether the aggrieved party may rely on a breach of contract and—if so—can get redress for it. It is all the more problematic that the different

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<sup>20</sup> Council Directive 93/13, 1993 O.J. (L 095) (EC) [hereinafter Directive 93/13].

<sup>21</sup> *Id.* art. 3(1).

<sup>22</sup> PRINCIPLES, DEFINITIONS, AND MODEL RULES OF EUROPEAN PRIVATE LAW: DRAFT COMMON FRAME OF REFERENCE (DCFR) OUTLINE EDITION, art. II-9:405 (Christian von Bar et al. eds., 2009), available at [http://ec.europa.eu/justice/policies/civil/docs/dcfr\\_outline\\_edition\\_en.pdf](http://ec.europa.eu/justice/policies/civil/docs/dcfr_outline_edition_en.pdf)

<sup>23</sup> CESL, *supra* note 7, at art. 86.

<sup>24</sup> INGEBORG SCHWENZER, PASCAL HACHEM & CHRISTOPHER KEE, GLOBAL SALES AND CONTRACT LAW ¶ 12.03; FARNSWORTH, *supra* note 1, at 582-91.

<sup>25</sup> R.M. HILTY, BASLER KOMMENTAR: BUNDESGESETZ ÜBER DEN UNLAUTEREN WETTBEWERB (UWG), Art. 2, ¶ 2 (2013); M.M. PEDRAZZINI & F.A. PEDRAZZINI, UNLAUTERER WETTBEWERB (UWG) ¶ 4.06 (2d ed. 2002); C. BAUDENBACHER, LAUTERKEITSRECHT: KOMMENTAR ZUM GESETZ GEGEN DEN UNLAUTEREN WETTBEWERB (UWG), Art. 2, ¶ 7 (2001).



approaches yield different results, thus making the outcome of a possible dispute highly unpredictable.

#### A. Typical Clauses

Limitation of liability clauses typically appear in three forms. First, they may seek to exclude liability entirely by excluding a certain cause of action or by increasing the threshold to meet the requirements for a certain cause of action. Second, they may seek to exclude liability for certain types of losses. Third, these clauses may seek to put an upper limit to the quantum of recoverable losses. In practice, more often than not all three forms of limitation of liability clauses are combined. For example, a clause may stipulate that the seller is liable only for gross negligence, that recovery of consequential losses is excluded, and that in all instances the quantum of recoverable loss is limited to the contract price.<sup>26</sup>

#### B. Restrictions

There is agreement among all legal systems that, in both B2C contracts and B2B relationships, exclusion and limitation of liability clauses are subject to certain legal restrictions.<sup>27</sup>

1. *Reasonableness* - The common starting point seems to be that such a clause is only valid if it is not unreasonable, unfair, unconscionable, or the like. Some legal systems explicitly refer to such a standard, including the English and Scottish Unfair Contract Terms Act,<sup>28</sup> the Uniform Commercial Code (U.C.C.) in the United States,<sup>29</sup> or the general clause in the German Civil Code.<sup>30</sup> It is noteworthy,

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<sup>26</sup> Cf. 1 CHITTY ON CONTRACTS ¶ 14-003 (H. G. Beale et al. eds., 31st ed. 2012); SCHWENZER, ET AL., *supra* note 24, ¶ 44.299; EWAN MCKENDRICK, CONTRACT LAW: TEXTS, CASES, AND MATERIALS 406–09 (4th ed. 2010).

<sup>27</sup> See, e.g., BGB, *supra* note 16, § 276(3); Art. 1229 C.c. (It.); Art. 1102 C.C. (Spain); Obligationenrecht [OR] [Code of Obligations] Mar. 30, 1911, art. 100 (Switz.) [hereinafter Code of Obligations]; U.C.C. §§ 2-316, 2-719 (2014); Civil Code of Québec, S.Q. 1991, c. 64, art. 1474 (Can.).

<sup>28</sup> Unfair Contracts Term Act 1977, *supra* note 4, § 2(2) (U.K.).

<sup>29</sup> U.C.C. § 2-302 (2014).

<sup>30</sup> BGB, *supra* note 16, at § 307.

however, that the majority of legal systems do not distinguish between an outright exclusion and a mere limitation of liability.<sup>31</sup>

2. *Personal Injury* - It is often alleged that it is universally recognized that a party may not limit or even exclude its liability for personal injury.<sup>32</sup> However, this is only clear in the case of personal injury to a consumer and where the exclusion or limitation of liability clause is found in standard terms.<sup>33</sup> Although it is true that personal injury will mostly occur to the ultimate purchaser or user of goods, and that in those situations the exclusion or limitation of liability most likely will be part of standard terms, there are no convincing reasons why the threshold of protection should be lowered in the case of personal injury to a business person or where the respective clause has been individually negotiated. Explicit equation of all cases of personal injury can be found in the English and Scottish Unfair Contract Terms Act,<sup>34</sup> as well as in the Civil Code of Quebec<sup>35</sup>. Similarly, in Switzerland, at least some scholarly writings suggest this result.<sup>36</sup>

3. *Gravity of Fault* - Civil law legal systems follow the fault-based liability approach.<sup>37</sup> Accordingly, restrictions on the ability of the parties to exclude or limit their liability are directed to the gravity of the *culpa*. However, the restrictions on the freedom of the parties to limit their liability to a certain degree of fault differ among legal systems and even differ within individual legal systems depending on whether

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<sup>31</sup> See *id.* § 309, No. 7; C.C. art. 1229 (It.); Civil Code of Québec, *supra* note 27.

<sup>32</sup> Cf. SCHWENZER, ET AL., *supra* note 24, at ¶ 44.317; MARCEL FONTAINE & FILIP DE LY, DRAFTING INTERNATIONAL CONTRACTS 386 (2009).

<sup>33</sup> See BGB, *supra* note 16, at § 309, No. 7(a); Directive 93/13, *supra* note 20, at annex (a); U.C.C. § 2-719(3) (2014).

<sup>34</sup> Unfair Contracts Term Act 1977, *supra* note 4, at § 2(1) (U.K.).

<sup>35</sup> Civil Code of Québec, *supra* note 27.

<sup>36</sup> INGEBORG SCHWENZER, SCHWEIZERISCHES OBLIGATIONENRECHT ALLGEMEINER TEIL ¶ 24.14 (6th ed. 2012); P. TERCIER & P. PICHONNAZ, LE DROIT DES OBLIGATIONS ¶ 1267 (5th ed. 2012); W. WIEGAND, H. HEINRICH & N.P. VOGT, BASLER KOMMENTAR: OBLIGATIONENRECHT I art. 100, ¶ 4 (5th ed. 2011).

<sup>37</sup> SCHWENZER, ET AL., *supra* note 24, ¶ 44.63; KONRAD ZWEIGERT & HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW 494 (3d. ed. 1998).

the clause is part of non-negotiated terms and whether it is a B2C or a B2B contract.<sup>38</sup>

Broadly speaking, legal systems employing a fault-based liability approach agree that in consumer transactions liability for one's own gross negligence and intent cannot be excluded in standard terms.<sup>39</sup> Again, this approach is similar to the one with regard to exclusion or limitation of liability in the case of personal injury. Some of these systems allow an exclusion of liability for gross negligence where the clause has been individually negotiated and/or is part of a B2B contract.<sup>40</sup> Furthermore, if the breach of contract is due to the act or omission of an auxiliary, exclusion or limitation is possible even if this person acted intentionally,<sup>41</sup> at least if it is not part of standard terms in a B2C contract.<sup>42</sup>

4. *Warranty and Guarantee* – Many, if not most, legal systems prohibit exclusion and limitation of liability if the obligor expressly warrants or guarantees certain features of the contract, especially specific features of the goods in sales contracts.<sup>43</sup> It would appear contradictory to allow the obligor to limit or even exclude its liability where an express warranty or guarantee is given.<sup>44</sup> Here, however,

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<sup>38</sup> SCHWENZER, ET AL., *supra* note 24, ¶¶ 44.311, 44.312.

<sup>39</sup> *See, e.g.*, CÓDIGO CIVIL (Civil Code), Apr. 2, 1976, art. 350(1) (Bol.); BGB, *supra* note 16, §§ 309, No. 7(b), 475; Art. 1.102 C.C. (Spain); Código Civil Federal [CC][Federal Civil Code], *as amended*, Diario Oficial de la Federación [DO], Aug. 30, 1928, art. 2106 (Mex.); Código Civil (Civil Code), art. 1328 (Peru).

<sup>40</sup> *See, e.g.*, Civil Code, art. 417(4) (Arm.); Civil Code, art. 372(4) (Belr.); BGB, *supra* note 16, at § 276(3) (Ger.); Code of Obligations, art. 395(2) (Geor.); GRAZHDANKII KODEKS ROSSIJSKOI FEDERATSII [GK RF] [Civil Code] art. 401 (Russ.).

<sup>41</sup> BGB, *supra* note 16, §§ 278, 276(3); Civil Code, art. 809, 800 (Port.); Code of Obligations, *supra* note 27, art. 101(2) (Switz.).

<sup>42</sup> BGB, *supra* note 16, § 309 No. 7(b).

<sup>43</sup> *See, e.g.*, BGB, *supra* note 16, § 444. *See also* U.C.C. § 2-316(1) (2014).

<sup>44</sup> H. P. Westermann, *in* MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, VOL. 3 § 444 ¶ 14 (F.J. Säcker & R. Rixecker, eds., 6th ed. 2012); JAMES WHITE & ROBERT SUMMERS, UNIFORM COMMERCIAL CODE 576 (2010).

everything will depend on when and how such a warranty or guarantee can be assumed in a B2B relationship.

5. *Minimum Adequate Remedy* - In accordance with the notion that no party may relieve itself of all risks under a contract by excluding its liability entirely, legal systems agree that each party must retain a minimum of remedial protection under a contract. A particularly visible statement is found in the United States where the Official Comment on Section 2-719 U.C.C. states, “it is of the very essence of a sales contract that at least minimum adequate remedies be available.”<sup>45</sup> The same reasoning underlies the German rule that, if repair of defective goods fails, the obligee at least must retain the right to either reduce the purchase price or avoid the contract.<sup>46</sup>

### III. EXCLUSION AND LIMITATION OF LIABILITY CLAUSES IN CISG CONTRACTS

The question whether a party may exclude or limit its liability under a CISG sales contract is important yet controversial. The CISG Advisory Council is currently preparing an opinion on this subject. According to Article 4 CISG, the “Convention . . . is not concerned with: (a) the validity of the contract or any of its provisions . . . .”<sup>47</sup> However, the CISG itself defines which questions are considered to be questions of validity and thus to be decided under domestic law.<sup>48</sup> It is, in essence, agreed that exclusion and limitation of liability clauses are questions concerning matters governed by the Convention in the sense of Art. 7(2) CISG.<sup>49</sup> Debate remains among the CISG Advisory Council, however, if general principles within the CISG can be found to settle this question.

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<sup>45</sup> U.C.C. § 2-719, cmt. 1 (2014).

<sup>46</sup> BGB, *supra* note 16, § 309 No. 8(b)(bb).

<sup>47</sup> CISG, *supra* note 3, art. 4.

<sup>48</sup> H.P. WESTERMANN, MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, Vol. 3, art. 4 CISG, ¶ 8 (W. Krüger & H.P. Westermann, eds., 6th ed. 2012); Schwenger & Hachem, *supra* note 6, art. 4, ¶ 31; C. BRUNNER, UN-KAUFRECHT – CISG, Art. 4, ¶ 5 (2005).

<sup>49</sup> *Cf.* WESTERMANN, *supra* note 48, art. 4 CISG, ¶ 6; Schwenger & Hachem, *supra* note 6, art. 4, ¶ 43.

## CONCLUSION

## A. B2B v. B2C

It seems to be unanimously agreed that, with regard to judicial control of contract terms and exclusion and limitation of liability clauses, there must be a clear distinction between B2C and B2B relationships.<sup>50</sup> Whereas consumers typically can neither influence the content of a contract nor have any real alternative to turn to, and thus freedom of contract has lost its justification altogether, in B2B contracts the situation is completely different. It is there where freedom of contract still retains its legitimate place as a starting point. However, this does not mean that there is unchained freedom of contract in these relationships below the threshold of public policy.

## B. Unified Approach in International B2B Contracts

It has been shown that many different approaches and levels of scrutiny can be found in domestic legal systems. However, in cross border transactions, foreseeability and predictability is of utmost importance. This is particularly true for the core area of any contract, the respective liability regime, and its limits. Therefore, it is a matter of priority to achieve uniform results in this respect. If it were not possible to have these questions governed by the CISG, at least in international sales contracts, it must be a primary aim to strive for unification on an international level.

Having regard to the comparative overview the starting point for judicial control of contract terms in international B2B relationships seems straight forward. Hard and fast rules as they can be found in black (conclusively invalid) or grey (presumptively invalid) lists (or unfair or invalid contract terms) are suitable for B2C relationships. In

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<sup>50</sup> Eva–Maria Kieninger, *AGB bei B2B-Verträgen: Rückbesinnung auf die Ziele des AGB-Rechts*, ANWALTS BLATT 301, 306 (Apr. 2012) (Ger.), available at [https://ius.unibas.ch/uploads/publics/40215/20121206163733\\_50c0bbbd851e8.pdf](https://ius.unibas.ch/uploads/publics/40215/20121206163733_50c0bbbd851e8.pdf); Barbara Dauner-Lieb, &Constantin Axer, *Quo vadis AGB-Kontrolle im unternehmerischen Geschäftsverkehr?*, ZIP, 2010, at 312-14 (Ger.); Barbara Dauner-Lieb & A. Khan, *Betriebsausfallschäden als Gestaltungsproblem*, in ZWISCHEN VERTRAGSFREIHEIT UND VERBRAUCHERSCHUTZ, FESTSCHRIFT FÜR FRIEDRICH GRAF VON WESTPHALEN 70-71 (Genzow, Grunewald, Schulte-Nölke, eds.).

B2C relationships, the bargaining positions and relevant interests of the parties involved do not differ very much. As previously indicated, business parties generally have the superior bargaining power. Likewise, the content of contracts in specific branches of trade is comparable. Therefore, in B2C relationships, standard terms prevail in these relationships. This militates unitary and simple rules.

In contrast, B2B contracts, and especially international B2B contracts, cannot be measured by the same yardstick. The respective bargaining position of the parties to an international contract can vary considerably. The same holds true for the contents of such contracts. Therefore, B2B contracts require differentiated solutions that can be adjusted to the individual circumstances of the case. Instead of black and grey lists, a general clause seems to be preferable.

The approach to the validity of exclusion and limitation of liability clauses in international B2B contracts should be one of fairness or reasonableness. As already explained above,<sup>51</sup> reasonableness and fairness can be found in the English and Scottish Unfair Terms Act,<sup>52</sup> the UNIDROIT Principles talk about clauses being grossly unfair,<sup>53</sup> the U.C.C. uses the term unconscionability,<sup>54</sup> and the German Civil Code employs the term of contravening principles of good faith albeit only related to standard terms.<sup>55</sup> As regards the CISG reasonableness can be regarded as a general principle underlying the CISG in the sense of Art. 7(2) CISG.<sup>56</sup> To meet the needs of foreseeability and predictability, a general clause must be accompanied by a list of criteria to be considered in the individual case.

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<sup>52</sup> Unfair Contracts Term Act 1977, c. 50, §§ 4(1), 11(1) (U.K.).

<sup>53</sup> UNIDROIT Principles, *supra* note 8, art. 7.1.6.

<sup>54</sup> U.C.C. § 2-302 (2014).

<sup>55</sup> BGB, *supra* note 16, § 307(1).

<sup>56</sup> CISG Advisory Council Opinion No. 6, Calculation of Damages under CISG Article 74, cmt. 2.1, *available at* <http://www.cisgac.com/default.php?ipkCat=128&ifkCat=148&sid=148>; J. VON STAUDINGERS KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, WIENER UNKAUFRECHT (CISG) art. 7, ¶ 45 (ULRICH MAGNUS & MICHAEL MARITNEK eds., Jan. 2005).

### C. Criteria to be Considered

One of the first criteria to be considered should be the position of the parties in the market and their respective bargaining power. This takes up the idea that many legal systems tend to extend the protection provided for consumers to small and medium sized enterprises (SMEs). A flexible approach certainly seems advisable, as there is a great variety also among SME's.

The fact of a specific clause forming part of standard terms or being individually negotiated might also be one criterion among others. However, this should not be the sole approach used to decide which level of judicial control to apply in international B2B contracts. To save transaction costs and due to the complex nature of the subject matter of the contract, most international B2B contracts depend on pre-formulated contract terms without one party necessarily being in a superior bargaining position. This is clearly evidenced by the current discussion in Germany, which heavily criticizes the practice of control of standard terms in B2B contracts.<sup>57</sup>

In assessing the validity of an exclusion and limitation of liability clause in a B2B contract, regard should be given to the contract as a whole, especially in relation to other contractual terms.<sup>58</sup> This holds true for the interplay between warranties and guarantees on the one hand and exemption clauses on the other.

Unlike in many existing legislation which apply the same rules to exclusion as well as to limitation of liability clauses<sup>59</sup> the two should be clearly distinguished. There undoubtedly exists a difference whether liability is entirely excluded where certain kinds of damages are excluded or where the amount of recoverable damages is capped. Consequently, the level of scrutiny must be higher when liability is fully excluded than in the case of a mere limitation. It is here, too, where the principle of minimum adequate remedy should have its legitimate scope of application.

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<sup>57</sup> Kessel, *supra* note 18.

<sup>58</sup> See CESL, *supra* note 7, art. 86(2)(c).

<sup>59</sup> See *id.*, § III(B)(1).

Neither gross negligence nor intentional breach of contract should lead to a limitation of liability clause to be void *ab initio* as is currently the case in many legal systems. Rather, the gravity of fault should be only one criterion among others to invalidate such a clause. The only case in which an *ab initio* invalidity is conceivable relates to personal injury where a differentiation between consumer and business person seems hardly justifiable.



**SHOULD CLAUSES PROHIBITING  
ASSIGNMENT BE OVERRIDDEN BY  
STATUTE?**

*Louise Gullifer\**

Many contracts for the supply of goods or services include a clause prohibiting assignment by the supplier of its rights under the contract. The existence of such clauses, both in particular contracts and more generally, can have a chilling effect on the use of receivables as collateral to obtain financing. Thus, there is a legislative override for such clauses so that they are not enforceable against third parties. There has been an ongoing debate as to whether the law of England and Wales should follow suit and, if so, what form the override should take. While the debate continues among academics and practitioners, the Government has enacted a power to make reforms in the Small Business, Enterprise and Employment Act 2015.<sup>1</sup> This paper examines the arguments for and against an override in English law, informed by two small-scale surveys undertaken by the author and others over the last four years.<sup>2</sup> The detailed form of an override will not be discussed

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\* Professor of Commercial Law, University of Oxford; Fellow and Tutor in Law, Harris Manchester College, Oxford.

<sup>1</sup> The Department of Business, Innovation and Skills has consulted on draft Regulations and further work is continuing, of which the author is a part. *See* Department for Business, Innovation and Skills, Invoice finance: nullifying the ban on invoice assignment contract clauses, <https://www.gov.uk/government/consultations/invoice-finance-nullifying-the-ban-on-invoice-assignment-contract-clauses> (2015); *see also* Small Business, Enterprise and Employment Act, 2015, c. 26 (U.K.).

<sup>2</sup> One of the surveys was carried out by Hugh Beale and Louise Gullifer in 2011 (“2011 Study”) with the assistance of Anna Kloeden. The survey was funded by the Asset Based Finance Association (ABFA), which stressed from the outset that it wanted a completely independent view. The second survey was carried out in 2014 as part of the work of the Secured Transactions Law Reform Project (“2014 Study”) by Sarah Paterson. I am grateful to both Hugh Beale and Sarah Paterson for

for reasons of space. The model that is likely to be adopted in England and Wales is that found in the Uniform Commercial Code Article 9, which provides that an anti-assignment clause is generally ineffective.<sup>3</sup>

#### I. THE ARGUMENTS FOR AND AGAINST AN OVERRIDE

In order to maximize the availability of finance and credit in the economy, it is important that as many sources of wealth as possible can be used as collateral. To do this, the source of wealth (the asset) must be able to be alienated to the secured creditor. The obvious assets which could be alienated are tangible assets: goods and land. However, sources of wealth also include intangible assets, most importantly, rights to be paid by another. Thus, many centuries ago, it became possible to use obligations owed to a borrower as collateral for a loan, first by pledging a document which represented that obligation (a documentary intangible), and then by enabling the benefit of obligations to be assigned, either absolutely or by way of security. A major difference between the use of tangible property as collateral, and the use of such obligations, known in English law as choses or things in action,<sup>4</sup> is that in the latter case there is another person to consider, namely the obligor. There is no real problem when the obligor takes on an obligation that is designed to be transferred, for example, a negotiable instrument. But, where the obligation can be transferred without the agreement, or even the knowledge, of the obligor, a policy imperative arises in competition to that of maximizing available collateral by permitting alienability: that of protection, where necessary, of the obligor. This policy can be seen in English law, for example, by the rule that only an assignee who has taken a statutory assignment can sue the debtor.<sup>5</sup> If an equitable assignment is taken, the assignor must be joined in any action. There are three main criteria for a statutory assignment: (1) the assignment must be in writing; (2) the assignment must not relate to part of a debt or a future debt; and (3)

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permitting me to use the results of the surveys in this paper, and for many useful discussions.

<sup>3</sup> U.C.C. § 9-406(d) (2015).

<sup>4</sup> Also known as intangibles; however, the category of intangibles is potentially wider than just choses in action, e.g., intellectual property and carbon trading units.

<sup>5</sup> Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20, § 136 (Eng.).

notice of the assignment must be given to the debtor. All serve some function in protecting the debtor. Additionally, the policy of protecting the obligor can be seen by the rule that the benefit of a contract for personal services cannot be assigned,<sup>6</sup> and more generally, by the fact that an obligor is permitted to protect himself by restricting the ability of the obligee to assign the benefits of the obligation to another. This permission, though, is justified by the even more fundamental policy of protection of freedom of contract.

Thus, whether there should be a statutory override of anti-assignment clauses can be seen as a matter of balancing competing policy imperatives: alienability of assets, which maximizes available collateral, and freedom of contract, which allows obligors to protect themselves against adverse effects of assignment of the right to which their obligation correlates. On that basis, many jurisdictions and transnational instruments favor alienability.<sup>7</sup> Gilmore described the view in favor of the unrestricted and unrestrictable alienability of contract rights as “so fundamental an order [that] belief is instinctive and irrational, not logical and reasoned.”<sup>8</sup> This argument has been used to justify a statutory provision making an anti-assignment clause unenforceable against third parties.

I would like to suggest that the policy position is not so simple. At least from the English law perspective, there is a view that the policy imperatives can be satisfied without any statutory interference and that legislative change has to be justified both by economic arguments (based on the effects of uncertainty of outcome), and by evidence that the availability and cost of borrowing is actually affected by the

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<sup>6</sup> Tolhurst v. Assoc. Portland Cement Mfrs. (1900) Ltd., [1903] A.C. 414 (H.L.).

<sup>7</sup> See ANTHONY DUGGAN & DAVID BROWN, AUSTRALIAN PERSONAL PROPERTY SECURITIES LAW 32 (2012) (relating to *Personal Property Securities Act 2009* (Austl.)); UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS, at sec. II par. 107, U.N. Sales No. E.09.V.12 (2010), available at [http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670\\_Ebook-Guide\\_09-04-10English.pdf](http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf); see also U.N. Secretary-General, *Legal Aspects of Receivables Financing*, ¶ 23, U.N. Doc. A/CN.9/397 (Apr. 29, 1994); U.N. Secretariat, *Receivables Financing: Analytical Commentary on the draft Convention on Assignment of Receivables in International Trade*, ¶ 100, U.N. Doc. A/CN.9/489 (Mar. 13, 2001).

<sup>8</sup> GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 212 (1965).

existence (or potential existence) of anti-assignment clauses in contracts giving rise to receivables. This is for several interconnected reasons. First, the current law, to a large extent, accommodates the protection of the obligor and validity of a proprietary interest of the assignee. Second, receivables financiers in England and Wales have managed reasonably well by adopting “workarounds” to enable themselves to function within the current system. Third, the main concern about anti-assignment clauses relates to borrowers who are small businesses, and is part of a larger problem of inequality of bargaining power. Finally, anti-assignment clauses play an important and justifiable role in loan agreements, derivative contracts, and other financial transactions. In fact, there is real concern about defining the scope of statutory controls so that these benefits are not lost.

## II. THE ACCOMMODATION OF THE CURRENT LAW

In analysing the law, terminology can be confusing. In this analysis, terms are adopted that relate to receivables arising from supply contracts, since this is the context in which anti-assignment clauses are said to cause most problems.<sup>9</sup> The parties to the contract giving rise to the receivable are called the “supplier,” (the obligee) and the “customer,” (the obligor). The supplier is the client of the “financier” to whom it assigns, or attempts to assign, the receivable.

A financier is concerned about three things in relation to the receivables it takes as collateral. First, a financier has a proprietary interest in the receivables and their proceeds, which will survive the insolvency of the supplier. Second, a financier has priority over any subsequent assignee or other person claiming an interest in the receivables. Third, if the customer does not pay, the financier can ensure that the debt is enforced, and it has a proprietary claim to the proceeds of that enforcement.

Under English law, there are two types of assignments. The first type of assignment is a statutory assignment under section 136 of the Law of Property Act 1925, which takes place when certain

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<sup>9</sup> Another context, i.e., receivables under loan agreements, is considered *infra* section V.

conditions are satisfied.<sup>10</sup> The most important condition, for purposes of this paper, is that there must be notification to the obligor (the customer). This means that the customer will, and indeed must, pay the financier rather than the supplier.<sup>11</sup> If the customer fails to pay, the financier is able to sue the customer directly. In effect, the supplier drops out of the picture. A statutory assignment will also give the financier a proprietary interest in the receivable in the event of the insolvency of the supplier, or if there are competing interests.<sup>12</sup> There is clear authority that a receivable containing an anti-assignment clause cannot be the subject of a statutory assignment<sup>13</sup> so that the customer can continue to pay the supplier and cannot be sued (at law) by the financier.

The second type of assignment is an equitable assignment. An assignment is equitable when one of the conditions for a statutory assignment is not fulfilled. For example, a valid equitable assignment can occur without notifying the customer. A financier who takes an equitable assignment has a proprietary interest in the receivable, which survives the insolvency of the supplier, and will also have priority over a competing interest, subject to the rules on priority. Until the customer is notified, if it pays it will, of course, pay the supplier and will get a good discharge by so doing. The supplier will then hold those proceeds on trust for the financier.<sup>14</sup> Further, valid set-offs may

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<sup>10</sup> See Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20 (Eng.).

<sup>11</sup> If the customer pays the supplier, it will have to pay the financier as well and try to recover the payment made to the supplier.

<sup>12</sup> The priority rules, which depend on those set out in the nineteenth century case *Dearle v. Hall*, (1828) 38 Eng. Rep. 475, are somewhat complex. If a receivable is assigned twice, the first assignee to give notice to the debtor will have priority, providing that he did not have notice of the other assignment at the time he took his own assignment. If the debtor has not been notified at all, the assignment that is first in time wins. The position is even more complex if one or both of the assignments is a security interest, as security interests are required to be registered, and registration can, but does not necessarily, constitute notice.

<sup>13</sup> See *Linden Gardens Trust Ltd. v. Lenesta Sludge Disposals Ltd.*, [1994] 1 A.C. 85, 106-09 (H.L.). Of course, the true effect of any contractual provision (including an anti-assignment clause) will always depend on its exact wording. Thus, the *Linden Gardens* case, though laying down certain principles, was considering a particular form of words.

<sup>14</sup> This trust is often expressly declared, but would arise in any event. See *G.E. Crane Sales Pty. Ltd. v. Comm'r of Taxation* (1971), 126 CLR. 177, 213-14 (Austl.); *Barclays Bank Ltd. v. Willowbrook Int'l Ltd.*, [1987] 1 F.T.L.R. 386 (Eng.).

continue to arise between the supplier and customer until the customer receives notification of the assignment;<sup>15</sup> after this, only set-offs arising from the contract itself or closely connected claims can arise.<sup>16</sup> If the customer does not pay, the financier cannot, in theory, sue the customer for non-payment without joining the supplier to the action, although this rule is less restrictive than it sounds. It is easy to join a party to an action since no consent is needed if they are joined as a defendant, and the court will not require joinder if there is no good reason.<sup>17</sup> Also, if the financier wishes to enforce, it will first give notice of the assignment to the customer. Doing so will not only require the customer to pay the financier rather than the supplier,<sup>18</sup> but will also, in most cases, convert the equitable assignment into a statutory assignment,<sup>19</sup> thus enabling the financier to sue the customer direct. Of course, where the financing is on a non-notification basis, such as invoice discounting, the financier would normally expect the supplier to enforce against the non-paying customer. If the financing is with recourse, the financier would have contractual rights against the supplier so that the risk of non-payment is on the supplier.<sup>20</sup> It is only when the supplier either refuses to sue or is insolvent that the financier would be concerned to have the right to sue the customer itself. Even then, the financier might not need to enforce directly if there is an

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<sup>15</sup> *Roxburghe v. Cox*, [1881] 17 L.R. 520 (Ch. D.) (Eng.); *Gov't of Nfld. v. Nfld. Ry. Co.*, [1888] 13 App. Cas. 199 (P.C.); *Bus. Computers Ltd. v. Anglo-African Leasing Ltd.*, [1977] 1 W.L.R. 578 (Eng.).

<sup>16</sup> Known in English law as “transaction set-off.”

<sup>17</sup> *See William Brandt's Sons & Co. v. Dunlop Rubber Co. Ltd.*, [1905] 2 A.C. 454 (Eng.); *Sim Swee Joo Shipping Sdn. Bhd. v. Shirlstar Container Transp. Ltd.*, (unreported) 17 Feb. 1994; *Raiffeisen Zentralbank Österreich AG v. Five Star General Trading LLC*, [2001] EWCA (Civ) 68, 60, [2001] 2 W.L.R. 1344 (Eng.). Good reasons include the possibility that the supplier might contest the assignment, or that the assignment is only part of the debt, so that unless the supplier is before the court, the customer might face more than one action.

<sup>18</sup> *Jones v. Farrell*, [1857] 1 De G & J 208; *Brice v. Bannister*, [1878] 3 Q.B.D. 569; *William Brandt's Sons & Co. v. Dunlop Rubber Co. Ltd.*, [1905] 2 A.C. 454 (H.L.).

<sup>19</sup> This would not be the case if the conditions for a statutory assignment were not fulfilled, for example, if the assignment was for part of a debt.

<sup>20</sup> *See* HUGH BEALE ET AL., *THE LAW OF SECURITY AND TITLE-BASED FINANCING* (2d ed. 2012).

efficient means of enforcing against the customer through the insolvency process of the supplier.<sup>21</sup>

If the receivable contains an anti-assignment clause, some, but not all, of the above analysis changes. The customer, who is discharged by paying the supplier before notification of the assignment, is also discharged by paying the supplier after notification: it is entitled to ignore the notification. Once the debt is paid, though, the supplier will hold the proceeds on trust for the financier despite the anti-assignment clause. There is little *direct* authority on this point in English law, but there are a number of dicta<sup>22</sup> and academic support<sup>23</sup> supporting this view. In fact, it is extremely common for invoice discounting agreements to include an express provision that the proceeds are held on trust for the financier, and an anti-assignment clause will not prevent such provision being effective.<sup>24</sup> It is thought that even if the clause purported to prohibit such a declaration, it would be ineffective to prevent such a trust arising since the customer has no interest in preventing the alienation of the proceeds and such a clause would be against public policy.<sup>25</sup> However, this point has never been litigated, so the position is not entirely clear.

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<sup>21</sup> See discussion in the rest of this section.

<sup>22</sup> Re Turcan, [1888] 40 Ch. D. 5, 10-11 (supported by Lord Browne-Wilkinson in Linden Gardens, [1994] 1 A.C. at 106; Barbados Trust Co. Ltd. v. Bank of Zambia, [2007] EWCA (Civ) 148, 28, 77 (C.A.) (Eng.). See also *Devefi Pty. Ltd. v. Mateffy Perl Nagy Pty. Ltd.*, [1993] 113 ALR. 225, 236 (Austl.); Don King Prods. Inc. v. Warren, [2000] 3 W.L.R. 276 (C.A.) (Eng.).

<sup>23</sup> See Bob Allcock, *Restrictions on the Assignment of Contractual Rights*, 42 C.L.J. 328, 335-36 (1983); Gregory Tolhurst, *Prohibitions on Assignment and Declaration of Trust: Barbados Trust v. Bank of Zambia*, LLOYD'S MAR. & COM. L.Q. 278 (2007); Gerard McMeel, *The Modern Law of Assignment: Public Policy and Contractual Restrictions on Transferability*, LLOYD'S MAR. & COM. L.Q. 483, 507-08 (2004); MARCUS SMITH, *THE LAW OF ASSIGNMENT* 347 (2007); Peter Zonneveld, *The Effectiveness of Contractual Restrictions on the Assignment of Contractual Debts*, 22 J. INT'L BUS. & F. L. 313 (2007); Chee Ho Tham, *Notice of Assignment and Discharge by Performance*, LLOYD'S MAR. & COM. L.Q. 38, 77 (2010); GOODE ON LEGAL PROBLEMS OF CREDIT AND SECURITY 3-39 (Louise Gullifer ed., 5th ed. 2013).

<sup>24</sup> Don King Prods. Inc., [2000] 3 W.L.R. 276; MARCUS SMITH & NICO LESLIE, *THE LAW OF ASSIGNMENT: THE CREATION AND TRANSFER OF CHOSSES IN ACTION*, Part 25.33-25.36 (2nd ed. 2013).

<sup>25</sup> Roy Goode, *Inalienable Rights?*, 42 MOD. L.R. 553 (1979); Linden Gardens, [1994] 1 A.C. at 108 (per Lord Browne-Wilkinson at 108). The supplier

If the customer does not pay, it is clear that the financier cannot sue directly, as there can be no statutory assignment. However, provided that the agreement between the supplier and financier can be said to give rise to a trust of the unpaid receivable (either expressly or impliedly),<sup>26</sup> it is likely that the financier can sue the customer, joining the supplier as defendant to the action under a procedure known as the *Vandepitte* procedure. A beneficiary under a trust of a right can bring an action to force the trustee to bring an action to enforce that right for its benefit. The *Vandepitte* procedure merely short-circuits this process by enabling the beneficiary to instigate an action, which brings all parties before the court. In a case dealing with the purported assignment of a syndicated loan containing a restriction on assignment, a majority of the Court of Appeal decided that the *Vandepitte* procedure<sup>27</sup> was available to the “assignee.”<sup>28</sup> However, other judges have expressed doubt as to the appropriateness of the *Vandepitte* procedure in this context.<sup>29</sup>

Further, if there is an effective trust of the receivable, the financier will have a proprietary interest which survives the supplier’s insolvency, and is effective against competing interests in the receivable. What is not entirely clear, however, is whether it is possible for a well-drafted anti-assignment clause to prevent a trust of the receivable from arising. The judges in *Barbados Trust* were divided on

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would be in breach of contract by declaring the trust, but it is hard to see what the damages would be.

<sup>26</sup> Whether this is the case depends on the interpretation both of the anti-assignment clause and the purported assignment. Two recent cases show that this interpretation is fact specific, and therefore subject to considerable uncertainty. *See* *Co-operative Group Ltd. v. Birse Developments Ltd.*, [2014] EWHC (TCC) 530 (Eng.); *Stopjoin Projects Ltd. v. Balfour Beatty Engineering Services (HY) Ltd.*, [2014] EWHC (TCC) 589.

<sup>27</sup> The *Vandepitte* procedure is named after the case of *Vandepitte v. Preferred Accident Insurance Corp. of New York*, [1933] A.C. 70 (P.C.) (Eng.). Where there is a trust of an obligation, the trustee would usually enforce the obligation by suing the obligor. If the trustee refuses to sue, the beneficiary can sue the trustee to force him to do so. The *Vandepitte* procedure avoids the duplicity of actions, by allowing the beneficiary to sue the obligor direct, providing that the trustee is joined as defendant. If the action is successful, the court will order payment to the trustee, who will then hold those funds on trust for the beneficiary.

<sup>28</sup> *Barbados Trust*, [2007] EWCA (Civ).

<sup>29</sup> *Don King Prods. Inc.*, [2000] 3 W.L.R. 276 (Lightman J); *Barbados Trust*, [2007] EWCA (Civ) at 139 (Hooper LJ).



this issue.<sup>30</sup> A strong case can be made for an analysis whereby the trust is invalid to the extent that it affects the customer, but is valid as between the financier and the supplier.<sup>31</sup> However, there is still considerable uncertainty as to the correct legal analysis.<sup>32</sup>

From the point of view of the customer, the anti-assignment clause protects its position by enabling it to get a good discharge by paying the supplier: it will never be required to pay anyone else. Even if it is sued by the financier under the *Vandepitte* procedure,<sup>33</sup> the order will be that the customer pay the supplier (the trustee), who will then hold the proceeds on trust for the financier. Further, a notice of assignment received by the customer is ineffective to prevent set-offs arising between the supplier and the customer.<sup>34</sup>

Therefore, the overall legal position is that the interests of the financier and the customer can both have a certain degree of protection if an anti-assignment clause is used. This position is subject to several caveats. First, the law is complex and quite uncertain in some areas. There are few cases precisely on the relevant point, and even those that there are have generally not arisen in the context of receivables financing.<sup>35</sup> Second, the legal position will depend on the

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<sup>30</sup> Barbados Trust, [2007] EWCA (Civ) at 44-47, 88, 129-39.

<sup>31</sup> GOODE ON LEGAL PROBLEMS OF CREDIT AND SECURITY 3-42 (Louise Gullifer ed., 5th ed. 2013).

<sup>32</sup> A contrary view is that the clause renders the receivable inalienable so that a valid trust cannot be declared of it. See Andrew McKnight, *Contractual Restrictions on a Creditor's Right to Alienate Debts*, 18 J. INT'L BANK. L. & REG., no. 2, 2003, at 43 (2003); Gerard McMeel, *The Modern Law of Assignment: Public Policy and Contractual Restrictions on Transferability*, LLOYD'S MAR. & COM. L.Q. 483 (2004); Gregory Tolhurst & John Carter, *Prohibitions on Assignment: A Choice to Be Made*, 73 C.L.J. 405 (2014); Peter Turner, *Charges of Unassignable Rights*, 20 J. CONT. L. 97 (2004).

<sup>33</sup> This would only occur if, despite the clause, a valid trust of the receivable existed.

<sup>34</sup> If, despite the clause, there is a valid declaration of trust, this will break the mutuality required for set-off. If the clause renders a trust invalid to the extent that it affects the customer, then the notification of the trust could be said to be ineffective for all purposes, including preventing set-offs. See J. Marshall, *Declaring a Trust Over Rights Under an "Unassignable" Contract*, 12 INSOLVENCY INTELLIGENCE 1 (1999).

<sup>35</sup> Linden Gardens, [1994] 1 A.C. 85; Don King Prods. Inc. v. Warren, *supra* note 23; Barbados Trust, [2007] EWCA (Civ) EWHC (TCC) 530. The one exception is Stopjoin, [2014] EWHC (TCC) 589.

precise wording of the anti-assignment clause and the purported assignment or declaration of trust.<sup>36</sup> Third, even if a financier is protected by the rule that the proceeds are held on trust, this will not help if the supplier has not kept the proceeds in an identifiable state so that they can be traced on its insolvency. A financier might be better off with a proprietary right to a debt owed by a solvent customer, than to proceeds that may or may not be held by an insolvent supplier.

It should be pointed out that the fact that there is a reasonable degree of protection in the current law does not necessarily rule out statutory intervention. For example, Uniform Commercial Code (U.C.C.) (1952) article 9-318(4),<sup>37</sup> which contained an override of anti-assignment clauses, was included in the original U.C.C. (1952) to reflect existing U.S. law rather than to change it.<sup>38</sup> However, this was in the context of a codification of commercial law and the introduction of a new system for secured financing. To make a case for free-standing legislation, a policy imperative is essential.

### III. INDUSTRY WORKAROUNDS

Until recently, there were two main types of receivables financing: factoring, which is on a notification basis, and invoice discounting, which is non-notification.<sup>39</sup> Factoring tends to be used for smaller suppliers, where a financier has concerns about the ability of the supplier to run its ledger properly and to operate a trust account, and also where the financier has concerns about the supplier's financial position.<sup>40</sup> Since factoring involves a statutory assignment, it gives the financier much more control over the collection of the debts.

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<sup>36</sup> *Id.*

<sup>37</sup> Now revised U.C.C. § 9-406(d) (2010).

<sup>38</sup> This is made clear by the official comment to the original U.C.C. Article 9, which states: “[the provision] can be regarded as a revolutionary departure only by those who still cherish the hope that we may yet return to the view entertained some two hundred years ago by the Court of the King’s Bench.” However, this is an overstatement. There were contrary cases that were overruled by the legislation, such as *Allhusen v. Caristo Construction Corp.*, 103 N.E.2d 891 (N.Y. 1952).

<sup>39</sup> Much of the information in this section comes from the 2011 Study, updated to take into account recent developments.

<sup>40</sup> Sometimes a financier will shift a client from an invoice discounting basis to a factoring basis if the client gets into financial difficulties.

Factoring is more expensive for the supplier than invoice discounting, and a supplier can pay even more for extra services, such as the taking on by the financier of the credit risk of the customer.<sup>41</sup> In invoice discounting, the collection of the receivables is carried out by the supplier, who holds the proceeds in a trust account for the financier.

Recently, two variations on these structures have become more popular, although the details vary in each case. One is discounting of individual invoices over an online platform: this takes place on a non-notification basis, with the platform merely acting as an intermediary. Another is supply chain financing whereby a customer arranges with a financier that the latter purchases receivables owed by the customer to its suppliers at the point when the receivables arise, once the invoice has been confirmed by the customer. This has the advantage that there is less likely to be disputes about the invoice, and also that it allows the financing to be based on the credit rating of the customer rather than that of the (smaller) supplier.<sup>42</sup> Having said this, this kind of financing is usually only offered to established suppliers whose invoices reach a certain, reasonably high, level and is also only offered by large customers.<sup>43</sup> There is also a concern that supply chain financing encourages large customers to extend the credit period they require, forcing small businesses to pay for a longer period of financing, albeit at a lower rate.<sup>44</sup>

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<sup>41</sup> Most receivables financing is on a recourse basis whereby the supplier either guarantees payment of the receivables or agrees to repurchase unpaid receivables.

<sup>42</sup> The U.K. Government launched a scheme in 2012 to encourage businesses and government agencies to offer supply chain financing. See Prime Minister's Office, *Prime Minister Announces Supply Chain Finance Scheme*, GOV.UK (Oct. 23, 2012), <https://www.gov.uk/government/news/prime-minister-announces-supply-chain-finance-scheme>.

<sup>43</sup> 2011 Study, *supra* note 2.

<sup>44</sup> See John Antunes, *The Supply Chain Finance Scheme: Hit or Miss?*, REALBUSINESS (Nov. 8, 2012), <http://realbusiness.co.uk/article/15791-the-supply-chain-finance-scheme-hit-or-miss>; James Hurley, *Payment Concerns Over Supply-Chain Finance Move*, TEL. (Oct. 26, 2012 7:00 AM), <http://www.telegraph.co.uk/finance/yourbusiness/9634184/Payment-concerns-over-supply-chain-finance-move.html>; *Supply Chain Finance Scheme: A Good Idea?* SELECT FACTORING (2012), <http://www.selectfactoring.co.uk/supply-chain-finance-scheme>.

Although some of the workarounds discussed below are adopted regardless of whether particular receivables arise from contracts containing an anti-assignment clause, English financiers very frequently check for the presence of anti-assignment clauses (and for other problematic clauses) in the invoices they finance.<sup>45</sup> Thus, one of the major arguments for a statutory override made in other jurisdictions (that it is not feasible for a receivables financier to discover anti-assignment clauses, causing the whole cost of financing to rise)<sup>46</sup> is not really made out in England and Wales. However, checking contracts is burdensome and takes time, particularly if it is necessary to consult lawyers about the effect of a particular clause.<sup>47</sup> The need to do so clearly increases costs, although it is probably the case that some checking would still take place even if there were to be a statutory override of anti-assignment clauses. It is also the case that most supply contracts are on a customer's standard terms, and financiers get to know the terms of large customers and whether they contain an anti-assignment clause, so checking involves merely looking at who the customers are rather than reading individual contracts.

If the financing is on a non-notification basis, the presence of an anti-assignment clause does not create problems for the financier on a day-to-day basis, since the customer does not know of the assignment and continues to pay the supplier.<sup>48</sup> Of course, the supplier would be in breach of contract: this may be of concern if, for example, the breach entitled the customer to terminate the supply agreement.<sup>49</sup>

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<sup>45</sup> Those interviewed for the 2011 Study all said that they checked for the presence of anti-assignment clauses. The picture was more mixed in relation to the 2014 Study, although most said that they checked at least in many cases.

<sup>46</sup> *Personal Property Securities Act 2009* (Austl.); ANTHONY DUGGAN & DAVID BROWN, *supra* note 7.

<sup>47</sup> 2011 Study, *supra* note 2.

<sup>48</sup> In the 2011 Study we were told that anti-assignment clauses created great problems for online auctions. However, the 2014 Study revealed that since then this part of the industry has developed workarounds similar to those in regular invoice discounting, and so what is said in relation to that also applies to online auctions.

<sup>49</sup> Although such a breach is unlikely to be repudiatory, it could fall within a clause entitling the customer to terminate for "any material breach" (which is quite common) or could trigger a cross-default clause. The absence of a general duty of good faith in English law could mean that a customer could rely on such a termination clause even if its real motivation for termination was something entirely

The financier might worry about two situations: (1) if the supplier becomes insolvent, and (2) if the customer does not pay and the supplier refuses to enforce.<sup>50</sup>

In relation to the first situation, financiers almost universally protect themselves by taking a security interest over all assets of the supplier.<sup>51</sup> This has the effect, under English law, of enabling the financier to appoint an administrator of the supplier should it become insolvent.<sup>52</sup> The financier is then in a good position to direct the administrator to collect the receivables and pass the proceeds to it. There seems to be little concern among financiers about the collecting in of debts if an administrator is appointed (even if not appointed by that particular financier), although the costs are sometimes a problem if the supplier is a very small business.<sup>53</sup> Financiers also see an “all assets” security interest as having an additional benefit, namely that it will cover receivables that are not assigned to the financier because of an anti-assignment clause. Sometimes, financiers specify that such “non-vesting debts” fall within a fixed charge, while much of the all assets security interest will be a floating charge. However, depending on the wording of the clause, to the extent that it prevents a valid assignment, an anti-assignment clause may also prevent the creation of a valid security interest.<sup>54</sup>

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different. In theory, a breach could entitle a customer to obtain an injunction to prevent further breaches (although this is unlikely) or to sue for damages. However, it is usually hard to see what loss is suffered.

<sup>50</sup> The 2014 Study indicated that the latter concern is at least as important, and, for invoice discounters, more important than the 2011 Study, although the sample for this particular question was small.

<sup>51</sup> 2011 and 2014 Study, *supra* note 2.

<sup>52</sup> The Insolvency Act 1986 provides that a qualifying floating charge holder can appoint an administrator out of court. The Insolvency Act 1986, c. 45, sch. B-1, ¶ 14 (U.K.).

<sup>53</sup> Seminar to explore and discuss the merits of an online register for all security interests, including outright assignments of receivables, Secured Transactions Law Reform Project, May 8, 2014; 2014 Study, *supra* note 2.

<sup>54</sup> Although a charge is not, in theory, an assignment, many charges are drafted as equitable mortgages, which involve an equitable assignment of the receivables. A fixed charge has been treated as an assignment in a number of cases. *See Biggerstaff v. Rowatt's Wharf Ltd.*, [1896] 2 EWCH 93 C.A. (U.K.); *N W Robbie & Co. v. Witney Warehouse Co.*, [1963] 1 W.L.R. 1324 (C.A.) (U.K.); *Foamcrete (UK) Ltd. v. Thrust Engineering Ltd.*, [2000] EWCA (Civ) 351. *See also Re Turner*

Another mode of protection often coupled with the all assets' security interest is for financiers to take a personal guarantee from the directors of the supplier company.<sup>55</sup> Of course, the effectiveness of such guarantee depends on the credit-worthiness of the directors, and also may entail costs in enforcing the claims under the guarantees, to which there could be arguable defenses.

Yet another possibility is for the financier to take a power of attorney enabling it to sue the customer in the name of the supplier.<sup>56</sup> This protection tends to be more useful in the second situation: when the supplier is solvent but refuses to sue. For the power of attorney to be irrevocable on the insolvency of the supplier, the financier must have some sort of proprietary right in the receivables or must be owed the receivables directly.<sup>57</sup> Where there is an anti-assignment clause, the latter is clearly not the case, and it is unclear whether a right under a trust is a sufficient proprietary interest to render the power irrevocable. The legal position is uncertain and untested.<sup>58</sup>

An anti-assignment clause causes much greater problems for financiers who operate on a notification basis. Here, there is a likelihood that the customer will refuse to pay the financier when notified, and will, instead, pay the supplier. The financier is then at risk of the proceeds being dissipated by the supplier, leaving the financier at the credit risk of the supplier. As a result, such financiers often refuse to finance receivables arising from contracts containing such clauses, or demand that the customer agrees to a waiver.<sup>59</sup> The evidence from the 2014 study is that financiers only sometimes pursue a waiver. There was considerable agreement<sup>60</sup> that the time and effort

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*Corp. Ltd. (In Liq)*, [1995] 17 ACSR 761 (Austl.) (where the Federal Court of Australia took the view that a clause prohibiting assignment also prohibited a charge).

<sup>55</sup> 2011 and 2014 Study, *supra* note 2.

<sup>56</sup> 2014 Study, *supra* note 2.

<sup>57</sup> Powers of Attorney Act, 1971, c. 27, § 4 (Eng.).

<sup>58</sup> See M. BRIDGE, L. GULLIFER, G. MCMEEL & S. WORTHINGTON, *THE LAW OF PERSONAL PROPERTY* 29-43 (2013).

<sup>59</sup> 2011 Study, *supra* note 2. It should be pointed out that invoice discounters also sometimes refuse to finance receivables if they contain an anti-assignment clause, will only finance them on a factoring basis, or will demand a waiver. This is particularly true if, for some reason, a security interest over the supplier's assets is not taken.

<sup>60</sup> Twelve out of the eighteen respondents agreed.

involved in obtaining a waiver was substantial or significant, and that by no means all customers were willing to agree to a waiver. Some customers would only agree to a waiver on terms that were disadvantageous to the supplier: this depended on the bargaining power between them and also on whether the financing was being sought at the beginning of the supplier/customer relationship.

In one sense, the increasing availability of supply chain financing is a workaround. This is customer driven: the customer waives the anti-assignment clause to enable supply chain financing with its nominated financier, but relies on the clause to prevent the supplier obtaining financing elsewhere. This means that the supplier is locked into the supply chain financing deal, which could be seen as anti-competitive. The discount rate for such financing is usually reasonably low since it is based on the credit rating of the (large) customer, but the period for which financing is required may be increased.<sup>61</sup> Nevertheless, supply chain financing does achieve protection for the customer; only invoices approved by the customer are financed, which reduces disputes, and the customer does not have to deal with a financier with whom it has no relationship.

It can be seen that the receivables industry has developed a number of workarounds which mean that, with the exception of the situation where factors cannot or do not try to obtain a waiver, receivables containing anti-assignment clauses are actually being financed. The workarounds, however, are costly in terms of time and effort, and also create more uncertainty, which can lead to costly disputes. In fact, one concern of the industry is that the existence of an enforceable anti-assignment clause may give a customer traction in disputes which it would not otherwise have, or will enable the customer to negotiate benefits for itself which would otherwise not exist. Although it is hard to prove, it seems likely that the existence of enforceable anti-assignment clauses will increase the cost of financing.<sup>62</sup>

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<sup>61</sup> See above, [text to notes 43 – 45].

<sup>62</sup> In the 2014 Study, eleven out of eighteen answered “always” or “sometimes” to the question: “Do you consider that (a) receivables are purchased at a greater discount to face value, or (b) the advance rate applied to the purchase of receivables will be reduced, as a result of the possibility that the contract governing

## IV. INEQUALITY OF BARGAINING POWER

At this point it is necessary to consider the reasons why a customer might want to include an anti-assignment clause in a supply contract. The reasons usually given in the literature are that the customer wishes to avoid paying the wrong party, that the customer wishes to make sure that set-offs can continue to arise between it and the supplier, and that the customer wishes to continue to deal with the supplier rather than the financier, who is an unknown quantity.<sup>63</sup> The information gathered from the two surveys (which came from all three constituencies: customers, suppliers, and financiers) shows that the motivations are more mixed. There appeared to be little concern about paying the wrong party per se,<sup>64</sup> but there did appear to be genuine concern about incorrect invoicing and the sorting out of disputes.<sup>65</sup> It was thought that financiers would be more concerned that the invoice was paid, and would wish disputes to be sorted out afterwards between the customer and the supplier. The problem of incorrect invoicing was being tackled both by self-invoicing and electronic invoice platforms.<sup>66</sup> However, the desire to retain the relationship with the supplier in order to sort out disputes is ongoing.<sup>67</sup> Not surprisingly, opinions varied as

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the receivable may contain a valid prohibition on assignment than would apply if such prohibitions on assignment were not binding as against an assignee?" However, only a small minority answered "yes" to the question: "Do you consider that the cost of finance is increased as a result of the inclusion of a prohibition on assignment within funded ledgers?" This discrepancy may be explained by the latter question being interpreted as relating only to where receivables with anti-assignment clauses were actually included in the funded ledger, which is seldom the case in factoring arrangements.

<sup>63</sup> See, e.g., Orkun Akseli, Contractual Prohibitions on Assignment of Receivables: an English and UN perspective, 7 J. BUS. L. 650, 656 (2009); LOUISE GULLIFER & JENNIFER PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY 378–79 (2011); Roy Goode, *Contractual Prohibitions against Assignment*, LLOYD'S MAR. & COM. L.Q. 300, 302 (2009).

<sup>64</sup> This was only mentioned by the financiers in the 2011 Study, but by no one else.

<sup>65</sup> Especially evidence from customers. 2011 Study, *supra* note 2.

<sup>66</sup> See, e.g., TUNGSTEN, <http://www.tungsten-network.com/uk/en/expertise/e-invoicing/> (last visited Jan. 22, 2015).

<sup>67</sup> This desire was mentioned by a number of respondents to the 2014 Study.



to how helpful the financiers were in sorting out disputes and how aggressively they sought payment.

Perhaps surprisingly, the issue of set-off did not seem to be of great importance to the parties.<sup>68</sup> This may reflect the fact that transaction set-off, that is, set-off of cross-claims arising out of the same contract or closely related to the claim, is not affected by assignment of the receivable. The desire to lock the supplier into a supply chain finance agreement was mentioned by one respondent to the 2014 Study and one respondent to the 2011 Study mentioned one customer who wanted total confidentiality and did not want its identity revealed to a financier. However, there seemed to be considerable consensus that, in many cases, customers did not include anti-assignment clauses to prevent receivables financing, but rather to prevent “assignment” (or sub-contracting) of suppliers’ obligations under the contract. Of course, under English law an obligation cannot be assigned, and so such a clause would be unnecessary, but it might be included out of ignorance or in order to make the sub-contracting of obligations a repudiatory breach, which would entitle the customer to terminate the relationship. In any event, many financiers felt that the clauses, in the form in which they precluded receivables financing, were included without a great deal of thought: out of habit or fear of the unknown or out of an over-abundance of caution by lawyers who drafted the boilerplate contract.<sup>69</sup>

It is certainly the case that anti-assignment clauses are generally found in standard form contracts used by large companies for their small and medium-sized suppliers.<sup>70</sup> The suppliers cannot negotiate the terms of the contracts and, as previously discussed, may find it difficult to obtain a waiver. Where the balance of bargaining power is reversed so that the supplier is a large company and the customer is a small company or consumer, the latter are not able to bargain for the protection of an anti-assignment clause. Control of anti-assignment clauses therefore raises the broader question of protection of small

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<sup>68</sup> This was the view of the customers in the 2011 Study, though one supplier thought that it was critical.

<sup>69</sup> 2014 Study, *supra* note 2.

<sup>70</sup> All respondents to the 2014 Study selected either large companies or government agencies (or both) as likely to include anti-assignment clauses in their contracts, although four also selected small companies.

businesses against potentially unfair terms. Under English law, unreasonable exclusion and limitation clauses in standard form contracts are unenforceable against businesses of all sizes<sup>71</sup> and penalty clauses are sometimes unenforceable,<sup>72</sup> but otherwise any control of unfair terms relates to consumer contracts. The Law Commission suggested in 2005<sup>73</sup> that some control should be extended to contracts with micro businesses,<sup>74</sup> but this suggestion has not been implemented. Some of the suppliers who responded to the 2011 Study suggested that there was a problem with unfair terms in supply contracts<sup>75</sup> which was wider than just with anti-assignment clauses, and that either legislation or wider codes of practice<sup>76</sup> were needed.

If it is right that inequality of bargaining power enables large customers to impose potentially unfair terms on small suppliers, then statutory control of anti-assignment clauses could have the effect that, deprived of this protection, the customers just imposed more swingeing terms in other areas.<sup>77</sup>

#### V. THE ROLE OF ANTI-ASSIGNMENT CLAUSES IN FINANCIAL TRANSACTIONS

In many financial transactions, there are specific reasons for the inclusion of anti-assignment clauses that are important for the proper functioning of the market. In some cases, the clause does not ban assignment, but permits it to certain entities and requires consent

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<sup>71</sup> Unfair Contract Terms Act 1977, c. 50, §§ 3, 6(3), 7(3) (U.K.).

<sup>72</sup> GUENTER H. TREITEL, *THE LAW OF CONTRACT* 20-129 to 20-145 (Edwin Peel ed., 14th ed. 2015).

<sup>73</sup> THE LAW COMMISSION AND THE SCOTTISH LAW COMMISSION, *UNFAIR TERMS IN CONTRACTS*, 292 (2005).

<sup>74</sup> Micro businesses are defined as businesses with nine or fewer employees.

<sup>75</sup> One example is a term making large sums payable on termination of the contract by the supplier.

<sup>76</sup> *See, e.g.*, GROCERIES CODE ADJUCIATOR, GROCERIES SUPPLY CODE OF PRACTICE, 2009 (U.K.), *available at* <https://www.gov.uk/government/publications/groceries-supply-code-of-practice>.

<sup>77</sup> For example, a term that an invoice for goods or services is not payable until the invoice has been approved by the customer. This possibility was discussed with the respondents to the 2011 Study, but is, of course, speculation because there can be no hard evidence.

for assignment to others. Thus, for example, in syndicated loan agreements, it is very common for the relevant clause to permit assignment to certain financial institutions, but require consent for assignment to others. This stems from a concern that were the loan to be assigned to, for example, a hedge fund specializing in distressed debt, it would be enforced in a much more aggressive way than it would be by a bank.<sup>78</sup> It also stems from a concern that a loan might be sold to one of the competitors of the borrower.<sup>79</sup> In derivatives contracts, which depend on close-out netting to protect against credit risk and for enforcement, it is critical that mutuality of parties is maintained and so restrictions on assignment are very important.

The existence of these reasons for anti-assignment (or restrictions on assignment) clauses to be enforceable means that any statutory override of anti-assignment clauses has to be limited in scope to the context in which such clauses cause most problems, namely, receivables financing. This, of course, raises definitional issues: for example, how do you exclude contracts for financial products without also excluding contracts for the provision of services relating to finance (such as computing services and financial advice)? The difficulties that such definitional issues pose, and the concern about the effects on the financial industry for getting the limitation of scope wrong, have led to considerable opposition to the statutory control of anti-assignment clauses from lawyers operating in the City of London and bankers.

## VI. SHOULD THERE BE A STATUTORY OVERRIDE?

As I have indicated, the debate in England and Wales has moved from a clash of policies to a discussion based on pragmatism and cost-benefit analysis. In most situations, the presence of anti-assignment clauses does not prevent suppliers from financing their receivables. This is because the law has developed in such a way that a financier will generally have an equitable interest in, at least, the proceeds of the receivables and probably in the receivables themselves.

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<sup>78</sup> The market has therefore developed ways of transferring the risk and benefit of the loan without actually assigning it, such as loan participation and, more commonly, credit default swaps.

<sup>79</sup> THE LAW COMMISSION NO. 296, COMPANY SECURITY INTERESTS, 2005, Cm. 6654, at126, (U.K).

Further, the industry has developed a number of workarounds, which means that the receivables will be collected for the ultimate benefit of the financier both where the customer does not pay and when the supplier is insolvent. None of this is surprising. In the absence of any statutory control of anti-assignment clauses it is to be expected that both the law and the industry will accommodate the interests of all parties to the extent that it can.

This, however, is not the end of the story. If the current position imposes costs on the industry, and thus on financing, which are not outweighed by the benefit of such clauses to the customers, then this would be a good reason for legislation. A further reason could be if certain suppliers were unable to obtain financing. Moreover, if it were felt that legislation could do little or no harm, but would have the beneficial effect of clarifying the existing law and making the balance of protection between all parties clear, this could also justify legislative change. All three of these arguments pertain in England and Wales today.

It is reasonably clear from both surveys<sup>80</sup> that some small suppliers, whom financiers will not finance on the basis of invoice discounting because of concerns about their ability to collect in the receivables and hold them on trust for the financier, are unable to have certain invoices financed because they contain anti-assignment clauses. The only way round this problem is for the customer to waive the clause, and this is only possible on some occasions. Often it will not be possible, either because the costs of waiving outweigh the benefits to both the supplier and the financier, or because the supplier has little bargaining power compared to the customer. The U.K. Government is very concerned about the funding of small businesses at the moment: they are seen as critical to economic recovery.<sup>81</sup> The effect on small businesses, then, is a good reason for a statutory override of anti-assignment clauses.

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<sup>80</sup> It should be born in mind that both surveys were fairly small-scale.

<sup>81</sup> *Small Business, Big Support Confirmed by Prime Minister*, GOV.UK (Jan. 27, 2014), <https://www.gov.uk/government/news/small-business-big-support-confirmed-by-prime-minister>.

It is also clear that the presence of such clauses leads to costs for the financing industry. While it should not be overemphasized,<sup>82</sup> there is the cost of discovering such clauses. Waivers can also be costly, as is the development and execution of the workarounds discussed above. Moreover, the existence of the workarounds themselves increases *ex ante* uncertainty, both in terms of the law<sup>83</sup> and also in that it increases the possibility of disputes. Finally, the law itself is complex and uncertain. A financier cannot be sure that it has a valid interest in a receivable containing an anti-assignment clause. It is clearer that it has an equitable interest in the proceeds, but this is not any good if the proceeds are not traceable.

Are these costs outweighed by the benefits of the clauses? It is clear that such clauses are of value in the context of financial contracts. However, some of the reasons why customers seem to include them in their contracts are of little or no merit,<sup>84</sup> and the results from the (small-scale) surveys suggest that some do not seem of concern in the real world.<sup>85</sup> The concern about preserving a relationship with the supplier in the event of dispute or incorrect invoices is a real one. Yet, the latter concern can be overcome with modern invoicing techniques, and the former argument is undermined by the fact that customers are prepared to permit assignment to a financier of their choice under a supply chain finance scheme. The argument that a financier might be more aggressive than a supplier in enforcing invoices is also flawed, since the risk of a third party influencing enforcement is an ever present one: the supplier could be taken over by more aggressive management. The customer's concern to remain in a relationship with the supplier may have more to do with the fact that the supplier is a small business compared to the customer, and therefore the customer is more likely to have the upper hand in negotiations than it would with

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<sup>82</sup> This is because financiers are familiar with the standard terms of the big customers, and also because they would read the contracts anyway for other adverse clauses.

<sup>83</sup> For example, whether a power of attorney will be enforceable on insolvency of the supplier, or whether an anti-assignment clause renders a charge void.

<sup>84</sup> The prevention of sub-contracting does not require an anti-assignment clause, and the "habit" or "fear of the unknown" reasons seem unmeritorious.

<sup>85</sup> There seems to be little concern about set-off, or about the danger of paying the wrong party.

a financier. The use of an anti-assignment clause to lock a supplier into supply chain financing also seems unmeritorious. If the supply chain financing was sufficiently attractive to the supplier, it would choose it over other sources of financing.

This brings us to the argument that a statutory override would do little harm, and could do some good in clarifying the law. One possible harm, however, is that the override is not sufficiently limited and might cause problems in the financial markets. This is a serious risk, but could be overcome by careful drafting, even if this were at the expense of not including some borderline cases within the override. Another possibility is that an override may lead to harsher terms being imposed by large customers on small suppliers in other areas. This again would be serious, but could be controlled by a code of practice.<sup>86</sup> It therefore seems that the benefit in clarifying the law would outweigh any possible detriment.

#### CONCLUSION

This paper has sought to elucidate the arguments both for and against a statutory override of anti-assignment clauses in English law. It is suggested that the arguments are not ones of principle, or even policy, but are more pragmatic. Since such clauses have not ever been the subject of statutory intervention, the common law has developed in such a way as to give all parties limited protection, and the industry has worked around the law to enable receivables financing to take place. However, on the basis of two recent surveys, the pragmatic arguments are assessed, and it appears that a statutory override would be beneficial.

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<sup>86</sup> See, e.g., GROCERIES CODE ADJUCIATOR, GROCERIES SUPPLY CODE OF PRACTICE, 2009 (U.K.), available at <https://www.gov.uk/government/publications/groceries-supply-code-of-practice>.

**AZIZ CASE AND UNFAIR CONTRACT  
TERMS IN MORTGAGE LOAN  
AGREEMENTS: LESSONS TO BE  
LEARNED IN SPAIN\***

*Immaculada Barral-Viñals\*\**

INTRODUCTION

This paper provides an overview of the judgments given by the European Court of Justice (ECJ) concerning unfair contract terms (UCTs) in mortgage loan agreements. My analysis of recent ECJ decisions will focus on three aspects. First, focusing on the consumer-friendly interpretation of the UCT Directive,<sup>1</sup> which has led to the development of substantive criteria for ascertaining unfairness, most notably in *Aziz v. CatalunyaCaixa*.<sup>2</sup> Second, I will identify various points at which the Spanish transposition of the UCT Directive needs to be revised. Third, I will focus on the possibility of controlling UCTs in mortgage foreclosure proceedings.

This article's approach will be based on a comparison of developments in ECJ decisions and recent decisions by Spain's Supreme Court, the Tribunal Supremo (T.S.). This comparison indicates that the T.S. has adopted an interpretation rule for mortgage loan agreements that is far from consumer-friendly. This finding is

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\*\* University of Barcelona; [ibarral@ub.edu](mailto:ibarral@ub.edu).

<sup>1</sup> Council Directive 93/13, 1993 O.J. (L 95) (EC).

<sup>2</sup> Case C-415/11, *Mohamed Aziz v. CatalunyaCaixa*, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013).

supported by decisions made by the T.S. on May 9, 2013,<sup>3</sup> a month and a half after the ECJ decision in *Aziz*, and September 8, 2014.<sup>4</sup>

The “social engineering” that emerges from ECJ decisions is a clear indication of the situation in Spain today, where judges seek preliminary rulings concerning the scope and interpretation of the UCT Directive to develop principles for a more consumer-friendly interpretation of mortgage foreclosure proceedings.<sup>5</sup> The lower courts in Spain are taking the lead to further develop these principles to protect consumers in real estate transactions, because the Spanish legislature and the T.S. seem reluctant to do so in what has become a major concern of Spain’s social policy.<sup>6</sup> For instance, the most far-reaching legislation requires renegotiation of mortgage terms only when “low-income borrowers” are involved.<sup>7</sup> “Low income borrowers” is a category that varies in the different statutes but which is highly limited in scope to include only those with very low or none incomes, and a high average of the rent used in paying the loan (more than 60%).<sup>8</sup> The ultimate option in this case for this category of consumers is the *datio pro soluto*, i.e., providing the same effects as non-recourse loans available in the United States, which affects an even smaller group of borrowers. Besides carving out an exception for this small, unique group of consumers, legislation reforms have focused chiefly on what constitutes unfair contract terms.

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<sup>3</sup> S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain).

<sup>4</sup> S.T.S., Sept. 8, 2014 (R. J., No. 3903/2014) (Spain).

<sup>5</sup> See JOSÉ MARÍA FERNÁNDEZ SEIJO, *LA DEFENSA DE LOS CONSUMIDORES EN LAS EJECUCIONES HIPOTECARIAS* (2013).

<sup>6</sup> Hans-W. Micklitz, *Unfair Contract Terms—Public Interest Litigation before European Courts—Case C-415/11 Mohamed Aziz*, in *LANDMARK CASES OF EU CONSUMER LAW: IN HONOUR OF JULES STUYCK 615* (Evelyne Terryn, Gert Straetmans & Veerle Colaert eds., 2013).

<sup>7</sup> See Urgent Measures to Protect Low Income Mortgage Debtors (B.O.E. 2012, 60) (Spain); Urgent Measures to Strengthen Protection Measures to Mortgage Debtors (B.O.E. 2012, 276) (Spain); Rights of Persons with Disabilities and their Social Inclusion (B.O.E. 2013, 289) (Spain) [hereinafter Rights of Persons with Disabilities].

<sup>8</sup> *Id.*



This article seeks to ascertain the consequences of ECJ Aziz case on UCTs.<sup>9</sup> My main goal is to examine the way in which the ECJ's interpretation of UCTs has given rise to the construction of a substantive concept of unfairness by analysing standard contract terms (SCTs) included in almost all mortgage loans granted in Spain. Further, this paper will focus on the way in which these non-binding clauses can result in a stay of foreclosure proceedings and can also reduce the mortgager's debt. Indeed, UCTs in Spain today constitute an indirect remedy against foreclosure, which can dramatically impact medium to low income families.

#### I. UNFAIR CONTRACT TERMS: WHY THEY SEEM TO BE A USEFUL TOOL IN MORTGAGE LOAN AGREEMENTS

SCTs often used in mortgage loan agreements are considered a means of unilaterally fixing contract clauses. As such, SCTs significantly limit freedom of contract, a notion embodied in the term "free will" in Article 1255 C.C.<sup>10</sup> The seller or supplier of mortgage loans fixes SCTs in advance, and the borrower must accept or reject them on a "take it or leave it" basis. Since SCTs are not individually negotiated, they are subject to both an incorporation and a fairness test when the adherent—the non-professional party—is legally considered a consumer.<sup>11</sup> In Spain, SCTs are governed by two different regulations, depending on whether the adherent is a consumer or not: the Standard Contract Terms Act of 1998 (*Ley de Condiciones Generales de la Contratación (LCGC)*),<sup>12</sup> which governs SCTs in any all kinds of contract, and the General Law for the Protection of Consumers (consolidated by Royal Legislative Decree 1/2007, *Que Aprueba el Texto Refundido de la Ley General para la Defensa de Consumidores y Usuarios y Otras Normas Complementarias*

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<sup>9</sup> I will not conduct an in-depth analysis of mortgage foreclosure proceedings, which is the main issue raised by *Aziz*.

<sup>10</sup> C.C., art. 1255 (2011) (Spain); Elena Lauroba Lacasa, *Rapport Introductif: Les Clauses Abusives*, in *LES CLAUSES ABUSIVES, SOCIETE DE LEGISLATION COMPAREE 9* (Yves Picod, Denis Mazeaud & Elena Lauroba eds., 2013).

<sup>11</sup> General Law for the Defense of Consumers and Users (B.O.E. 2007, 287) (Spain) [hereinafter *TRLGDCU*].

<sup>12</sup> General Conditions of Contract (B.O.E. 1998, 89) (Spain) [hereinafter *LCGC*].

(TRLGDCU)),<sup>13</sup> which only applies to business-to-consumer (B2C) contracts. For contracts that do not involve consumers, if the adherent has knowledge of existence of SCTs in the contract, the contract will be binding on both parties, even if the adherent has not yet read or understood the SCTs. As such, the law deals only with the external control of SCTs by employing the incorporation test, under which SCTs may be considered part of the binding contract if the adherent has had the possibility of knowing that the contract contains SCTs.<sup>14</sup> The incorporation test also applies when a contract containing SCTs involves a consumer. However, a fairness test is an additional internal control applied with respect to the content of the SCTs. This test determines whether there is a significant imbalance between parties' bargaining power so that and if an SCT is deemed unfair, it will not be binding on the consumer.<sup>15</sup>

The Spanish legal framework in relation to UCTs has not evolved due to the economic crisis of 2008, except in one aspect: Article 27 of Act 3/2014<sup>16</sup> referring to the non-revision of a UCT, which is explored further below. However, the ECJ's ruling in *Aziz* lead to the Act 1/2013 of 14 May,<sup>17</sup> on measures to strengthen the protection to mortgagors, debt restructuring and social rent that had

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<sup>13</sup> TRLGDCU (B.O.E. 2007, 287).

<sup>14</sup> However, the adherent's acceptance does not imply that he has actual knowledge of the material scope of each term. Whether the SCTs are incorporated as part of a binding contract depends on "accessibility" of the adherent to the SCTs. Thus, it is unreasonable to uphold that the adherent has consented to the content of the SCTs, since the existence of a possibility for the adherent to know the SCTs does not necessarily mean that the adherent has made an informed decision. *See* EUGENIO LLAMAS POMBO, *COMENTARIOS A LA LEY GENERAL DE DEFENSA DE CONSUMIDORES Y USUARIOS* 284 (2005).

<sup>15</sup> A further condition for enforcing SCTs is that they must be drafted in plain, intelligible language and have an interpretation *contra proferentem*, i.e., the supplier must assume the consequences of confusing wording. A lack of transparency is a ground for non-incorporation, since confusing clauses cannot form part of a contract. LCGC art. 5, 7 (B.O.E. 1998, 89). This idea is developed further in the T.S. judgment of 9 May 2013, S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain), which seeks to construe unfairness in terms of a lack of transparency.

<sup>16</sup> *See* Consumer Protection Act (B.O.E. 2014, 76) (Spain).

<sup>17</sup> Measures to Protect Mortgagees, Debt Restructuring and Social Rents (B.O.E. 2013, 116) (Spain) [hereinafter Measures to Protect Mortgagees, Debt Restructuring and Social Rents].

modified the Mortgage Act (Ley Hipotecaria –LH–)<sup>18</sup> and the Code of Civil Procedure (Ley de Enjuiciamiento Civil) with regard to the consequences for mortgage foreclosure proceedings when the mortgage loan agreement contains clauses or terms that are deemed unfair. Although various ECJ cases have redefined Spanish legislation on UCTs in mortgage agreements,<sup>19</sup> these cases are contrary to the May 9, 2013 decision issued by the T.S., which has generated considerable controversy. The practical impact of these ECJ judgments on SCTs is of great importance, since the majority of mortgage loan agreements in Spain contain SCTs.

The lower Spanish courts—*Audiencias provinciales*—have examined a number of frequently used SCTs in mortgage loan agreements that might be deemed unfair, including SCTs relating to: (1) the early maturity of the loan, (2) the default interest rate, (3) the unilateral determination of the amount owed, and (4) the so-called “floor clause” in variable interest loans. In *Aziz*, the ECJ ruled on the fairness of the first three types of SCTs. Preliminary rulings by the ECJ focused on two aspects: the criteria to be applied in examining the fairness of a clause and the effects of an unfair clause. Similarly, the T.S. has ruled on the “floor clause,” which is a problem only in Spain in the context of the UCT Directive concerning the scope of application of the fairness test to the main subject matter of the contract.

We start by examining this latter point as a *primum* for the analysis of the above-mentioned clauses.

## II. THE APPLICATION OF THE FAIRNESS TEST TO THE MAIN SUBJECT MATTER OF THE CONTRACT

An initial set of ECJ and T.S. decisions deal with the transposition of the UCT Directive by the Spanish legislature. Article

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<sup>18</sup> Mortgage Act) (B.O.E. 1946, 58) (Spain) [hereinafter Mortgage Act].

<sup>19</sup> Case C-484/08, Caja de Ahorros de Madrid v. Ausbanc, 2010 E.C.R. I-04785; Case C-618/10, Banco Español de Crédito v. Joaquín Calderón Camino, 2012 EUR-Lex CELEX LEXIS 4274 (June 14, 2012); Case C-415/11, Mohamed Aziz v. CatalunyaCaixa, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013); Case C-226/12, Constructora Principado v. José Ignacio Menéndez-Álvarez, 2014 EUR-Lex CELEX LEXIS 7 (Jan. 6, 2014).

4(2) of the UCT Directive states that the assessment of the unfairness of a contractual term should not include the “main subject matter of the contract nor to the adequacy of the price and remuneration . . . as against the services or goods supplied in exchange . . . .”<sup>20</sup> As such, the ECJ has been requested to give a preliminary ruling as to whether it is actually possible to assess the fairness of the subject matter of the contract and the adequacy of the price and remuneration in light of the value of the services or goods supplied in exchange, that is to say, the fairness of the contract price.

The question is whether the transposition of the UCT Directive by the Spanish legislature complies with Article 4(2) of the Directive, given that Spanish law has not expressly transposed this limit to the assessment of fairness. This question was answered by the ECJ in *Caja de Aborros de Madrid v. Ausbanc*.<sup>21</sup> The Court in *Ausbanc* held that a Spanish law providing for an assessment of the fairness of terms relating to the main subject matter of the contract was consistent with the UCT Directive.<sup>22</sup> The ECJ determined that Article 4(2) is not a binding provision. Member States may opt not to transpose Article 4(2) and, in so doing, may afford a higher level of protection than that established by the Directive.<sup>23</sup> This option satisfies the requirement in the UCT Directive of “minimum harmonisation” of national

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<sup>20</sup> Council Directive 93/13, *supra* note 1, art. 4(2).

<sup>21</sup> See *Ausbanc*, 2010 E.C.R. I-04785.

<sup>22</sup> In *Ausbanc*, the T.S. requested the ECJ make a preliminary ruling regarding the unfairness of a SCT that allowed the bank to round up the interest rate in a variable mortgage agreement to the next quarter of a percentage point. See *id.*

<sup>23</sup> It follows from the wording of Article 4(2) of the UCT Directive that “[Article 4(2)] . . . cannot be regarded as laying down the scope *ratione materiae* of the Directive.” *Id.* at I-4837. Article 4(2) cannot be inferred as constituting “a mandatory and binding provision and that, as such, its transposition by Member States was obligatory. On the contrary, the Court merely held that, in order to safeguard in practice the objectives of consumer protection pursued by the Directive, any transposition of Article 4(2) had to be complete, with the result that the prohibition of the assessment of the unfairness of the terms relates solely to those which are drafted in plain, intelligible language.” *Id.* at I-4838. Further, the Court in *Ausbanc* stated that “it must be held that, in authorising the possibility of a full judicial review as to the unfairness of terms such as those referred to in Article 4(2) of the Directive, provided for in a contract concluded between a seller or supplier and a consumer, the Spanish legislation at issue in the main proceedings makes it possible for consumers to be afforded, in accordance with Article 8 of the Directive, a higher level of protection than that established by that directive” *Id.* at I-4838.

legislation.<sup>24</sup> A number of decisions by the T.S. adhere to this interpretation of the UCT Directive, as I will explain. Notably, prior to *Ausbanc*, the T.S. had already ruled in a manner consistent with the ECJ's holding. For example, in T.S. judgement of 1 July, 2010,<sup>25</sup> which concerned clauses defining risks in insurance contracts, the T.S. ruled that courts should assess the fairness of clauses related to the main subject matter of such contracts because it determines the price of the insurance.

Yet, more noteworthy is the judgment against this interpretation, since it deals with mortgage contracts, bearing in mind that only a clause unrelated to the subject matter of the contract or the adequacy of the price can be submitted to the unfairness test. Thus, the question is that the T.S. resolution of 18 June, 2012, which is concerned with remunerative interest rate, states that Spanish legislation on UCTs prohibits the assessment of the fairness of contract clauses that are related to price.<sup>26</sup> It appears that the remunerative interest rate, which is the main tool for calculating the contract price, is outside the scope of the unfairness test.

Control of the remunerative interest rate clearly entails an analysis of the adequacy of the contract price, since the assessment of the nominal interest rate applied is the “price” of the loan. No assessment of fairness, however, is undertaken in fixing this rate. Instead, fairness is assessed as to the price agreed to by the parties. This conceptual separation of Article 4(2) of the UCT Directive of the control of the price as the main subject matter of the contract, and the adequacy of the price and the remuneration, on the one hand, as against the services or goods supplied in return, on the other, was highlighted by the ECJ in *Constructora Principado v. Álvarez*.<sup>27</sup> The nature of unfairness does not require an economic imbalance in the contract, which the Court understands as not being relevant. Instead, unfairness refers to the *legal* imbalance created by those contract clauses that

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<sup>24</sup> *Id.* at I-4836.

<sup>25</sup> S.T.S. Jul. 1, 2010 (R.J., No. 6031/2010) (Spain).

<sup>26</sup> S.T.S. June 18, 2012 (R.J., No. 5966/2012) (Spain).

<sup>27</sup> In *Constructora Principado* (like *Ausbanco*, a preliminary request from a Spanish judge), the ECJ was asked to determine whether obliging consumers to pay for expenses that by law need to be borne by the sellers is unfair. *See* Case C-226/12, *Constructora Principado*, 2014 EUR-Lex CELEX LEXIS 7, ¶ 44 (Jan. 6, 2014).

impose on the consumer certain charges for which he is not liable under the applicable law. In other words, it is unfair to create a legal imbalance, irrespective of the economic impact on the parties.<sup>28</sup>

Spanish scholars<sup>29</sup> have reached a consensus that UCTs are not the appropriate tool for determining the adequacy of the contract price and remuneration as against the services or goods supplied in return. Spanish law calls for complete freedom of parties to determine contract prices, and therefore, there are no remedies<sup>30</sup> for seeking a fair price.<sup>31</sup> Thus, the control assessment of fairness is not about the adequacy of the price, which is separate from the possibility of assessing unfairness, but about the way some clauses help to determine the total price that consumers have to pay for the loan. This is precisely why many SCTs in mortgage loans might be considered unfair.<sup>32</sup>

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<sup>28</sup> See IMMACULADA BARRAL VIÑALS, CENTRO DE ESTUDIOS DE CONSUMO, ABUSIVAS POR DESEQUILIBRIO IMPORTANTE, PERO NO IMPORTA LA CANTIDAD (2014) (detailing a discussion on legal imbalance not being an economic imbalance in the ECJ decisions).

<sup>29</sup> See SERGIO CÁMARA LAPUENTE, EL CONTROL SOBRE LAS CLÁUSULAS “ABUSIVAS” SOBRE ELEMENTOS ESENCIALES DEL CONTRATO 71 (Thompson-Aranzadi ed., 2006) (discussing the tension between unlimited freedom to negotiate the contract price and social justice).

<sup>30</sup> An exception to the general rule that no remedies exist for seeking a fair contract price is the *laesio ultra dimidium* in Catalonia for immovable property under certain circumstances. This exception, however, is beyond the scope of this paper.

<sup>31</sup> See IGNASI FERNÁNDEZ DE SENESPLEDA, PABLO IZQUIERDO WHITE, ADELA RODRIGUEZ SERRA & GUILLEM SOLER SOLÉ, CLÁUSULAS ABUSIVAS EN LA CONTRATACIÓN BANCARIA 86 (2014) (calling for the impossibility of controlling the price by the fairness test). Nevertheless, the argumentation cited deals precisely with the idea of adequacy between the price and the services and goods supplied. See also LAPUENTE, *supra* note 29, at 71 (discussing the liberal doctrine of freedom of pricing and the social justice of the contract). However, we understand that the thesis of social intervention of the contract exceeds the issue of unfair terms and seeks, not to determine whether there is an imbalance in a specific contract, but rather to restore a prior balance when starting from the premise that both parties have very different powers of negotiation.

<sup>32</sup> Article 32 of the Directive on Consumer Rights inserts Article 8 to the UCT Directive, stating that when a Member State adopts provisions in accordance with Article 8, it must inform the Commission, especially if those provisions “extend the unfairness assessment to . . . the adequacy of the price or remuneration.” Council Directive 2011/83, on Consumer Rights, 2011 O.J. (L 304) 64 (EU), amending Council Directive 93/13, *supra* note 1, and Council Directive 1999/44, 1999 O.J. (L

In terms of remunerative rates of interest, it should be stressed that control of the amount, if any, is concerned directly with assessing the adequacy of the service provided against the remuneration. In short, the control of the amount impacts pricing freedom. Article 1 of the Repression of Usury Act of 23 of July 1908 governs the determination of whether the remunerative rate of interest is excessive or not.<sup>33</sup> The Usury Act is useful for controlling the adequacy of the loan price because it mandates that the lending of money cannot be considered binding where there is an “interest notoriously higher than the normal price of money or clearly out of proportion in the circumstances of the case, or leonine. . .”<sup>34</sup> However, when the lending is excessive or leonine, the loan is void in its entirety. Thus, the requirements of the Usury Act differ from the unfairness test, under which only the unfair clauses would be non-binding. In short, there is a specific tool in Spanish law for analysing when the price of the loan is excessive, namely, the adequacy of the price, which lies outside the scope of laws that address UCTs.

An important case that addresses the issue of price control is the Judgement of 9 May 2013,<sup>35</sup> a T.S. decision which was published shortly after the ECJ decided *Aziz*. The T.S. held that, although the rate of default interest constitutes part of the main subject matter of the contract, it can only be deemed unfair if the clause lacks transparency. These issues are discussed below in section IV, sub-

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171) 12 (EC), and repealing Council Directive 85/577, 1985 O.J. (L 372) 31 (EC) and Council Directive 97/7, 1997 O.J. (L 144) 19 (EC). The Directive on Consumer Rights was transposed by the Spanish legislature in the Consumer Protection Act, (B.O.E. 2014, 76) (Spain), amending TRLGDCU. Importantly, note that Article 8 does not deal directly with the price as the main subject matter of the contract, but rather with the adequacy of the price or remuneration.

<sup>33</sup> Represión de la Usura (Usury Repression Act) (B.O.E. 1908, 206) (Spain) [hereinafter Usury Repression Act].

<sup>34</sup> Nevertheless, the main idea of the Usury Repression Act is to provide a subjective approach by taking into account the personal characteristics of the debtor in determining whether the loan is usurious or not. See Immaculada Barral-Viñals, *Freedom of Contract, Unequal Bargaining Power and Consumer Law on Unconscionability*, in UNCONSCIONABILITY IN EUROPEAN PRIVATE FINANCIAL TRANSACTIONS: PROTECTING THE VULNERABLE (Mel Kenny, James Devenney & Lorna Fox O’Mahony eds., 2010) (relating the concept of unconscionability in common law and how this Act might be considered the first Spanish law protecting the weak part of the contract).

<sup>35</sup> S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain)

section C in conjunction with the criteria for determining fairness, because unlike remunerative interest rates, default interest rates do not form part of the price. Instead, default interest rates are part of the compensation for the eventual damage suffered by the creditor because of non-payment. In other words, these rates fall outside the notion of price and, as such, are susceptible to an unfairness test.<sup>36</sup>

These T.S. cases permit application of the fairness test to any kind of clause in a mortgage loan, and this application should be the first step in considering individual clauses typically included in mortgage loan agreements in Spain.

### III. SUBSTANTIVE CRITERIA FOR DEALING WITH THE CONCEPT OF “UNFAIRNESS”

The ECJ has issued a number of guidelines on determining the fairness of SCTs. These guidelines are only of persuasive authority for judges in national courts because the Court in Luxembourg only gives instructions to the referring court in accordance with the interpretation of the scope of the fairness control provided in the UCT Directive.<sup>37</sup> In *Azijs*, however, the ECJ provided national courts with direct guidance—which has been cited in subsequent cases such as *Constructora Principado*—for analysing SCTs. All in all, the ECJ analyses

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<sup>36</sup> MARIA CARMEN GONZALEZ CARRASCO, CENTRO DE ESTUDIOS DE CONSUMO, LA CLÁUSULA QUE IMPONE UN INTERÉS DE DEMORA DESPROPORCIONADO DETERMINA LA APRECIACIÓN DE OFICIO DE LA NULIDAD DE LA MISMA SIN POSIBILIDAD DE ONTEGRACIÓN JUDICIAL.(2013).

<sup>37</sup> The judgments that stress the idea that the ECJ only gives instructions to the referring court in accordance with the interpretation of the scope of the fairness control provided in the UCT Directive are numerous. *See* Case C-243/08, *Pannon GSM Zrt. v. Erzsébet Sustikné Győrfi*, 2009 E.C.R. I-04713; Case C-137/08, *VB Pénzügyi Lízing Zrt. v. Ferenc Schneide*, 2010 E.C.R. I-10847; Case C-92/11, *RWE Vertrieb AG v. Verbraucherzentrale Nordrhein-Westfalen eV*, 2013 EUR-Lex CELEX LEXIS 4659 (Mar. 21, 2013). A summary of this construction can be found in Case C-472/10, *Nemzeti Fogyasztóvédelmi Hatóság v. Invitel Távközlési Zrt.*, 2012 EUR-Lex CELEX LEXIS 4104 (Apr. 26, 2012) (“it is for that [national] court to determine, in light of those criteria, whether a particular contractual term is actually unfair in the circumstances of the case . . . . It is thus clear that the Court of Justice must limit itself, in its response, to providing the referring court with the indications which the latter must take into account in order to assess whether the term at issue is unfair.”).



three different clauses used in virtually all mortgage loan agreements. These clauses are discussed separately below.

#### A. The “Early Maturity of the Loan” Clause

The “early maturity” clause is an SCT that confers on the bank the right to call in the totality of the loan on expiry of a stipulated time limit where the debtor fails to fulfill his obligation to pay any part of the principal or the interest on the loan. This clause implies the acceleration of the loan due to any kind of non-compliance. The ECJ in *Aziz* referred to this clause as the “acceleration clause.”

There is considerable variety of early maturity clauses used for a range of circumstances, such as when a debtor enters into insolvency proceedings and in the sale of an immovable property. The discussion in this section focuses on the type of early maturity clause considered in the case brought before the ECJ: one that provides for early maturity on account of non-payment of a loan installment. For this clause to take effect, there must be a failure to comply with an obligation that is of essential importance in the contractual relationship, such as non-payment in due time by the borrower.<sup>38</sup> But, the substantive issue discussed by the ECJ was the early maturity that occurred, or could occur, as a consequence of the non-payment of a single installment, and whether the early maturity clause may be considered unfair because of being disproportionate. The problem is not the possibility of calling in the loan because of the debtor’s non-compliance. Rather, the problem is the imbalance between the term and the amount of the loan, and the non-payment of a single installment.<sup>39</sup> Some Spanish scholars argue that, since early maturity for non-compliance is authorized by Spanish regulations on UCTs,<sup>40</sup> the central problem is whether absolute non-compliance can be assumed after defaulting on just one installment.<sup>41</sup> The meaning of non-payment is not defined in

<sup>38</sup> See, e.g. S.T.S., Dec. 16, 2009 (R.J., No. 8466/2009) (Spain).

<sup>39</sup> See PASCUAL MARTÍNEZ ESPIN, CENTRO DE ESTUDIOS DE CONSUMO, *ES ABUSIVA LA CLÁUSULA DE VENCIMIENTO ANTICIPADO POR IMPAGO DE UNA CUOTA DE LA HIPOTECA* (2013).

<sup>40</sup> TRLGDCU art. 85(4) (B.O.E. 2007, 287).

<sup>41</sup> See Carlos Ballugera Gómez, *Carácter Abusivo del Vencimiento Anticipado por Impago de una Sola Suota del Préstamo Hipotecario en la STS de 16 de Diciembre de 2009*, 7507 DIARIO LA LEY 10, 10 (2010); Maria Teresa Alonso Pérez, *Cláusulas Frecuentes en Préstamos Hipotecarios para Adquisición de Vivienda: Cláusula Suelo, Cláusula de*

the regulations. However, the ECJ provides three criteria –marked in bold- for determining whether the non-compliance is sufficiently serious: “whether that right is provided for in cases in which such non-compliance is sufficiently serious in the light of the **term and amount of the loan**, whether **that right derogates from the relevant applicable rules** and **whether national law provides for adequate and effective means enabling the consumer subject to such a term to remedy the effects** of the loan being called in.”<sup>42</sup>

Even though the ECJ does not conclude whether this clause is unfair, its criteria reflects the normal circumstances of a mortgage loan for a family home in Spain. Typically, banks in Spain grant mortgage loans with pay back time of at least thirty years.<sup>43</sup> As such, non-payment of a single monthly installment, without more, does not appear to be a severe violation of the borrower’s payment obligation.

In line with these criteria, the Spanish legislature set a limit on the maximum delay of payment, beyond which would indicate a serious intention of the borrower to breach his payment obligation. In 2013, the legislature promulgated Act 1/2013,<sup>44</sup> which modifies Article 693(2) of the Code of Civil Procedure to require a finding of non-compliance with the loan agreement based on non-payment of monthly installments for three or more months or its equivalent if the terms are not quantified in a monthly basis.

Act 1/2013 also takes into account the second criterion provided by the ECJ, and addresses the question of whether the right to call in the loan for the non-payment of one installment derogates from the relevant applicable rules. If there is no early maturity clause in the contract, the mortgage can only be executed following the “essential non-compliance” in the terms provided by Article 1124 C.C.,<sup>45</sup> which seems to require more than the non-payment of a single

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*Vencimiento anticipado y Cláusula de Cntereses Moratorios Excesivamente Elevados, in VIVIENDA Y CRISIS ECONÓMICA 183 (María Teresa Alonso Pérez ed., 2014).*

<sup>42</sup> L.E. CIV art. 693(2) (Spain).

<sup>43</sup> *See, e.g.*, Case C-415/11, Mohamed Aziz v. Catalunyaixa, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013) (the mortgage loan at issue was for thirty-three years).

<sup>44</sup> *See* Measures to Protect Mortgagees, Debt Restructuring and Social Rents (B.O.E. 2013, 116).

<sup>45</sup> C.C. art. 1124 (Spain).

installment. Thus, by specifically requiring three months of non-payment, Act 1/2013 establishes a criterion in which non-compliance is of essential importance.

However, the last criterion provided by the ECJ on the need to examine whether there are adequate means to remedy the effects of the clause is largely ineffective. Article 693(3) of Code of Civil Procedure clearly provides for the possibility of the debtor thwarting the execution of the mortgage by paying the due installments, a power conceded to the debtor of the mortgage on the family home, without the consent of the creditor. Therefore, in light of the effectiveness of reacting to the implementation of the clause, the Spanish legal system provides reasonable solutions to ensure the clause is not deemed unfair.

Act 1/2013 establishes that, in the absence of non-payment for at least three months, the judge cannot proceed to foreclosure. However, the question remains as to whether, even if the bank has declared the loan is expired after the minimum time limit for compliance established by law, the contract contains a clause for early maturity for non-payment of a single installment. Courts are likely to declare this clause unfair and therefore not binding on the debtor, in which case there would be a stay on mortgage foreclosure due to the lack of necessary procedural prerequisites, i.e., the credit has not fallen due.<sup>46</sup> Here, however, judges must decide on a case-by-case basis whether the elements listed above for determining whether a clause is unfair are present. In fact, the Code of Civil Procedure does not make early maturity clauses unfair only upon one or two non-payments. Instead, the Code of Civil Procedure only limits the foreclosure of the mortgage to three unpaid installments, which indicates a poor understanding of the judgment in *Aziz*.

#### B. The Clause for Unilateral Quantification of the Amount Owed

Clauses for unilateral qualification of the amount owed allow banks to immediately and unilaterally determine the balance of a loan by submitting a certificate indicating the amount owed. This clause is

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<sup>46</sup> Encarna Cordero, *Y Ahora Viene lo Difícil: ¿Cómo Controlar en el Ejecutivo Hipotecario el Carácter Abusivo de la Cláusula?*, 5 REVISTA CESCO DE DERECHO DE CONSUMO 26 (2013).

essential to the security provided by a mortgage because it provides the creditor with recourse to the procedures set out in Article 572(2) of Code of Civil Procedure.<sup>47</sup> Article 572(2) requires providing for the presentation of certification of the amount owed, duly verified before a notary, to determine the outstanding balance to proceed to enforcement. If such certification does not exist, the enforcement proceedings cannot be initiated owing to the absence of one of the procedural requisites, viz., the liquidity of the debt.<sup>48</sup> Prior to the enforcement proceeding, the debtor would be required to initiate a declaratory proceeding to establish the amount due. Therefore, the law allows unilateral declaration to establish the liquidity of the debt.

Clauses for unilateral qualification of the amount owed might seem unfair because they require only unilateral declaration by the bank. However, such a clause whose requirements and effects are provided for by procedural legislation<sup>49</sup> can hardly be considered unfair provided that all the requirements and effects of the clause are clear. In fact, this was the approach used by the Advocate General in *Aziz*, which highlights the essential character of this type of SCT for initiating enforcement.<sup>50</sup> He also pointed out the need to analyze the rules of this procedure and, in particular, the debtor's power of challenge, which appears guaranteed when claiming more than is due as regulated in Art. 558 Code of Civil Procedure.<sup>51</sup>

*Aziz*, however, deviates from Advocate General opinion for analyzing the procedures of mortgage enforcement proceedings and directly adopts the comparison with national legislation in the absence of an agreement.<sup>52</sup> Yet, without a unilateral determination clause,

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<sup>47</sup> L.E. CIV.art. 572(2) (Spain).

<sup>48</sup> See FERNÁNDEZ DE SENESPLENA, *supra* note 31, at 175.

<sup>49</sup> L.E. CIV. art. 572 (Spain).

<sup>50</sup> See Case C-415/11, Mohamed Aziz v. Catalunyaixa, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013).

<sup>51</sup> L.E. CIV. art. 558 (Spain).

<sup>52</sup> *Aziz*, 2013 EUR-Lex CELEX LEXIS, at ¶ 75 (“With regard, finally, to the term concerning the unilateral determination by the lender of the amount of the unpaid debt, linked to the possibility of initiating mortgage enforcement proceedings, it must be held that, taking into account paragraph 1(q) of the Annex to the directive and the criteria contained in Articles 3(1) and 4(1) thereof, the referring court must in particular assess whether and, if appropriate, to what extent, the term in question derogates from the rules applicable in the absence of agreement

enforcement proceedings may not be initiated, so, this SCT is clearly carrying consequences detrimental to the consumer. Therefore, *Aziz* indicates that the unilateral declaration of the amount is unfair, since this requires an agreement that derogates the applicable law. In the absence of an agreement, the law provides for the creditor to initiate declaratory proceedings to settle the debt, thus losing the advantages of the mortgage enforcement, which is one of the lender's most obvious advantages. Enforcement based on unilateral declaration of the amount owed offers few safeguards for the debtor, because unilateral declaration does not contain a phase in which objections might be lodged, nor is it corrected by the intervention of the notary. In short, in light of Spanish procedural law, it seems more effective to address the issue of the clauses for unilateral qualification of the amount owed from the perspective of the guarantee of procedures rather than from that of the unfair nature of the clause itself.

### C. Disproportionate Default Interest Rate Clause

The disproportionate default interest rate clause is also analyzed in *Aziz*. Unlike the remunerative rate of interest, which forms part of the price, the default interest is the price (compensation) for the debtor's failure to pay, which derives from the default and is provided for under Article 1108 C.C.<sup>53</sup> Thus, as indicated in Section III, the critical issue is not whether it is possible to control the content of the clause. Rather, the issue is whether the interest rate is disproportionate, and because of that, become unfair.

The ECJ opined in *Aziz* that the rate of default interest should be appropriate for ensuring the attainment of its objectives: so, a disproportioned default interest rate cannot be imposed because it settles a disproportionate compensation. The ECJ establishes two criteria for establishing a proportionate default interest rate: first, a comparison with what is provided for under national law in the absence of any agreement; and second, the rate of default interest applicable in art. 1108 Civil Code.<sup>54</sup> Clearly, the agreement of a default

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between the parties, so as to make it more difficult for the consumer, given the procedural means at his disposal, to take legal action and exercise rights of the defence.”).

<sup>53</sup> C.C. art. 1108 (Spain).

<sup>54</sup> See *Aziz*, 2013 EUR-Lex CELEX LEXIS, ¶ 74 (“regarding the term

interest rate alters the legal framework under Article 1108 C.C., which provides that the legal interest rate should be four percent,<sup>55</sup> a figure that is well above the usual percentage in mortgages. The question is what standard of comparison should be employed, and there are at least three possible answers: first, to take Article 1108 C.C., which establishes the legal interest rate of borrowing in the event of no agreement,<sup>56</sup> as a point of reference; second, to apply in accordance with Spanish legislation the limit on the legal interest rate of tacit overdrafts on personal loans subject to Article 20(4) LCC,<sup>57</sup> which is 2.5 times the legal interest rate;<sup>58</sup> and third, to compare the remunerative rate of interest of the loan itself with the default interest rate.

Consumers often default on their loan payments at the risk of foreclosure proceedings and find themselves unable to pay high rates of default interest. Therefore, RD-L 6/2012, before providing a ruling in the *Aziz* case, determined an upper limit for default interest rate in mortgage foreclosures affecting debtors with few resources (Article 4 RD-L 6/2012).<sup>59</sup> This regulation provides for the so-called “debtor on the threshold of social exclusion,” who enjoys special protection and

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concerning the fixing of default interest, it should be recalled that, in light of paragraph 1(e) of the Annex to the Directive, read in conjunction with Articles 3(1) and 4(1) of the directive, the national court must assess in particular, as stated by the Advocate General in points 85 to 87 of her Opinion; first, the rules of national law which would apply to the relationship between the parties, in the event of no agreement having been reached in the contract in question or in other consumer contracts of that type; and, second, the rate of default interest laid down, compared with the statutory interest rate, in order to determine whether it is appropriate for securing the attainment of the objectives pursued by it in the Member State concerned and does not go beyond what is necessary to achieve them”). *See also* Case C-488/11, Dirk Frederik Asbeek Brusse, Katarine de Man Garabito v. Jahani BV, 2013 EUR-Lex CELEX LEXIS 2538 (May 30, 2013).

<sup>55</sup> State Budget 2014 (B.O.E. 2013, 309) (Spain) (stating the state budget for 2014. Additional disposition 32).

<sup>56</sup> C.C. art. 1108 (Spain).

<sup>57</sup> Consumer Credit Act art. 9 (B.O.E. 1995, 72) (Spain) (derogated by Consumer Credit Act (B.O.E. 2011, 151) (Spain) [hereinafter Consumer Credit Act]. Neither of the two statutes apply to mortgage loan agreements.

<sup>58</sup> *See* FERNÁNDEZ DE SENESPLEDA, *supra* note 31, at 145. This criterion has been followed by provincial courts seeking a limit in the default interest rate in the face of recent legal reforms.

<sup>59</sup> Urgent Measures to Protect Low Income Mortgage Debtors (B.O.E. 2012, 60) (Spain).

is limited to the remunerative interest agreed to by parties at the time of making the loan agreement plus 2.5% of the loan principal. Nevertheless, the requirements for being recognized as this type of debtor are cumbersome and complicated, and few debtors are deemed eligible for this protection.

The ceiling on default interest in Article 114 LH, amended by Law 1/2013 limits default interest to a rate that is three times the statutory interest rate when the mortgage is for the acquisition of the main residence and the mortgage agreement has been secured on that residence. Thus, a solution was implemented to depart from the statutory interest rate provided by the C.C. and to increase the ceiling on personal loans. Today, there is a legal limit on interest rates when the rate has been agreed to in a new mortgage contract. Hence, *disposicion trasitoria* (DT) 2 of Act 1/2013 applies this limit to foreclosures that are pending or to be initiated after the effective date of Act 1/2013 that will have a greater impact as a lot of cases can be in its scope of application.<sup>60</sup> This indicates that the court clerk or notary will recalculate the rate of interest if it exceeds the statutory limit. As such, DT 2 of Act 1/2013 seems to represent an effort to moderate the clause in opposition to ECJ case law and the provisions in Article 85 TRLGDCU, which will be further discussed in Section V below.

Another interesting aspect of disproportionate default interest rate clauses concerns the proceedings taken when an interest rate is declared unfair and therefore void. The provincial courts have adopted two approaches to this issue. The first approach is to apply a zero interest rate if a court declares the default interest rate void as disproportionately high and the judge is unable to moderate the clause, as demonstrated in Section V. The second approach is to apply Article 1108 C.C., which provides that, in the absence of an agreement between the parties, the rate of default interest shall be the statutory interest rate. I favor this second approach because the supplementary application of Article 1108 C.C. does not constitute a revision of the clause, but only a use of the statutory interest rate in the absence of an agreement between the parties, defined as lack of foresight or

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<sup>60</sup> See Measures to Protect Mortgagees, Debt Restructuring and Social Rents (B.O.E. 2013, 116).

unenforceability by other cause.<sup>61</sup> The logic of Article 1108 C.C. is to provide a model for the quantification of the legal obligation for paying default interest, which is used by the ECJ as a reference for finding unfairness. The agreement on a default interest rate modifies the application of this precept.<sup>62</sup>

#### D. The “Floor” Clause

In Spain, most loan agreements for purchasing a family home charge a variable interest rate. A “floor” clause affects the variability of a loan by providing a fixed interest rate. Floor clauses do not allow lower rates of interest to be applied, even if a lower rate is available under the Euribor or other mechanism of calculation. Financial institutions use floor clauses to protect themselves against possible falls in the Euribor. Hence, the potential unfairness of floor clauses has been called into question because such clauses cause an imbalance in the contract, since the debtor is unable to benefit from interest rate cuts lower than the limit established by the floor clause, and it can be deemed unfair because the lack of financial knowledge of the debtor means he may be unaware that the clause might be applied, which has occurred during the present economic crisis. Although the ECJ has not addressed the fairness of floor clauses, the T.S. ruled on this issue in the May 9, 2013<sup>63</sup> and September 8, 2014 decisions<sup>64</sup> and applied much more restrictive criteria.

The T.S. cases considered floor clauses from two points of view. The first, which is contrary to the interpretation by the ECJ in *Aziz*, is that “floor” clauses, insofar as they determine the contract price, cannot be considered unfair. The second is that floor clauses can only be considered invalid for lack of transparency. Thus, the test for fairness is its inclusion within the loan agreement (Articles 5 and 7 LCGC and 80 of TRLGDCU), which is understood to be made when

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<sup>61</sup> See Miguel Martin Casals, *Les Clauses Abusives Dans le Projet de Cadre Commun de Reference*, in *LES CLAUSES ABUSIVES: APPROCHES CROISEES FRANCO-ESPAGNOLES* 73 (Yves Picod, Denis Mazeaud, & Elena Lauroba eds., 2012) (pointing out that the contract remains when a clause is unfair either because the clause is not essential to the contract’s purpose or because the law includes a defective application of the norm. In our case, the defective norm is C.C. art. 1108).

<sup>62</sup> See GONZALEZ CARRASCO, *supra* note 36, at 4.

<sup>63</sup> See S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain).

<sup>64</sup> See S.T.S., Sept. 8, 2014 (R.J., No. 3903/2014) (Spain).



the bank complies with all previously established information and documentation requirements.<sup>65</sup> Surprisingly, the T.S. checks the transparency of contractual clauses that cannot be deemed unfair as they form part of the price in function of the criterion of transparency in what is known as “double filter transparency”. Indeed, this criterion for the transparency of contract clauses is not contemplated by Article 82 TRLGDCU, which is limited to requiring only that the content of the clauses shall not be “contrary to the requirement of good faith” or “cause a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer and user.” Nor does Article 3 of the UCT Directive require a check on the transparency of contract clauses. Thus, the transparency control in Spanish law is effectively a control of the incorporation of general contract conditions, and not a control over the fairness of the SCT.<sup>66</sup> Indeed, the control of accessibility tackles the issue of fairness more directly than the control of transparency because the former is based on whether the consumer had the opportunity of knowing the content, while the latter is only a posterior analysis of whether the clause is worded clearly or not. Further, even if the wording of the contract term is unclear, it will be ineffective rather than unfair.<sup>67</sup>

In practice, the T.S. adopts the ECJ’s interpretation of the concept of unfairness due to a lack of transparency, which provides that the clarity of the contract language requires the lender to fulfill its affirmative duty of supplying sufficient information for the consumer to appreciate the circumstances related to contract formation.<sup>68</sup> This requirement is grounded in the idea that the test for unfairness should require that consumers understand the economic significance of the contract terms. This is precisely the concept that the T.S. adopts in

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<sup>65</sup> See Orden Sobre Transparencia de las Condiciones Financieras de los préstamos hipotecarios (May 5, 1994) (B.O.E. 1994/112) (on transparency of the financial conditions of mortgage loans or credits) (derogated by Orden EHA/2899/2011, de Transparencia y Protección del cliente de servicios bancarios (Oct. 28, 2011) (B.O.E. 2011/261) (on transparency and protection of bank clients)).

<sup>66</sup> FRANCISCO PERTÍÑEZ VÍLCHEZ, *LAS CLÁUSULAS ABUSIVAS POR UN DEFECTO DE TRANSPARENCIA* (2004).

<sup>67</sup> See Consumer Protection Act art. 10 (B.O.E. 2014, 76) (Spain) (amended to require clarity with the material delivery of the conditions).

<sup>68</sup> See Nemzeti Fogyasztóvédelmi Hatóság v. Invitel Távközlési Zrt., *supra* note 37; Hans-W. Micklitz & Norbert Reich, *The Court and Sleeping Beauty: The Revival of the Unfair Contract Terms Directive (UCTD)*, 51 C.M.L.R. 771, 771-808 (2014).

determining the lack of transparency: the floor clause is void due to a lack of transparency because such a clause prevents the consumer from understanding the economic significance of the loan. However, the problem is that both transparency and reporting obligations to highlight the economic significance of the contract are for the ECJ, examples of substantive criteria for determining the unfair nature of a clause because they generate imbalance and are contrary to good faith, regardless of the clarity of writing. In other words, the argument of the economic importance of the contract is useful, but then we talk about content control, which is precisely what the T.S. rejects at the beginning of its argument, indicating that the floor clause refers to an essential contract element. In my opinion, it is more useful to start from the fact that floor clauses are unfair terms, and avoid the question of transparency because the content control would address the fairness issue in a more direct manner.

#### IV. ON THE EFFECTS OF UNFAIRNESS: NON-REVISION AND FULL RESTITUTION

Another important issue concerns the difference between the way in which the Spanish legislature and the T.S. interpret the effects of unfair terms and the doctrine established by the ECJ. First, until 2013, the TRLGDCU had authorized judges to integrate terms that had been declared unfair. Second, the T.S., in its 9 May, 2013 decision,<sup>69</sup> stated that the law did not require restitution of the amounts paid under a “floor clause” that had been declared unfair due to a lack of transparency. Here, the discussion will focus on these two points: the non-revision of an unfair contract term, and the restitution effect when it is declared unfair.

##### A. Non-revision of an Unfair Contract Term

An even more surprising issue that arises from the transposition of the UCT Directive by the Spanish legislature is that Article 85 of RD 1/2007 allowed Spanish courts to revise unfair clauses. However, as reported in a number of ECJ judgments,<sup>70</sup>

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<sup>69</sup> S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain).

<sup>70</sup> Case C-76/10, *Pohotovost’ s. r. o. v. Iveta Korčkovská*, 2010 E.C.R. I-11557.

revision of UCTs by courts is not permissible under Article 6 of the UCT Directive.<sup>71</sup>

In 2014, the Spanish legislature amended the TRLGDCU: L 3/2014, which transposes the 2011 Directive on consumer rights, provides in Article 27 that unfair terms are null and void and cannot be revised by judges: Article 27 amends Article 83 of TRLGDCU. So, judges are not permitted to revise unfair contract terms because the supplier or seller bears the risk of the use of the clause, *i.e.*, the supplier or seller cannot benefit from a partial implementation of the agreement when the clause is unfair.<sup>72</sup>

This subject is currently of great interest because of its effects on default interest clauses. Besides what has been discussed regarding the application of the statutory limit provided in art. 1108 C.C. in the absence of agreement, there is another controversial provision, the DT 21/2013 that appears to permit revision by judges upon finding UCTs. DT 21/2013, which amends Article 114 LH, grants the court clerk or notary the power to authorize the creditor to recalculate interest if the clerk or notary finds that the default interest clause exceeds the statutory limit in C.C. This rule, the constitutionality of which has been questioned,<sup>73</sup> seems to permit the revision of a term that is no longer

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<sup>71</sup> See, e.g., Case C-618/10, Banco Español de Crédito SA v. Joaquín Calderón Camino, 2012 EUR-Lex CELEX Lexis 4274 (June 14, 2012). “Article 6(1) of Directive 93/13 cannot be understood as allowing the national court, in the case where it finds that there is an unfair term in a contract concluded between a seller or supplier and a consumer, to revise the content of that term instead of merely setting aside its application to the consumer.” *Id.* at ¶ 71. In addition, it is for the court to ascertain what which national rules are applicable to the dispute and to take the whole body of domestic law into consideration and apply the interpretative methods recognized by domestic law, with a view to ensuring that Article 6(1) of Directive 93/13 is fully effective and achieves an outcome consistent with the objective pursued by it. *Id.* at ¶ 72. See also Case C-282/10, Dominguez v. Centre Informatique du Centre Ouest Atlantique, 2012 EUR-Lex CELEX LEXIS 4658, ¶ 27 (January 24, 2012). The answer to the second question is that Article 6(1) of Directive 93/13 must be interpreted as precluding legislation of a Member State, such as Article 83 of Legislative Decree 1/2007, which allows a national court, if it declares void an unfair term in a contract concluded between a seller or supplier and a consumer, to modify that contract by revising the content of that term. Banco Español de Crédito v. Joaquín Calderón Camino, 2012 EUR-Lex CELEX LEXIS 4274.

<sup>72</sup> See Micklitz & Reich, *supra* note 68, at 793.

<sup>73</sup> Spain’s Constitutional Court has admitted application 4985-2013,

permitted under Article 83 TRLGDCU. If the interest rate in the SCT exceeds the statutory maximum, its unfairness can be assessed by the court or the debtor can make the corresponding allegation so the interest rate is not applied.

#### B. Full Restitution

The unfairness of a term might imply that the debtor has paid more than what he should have been paid, so he is entitled to restitution in accordance with the regulations of each Member State. Restitution is clearly recognized by the ECJ.<sup>74</sup> The T.S., however, has held that the annulment of floor clauses is not retroactive, so restitution is not warranted.<sup>75</sup> Yet, Article 1303 C.C.<sup>76</sup> provides that the nullity involves recovery of benefits and that it acts *ex tunc*. Besides this rather unusual ruling—or “invention”—of non-retroactive annulment, the T.S.’s holding in judgement 9 May, 2013 has no legal basis.<sup>77</sup> The T.S. judgement is presenting four arguments: First, the existence of rules that do not involve retroactivity in case of annulment, but it is clear that in the case of unfair terms, there is no reason to deviate from the general system. Second, the lack of transparency does not entail annulment because the clause could be lawful. However, the reasoning for this argument is clearly circular because the term is either unfair for lack of transparency as held by the T.S., or the term is unfair but does not lack transparency, in which case the law permits annulment. Third, judges may make a retroactive revision. However, this possibility was removed by the amendment of Art. 83 TRLGDCU, which was promulgated after the T.S. judgment.<sup>78</sup>

Finally, the only argument of any weight, although not a legal argument, is the “risk of serious difficulties in the economic public

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presented by more than fifty members of parliament from the Socialist Group, against this precept. Also the judge in the Avilés court of first instance (n° 7) has presented a claim of unconstitutionality.

<sup>74</sup> Nemzeti Fogyasztóvédelmi Hatóság v. Invitel Távközlési Zrt., *supra* note 37; Case C-397/11, Joros v. Aegon, 2013 EUR-Lex CELEX LEXIS 2540 (July 18, 2013).

<sup>75</sup> S.T.S., May 9, 2013 (R.J., No. 1916/2013) (Spain).

<sup>76</sup> C.C. art. 1303 (Spain).

<sup>77</sup> For an impeccable analysis, see Alonso Perez, *supra* note 41, at 170.

<sup>78</sup> TRLGDCU art. 83 (B.O.E. 2007, 287).

order.”<sup>79</sup> So, the T.S. permitted revision of the amount of the execution, but did not allow recovery of the amounts unduly paid.

#### V. EXPLORING THE RESULTS OF UNFAIRNESS CRITERIA IN MORTGAGE FORECLOSURE PROCEEDINGS

The most significant consequence of *Aziz* is the promulgation of Act 1/2013 to reform mortgage foreclosure proceedings. Indeed, besides the unfair nature of certain clauses, *Aziz* holds that the mortgage foreclosure process, by not permitting the control of unfair terms, is inconsistent with the principle of effectiveness in the UCT Directive.<sup>80</sup> *Aziz* also points out that the rules of Member States contradict those of the Community if they do not provide for the possibility of controlling unfair terms in foreclosure proceedings, or if these proceedings cannot be suspended providing interim relief, if the unfair nature of these terms is discussed in a declaratory judgment.<sup>81</sup> Although the law regulates the effects of an unfair contract term in these proceedings, the legislation on unfair terms remains the same: the reforms have led to the redrafting of the Mortgage Act (Article 129) in those cases in which the foreclosure is made extrajudicially before a notary. In these cases, the notary has control of the unfair terms and has the authority to suspend the sale of the mortgaged property if a claim on the UCT has been filed.<sup>82</sup>

For practical purposes, greater importance should be attached to the amendments to the Code of Civil Procedure, which are widely used by lawyers to identify the effect of suspending foreclosure proceedings, although the suspension only delays the loss of the mortgagor’s house as he is unable to repay the loan.<sup>83</sup> Two amendments have been made to the Code of Civil Procedure. First, the Code directly foresees an avenue for controlling the terms by the

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<sup>79</sup> S.T.S., May 9, 2013 (R.J., No. 1916/2013, ¶ 293) (Spain).

<sup>80</sup> See Case C-415/11, Mohamed Aziz v. Catalunyaixa, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013)

<sup>81</sup> *Id.*

<sup>82</sup> See Mortgage Act art. 129 (B.O.E. 1946, 58) (Spain).

<sup>83</sup> Andres Dominguez Luelmo, *La STJUE de 14 de Marzo De 2013: Dificultades de Interpretación y aplicación por los Tribunales*, 5 REVISTA CESCO DE DERECHO DE CONSUMO 5 (2013).

judge with a pre-hearing process,<sup>84</sup> the need for which has been called into question.<sup>85</sup> The pre-hearing process is resolved via a judicial writ in which the decision is made as to whether to proceed with the foreclosure as presented given the absence of any unfair terms; or, if unfair terms are thought to exist, foreclosure can be denied if the unfair term is the basis for the foreclosure or to reach an agreement, but for a smaller amount, if the term only affects the amount.<sup>86</sup>

Second, a procedural step was introduced to enable the debtor to invoke the unfairness of a term, which is a direct consequence of *Aziz*; the possibility of objecting to foreclosure because of the existence of an unfair term in the loan agreement.<sup>87</sup> These proceedings (*incidente de oposición*) only permit an allegation of the unfairness of a term that either allows the proceedings to be stayed, or for the amount due to be modified, while all other remedies must be sought in declaratory proceedings.<sup>88</sup> If the judge finds the clause to be fair, the foreclosure proceedings continue; otherwise, the judge must either dismiss the proceedings on grounds that the term forms the basis of the foreclosure or continue the proceeding for a smaller amount of money.<sup>89</sup> The first draft of this *incidente de oposición* only allows the bank to appeal against the writ, which is the subject of the recent judgment of the ECJ of 17 July 2014.<sup>90</sup> The response of the Spanish legislature, in this case, has been nothing short of instantaneous: RD Law

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<sup>84</sup> L.E. Civ., art. 552.1, 681.1 (Spain).

<sup>85</sup> Alberto Lafuente Torralba, *El Control de las Cláusulas Abusivas en la Ejecución Hipotecaria: Luces y Sombras de la Regulación Legal*, in *VIVIENDA Y CRISIS ECONÓMICA* 232 (María Teresa Alonso Perez ed., 2014).

<sup>86</sup> L.E. Civ., *supra* note 42, art. 561.1.3, 695.3.

<sup>87</sup> According to Carrasco Perera a coherent solution would be to allow the judge to arbitrate and then to open contentious proceedings, but not to duplicate the routes available for controlling unfairness. See ANGEL FRANCISCO CARRASCO PERERA, CENTRO DE ESTUDIOS DE CONSUMO, LA LEY 1/2013, DE 14 DE MAYO, DE REFORMA HIPOTECARIA Y LA ARTICULACIÓN PROCESAL DEL CONTROL SOBRE CLÁUSULAS ABUSIVAS EN LA EJECUCIÓN HIPOTECARIA (2013).

<sup>88</sup> L.E. Civ. art. 557.1.7, 695.1.4 (Spain).

<sup>89</sup> *Id.* at art. 695.3.

<sup>90</sup> Case C-169/14, Juan Carlos Sánchez Morcillo and María del Carmen Abril García v Banco Bilbao Vizcaya Argentaria SA (July 17, 2014), available at <http://curia.europa.eu/juris/liste.jsf?td=ALL&language=en&jur=C,T,F&num=C-169/14>.

11/2014, of 5 September, amending Art. 695 Code of Civil Procedure, allows both parties the right of appeal.<sup>91</sup>

Thus, both in the judge's assessment of unfairness and the *incidente de oposición*, the possibility of avoiding the foreclosure process by analysing the unfairness of the contract terms so far is discrete. Indeed, the appreciation of the early maturity clause is the basis of this *incidente de oposición*, because if the clause is declared invalid, the debt is not due and cannot be executed; however, this SCT can hardly be regarded as unfair. The unfairness of a unilateral declaration of a debt clause suspends foreclosure, because the debt would have no liquidity and cannot be executed. Moreover, neither the unfairness of the default interest clause nor the "floor clause" permits proceedings to be suspended. The unfairness of such clauses only results in modifications to the amount due, and in the latter case, involving only very small amounts relative to the sum for which foreclosure is executed, as occurred in *Aziz*.

Moreover, the criteria of unfairness provided by the ECJ can be used to determine whether a clause is unfair in declaratory proceedings. In addition, *Aziz* focused on the assumption that, after initiating foreclosure proceedings—and without the legal means to analyze the fairness—the debtor can initiate declaratory proceedings concerning the existence of unfair terms that lack suspensory effect of the foreclosure proceedings. The bottom line is that the judge in declaratory proceedings could grant interim relief<sup>92</sup>—the staying of those enforcement proceedings and this possibility was explicitly accepted by the ECJ<sup>93</sup>. However, the Spanish legislature has not addressed this issue, so the possibility of a suspensory effect in the foreclosure proceeding continues to be of uncertain application given the rigidity of the precepts that govern the enforcement process. This is unfortunate because declaratory proceedings are a better forum for discussing the scope of an unfair term than foreclosure proceedings.

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<sup>91</sup> Urgent Insolvency Matters (B.O.E. 2014, 217) (Spain).

<sup>92</sup> See Case C-415/11, Mohamed Aziz v. CatalunyaCaixa, 2013 EUR-Lex CELEX LEXIS 191 (Mar. 14, 2013).

<sup>93</sup> See *id.* at ¶ 77.

## CONCLUSION

The legal developments following *Aziz* on the control of unfair SCTs have been somewhat limited. However, these developments highlight the difference between European consumer protection law and domestic procedural law with regard to enforcement proceedings and have given grounds for challenging the legal system and some lessons are to be learned:

First, in *Aziz*, a consumer-friendly interpretation has been given to the UCT Directive which has led to the development of substantive criteria for ascertaining unfairness in three SCT that almost every housing mortgage loan has in Spain: the early maturity of the loan, the unilateral declaration of the debt and the default interest rate.

Second, coming from *Aziz*, various points at which the Spanish transposition of the UCT Directive needs to be revised have been identified: On the one hand, the non-revision of the unfair clause by the judge has been finally stayed by an amending of art. 83 TRLGDCU, but it still remains in the foreclosure proceedings by the means of DT 2 Act 1/2013. That shows how the Spanish legislature has not understood the *Aziz* doctrine. On the other hand, the ECJ opts for a full restitution when a clause is deemed unfair, nevertheless that has not been the case in the two Spanish T.S. judgements referring to a floor clause considered unfair by lack of transparency.

Third, the possibility of controlling UCTs in mortgage foreclosure proceedings has not become a reality. Even if *Aziz* states that a way of controlling fairness should be granted in the foreclosure proceedings, it is true that the clauses abovementioned have no deep impact on the possibility of staying the foreclosure, and in some cases—disproportioned default rate—are only able to low the amount of the debt.

In short, the problem of defaulting on mortgage loan repayments is not strictly an issue of controlling UCTs, and consumer protection provides no more than indirect tools to stay the mortgage foreclosure. Given that many mortgagors find themselves unable to make their loan payments—and thus at risk of losing their homes—shifting attention to UCT legislation has been helpful in seeking a stay



on foreclosure proceedings and the ECJ judgements have questioned the Spanish procedural law in mortgage foreclosures. Yet, problems still exist in areas such as the over-indebtedness of consumers (a question that the Spanish legislator has largely ignored); weak Spanish legislation protecting consumer rights with regard to financial products and the role of the Bank of Spain as regulator of the sector; and mortgage foreclosure regulations that provide the banks with many facilities of recovery while lenders may fail to clear their debt if the value of their home does not cover the total amount owed. Deeper research in these three mentioned areas is needed to find a legal solution to unpaid housing mortgages as a whole.

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## FROM PAPER TO ELECTRONIC ORDER: THE DIGITALIZATION OF THE CHECK IN THE USA\*

*Benjamin Geva\*\**

### INTRODUCTION

A check is a paper instrument embodying an unconditional order in writing. It is signed by a drawer and addressed to a drawee bank with which the drawer typically maintains an account. The check instructs the bank<sup>1</sup> to make payment on demand to, or to the order of, a designated payee, or to the bearer.<sup>2</sup> The person to whom a check is payable and who is in the possession of the check is its holder.<sup>3</sup> A check is issued when the drawer delivers it to the first holder,<sup>4</sup> who is either the payee of a check payable to order or the first bearer of a check

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\*\* Professor of Law, Osgoode Hall York University, and Counsel, Torys LLP, Toronto, Canada. The article substantially updates and expands on Benjamin Geva, *Recent International Developments in the Law of Negotiable Instruments and Payment and Settlement Systems*, 42 TEX. INT'L L.J. 685, 687-99 (2007) and is a sequel to B. Geva, *Is Death of the Paper Cheque upon Us? The Electronic Presentment and Deposit of Cheques in Canada*, 30 B.F.L.R. 113 (2014). I am grateful to Joe Wahba of the 2016 graduating class of Osgoode Hall Law School for his research assistance. All errors are mine.

<sup>1</sup> “Bank” is broadly defined to include any person “engaged in the business of banking.” See U.C.C. § 1-201(b)(4) (2014). Undoubtedly, any institution that either takes deposit and/or offers account services falls into this definition. Technically, however, the account relationship requirement is not spelled out by statute.

<sup>2</sup> U.C.C. §§ 3-104(f), 3-103(a)(8) (2014).

<sup>3</sup> U.C.C. § 1-201(b)(21)(B) (2014).

<sup>4</sup> See U.C.C. § 3-105(a) (2014) (defining “issue” as “the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.”). Issue to a non-holder is less common and is outside the scope of the present discussion.

payable to bearer. Once issued, a check may circulate from hand to hand by negotiation, namely by its delivery from one holder to another. In the case of a check payable to order, negotiation consists of delivery accompanied by the signature of the holder, called “indorsement.”<sup>5</sup> To obtain payment, the last holder is to have the check physically presented to the drawee bank.<sup>6</sup>

Nowadays, there is very little circulation of checks, so presentment is usually made by or on behalf of the first holder. Regardless, a holder typically will not present the check to the drawee bank in person. Rather, the holder is likely to have the check deposited with and collected by a depositary bank with which the holder maintains an account. The depositary bank will then either present the check directly to the drawee bank, or will negotiate it to an intermediary bank. There may be one or more negotiations with one or more intermediary banks. The last intermediary bank will present the check for payment to the drawee. In that process, all banks other than the drawee, namely the depositary bank and each intermediary bank, are collecting banks, the drawee bank is the payor bank, and the collecting bank that presents the check for payment to the drawee bank is the presenting bank.<sup>7</sup>

The normal life cycle of a check thus entails a series of physical deliveries of the piece of paper embodying it. First, the check is physically issued by the drawer to the first holder. Second, there may be one or more physical negotiations outside the banking system. Third, there is the physical delivery of the check by the holder to the depositary bank. Fourth, there may be one or more deliveries of the check to intermediary bank(s). Fifth, the process concludes with a physical presentment of the check to the drawee. Following payment, there is possibly a sixth and post-concluding stage in which the cancelled check is delivered by the payor bank to the drawer, together with the periodic statement containing it. Alternatively, where the

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<sup>5</sup> U.C.C. §§ 3-201(a), 3-201(b), 3-204 (2014).

<sup>6</sup> This point is implied, though not specifically provided for, in U.C.C. § 3-501(b)(2) (2014), which addresses the exhibition of the check to, and its handling by, the drawee.

<sup>7</sup> For applicable definitions, see U.C.C. §§ 4-104, 4-105 (2014).

drawee dishonors the check, the check is returned in a reversed itinerary.

Modern law facilitates variations by agreement. On occasion, it may further provide for the impact of such variations on third parties not privy to agreed variations. First, a check may be given as a source of information to be used to initiate a one-time electronic fund transfer, often described as an “electronic check.” Second, a check may be remotely created. Third, a check may be presented for payment electronically. Fourth, a check may be negotiated to a collecting bank, whether by its customer the holder or another collecting bank, by means of electronic transmission. At the same time, a practice of electronic negotiation other than to banks has not developed so that no provision for such electronic transmission has been made. Finally, there is the possibility that a payment order will be issued electronically and will not be embodied in a piece of paper at its inception.

As a source of information, a check may be given to the payee with the authority to convert it to an electronic image. A remotely created check is drawn by the payee, as an agent of the drawer, on the basis of information provided by the drawer to the payee, typically over the telephone. This practice is more concerned with the remote creation of a paper check rather than with its dispensation and thus is not addressed in this article. Both electronic negotiation and presentment involve check truncation, namely a procedure in which the physical movement of checks is curtailed or eliminated, being replaced, in whole or in part, by electronic transmission of information.<sup>8</sup> Issued and processed electronically, and thus not being “written,” an electronic payment order is not an “order” under U.C.C. Section 3-103(a)(8). As such it is not a “draft” under Section 3-104(e) and thus not a “check” under Section 3-104(f). However, an electronic payment is a functional equivalent for a check. Being the logical

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<sup>8</sup> See, e.g., the definitions listed in COMMITTEE ON PAYMENT AND SETTLEMENTS, A GLOSSARY OF TERMS USED IN PAYMENTS AND SETTLEMENT SYSTEMS (2003). For similar definitions focusing on the conversion of data on a paper to an electronic image, see *Wells Fargo Bank v. Burrier (In re Burrier)*, 399 B.R. 258, 264 (Bankr. D. Co. 2008).

conclusion of the check electronification process, this method of payment is addressed in this article.

This article explores the various stages in the check payment in which electronic transmission has replaced physical delivery. Part I discusses converting the check into an electronic entry at a point of sale of goods and services. Part II addresses the electronic presentment of a check. Part III deals with the possible conversion of the check from paper to electronic, and vice versa, within the interbank check collection system. Interbank exchange of check images is the subject of Part IV. Part V addresses the electronic order that operates like a check but that has never been in a paper format. This article examines the applicable provisions of the Uniform Commercial Code, U.S. federal regulations and legislation, and proposals for reform, as well as private-sector norms. Having explored existing norms and proposals, the article concludes with a plea for advancing the process of the complete electronification of the check and its collection process as well as for the establishment of a comprehensive legal scheme to govern such matters

#### I. THE SO-CALLED “ELECTRONIC CHECK”

On occasion, a check may not be “issued” with the view of giving the payee the rights to enforce payment on it in discharge of the underlying obligation.<sup>9</sup> Rather, contrary to the usual presumption of conditional payment by check,<sup>10</sup> a check may be given to the payee merely as a source of information to be used to initiate a one-time electronic fund transfer from the drawer’s account in payment of the obligation. The check is then used as a source document for the drawer’s routing number and account number, as well as the check’s serial number, and the sum payable. In effect, the check is thus converted to a single debit entry, which is then input into the Automated Clearing House (ACH) Network. This arrangement is

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<sup>9</sup> “Issue” is defined as “the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.” U.C.C. Section 3-105(a) (2015).

<sup>10</sup> For an explanation of this presumption, see U.C.C. Section 3-310(b) (2015) (“[u]nless otherwise agreed . . . if . . . an uncertified check is taken for an obligation, the obligation is suspended . . . until dishonor of the check or until [the check] is paid or certified”).

particularly common in consumer transactions. Thus, where the check is mailed to the payee-merchant, the check is converted to an ARC—Accounts Receivables Entry. Similarly, where the check is given to the payee-merchant in a face-to-face transaction, the check is converted to a Point-of-Purchase (POP) Entry.<sup>11</sup> Once converted, the check itself is voided; practically speaking in a face-to-face transaction the voided check is typically returned to the consumer-drawer.<sup>12</sup>

The electronic image created by the merchant, usually at the point-of-sale, is often colloquially referred to as an “electronic check.” However, as will be further discussed below, the term may have been “hijacked” by the Federal Reserve Board to denote the digital image of a check. In any event, in the present context, “electronic check” is a misnomer; rather, what is generated, is an ACH debit entry. Payment is thus not governed by U.C.C. Articles three and four, but instead is covered by Regulation E, issued by the Federal Reserve Board, which governs consumer electronic fund transfers.<sup>13</sup> Regulation E requires the merchant to “provide a notice that the transaction will or may be processed as an EFT<sup>14</sup> and obtain a consumer’s authorization for each transfer.”<sup>15</sup>

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<sup>11</sup> Related entries are TEL and WEB, respectively, ACH entries made on the basis of payment instructions made by phone-calls and over the Internet rather than at a physical point of sale as the POP entry.

<sup>12</sup> *See, e.g.*, NACHA OPERATING RULES AND GUIDELINES AND ACH OPERATING RULES, A COMPLETE GUIDE TO THE RULES GOVERNING THE ACH NETWORK, Sections 3.7 and 3.8 (2014) (providing a brief explanation of the “ACH Primer” preceding National Automated Clearing House Association (NACHA) Operating Rules) [hereinafter NACHA OPERATING GUIDELINES].

<sup>13</sup> Electronic Fund Transfers (Regulation E), 12 C.F.R. § 205(c) (2015) (Regulation E does not cover “[a]ny transfer of funds originated by check.”). The theory of the check conversion is, however, that the transfer is initiated by the converted debit entry, rather than the check that has been used as a mere source of information.

<sup>14</sup> EFT stands for Electronic Fund Transfer.

<sup>15</sup> 12 C.F.R. § 205.3(b)(2). *See also generally* 12 C.F.R. § 205 (Briefly stated, the underlying theory of the requirement is that conversion may change the consumer’s position, e.g., insofar as payment is likely to be speedier and the cancelled check will not prove payment.).

## II. ELECTRONIC CHECK PRESENTMENT

Electronic presentment is provided for by U.C.C. Section 4-110. Thereunder, the presentment of a check may be made pursuant to an interbank agreement for presentment. An “agreement for electronic presentment” can be in the form of an agreement, clearing-house rule, or Federal Reserve regulation or operating circular.<sup>16</sup> The agreement is to provide “that presentment . . . may be made by the transmission of an image of [a check] or information describing [it] . . . rather than delivery of the [check] itself.” The transmission of the image or information constitutes a “presentment notice”; its receipt is the actual presentment. Other elements that may be covered by the agreement for electronic presentment are “procedures governing retention . . . payment, dishonor and other matters.” Arguably, return procedures fall within the scope of the agreement.

An interbank voluntary agreement may be either bilateral or multilateral.<sup>17</sup> In any event, per the language quoted above, an “agreement for electronic presentment” under U.C.C. Section 4-110 may not be entirely consensual. This is, however, consistent with the general principle under which “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of

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<sup>16</sup> See, e.g., Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire (Regulation J), 12 C.F.R. § 210 (2015) (defining “item” in Section 210.2(i) to include “electronic item,” such as an electronic image of a check or any other paper item). See also FEDERAL RESERVE FINANCIAL SERVICES FEDERAL RESERVE BANKS, OPERATING CIRCULAR NO. 3: COLLECTION OF CASH ITEMS AND RETURNED CHECKS (2012) (electronic access to Reserve Bank’s Services is governed by Section 5 and Appendices E (MICR presentment services), E1 (truncation service), E2 (MICR presentment plus service), and E3 basic (MICR presentment service)).

<sup>17</sup> One such multilateral agreement is under the rules of the check truncation program of NACHA for electronic images of truncated checks input to the ACH Network. See NACHA OPERATING GUIDELINES, *supra* note 12, at § 1(2)(c) (check truncated items input to the ACH Network are TRC/TRX entries referred to as a category of Payment Applications which are governed by Art. 10 of the NACHA Operating Rules). See also NACHA OPERATING GUIDELINES, *supra* note 12, at ACH Primer § C(3). For bulk electronic payments processed through the ACH Network and for NACHA, as well as for NACHA Operating Rules and Guidelines, see Section 5 *infra*.

agreements . . . whether or not specifically assented to by all parties interested in items handled.”<sup>18</sup>

### III. THE “SUBSTITUTE CHECK”

Electronic negotiation to a collecting bank is the most elaborate statutory and regulatory scheme. The scheme is governed by the Check Clearing for the 21<sup>st</sup> Century Act (“Check 21 Act”)<sup>19</sup> and implemented by Regulation CC subpart D.<sup>20</sup> In essence, the Check 21 Act authorizes a collecting bank to create a substitute paper check<sup>21</sup> for further negotiation or presentment. Having agreed to receive a check in an electronic form, a collecting bank that receives the electronic check image or information is authorized under the Check 21 Act to create a substitute check. Upon compliance with specified requirements, the substitute check becomes “the legal equivalent of the original check for all purposes.”<sup>22</sup> The Check 21 Act further includes warranty and indemnity provisions, as well as expedited re-credit procedures, designed to protect substitute check recipients.<sup>23</sup>

In practice, the creation of a substitute check by a collecting bank is predicated upon the existence of two preconditions. First, the creating bank must receive a transmission of an image of the original check, instead of the check itself. The sender of that transmission could be a customer, the holder of the check, in which case the creating bank is the depositary bank. Alternatively, the sender of that transmission could be a collecting bank, in which case the creating bank is an intermediary bank. Second, the bank to receive the

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<sup>18</sup> U.C.C. § 4-103(b) (2015).

<sup>19</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>20</sup> Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229 (2015).

<sup>21</sup> *See* 12 U.S.C. § 5001(b)(1) (where an explicit purpose of the Check 21 Act was “[t]o facilitate check truncation by authorizing substitute checks.”)

<sup>22</sup> 12 C.F.R. § 229.51(a).

<sup>23</sup> For a comprehensive overview, though written prior to the promulgation of the final text of 12 C.F.R. § 229.51, *see* PAUL S. TURNER, ANALYSIS OF THE CHECK CLEARING FOR THE 21ST CENTURY ACT (“CHECK 21”) (2004). For more on the background of the Check 21 Act, see Availability of Funds and Collection of Checks, 12 C.F.R. § 229, 69 Fed. Reg. 1470 (July 26, 2004) (to be codified at 12 C.F.R. § 229), and Availability of Funds and Collection of Checks, 69 Fed. Reg. 47290 (Oct. 22, 2004) (to be codified at 12 C.F.R. § 229).



substitute check, being either an intermediary bank or the drawee bank, has not agreed to accept electronic transmission of an image, which would be the case for a small bank that does not have the required processing equipment.

Stated otherwise, the Check 21 Act does not require banks to accept electronic transmissions of check information or check images. Rather, it authorizes a collecting bank that agrees to accept the electronic transmission, whether from its customer or a prior collecting bank, to issue a substitute check to be processed onward as if it were the original check. A bank, either a subsequent collecting/intermediary bank or the drawee bank, must accept the substitute check as the equivalent of the original check. By the same token, a customer who has received original checks with the periodic statement showing account activity cannot object to receiving the substitute check in lieu of original checks that have been so truncated in the collection process.<sup>24</sup>

By truncating the paper check, the Check 21 Act eliminates long-distance transport of the physical checks, though the act does not eliminate or bypass intra-city or local check transportation. For example, suppose Drawer has a bank account with Drawee/Payor Bank in New York. Drawer sends a check drawn on that account to Payee in California who in turn deposits the check in their account with a California Depository Bank (Depository Bank). Assume the Depository Bank is a large institution that has equipment necessary for the transmission of the check's image. At the same time, the Payor Bank is a small institution that lacks the processing equipment capable of receiving the electronic transmission of a check. There is nothing within the U.C.C, the Check 21 Act, or anywhere else, to force Payor Bank to accept electronic transmission; hence, electronic presentment is precluded for this transaction. Rather, Depository Bank may transmit the image of the check to an Intermediary Bank in New York, which is capable of accepting such transmissions.<sup>25</sup> In effect, this is an

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<sup>24</sup> See 12 U.S.C. § 5003(a) (an agreement of the recipient is dispensed with for a substitute check deposited, presented, sent for collection, or returned, "so long as a bank has made the warranties in section 5 with respect to such substitute check.")

<sup>25</sup> Interbank settlement between California Depository Bank and New York Intermediary Bank may take various forms. For example, it may be either bilateral (on a correspondent account one bank has with the other), or part of

electronic negotiation of the check. Having agreed to accept the electronic transmission, the New York Intermediary Bank is now required under the Check 21 Act to create a paper substitute check. The Act further requires Payor Bank to accept the presentment of the substitute check as if it were the original check. Finally, any requirement, either by statute or agreement, to provide the canceled check, as under the contract between Drawer and Payor Bank, is to be satisfied under the Check 21 Act by providing the substitute check. In this hypothetical example, coast-to-coast physical transportation was eliminated; only local delivery of the substitute check could not be avoided.

A substitute check is a paper production of the original check that contains the image of the front and back of the original check. It bears a MICR<sup>26</sup> line containing the same information which appears on the MICR line of the original check, and conforms, particularly in paper stock and dimension, to generally applicable standards for substitute checks. As a result, the check is suitable for automated processing in the same manner as the original check.<sup>27</sup> Moreover, a substitute check, to be the legal equivalent of the original, must “accurately represent . . . all of the information on the front and back of the original check as of the time the original check was truncated” and bear the legend “This is a legal copy of your check. You can use it the same way you would use the original check.”<sup>28</sup>

As in the hypothetical above, a substitute check is typically created by a collecting intermediary bank. A substitute check, however, can also be created by the depository bank when it agrees to receive the deposit of the check from the payee/holder by means of electronic

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multilateral clearing house settlement. If the check is collected through the Reserve Banks, settlement will take place on the books of the Reserve Banks. The Check 21 Act does not deal with interbank settlement arrangements. *See* 12 U.S.C. §§ 5001-5018.

<sup>26</sup> MICR stands for Magnetic Ink Character Recognition Code (MICR Code), which is a character-recognition technology facilitating the automated processing of checks. The code typically includes the document-type indicator, bank code, bank account number, cheque number, cheque amount, and a control indicator. The technology allows MICR readers to scan and read the information directly into a data-collection device.

<sup>27</sup> 12 U.S.C. § 500(16); 12 C.F.R. § 229.2.

<sup>28</sup> 12 U.S.C. § 5003(b)(2); 12 C.F.R. § 229.51(a).

transmission. Furthermore, a substitute check may be created even by the payee/holder. For example, substitute check creation may be desirable for a large organization that receives checks in various locations, but would rather deposit them in one place. The organization may then arrange for the electronic transmission of check images to one place where substitute checks will be created. Alternatively, even an individual may transmit a check image to a depository bank using a mobile device. In general, a check may be transformed from electronic form to substitute checks form several times in the course of the collection and return process.

In connection with a substitute check, the Check 21 Act provides for warranties and an indemnity. The warranties ensure the substitute check meets the requirements for legal equivalence and also protects against double payment on the original check, or any other representation of the check.<sup>29</sup> The indemnity is “to the extent of any loss incurred . . . due to the receipt of a substitute check instead of the original check.”<sup>30</sup> Other than for costs, expenses, and reasonable attorney’s fees, amount to be indemnified is the extent of loss proximately caused by the breach of warranty.<sup>31</sup> In the absence of a breach of a warranty, amount of indemnity is limited to the amount of the substitute check.<sup>32</sup> Either way, amount of loss to be indemnified is reduced by amount representing loss resulting “from the negligence or failure to act in good faith on the part of an indemnified party.”<sup>33</sup> An example of loss incurred notwithstanding the lack of any breach of warranty occurs where forgery, proof of which would have allowed a purported drawer to avoid liability, cannot be proved on the substitute check, but allegedly could have been proved on the original. Thus, on occasion, an effective method to determine the authenticity of a manual signature could be by measuring the pen pressure input by the signer.<sup>34</sup> This feature does not carry over to the copy of the check and certainly not to a substitute check created from the image of the check.

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<sup>29</sup> 12 U.S.C. § 5004 (2003); 12 C.F.R. § 229.52(a).

<sup>30</sup> 12 U.S.C. § 5005(a).

<sup>31</sup> 12 U.S.C. § 5005(b)(1).

<sup>32</sup> 12 U.S.C. § 5005(b)(2).

<sup>33</sup> 12 U.S.C. § 5005(c) (2003); *see also* 12 C.F.R. § 229.53 (2015).

<sup>34</sup> *See e.g.*, PAUL S. TURNER, *supra* note 23, at 26.

Substitute check warranties are given by each bank “that transfers, presents, or returns a substitute check and receives consideration for the check.”<sup>35</sup> A “reconverting bank” is not listed. Being the bank that creates the substitute check or, where the substitute check is created by the depositor, the first bank that transfers or presents the substitute check, this bank can hardly be described as a bank that transfers a substitute check, unless “transfer” is to include the first delivery or issue. This indeed appears to be the view of the Federal Reserve.

In turn, indemnity liability is incurred by “[a] reconverting bank and each bank that subsequently transfers, presents, or returns a substitute check in any electronic or paper form, and receives consideration for such transfer, presentment, or return.”<sup>36</sup> Accordingly, the reconverting bank is listed as one to become liable to indemnify for loss caused by the breach of warranty.

As indicated, a substitute check need not necessarily be created by a bank; rather it may be created by a person other than a bank, typically a large organization-payee. In such a cases, under the Check 21 Act, warranties and indemnity liability originate from not from either payee or the creator of the substitute check, but rather from the first bank that transfers or presents such substitute check; such a bank, being the depository bank, is then considered to be the “reconverting bank” in the collection process.

Both substitute check warranties and the indemnity are stated to run to the benefit of the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser.<sup>37</sup> Since a check can be transformed from electronic form to substitute check form several times in the course of the collection and return process, it is possible that there could be multiple substitute checks, and thus multiple reconverting banks, with respect to the same payment transaction. A subsequent participant may thus benefit from warranties and indemnity of more than one reconverting bank. As well, a collecting bank receiving an electronic representation of a substitute (rather than original) check

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<sup>35</sup> 12 U.S.C. § 5004.

<sup>36</sup> 12 U.S.C. § 5004-5005; *see also* 12 C.F.R. §§ 229.52, 229.53.

<sup>37</sup> 12 U.S.C. §§ 5004-5005.

will both receive and pass on the reconverting bank's Check 21 Act warranty and indemnity protections.

The Check 21 Act further contains provisions covering expedited re-credit for consumers and banks. First, Section seven permits a consumer to challenge a debit for a substitute check either where the check was not properly charged to the consumer's account or where the consumer has a warranty claim.<sup>38</sup> In each case, the consumer must have suffered a resulting loss, and the production of the original check or a better copy of it is necessary to determine the validity of the challenge or claim. Second, Section eight governs a claim by a bank that is obligated to provide an expedited re-credit to the consumer or that has otherwise suffered loss in circumstances where "production of the original check . . . or a better copy of [it] is necessary to determine the validity of the charge to the customer account or any warranty claim connected with such substitute check."<sup>39</sup> The claim is a claim for indemnity from another bank that incurred the indemnity liability to the claimant bank under Section eight.<sup>40</sup>

The Check 21 Act allocates losses only among banks that handle a substitute check. However, it is possible that the problem giving rise to liability under the Check 21 Act was created prior to the creation of a substitute check. For example, electronic information derived from the check may have consisted of a poor image of the original check. This would preclude the reconverting bank from creating a legally equivalent check and thus cause it to be in breach of a substitute check warranty. Otherwise, a substitute check created by the payee and deposited at the depository bank may have been deficient in one way or another. At the same time, neither warranties nor indemnity liabilities are provided in the Check 21 Act in connection with the electronic transmission of check image or information. Similarly, no warranties or indemnity liability are fastened on a payee who creates a substitute check. Responsibilities of transmitters of electronic information and depositors of substitute checks are thus to be provided by their respective contracts with the immediate recipients of electronic information and substitute checks. This is consistent with

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<sup>38</sup> 12 U.S.C. § 5006.

<sup>39</sup> 12 U.S.C. § 5007(a)(1)(D).

<sup>40</sup> See 12 C.F.R. §§ 229.54-.55 (corresponding to and implementing 12 U.S.C. §§ 5006-5007).

the overall position under the Check 21 Act, under which no bank is required to receive electronic transmission of check data and no depository bank is required to accept the deposit of substitute checks. Having nevertheless agreed to accept such information or substitute checks, it is up to the collecting banks to execute their contractual obligations.

Contract, however, is not the exclusive source of regulating responsibilities outside the Check 21 Act. Under Regulation J, a sender of an electronic item derived directly from the original check makes two sets of warranties for the electronic item. First, the sender makes transfer warranties as if the item was a paper check governed by the U.C.C. Second, the sender makes warranties as if the item were a substitute check governed by the Check 21 Act.<sup>41</sup> For checks handled by Reserve Banks governed by Regulation J, an end-to-end combined U.C.C and Check 21 liability structure is thus provided.<sup>42</sup>

#### IV. INTERBANK EXCHANGE OF CHECK IMAGES

The Check 21 Act<sup>43</sup> does not provide rules to govern image exchange, inter-bank electronic negotiation, or electronic presentment or return. Rather, the Check 21 Act requires a collecting bank that agrees to accept the electronic transmission, whether from its customer or a prior collecting bank, to issue a substitute check to be processed onward as if it were the original check.

A bank's authority to accept an electronic check transaction derives from the U.C.C. As indicated, under U.C.C Section 4-110 (b), "[p]resentment of an item pursuant to an agreement for presentment is made when the presentment notice is received." Under U.C.C Section 4-110(a), "Agreement for electronic presentment" is defined to mean "an agreement, clearing-house rule, or Federal Reserve regulation or operating circular, providing that presentment of an item may be made by transmission of an image of an item or information describing the item ("presentment notice")." While this is limited to

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<sup>41</sup> See Collection of Checks and Other Items by Federal Reserve Banks and Fund Transfers Through Fedwire, 12 C.F.R. §§ 210.2, 210.6, 210.12 (2015).

<sup>42</sup> For background see 12 C.F.R. 210 (2015).

<sup>43</sup> 12 U.S.C. § 5001 *et seq.*

the electronic presentment of checks, U.C.C Section 4-103(a) is broader. Thereunder, in general and subject to limitations relating to disclaimer clauses, “[t]he effect of the provisions of . . . Article [4] may be varied by agreement.” While such agreements bind only those who are parties to them, under U.C.C. Section 4-103(b), “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of agreements under subsection (a), whether or not specifically assented to by all parties interested in items handled.” “Clearing house” is defined in Section 4-104(a)(4) as “an association of banks or other payors regularly clearing items.” Accordingly, bilateral and multilateral agreements, clearing house rules, and Federal Reserve regulations and operating circulars may govern the exchange, namely the interbank negotiation presentment and return of check images or information relating to them, as substitutes to physical delivery.

In practice, there are two principal sets of image exchange rules. Essentially, both endeavor to equate the position of check images to that of the checks themselves under existing legislation and other sources of law. In fact, they extend the legal framework of the Check 21 Act<sup>44</sup> to cover image exchanges. The first set of image exchange rules is Subpart A of Regulation J governing interbank exchange through Federal Reserve Banks.<sup>45</sup> Further implemented by Operating Circular No. 3, it specifically deals with the collection of checks and other items by Federal Reserve Banks. Thereunder, an “item” is broadly defined to cover an electronic image of a paper check.<sup>46</sup> The second is Electronic Check Clearinghouse Organization (ECCHO) Operating Rules.

ECCHO<sup>47</sup> is “a national not-for-profit ‘rule-making organization’ owned entirely by its member banks.”<sup>48</sup> As “an

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<sup>44</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>45</sup> 12 C.F.R. § 210.

<sup>46</sup> 12 C.F.R. § 210.2(i)(1)(ii).

<sup>47</sup> See ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION, RULES SUMMARY (2012); see also *Membership Overview*, ECCHO, <http://www.eccho.org/membership> (last visited Oct. 18, 2015); see also VIVECA Y. WARE, CHECK IMAGE EXCHANGE: COVERING LEGAL BASES (2008).

<sup>48</sup> Alvin C. Harrell, *Electronic Checks*, 55 CONSUMER FIN. L.Q. REP. 283 (2001).

association of banks or other payors regularly clearing items,” ECCHO is a clearing house under U.C.C Section 4-104(a)(4). This is so even though ECCHO does not process payments. Rather, ECCHO develops rules governing electronic exchanges of check images. Such rules qualify as “clearing-house rules” under U.C.C Section 4-103(b), which govern bilateral and multilateral exchanges of member banks that choose to adhere to them. Per that provision, “all parties interested in [the checks]” are bound by such rules governing their exchange.<sup>49</sup>

ECCHO was established in 1990. It is common knowledge that the primary drive behind its establishment was to address the increased risk resulting from the introduction of tight funds availability schedules for checks under Regulation CC.<sup>50</sup> The use of electronics expedited both the forward presentment and return processes so as to allow banks to meet the statutory tight schedules.

ECCHO has four membership classes: Full Members, Affiliate Members, Participating Members, and Sponsored Members. The different classes reflect variations in Members’ roles in the corporate governance of the organization. A Member must establish the technological and communication methods for exchanging electronic check transactions with another Member.

ECCHO Rules apply to the interbank exchange, by negotiation or presentment, of check images. ECCHO Rules do not, however, apply to the substitute checks that reproduce check images. Substitute checks, and to some extent, images of substitute checks, are governed by Check 21 Act<sup>51</sup> and provisions of Regulation CC<sup>52</sup> implementing it. ECCHO Rules govern only electronic check transactions between two Members. A Member is not required, by virtue of its membership, to send and receive electronic check transactions with another Member. Member agreements may designate a particular electronic communication switch or a check image archive to exchange electronic check images and are outside the ECCHO framework. While

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<sup>49</sup> U.C.C. § 4-103(b) (2015).

<sup>50</sup> Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229 (2015).

<sup>51</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>52</sup> 12 C.F.R. § 229.



supporting a number of processes for check image exchange, ECCHO Rules do not establish the rules for accessing or using private networks/archives. Members may thus exchange electronic check transactions in whatever way they choose. On occasion, two networks may agree to establish a “bridge” or link to facilitate an exchange between sending and receiving Members each using a separate network.

A Member which agreed with another Member to exchange electronic check transactions under ECCHO Rules is bound to comply with ECCHO Rules. These Rules do not constitute customer agreements, but they bind customers by virtue of U.C.C Section 4-103(b).

ECCHO Rules provide for the legal framework for both forward check image presentment and return of a check image. In a forward check image presentment, both the Electronic Image and the related MICR line information are sent<sup>53</sup> or made available to the receiving Member by an applicable deadline. The check itself is not sent to the receiving Member. Under ECCHO Rules, the Electronic Image is an “item” as well as “check” under the U.C.C and Regulation CC.<sup>54</sup> ECCHO Rules also provide for the time presentment is actually made and further address diverse matters such as indorsements and storage and retrieval of the original check.<sup>55</sup> To protect the receiving Member in each electronic check transaction, ECCHO Rules provide for indemnifications and warranties, some of which are in addition to those provided under the U.C.C and Regulation CC.<sup>56</sup> Particularly, these warranties relate to the compliance with ECCHO Rules as well as the accuracy and quality of the Electronic Image.

An important warranty given by a sending bank is a warranty against double payment. This warranty is originated by the first bank

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<sup>53</sup> For transmission of an electronic image of a check via wire communication, albeit to a Federal Reserve Bank, *see, e.g., United States v. Jimian*, 712 F.3d 1255, 1259 (9th Cir. 2013).

<sup>54</sup> 12 C.F.R. § 229.

<sup>55</sup> ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION, OPERATING RULES AND COMMENTARY (2014).

<sup>56</sup> *Id.*

that transferred an image. A bank may mistakenly send the same image more than once. Where the first image is created by the depositor, a few alternative scenarios may develop as the result of either error or fraud. The holder may send an image of the check for deposit more than once, and may not send it to the same bank. Alternatively the holder may send the image of the check for deposit to a bank and then negotiate the paper check to a subsequent holder. Practically, the latter may be a check cashing service, or even another depository bank. The chance is that any subsequent holder, including a depository bank which took either the paper check or an electronic image of it, will be a holder in due course.<sup>57</sup>

The warranty given by the bank that originated the image is designed to protect the payor bank in all such scenarios. Thus, a payor bank that paid twice may not be able to debit the drawer-customer's account more than once and will recover on the aforesaid warranty. The Paying Bank is only required to establish the existence of a double payment for the same item and that the Paying Bank incurred a loss as a result. ECCHO Rules do not provide for a warranty or any other responsibility on a depositor who remotely deposited the check by capturing its image and sending it to the depository bank. It is up to the latter to provide for a recourse against the capturing depositor in its customer agreement.

The application of the warranty against double payment in the context of a holder in due course is consistent with and furthers the general underlying policy as expressed in the warranty provisions of the Check 21 Act,<sup>58</sup> Regulation CC<sup>59</sup> provisions applicable to substitute checks, and the ECCHO Rules. This policy aims at protecting the payor bank and drawer customer from losses associated with double payment of a check image or substitute check. Moreover, where the first image was created by the depositor, it is appropriate for the depository bank to bear risk of loss from any resulting double payment. This is so because the bank that transferred the first check image introduced the risk of double payment into the system by allowing its customer to engage in remote deposit capture.

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<sup>57</sup> U.C.C. §§ 3-302, 4-211.

<sup>58</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>59</sup> 12 C.F.R. § 229.

Under a proposal of the Board from 2013,<sup>60</sup> and unless otherwise agreed by the sending and receiving banks,<sup>61</sup> electronic images of checks and electronic information related to checks that banks send and receive by agreement would be subject to Subpart C of Regulation CC as if they were paper checks. Under the earlier version of the Proposal from 2011, the object of each such electronic transmission was called “electronic collection item” or, in the case of returning it dishonored, “electronic return.” The 2013 Proposal preferred to rename them “electronic check” and “electronic return check,” respectively.<sup>62</sup> In departure from the 2011 version, under the 2013 Proposal, electronic checks and electronic returned checks could consist of either check electronic image or check electronic information, and not necessarily both.<sup>63</sup>

Since under proposed Section 229.30(a)<sup>64</sup> electronic checks and electronic returned checks are subject to the provisions of subpart C as if they are checks, a bank that handles them gives all checks warranties and indemnities.<sup>65</sup> Proposed §229.34(a) will provide for additional “Check-21-like warranties”<sup>66</sup> specifically given with respect to electronic checks and electronic returns. Under proposed §229.34(a)(1), each bank that transfers or presents an electronic check

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<sup>60</sup> Availability of Funds and Collection of Checks, 79 Fed. Reg. 6673-6737 (Feb. 4, 2014) (to be codified at 12 C.F.R. 229) [hereinafter FRS Availability Proposal].

<sup>61</sup> In 12 C.F.R. § 229.37(a), the FRS Availability Proposal would permit a sending and receiving bank by agreement to vary the warranties the sending bank makes to the receiving bank for electronic checks and electronic returned checks. Such an agreement could provide, for example, that the bank transferring the electronic check does not warrant that the electronic image or information are sufficient to create a substitute check. The agreement would not, however, vary the effect of the warranties with respect to banks and persons not bound by the agreement. *Id.* at 6684.

<sup>62</sup> Availability of Funds and Collection of Checks, 76 Fed. Reg. 16862 (Mar. 25, 2011) (to be codified at 12 C.F.R. § 279).

<sup>63</sup> See FRS Availability Proposal, *supra* note 60.

<sup>64</sup> *Id.*

<sup>65</sup> See Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. §229.34(d)-(f) (2015) (warranties relating to (i) settlement amount, encoding, and offset; (ii) returned checks; and (iii) notice of nonpayment).

<sup>66</sup> See FRS Availability Proposal, *supra* note 60 at 6683.

or electronic returned check and receives a settlement or other consideration for it warrants that:

- (i) The electronic image accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated and the electronic information contains an accurate record of all MICR line information required for a substitute check . . . and the amount of the check, and
- (ii) No person will receive a transfer, presentment, or return of, or otherwise be charged for an electronic check or electronic returned check, the original check, a substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid.<sup>67</sup>

This is a double warranty for (i) the accuracy and completeness of the electronic record, and (ii) double payment of the check. Under paragraph 2, the beneficiary of the double warranty, is:

- (i) In the case of transfers for collection or presentment, the transferee bank, any collecting bank, the paying bank, and the drawer; and
- (ii) In the case of transfers for return, the transferee returning bank, any subsequent returning bank, the depositary bank, and the owner.<sup>68</sup>

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<sup>67</sup> *See id.* at § 229.34(a)(1).

<sup>68</sup> *See id.* (Board requested comment on whether the drawer under sub-paragraph (i) or owner under sub-paragraph (ii) should be required to make a claim against his or her bank before making a breach of warranty claim against a prior collecting bank.).

Under proposed §229.34(g), an additional indemnity is given in the case of a remote deposit capture, namely where an electronic check is created by the depositor. This indemnity inures to the benefit of a depository bank to which the depositor, having deposited the electronic check, deposited the original paper check with another depository bank. In such a case, an indemnity is given by a depository bank which “(i) [i]s a truncating bank under § 229.2(eee)(2) because it accepts deposit of an electronic check related to an original check; (ii) [d]oes not receive the original check; (iii) [r]eceives settlement or other consideration for an electronic check or substitute check related to the original check; and (iv) [d]oes not receive a return of the check unpaid.”<sup>69</sup> Such a depository bank shall indemnify a depository bank that accepts the original check for deposit for losses incurred by that depository bank if the loss is due to the check having already been paid.

The indemnity would allow a depository bank that accepted a deposit of an original (paper) check to recover directly from a bank that permitted its customer to deposit the check through remote deposit capture.

Under proposed §229.34(i)(1), the indemnity amount shall not exceed the sum of—

- (i) The amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank; and
- (ii) Interest and expenses of the indemnified bank (including costs and reasonable attorney’s fees and other expenses of representation).<sup>70</sup>

However, under proposed §229.34(i)(2)(i), and without reducing “the rights of a person under the UCC or other applicable provision of state or federal law,”<sup>71</sup> if such loss

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<sup>69</sup> See *id.*

<sup>70</sup> See *id.*

<sup>71</sup> See *id.* at §229.34(i)(2)(ii).

results in whole or in part from the indemnified bank's negligence or failure to act in good faith, then the indemnity amount . . . shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank.<sup>72</sup>

In its Commentary to the Proposal, the Board rationalized the allocation of the double deposit risk to the truncating bank as follows:

[T]he depositary bank that introduced the risk of multiple deposits of the same check by offering a remote deposit capture service should bear the losses associated with multiple deposits of a check. A depositary bank that receives the benefit of permitting its customers to use remote deposit capture should also internalize any risk or cost to other banks that may result from remote deposit capture. One such risk is that the customer will deposit the original check at another bank. That bank that accepted the check by remote deposit capture is in a better position than any other bank to minimize those costs and risks through the terms of its contract with its customer.<sup>73</sup>

At the same time, the Board requested comments on unintended consequences that might result from the indemnity as well as “on whether the depositary bank that accepts the original check for deposit would be able to identify the depositary banks against which it may bring a claim for indemnity . . . and whether there are other more efficient or practical remedies to address the underlying problem.”<sup>74</sup> However, no remedy is provided in the case of multiple electronic checks created by a depositor related from the same paper check.

It should be noted that, under the U.C.C., a bank that receives an electronic deposit of a check may arguably be able to control the risks of multiple deposits and negotiation of the paper check to a

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 6685.

<sup>74</sup> *Id.*

holder in due course by having the negotiability of the check curtailed.<sup>75</sup> Thus, U.C.C Section 3-104(d) effectively provides<sup>76</sup> that:

a check is [a negotiable instrument even] if, at the time it is issued. . . , it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by this Article.<sup>77</sup>

This language does not appear to preclude a requirement made by a bank receiving an electronic deposit to have the check marked as “non-negotiable” or some other language to that effect at the time of the deposit (as opposed to the time of its issue). Such marking may even preclude a competing depositary bank from claiming a holder in due course status to the extent that U.C.C Section 4-205 protects a depositary bank claiming a holder in due course status only against the lack of indorsement but not otherwise.<sup>78</sup>

A more limited protection appears to be offered under U.C.C Section 4-201(b), providing that once an item has been indorsed with words such as “pay any bank,” “only a bank may acquire the rights of

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<sup>75</sup> For the holder in due course and the holder in due course power to defeat competing claims to the instrument, *see* U.C.C. §§ 3-302, 305, 306 (2015).

<sup>76</sup> The provision reads in full as follows: “A promise or order other than a check is not [a negotiable instrument] if, at the time it is issued or first comes into possession of a holder, it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by this Article.”

<sup>77</sup> U.C.C. § 3-104 (2015).

<sup>78</sup> *See* U.C.C. § 4-205 (2015) (stating that “[i]f a customer delivers an item to a depositary bank for collection: (1) the depositary bank becomes a holder of the item at the time it receives the item for collection if the customer at the time of delivery was a holder of the item, whether or not the customer indorses the item, and, if the bank satisfies the other requirements of U.C.C. § 3-302 (2015), it is a holder in due course.”); *see also* U.C.C Section 4-104(a)(9) (2015) (where “item” is defined as “[a negotiable] instrument or a promise or order to pay money handled by a bank for collection or payment”). While an item need not necessarily be “negotiable,” under U.C.C § 3-302, a holder in due course may exist only in connection with a negotiable instrument.

a holder”<sup>79</sup> so as to be able to defeat an adverse claim by a non-bank, albeit not necessarily by a competing depositary bank. However, along these lines, protection expands and becomes maximal under U.C.C. Section 3-206(c) covering a check bearing:

an indorsement (i) described in Section 4-201(b), or (ii) in blank or to a particular bank using the words “for deposit,” “for collection,” or other words indicating a purpose of having the instrument collected by a bank for the indorser or for a particular account . . . .<sup>80</sup>

In this case, Section 3-206(c) states:

- (1) A person, other than a bank, who purchases the instrument when so indorsed converts the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement.
- (2) A depositary bank that purchases the instrument or takes it for collection when so indorsed converts the instrument unless the amount paid by the bank with respect to the instrument is received by the indorser or applied consistently with the indorsement.<sup>81</sup>

Effectively, this means that to achieve maximum protection,<sup>82</sup> and notwithstanding the fact that from a business perspective this may

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<sup>79</sup> See U.C.C. § 4-201(b) (2015) (where this is so, until the item has been: “(1) returned to the customer initiating collection; or (2) specially indorsed by a bank to a person who is not a bank.”)

<sup>80</sup> U.C.C. § 3-206(c) (2015).

<sup>81</sup> *Id.*

<sup>82</sup> Having transmitted to Bank A an image of a check indorsed to Bank A, a defrauding depositor may erase the indorsement, indorse the check to Bank B (or to non-bank C), and transmit the image for deposit to Bank B (or negotiate the paper check to non-bank C). I would argue that in such a case, the defrauding customer effectively either forged the holder’s indorsement on the check or altered the check in which the starting point for the discussion on the loss allocation is either U.C.C. §§ 3-403 or 3-407 (2015).



be unappealing, a depository bank would be advised to accept electronic deposit only of images of checks indorsed specifically to it.

#### V. ELECTRONIC PAYMENT ORDER (EPO) AS “PAPERLESS CHECK”<sup>83</sup>

So far, the electrification of check transaction has been discussed as it relates either to the issue of a check on the basis of the issue of electronic instruction, or to the “conversion,” deposit, interbank negotiation, and presentment of the check. Other than inter-party negotiation outside the bank collection system for which, so far, no strong business case has been made, the “last mile” in check electrification is concerned with the elimination of paper as early as on the issue of the “check.” This is feasible technologically and efficient economically; it is indeed said that the EPO possesses features such as “speed, finality, relatively low cost, and ubiquity.”<sup>84</sup> At the same time, from a legal perspective, the legal features of the EPO are not entirely clear. Particularly, strictly speaking, this payment method is not a “check” as it does not involve anything tangible in writing. Indeed, check truncation in all its forms is premised on an image as well as a substitute check as derivations of a paper check issued by the drawer to the payee (or bearer).

In the absence of a statutory or otherwise precise definition, broadly speaking, an electronically issued payment order, with all other characteristics of a check, which is treated as a ‘paperless check’ is known as an EPO. Like a paper check,<sup>85</sup> an EPO is typically issued by the drawer/payer and is addressed to the drawee/payor bank, ordering the payor bank to pay on demand a sum certain in money to the payee (or bearer) to whom the order is issued. As with a paper check, an EPO may be issued on behalf of the drawer by the payee or at the drawer’s

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<sup>83</sup> See, e.g., KATY JACOB ET AL., FEDERAL RESERVE BANK OF CHICAGO: FINANCIAL MARKETS GROUP, DIGITAL CHECKS AS ELECTRONIC PAYMENT ORDERS (2009); see also MARY KEPLER, RETAIL PAYMENTS RISK FORUM, A SUMMARY OF THE ELECTRONIC PAYMENT ORDER FORUM (2013); see also PHYLLIS MEYERSON, ELECTRONIC PAYMENT ORDERS (EPOs) (2013). The discussion in this subsection draws on these sources.

<sup>84</sup> See generally KEPLER, *supra* note 83.

<sup>85</sup> “Paper-check,” as defined in U.C.C. § 3-104(f) (2015), in conjunction with U.C.C. §§ 3-103(a)(8) and 3-104(e) (2015), is used in this section in the sense of a “check” to distinguish it from the EPO.

instruction by the bank itself. In the former case it is the equivalent of either a Remotely Created Check (RCC), or even an electronic check. In the latter case, when issued by the drawer's bank, it is the equivalent of a cashier's check or a teller's check.<sup>86</sup>

An EPO generated from a mobile device such as a mobile phone is also referred to as a "digital check." It is issued under a banking application which exploits the computing properties of the mobile platform to provide built-in authentication, communications, and security for electronic check writers. Thus, an account holder who wishes to make payment may use his or her mobile device to issue a "digital check." He or she may access the address book on the mobile device for a list of potential payees. The list can be updated by the account holder using the mobile device at any time. The account holder then sets out the amount of the "check" and the date, and then *physically* 'signs' on the screen as if he or she signs manually on a piece of paper. As a security safeguard, the pressure and speed the writer uses in making the signature can be recorded for the transaction. This "improves" on the loss of the ability to determine pen pressure in images and, in the case of substitute checks, prevents disputes as to the authenticity of the payment instructions. A proposed complementary security method is that of a national check registry.<sup>87</sup>

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<sup>86</sup> See U.C.C § 3-104(g) (2015) (a "[c]ashier's check' means a draft with respect to which the drawer and drawee are the same bank or branches of the same bank."). A "[t]eller's check' means a draft drawn by a bank (i) on another bank, or (ii) payable at or through a bank." Effectively, a cashier's check as well as a teller's check is a check drawn by a bank.

<sup>87</sup> *Id.* ("Such a national registry would have been totally impractical to implement in an all-paper environment, but would be relatively straightforward in a digital environment. Given a national registry operating as a utility, EPO users could download blank check images from the national check registry. As EPOs were processed and cleared through the banking system, the existence of each item could be verified in the national registry. Each device could obviously have its own internal check registry for each separate account. As items cleared against an individual account, the update would be reflected on the internal registry so account holders would have an up-to-date picture of their account balances. In addition to helping with budgeting and self-control issues, this concurrent information would also be useful to detect potential fraud." JACOB, *supra* note 67, at 15-16. However, the authors add a warning: "While straight forward conceptually, a national registry [being 'organized as a top-down utility'] could end up being a roadblock to enhanced security over time.")

The software check program then creates a visual image of both the front and the back of the “check,” and takes a screen shot of the image. The program then transmits an encrypted version of the imaged “check” (to which the “handwritten” signature is attached) to the payee who will then deposit it electronically to his or her account with the depository bank. In principle, there is no preclusion from devising a scheme that will allow the electronic negotiation of the “check” outside the banking system prior to its deposit by the last non-bank holder.

Arguably, so far as payments out of consumer accounts are concerned, the Electronic Fund Transfer Act<sup>88</sup> and Regulation E<sup>89</sup> implementing it would govern the relationship between the drawer and the drawee bank.<sup>90</sup> In the absence of an existing comprehensive statutory and regulatory framework, private agreements are required to fill the gap and determine legal issues involving the EPO. A natural inclination is to resort to the U.C.C. and the Check 21 Act. Briefly stated, two caveats are to be mentioned. First, both U.C.C. Articles 3 and 4 envisage paper documents and as such cannot be made to apply mechanically on a wholesale basis. Second, since there is no paper item to begin with, Article 4 does not apply on its own force as a statute. Accordingly, Section 4-103(b), under which “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of agreements . . . whether or not specifically assented to by all parties interested in items handled,” cannot be relied upon to affect “parties interested in items handled” who have “not specifically assented to” them.<sup>91</sup>

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<sup>88</sup> 15 U.S.C. § 1693 *et seq.* (2010).

<sup>89</sup> Electronic Fund Transfers, 12 C.F.R. § 205 (2015).

<sup>90</sup> *See generally* 12 C.F.R. § 205.3; *see also* 12 C.F.R. § 205.3(b) (“The term electronic fund transfer [to which the Regulation applies] means any transfer of funds that is initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit a consumer’s account.”); *see also* 12 C.F.R. § 205.2(e) (Enumerated non-exclusive example focus on public access terminals. “Consumer” is defined as “a natural person.”).

<sup>91</sup> U.C.C. § 4-103(b) (2015).

Purporting to address the collection of EPOs,<sup>92</sup> the Federal Reserve Board (“Board”) noted that not being derived from an original paper check, an electronically-created check image cannot be used to create a substitute check that meets the requirements of the Check 21 Act and Regulation CC. The Board, however, observed that as a practical matter a collecting bank receiving an electronically-created check image cannot distinguish it from an image of a paper check that it receives electronically. The bank may transfer the image as if it were derived from a paper check, or produce a paper item that is indistinguishable from a substitute check. Under a proposed revision to Section 229.34 of Regulation CC, the Board proposed that a bank that transfers an image in the collection system would make all warranties the bank would make if the image were derived from a paper check. By the same token, such an image could be the basis from which a valid substitute paper check be created.

In addition, under the proposal a bank receiving a warranty claim related to an electronic collection item, electronic return, or a nonconforming substitute check would be able to pass back its liability for the item to the bank from which it had received the electronically-created image and information. Recognizing that in some instances the first bank to make the warranty may not know whether an image and information came from a paper instrument, the Board nevertheless expressed its view that that bank is in the best position to know and to protect itself contractually against the risk.

Accordingly, under the Board’s 2013 Availability Proposal,<sup>93</sup> proposed Section 229.34(b) provides for an indemnity with respect to an electronic image or electronic information not related to a paper check. It covers situations where either the drawer or the payee under the drawer’s authority creates an electronic image. The latter case may be referred to as an eRCC.<sup>94</sup> Under proposed Section 229.34(b):

Each bank that transfers or presents an electronic image or electronic information that is not derived

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<sup>92</sup> Availability of Funds and Collection of Checks, 76 Fed. Reg. 16862 (March 25, 2011) (to be codified at 12 C.F.R. 229); *see also* FRS Availability Proposal, *supra* note 60.

<sup>93</sup> Availability of Funds and Collection of Checks, *supra* note 92.

<sup>94</sup> eRCC stands for a Remotely Created Electronic Check.

from a paper check and for which it receives a settlement or other consideration shall indemnify each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against losses as set forth in paragraph (i) of this section that result from the fact that the electronic image or electronic information is not derived from a paper check.<sup>95</sup>

Presumably, the reference is to Proposed Section 229.34(a)(1)(i) under which the warranty given with respect to electronic checks and electronic returns is that:

The electronic image accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated and the electronic information contains an accurate record of all MICR line information required for a substitute check . . . and the amount of the check.<sup>96</sup>

As explained in the Commentary to the Proposal:

Proposed § 229.34(b) would provide that a bank that transfers an electronic image or electronic information that is not derived from a paper check indemnify the transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check. This proposed indemnity would protect a bank that receives an electronically-created item from a sending bank against any loss or damage that results from the fact that there was no original check corresponding to the item that the sending bank transferred.<sup>97</sup>

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<sup>95</sup> See FRS Availability Proposal, *supra* note 60.

<sup>96</sup> *Id.*

<sup>97</sup> See *id.* at 6695.

In particular, this purports to cover all losses caused by warranty breaches had the electronically-created item been derived from a paper check. It also covers losses caused by the absence of paper at any stage of the life of the payment item, a fact of which the drawee bank may be unaware.

The indemnity under proposed Section 229.34(b) would not flow to the drawer, payee, or the depository bank. The Board rationalized that “the payee and the depository bank are in the best position to know whether an item is electronically created and to prevent the item from entering the check collection system.”<sup>98</sup> The Board went on to explain that the depository bank can contractually pass the risk to the payee. Finally, it is the drawer who introduced “items electronically created by the [drawer]” into the check collection system.<sup>99</sup> At the same time, had the item been introduced as an eRCC without the purported drawer’s authority, the latter will be protected under U.C.C 4-401(a) as an item which is not “properly payable.”

Under proposed Section 229.34(i)(1) the indemnity amount shall not exceed the sum of:

- (i) The amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank; and
- (ii) Interest and expenses of the indemnified bank (including costs and reasonable attorney’s fees and other expenses of representation).

However, under proposed Section 229.34(i)(2)(i), and without reducing “the rights of a person under the UCC or other applicable provision of state or federal law” if such loss “results in whole or in part from the indemnified bank’s negligence or failure to act in good faith, then the indemnity amount . . . shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank.”<sup>100</sup> The Board requested comment on its proposal to provide an

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<sup>98</sup> *See id.*

<sup>99</sup> *Id.* at 6696.

<sup>100</sup> *See id.* at § 229.34(i)(2)(ii).

indemnity claim related to electronically-created items instead of extending the check warranties of § 229.34 to electronically-created items.<sup>101</sup>

#### CONCLUDING OBSERVATIONS

Wishing to accommodate both manual and electronic handling of checks by the various participants in a check transaction, regulators have been providing for an extremely flexible scheme covering diverse situations and facilitating maximum freedom of movement between paper and image, original and copy. However, an environment in which one set of rights and duties is embodied in original paper, its copy, and its electronic image, all of which co-exist, albeit not necessarily in the same hands, is quite unsafe, as it may lead to conflicting claims to the paper and its image. It is bound to create an ‘explosive’ mixture leading to conflicting legitimate expectations. To minimize surprises, rules are to be detailed. At the same time they cannot satisfy every innocent party in the check transaction.

In the final analysis, a move towards complete electronification from end to end seems to be appropriate in the electronic age and is to be encouraged. A fully electronic check transaction is interchangeable with a one-time electronic debit transfer. In the latter, the payor authorizes the payee to draw funds out of the payor’s account. The issuance of an EPO to the payee serves the same purpose. It is obvious then that the two transactions converge. From that perspective, the convergence between the laws that govern those transactions ought to be seriously considered. A cohesive forward-looking legal framework, consisting of statutory, regulatory, and contractual sources, ought to address debit transfers as a distinct form of payment. This is true even if in response to business demands a mixed paper and electronic image environment is still to be accommodated, at least for some time. Indeed, Articles 3 and 4 of the Uniform Commercial Code provide a comprehensive framework governing the payment and collection of paper based debit instruments. At the same time consideration is to be given to the

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<sup>101</sup> *Id.* at 6684 (the Board further requested comment on whether losses proximately caused from not being able to make the warranty claim should be interpreted to cover damages awarded for violations of Regulation E).

drafting of a new Article 3A of the Uniform Commercial Code to form a comprehensive piece of legislation governing electronic debit transfers including the electronic cheque transaction. The current mixture of state and federal laws as well as private agreement is too segmented to guaranty a sound evolution of the law to address forthcoming innovations and the new issues they raise.



**CLEAN BILL OF LADING IN CONTRACT  
OF CARRIAGE AND DOCUMENTARY  
CREDIT: WHEN CLEAN MAY NOT BE  
CLEAN**

*Časlav Pejović\**

INTRODUCTION

*X is a small producer of plastic products from China. Searching on internet for suppliers of plastic raw materials X found Y, a supplier based in the United States, offering these materials at a very favourable price. X and Y entered into sale contract under Cost, Insurance, and Freight (CIF) terms. Following CIF terms, payment was to be made by letter of credit. Y shipped the goods in a container and delivered for carriage within the agreed time. Carrier then inserted a “said to contain” clause into the bill of lading, and the bank accepted such document. When X opened container it discovered that the goods were in such bad condition that they could not be used in the manufacturing process. X contacted Y, by email, and demanded delivery of substitute goods, which would conform to the contract. Y refused, claiming that the goods were delivered for carriage in good condition. Y could not be reached by telephone, and its address stated on its website was wrong. X had no redress against the Carrier, because the Carrier validly excluded its liability with a “said to contain” clause. The Bank was also not liable, because this clause was acceptable under the letter of credit rules. X contacted a lawyer in the United States, and after receiving an estimate of attorney expenses, which would not be recoverable under the U.S. law, X decided to give up the case and bear the loss.<sup>1</sup>*

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\* Professor of Law, Kyushu University, Faculty of Law; LL.B., Montenegro University; LL.M., Belgrade University; LL.M., Kyoto University;

It is common knowledge, in international trade community, that bills of lading (bills), under certain conditions, may contain reservations inserted by the master, and that banks normally should reject bills that are not clean. Yet, it is far less known that clean bills of lading, under the rules governing carriage of goods and those governing letters of credit may be not only different, but even contradictory. Specifically, certain clauses may make a bill of lading unclean under rules of carriage, but not under the letter of credit rules. It is interesting to note that all leading texts on letters of credit are silent on this issue.<sup>2</sup> One of the few scholars who has identified this issue is Hugo Tiberg, one of the world's leading maritime law authorities. Tiberg suggested that the Uniform Customs and Practices for Documentary Credits (UCP)<sup>3</sup> should expand the meaning of "uncleanliness."<sup>4</sup>

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Ph.D., Zagreb University. The author is grateful to Hugo Tiberg, Jan Ramberg, and Rawi Meckvichai for their constructive comments and suggestions, which helped to refine this article. I owe special thanks to David Meynell, Senior Technical Adviser to the ICC Banking Commission who provided valuable information regarding background of relevant provisions of the UCP. Of course, I remain responsible for all eventual errors in this paper.

<sup>1</sup> This is not hypothetical but a real case brought to my attention by my ex-student whose family was subjected to this kind of trouble.

<sup>2</sup> Ebenezer Adodo in his recent book on letters of credit, in an attempt to justify omission of a detailed discussion of transport documents in his text states that transport documents have not been "the subject of serious controversies in the last several decades", and that the banks are not "in great need of fresh insights" regarding this theme: EBENEZER ADODO, *LETTERS OF CREDIT: THE LAW AND PRACTICE OF COMPLIANCE* 7.02 (2014).

<sup>3</sup> The Uniform Customs and Practice for Documentary Credits were promulgated by the International Chamber of Commerce (I.C.C.) in 1933, and were revised in 1951, 1962, 1974, 1983, 1993, and 2007 (I.C.C. Pub. No. 600). For most current version, see Int'l Chamber of Commerce, *Uniform Customs and Practice for Documentary Credits*, I.C.C. Pub. No. 600 (2007) [hereinafter UCP].

<sup>4</sup> Hugo Tiberg, *Carrier's Liability for Misstatements in Bills of Lading*, in *MARITIME FRAUD* 71 (1983). I have also written one paper on this issue, but from a different angle, with the main focus on the cause of the discrepancy of rules and different legal effects of clauses under two different sets of rules. Časlav Pejović, *Clean Bill of Lading in Contract of Carriage and Contract of Sale: Same Name and Different Meanings*, 2 J. INT'L COM. L. (2003).

The main objective of this article is to analyze the discrepancies between the rules governing carriage of goods by sea and the rules governing letters of credit, as well as highlight the potential problems that may arise as a consequence of this discrepancy, particularly in light of the risk of documentary fraud. The ultimate goal of this article is to draw attention to the need to revise the definition of a clean bill of lading in future UCP revisions.

## I. BACKGROUND

The two most basic obligations in contracts of sale are (1) the obligation of the seller to deliver the goods and (2) the obligation of the buyer to pay the price. In international sales, the performance of both of these obligations is met with certain difficulties, mainly because of the distance between the parties. International sales involve a number of parties that are often geographically distant from each other; the seller's obligation of delivery is performed through a carrier under a contract of carriage, while the buyer's obligation of payment is normally performed through a bank, typically by letter of credit. The payment is regularly conditioned on evidence of the movement of the goods, i.e. by evidence that the goods are loaded onboard and are on their way to the destination.

An essential characteristic of overseas sales is that the buyer pays not against the delivery of the goods, but against the tender of a set of documents usually comprised of an invoice, a bill of lading, and a marine insurance policy. This implies that the seller has an obligation to make two kinds of delivery: (1) delivery of the goods and (2) delivery of the documents.<sup>5</sup> Because the documents appear to be the subject matter of the sale, this sale is sometimes referred to as a "sale of documents."<sup>6</sup> Once in possession of documents required by the

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<sup>5</sup> Article 30 of the Convention on Contracts for the International Sale of Goods (CISG) provides for this double obligation: "The Seller must deliver the goods, hand over any documents relating to them . . ." United Nations Convention on Contracts for the International Sale of Goods, Apr. 10, 1980, 1489 U.N.T.S. 3, 19 I.L.M. 671, art. 30 [hereinafter CISG].

<sup>6</sup> In *Arnbold Karberg & Co. v. Blythe Green Jourdain & Co.* [1915], 2 K.B. 379 at 388 (Eng.), Scrutton J referred to a CIF (cost, insurance, and freight) contract as a sale of 'documents relating to goods' but this was disapproved on appeal *Arnbold Karberg & Co. v. Blythe Green Jourdain & Co.* [1916], 1 K.B. 495 at 510, 514 (Eng.).

contract of sale, the seller notifies the buyer that he will tender those documents against payment or acceptance. The seller then presents the bill of exchange to the buyer's bank, together with a bill of lading and other documents. The bank should pay against the documents only if those documents are in accordance with requirements set by the UCP and the specific instructions of the buyer.

This specific character of a documentary sale is based on the bill of lading. When the parties agree that payment is to be made against documents, the seller must transfer to the buyer the bill of lading at the moment the buyer pays the price. By transferring the bill of lading to the buyer, the seller furnishes proof that he exercised his obligations under the sale contract and transfers to the buyer the right to receive the goods when they arrive at the port of destination. In this way, the seller can receive the price while the goods are still in transit and is assured that the title to the goods cannot pass to the buyer before he pays the price, while the buyer is assured that the goods will be delivered to him after he pays the price. One of the factors that contribute to the reliability of bills of lading is that the carrier warrants the accuracy of statements regarding the goods and is liable to their third party lawful holders in case of their inaccuracy. A buyer cannot inspect the goods while they are at sea, so he has to rely on the statements in the bill of lading. These statements provide evidence that the seller has properly performed his obligations by loading on time the conforming goods.<sup>7</sup>

## II. CLEAN BILL OF LADING IN CONTRACT OF CARRIAGE

After the goods are delivered to the carrier, and upon demand of the shipper, the carrier must issue a bill of lading. Under Article 3(3) of the Hague-Visby Rules, bills of lading must show the leading marks, quantity, weight, or number of packages or pieces, and the apparent condition of the goods, furnished in writing by the shipper.<sup>8</sup> Similar

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<sup>7</sup> Under clause CIF A8 of the Incoterms 2010, the seller has a duty to provide the buyer with a "usual transport document." This is usually understood to mean a clean on board bill of lading providing for the carriage of goods under deck, and for carriage to be performed without unreasonable deviation. INT'L CHAMBER OF COMMERCE, INCOTERMS 2010 cl. CIF A8 (2010), .

<sup>8</sup> International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, Aug. 25, 1924, 120 L.N.T.S. 155 (entered into force June

provisions are found in the Hamburg Rules<sup>9</sup> and the Rotterdam Rules.<sup>10</sup>

The carrier can, under certain conditions, insert reservations in the bill of lading, which can drastically lessen its evidential value. Reservations are remarks inserted in a bill of lading by the carrier, his master, or his agent, which indicate the carrier does not guarantee the accuracy of particulars concerning the marks, nature, or quantity of the goods contained in the bill of lading, or that there are defects noticed in the condition of the goods or its packing for which the carrier is not responsible.

Under Article 3(3) of the Hague-Visby Rules:

no carrier, captain or agent of the carrier shall be bound to state or show in the bill of lading any marks, number, quantity, or weight which he has reasonable ground for suspecting not accurately to represent the goods actually received, or which he has had no reasonable means of checking.

The literal meaning of this provision refers to something which its drafters probably never intended. It is difficult to imagine that they meant that the carrier can issue a bill of lading without particulars concerning the “marks, number, quantity or weight,” since those particulars are essential for the existence of a bill of lading.<sup>11</sup> Under

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2, 1931) [hereinafter Hague Rules], as amended by Protocol to Amend the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, Feb. 23, 1968, 1412 U.N.T.S. 128 [hereinafter Hague-Visby Rules]. For the matter of simplicity, I will use the Hague-Visby Rules and will not refer to the Hague Rules, which are still applied in a number of jurisdictions.

<sup>9</sup> United Nations Convention on the Carriage of Goods by Sea, Mar. 31, 1978, 1695 U.N.T.S. 3, 17 I.L.M. 608 (entered into force Nov. 1, 1992) [hereinafter Hamburg Rules].

<sup>10</sup> United Nations Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea, G.A. Res. 63/122, U.N. Doc A/RES/63/122 (Feb. 2, 2009) [hereinafter Rotterdam Rules]. Rotterdam Rules are not yet in force.

<sup>11</sup> It should be noted that the original text of the Hague Rules (1921) adopted by the International Law Association (ILA) was somewhat different. It provided that, “no carrier, master or agent of the carrier shall be bound to issue a bill of lading showing description, marks, number, quality, or weight which he has reasonable

this literal interpretation, problems may have arisen with Article 3(3) of The Hague-Visby Rules. Instead, remedying this error, the content of Article 3(3) has been interpreted to imply that the carrier, in fact, should insert particulars concerning the goods as furnished by the shipper. Additionally, the carrier is entitled to qualify those particulars by inserting in the bill of lading reservations under conditions specified in this article.

The Hamburg Rules and the Rotterdam Rules expressly provide that the carrier has a duty to insert a reservations in the bill of lading under conditions that are essentially the same as in the Hague-Visby Rules.<sup>12</sup> Reservations are aimed at protecting the carrier from liability for inaccurate or false particulars furnished by the shipper. The justifications for these reservations are that the carrier cannot be asked to take responsibility for the accuracy of particulars that he cannot check and the necessity to protect the good faith of third party bill of lading holders. The reservations are not aimed at relieving the carrier from liability, but only at excluding the presumption that the goods are received for carriage by the carrier as described in the bill of lading.

In practice, it is often disputed whether loss of, or damage to, the goods occurred during the voyage, or whether it existed before the goods were delivered for carriage. One of the crucial problems for the buyer is to establish who is responsible for damage: the carrier or the seller. Here the bill of lading may play a key role as evidence. If the bill of lading contains remarks stating that the cargo was loaded in poor condition, this may provide evidence of the seller's liability for delivery of non-conforming goods. On the other hand, if the bill of lading contains no such remarks, this may evidence the carrier's liability.

If the carrier signs a bill of lading presented by a shipper without controlling the accuracy of the particulars furnished by him, he risks liability to a third party holder of the bill of lading if those particulars are inaccurate. This is why the carrier should be very careful

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ground for suspecting do not accurately represent the goods actually received.” It is one thing that the carrier is not bound to issue a bill of lading, and a different one that the carrier issues the bill of lading but is not bound to state in the bill of lading the particulars concerning the goods (on file with author).

<sup>12</sup> Hamburg Rules, *supra* note 9, art. 16(1); Rotterdam Rules, *supra* note 10, art. 40(1).

when receiving the goods from the shipper and should check the accuracy of the description of the goods as furnished by the shipper, as well as the apparent condition of the goods. However, sometimes it is impossible to perform such checks, e.g., if the goods are delivered for carriage shortly before the ship's departure or if the goods are in sealed containers so that the number of packages and condition cannot be verified. In such cases the carrier is entitled to insert reservations into the bill of lading.

There are two types of reservations: (1) reservations which refer to the particulars furnished by the shipper concerning the general nature, marks, number, and weight of the goods and (2) reservations concerning the condition of the goods. The legal effect of these two types of reservations is different.

A. Reservations Referring to the Nature, Marks, Number, and Weight of the Goods

Reservations referring to the particulars furnished by the shipper deprive those particulars of their evidential value. It is assumed that the carrier delivered the goods to the consignee as he received them from the shipper. Such a bill of lading is not even prima facie evidence of the particulars to which the reservation refers. Those particulars are deprived of every evidentiary effect, and are considered to be only a declaration made by the shipper, without the carrier's liability for their accuracy. The carrier is only liable on the basis of the receipt of the goods (*ex recepto*), which means that he must deliver the goods to the consignee as he received them from the shipper. As a result, a third party holder of the bill of lading is entitled to the goods not as they are described in the bill of lading, but as they were delivered for carriage by the shipper.

Reservations limit, but do not eliminate, the evidentiary effect of the bill of lading. Only the particulars to which the reservations refer lose their evidentiary value, while other particulars retain their evidentiary effect. For instance, a reservation referring to weight has

no influence on the evidentiary effect of the number of pieces stated in the bill of lading.<sup>13</sup>

Reservations do not exempt the carrier from his responsibility, but only switch the burden of proof (*onus probandi*) from the carrier to the consignee. If the carrier fails to insert notations, he would be precluded from proving against third party holders of the bill of lading that the particulars in the bill of lading were inaccurate and would bear the burden to prove that he is not liable for loss or damage. In that case the consignee would not be bound to prove the carrier's liability, but the carrier has the burden to prove that he is not liable for loss or damage. A reservation switches the burden of proof to the consignee, who must prove that the particulars in the bill of lading were correct and that the carrier is liable for loss or damage.

The effect of reservations is that they make such proof more difficult. If the bill of lading does not contain reservations, the consignee would only have to prove that the goods he received from the carrier do not correspond with the bill of lading description leaving to the carrier to avail himself of any defenses to avoid liability. If the bill of lading does contain reservations, then the consignee cannot rely on the bill of lading as proof but must offer other evidence of carrier's liability for damage.

#### B. Reservations Referring to the Condition of the Goods

The bill of lading should show only the apparent condition of the goods, which means the external condition of the goods "so far as meets the eye."<sup>14</sup> Even if a bill of lading does not contain this clause, the goods will be considered as delivered for carriage in apparent good condition, unless the master has inserted remarks in the bill of lading stating the goods defects.

Reservations referring to the condition of the goods are based on the carrier's observation and represent, in fact, his statement of any defects in the goods noticed during the inspection of the goods at the port of loading. These reservations are *prima facie* evidence that the

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<sup>13</sup> Attorney General of Ceylon v. Scindia Steam Navigation Co., India [1962] A.C. 60 (Eng.).

<sup>14</sup> The Peter der Grosse [1875] 1 P.D. 414 (Eng.).



goods were loaded in the condition as described in the reservations. Therefore, they place the burden of proof on the consignee, who needs to prove that the goods were loaded in good condition, and that the damage occurred during the voyage.

If the carrier fails to insert reservations concerning the condition of the goods and the goods are found to be damaged when delivered to the consignee, the carrier will be held responsible for damage unless he proves that the damage was caused by one of the circumstances for which he is not responsible. Where the goods are loaded in poor condition, it is still possible to avoid clausing a bill of lading. If the shipper's description of the goods in the bill of lading provides a complete and accurate description of the cargo, there would be no need for any clausing of the bills of lading by the master. The goods that are properly described as damaged can be considered as "in good condition" in the sense of being in "proper" order and condition.<sup>15</sup> The cargo that is properly described as damaged or imperfect in some way can be stated to be in "good order and condition" in the sense of being in "proper" order and condition. Thus a cargo described in a bill of lading as "scrap" or as "hot rolled steel coils with pitting and gouging" can be stated to be in "good order and condition."<sup>16</sup> If the description of the goods is such that the master can sign a bill of lading that says that those goods, as described, are in "apparent good order and condition," then the cargo will not be "subject to clausing of the bill of lading." But if the master would have to make a notation on the bill of lading so as to reconcile the description of the goods with a statement that they are in "apparent good order and condition," then the cargo is "subject to clausing of the bill of lading."<sup>17</sup>

The fact that the bill of lading does not state that the goods loaded are in bad condition does not exclude the possibility that there are defects in loaded goods.<sup>18</sup> If the carrier proves that the damage to the goods was of such a character that it was impossible to discover it

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<sup>15</sup> Sea Success Maritime Inc. v. African Maritime Carriers Ltd. [2005] EWHC (Comm) 1542 (Eng.).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Tokio Marine Fire & Ins. Co. v. Retla S.S. Co., 426 F.2d 1372 (9th Cir. 1970).

by an ordinary examination of their external condition, the cargo claimant would not only have to prove that the goods were not damaged when delivered for carriage, but also provide such proof as may be needed to impose carriage liability, e.g., that the ship was not seaworthy. However, if the consignee proves that the carrier knew, or should have known, that the goods were damaged when he received them for carriage, the carrier will be responsible if he failed to insert the reservation in the bill of lading stating that damage.<sup>19</sup>

#### IV. CLEAN BILLS OF LADING IN LETTERS OF CREDIT

In a documentary sale, the bill of lading serves as evidence of whether the goods are loaded, when they are loaded, and which goods are loaded. Based on the bill of lading, it can be established whether the goods were delivered for carriage and loaded on time, as stipulated by the contract of sale, as well as whether the goods delivered for carriage correspond with the goods agreed by the contract of sale. To perform its role in a documentary sale, the bill of lading must provide certainty to its holder with respect to the accuracy of the particulars contained in it, and the carrier must be precluded from denying the accuracy of those particulars.

The letter of credit rules provide specific requirements related to reservations. As a matter of principle, the bill of lading should be free of all notations with respect to the apparent condition of the goods and packaging. Under Article 27 of the UCP, a clean bill of lading is defined as “one that bears no clause or notation which expressly declares a defective condition of the goods and/or the packaging.” Banks must refuse bills of lading that contain such clauses or notations, unless the letter of credit expressly stipulates the clauses or notations that may be accepted. The buyer can give instructions to its bank with respect to the requirements of the documents; if there are no such instructions, the requirements contained in the UCP rules will apply.

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<sup>19</sup> *The Nogar Marin* [1988] 1 Lloyd’s Rep. 412 (Eng.); *Dent v. Glen Line* [1940] 67 Lloyd’s Rep. 72 (Eng.); Cour d’appel [CA] [regional court of appeal] Rouen, Oct. 10, 1991, D.M.F. 1993, 108 (Fr); Cour d’appel [CA] [regional court of appeal] Paris, Apr. 17, 1995, D.M.F. 1985, 173 (Fr).

## V. DISCREPANCIES AND CONFUSION

When the meaning of clean bill of lading under the rules applying to carriage of goods and to letters of credit is compared, discrepancies become obvious. All international conventions governing carriage of goods by sea provide that reservations regarding leading marks, quantity, the general nature of the goods, and their condition make a bill of lading unclean.<sup>20</sup> The UCP limits the definition of a clean bill of lading to notations declaring defective condition of the goods and/or packages. This definition is in line with some well-known cases.<sup>21</sup> On the other hand, it deviates from other cases that gave effect to notations related to quantity, making such bills unclean under the rules governing carriage by sea.<sup>22</sup> There are also other discrepancies, e.g., regarding the effect of “said to contain” clauses.

At a more general level, the confusion about the meaning of a clean bill of lading is caused by the fact that the parties in a contract of carriage are usually also the parties in the contract of sale (the shipper is often the seller, while the consignee is often the buyer), and because the subject matter of these contracts is the same (the carried goods are identical with the sold goods). However, even though the same parties and goods appear in both the contract of carriage and the contract of sale, these two contracts are regulated by different rules. The rules regulating the contract of carriage are aimed at defining the duties and rights of the carrier and the shipper and/or consignee, while the rules regulating the contract of sale are aimed at specifying the duties and rights of the seller and the buyer.

The rules regulating the liability of the carrier are limited in scope to the contract of carriage and are not concerned with the contract of sale. If the carrier issues a clean bill of lading, it does not mean that the goods are in conformity with the goods under the

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<sup>20</sup> Hague-Visby Rules, *supra* note 8, art. 3(3), Hamburg Rules, *supra* note 9, art. 16(1); Rotterdam Rules, *supra* note 10, art. 40(1) referring to art. 36(1).

<sup>21</sup> *British Imex Indus. Ltd. v Midland Bank Ltd.* (1958) 1 Q.B. 542 (Eng.); *Golodetz & Co. v Czarnikow* (1980) 1 W.L.R. 495 (Eng.).

<sup>22</sup> *New Chinese Antimony Co. Ltd. v. Ocean S.S. Co.* [1917] 2 K.B. 664 (Eng.), *Attorney General of Ceylon v. Scindia Steam Navigation Co., India* [1962] A.C. 60 (Eng.); *The Mata K* [1998] 2 Lloyd's Rep. 614 (Eng.).

contract of sale. The carrier is not entrusted with checking whether the goods comply with sale contract, but only with their carriage; he is responsible only if the goods do not correspond with their description in the bill of lading. The rationale of the carrier for inserting reservations is the protection of his own interests as a party in the contract of carriage. From the carrier's perspective, the fact that he inserted reservations in a bill of lading, or that he failed to do so, is relevant only for his relation with the bill of lading holder. However, that fact can be very important for the relation of the parties in the contract of sale, as well as in letters of credit.

The bill of lading is a transport document issued under a contract of carriage and is not always suitable to serve as evidence in a contract of sale. The buyer cannot rely on the carrier and transport documents as sufficient grounds for establishing whether the goods were in conformity at the moment of loading because the carrier applies his own standards and rules based on rules governing carriage of goods, and not sale, when checking the goods.

The fact that the carrier has issued a clean bill of lading does not necessarily mean that the seller has delivered for carriage the goods as provided by the contract of sale, but only that the carrier acknowledged that the goods correspond with their description in the bill of lading and that they are in apparent good order and condition. For example, the seller might deliver for carriage the goods of a quality which does not correspond to one agreed by the contract of sale, but the carrier cannot be expected to state this discrepancy of quality in the bill of lading, since he is usually not an expert on the goods and is not liable for the quality of the goods.

## VI. SPECIFIC PROBLEMS UNDER THE UCP

The UCP contains rather imprecise guidance regarding "clean bills of lading," which deviates from the rules on clean bills of lading in the law governing carriage of goods by sea. There are even some discrepancies with the rules governing international sales, while some of problems are confined to the UCP. The problems may arise in cases of all particulars on the goods, as will be shown below.

### A. Quantity

A bill of lading containing a notation that states a shortage of the goods cannot be clean. This fact is clearly stated in all international conventions regulating carriage of goods by sea and is confirmed by numerous court decisions. In a clear contrast to the rules governing carriage by sea, the UCP definition of clean bill of lading is restricted to the condition of the goods and packages. For some unclear reason, the reservations regarding quantity are omitted from the definition of clean bill of lading. Hugo Tiberg proposed a wider meaning of unclean bill of lading to refer to a “document bearing an express notation of insufficiency concerning either the quantity or condition of the goods or their packaging.”<sup>23</sup> This proposal is the starting point for a more detailed elaboration on this issue below.

The failure to include reservations related to quantity in the definition of clean bill of lading raises the issue of whether this failure can be remedied by other provisions of the UCP. To certain extent, Article 30 of the UCP may play this role. This provision does not specifically make reference to transport documents, but it obviously applies to them, as well as to the invoice. Article 30(b) provides for tolerance of 5% for quantity “provided the credit does not state the quantity in terms of a stipulated number of packing units or individual items and the total amount of the drawings does not exceed the amount of the credit”. This means that reservations indicating shortages of less than 5% of quantity would be acceptable, but this tolerance is not applicable to the number of packing units or individual items when stated in the letter of credit.

The application of Article 30(b) depends on the type of merchandise shipped.<sup>24</sup> Article 30(b) would apply where the credit states, e.g., “1000kg of coffee.” In this case, the beneficiary could ship up to 5% less, i.e., between 950kg and 1000kg, or up to 5% more, i.e., between 1000kg and 1050kg (subject to credit amount not being

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<sup>23</sup> See Tiberg, *supra* note 4, at 78.

<sup>24</sup> Example: letter of credit value is \$100,000.00 (USD); Goods shipped: 1000kg of coffee. In this case, the exporter is allowed to ship up to 1050kg (or 950 kg) of coffee but not allowed to draw more than \$100,000.00 (USD). This tolerance disappears in case of the number of packing units or individual items, e.g., if the bill of lading states that 1000 boxes containing bottles of wine are loaded.

exceeded). This means that banks should reject bills of lading when there is a discrepancy higher than 5% in the case of quantity, as well as in case of any discrepancy related to the number of packages. A problem may arise if a bill of lading indicates a shortage within the tolerance defined by Article 30(b), e.g., when it contains a clause stating: “10 tons missing” (if we assume that the total amount is 1000 tons, a shortage of ten tons is just 1% of the total amount). Should the bank accept such bill of lading? From the position of the buyer, a shortage of the quantity should be valid cause for rejecting documents. On the other hand, under the UCP, the bank will be required to accept such bill of lading, unless specifically instructed not to do so.

Article 30(b) creates a discrepancy in the rules applicable to letters of credit, as well as a number of ambiguities that may arise in various situations related to its application to bills of lading. For example, why should a bank accept a bill of lading containing a shortage of ten tons of cargo when the quantity stated in the bill of lading is 1000 tons, and why should it reject the bill of lading when one out of a hundred boxes is missing? What is the logic? Is one box containing twelve bottles of mineral water more valuable and important than ten tons of coffee? There should be some reason for this kind of drafting of the UCP, but if so, it is far from obvious.

A notation that refers to a minor defect may be acceptable to the buyer, but not to the bank, because such notation makes a bill of lading unclean under the UCP rules. On the other hand, a notation within the tolerance defined by Article 30(b) would be acceptable to the bank, but not necessarily to the buyer. Would the buyer agree to a every shortage that is less than 5%? There have been many cases where a buyer has sued the seller or carrier for far lower percentages of shortage. Article 30(b) may contradict the law governing contract of sale, for the law of each country sets out its own percentage of tolerance. The problem will arise particularly where the law governing contract of sale provides a lower tolerance. This means that Article 30(b) of the UCP may contravene both the rules applying to carriage of goods by sea and those applying to contract of sale. The real risk for the buyer is that this provision requires the bank to pay against bill of lading which contains express reservation regarding shortage of quantity, where the shortage is within the tolerance of 5%.

The report on clean bills of lading prepared by the International Chamber of Commerce (ICC) states that clauses relating to quantity “are in a different class, in that they merely reflect a difference of opinion between seller and carrier as to the exact quantity of good loaded on board.”<sup>25</sup> It is true that these clauses are in a different class, but not merely because they reflect a different opinion, because the clauses related to condition may also reflect a difference in opinion between seller and carrier. For example, there is often a discussion between the shippers and the master (or his agent) as to the proper description of the condition of the cargo.<sup>26</sup> In fact, shipper and carrier are more likely to have “a difference of opinion” regarding condition rather than regarding quantity; quantity can be more easily verified, when in dispute, while the assessment of apparent condition of the goods is often based on subjective impression.

The difference between these two types of clauses lies in their different legal effects: while clauses related to quantity deprive them of evidential legal effect, clauses related to condition create a presumption that the goods are loaded with defects as stated in the reservation. This difference does not justify omitting reservations related to quantity from the definition of clean bill of lading. It is obvious that a bill of lading with a notation stating shortage of quantity of goods cannot be a clean bill of lading, particularly from the perspective of the buyer’s interests. To avoid the risk, the buyer should specifically instruct its bank to reject clauses that refer to a shortage of the goods.

While banks normally have no problem with accounting, why should the banks bear a duty to calculate the percentage of shortage and then determine whether the shortage is within the tolerated amount? Would it not be more practical to simply adopt the same rule as in carriage of goods: any reservation regarding quantity should make the bill of lading unclean? The tolerance of shortage should not be prescribed as a standard in the UCP, but it should be an exception agreed upon by the parties to the contract of sale. If the parties agreed certain degree of tolerance, the buyer should arrange to have this condition in the letter of credit so as to override the default 5%

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<sup>25</sup> INTERNATIONAL CHAMBER OF COMMERCE, *THE PROBLEM OF CLEAN BILLS OF LADING* 14 (1962).

<sup>26</sup> *Sea Success Mar. Inc. v. African Mar. Carriers Ltd.* [2005] EWHC (Comm) 1542 (Eng.).

tolerance. In such case the applicant should expressly instruct the bank in the letter of credit that specified tolerances may be allowed; if the instructions are silent on this, there should be no tolerance. As it is shown above, there are plenty of arguments speaking in favor of expanding the UCP definition of clean bill of lading so as to include notations regarding quantity.

#### B. “Said to Contain” Clauses

Another point of confusion relates to Article 26(b) of the UCP. According to this article, banks will accept bills of lading that contain clauses such as “shipper’s load and count,” “said by shipper to contain,” or words of similar effect.<sup>27</sup> In the context of the UCP, this provision can be justified by the fact that these clauses do not expressly declare a defective condition of the goods and, therefore, do not make bills of lading unclean under the UCP rules. The situation, however, can be different in contract of carriage.

In contracts of carriage clauses, “shipper’s load and count” or “said by shipper to contain” are often not given effect by the courts when they are pre-printed in bills of lading. In such cases, Article 31(ii) of the UCP would not cause problems. However, under certain conditions, these clauses can have effect under the rules governing carriage of goods and make a bill of lading unclean. Where the goods are carried in containers packed and sealed by the shipper, the carrier has no duty to open them to check the contents. In this case it is clear in *re ipsa* that the carrier cannot check the contents due to the conditions of carriage. This means that there is no need for the reservations to be specific and the carrier can insert reservations such as “said by shipper to contain” or simply “said to contain.” This kind of reservations has been upheld in a number of jurisdictions.<sup>28</sup>

English courts give effect to general reservations relating to weight or quantity unknown.<sup>29</sup> If a bill of lading states that the weight

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<sup>27</sup> See UCP, *supra* note 3, art. 26(b).

<sup>28</sup> Robert Wijffels, *Aspects juridiques du transport par conteneurs*, E.T.L. 337 (1967).

<sup>29</sup> *The Mata K* [1998] 2 Lloyd’s Rep. 614 (Eng.); *Noble Res. Ltd. v. Cavalier Shipping Corp.* [1996] 1 Lloyd’s Rep. 642 [hereinafter *The Atlas*] (Eng.); *The Esmeralda* [1988] 1 Lloyd’s Rep. 206 (Eng.).



of goods is unknown, the carrier can rely on it as evidence to contradict the weight recorded in the bill of lading.<sup>30</sup> In such case, no estoppel can be raised against the carrier, since he made no representation. In common law the main focus is on the fact of whether a representation is made, rather than whether the qualification is true.<sup>31</sup> If the statement of the weight or quantity of goods in the bill of lading is qualified by such words as “weight or quantity unknown”, the bill of lading is not even prima facie evidence against the carrier of the weight or quantity shipped.<sup>32</sup> Similarly, where goods are shipped in a container and the bill of lading is “said to contain” a given number of packages, so that it is plain that the carrier has no knowledge of the contents of the container, the carrier is not estopped from denying that the stated number of packages were in fact in the container. The onus is on the cargo-owner to prove what was in fact shipped.<sup>33</sup>

Many other jurisdictions have taken a similar stance. In the United States, Section 7-301(b) of the Uniform Commercial Code (U.C.C.) recognizes the validity of clauses such as “contents, condition, and quality unknown,” and “said to contain,” in case of the goods “concealed in packages.”<sup>34</sup> German law provides for the possibility of inserting the reservation “contents unknown” (“Inhalt unbekannt”) if the goods are carried packaged or in containers.<sup>35</sup> Italian courts take a similar view “when it is reasonably impossible to establish if the carrier has no reasonable means of checking the information furnished by the

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<sup>30</sup> *The Atlas*, 1 Lloyd’s Rep. at 646.

<sup>31</sup> RICHARD AIKENS, RICHARD LORD & MICHAEL BOOLS, BILLS OF LADING 4.32 (2006).

<sup>32</sup> *Conoco (UK) Ltd. v Limai Mar. Co.* [1988] 2 Lloyd’s Rep. 613 (Eng.) [hereinafter *The Sirina*].

<sup>33</sup> WILLIAM TETLEY, MARINE CARGO CLAIMS 351 (4th ed. 2008).

<sup>34</sup> *Transatlantic Marine Claims Agency v. M/V IBN Zuhr*, Civ. A. No. CV 493–292, 1994 WL 654548 (S.D. Ga. May 27, 1994); *Recumar Inc. v. S/S Dana Arabia*, 83 Civ. 6486 (BN) (JES), 1985 WL 479 (S.D.N.Y. Apr. 5, 1985); *Aetna Ins. Co. v. General Terminals*, 225 So.2d 72 (La. Ct. App. 4 1969); THOMAS SCHOENBAUM, ADMIRALTY AND MARITIME LAW § 10-22 (4th ed. 2004).

<sup>35</sup> *Oberlandesgericht [OLG] [Hamburg Regional Court] Oct. 2, 1969* VersR 1125, 1970 (Ger.); *Oberlandesgericht [OLG] [Hamburg Regional Court] Nov. 30, 1972* VersR 344, 1973 (Ger.); SEEHANDELSRECHT 511 (Prussman-Rabe eds., 5th ed. 2000); SCHAPS/ABRAHAM: SEERECHT 821 (Walter de Gruyter ed., 1964).

shipper.”<sup>36</sup> A similar position is taken by Belgian courts, which have held that the notation “said to contain” inserted in a bill of lading represents a valid qualification where the carrier is not able to check the condition of the goods.<sup>37</sup>

Article 40(4) of the Rotterdam Rules contains specific provisions for situations in which goods are delivered for carriage to the carrier in a closed container. In such case the carrier may qualify the particulars on the goods if the goods inside the container have not actually been inspected by the carrier and the carrier did not have actual knowledge of its contents before issuing the transport document. With respect to the particulars on the weight of the goods, the carrier may qualify those particulars if he did not weigh the container, and the shipper and carrier had not agreed prior to the shipment that the container or vehicle would be weighed and the weight would be included in the contract particulars, or there was no physically practicable or commercially reasonable means of checking the weight of the container or vehicle. Another scenario is found in Article 40(1) of the Rotterdam Rules, which deals with situations in which goods are not delivered for carriage in a closed container, or when they are delivered in a closed container and the carrier actually inspects them. In this case the carrier may insert reservations in the transport document if he had no physically practicable or commercially reasonable means of checking the information furnished by the shipper, or he has reasonable grounds to believe the information furnished by the shipper to be inaccurate.<sup>38</sup>

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<sup>36</sup> Corte di Cassazione 29 November 1999, No. 13341, *Giur. it.* 2001, III, 729 (It.); Corte di Appello di Napoli, 21 June 1996, unreported, *Rocco Giuseppe & Figli S.p.A. v. D.I.A.R. Maritime S.r.l.* (It.).

<sup>37</sup> Hof Van Beroep [HvB] [Court of Appeal] Antwerpen May 27, 2013, *European Transport Law [E.T.L.]* 2013, 581 (Belg.).

<sup>38</sup> Article 40(1) of the Rotterdam Rules may create problems in practice. For example, there might be disagreement as to what extent the carrier who actually inspected the goods in a closed container was able to verify the information furnished by the shipper. It is also not very clear who would have the burden of proof in case of a dispute: would the carrier have the burden of proof that he was entitled to insert qualification in the transport document, or would it be on the claimant to prove that the qualification was not justified? The answer to these questions can be obtained only if the Rotterdam Rules enter into force, and it is very likely that those answers may not be the same in all jurisdictions. Rotterdam Rules, *supra* note 10, art. 40(1).

The previous examples from several leading maritime jurisdictions and the text of the Rotterdam Rules demonstrate a clear discrepancy between the UCP and the laws governing carriage of goods by sea. Namely, under the UCP, clauses such as “said to contain” do not have effect on the status of bills of lading, which remain clean and acceptable by banks. On the other hand, similar clauses may have an effect under carriage by sea rules, making bills unclear.

The UCP’s unreserved acceptance of “said to contain” type clauses can make the buyer a victim of fraud, if the seller as shipper furnishes the carrier with a false description of the goods loaded in a container (e.g., the bill of lading states that music records are loaded, while in fact some garbage is loaded), and the carrier inserts in the bill of lading the clause “said by shipper to contain.”<sup>39</sup> In such a case the bank will pay against such a document, the carrier will not be liable for wrong description of the goods, and the seller may ‘disappear’ or become insolvent. Bills of lading should provide security to the buyer, and that security may be compromised if the banks accept bills which would not be acceptable to the buyer. The UCP needs a revision of its text to avoid potential risks, confusion, and problems arising from the discrepancy of rules applicable to “said to contain” type clauses. One possible solution is simply to delete Article 26(b) and leave the parties to deal with these issues on a case-by-case basis.

Under the existing rules the buyers can still protect their interests and ensure that banks will not accept transport documents that are not acceptable to them. The buyers are advised to include in the letter of credit requirements obligating the beneficiary (seller) to produce the certificate of control where the goods are to be carried in container sealed by the shipper. Less experienced traders may not be familiar with these protective devices, as the illustration that opened this text has shown, but such problems may happen even to large companies.<sup>40</sup>

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<sup>39</sup> Discount Records Ltd. v Barclays Bank Ltd. [1975] 1 W.L.R. 315 (Eng.).

<sup>40</sup> Daewoo Int’l (America) Corp. v. Sea-Land Orient Ltd., 196 F.3d 481 (3d Cir. 1999).

### C. Condition

Serious difficulties may also arise with respect to notations on the condition of goods. It is not always clear which notations make a bill of lading unclean in documentary sale. Even a notation that is acceptable to the buyer is likely to cause a bank to refuse the bill of lading due to the “strict compliance” rule.<sup>41</sup> A clean bill of lading does not always mean that the condition, and especially the quality, of the goods is in conformity with the sale contract in much the same way as an unclean bill of lading does not always mean that the goods are not in conformity with what the seller and buyer have agreed. This is because the notations in a bill of lading are aimed at protecting the carrier from liability under the contract of carriage. The notations are inserted by the carrier, who is not expected to know whether the goods delivered for carriage are in conformity with the goods under sale contract. Therefore, those notations cannot be expected to offer a firm answer as to whether the goods correspond with the sold goods. A requirement for a clean bill of lading may serve the buyer as an excuse to refuse an unclean bill of lading, even when the reservation states a fact the seller and the buyer have agreed upon.

A notation inserted by the carrier does not necessarily make a bill of lading unclean as between the seller and the buyer, even if it expressly declares the defective condition of the goods or packaging. For example, a bill of lading with the notation “atmospheric rust spotted” relating to iron products should not be refused by the buyer, because in the case of sea carriage of iron products traces of atmospheric rust are usual and perhaps even inevitable.

Similar situations may arise in cases of description of packing. Buyers are, of course, mainly interested in goods rather than packing, which only serves to protect the goods. For example, the notation “used bags” would not necessarily make a bill of lading unclean, unless the buyer insists on new bags. Actually, it may well be that the buyer and the seller have agreed in a contract of sale on cheaper packing, which might not be very suitable for the goods but would enable the buyer to cut the price, e.g., cardboard boxes instead of wooden boxes. In such a case a notation inserted by the carrier in the bill of lading

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<sup>41</sup> *Golodetz & Co. v Czarnikow* (1980) 1 W.L.R 495 (Eng)..

stating insufficient packing will not give the buyer the right to refuse the bill of lading because the buyer agreed to such packing in the contract of sale.

As far as the carrier is concerned, he is usually not interested in the transaction between the seller and buyer, but only in the proper performance of the duties he has under the contract of carriage. If he noticed upon receipt of the goods that the packing was insufficient and has stated this in the bill of lading, he will be protected in case of loss or damage caused by such packing. Needless to say, such notation will require the bank to refuse documents, unless specifically authorized to accept them.

On the other hand, the buyer should also be aware that the carrier's duty of control over the condition of the goods is limited to the apparent condition, so that a clean bill of lading does not have to mean that the goods are actually in good condition.

The present UCP definition of clean bill of lading does not require change in the part regarding condition of the goods, but certain caution may be necessary in relying on such definition. Depending on the kind of goods, the buyer might need the services of a surveyor at the port of shipment to determine whether the goods correspond with the requirements of the contract of sale.

#### D. Marks and General Nature of the Goods

Reservations related to marks should be stamped in such a manner that they are clear and legible not only at the moment of loading, but also at the time of delivery to the consignee. Marks can be very important for the buyer, and when the goods are properly marked they can be identified at the destination. On the other hand, improper leading marks may expose the buyer to serious risk and difficulties. It is not clear why the UCP failed to include reservations regarding deficiency of marks in the definition of clean bill of lading. Maybe those reservations are not often used, and practical importance is lower than in the case of remarks concerning condition. But, as a matter of principle, the UCP should have at least made a reference to those reservations. The same applies to the nature of the goods, although it may be assumed that reservations regarding the nature of the goods are very seldom used.

## CONCLUSION

The fact that a clean bill of lading has two different and sometimes contradictory meanings has not been adequately addressed so far in the literature on letters of credit. Problems related to discrepancy of rules may exist in cases of all particulars on goods inserted in bills of lading. Such discrepancies can cause serious difficulties to all parties involved. It is rather cumbersome and can be confusing to assess the legal effect of the same document by applying different and even conflicting rules and standards when there is no obvious reason for that. This is a flaw in the system that could be rectified by clearer rules.

The UCP rules on clean bills of lading are not sufficiently clear, which may expose buyers to serious risks. The main controversies exist in cases of reservations related to quantity and “said to contain” type clauses.

Serious problems may arise in case of reservations regarding the quantity of the goods, since the UCP lacks clear guidance in such situations. There is also a clear departure from the rules on clean bills that apply to contract of carriage, which is particularly confusing and difficult to explain. Reservations stating shortage of the quantity are usually not acceptable for the buyers, and it is difficult to understand why the UCP ignored this. Buyers should be aware of the risk that banks would pay against a bill of lading containing a reservation related to quantity where the shortage is within the tolerance of 5% as provided by Article 30(b). This provision, however, has a different objective and may not be suitable for applying to the reservations regarding quantity, which may create additional confusion and problems to buyers. To avoid this risk, buyers should expressly instruct banks not to pay against a bill of lading containing reservations regarding the quantity.

Another problem that may arise is related to different standards regarding the legal effects of “said to contain” type clauses. This clause may make a bill of lading unclean under the contract of carriage, but will never do so under the UCP, thus exposing buyers to a potentially great risk. Drafters of the next UCP may consider deleting Article 26(b), which contravenes the carriage rules and may even

facilitate the fraud. To avoid the risk imposed by “said to contain” type of clauses, the buyer should arrange for inspection of the goods before their delivery to the carrier and demand the seller to produce the certificate of inspection. Relating to documentary fraud, the principle of autonomy applying to letters of credit, and the fact that banks are bound to examine merely whether the documents comply with the terms of the credit makes it easier for dishonest sellers to commit fraud. Part of the problem is that the UCP often rely on trust instead on verification. Things are made even worse by some court decisions, which restricted the fraud exception to fraud by the beneficiary, making third party fraud outside the scope of the fraud exception.<sup>42</sup>

The shortcomings in the present text of the UCP are obvious. For an outsider, it is difficult to understand why the ICC failed to rectify them in numerous revisions of the UCP. One possible explanation is that banks are not prepared to take additional burdens in examining transport documents. Another possible reason is that letters of credit function relatively well and not many problems actually arise in practice. However, the risk of fraud should not be underestimated, as even large companies may be defrauded under the existing system.<sup>43</sup> Manoeuvring through the murky waters of fraud infected letters of credit can be very risky and cumbersome. Revisions of the relevant UCP provisions may substantially reduce the potential for fraud. Prevention is better than cure.

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<sup>42</sup> United City Merchs. (Inv.) Ltd. v. Royal Bank of Can. [1983] 1 A.C. 168 (Eng.).

<sup>43</sup> See, e.g., Discount Records Ltd. [1975] 1 W.L.R. 315; see also Daewoo Int'l., 196 F.3d 481. Recently (June 2015) I received information about similar problems facing one of the largest companies in Thailand. This company bought steel scrap from an U.S. company. The goods were shipped in containers sealed by the shipper. Carrier inserted “said to contain” clause in the bill of lading, the bank has made payments pursuant to the UCP. After the containers were opened it was found that 80% in the cargo was soil, and not scrap. The lawyers of the buyer are aware that there is no valid claim against the carrier, or against the bank. The only chance is to sue the seller, which seems to be without significant assets, so even if successful, the award may not be enforceable. This kind of trouble was ultimately caused by a defect in the UCP, and not only by failure to engage a surveyor. After all, many companies may not employ the surveyor’s services to verify condition of the scrap cargo.

The UCP should be drafted in the way to protect the customers, and many of its provisions on transport documents serve that purpose. Revisions of the UCP suggested by this text would not be difficult and would not cause problems in implementation. Harmonizing the rules on letter of credit with rules applying to contract of carriage, where possible, would reduce legal uncertainty and problems that arise in practice. This would also help the letters of credit to maintain its position as a leading instrument of payment in international trade in the face of challenges by other forms of financing.

Under the assumption that at least some arguments in this paper are correct, the drafters of the next revision of the UCP should take care to correct shortcomings in its present text and make efforts to harmonize letter of credit rules on clean bills of lading with corresponding rules that apply in carriage of goods.

Another recommendation would be that all provisions related to clean bills of lading should be placed in one article rather than being scattered in different provisions. This would contribute to greater clarity and would reduce unnecessary confusions.

The UCP has proven to be a great success, achieving greater uniformity than any other international instrument has ever been able to achieve in the area of transnational commercial law. Of course, the credit for this success goes to its drafters. But nothing is so good that it cannot be improved further. It is hoped that ideas expressed in this paper may contribute to a still better UCP.<sup>44</sup>

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<sup>44</sup> I have shared this text and my views in informal contact with the ICC Banking Commission and the reaction was receptive and positive. I hope that some of the ideas from this text may eventually be incorporated in the next revision of the UCP.



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## THE HAGUE PRINCIPLES, THE CISG, AND THE “BATTLE OF FORMS”

*Peter Winship\**

The Hague Conference on Private International Law is about to adopt Principles on Choice of Law in International Commercial Contracts (Principles).<sup>1</sup> Assume an enterprise in Texas agrees to provide commercial services to an enterprise in Peru, and the parties agree that the law of Texas applies to any dispute arising from their contract. Will a court enforce this choice-of-law agreement? Courts in most States will do so. For these States the Principles provide a codification of basic rules together with some refinements. Some States, however, do not enforce such agreements or restrict their enforceability. The Principles and the accompanying Commentary seek to persuade these latter States that recognizing party autonomy as to the choice of law is preferable. As the Introduction to the Principles states, “[p]arty autonomy . . . enhances certainty and predictability . . .

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\* James Cleo Thompson Sr. Trustee Professor, SMU Dedman School of Law.

<sup>1</sup> The Hague Conference on Private International Law published a revised draft in July 2014. HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, THE DRAFT HAGUE PRINCIPLES ON CHOICE OF LAW IN INTERNATIONAL COMMERCIAL CONTRACTS, Prel. Doc. No. 6 (revised) (July 2014) [hereinafter Hague Principles or Principles], *available at* [http://www.hcch.net/upload/wop/gap2014pd06rev\\_en.pdf](http://www.hcch.net/upload/wop/gap2014pd06rev_en.pdf). Member States of the Hague Conference had until August 31, 2014 to submit comments on recent amendments to the text of the Commentary. COUNCIL ON GENERAL AFFAIRS AND POLICY OF THE HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, CONCLUSIONS AND RECOMMENDATIONS ADOPTED BY THE COUNCIL, ¶ 2 (April 2014), *available at* [http://www.hcch.net/upload/wop/genaff2014concl\\_en.pdf](http://www.hcch.net/upload/wop/genaff2014concl_en.pdf). In the light of these comments, the Conference’s Working Group will prepare a definitive final text, which the Conference will then circulate to Member States. If there are no objections within sixty days the draft will be an official text of the Hague Conference. *Id.* [Ed. The Principles entered into force on March 19, 2015. The final text may be found at <http://www.hcch.net/upload/conventions/txt40en.pdf>].

and recognises that parties to a contract may be in the best position to determine which set of legal principles is most suitable for their transaction.”<sup>2</sup>

The Hague Principles are no stranger to the International Academy of Commercial and Consumer Law. At the Academy’s July 2012 meeting in Mexico City, Neil Cohen, a participant in the Working Group drafting the Principles, traced the history of the project and identified the principal issues addressed by the Hague draft.<sup>3</sup> Since his report the number of commentaries analyzing the Principles has grown.<sup>4</sup> Most of this literature comments on the Principles as a whole. This paper, however, is more limited in scope. It considers only one issue: the relation of the Hague Principles to the United Nations Convention on Contracts for the International Sale of Goods (CISG)<sup>5</sup> when parties to an international contract of sales refer during negotiations to their standard terms and these standard terms include choice-of-law terms that conflict.

Paragraph 1 *b*) of Article 6 of the Principles purports to answer whether parties to an international commercial contract—including an international contract of sale—have agreed on a choice of law when they make such references without resolving differences in their standard terms. Article 6 as a whole provides:

#### Hague Principles

#### Article 6 (Agreement on choice of law and battle of forms)

#### Paragraph 1

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<sup>2</sup> Hague Principles, *supra* note 1, at ¶ I.3.

<sup>3</sup> Neil B. Cohen, *The Proposed Hague Principles on Choice of Law in International Commercial Contracts*, in *THE EVOLUTION OF THE GLOBAL TRADE OVER THE LAST THIRTY YEARS 157-71* (Elvia Arcelia Quintana Adriano, ed., 2014).

<sup>4</sup> See HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, HAGUE DRAFT PRINCIPLES ON CHOICE OF LAW IN INTERNATIONAL CONTRACTS: BIBLIOGRAPHY, *available at* [http://www.hcch.net/upload/draft\\_principles\\_bibl-e.pdf](http://www.hcch.net/upload/draft_principles_bibl-e.pdf).

<sup>5</sup> Convention on Contracts for the International Sale of Goods, Apr. 10, 1980, 1489 U.N.T.S. 3, 19 I.L.M. 671 [hereinafter CISG].

Subject to paragraph 2 -

whether the parties have agreed to a choice of law is determined by the law that was purportedly agreed to;

if the parties have used standard terms designating two different laws and under both of these laws the same standard terms prevail, the law designated in the prevailing terms applies; if under these laws different standard terms prevail, or if under one or both of these laws no standard terms prevail, there is no choice of law.

Paragraph 2

The law of the State in which a party has its establishment determines whether that party has consented to the choice of law if, under the circumstances, it would not be reasonable to make that determination under the law specified in paragraph 1.<sup>6</sup>

The solution in paragraph 1 *b*) draws heavily on the thoughtful analysis of Thomas Kadner Graziano, a Swiss member of the Working Group.<sup>7</sup> In his preliminary analysis of the Hague Principles, Symeon Symeonides rightfully pays tribute to Professor Kadner's contribution to resolving this "difficult problem"<sup>8</sup>—a problem acknowledged to be one of the more challenging problems in private international law.<sup>9</sup> Because of its novelty, the solution in Article 6 will no doubt attract considerable attention from scholars and possibly judges and arbitrators. To assist the reader, the Commentary to Article 6 analyzes four scenarios, the fourth of which purports to apply the Principle to a contract of sale governed by the CISG.

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<sup>6</sup> Hague Principles, *supra* note 1, at art. 6.

<sup>7</sup> Thomas Kadner Graziano, *Solving the Riddle of Conflicting Choice of Law Clauses in Battle of Forms Situations: The Hague Solution*, 14 Y.B. PRIV. INT'L L. 71 (2013).

<sup>8</sup> Symeon C. Symeonides, *The Hague Principles on Choice of Law for International Contracts: Some Preliminary Comments*, 61 AM. J. COMP. L. 873, 877 (2013).

<sup>9</sup> See generally Gerhard Dannemann, *The "Battle of the Forms" and the Conflict of Laws*, in LEX MERCATORIA: ESSAYS ON INTERNATIONAL COMMERCIAL LAW IN HONOUR OF FRANCIS REYNOLDS 199 (F.D. Rose ed., 2000).

This paper considers only this last scenario: the relation of the Hague Principles to the CISG when a seller and a buyer fail to resolve differences in their choice-of-law standard terms. I leave to separate papers the analysis of Article 6 and an evaluation of the Principles as a whole. The thesis of this paper is that the solution offered in the Commentary is not the only reasonable way to analyze the scenario.

## I. PRELIMINARY REMARKS

### A. The “Battle of Forms”

The “battle of forms” is to academic lawyers what a candle is to moths. Most of my acquaintances have written about the “battle.” They ask: Do persons who exchange forms with different pre-established standard terms have a contract when neither reads the other’s form but each performs as if there is a contract? And if there is a contract, what are its terms? They classify national and international solutions to these questions with descriptive tags—“no contract”; “first shot”; “last shot”; “knock out”; “hybrid”—used by aficionados who barely pause to elaborate.<sup>10</sup> These classifications and the concept of non-negotiated standard terms are so familiar I will not take up space to define them.

Something, however, should be said about the “battle of forms” and the CISG. As with other laws, there is a growing literature analyzing the problem.<sup>11</sup> Attempts at the 1980 Diplomatic Convention to address the issue with a specifically-tailored provision failed.<sup>12</sup> It is

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<sup>10</sup> See generally Kadner Graziano, *supra* note 7; see also Dannemann, *supra* note 9.

<sup>11</sup> A search in the bibliography of published commentaries maintained by the CISG Database maintained by Pace Law School yielded seventy-four entries with the word “battle” in the title. *Bibliography*, PACE LAW SCH. INST. OF INT’L COMMERCIAL LAW, <http://www.cisg.law.pace.edu/cisg/biblio/biblio.html> (last visited June 30, 2014).

<sup>12</sup> At the 1980 diplomatic conference, Belgium proposed to add a paragraph (4) to Article 19 (“(4) When the offeror and the offeree have expressly (or implicitly) referred in the course of negotiations to *general conditions* the terms of which are mutually exclusive the conflict clauses should be considered not to form an integral part of the contract.”). *Report of the First Committee*, U.N. Doc. A/CONF.97/11 (Apr. 7, 1980).

generally agreed that the solution must be found in Article 19 CISG, which, with slight modifications, requires the terms of an acceptance to be the same as those in the offer.<sup>13</sup> Two solutions—“knock out” and “last shot”—have found favor with both courts and commentators. There appears to be a trend among commentators to favor the knock-out solution;<sup>14</sup> it is more difficult to identify a trend in the decisions of judges and arbitrators.<sup>15</sup>

Despite the academic interest in the subject, most authors concede that it is far from clear that the “battle” is of much interest in practice. This is certainly true with respect to the CISG. During the last twenty-five years, only a relatively small number of reported CISG cases have wrestled with the issue of conflicting standard terms.<sup>16</sup> As for a “battle” between differing choice-of-law terms, the number of reported cases can be counted on the fingers of one hand.<sup>17</sup>

## B. CISG Policies

Before turning to analysis of the specific issue addressed, several basic policies embodied in the provisions in CISG Part I (Sphere of application and general provisions) should be noted.

Article 1(1) is the basic provision defining when the Convention is applicable:

CISG

Article 1

(1) This Convention applies to contracts of sale of goods between parties whose places of business are in different States:

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<sup>13</sup> CISG, *supra* note 5, at art. 19.

<sup>14</sup> See COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS Art. 19, ¶¶ 34-38 (Peter Schlechtriem & Ingeborg Schwenzer, eds., 2d ed. 2005).

<sup>15</sup> See *generally* UNCITRAL, Digest of Case Law on the United Nations Convention on Contracts for the International Sale of Goods, at 103-07 (2012).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

when the States are Contracting States; or

when the rules of private international law lead to the application of the law of a Contracting State.<sup>18</sup>

Subsequent articles qualify this statement by excluding, for example, particular sale transactions and particular issues. For the purpose of this paper, however, the most relevant qualification is Article 6, which allows a seller and buyer to agree to exclude application of the CISG when the Convention would otherwise be applicable. Article 6 provides in relevant part:

CISG

Article 6

The parties may exclude the application of this Convention . . . .<sup>19</sup>

It is the interplay between these CISG scope provisions and Article 6 of the Hague Principles that is at issue in this paper.

When considering this issue, three general provisions in CISG Part I are of particular importance. Two of these provisions direct the reader as to how to interpret or construe the Convention, while the third sets out rules on the interpretation of a party's acts or statements. Article 7(1) states:

CISG

Article 7

**(1) In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.**<sup>20</sup>

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<sup>18</sup> CISG, *supra* note 5, at art. 1.

<sup>19</sup> *Id.* at art. 6.

<sup>20</sup> *Id.* at art. 7(1) (emphasis added).

Article 7(2) goes on to provide that:

(2) Questions concerning matters governed by this Convention which are not expressly settled by it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.<sup>21</sup>

As for the interpretation of a party's statements, sub-articles (1) and (2) of Article 8 state:

CISG

Article 8

(1) For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.

(2) If the preceding paragraph is not applicable, statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.<sup>22</sup>

Article 9 supplements this article by binding parties to usages of trade and their course of dealing with each other.<sup>23</sup>

## II. THE BASIC SETTING

The Commentary to Article 6 of the Hague Principles analyzes the following scenario (Scenario 4):

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<sup>21</sup> *Id.* at art. 7(2) (emphasis added).

<sup>22</sup> *Id.* at art. 8(1) and (2).

<sup>23</sup> *Id.* at art. 9.

Party A to a transborder sales contract designates in its standard terms the law of State X, which is a CISG Contracting State, as the law applicable to the contract. Party B designates in its standard terms the law of State Y, which is also a CISG Contracting State, but explicitly excludes the CISG. The general contract law of State Y follows the knock-out rule. The case is brought before a court in a CISG Contracting State.<sup>24</sup>

Paragraphs 6.25-6.27 of the Commentary apply Article 6 of the Principles to this scenario and conclude that the parties have not agreed on the designation of an applicable law and therefore have not excluded application of the CISG.<sup>25</sup>

The analysis in the Commentary is straightforward. The law designated by each party's choice-of-law term is examined to determine how that law would resolve a "battle of forms." If under one or both of these laws no term prevails, the parties are deemed not to have chosen the applicable law. Party A's designation of the law of State X leads—in accordance with the general consensus of courts and commentators—to application of the CISG rather than domestic contract law. Article 19, the relevant contract formation rule of the CISG, is then identified. The Commentary accurately notes that there is no consensus among courts and commentators on whether Article 19 is a "knock out" or "last shot" rule, and the Commentary does not try to resolve this issue of CISG interpretation. A separate analysis of Party B's choice-of-law term is then made, although made simpler because the scenario itself indicates that State Y's general contract law—which is applicable, because Party B's term expressly excludes the CISG—follows the knock-out rule. Because no term prevails under one (or possibly both, depending on interpretation of CISG Article 19) of the laws designated by the two forms, the alternative set out in paragraph 1 *b*) of Article 6 of the Hague Principles provides that there has been no choice of the applicable law.<sup>26</sup>

A basic assumption of the Commentary is that no part of the CISG is relevant when determining whether the parties have agreed to

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<sup>24</sup> Hague Principles, *supra* note 1, Commentary at ¶ 6.24.

<sup>25</sup> *Id.* at ¶¶ 6.24-6.27.

<sup>26</sup> *Id.*



exclude the Convention pursuant to Article 6 of the CISG: “[i]f the parties enter into a choice of law agreement excluding the CISG, the CISG will not apply”<sup>27</sup> and “[because under the doctrine of severability] the choice of law agreement is a separate contract that is distinguished from the main contract (*e.g.*, the sales contract) . . . the Principles govern the choice of law agreement, whereas the CISG governs the sales contract . . . .”<sup>28</sup>

The issue is therefore whether this assumption is correct. In a separately published analysis, Professor Kadner concedes that his position—which supports the solution in the Hague Principles—is contrary to the “currently dominant position.”<sup>29</sup> He cites five authors and one court decision as favoring the view that the contract formation provisions of the CISG (Part II: Arts. 14-24) apply to the formation of the choice-of-law agreement.<sup>30</sup> He rejects this position on the principal ground that a choice-of-law agreement is distinct (“severable”) from the contract of sale.<sup>31</sup> For this proposition, he relies on Article 7 of the Hague Principles, which states the severability principle,<sup>32</sup> and Article 4 of the CISG, which states that the Convention “governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract.”<sup>33</sup> In support of his interpretation, Professor Kadner suggests several useful consequences. He notes that looking to general contract law rather than Part II of the CISG has the advantage of providing more comprehensive contract formation rules.<sup>34</sup> He also points out that, because Article 4(a) of the CISG excludes coverage of issues of validity, a solution that leads to

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<sup>27</sup> *Id.* at ¶ 6.25.

<sup>28</sup> *Id.* at ¶ 6.26

<sup>29</sup> To be accurate, Professor Kadner addresses the issue in his analysis of paragraph (1)(b) of Article 1 of the CISG. That paragraph provides that the CISG governs a contract of sale if rules of private international law lead to the law of a Contracting State. Professor Kadner’s analysis of Article 1 is equally applicable to Article 6 of the CISG. Kadner, *supra* note 7, at 95-98.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Hague Principles, *supra* note 1, art. 7.

<sup>33</sup> CISG, *supra* note 5, art 4.

<sup>34</sup> Kadner, *supra* note 7, at 97.

general contract law provides a single law for issues of both formation and validity.<sup>35</sup>

Without necessarily endorsing the dominant position—at least as it is summarized by Professor Kadner—I find Professor Kadner’s reliance on Article 4 of the CISG unpersuasive. On its face, the CISG governs more than contract formation (Part II) and the rights and obligations of sellers and buyers (Part III). The CISG clearly also governs the Convention’s sphere of application, not to mention the Final Provisions in Part IV. There is little reason to think that the general provisions in Part I (Arts. 7-13) do not apply to interpretation of the sphere of application provisions (Arts. 1-6) as well as to the provisions of Parts II and III. Thus, if the policies and rules of interpretation found in Part I support the proposition that the CISG determines whether the parties have agreed to exclude the CISG, there is no need to rely on direct application of Article 19 of the CISG.

Moreover, I think Professor Kadner pays insufficient attention to the CISG policies and principles of interpretation noted above in this paper’s preliminary remarks. Although the CISG does not deny a role for private international law as its predecessor (Uniform Law on the International Sale of Goods (ULIS)) did,<sup>36</sup> the CISG subordinates the role of private international law to the Convention’s provisions and the general principles on which the CISG is based. The subordination of private international law is evident in the basic scope provision of Article 1(1) of the CISG: if the seller and buyer have their places of business in different Contracting States, the CISG applies;<sup>37</sup> only if that paragraph is not satisfied does private international law play a role in making the CISG apply. To argue that private international rules are the *exclusive* source of rules when determining whether the parties have agreed to exclude the CISG pursuant to Article 6 is to upset the agreed relation between the CISG and private international law. It should not be forgotten that until it is shown that the parties agreed to exclude the CISG pursuant to Article 6 of the CISG, the Convention governs. In

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<sup>35</sup> *Id.* at 96-97.

<sup>36</sup> Uniform Law of International Sales, art. 2. The Uniform Law is set out in the annex to the 1964 Convention Relating to a Uniform Law on the International Sale of Goods, 834 U.N.T.S. 107 (1972).

<sup>37</sup> CISG, *supra* note 5, art. 1(1)(a).

other words, Article 6 itself is in a sense subordinate to the scope provisions of Article 1(1).<sup>38</sup>

One reason for subordinating private international law is that the CISG endorses the policy of uniformity, and private international rules do not always lead to uniform outcomes. This is true in the context of contracts and is especially true when parties use standard terms, where the rules are uncertain in part because of the failure of commentators to analyze the issues. There is no assurance that the Hague Principles will be successful in securing uniformity by their formula for analyzing the battle of forms. Even if widely implemented, the Hague Principles allow for potential non-uniform outcomes. For example, the Principles rely on non-uniform rules of interpretation unlike the CISG, which, as noted earlier, incorporates uniform provisions on interpretation of the parties' statements and on the binding quality of the parties' course of dealing and usages of trade.

### III. MORE DETAILED ANALYSIS OF SCENARIO 4

In the scenario set out in the Hague Commentary, the judge sits in a State party to the CISG.<sup>39</sup> The judge is bound by Article 1(1)(a) to apply the CISG unless it can be shown that Party A and Party B agreed to exclude the Convention pursuant to Article 6. How the judge might analyze the issues involved may best be understood by considering several simpler hypothetical cases.

If Party A and Party B had negotiated a term that expressly excluded the CISG but did not designate the applicable law, the issue whether the parties agreed to the term is a matter of interpreting Article 6 of the CISG. The CISG does not provide an explicit answer, so, before turning to private international law, Article 7(2) directs the reader to look to the general principles on which the CISG is based. These principles can be derived from Part II and can be summarized

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<sup>38</sup> For an analysis of the relation of Article 6 of the CISG and private international law, see COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS, *supra* note 14, Art. 6, ¶¶ 4-5 (“The formation and interpretation of the exclusion of the CISG is subject to the rules of the Convention as the CISG determines its sphere of application autonomously”).

<sup>39</sup> Hague Principles, *supra* note 1, Commentary at ¶ 6.24.

as requiring clear evidence of actual agreement. Article 19 would not be directly applicable, but indirectly the insistence on a “mirror-image” acceptance of an offer is evidence of this principle. If a court should find that there was an agreement to exclude the CISG, the court would then apply private international law rules to determine which State’s law applies when the parties have not chosen the applicable law.

This analysis becomes only slightly more complicated if Party A and Party B each includes in its standard terms a term excluding the CISG without designating another law as the law applicable. The complication arises because each of the exclusion terms must be read in the light of Article 8 of the CISG (and, when relevant, Article 9 on binding trade usages and the parties’ course of dealing). If each exclusion term is unambiguous there would be consensus on exclusion and again a judge would apply the national law applicable by virtue of the rules of private international law. If, however, one of the terms is interpreted as not excluding the CISG, the judge would look to the general principles on which the CISG is based as directed by Article 7(2). This general principle, I suggest, is to enforce the agreement of the parties when interpretation of their statements and acts under Article 8 show that there is consensus. The general principle is derived from Part II of the CISG and is not bound by any particular interpretation of Article 19. In a case where one standard term excludes the CISG and the other does not, a court should find that the seller and buyer have not agreed to exclude the CISG.

Sellers and buyers will rarely agree to exclude the CISG without designating the law applicable instead. Somewhat more likely is a transaction where Party A and Party B negotiate a term excluding the CISG and a separate term that designates the law of State Z, a non-CISG State, as the applicable law. The judge in this case must answer two questions: Did the parties agree to exclude the CISG? and, Did the parties effectively choose the law of State Z? As in the cases analyzed in the preceding two paragraphs, the judge should analyze the first of these questions in light of the CISG’s general principles on the formation of an enforceable agreement. That the parties purport to choose the law of State Z as the applicable law is some evidence of their intent to exclude the CISG. Whether or not their choice of State Z’s law is valid is a separate question. If the judge concludes that the parties agreed to exclude the CISG, the judge must then determine

whether rules of private international law would give effect to the parties' choice of the law of State Z.

These same two questions are posed even if Party A and Party B include the exclusion and the choice of the law of State Z in a single term of their agreement—or in substantively-equivalent terms in each of their standard terms. There is no reason for the judge to analyze the case differently. Even if the parties use a more likely formula—the term merely designates the law of State Z as the applicable law—there are the same two questions and the same analysis. Note, in particular, that absent an express exclusion of the CISG the choice of the law of State Z might be intended merely to designate the applicable domestic law if there are gaps in the CISG.<sup>40</sup>

Scenario 4 of the Hague Commentary also involves the same two questions and the same analysis. One standard term designates the law of State X, which effectively is a choice of the CISG; the other standard term designates the law of State Y but expressly excludes application of the CISG, which effectively is a choice of the domestic law of State Y. Applying the CISG's general principles on contract formation to the first question, there is no consensus on exclusion of the CISG under Article 6 of the CISG. Nor, as it happens, is there an effective choice of the applicable law by application of the analysis found in the Commentary to Article 6 of the Hague Principles. The analysis of the two questions is simpler and more direct than that based solely on Article 6 of the Principles. It recognizes a role, albeit a subordinate one, for private international law. In other words, the analysis is a rational alternative to the reasoning of the Hague Principles.

#### IV. ADDITIONAL REMARKS

Whether one analyzes Scenario 4 using the Hague Commentary or my alternative analysis the result is the same: Party A and Party B have not agreed to exclude application of the CISG so the Convention governs their transaction. Nevertheless, several additional remarks are in order.

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<sup>40</sup> CISG, *supra* note 5, art. 7(2).

First, the Commentary apparently assumes that there is at all times an enforceable sales contract. This is apparently based on the concept of severability: whether or not the parties have a contract of sale excludes any consideration of choice-of-law terms even if all the terms are in a single document. It is difficult to imagine that sellers and buyers think of their “deal” as consisting of two distinct contracts. My alternate analysis leaves open the question of whether the parties have formed a contract of sale. If the parties have not agreed to exclude the CISG, a judge will determine whether the parties concluded a sales contract by looking to Article 19 and applying it to *all* terms (including the choice-of-law term) of the parties’ deal.

Second, the Commentary makes the result appear easy by simply stating State Y’s contract law rule on battle of forms without going through the potentially difficult task of ascertaining and interpreting that rule.<sup>41</sup> Having reported that the rule is a “knock-out rule” the result follows by a simple application of paragraph 1 *b*) of Article 6 of the Hague Principles: “if the parties have used standard terms designating two different laws and . . . [if] under one or both of these laws no standard terms prevail, there is no choice of law.”<sup>42</sup> Under the “knock-out rule” of State Y, no standard term prevails so there is no choice of law. In practice, however, identifying how a jurisdiction deals with conflicting standard terms may be contentious and time-consuming—and in the case of conflicting standard choice-of-law terms the analysis will have to be done for each of the jurisdictions designated in the conflicting standard terms.<sup>43</sup>

Third, it follows from the second point that, if Article 19 of the CISG is interpreted as adopting a “knock-out rule,”<sup>44</sup> parties will never chose the applicable law if one of the parties designates the law

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<sup>41</sup> Hague Principles, *supra* note 1, Commentary ¶ 6.24.

<sup>42</sup> *Id.* at art. 6 1 *b*).

<sup>43</sup> If the CISG is interpreted as adopting a knock-out rule, there never will be a choice of law when one of the States is a CISG state. The answer to scenarios like that of Scenario 4 will always be that there is no choice of law. The Hague Commentary avoids interpretation of Article 19 because the scenario itself states that the law of State Y regarding battle of forms applies a knock-out rule.

<sup>44</sup> It should be noted that the Hague Commentary quite rightly does not interpret Article 19, merely calling attention to the several possible interpretations recognized in case law and the literature.

of a CISG state as the applicable law. The answer to scenarios like that of Scenario 4 will always then be that there is no choice of law agreement. This would simplify analysis using the Commentary's approach because no further analysis is necessary if one party has designated a CISG state.

Finally, by commenting on the interface between the Principles and the CISG only with respect to the "battle of forms," the Commentary misses an opportunity to provide a more systematic analysis of that interface. If, for example, the parties are not located in different Contracting States, what is the relation of the Hague Principles to CISG Article 1(1)(b)? Even within Article 6 of the Principles there are questions that might have been addressed. Consider the following variation on Scenario 4:

Party A's standard terms designate the law of State Z, a non-CISG State, and Party B's standard terms neither exclude the CISG nor choose an applicable law. (All other facts remain the same as in Scenario 4.)

Paragraph 1 *b*) of Article 6 is not relevant—the parties' standard terms have not chosen two different laws—so paragraph 1 *a*) is the relevant rule. As a similar provision in Article 10 of the Rome I Regulation is interpreted, the law of State Z is the law the two parties "purportedly agreed to."<sup>45</sup> In such a case, Professor Kadner argues that the domestic contract law of State Z determines whether the choice is valid.<sup>46</sup> If it is valid, the Principles would conclude that, because the CISG is not the law in State Z, the parties had excluded the CISG even though Party A and Party B have their places of business in different Contracting States. By contrast, an analysis that applies the CISG principles to determine whether the parties have agreed to exclude the CISG would look to the statements and acts of both parties rather than a "purported agreement" derived from only one of them. The silence of Party B should not be deemed an acceptance of Party A's term. This is a general principle found in Article 18(1) of the CISG ("Silence . . . does not in itself amount to acceptance.")<sup>47</sup> Moreover, given the

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<sup>45</sup> Council Regulation 593/2008, The Law Applicable to Contractual Obligations (Rome I), 2008 O.J. (L 177) 6.

<sup>46</sup> Kadner, *supra* note 7, at 94-99.

<sup>47</sup> CISG, *supra* note 5, art. 18(1).

widespread adoption of the CISG, Party B's silence may reflect a judgment that there is no need to choose a law when dealing with businesses located in other Contracting States because the CISG will apply and Party B thinks its provisions satisfactory. This analysis leads to the conclusion that Party A and Party B have not agreed to exclude the CISG.

The Commentary's relatively straightforward analysis of Scenario 4 may leave the impression that all applications of the Hague Principles will be equally straightforward. This is not the case. The Commentary rightly points to the potential importance of applying the Principles to CISG transactions. It is unfortunate—but understandable for reasons of space—that the Commentary addresses only one scenario. For informed analysis of additional scenarios, the reader must look to Professor Kadner's separate publication.<sup>48</sup>

#### CONCLUSION

In this paper I analyze the relation of the Hague Principles on the Choice of Law in International Commercial Contracts to the CISG when a seller and a buyer exchange different choice-of-law terms in their standard terms. I have done so by studying a scenario ("Scenario 4") in the Commentary to Article 6 of the Principles. The thesis of the paper is that the solution offered in the Commentary is not the only reasonable way to analyze the scenario. In support of my thesis it is not necessary that I demonstrate that my analysis is the only proper analysis or even that my analysis is the better one. I merely have to show that a rational judge or arbitrator might choose my analysis over that offered by the Commentary. If I am persuasive, adoption of the Principles should not be read as endorsing the Commentary solution as definitive.<sup>49</sup>

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<sup>48</sup> Kadner, *supra* note 7, at 94-99.

<sup>49</sup> The final text of the Commentary adds a final sentence to paragraph 6.23: "The interpretations of the CISG in this Commentary do not purport to be exclusive or authoritative interpretations of the CISG by the Hague Conference or its members." *See supra*, note 1.



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**AN INSTITUTIONAL APPROACH TO THE  
CREATION OF INNOVATION  
ECOSYSTEMS AND THE ROLE OF LAW**

*Toshiyuki Kono\* and Kazuaki Kagami\*\**

INTRODUCTION

Innovation is considered a source of social development, and the promotion of innovation has been encouraged all over the world. The methods for which innovation can be achieved, however, have not been clearly identified. The concept of an “ecosystem” has recently emerged as a tool to illustrate the organizational aspects of innovation, but the conditions and mechanisms necessary to create and manage a successful innovation ecosystem remain unclear.

Many countries, including Japan, have been trying to create an ecosystem similar to Silicon Valley by inviting and accumulating venture companies, research institutions, and universities, and by providing special measures for tax reduction, new funding schemes, and opening new facilities. However, one important aspect seems to have been overlooked: even if each player is innovative, if they do not create relationships that lead to innovations, the area as a whole cannot function as an innovation ecosystem. When an ecosystem is established, the conditions of its autonomous functioning are not automatically fulfilled. Hence, we are interested in the role of law, which might contribute to the development of these conditions. In particular, we will focus on a factor that would lead to the

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\* Distinguished professor, Graduate School of Law, Kyushu University.

\*\* Professor, Faculty of Economics, Toyo University.

establishment of innovation ecosystems and functions—we<sup>1</sup> call it “mode,” which we understand as those factors that determine the direction of the player’s thinking and activities—and analyze the role of law to facilitate the sharing of modes by relevant players.

To illustrate the goal of this article, let’s have a look at the Ohta Ward in Tokyo. In Ohta Ward, many diverse small and mid-sized companies have gathered and countless innovations are continuously created. In this area, a number of voluntary interactions among these companies take place. Furthermore, networks between these companies, research institutes and governmental agencies are well established. Importantly, in Ohta Ward, laws and rules have played a crucial role in establishing these networks and their management. An innovation ecosystem, along with the supporting infrastructure, is firmly established in Ohta Ward. The supporting infrastructure includes not only measures related to tax and finance, but also measures aimed at development and education of human resources, the supply of human resources into the ecosystem, support for matching players, and the reduction of friction related to the establishment of networks and their management. In short, various types of support focusing on specificities of the ecosystem are offered as institutional bases of this well-functioning ecosystem.<sup>2</sup>

## I. INNOVATION ECOSYSTEM AND THE ROLE OF LAW

Many policymakers and other governmental authorities have focused on innovation. Various policy measures have been introduced and implemented to achieve innovation. Industrial policies, particularly centralized industrial policies, are often adopted by developing countries to “catch up” with developed countries. Such policies are

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<sup>1</sup> This refers to the authors of the article and is used throughout this article.

<sup>2</sup> Chiiki ni okeru sangyō shūseki no keisei oyobi kaihatsu ni kansuru hōritsu shinki jigyō ritchi no sokushin o tsūjite-tō [Act on Formation and Development of Regional Industrial Clusters through Promotion of Establishment of New Business Facilities, etc.], Act No. 40 of May 11, 2007 (Japan).

inadequate to create new technologies or ideas, or to develop new types of market. Instead, open and decentralized systems have recently been attracting the attention policymakers. This is the so-called “ecosystem.”

We share the view that an ecosystem is one of the most important keys for innovation.<sup>3</sup> Although a well-established and widely shared definition of the concept of an ecosystem does not yet exist, there is one shared understanding of the ecosystem:<sup>4</sup> an organization or system where continuous and dynamic interactions among various players take place. Inherent in this definition is the idea that innovative outcomes cannot be obtained solely by a single “genius” individual or through a well-controlled and uni-linear evolution process. Rather, it is presumed that outcomes can be obtained as a result of multi-layered and voluntary interactions among various players.<sup>5</sup>

Various policy measures have been implemented to promote innovations, including education policies to build the capacity of (potential) players in the ecosystem, cultural policies to promote innovation-oriented minds, intellectual property (IP) protections and tax policies to incentivize players, accumulation policies to raise the degree of players’ density, and subsidization policies. If these policy measures are successful, we would find a number of successful innovation ecosystems. The reality, however, is that despite many countries’ efforts to create a second Silicon Valley, their trials often yield unsuccessful results. This failure implies that the proper

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<sup>3</sup> See *infra*, note 6.

<sup>4</sup> Ecosystem is defined as “a multi-faceted and continual interaction among many aspects of our economy and society.” COUNCIL ON COMPETITIVENESS, INNOVATE AMERICA: NATIONAL INNOVATION INITIATIVE SUMMIT AND REPORT 46 (2005).

<sup>5</sup> Regarding the evolution of the innovation concept, see RICHARD S. ROSENBLUM & W. J. SPENCER, ENGINES OF INNOVATION: U.S. INDUSTRIAL RESEARCH AT THE END OF AN ERA (1996); ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURES AND COMPETITION IN SILICON VALLEY AND ROUTE 128 2-4 (1994) (comparing the independent firm-based system and the regional network-based system, and asserting that the latter is more suitable).

understanding of the conditions and means necessary to create innovative ecosystems is still lacking.<sup>6</sup> Why is that so?

Our view is that policy measures have tended to target individual players themselves, and have failed to focus on the *interaction between players*. Even if excellent inventors, scholars, and entrepreneurs had populated a particular area, that area would not function well as an ecosystem if their interactions are ineffective. This idea reflects the shortcomings of previous research on ecosystems. It is a widely accepted belief that networking, communication, and collaboration are crucial, but how to facilitate this remains somewhat unclear. In short, the conditions of a well-functioning ecosystem has not been a topic of significant research.

A key factor of a well-functioning ecosystem is the transaction costs caused by interactions among players.<sup>7</sup> If transaction costs are high, interactions stagnate and the ecosystem remains ineffective. Further, if transaction costs matter, a law and economics approach might contribute to a clarification of the conditions. What can law do to promote interactions among players to create successful ecosystems?

## II. INNOVATION ECOSYSTEM AND MODE

### A. Mode of Thinking and Behavior

1. *Generally recognized facts on innovation.* – As already mentioned, innovations are created through interactions among multiple players under specific conditions. Such interactions can be affected by players' internal nature and external environment. Players' internal nature includes their knowledge, technical strength, passion, financial power,

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<sup>6</sup> In this context, see VICTOR W. HWANG & GREG HOROWITT, *THE RAINFOREST: THE SECRET TO BUILDING THE NEXT SILICON VALLEY* 304 (2012).

<sup>7</sup> For a discussion of transaction costs related to communications, see KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974); OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES* (1975).

way of thinking, and behavior. These elements of a players' internal nature might be so player-specific that trying to determine an "average type" or "typical features" is unhelpful. In addition, these elements are usually formed within each player and become quasi-inherent. Therefore, a players' internal nature is not easily changeable, and any change would require significant time and costs.

A player's external environment consists of external factors that influence his activities and performances, but that cannot be directly controlled by the player. Such factors include other players' capabilities, types of players, or the density of players; funding systems; legal systems to protect contracts and/or property; the quality and quantity of lawyers; the credibility of the judicial system; macro-economy and industrial structure; and consciousness on invention or entrepreneurship in society.

Recognizing the fact that a number of factors affect innovations, we propose to focus on mode and to clarify the role of law in relation to mode because mode has been neglected in preceding scholarly works and has not been integrated into policy measures.

*2. The concept of mode and its functions.* – In this paper, we understand mode as those factors that determine the direction of each player's thinking and activities. This understanding of mode considers each player's internal nature, but excludes purely innate factors such as IQ. Mode overlaps to some extent with personal character; however, mode is not identical to individual personality or philosophy, since personality and philosophy remain individual and internal. Instead, mode has such aspects that affect performances and outcomes of collaborative works with other players. Focus should be placed on such factors that can be acquired after birth and that are to some extent adjustable, such as language. Even if an individual is honest,

industrious and has good sense of humor, he cannot contribute to innovation if he does not have a mode to work with others.

Mode is also closely linked to organizational cultures.<sup>8</sup> Schein defines organizational cultures as:

[A] pattern of shared basic assumptions that was learned by a group as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems.<sup>9</sup>

This definition is very close to our understanding of mode. However, mode in our view has a larger scope than that of organizational culture. Analysis of organizational cultures has often focused only on a single corporation, where the membership is fixed and has to follow the top-down authority. But mode is not limited to a single corporation. Mode as specific patterns of thinking and activities can apply to several organizations. In addition, even if an organization has a fluctuating membership, it could have its own mode. In addition, although studies on organizational cultures often presume that organizations can stand-alone without being affected by the outer world, this presumption seems unrealistic. Organizations cannot remain unaffected from interventions from outside, and mode is a useful tool to explain such situations.

The mode of a community or a region may have similarities to socio-cultural norms. In preceding discussions on socio-cultural norms, socio-cultural norms tend to be understood as unilaterally

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<sup>8</sup> For a discussion of organizational culture, see TERRENCE DEAL & ALLAN KENNEDY, *CORPORATE CULTURES: THE RITES AND RITUALS OF CORPORATE LIFE* (1982); EDGAR H. SCHEIN, *ORGANIZATIONAL CULTURE AND LEADERSHIP* (4th. ed. 2010). For an analysis from an economics perspective, see David M. Kreps, *Corporate Culture and Economic Theory*, in *PERSPECTIVES ON POSITIVE POLITICAL ECONOMY* 90-143 (James E. Alt & Kenneth A. Shepsle, eds., 1990).

<sup>9</sup> SCHEIN, *supra* note 10, at 18.

influencing individuals or organizations, while feedback from individuals or organizations to such norms tends to be neglected. Even if such feedback would be taken into consideration, the self-organizational nature of society is so emphasized that little attention is paid to the laws or powers that would intervene from outside of the society.<sup>10</sup> In addition, such focus on the self-organizational nature might lead to an overlook the fact that societal relationships are more complex: such relationships include those between one society and other societies, between a society and a supra-society, or between a society and a partial society.

The concept of mode helps us to pay due attention not only to each component of a society, i.e., mode of individuals, modes of organizations, inter-organizational relationships, and composite situations with these components,<sup>11</sup> but also to relationships between a society and its outer world.

Each player's mode can be adapted to his external environment. Thus, his mode is influenced by the cultures, values, religions, norms, customs, and fashions of society as a whole.

*3. Interactions between different players with different modes result in high transaction costs.* – If each player's personal mode and the mode of his organization, community, and region (locale) are different, it is extremely difficult for such an organization or community to function as an ecosystem.<sup>12</sup> In other words, members of an organization or community must share a specific mode. However, in order to foster innovation in an ecosystem, sharing specific modes by members will

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<sup>10</sup> See ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991).

<sup>11</sup> See Robert Sugden, *Spontaneous Order*, 3 J. ECON. PERSP. 85 (1989); Jon Elster, *Social Norms and Economic Theory*, 3 J. ECON. PERSP. 99 (1989); H. Peyton Young, *The Economics of Conventions*, 10 J. ECON. PERSP. 105 (1996); Randal C. Picker, *Simple Games in a Complex World: A Generative Approach to the Adoption of Norms*, 64 U. CHI. L. REV. 1225 (1997).

<sup>12</sup> See JOHN P. KOTTER & JAMES L. HESKETT, *CORPORATE CULTURE AND PERFORMANCE* (1992); JIM C. COLLINS & JERRY I. PORRAS, *BUILT TO LAST: SUCCESSFUL HABITS OF VISIONARY COMPANIES* (1994).

not suffice. Each member's mode should be adapted to the external environment and should be consistent with the purpose of the community. For example, Toyota has not only been trying to let its employees share the same modes (organizational modes), irrespective of the location of subsidiaries, but has also been creating the modes in their supply chains (community modes). In Silicon Valley, there exists explicit or implicit modes to conduct business.<sup>13</sup> To be noted here is the fact that a mode in an organization (e.g., Toyota) or in a region (e.g., Silicon Valley) is usually different from other organizations (e.g., General Motors) or regions (e.g., Ohta Ward). In other words, each ecosystem should have its own mode to function well.

To create an open innovation ecosystem or meta-national ecosystem beyond one organization or one region, several communities with different modes or individuals from different communities must interact, for example, merger and acquisition between private companies; joint venture; collaboration between private company and university or private company and government. Also, with regard to merger and acquisition between private companies, many unconventional collaborations might occur, such as collaboration between manufacturer and distributor. This situation, however, would lead to constant conflicts of modes. Many failed merger and acquisition cases (e.g., *Daimler Chrysler*<sup>14</sup> and *AOL-Time Warner* merger<sup>15</sup>) imply that, in such conflicted circumstances, no innovation ecosystems can be created.

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<sup>13</sup> For a discussion of the history and institutions of Silicon Valley, especially functions as ecosystem and relations to external environment, see MARTIN KENNEY, *UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION* (2000).

<sup>14</sup> Roberto A. Weber and Colin F. Camerer, *Cultural Conflict and Merger Failure: An Experimental Approach*, 49 *MGMT. SCI.* 400 (2003).

<sup>15</sup> Tim Arango, *How the AOL-Time Warner Merger Went So Wrong*, *N.Y. TIMES*, Jan. 11, 2010, <http://www.nytimes.com/2010/01/11/business/media/11merger.html?pagewanted=all>.



In a well-functioning innovation ecosystem, innovations are expected to occur autonomously and continuously. However, integrating (new) players with different modes into an ecosystem with its own mode may be difficult, since such integration could inevitably cause friction between the new players and the mode of the ecosystem. More difficult is the challenge of adjusting each community's mode and non-community-members' mode, because the mode of a community is usually so designed that the community functions well as an autonomous mechanism. Integration of such a mode and the mode of non-community-members would not occur autonomously. Hence, we need external interventions, such as law, to facilitate integration of different modes.

Here, then, is the question we must answer: how should law be designed as a useful tool to adjust to conflicts of modes? Roughly speaking, there are two possible directions: (1) to introduce a unified mode, disregarding players' different modes; and (2) to select appropriate modes on a case-by-case basis, maintaining the difference of modes.

### III. ANALYSIS

#### A. Interactions in a Community: Hypothesis

We assume that players enter into a community voluntarily with an aim to do business, but they cannot predict who they will meet in the community. We will further assume that diverse players belong to the community. To illustrate this assumption in a simpler form, let us assume that two players 1, and 2, belong to the community. Players, 1 and 2, encounter each other by coincidence and create a relationship. The outcome of this relationship will depend on the players' modes and external environment, assuming each player chose his mode prior to the encounter and that his mode cannot be changed.

Innovations occur through players' voluntary interactions. Such successful interactions which can bring about innovations requires that the mode of each player matches with others' modes. If players' modes do not match, their relationships will not function as

an ecosystem. In such a case, investment would be wasted without any return. Therefore, in Table 1, we assume a negative outcome if players' modes do not match. Even if players' modes match, benefits are smaller if their modes are not consistent with external circumstances. In Table 1, it is assumed that modes of two parties are [i] in an environment [i], benefits 30 could be produced to each player. If such a match occurs in an environment [j], benefits would be only 5. If their modes do not match, frictions occur and benefits would be -10. Equally, if their modes are [j] in an environment [j], benefits would be 30, while benefits would be only 5, if their modes are [i].

Table 1: The pay-off matrixes of Players 1 and 2.

		external circumstance: i	
		mode i	mode j
1	2		
mode i		30, 30	-10, -10
mode j		-10, -10	5, 5

		external circumstance: j	
		mode i	mode j
1	2		
mode i		5, 5	-10, -10
mode j		-10, -10	30, 30

Strictly speaking, differences of modes are more complex. Let's assume that mode "i" represents a mode which is innovation oriented. We use [a] and [b] to illustrate two specific modes as variations of "i". For example, mode [a] puts more emphasis on production process, while marketing is more important in mode [b]; even though both modes do not hesitate to take risks, mode [a] prefers *ex ante* investigation and planning, while in mode [b] *ex post* risk management is more important; certain types of conflicts of modes are small and can be resolved through players' cooperative negotiations, but other types of conflicts of modes are so great that they need organizational reforms. In any case, such complexity is reflected in the size of transaction costs.

## B. The Role of Law in Promoting Innovation

*1. Traditionally recognized functions of law.* – Even in a well-functioning ecosystem where relationships among players are autonomously established, law plays a crucial role as an element of the external environment.

First, law can be a tool to enhance each player's individual capacity. In addition, educational and training schemes can be introduced from outside of the ecosystem by law. If each player's knowledge, technique, and comprehension can be enhanced by these schemes, outcomes such as the figure 30 in Table 2 can be increased to fifty or one hundred.

Second, contracts and properties can be protected by law. To achieve the outcomes in Table 2—either thirty or five—contracts and property rights must be protected. Some ecosystems can offer protective functions by its traditional customs or social norms. However, they have a few shortcomings compared to law: it is more difficult to enforce these non-law customs and norms than it is to enforce law; there is no guarantee that such customs and norms would be appropriately designed and applied; and it is more difficult to amend or abolish customs and norms than it is to abolish law.

Third, law is necessary to develop and manage infrastructures, including financial systems, information systems, traffic systems, distribution systems, production systems, and legal systems, for innovations. These infrastructures improve the quality of each player's activities, and the contents and frequency of innovations, by enlarging and facilitating players' interactions.

These functions have traditionally been expected as the roles of law, and have been integrated into various policy measures. The important thing is to understand that the roles of law are not limited to these functions.

*2. Autonomous adjustment by ecosystem and its limits.* – As stated above, conflicts of modes are fatal for innovations. If modes of players

do not match, modes can be adjusted by autonomous mechanisms in the ecosystem to which they belong.

The simplest autonomous mechanism is named “cheap talk” in economic theory.<sup>16</sup> Let’s take Table 1 again and assume that the external environment is [i]. If a player adopts mode [i], it is desirable that another player would also adopt mode [i]. In other words, both players want to cooperate, i.e., choose the same “mode,” if they know what the other player’s choice will be, but uncertainty about the other player’s choice will make such cooperation fail. Under such circumstances, the appropriate action for one player is to inform the other player of his choice of mode before the other player chooses his mode. Since both players wish to collaborate, they can trust that such notice is correct and the other player will take the same mode. Therefore, the desirable result, i.e., choice of mode [i] by both players in the environment [i], would occur through both parties’ voluntary actions. The problem, however, is that this situation does not often exist.

Another useful mechanism to adjust modes is an “evolutionary process.” This mechanism assumes that each player will choose his “mode,” which might bring about greater benefits. Then the player will look at his mode or the mode of other players in a close circle. These players would learn a better mode-to bring about more benefits-and try to imitate it. Repeating trials to imitate and learn other modes would lead to a situation in which the more beneficial mode would become dominant in society. This mechanism does not require players to be rational or perfect usable information. A number of trials to learn others’ modes and imitate them would lead to specific modes becoming dominant in the society.

Conditions of this mechanism, however, are not easy to fulfill. First, to learn or imitate a more beneficial mode (mode as objective), players should share the same learning mode or imitation mode (mode

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<sup>16</sup> See Joseph Farrell & Matthew Rabin, *Cheap Talk*, 10 J. ECON. PERSP. 103 (1996).

as method). To observe, understand, obtain, and apply other players' ways of thinking and behavioral patterns (mode) requires complex interactions between players on both the learning and teaching sides. If learning or imitation of others' mode is difficult, the entire to-be-evolutionary process may not evolve. Second, during the evolutionary process, the external environment should be stable. If the external environment changes, the evolutionary process will lose orientation. The external environment of innovations, however, often changes. Therefore, even if the evolutionary process evolves, it may not reach a desirable goal, i.e., to achieve expected benefits and create an ecosystem.

We cannot simply assume that an ecosystem would autonomously function to resolve conflicts of modes among players and promote innovations. When conflicts of modes occur, an ecosystem may not function and innovations will not occur. We should not fully depend on the autonomous adjustment functions of an ecosystem, and may have to use mechanisms and powers outside the ecosystem. Here, we see the potential utility of law, although preceding analysis overlooked this aspect.

### C. Mode and Law

As we saw in Section A, there are three functions for which law has traditionally been performing in order to support the creation of an innovation ecosystem. However, we realized that the mode has been neglected and autonomous adjustment mechanism inherent in an ecosystem has limits. Here, we see a new role of law, i.e., adjustment of modes. This includes the following: First, law might encourage each player to change his mode before their encounter, which will prevent conflicts of modes in advance. This is unnecessary for players in the same region or industry; however, when private companies and authorities cooperate for innovations, or when small- or medium-size companies want to expand their business in foreign countries, adjustment of modes assisted by law might be necessary. In addition, when a special economic zone is created to promote innovations, modes of players should be adjusted prior to their involvement in the zone. Law can play a crucial role in facilitating such an adjustment.

Second, when players' share the same mode [j], although the mode of external environment is [i],<sup>17</sup> such equilibrium between players does not bring about an optimal outcome; however a player will not be incentivized to change his mode [j] as long as other players retain mode [j], since maintaining mode [j] would be his best choice. To depart from such equilibrium is more difficult as the number of players gets larger, but a more appropriate mode will be adopted in order to achieve more innovations. Law can play a crucial role in facilitating the change of mode. To identify a more desirable mode might be costly for players, but if the law can identify the mode at a lower cost or more effectively, players might be encouraged to change their mode. A good example which illustrates the change of mode is the Meiji Restoration in Japan at the end of the nineteenth century. After the feudal system, begun under Tokugawa Shogunate in the seventeenth century was collapsed, the new Meiji Government sought a model of a modern State. After a thorough investigation, the Meiji Government decided to introduce the system from Prussia, and modeled the Imperial Constitution of Japan as well as important basic laws after the Prussian system.

Law can also synchronize the timing as a mode. For example, today's academic calendar in Japan begins in April and ends in March of the following year, which we could describe as the April-March mode. This was not the case, however, until the early twentieth century. In 1886, the academic year of elementary schools was changed to follow the State's fiscal year, which starts in April. The calendar of high schools was changed in 1919, and in 1921, when the academic calendar of universities was changed, all schools adopted the April-March mode. This change affected not only the life style of people, but also business customs. Thus the April-March mode became the standard calendar mode of Japan and it affected various investments.

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<sup>17</sup> This could happen if, due to the change of external environment, the optimal match between the mode shared by players and modes of the external environment is lost.

Third, previous discussions on innovation ecosystem seem to only focus on success stories. However, as there are few Silicon Valley ecosystems in the world, it is important to also analyze the many failed cases. We should look at these cases through the lens of the functions of law to adjust different modes of players and environment and facilitate the creation of ecosystems.

#### D. Modes Beyond a Community

Adjustment of modes in one community is relatively simple, and it is easier to understand how to solve conflicts of modes in one community. However, recent open-innovation and meta-national innovations imply interactions beyond one organization, one region, or one state. Today, it is necessary to solve conflicts of modes in a “beyond-one-community-context.” Law can serve this purpose.

In an ecosystem, innovations can be achieved when the majority of the ecosystem’s members share the same mode. Within an ecosystem the unification of modes can be promoted. However, in order to develop innovations beyond an organization or a State, we will inevitably face various modes of diverse stakeholders and environments. Multiple ecosystems with different modes will co-exist. A key question for us is how to cultivate mutually beneficial interactions among these ecosystems. It is incorrect to assume that there is one universal mode to which all ecosystems should be oriented.

Diversity of mode occurs because, first, an ecosystem tends to internalize modes which are adaptable to regional circumstances, and support by local policies accelerates this tendency.<sup>18</sup> Second, if there can be several modes with equal desirability for innovations, the choice of mode to be shared in an ecosystem can be determined by coincidence. Therefore, two ecosystems facing the same external environment may choose different “modes,” and there would be plural equilibria. Third, sharing a mode is either path-dependent or history-

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<sup>18</sup> This idea was proposed by Charles M. Tiebout. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

dependent. When a mode has been shared in an ecosystem at a point in the past, investments would have been made presuming this mode would remain shared in the ecosystem. Through these investments, this mode would fit to innovation better. For example, if this mode is shared in a community in which individual investors (“angels”)<sup>19</sup> provide money to venture companies, various services to improve this mode would be developed, such as services to match angels and ventures; services to provide information to angels; services to support contracts between angels and ventures; and services to solve problems between angels and ventures. When these services are well-established, this mode is further strengthened.

Hence, it should be assumed that the mode shared in one ecosystem is usually different from modes of other ecosystems. However, as we saw above, how to cope with conflicts of modes is the key for innovations. Law can play a crucial role in this context. *Ex ante* adjustment and *ex post* adjustment are two possible designs of law to cope with conflicts of modes.

#### E. Legal System for *Ex Ante* Adjustment

*Ex ante* adjustment is inspired by the concept of uniform law; it establishes in advance a widely applicable mode and urges various players to adopt it. This approach can be further analyzed in detail: each community can retain its mode for internal interactions of players, but accept a widely applicable mode (mode [U]) for beyond-one-community-interactions among players (Table 2). Or, each community can force all players to adopt a universally applicable mode (mode [U]) (Table 3).<sup>20</sup>

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<sup>19</sup> Individual investors who provide start-ups with capital for their business are called as ‘angels’. This term originally stems from those wealthy individuals who financially supported theatrical productions in Broadway which would have otherwise been shut down.

<sup>20</sup> In Japan, there is a good example of this model, i.e. JIS (Japanese Industrial Standards) based on Kōgyōhyōjunkahō [Industrial Standardization Law], Act No. 185 of 1949 (Japan). This law was enacted in 1949 with aims at unification



Table 2, Uniform-Law Approach I.

1 \ 2	mode i	mode j	mode U
mode i	30, 30	-10, -10	-10, -10
mode j	-10, -10	5, 5	-10, -10
mode U	-10, -10	-10, -10	12, 12

Table 3, Uniform-Law Approach II.

1 \ 2	mode i/U	mode j/U	mode U
mode i/U	?, ?	?, ?	-10, -10
mode j/U	?, ?	?, ?	-10, -10
mode U	-10, -10	-10, -10	12, 12

In Tables 2 and 3, we assume that benefits brought about by the shared mode [U] [12] are smaller than the biggest benefits in Table 1 [30]. If benefits to be achieved by the mode [U] are bigger than [30], each community will voluntarily introduce this mode into their ecosystem, and it would be unnecessary to unify modes. However, if

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of industrial products and related technologies, designs, manufactures and managements in Japan. This law established unified modes on industries in Japan and facilitated transactions beyond individual organizations or regions and let to the improvement of the quality of industrial products. If this model is valid in international context or not, is our concern.

the mode [U] would bring about less than [5], the introduction of the mode [U] would be meaningless.

Table 3 illustrates that the modes applicable to intra-community and inter-community interactions mode are clearly separable. In reality, however, such clear separation is questionable, since an ecosystem usually consists of complex interrelationships of various players that include intra-community and inter-community interactions.

Unlike Table 2, Table 3 assumes that even if a policymaker forces an ecosystem to abandon its modes [i] or [j] and to apply the new mode [U], which does not necessarily match with their external environment. It is questionable whether a well-functioning ecosystem can easily abandon its original modes. Hence, applying a mode [U] that is applicable beyond a community would be difficult to implement.

In addition, although in these Tables we assume that both players would equally obtain benefits [12] by applying a mode U, in reality, each player's benefits are asymmetrical. Designing a mode and applying it would become a game among various players. Even if there is a mode [U] which could produce greater benefits as a whole, some players whose benefits would decrease by the mode [U] would oppose the mode. Such a power game would result in significant costs to societies, which could otherwise have been spent pursuing innovations.

#### F. Legal System for *Ex Post* Adjustment

We support the *ex post* adjustment system as the more functional approach. This system would modify modes and external environment only after conflicts of modes are recognized and the external environment of concerned interactions is investigated (Table 5). Whether players' modes would be modified or there would be an intervention into the external environment would be decided *ex post*. Modification of the external environment could also be made by law.

Different from the *ex-ante* adjustment system, the *ex post* adjustment system does not aim at the ideal solution. Of particular

importance is that this system is functional and there are less hurdles to overcome when introducing it. First, the *ex post* adjustment system would intervene only in the case of conflicts of modes. If the interaction of players is well-functioning, no costs would occur. Second, costs to consider all possible scenarios in advance, to negotiate with concerned players or communities, to develop a unified desirable mode and to disseminate it to related players or communities, would not occur. Finally, the *ex post* adjustment system does not affect already shared modes in a relevant ecosystem.

Table 4: Ex-post Adjustment approach.

1 \ 2	mode i	mode j
mode i	30, 30	-10, -10
mode j	-10, -10	5, 5

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1 \ 2	mode i	mode j
mode i	30, 30	i: 10, 2 j: 2, 10
mode j	i: 2, 10 j: 10, 2	5, 5

### CONCLUSION

To promote innovation, autonomous ecosystems in which various players are organically linked are crucial. Such ecosystems presume that specific mechanisms are shared among its closed membership. Introducing more open and universal mechanisms would hamper the original function of the ecosystem due to the conflicts of modes. Law would play a crucial role to adjust conflicts of modes between players and the environment, or among players. Under such conditions, we propose an *ex post* adjustment system by law. Such a system would enable both the maintenance of the diversity of the innovation ecosystem and, at the same time, the adjustment of interactions beyond one ecosystem.

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## LIMITS ON PARTY AUTONOMY IN INTERNATIONAL COMMERCIAL ARBITRATION

*Giuditta Cordero-Moss\**

### INTRODUCTION

International contracts are often drafted in a rather standardized manner, making use of so-called boilerplate clauses that aim at regulating the interpretation and operation of the contract. In addition, they often contain an arbitration clause that requires the parties to submit all disputes arising out of or relating to the contract to arbitration, thus excluding any involvement of national courts.

Standardised contract terms, including a boilerplate legal framework for the contract and arbitration clauses, are elements that seem to indicate an intention to render the contract self-sufficient. By including a detailed and extensive regulation of the legal relationship between the parties, the contract aims at making national law dispensable. If national law is not relevant, and the only basis for regulating the parties' legal relationship is the contract, it becomes possible and meaningful to standardise contract terms, even when contracts are intended to be implemented in a variety of legal systems, without the need to adapt them to the legal framework of the specific transaction. The impression of self-sufficiency is enhanced by the exclusion of national courts and the referral to arbitration instead. A

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\* Director of the Department of Private Law, Professor of Law at the University of Oslo. I presented the main lines of this article at the International Academy of Consumer and Commercial Law in Istanbul, July 2014. The article is originally published in the Oslo Law Journal 2014 No. 1, and is reproduced here with the consent of the publisher. The article was based on a paper that I presented at the Arbitration Forum of the Center for Transnational Litigation, Arbitration and Commercial Law, New York University, on February 3, 2014.

closed circuit is created, dominated by the will of the parties: the relationship is regulated by terms of contract agreed to by the parties, and disputes are solved by a private body bound by the contractual terms set forth by the parties. External sources, including national law, may seem redundant.

Self-sufficiency may seem a realistic goal as long as the legal relationship remains within the borders of the closed circuit. This assumes that the legal relationship is, at any time, subject to the terms and legal framework agreed between the parties.

There are, however, situations in which this assumption may turn out not to be true. For example, if a difference arises between the parties, and the parties disagree on what is the legal framework (notwithstanding that they may have agreed in the past, prior to the conflict); or if third parties' interests or public interests are affected, and mandatory rules or policies override the parties' agreement; or if the agreed terms or legal framework may be interpreted in more than one way or need specification by external sources. In these situations, the closed circuit is interrupted and recourse to external sources becomes necessary. To a certain extent, guidance may be sought in non-national, non-authoritative rules that may permit a uniform, transnational solution and thus reinstate the closed circuit. Where such a uniform guidance is not available, the closed circuit is interrupted again. When a full closed circuit cannot be assumed, party autonomy may be limited.

To assess the limits of party autonomy, it will be necessary to analyse the above mentioned situations where interference with the closed circuit may occur. Section II will briefly discuss to what extent the legal framework provided by the contract and possibly given effect to in arbitration may resist control and interference by national law; Section III will discuss to what extent the terms of the contract are capable of being interpreted in a uniform manner; Section IV will discuss to what extent transnational sources may provide a uniform legal framework capable of replacing national governing law; Section V will investigate to what extent the principle of faithful interpretation to the wording of the contract may be a guiding principle for arbitral tribunals.

## I. EXTERNAL LIMITS TO PARTY AUTONOMY: COURT CONTROL

The closed circuit described above meets the expectations as long as the arbitral tribunal gives effect to the will of the parties as embodied in the contract and the award is complied with by the losing party or enforced by the courts. The closed circuit fails when an arbitral award becomes invalid or unenforceable as a consequence of having given effect to the contract terms.

International arbitration is an alternative method of solving contractual disputes that is based on the consent of the parties. If the parties agree to submit their disputes to arbitration, then the ordinary courts will have to decline jurisdiction on those disputes, and the only possible mechanism to solve the dispute will be the arbitration that has been chosen by the parties. If, on the contrary, the parties have not entered into an arbitration agreement, disputes between them will have to be solved by the national court that has jurisdiction. An arbitral tribunal, in other words, bases its existence upon the parties' agreement. Moreover, the parties determine the composition of the arbitral tribunal, the procedural rules that have to be followed by the arbitral tribunal, the scope of the tribunal's competence and its power. The arbitral tribunal is bound to follow the instructions of the parties; otherwise, it exceeds the power that the parties have conferred on it. If the arbitral tribunal exceeds its power, neither its jurisdiction nor its award are founded on the parties' agreement, and there is, consequently, no legal basis for either of the two. These basic elements of arbitration are based on the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, June 6, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38, ratified by 155 countries<sup>1</sup> and are reflected in most national arbitration laws, as well as in the UNCITRAL Model Law on International Commercial Arbitration, adopted in sixty-nine countries.<sup>2</sup>

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<sup>1</sup> For a list of ratifications, see UNCITRAL, Status Convention on the Recognition and Enforcement of Foreign Arbitral Awards, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html) (last visited on June 19, 2015).

<sup>2</sup> For a list of Model Law countries, see UNCITRAL, Status UNCITRAL Model Law on International Commercial Arbitration (1985), with amendments as adopted in 2006,

Arbitration's dependence on the parties' will, which is so uniformly recognised, is an important factor strengthening the opinion that arbitration is a private matter between the parties, that the arbitral tribunal is bound to follow the parties' instructions, and that national courts or state laws have no possibility of interfering with the parties' will. This opinion is certainly confirmed by the observation that the vast majority of arbitral awards are complied with voluntarily by the losing party. The parties agree to submit the dispute to arbitration, then they instruct the arbitral tribunal as to the scope of the dispute, the rules to be applied, etc., then the losing party recognizes the arbitration's result and complies voluntarily with the award. In situations such as this one, the totality of the arbitration takes place in the private sphere of the parties. There is no point of contact between the national courts and the arbitration. Consequently, no national judge may decide to override the parties' contract or expectations by considering an agreement invalid due to violations of E.U. competition law<sup>3</sup> or a contract not binding due to one of the parties not having legal capacity according to the law to which it is subject.<sup>4</sup> The arbitrators may or may not decide to apply these rules, but, as long as the losing party accepts the result of the arbitration, there will be no possibility for any judge to verify the arbitrator's decision. In these cases, therefore, limits to party autonomy are relevant only to the extent that the parties request the arbitral tribunal apply state law or the tribunal elects to do so on its own motion. When the losing party does not voluntarily comply with the award, the courts will intervene. In these cases, the closed circuit is interrupted and limitations to party autonomy may become relevant.

The formal framework for arbitration grants it a relative autonomy, which actually gives the appearance of an autonomous

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[http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html) (last visited June 19, 2015).

<sup>3</sup> Violation of E.U. competition law is, according to a controversial ECJ decision, to be deemed as a violation of *ordre public* and therefore prevents enforcement of the award under the New York Convention. Case C-126/97, Eco Swiss China Time Ltd. v. Benetton Int'l NV, 1999 E.C.R. I-03055.

<sup>4</sup> That each of the parties' own law governs their legal capacity, quite irrespective of which law the parties chose to govern the contract, is regulated by the New York Convention and the UNCITRAL Model Law and was confirmed by the Swedish Court of Appeal. Hovrätt (HOVR) (Court of Appeals) 2007-12-17 T3108-06 (Swed.); see KLUWER ARBITRATION, 6 ITA MONTHLY REPORT, MAY (2008).

system. The main instrument upon which arbitration is founded, as previously mentioned, is the New York Convention, that binds the courts of these countries to recognise arbitration agreements and thus dismiss claims that are covered by an arbitration agreement, as well as to recognise and enforce arbitral awards without any review of the merits or of the application of law – with only a restrictive and exhaustive list of grounds to refuse recognition and enforcement. UNCITRAL Model Law is also an important instrument, issued in 1985 and revised in 2006, which has contributed to a considerable harmonisation of the areas of arbitration law that are not covered by the New York Convention. The UNCITRAL Model Law is, in turn, based on the same principles as the New York Convention, which means that together these instruments create a harmonised legal framework for arbitration. Both instruments give a central role to the will of the parties. The power of the arbitral tribunal actually derives from the agreement of the parties; therefore, the arbitral tribunal is obliged to follow the parties' instructions in respect of the scope of the dispute, the law to be applied, and the remedies to be granted.

All this confirms, to a large extent, the understanding of arbitration as an autonomous system, based on the will of the parties and detached from national law. However, both the New York Convention and the UNCITRAL Model Law refer to national, non-harmonised legislation in a number of instances and thus reduce in few, but significant, respects the detachment of arbitration from national laws. Thus, national law defines what may be subject to arbitration, when an award is deemed to conflict with public policy, what the criteria are for an arbitration agreement to be binding on the parties, what mandatory rules of procedure apply, and when an award is valid.<sup>5</sup> In these situations, the closed circuit is interrupted.

For example, a contract between a Norwegian and a Ukrainian party was submitted by the parties to Swedish law; after a dispute arose and arbitration was initiated, the Ukrainian party maintained that it was

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<sup>5</sup> For a more extensive analysis, see Luca Radicati di Brozolo, *International Arbitration and Domestic Law*, in INTERNATIONAL COMMERCIAL ARBITRATION, DIFFERENT FORMS AND THEIR FEATURES 40, 40-57 (Giuditta Cordero-Moss ed., 2013); see also Giuditta Cordero-Moss, *International Arbitration is Not Only International*, in INTERNATIONAL COMMERCIAL ARBITRATION, DIFFERENT FORMS AND THEIR FEATURES 7, 7-39 (2013).



not bound by the contract, because its representatives had signed the contract in a way that did not meet the formal requirements of Ukrainian law; the arbitral tribunal followed the choice of Swedish law contained in the contract, considered the contract validly signed according to Swedish law and disregarded Ukrainian law as irrelevant. The arbitral tribunal, therefore, fulfilled the closed circuit; however, the award was set aside by the courts of the country where it was rendered, Sweden, because the legal capacity of a party is subject not to the law chosen by the parties in the contract, but to the law of each of the parties.<sup>6</sup> The closed circuit was interrupted, and party autonomy restricted.

In another example, the European Court of Justice found that an award would be invalid and unenforceable for violation of public policy if it gave effect to a contract that does not comply with competition law.<sup>7</sup> Had the arbitral tribunal been willing to follow the terms of the contract in full, the award would not be valid or enforceable; this is, therefore, another limitation to party autonomy.

Another example is a decision by a Russian court, refusing to enforce an award that had given effect to a shareholders agreement among the shareholders of a Russian company.<sup>8</sup> The shareholders agreement regulated the parties' rights and obligations in a manner that did not comply with Russian company law, and the court found that enforcing the award would have violated Russian public policy. The harmonised framework for arbitration is, therefore, subject to national law in several significant respects, and this may have an impact on the

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<sup>6</sup> Hovrätt (HOVR) (Court of Appeals) 2007-12-17 T3108-06 (Swed.); *see* Kluwer Arbitration, *supra* note 4. For a more extensive analysis, *see* Giuditta Cordero-Moss, *Legal Capacity, Arbitration and Private International Law*, in CONVERGENCE AND DIVERGENCE IN PRIVATE INTERNATIONAL LAW – LIBER AMICORUM KURT SIEHR (Katharina Boele-Woelki et al. eds., 2010).

<sup>7</sup> Eco Swiss China Time Ltd., 1999 E.C.R. I-03055.

<sup>8</sup> [Ruling of the Western-Siberian District Commercial Court on March 31, 2006], No.F04- 2109/2005(14105-A75-11) (Rus.) (regarding an arbitral award on a shareholder agreement between, among others, OAO Telecominvest, Sonera Holding BV, Telia International AB, Avenue Ltd, Santel Ltd, Janao Properties Ltd and IPOC International Growth Fund Ltd.).

enforceability of arbitration agreements and of arbitral awards, which in turn restricts the effects of party autonomy.<sup>9</sup>

## II. TERMS OF CONTRACT: ABSOLUTE AND UNIFORM INTERPRETATION?

With the exceptions seen in Section 1, the liberal framework for arbitration permits to recognise and enforce awards even if the award were based on a wrong interpretation of the contract or of the evidence, it applied the applicable law wrongly, or it applied the wrong law. If the award gives effect to the regulation contained in the contract, therefore, it will mostly be recognised and enforced even though the contract may have disregarded and violated the applicable law. Arbitration, therefore, to a large extent seems to permit relying on the assumption of the closed circuit. This, however, does not imply that party autonomy is absolute. An absolute party autonomy, not at all affected by external elements, assumes that the terms of the contract have a uniform meaning flowing from the words, and that they therefore may be interpreted equally in all legal systems.

It is, however, not uncommon that contract terms need to be understood in light of assumptions and effects founded on the applicable legal framework. Even plain words may acquire different meanings, depending on the culture and tradition of the interpreter. Take an apparently self-explanatory expression such as “summer nights.” If read by an Italian, it will create associations with a dark and warm night, possibly with crickets singing and a sky full of stars. If read by a Norwegian, it will evoke a bright and chilly night, with the sun as the only visible star. If the meaning of plain words is affected by the context, even more so it is for terms of a contract, as they refer not to a natural phenomenon, but to legal effects that are created and supported by legal systems, which in turn use words as the most

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<sup>9</sup> For a more extensive analysis of the matter, see GIUDITTA CORDERO-MOSS, *INTERNATIONAL COMMERCIAL CONTRACTS* ch. 5 (2014); *see also* Giuditta Cordero Moss, *International Arbitration and the Quest for the Applicable Law*, 8 *GLOBAL JURIST* 1 (2008). A research project at the University of Oslo analyses the limits that this may impose on party autonomy. *See* UiO Dep’t of Private Law, The Fac. Of Law, *Arbitration and Party Autonomy (APA)*, (Nov. 17, 2009), <http://www.jus.uio.no/ifp/english/research/projects/choice-of-law/index.html>.

important means to create and define those legal effects. It then becomes even more difficult to separate the legal effects from the words used to express them. In this situation, it may be illusionary to expect that the terms of a contract have an absolute meaning, fully independent of any legal framework or legal tradition.

National legal systems may differ from each other in many respects that are relevant to a contract, even when the systems belong to the same legal tradition, so-called legal family. Even more so there will be differences across legal families, such as the common law and the civil law. Modern comparative law research is inclined to consider this divide as overrated and largely overcome by a common core of European contract law. The common core reveals a certain synchrony between the systems on an abstract level, but it does not necessarily lead to harmonised solutions on a specific level.<sup>10</sup> Awareness about a common core may show that a certain principle may be recognised and a certain result may be achieved in a plurality of legal systems, albeit by employing different legal techniques. In a specific case, however, it is the particular legal technique employed in the contract that counts, and not the abstract possibility of achieving the desired result, if only the right legal technique had been adopted.

#### A. The Applicable Law's Impact on Force Majeure Clauses

An example of term of contract that may have different legal effects depending on the legal framework, is the so-called Force Majeure clause. This clause is meant to excuse a party's non-performance of its obligation if fulfilment was prevented by an event beyond that party's control that was unforeseeable and could not be reasonably overcome. One question is how the requirement of "beyond the control" shall be interpreted. Interpretation may be

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<sup>10</sup> BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW (Giuditta Cordero-Moss ed., 2011). This book is based on a research project that I ran at the University of Oslo from 2004 to 2009, and shows that the same contract wording may lead to diametrically different legal effects, depending on the governing law. See, particularly, part 3 in the book, as well as the Conclusion; see also INTERNATIONAL COMMERCIAL CONTRACTS, *supra* note 9, ch. 3.

influenced by the legal system's understanding of the assumptions for liability.

An illustration of this situation is when a producer cannot fulfil its obligations, because it did not receive raw materials from its supplier. The question is whether failure by a party's supplier may be deemed as an event falling outside of that party's sphere of control. To answer this question, it is necessary to understand the purpose of the Force Majeure clause.

There may be several different goals for regulations on exemptions from liability for non-performance. In some legal systems, the aim is to allocate between the parties the risk for supervening unexpected events according to which one of the two parties is closer to bear that particular risk. This approach assumes a strict liability, triggered irrespective of the conduct of the party that was prevented from performing its obligations.

According to an alternative approach, the risk for unexpected events should not be borne by a party, as long as that party has acted diligently and cannot be blamed for the occurrence of the impediment - even if in an objective allocation of risk that party would be closer to bear such risk.

The legal systems, that follow the criteria of the strict liability and the allocation of risk between the parties according to the respective spheres of control, would consider the choice of supplier to be an event falling within the sphere of control of the seller. Certainly this impediment would not fall within the sphere of the buyer and, since all risks have to be allocated between the parties, it follows that it must fall within the sphere of the seller. That the producer has been diligent in selecting its supplier and cannot be blamed for the supplier's failure to deliver is not relevant. This is the approach taken by English law.<sup>11</sup>

German law has a different approach. According to § 276 BGB, if the prevented party is to be blamed for the impediment or its consequences, it cannot be excused from liability. If, however, the

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<sup>11</sup> EDWIN PEEL, *TREITEL ON THE LAW OF CONTRACT*, ¶. 17064 (13th ed. Sweet & Maxwell, 2011).

prevented party can prove that it has not acted negligently, it will be excused from liability. If the seller has operated with diligence in the choice of supplier, it would not be considered liable for non-performance due to failure by the supplier.

The distinction between Common Law and Civil Law in the context of liability for non-performance can be explained with the inclination of the English system to privilege predictability, for the sake of ensuring that business is carried out smoothly, rather than ensuring that an equitable justice is made in the specific case.<sup>12</sup> Common Law allocates the risk of non-performance between the parties according to where it is most likely that the risk should be borne. This objective rule is not to be defeated by subjective criteria such as lack of negligence, because it would render the system less predictable. Civil Law systems privilege (in different degrees) the subjective elements of the specific case, in order to ensure that an equitable solution is reached.

Applied to the example made above, this means that the Force Majeure clause may be understood differently under the different governing laws. As a result, in a contract containing the same wording, a producer who cannot fulfil its supply obligations due to failure by the raw materials supplier, is not excused under English law,<sup>13</sup> whereas he is excused under, for example, Norwegian law.<sup>14</sup>

#### B. The Applicable Law's Impact on Entire Agreement Clauses

Another example of term of contract that may be interpreted differently depending on the legal framework is the so-called Entire Agreement clause. This is a recurring clause in contract practice and states that the document signed by the parties contains the whole agreement and may not be supplemented by evidence of prior statements or agreements.

The purpose of the Entire Agreement clause is to isolate the contract from any source or element that may be external to the document. This is also often emphasised by referring to the four

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<sup>12</sup> For a more extensive discussion and references, see INTERNATIONAL COMMERCIAL CONTRACTS, *supra* note 9, ch. 3.

<sup>13</sup> PEEL, *supra* note 11.

<sup>14</sup> See *infra* notes 32-35.

corners of the document as the borderline for the interpretation or construction of the contract. The parties' aim is thus to exclude that the contract is integrated by terms or obligations that do not appear in the document.

The parties are obviously entitled to regulate their interests and to specify the sources of their regulation. However, many legal systems provide for ancillary obligations deriving from the contract type,<sup>15</sup> a general principle of good faith,<sup>16</sup> or a principle preventing an abuse of rights.<sup>17</sup> This means that a contract would always have to be understood not only on the basis of the obligations that are spelled out in it, but also in combination with the elements that, according to the applicable law, integrate it. A contract, therefore, risks having different content depending on the governing law: the Entire Agreement clause is meant to avoid this uncertainty by barring the possibility of invoking extrinsic elements. The Entire Agreement clause creates an illusion of exhaustiveness of the written obligations.

This is, however, only an illusion: first of all, often ancillary obligations created by the operation of law may not be excluded by the contract.<sup>18</sup> Moreover, some legal systems permit bringing evidence that

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<sup>15</sup> For France, see, Xavier Lagarde et al., *The Romanistic Tradition: Application of Boilerplate Clauses Under French Law*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10, § 2. For Italy, see Art. 1347 C.c. [Civil Code] (It.); Giorgio De Nova, *The Romanistic Tradition: Application of Boilerplate Clauses Under Italian Law*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10, § 1, as well as the general considerations on Art. 1135 of the Civil Code in Section 1. For Denmark, see Peter Møgelvang-Hansen, *The Nordic Tradition: Application of Boilerplate Clauses Under Danish Law*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10, § 1.

<sup>16</sup> See BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Jan. 2, 2002, § 242 (Ger.) (for the general principle on good faith in the performance of contracts); see Gerhard Dannemann, *Common Law Based Contracts Under German Law*, *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10, §§ 3.2-3.3 (for examples of its application by the Courts).

<sup>17</sup> See, for Russia, Ivan Zykin, *The East European Tradition: Application of Boilerplate Clauses Under Russian Law*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10, § 1.

<sup>18</sup> See, for France and Italy, *supra* note 15. For Finnish law, see Gustaf Möller, *The Nordic Tradition: Application of Boilerplate Clauses Under Finnish Law*, in

the parties' agreement creates obligations different from those contained in the contract.<sup>19</sup> Furthermore, many civilian legal systems openly permit the use of pre-contractual material to interpret the terms written in the contract.<sup>20</sup> Finally, a strict adherence to the clause's wording may, under some circumstances, be looked upon as unsatisfactory even under English law, in spite of the formalistic interpretation style that English law may employ in respect of other clauses.<sup>21</sup>

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BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 2.1.

<sup>19</sup> See, for Germany, BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE] § 309, no. 12 (Ger.), prohibiting clauses which change the burden of proof to the disadvantage of the other party; see Ulrich Magnus, *The Germanic Tradition: Application of Boilerplate Clauses Under German Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 5.1.1.a. Italy, on the contrary, does not allow oral evidence that contradicts a written agreement. See Giorgio De Nova, *The Romanistic Tradition: Application of Boilerplate Clauses Under Italian Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 1.

<sup>20</sup> In addition to Germany, *supra* note 19, see for France, Xavier Lagarde et al., *The Romanistic Tradition: Application of Boilerplate Clauses Under French Law*, in CORDERO-MOSS (ed.), *supra* note 10, § 2; for Italy, Giorgio De Nova, *supra* note 15, § 4; for Denmark, Peter Møgelvang-Hansen, *The Nordic Tradition: Application of Boilerplate Clauses Under Danish Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 2.1; for Norway, Viggo Hagstrøm, *The Nordic Tradition: Application of Boilerplate Clauses Under Norwegian Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 3.1; for Russia, Ivan Zykin, *The East European Tradition: Application of Boilerplate Clauses Under Russian Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 2.1. The situation seems to be more uncertain in Sweden, see Lars Gorton, *The Nordic Tradition: Application of Boilerplate Clauses Under Swedish Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 5.4.2.d, and more restrictive is Finland, see Gustaf Möller, *The Nordic Tradition: Application of Boilerplate Clauses Under Finnish Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 2.1.

<sup>21</sup> See Edwin Peel, *The Common Law Tradition: Application of Boilerplate Clauses Under English Law*, in BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW, *supra* note 10, § 2.1.

The effect of the clause, therefore, does not flow from its simple words, but is the result of a combination of the clause and of the governing law.

### III. TRANSNATIONAL LAW: A UNIFORM LEGAL FRAMEWORK?

We have seen above that contracts' terms are not capable of being interpreted without making reference to the applicable legal framework. Even though arbitral tribunals in many situations are allowed to consider exclusively the terms of the contract without running the risk of triggering invalidity or unenforceability of the award, they may find that the terms of the contract are not a sufficient basis for the decision and must be integrated by external elements. Admittedly, arbitration may (to a certain extent, as was seen in Section 1) be capable of giving effect to the regulation agreed to by the parties in the contract without being obliged to comply with the peculiarities of the applicable law. However, the terms of the contract are not self-explanatory and have to be interpreted in light of the applicable legal framework, as was seen in Section 2. That the arbitral tribunal is free to interpret the contract and to decide how, if at all, the contract shall interact with the applicable law, does not give an answer to the question of how to interpret terms that are not self-explanatory. This may result in different interpretations of the same contract terms depending on the arbitrator's background and inclination, and thus impacts on party autonomy.

It is worthwhile exploring whether the idea of an absolute party autonomy may be reinstated by including a uniform legal framework into the closed circuit. It is often proposed that transnational sources may give a uniform legal framework for international contracts. Transnational sources are concerned with giving effect to commercial practice without abiding by the peculiarities of the various legal systems; this could be deemed to make national laws redundant.

The differences among the various national legal systems have prompted various initiatives to formulate trans-national sets of rules, in part developed spontaneously by business practice and in part restated and codified by branch organizations, international organisations, academic fora, etc. This complex of sources goes under



various names, such as *lex mercatoria*, transnational law or soft law.<sup>22</sup> If transnational sources gave an exhaustive and harmonised regime, it would be possible to include these sources as the only applicable legal framework for the contract and thus reinstate the closed circuit.

As I argue elsewhere, however, transnational sources are not sufficiently precise and systematic to replace national laws<sup>23</sup> - not to mention the formal circumstance that transnational sources may not, as a matter of private international law, govern a contract to the exclusion of any state laws.<sup>24</sup> Some of the most recognized transnational sources – in particular, the UNIDROIT Principles of International Commercial Contracts (UPICC) and the Principles of European Contract Law (PECL) – are heavily based on a general principle of good faith.<sup>25</sup> Good faith is a legal standard that needs specification and there does not seem to be any generally acknowledged legal standard of good faith that is sufficiently precise to be applied uniformly, irrespective of the governing law.

Moreover, these instruments grant the interpreter much room for interference regarding the wording of the contract – based on the central role given to the principle of good faith. This seems to contradict the very intention of standard contracts. International contract practice is meant to be exhaustive and self-sufficient, and not to be influenced by the interpreter's legal tradition.<sup>26</sup> Any correction by principles such as good faith would run counter to the expectations of the parties.

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<sup>22</sup> Literature on the subject matter is very vast. Among the works most frequently referred to are FILIP DE LY, *INTERNATIONAL BUSINESS LAW AND LEX MERCATORIA* (1992); KLAUS PETER BERGER, *THE CREEPING CODIFICATION OF THE LEX MERCATORIA* (2d. ed., 2010), and Ole Lando, *The Lex Mercatoria in International Commercial Arbitration*, 34 *INT'L & COMP. L.Q.* 747, 747-768 (1985). For extensive references see ROY GOODE ET AL., *TRANSNATIONAL COMMERCIAL LAW – TEXTS, CASES AND MATERIALS 24* (Oxford Univ. Press 2007).

<sup>23</sup> For a more extensive discussion, see *INTERNATIONAL COMMERCIAL CONTRACTS*, *supra* note 9, §§ 2.4, 4.2.3.

<sup>24</sup> For a more extensive discussion, see *id.* § 4.2.3.

<sup>25</sup> For a more extensive discussion, see *id.* § 2.4.2.

<sup>26</sup> For a more extensive discussion of the ambitions of self-sufficiency in contract practice, *id.* ch. 1.

The same applies to the instruments developed so far in the ongoing work on a European contract law. The Academic Draft Frame of Reference, the Acquis Principles, and the Common European Sales Law (CESL), all largely based on the PECL, have a double approach to commercial contracts: they extend rules of consumer protection to commercial contracts (including an extensive and mandatory principle of good faith), and then moderate them by reserving for contrary good commercial practice. Reference to good commercial practice as the only concretisation of the principle of good faith assumes that the interpreter is in a position to define good commercial practice and to assess its content. What constitutes good commercial practice, however, is not clear. It may be assumed that it coincides with the above mentioned spontaneous or academic transnational sources that often are deemed to be particularly apt to govern international contracts and that go under the name of transnational law or *lex mercatoria*: scholarly works on the convergence of legal systems, general principles, restatements, and trade usages. As will be seen, these sources are not capable of giving a clear and harmonized picture of the transnational law of commercial contracts; hence, they do not give a clear picture of what good commercial practice is. Reference to good commercial practice, therefore, does not create a concrete standard of good faith.

Transnational sources, thus, do not always provide a uniform solution. The arbitrator who is required to interpret contract terms will not find a definitive and uniform standard of interpretation in these sources, and will need to make recourse to other sources, thus interrupting again the closed circuit.

A. Interpretation of Force Majeure Clauses under Transnational Law

To test the ability of transnational law to overcome the disparity of legal traditions, we can look at the examples made in Section 2 above. We saw that the expression “beyond the control” in *Force Majeure* clauses may be interpreted differently depending on the governing law. Does the transnational law offer a uniform solution? One of the most successful instruments of harmonization of contract law is the 1980 Vienna Convention on Contracts for the International Sale of Goods (CISG), ratified by over sixty countries and looked

upon, especially in some academic circles,<sup>27</sup> as embodying principles that are generally recognized and reach well beyond the convention's scope of application.

According to Article 79 of the CISG, a party is not liable for failure to perform its obligations if it proves that the failure was due to an impediment beyond its control that was unforeseeable and could not reasonably have been overcome.

The CISG does not contain any reference to the diligence of the affected party as criterion for exempting it from liability; in another context, the convention confirms that diligence is not a criterion for excuse: Articles 45(1)(b) and 61(1)(b) regulate that each party may exercise contractual remedies for non-performance against the other party without having to prove any fault or negligence or lack of good faith on that party, nor do they mention that any evidence of diligence would relieve the other party from its liability.

The Secretariat Commentary does not address the question of how the criterion of the sphere of control shall be interpreted, whether literally, or as a reference to the diligent conduct of the seller.<sup>28</sup> Bearing in mind that the CISG requires it to be interpreted autonomously, without reference to domestic legal systems, it seems appropriate to apply the literal interpretation and to see Article 79 as a reference to an objective division of the landscape into two spheres, that of the seller and that of the buyer, without reference to specific actual possibilities to exercise control. This is confirmed by case law and doctrine, which affirm that procurement risk falls within the sphere of risk of the seller, and that therefore failure by the seller's supplier is not deemed to fall outside of the seller's sphere of responsibility (unless the relevant good has disappeared completely from the international market).<sup>29</sup> In the

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<sup>27</sup> For a thorough analysis of the enormous impact of the CISG on scholars, see *THE CISG AND ITS IMPACT ON NATIONAL LEGAL SYSTEMS* 436 (Franco Ferrari, ed., Sellier European Law Publishers, 2008). Ferrari also shows, however, that the level of awareness about the CISG in the business community and among practicing lawyers is strikingly low. *Id.* at 421.

<sup>28</sup> *Commentary On The Draft Convention On Contracts For The International Sale Of Goods, Prepared By The Secretariat, U.N. Doc. A/CONF.97/5* (Mar. 1, 1979).

<sup>29</sup> See Dionysios Flambouras, *The Doctrines of Impossibility of Performance and clausula rebus sic stantibus in the 1980 Vienna Convention on Contracts for the International Sale*

comment to the second paragraph of article 79 on use of sub-contractors, the Commentary specifies that this special rule does not include suppliers of raw material or of goods to the seller.<sup>30</sup>

However, this is not the only way of understanding the criterion of “beyond the control.” Article 79 of the CISG may be interpreted differently, depending on the interpreter’s legal tradition – something that has been defined as “troubling.”<sup>31</sup>

Norway implemented the CISG with the Sale of Goods Act. The Sale of Goods Act, in Section 27, introduced the concept of impediment beyond the control of the prevented party, with a literal translation of Article 79 of the CISG.<sup>32</sup> By introducing this concept, the legislator intended to mitigate the then-existing regime, which was based on strict liability.<sup>33</sup>

Norwegian legal doctrine interprets the criterion of “beyond the control” not as having an *abstract* understanding of each party’s sphere of control, but on the basis of the *actual* sphere of control of each party.<sup>34</sup> Only if one party actually has the possibility of influencing a certain process are the events caused by that process deemed to be within the sphere of control of that party. That a party has started a process, in itself, does not mean that any events occurring in the course of that process are in the sphere of control of that party. The test must be if that party actually had the possibility of influencing the part of the process in connection with which those events occurred. Hence, in the case of procurement risk, the interpretation of what is “beyond

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*of Goods and the Principles of European Contract Law: A Comparative Analysis*, 13 PACE INT’L L. REV. 261, n.20 (2001). See also COMMENTARY ON THE UN CONVENTION OF THE INTERNATIONAL SALE OF GOODS (CISG) art. 79, ¶¶ 11, 18, 37 (Schlechtriem & Schwenger, eds., Oxford Univ. Press 2010) (although ¶ 27 seems to embrace the Germanic tradition).

<sup>30</sup> See *supra* note 28, at 64.

<sup>31</sup> Schlechtriem & Schwenger, eds., *supra* note 29, art. 79, ¶ 11, at n.30.

<sup>32</sup> Sale of Goods Act of 13 May 1988 §27 (Nor.).

<sup>33</sup> Ot.prp. nr. 80 (1986–87), pp. 38 et seq. and, extensively on the preparatory works in this context, Viggo Hagström, *Obligasjonsrett*, § 19.4.2. (Universitetsforlaget, 2d. ed., 2011).

<sup>34</sup> See Hagström, *supra* note 33. For a more extensive analysis, see Giuditta Cordero-Moss, *Lectures on comparative law of contracts*, 166 Institutt for privatretts stensilserie bd. 151 et. seq. (2004).

the control” is opposite to the outcome under the CISG: the producer chose its supplier, and this choice is certainly within the producer’s sphere of control (it could have chosen another supplier, and then the default would not have happened). However, the producer has no actual possibility of influencing the performance of the supplier, therefore any impediment in connection therewith is to be deemed outside of its sphere of control.<sup>35</sup>

In conclusion, the CISG does not seem to provide a uniform standard for the interpretation of Force Majeure clauses.

#### B. Interpretation of Entire Agreement Clauses under Transnational Law

The other example of contract term with inconsistent legal effects made in Section 2 above, is the Entire Agreement clause.

This clause is recognised in Article 2.1.17 of the UPICC and Article 2:105 of the PECL, with some restrictions: the provisions specify that prior statements or agreements may be used to interpret the contract. This is one of the applications of the general principle of good faith; it is, however, unclear how far the principle of good faith goes in overriding the clause inserted by the parties. If prior statements and agreements may be used to interpret the contract, does this mean that more terms may be added to the contract if, for example, the parties have discussed certain specifications at length during the negotiations and this has created in one of the parties the reasonable

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<sup>35</sup> Viggo Hagstrøm *supra* note 33, § 5.3. Hagstrøm’s interpretation is based on a Supreme Court decision rendered in 1970, long before the implementation of the CISG in the Norwegian system. However, the Supreme Court’s decision is still referred to as correctly incorporating Norwegian law after the enactment of the Sales of Goods Act, as the reference made by Hagstrøm confirms. *See also* Anders Mikkelsen, *HINDRINGSFRI TAK 33* (Gyldendal, 2011). A Supreme Court decision affirmed that liability is strict when the goods to be delivered are generic. *See* HR-2004-00755-A-Rt-2004-675 (Supreme Court, Dom) (Nor.). The test will then be whether the defects objectively are within the sphere of control of the seller. In this context, therefore, the Supreme Court has rejected the test of actual control and is more in line with the regulation contained in the CISG. This approach is consistent with the German tradition, that distinguishes between generic obligations (where liability is strict) and specific obligations (where the criterion of diligence applies). This distinction was abandoned with the 2002 reform of the BGB.

expectation that the specifications would be implied in the contract even though they were not included in the final contract text? Article 1.8 of the UPICC would seem to indicate that this would be the preferred approach under the UPICC. According to this provision, a party may not act in a way inconsistent with reasonable expectations that it has created in the other party. This is spelled out in the PECL, Article 2:105, Paragraph 4, which states that, “[a] party may by its statements or conduct be precluded from asserting a merger clause<sup>36</sup> to the extent that the other party has reasonably relied on them.”

According to this logic, the detailed discussion during the phase of negotiations of certain characteristics for the products may create the reasonable expectation that those specifications have become part of the agreement even if they were not written in the contract; their subsequent exclusion on the basis of the Entire Agreement clause may be deemed to be against good faith.

According to the opposite logic, however, the very fact that the parties have excluded from the text of the contract some specifications that were discussed during the negotiations, indicates that no agreement was reached on those matters. Exclusion of those terms from the contract, combined with the Entire Agreement clause, strongly indicates the will of the parties not to be bound by those specifications. Their subsequent inclusion on the basis of the good faith principle would run counter to the parties’ intention.

The foregoing shows that the application of the UPICC and of the PECL requires a specification of the principle of good faith. Is it to be intended as an overriding principle, possibly creating, restricting or modifying the obligations that flow from the text of the contract? Or is it meant to take the text of the contract as a starting point, ensuring that the obligations contained therein are enforced accurately and precisely as the parties have envisaged them? This represents the dichotomy between, on the one hand, the understanding of fairness as a principle ensuring balance between the parties notwithstanding the regulation on which the parties may have agreed, and, on the other hand, the understanding of fairness as a principle ensuring

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<sup>36</sup> “Merger clause” is another definition of the Entire Agreement clause, which may also be called the “Integration clause.”

predictability, and leaving it to the parties to evaluate the desirability of their contract regulation. This dichotomy characterises the different approaches of the common law and the civilian tradition.<sup>37</sup> To enhance the ability of the UPICC to harmonize contract law, UNIDROIT has created in 1992 a data base collecting court decisions and arbitral awards on the various provisions of the UPICC. This is, therefore, the best source to turn to when inquiring how to interpret the Entire Agreement clause under the UPICC.

As of 2013, the Unilex database contained five decisions on Article 2.1.17 of the UPICC. These decisions are not based on a consistent understanding of the standard according to which the clause shall be applied.<sup>38</sup> The Unilex database shows two approaches to Article 2.1.17 of the UPICC: one advocating the primacy of the contract's language, and the other assuming that the UPICC provides for the primacy of the real intention of the parties, which in turn may lead to considerably restricting the effect of the Entire Agreement clause. Evidently, this is not sufficient to give guidance as to which approach to choose when addressing the conflict between the contract's language and the principle of good faith. This leaves so much room to the discretion of the interpreter that it seems unlikely for Article 2.1.17 of the UPICC to give a harmonized regulation of its subject-matter. The UPICC, therefore, does not contribute considerably to a harmonized standard of interpretation.

#### IV. ARBITRAL TRIBUNALS: FAITHFUL TO THE INTENTION OF THE PARTIES

Above we have seen that the arbitral tribunal may, to a large (but not unlimited) extent, disregard the governing law without consequences for the validity and enforceability of the award; we have also seen that this is not a sufficient answer to the question of how to interpret terms of the contract that are not self-explanatory; we have further seen that it is not always possible to find a uniform standard of interpretation in translation sources. A principle that is often invoked

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<sup>37</sup> For a more extensive discussion, see INTERNATIONAL COMMERCIAL CONTRACTS, *supra* note 9, ch. 3.

<sup>38</sup> *Id.* § 2.4.2.1.

in these circumstances is that the arbitral tribunal has a duty to be faithful to the will of the parties.

Does a duty to be faithful to the will of the parties give sufficient guidelines?

The arbitral tribunal may certainly not be inclined to let the terms of the contract be overridden by the formalities of the various national legal systems, but that does not give an answer to the question of how contract terms shall be interpreted.

We can assume a long-term loan agreement with an Early Termination clause permitting immediate termination of the contract and consequently the immediate repayment of the whole principal upon breach of the obligations contained in a certain clause.

A literal interpretation of the Early Termination clause permits termination even when the breach is insignificant – for example, when the borrower has submitted its financial statements to the lender with one-day delay.<sup>39</sup> The breach may have had no consequences on the borrower's creditworthiness, on its ability to repay the loan, or on the lender's ability to verify these matters; the real reason for the lender to terminate the loan may have been that the interest rates had increased since the time of signing the loan, and that the lender considered the threat of early termination as effective leverage for negotiating a higher interest rate. This would not be relevant in a literal interpretation: the clause would be considered applicable without regard to the real reasons for which it is invoked.

A purposive interpretation of the clause takes into consideration the purpose of the clause and tries to assess whether the particular situation may be deemed to fall into the scope of the clause. This may lead to considering the clause as not applicable in a situation where the reasons for which it is invoked do not correspond to the purpose of the clause.

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<sup>39</sup> The borrower's obligation to submit its financial statements is usually in loan agreements and is generally to be found in the section of the so-called covenants. It is meant to make it possible for the lender to control the borrower's continued creditworthiness.



What is more faithful to the intention of the parties: a literal implementation of the clauses that may permit speculative or abusive conduct or an integration of the clauses with considerations of business purpose, good faith, and trade usages? There seems to be no absolute answer to the question of what interpretation better meets the expectations of the parties: a strictly literal interpretation of the terms of the contract, or an integration of the contract with principles of good faith and commercial sense based on law, trade usages, transnational principles or other sources. The former would better reflect the parties' expectations if it is assumed that the parties have consciously intended to achieve specific legal effects with each and every of the words that they have written in the contract. This, however, does not reflect the reality of how contracts are drafted and negotiated, as will be seen below.

#### A. The Dynamics of Contract Drafting

Often, some of the clauses in a contract are inserted without the parties having given any particular consideration to their content or their effects under the applicable law.<sup>40</sup> This practice may be surprising, considering the importance that the governing law has for the application and even the effectiveness of contract terms, as was seen above. However, the practice of negotiating detailed wording without regard to the governing law, or even of inserting contract clauses without having negotiated them, is not necessarily always unreasonable. From a merely legal point of view, it makes little sense, but from the overall economic perspective, it is more understandable. The gap between the parties' reliance on the self-sufficiency of the contract and the actual legal effects of the contract under the governing law does not necessarily derive from the parties' lack of awareness regarding the legal framework surrounding the contract. More precisely, the parties may often be aware of the fact that they are unaware of the legal framework for the contract. The possibility that the wording of the contract is interpreted and applied differently from

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<sup>40</sup> A more extensive analysis of the practice of contract drafting is made in INTERNATIONAL COMMERCIAL CONTRACTS, *supra* note 9, ch. 1.

what a literal application would seem to suggest may be accepted by some parties as a calculated risk.<sup>41</sup>

Considerations regarding the internal organization of the parties are also a part of the assessment of risk. In large multinational companies, risk management may require a certain standardization, which in turn prevents a high degree of flexibility in drafting the single contracts. In balancing the conflicting interests of ensuring internal standardization and permitting local adjustment, large organizations may prefer to enhance the former.<sup>42</sup> It is, in other words, not necessarily the result of thoughtlessness if a contract is drafted without having regard for the governing law. Neither is it a symptom of a refusal of the applicability of national laws. It is the result of a cost-benefit evaluation, leading to the acceptance of a calculated legal risk. The sophisticated party, aware of the implications of adopting contract models that are not adjusted to the governing law and consciously assessing the connected risk, will identify the clauses that matter the most, and concentrate its negotiations on those, leaving the other clauses untouched and accepting the corresponding risk.

A faithful interpretation of the contract assumes an understanding of this uneven approach to contract drafting.

#### B. The Need for Predictability

On the other hand, predictability is extremely important in commercial contracts. The parties are interested in enforcing their rights, and, for this purpose, they depend on one or more national legal systems and their courts. Therefore, once a contract is finalized, parties are interested in its enforceability and in the predictability of the parameters according to which enforcement may be achieved.<sup>43</sup>

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<sup>41</sup> See more extensively David Echenberg, *Negotiating International Contracts: Does the Process Invite a Review of Standard Contracts from the Point of View of National Legal Requirements?*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10.

<sup>42</sup> See more extensively, Maria Celeste Vettese, *Multinational Companies and National Contracts*, in *BOILERPLATE CLAUSES, INTERNATIONAL COMMERCIAL CONTRACTS AND THE APPLICABLE LAW*, *supra* note 10.

<sup>43</sup> See QUEEN MARY UNIVERSITY OF LONDON SCHOOL OF INTERNATIONAL ARBITRATION, 2010 INTERNATIONAL ARBITRATION SURVEY:

Litigation lawyers carefully analyse the specific contract and its effects under the governing law and try to assess as precisely as possible the possibility of winning a case in court or in arbitration on the basis of the contract wording, the applicable law and the degree of factual background that the governing law allows to bring into the dispute. Thus, on the one hand, drafting lawyers, while negotiating a contract, may have willingly disregarded the legal effects of some clauses. On the other hand, litigation lawyers, while assessing enforceability of the same contract, will carefully study its legal effects under the governing law. The varying degree of awareness during negotiations, thus, must be considered in light of the need for predictability once a dispute arises.

Furthermore, contracts are often meant to circulate, for example, because they are assigned to third parties, are used as security, or serve as a basis for calculating insurance premiums. In these situations, it is essential that contracts are interpreted strictly in accordance with their terms: third parties are not aware of and should not be assumed to take into consideration the relationship between the original parties to the contract, what the original parties may have assumed or intended, or any circumstances that relate to the original parties and that may have had an impact on these parties' interests. It is, therefore, expected that a contract is interpreted primarily, if not exclusively, in light of its terms – without considering things such as what a fair balance between the parties' interests would be or what one party's expectations might have been.

### C. How to Square the Circle: The Applicable Law

The arbitral tribunal is, therefore, expected to understand the dynamics of negotiations in order to properly give effect to the intention of the parties. Blindly applying the wording of the contract without any regard to the principles of the governing law or, to the extent that they are determinable and applicable, of transnational law, would not necessarily reflect the true intention of the parties if the clause that is being applied literally is one of the boilerplate clauses that

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CHOICES IN INTERNATIONAL ARBITRATION: CHOICES IN INTERNATIONAL ARBITRATION 13 (2010). *See also* THE LAW SOCIETY, LAW SOCIETY REPORT: FIRMS' CROSS-BORDER WORK 1, 8 (2010). For further references, see INTERNATIONAL COMMERCIAL CONTRACTS, *supra* note 9, § 2.1.

the parties did not consider. Integrating or correcting a clause with national or transnational principles, on the other hand, might not necessarily reflect the parties' intention either, if the clause that is being interpreted is one of the clauses that the parties carefully negotiated.

Leaving broad discretion to the interpreter, however, runs the risk of undermining predictability, if the criteria for exercising such discretion are not clearly determinable. As was seen above, interpretation of the contract should take into consideration the need for predictability. Overriding the terms of the contract in the name of principles of good faith or equity, thus, would lead to results that are not compatible with the expectations of international business practice, if the standards that are applied are not clearly determinable. From the overview made in Section 3 above, it seems that the standard of good faith is not sufficiently determinable on a transnational level. This seems to speak for the advisability of taking into consideration the criteria developed in the applicable law.

#### D. Variety of Approaches

There is no uniform answer to the question of what interpretation is the most faithful to the parties' intentions. A seminar organised at the University of Oslo in 2011<sup>44</sup> discussed the arbitrators' approach to the interpretation of contracts and identified a variety of approaches.<sup>45</sup> The results of this seminar are summarised below.

Contracts are not necessarily always applied in strict accordance with their terms. There are different degrees of interference and the sources of the interference also vary quite considerably. There is a scale moving from a strict application of the governing law to integrate the contract, via interpretation of the contract terms in the context of transnational soft law principles such

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<sup>44</sup> See *Arbitration and Party Autonomy (APA)*, *supra* note 9. The programme for the seminar, the list of panel participants and the transcript from the panel discussions are available at <http://www.jus.uio.no/ifp/english/research/projects/choice-of-law/events/2011/2011-arbitration-and-the-not-unlimited-party-autonomy.html>.

<sup>45</sup> See *INTERNATIONAL COMMERCIAL CONTRACTS*, *supra* note 9, ch. 3, § 7; see also Giuditta Cordero-Moss, *Interpretation of Contracts in International Commercial Arbitration: Diversity on More than One Level*, 22 *EUR. REV. PRIVATE L.* 13, 13-36 (2014).

as the UPICC and the PECL (which are heavily based on the principle of good faith and may give rise to a substantial possibility of interfering with the contract language), to interpretation of the contract on the basis of its own terms combined with the parties' interests and trade usages, to interpretation of the contract solely on the basis of its own terms. There is also a further approach to interpretation of the contract, which goes under the label of "splitting the baby." This Solomonic approach consists of rendering an award in the middle range between the claims of each of the parties. This is not necessarily based on a literal consideration of the contract terms or on an integration of the contract with other sources, but simply on the desire to accommodate both parties.<sup>46</sup> Interestingly, there does not seem to be a uniform perception of the frequency of this approach: a recent empirical study shows that the parties to arbitration perceive that they got a Solomonic award in 18–20% of the cases, whereas the arbitrators perceive that they take this kind of equitable decision in only 5% of the cases.<sup>47</sup> This, therefore, adds a new variable to the equation of the interpretation of contracts. Not only is it uncertain whether the arbitrators will interpret the contract literally, whether they will use sources of law, or whether they will apply transnational principles to give a more purposive interpretation, but it is also possible that the decision will be influenced by equitable considerations that are not based on the contract or on other legal sources.

#### CONCLUSION

Party autonomy is limited in international arbitration, in spite of the widespread opinion that contracts are self-sufficient and that, together with arbitration, they create a closed circuit that manages to leave national law out.

First of all, the legal framework for arbitration ensures that arbitration enjoys a significant autonomy, but this autonomy is not unlimited. If the losing party decides not to comply with the arbitral

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<sup>46</sup> This appears in the 2012 Survey of the School of International Arbitration of Queen Mary University of London. QUEEN MARY UNIVERSITY OF LONDON AND WHITE & CASE, 2012 INTERNATIONAL ARBITRATION SURVEY: CURRENT AND PREFERRED PRACTICES IN THE ARBITRAL PROCESS § 7 (2012).

<sup>47</sup> Queen Mary University, *supra* note 46, at 38.

award, courts of law may exercise judicial control. Judicial control on arbitration is restricted, but there is room for overriding party autonomy in several respects.

Furthermore, even within the area where no judicial control may be exercised and arbitration is autonomous, the necessity may arise to integrate contract terms with external sources. Contract terms do not always have an absolute meaning with legal effects flowing directly from the words, and recourse to a legal framework may be required to interpret the terms and to define their legal effects. To the extent that transnational sources provide a uniform legal framework, they may integrate the contract and reinstate self-sufficiency. Where transnational sources are not sufficient, however, the arbitral tribunal will have to integrate the contract with external principles and rules, primarily stemming from the governing law.

All the above constitutes limitations to party autonomy in arbitration.

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**THE GOOD, THE BAD, AND THE UGLY  
IN DISTRIBUTION CONTRACTS:  
LIMITATION OF PARTY AUTONOMY IN  
ARBITRATION?**

*Pilar Perales Viscasillas\**

INTRODUCTION, CONCEPTS AND LEGAL FRAMEWORK

Distribution contracts might respond to different kinds of modalities in practice. In fact, under some domestic laws, the name “distribution contract” is considered a generic category that includes specific contracts, such as: agency, franchise, concession, or distribution contracts, the latter being a specific kind of contract. The aforementioned contract types are considered to be cooperation or collaboration commercial contracts since they imply cooperation between two businessmen. Depending on the type of contract, cooperation may be more or less intense.<sup>1</sup>

From a legal perspective, it is clear that distributors and franchisees are independent businesspersons who invest and risk their

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\* Pilar Perales Viscasillas is a Commercial Law Professor at the Carlos III University of Madrid. She serves as Counsel at Baker & McKenzie. This paper was written under a research project for the Ministerio de Economía y Competitividad. (DER2013-48401-P).

<sup>1</sup> On the basis of such cooperation the contracts are classified under the STUDY GROUP ON A EUROPEAN CIVIL CODE, PRINCIPLES OF EUROPEAN LAW: COMMERCIAL AGENCY, FRANCHISE AND DISTRIBUTION CONTRACTS (PEL CAFDC) (2006). See also Eleanor Cashin Ritane, The Common Frame of Reference (CFR) and the Principles of European Law on Commercial Agency, Franchise and Distribution Contracts, ERA Forum, Dec. 2007 at 563.

own funds.<sup>2</sup> Agents are also legally independent from their principal but their status under domestic law might vary and there are some legal systems that provide them special treatment under their own labor laws.<sup>3</sup>

As far as arbitration is concerned, the object of this paper is to explore the limitations imposed by certain countries on the freedom of the parties to submit their contracts to arbitration and whether this approach should be rejected considering that other countries follow policies in favor of arbitration.

#### A. Substantive Regulation of Distribution Contracts

The substantive regulation of these contracts varies depending on the kind of contract and the binding force of the instrument at an international level. This section sets forth an overview of the three major types of contracts.

1. *Agency Contracts* - UNIDROIT approved a Convention on Agency in the International Sale of Goods<sup>4</sup>, which defines an agency contract as a contract “where one person, the agent, has authority or purports to have authority on behalf of another person, the principal, to conclude a contract of sale of goods with a third party.”<sup>5</sup>

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<sup>2</sup> See UNIDROIT, GUIDE TO INTERNATIONAL MASTER FRANCHISE AGREEMENTS (2d ed. 2007) [hereinafter UNIDROIT GUIDE], available at <http://www.unidroit.org/instruments/franchising/guide/second-edition-2007>.

<sup>3</sup> Spain, for example, treats agents differently and affords them special treatment. Besides the 1992 Law on Agency Contracts, the so-called “economic dependent agents” are considered to be autonomous workers and thus partially regulated under a special Labor Law. See Ley del Estatuto del Trabajador Autónomo (LETA) (B.O.E. 2007, 20) (Spain).

<sup>4</sup> UNIDROIT, *Convention on Agency in the International Sale of Goods*, 22 I.L.M. 249 (opened for signature Feb. 17, 1983).

<sup>5</sup> It has not entered into force yet, as ten ratification instruments are required. So far, it has been ratified by: France, Italy, Mexico, Netherlands, and South Africa. See UNIDROIT, *Status of the Convention on Agency in the International Sale of Goods - Signatures, Ratifications*, <http://www.unidroit.org/status-agency> (last visited Nov. 30, 2015).



European Union law<sup>6</sup> has a similar definition, but it is more precise as it considers the power to negotiate or to negotiate and conclude the contract by the agent. It defines a ‘commercial agent’ as one who is a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person, hereinafter called the ‘principal’, or to negotiate and conclude such transactions on behalf of and in the name of that principal.<sup>7</sup>

In terms of soft law instruments, there is also the possibility for the parties to agree on the UNIDROIT Principles of International Commercial Contracts<sup>8</sup> (UPICC, 2010). Furthermore, there is also a model contract offered by the International Chamber of Commerce (ICC).<sup>9</sup>

2. *Distribution or Concession Contracts* - In many legal systems, distribution or concession contracts are atypical contracts, or are only partially regulated.<sup>10</sup> At an international level, there is no uniform legal instrument such as the CISG for distribution contracts, although the CISG might apply to specific distribution contracts.<sup>11</sup> It is also possible that the parties could agree on the application of The UNIDROIT

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<sup>6</sup> Council Directive 86/653, On Self-Employed Commercial Agents, 1986 O.J. (L 382) 17 (EC).

<sup>7</sup> *Id.* art. 1.2. The common law concept of “agent” is in fact to all intents and purposes the same as that of the general agent under the civil law systems, according to the UNIDROIT Guide. UNIDROIT GUIDE, *supra* note 2, at 9.

<sup>8</sup> See UNIDROIT, *Unidroit Principles of International Commercial Contracts*, at Preamble, (2010). As explained by Comment 2 to the Preamble: “The Principles do not provide any express definition, but the assumption is that the concept of “commercial” contracts should be understood in the broadest possible sense, so as to include not only trade transactions for the supply or exchange of goods or services, but also other types of economic transactions, such as investment and/or concession agreements, contracts for professional services, etc.” *See id.* cmt. 2.

<sup>9</sup> See generally INTERNATIONAL CHAMBER OF COMMERCE, ICC MODEL CONTRACT: COMMERCIAL AGENCY (2d ed. 2002).

<sup>10</sup> For example, in Spain, although sometimes the Courts have applied by analogy some of the substantive provisions of the Agency Law.

<sup>11</sup> See generally María del Pilar Perales Viscasillas, *International Distribution Contracts and CISG*, in ESTUDIOS DE DERECHO MERCANTIL (2013).

Principles or the ICC, which also offers a model contract for the parties.<sup>12</sup>

There is no universal definition of an international distribution contract, but a good example to illustrate this type of contract and its modalities is found in the Draft Common Frame of Reference (DCFR): IV. E. – 5:101 (Scope and definitions), which follows The Principles on Agency, Franchise and Distribution Contracts (PEL CAFDC)<sup>13</sup>:

(1) This Chapter applies to contracts (distribution contracts) under which one party, the supplier, agrees to supply the other party, the distributor, with products on a continuing basis and the distributor agrees to purchase them, or to take and pay for them, and to supply them to others in the distributor's name and on the distributor's behalf.

(2) An exclusive distribution contract is a distribution contract under which the supplier agrees to supply products to only one distributor within a certain territory or to a certain group of customers.

(3) A selective distribution contract is a distribution contract under which the supplier agrees to supply products, either directly or indirectly, only to distributors selected on the basis of specified criteria.

(4) An exclusive purchasing contract is a distribution contract under which the distributor agrees to purchase, or to take and pay for, products only from the supplier or from a party designated by the supplier.

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<sup>12</sup> *See generally* INTERNATIONAL CHAMBER OF COMMERCE, ICC MODEL DISTRIBUTORSHIP DISTRIBUTION CONTRACT (2002).

<sup>13</sup> PRINCIPLES, DEFINITIONS AND MODEL RULES OF EUROPEAN PRIVATE LAW: DRAFT COMMON FRAME OF REFERENCE 2435 (Christian von Bar et al. eds., 2009), *available at* [http://ec.europa.eu/justice/contract/files/european-private-law\\_en.pdf](http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf)

A more succinct example, the UNIDROIT Guide provides:

The distributor is wholly independently owned and financed and buys the products from the supplier by whom it has been granted the distribution rights. In some jurisdictions these distribution rights may be granted also for the supplying of services. In others, the distribution agreement is considered to incorporate the distributor into the manufacturer's or supplier's sales organization.<sup>14</sup>

3. *Franchising Contracts*- In many legal systems, franchising contracts are also atypical contracts and therefore there is no special regulation for these contracts. UNIDROIT has, however, developed partial regulation guides for these contracts.<sup>15</sup>

According to Article 2 of The UNIDROIT Model Franchise Disclosure Law (2002):

[F]ranchise means the rights granted by a party (the franchisor) authorizing and requiring another party (the franchisee), in exchange for direct or indirect financial compensation, to engage in the business of selling goods or services on its own behalf under a system designated by the franchisor which includes know-how and assistance, prescribes in substantial part the manner in which the franchised business is to be operated, includes significant and continuing operational control by the franchisor, and is substantially associated with a trademark, service mark, trade name or logotype designated by the franchisor. It includes:

(A) the rights granted by a franchisor to a sub-franchisor under a master franchise agreement;

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<sup>14</sup> See UNIDROIT Guide, *supra* at 2.

<sup>15</sup> See UNIDROIT, A MODEL LAW ON PRECONTRACTUAL INFORMATION (2002); see also UNIDROIT, A GUIDE FOR INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS (2d ed. 2007).

(B) the rights granted by a sub-franchisor to a sub-franchisee under a sub-franchise agreement;

(C) the rights granted by a franchisor to a party under a development agreement.<sup>16</sup>

As considered by the UNIDROIT Guide, in most franchise agreements there is an exclusivity clause that provides that the franchisee is allowed to market only the products of the franchisor. The vendor-purchaser relationship may also be present in a franchise relationship, but will typically be a mere feature of the broader franchise arrangement, which will also include the licensing of the trademark, system of the franchisor, and the providing of certain services by the franchisor to the franchisee, such as training and continued assistance.<sup>17</sup>

#### B. International Commercial Arbitration

As previously mentioned, distribution contracts are based upon the cooperation between two parties: the supplier and the distributor. In order to minimize transaction costs, the supplier has a priority interest to base his relationship with the distributors on the same model contract containing the same arbitration clause and providing for the same forum.<sup>18</sup> Therefore, it is not unusual to find arbitration clauses in these contracts because the advantages of arbitration in commercial contracts, particularly international contracts, also applies to distribution contracts.

Generally speaking, arbitration laws do not contain specific regulations as to distribution contracts and thus general arbitration rules apply. In fact, the 1985 UNCITRAL Model Law on International Commercial Arbitration (MAL) does not contain any specific rules for distribution contracts. Yet, within the general definition of what is

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<sup>16</sup> UNIDROIT, MODEL FRANCHISE DISCLOSURE LAW art. 2 (2002).

<sup>17</sup> See UNIDROIT Guide, *supra* note 2, at 10.

<sup>18</sup> See generally Stefan Kröll, *The "Arbitrability of Disputes Arising from Commercial Representation, in ARBITRABILITY: INTERNATIONAL & COMPARATIVE PERSPECTIVES* 317 (2009).

considered to be commercial distribution contracts are included, as well as agency and other forms of industrial or business cooperation.<sup>19</sup>

Some countries do provide specific legislation on this area, adopting certain restrictions on arbitration or the applicable law and thus limiting party autonomy in arbitration.

The reasons for adopting such limitations are based upon the idea that there is a weaker party and thus an unequal bargaining power whereby the principal imposes arbitration clauses on the agent, distributor, or franchisee. Such a clause might have the effect of depriving the weaker party of the rights afforded by the domestic statutes, and shows that there is a need to protect the essential conditions of a given market.

As will be developed in this paper, these limitations primarily affect the arbitrability of the dispute (*see infra* section I). On the other hand, other legal regimes have adopted a more liberal approach towards arbitration in the area of distribution contracts as a way to attract investment and trade (*see infra* section II).

There are also other issues in arbitration and distribution contracts that are shared by other commercial contracts, which includes the extension of the arbitration clause to third parties that might have an impact in networking distribution contracts or in franchising contracts, particularly if there is a master franchise

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<sup>19</sup> United Nations Committee on International Trade Law (UNCITRAL), UNCITRAL Model Law on International Commercial Arbitration art. 1 ¶ 1, U.N. Sales No. E.95.V.18 (1985). This provides:

The term “commercial” should be given a wide interpretation so as to cover matters arising from all relationships of a commercial nature, whether contractual or not. Relationships of a commercial nature include, but are not limited to, the following transactions: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; factoring; leasing; construction of works; consulting; engineering; licensing; investment; financing; banking; insurance; exploitation agreement or concession; joint venture and other forms of industrial or business cooperation; carriage of goods or passengers by air, sea, rail or road.

contract;<sup>20</sup> the incorporation of arbitration clauses in general terms and conditions;<sup>21</sup> the delimitation between the mediator, the expert and the arbitrator in distribution contracts which might be problematic in the automotive sector;<sup>22</sup> the power of arbitrators in long-term contracts;<sup>23</sup> the consent to arbitration when an agent is concluding the contract on behalf of the principal;<sup>24</sup> the impact upon distribution contracts of issues where arbitrability might be contentious, for example, when intellectual rights or competition issues are linked to the distribution contract;<sup>25</sup> and the application of the standards of independence and impartiality to arbitrators.<sup>26</sup>

## I. LIMITATION OF PARTY AUTONOMY IN ARBITRATION

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<sup>20</sup> BERNARD HANOTIAU, *COMPLEX ARBITRATIONS: MULTIPARTY, MULTICONTRACT, MULTI-ISSUE AND CLASS ACTIONS 1* (Kluwer International Law, 2005); Stephen R. Bond, *Multi-party Arbitration — The Experience of the ICC International Court of Arbitration*, in *MULTI-PARTY ARBITRATION* 39 (INT'L CHAMBER COM., 1991); Carmine R. Zarlenga, *Defending Against Litigation by Third Parties in the Franchise Context*, 11 *FRANCHISE L.J.* 1, 19-24 (1991) (examining franchising contracts).

<sup>21</sup> Vera Van Houtte, *Consent to Arbitration through Agreement to Printed Contracts: The Continental Experience*, 16 *ARB. INT'L.* 1, 1–18 (2000).

<sup>22</sup> LAURENT DU JARDIN ET AL., *ARBITRAGE V. EXPERTISE EN DROIT DE LA DISTRIBUTION* (2006); JOHAN ERAUW ET AL., *L'ARBITRAGE ET LA DISTRIBUTION COMMERCIALE* 159-170 (2005).

<sup>23</sup> Didier Matray, Françoise Vidts, & Baudouin Roels, *L'Arbitrage et le caractère évolutif des contrats de distribution*, in *L'ARBITRAGE ET LA DISTRIBUTION COMMERCIALE* 109 (2005); ERAUW ET AL., *supra* note 22, at 111-55.

<sup>24</sup> See Stefan Kröll, *El desarrollo del arbitraje en los años 2007-2008*, 9 *REVISTA DEL CLUB ESPAÑOL DEL ARBITRAJE* 15 (2010). For an overview of German Domestic Law and the lack of power by commercial agents to conclude arbitration agreements, see *HANDELGESETZBUCH [HGB] [COMMERCIAL CODE]*, May 10, 1987, *REICHGESETZBLATT [RGL.]* 219, art. 53.2 (Ger.), see also *Oberlandesgericht München [OLG] [Munich Appellate Court]*, Aug. 19, 2008, 34 *SchH* 007/07 (Ger.).

<sup>25</sup> Hans Van Houtte, *Distribution Arbitration and European Competition Law*, in *JOHAN ERAUW ET AL., L'ARBITRAGE ET LA DISTRIBUTION COMMERCIALE* 97-107 (Bruylant, 1st ed. 2005); Pilar Perales Viscasillas, *Arbitrabilidad de los Derechos de la Propiedad Industrial y de la Competencia*, 6 *ANUARIO DE JUSTICIA ALTERNATIVA: DERECHO ARBITRAL* 4-43 (2005).

<sup>26</sup> Doak Bishop & Lucy Reed, *Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Distribution*, 14 *ARB. INT'L.* 28-32 (1998).

## THROUGH ARBITRABILITY

Distribution contracts are commercial contracts. Traditionally, commercial contracts might be subject to arbitration without the need to impose limitations. The rationale behind this general rule is that in commercial contracts, both parties share equal contracting power and thus there is no need to impose limitations, like, for example, in consumer arbitration.<sup>27</sup>

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<sup>27</sup> Jan Kleinheisterkamp, *The Impact of Internationally Mandatory Law on the Enforceability of Arbitration Agreements 1-2* (LSE LAW, SOC'Y AND ECON. WORKING PAPERS No. 22 2009), available at, <http://ssrn.com/abstract=1496923> (See for all with special reference to distribution contracts).

See also Directive 2013/11, of the European Parliament and of the Council of 21 May 2013, On Alternative Dispute Resolution for Consumer Disputes, 2013 O.J. (L 165/63) (EU). For a further discussion, see Norbert Reich, *Party Autonomy and Consumer Arbitration in conflict -A "Trojan Horse" in the Access to Justice in the EU ADR-Directive 2013/11?*, 4 PENN. ST. J.L. & INT'L AFF. 290 (2015).

Following art. 10 of Directive 2013/11, Spanish Consumer Arbitration has been recently changed by Modificación del texto refundido de la Ley General para la Defensa de los Consumidores y Usuarios y otras leyes complementarias (B.O.E. 2014, 3) [hereinafter Law 3/2014], art. 57.4 (B.O.E. 2007, 1) [hereinafter Ley 1/2007]. According to the old system, pre-disputed arbitration clauses in Law 1/2007 (art. 57.4), as well as agreements to arbitrate contained in general conditions governed by Law 1/2007 (art. 90), were binding on consumers if the arbitration system provided for was the special consumer arbitration system created by the State and regulated under the consumer arbitral system (Sistema Arbitral de Consumo (B.O.E. 2008, 231) [hereinafter Royal Decree 231/2008]). Now, under the new art. 57.4 as modified by Law 3/2014, any arbitration agreement concluded before the dispute does not bind the consumer, but it binds the merchant if the consumer later accepts it, and when a further condition is met: the arbitration agreement should meet the conditions required by the applicable laws. Presently, Article 57.4 Law 1/2007 as amended by Ley 3/2014 states that:

No serán vinculantes para los consumidores los convenios arbitrales suscritos con un empresario antes de surgir el conflicto. La suscripción de dicho convenio, tendrá para el empresario la consideración de aceptación del arbitraje para la solución de las controversias derivadas de la relación jurídica a la que se refiera, siempre que el acuerdo de sometimiento reúna los requisitos exigidos por las normas aplicables.

For further details, see Pilar Perales Viscasillas, *Los convenios arbitrales con los consumidores (La modificación del art. 57.4 TRLGDCU por la Ley 3/2014 de 27 de*

Scholars studying arbitrability typically distinguish between objective arbitrability (arbitrability *rationae materiae*, i.e. matters that are capable of settlement by arbitration) and subjective arbitrability<sup>28</sup> (authority and capacity of the parties). Objective arbitrability is an issue to be decided in accordance with domestic laws on arbitration, which defines arbitrability as including both the subject matter of arbitration and the need for a dispute to exist. The issue of arbitrability goes beyond the scope of an arbitration agreement. It is inherent to the power of States to decide what issues are capable of being resolved through arbitration, and it is outside the will of the parties. On the other hand, the object of an arbitration clause is an issue to be decided by the will of the parties, who within the scope of issues that are arbitrable, might exclude some of them. The parties cannot, however, agree to submit to arbitration disputes that are not arbitrable.

Generally, domestic laws consider arbitrability under general rather than exhaustive provisions. Some national laws provide that all rights or matters that the parties “may freely dispose”<sup>29</sup> or “property issues”<sup>30</sup> might be subject to arbitration. Also, many statutes link arbitrability with the transaction, and thus the matters that are the object of a transaction might be also subject to arbitration.<sup>31</sup> These general

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marzo), 7 La Ley Mercantil 22 (2014).

<sup>28</sup> See JULIAN D. M. LEW, LOUKAS A. MISTELIS & STEFAN MICHAEL KRÖLL, *COMPARATIVE INTERNATIONAL COMMERCIAL ARBITRATION* Ch. 9 (Kluwer Law International, 2003); see also Kresimir Sajko, *Arbitration Agreement and Arbitrability. Solutions and Open Issues in Croatian and Comparative Law*, 3 CROAT. ARB. Y.B. 43, 44 (1996) (some authors also refer to arbitrability *ratione jurisdictionis*); Alan Uzelac, *New Boundaries of Arbitrability under the Croatian Law on Arbitration*, 9 CROAT. ARB. Y.B. 139, 140, 152, 155 (2002) (referring also to arbitrability *ratione institutionis*).

<sup>29</sup> Ley de Arbitraje art. 2.1 (B.O.E. 2003, 60) (Spain); Code Civil [C. CIV.] art. 2059 (Fr.); Codice di Procedura Civile [C.p.c.] art. 808, art. 1966.2 (It.); Peru Arbitration Act, art. 1 (2008); ORGANIZATION FOR THE HARMONIZATION OF BUSINESS LAW IN AFRICA (OHADA), UNIFORM ACT OF ARBITRATION (1999).

<sup>30</sup> LOI FÉDÉRALE SUR LE DROIT INTERNATIONAL PRIVÉ [LDIP] [PRIVATE INTERNATIONAL LAW] Dec. 18, 1987, RO 1776, art. 177.1 (Switz.); ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE] Jan. 30, 1877, REICHSGESETZBLATT [RGBL.] art. 1030.1 (Ger.); Lei No. 9.307, de 23 de Setembro de 1996, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] (t. 1): de 24.9.1996 (Braz.).

<sup>31</sup> ZIVILPROZESSORDNUNG [ZPO] [CIVIL PROCEDURE STATUTE] REICHSGESETZBLATT [RGBL.] No. 113/1895 (Austria); Finnish Arbitration Law, art. 2, (Oct. 23 1992); Chūsai-hō [Arbitration Law], Law No. 138 of 2003, art. 13.1 (Japan);



clauses require significant specification and interpretation in order to assess which of the specific issues related to distribution contracts are arbitrable.

Arbitrability will vary from country to country, and even within a given country it will vary since it is a concept that has changed with time. Despite this, however, one clear principle applies to arbitrability, particularly in international commercial arbitration: the principle of favour arbitris. The application of this principle to arbitrability means, first, there is a general presumption in favour of the arbitrability of commercial disputes (policy favouring arbitrability);<sup>32</sup> and second, there is a tendency to expand the scope of the subject-matter of arbitration.

Despite this modern approach to arbitrability, some countries adopt limitations to party autonomy by restricting objective arbitrability of the dispute, either by excluding arbitration before the dispute has arisen (*see infra* section I.A) or by excluding it through the imposition of the exclusive jurisdiction of the State Courts (*see infra* I.B).

#### A. Invalidation of the Pre-Disputed Arbitration Clauses: United States

The idea of the protecting the weaker party in distribution contracts, i.e., the agent, distributor or franchisee, as if they were consumers is the impetus for certain laws. These laws are intended to restrict arbitration from hindering an agreement before a dispute has arisen.

An example of this is The Motor Vehicle Franchise Contract Arbitration Fairness Act (2002) (United States).<sup>33</sup> This act would have

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1a § LAG OM SKILJEFÖRFARANDE (Svensk författningssamling [SFS] 1999:116) (Swed.).

<sup>32</sup> María Fernanda Vasquez Palma, 2 IUS ET PRAXIS 407-410 (2012) (reviewing MARTA DE GONZALO QUIROGA, ORDEN PÚBLICO Y ARBITRAJE INTERNACIONAL ARBITRAJE INTERNACIONAL EN EL MARCO DE LA GLOBALIZACIÓN COMERCIAL GLOBALIZACIÓN COMERCIAL ARBITRABILIDAD Y DERECHO APLICABLE DERECHO APLICABLE AL FONDO DE LA CONTROVERSA INTERNACIONAL (2003)).

<sup>33</sup> S. REP. NO. 107-266, at 2 (2002):

This legislation would allow motor vehicle dealers the option of either going to arbitration or utilizing procedures and remedies

applied to Business to Business transactions, i.e., to contracts whereby “a motor vehicle manufacturer, importer or distributor sells motor vehicles to any other person for resale to an ultimate purchaser and authorizes such other person to repair and authorizes such other person to repair and service manufacturer’s motor vehicles.”<sup>34</sup> Leaving aside the confusion between distribution and franchise contracts, this act would have considered arbitration valid only if agreed to by the parties after the controversy arises.<sup>35</sup>

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available under State law such as those involving State-established administrative boards specifically created and uniquely equipped to resolve disputes between motor vehicle dealers and manufacturers. This legislation is intended to ensure that motor vehicle dealers are not required to forfeit important rights and remedies afforded by State law as a condition of obtaining or renewing a motor vehicle franchise contract.

The report of the Senate refers also extensively to the unequal bargaining power between the parties and the fact that arbitration agreements are included in standard terms or conditions on a “take it or leave it” basis, which converts those clauses in “mandatory binding arbitration” with the effect of making null or void the substantive protective rights afforded by the Statute.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 17 (2002) (discussing motor vehicle franchise contracts):

(a) For purposes of this section, the term (2) “motor vehicle franchise contract” means a contract under which a motor vehicle manufacturer, importer, or distributor sells motor vehicles to any other person for resale to an ultimate purchaser and authorizes such other person to repair and service the manufacturer’s motor vehicles.

(b) Whenever a motor vehicle franchise contract provides for the use of arbitration to resolve a controversy arising out of or relating to the contract, arbitration may be used to settle such controversy only if after such controversy arises both parties consent in writing to use arbitration to settle such controversy.

(c) Whenever arbitration is elected to settle a dispute under a motor vehicle franchise contract, the arbitrator shall provide the parties to the contract with a written explanation of the factual and legal basis for the award.

An identical solution is found in the Draft Arbitration Fairness Act (2013) in relation to consumer, labor and competition issues. Franchising contracts were included in previous drafts.<sup>36</sup>

B. Exclusive Jurisdiction of State Courts: Panama

A more restrictive view towards arbitration has been adopted by certain legal systems that consider both pre and post-dispute arbitration clauses to be invalid, because in these jurisdictions only the state courts are considered competent to hear a dispute. Therefore, arbitration as a means to solve disputes is preempted by imposing the exclusive jurisdiction of state courts. An example is the recent Code of Private International Law of the Republic of Panama.<sup>37</sup>

According to this Code, commercial contracts follow a presumption that contracts are concluded among equal parties.<sup>38</sup> However, a special regulation is provided for distribution contracts when the commissioner is rendering the services in Panama. According to the Law, these contracts are considered to be unequal contracts or adhesive contracts<sup>39</sup> and are under the exclusive jurisdiction of the courts in

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<sup>36</sup> See Kröll, *supra* note 18 § 16-30, 16-32.

<sup>37</sup> Code of Private International Law of the Republic of Panama (May 8, 2014).

<sup>38</sup> *Id.* art. 88.

<sup>39</sup> *Id.* art. 89. (Unequal contracts are also considered those whereby the weaker party has not capacity to negotiate the essential elements of the contract; those are considered to be: price, clauses for the performance of the contract, and the settlement of disputes).

Panama if the contract is performed within Panamanian borders.<sup>40</sup> The same limitation applies to labor and consumer contracts.<sup>41</sup>

At the same time, when the contract is an international commercial representation or franchising contract, the Code establishes certain limitations to the general principle of freedom of contract in relation to the applicable law to the indemnification for breach of the contract or unilateral termination. . In this situation, the commissioner or the franchisee has the only option to choose between the application of the law applicable to the performance of the contract or the law that provides the highest standard of protection.

Belgium is another example of a jurisdiction where legislation provides for the exclusive jurisdiction of the state courts, as well as for the mandatory application of state law for certain distribution contracts and agency contracts. Belgian case law tends to apply Article II(3) of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and, thus, Belgian courts have found that arbitration agreements are null and void because of the exclusive competence of state courts.<sup>42</sup>

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<sup>40</sup> *Id.* art 90, 91. (These limitations both in regard to arbitration and to the choice of law do not encompass some other well advanced provisions. To this regard, Panama has an arbitration Law that follows very closely The United Nations Committee on International Trade Law (UNCITRAL), UNCITRAL Model Law on International Commercial Arbitration, U.N. Sales No. E.08.V.4 (2008) as modified in 2006. *See* Arbitration Law of Panama (Dec. 31, 2013). Arbitrability of the subject matter of the dispute is seen under the general rule of the free disposition of the parties in art. 4, and in terms of applicable law, due regard is to be given by the arbitrators to the UNIDROIT Principles of International Commercial Contracts, since in all cases the arbitrators will have to take into account the provisions of the contract, the usages of trade as well as the UNIDROIT Principles when the contract is international, as required by art. 56.3.

Identical conclusions in regard to the Code of Private International Law of the Republic of Panama, *supra* note 37, that recognizes the principle of *pacta sunt servanda* in art.72, and also recognizes the agreement of the parties to apply the UNIDROIT Principles as a secondary source to the applicable Law or as a mean to interpret an international commercial contract by the judge or the arbitrator in art.86.

<sup>41</sup> Code of Private International Law of the Republic of Panama, *supra* note 37, art. 90.

<sup>42</sup> *See* Kleinheisterkamp, *supra* note 27, at 1 et seq.; Kröll, *supra* note 17, at 16-33 et seq.; Pilar Perales Viscasillas, *Contratos de internacional Distribución Internacional*

The overriding effect of domestic laws upon arbitration, even with regard to other substantive laws, including those that are based upon European Union (EU) Law, is seen when analyzing the Unamar case, ECJ 17 October 2013.<sup>43</sup> In Unamar, the court states the important consequences for agency contracts within the EU, but does not consider arbitration in its analysis.

In *Unamar*, the parties were an agent from Belgium and a principal from Bulgaria, the applicable law in the contract was Bulgarian Law, and there was also an arbitration clause that provided for an arbitral seat and institution in Bulgaria (Bulgaria Chamber of Commerce). Article 27 of the Belgium Law on commercial agency contracts provides that:

Without prejudice to the application of international conventions to which Belgium is a party, any activity of a commercial agent whose principal place of business is in Belgium shall be governed by Belgian law and shall be subject to the jurisdiction of the Belgian courts.

The Hof van Cassatie (Court of Cassation), considering art. II(3) NYC, held that it had jurisdiction,<sup>44</sup> thereby considering the *lex fori* in its analysis,<sup>45</sup> but submitted the question of the applicable law to a preliminary ruling. The ECJ in the UNAMAR Case had to consider

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*y Arbitraje*, in *DISTRIBUCIÓN COMERCIAL Y DERECHO DE LA COMPETENCIA* 45-102 (Jorge Viera González & Joseba Aitor Echevarría Sáenz eds., 2011).

<sup>43</sup> C-184/12, *United Antwerp Maritime Agencies (Unamar) NV v. Navigation Maritime Bulgare*, 2013 EUR-Lex CELEX Lexis 4306 (Oct. 17, 2013). See also Hilda Grieder Aguilar, *La Intervención de las "Leyes De Policía" Como Límite al Principio de la Autonomía de la Voluntad de las Partes en los Contratos de Agencia Comercial: Un Nuevo Paso en la Comprensión del Sistema*, *DIARIO LA LEY* No. 8234 (2014).

<sup>44</sup> See Hof van Cassatie [Cass.] [Court of Cassation], May 4, 2012, N-20120405-2, <http://www.cass.be> (Belg.) (where the parties agree to arbitration in Quebec (Canada) and the arbitration clause was considered to be null and void; as usual in Belgian Law a comparison is drawn between the applicable law chosen by the parties and Belgian Law, being the one agreed less protective to the agent.).

<sup>45</sup> Pilar Perales Viscasillas, *Contratos de Distribucion Internacional* 77 et seq., in *DISTRIBUCION COMERCIAL Y DERECHO DE LA COMPETENCIA* (La Ley Grupo Wolters Kluwer, 2011) (an analysis that has been very much subject to criticism because it ought to have been in accordance to the *lex contractus*, see further details).

whether the Agency Law of Belgium was or was not part of the international public policy, within the meaning of Article 7 of the Rome Convention.<sup>46</sup>

According to the facts of the case, Bulgaria correctly implemented the Agency Directive into its domestic law, which is a minimum harmonization directive. However, it did so in less protective terms when compared to Belgium Agency Law. Therefore, the question was whether Articles 3 and 7(2) of the Rome Convention might authorize the Belgium courts (law of the forum) to disregard the application of the law chosen by the parties (Bulgarian Law) in favor of the mandatory laws of the forum (Belgium Law on Agency Contracts), despite the fact that the law chosen (Bulgarian Law) meets the requirement of Directive 86/653.

The answer to this question was that Bulgarian Law could be disregarded by the Belgian Court owing to the mandatory nature, in the legal order of Belgium, of the rules governing the situation of self-employed commercial agents.

These rules are mandatory only when the court before which the case has been brought finds, on the basis of a detailed assessment, that, in the course of *that transposition, the legislature of the forum state (Belgium) found it to be crucial, in the legal order concerned, to grant the commercial agent protection going beyond that provided for by the directive.* In that regard, the

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<sup>46</sup> Convention on the Law Applicable to Contractual Obligations, art. 7 1980 OJ (L 266) (EC) [hereinafter Rome Convention]:

1. When applying under this Convention the law of a country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and in so far as, under the law of the latter country, those rules must be applied whatever the law applicable to the contract. In considering whether to give effect to these mandatory rules, regard shall be had to their nature and purpose and to the consequences of their application or non-application

2. Nothing in this Regulation shall restrict the application of the provisions of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the non-contractual obligation.

legislature of the forum state must also take into account the nature and of the objective of such mandatory provisions.<sup>47</sup>

Therefore:

it is thus for the national court, in the course of its assessment of whether the national law which it proposes to substitute for that expressly chosen by the parties to the contract is a 'mandatory rule', to take account not only of the exact terms of that law, but also of its general structure and of all the circumstances in which that law was adopted in order to determine whether it is mandatory in nature in so far as it appears that the legislature adopted it in order to protect an interest judged to be essential by the Member State concerned. As the Commission pointed out, such a case might be one where the transposition in the Member State of the forum, by extending the scope of a directive or by choosing to make wider use of the discretion afforded by that directive, offers greater protection to commercial agents by virtue of the particular interest which the Member State pays to that category of nationals" (pfo.50).

C. The Mandatory Character of Substantive Rules for the Protection of the Weaker Party and its Impact on Arbitration: Agency Contracts in Europe

As we have considered in the two previous sections, arbitration agreements might be totally or partially affected by an express rule limiting arbitrability of the dispute. A third approach to limit the freedom of the parties to submit disputes to arbitration is somewhat indirect because it is derived from the idea that there is a fraud of law by one of the parties (the party with more contracting power) when imposing arbitration with a foreign seat and with a foreign law. This implies that the principal is trying to escape from the mandatory laws protecting the agent, distributor, or franchisee. In fact, this

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<sup>47</sup> See Unamar, *supra* note 43.

consideration is also behind those laws that expressly prohibit arbitration.<sup>48</sup>

A typical example of forum shopping in this area is found in real cases: a Californian principal, with a commercial agent in Europe, elects for arbitration proceedings in California, under Californian law. Interestingly, California law does not recognize a possible indemnification to the commercial agent after the termination of the contract, contrary to the 1986 Agency Directive<sup>49</sup>. In this regard, art. 17 of the Agency Directive is considered a mandatory rule within the European Union that cannot be evaded by the simple expedient of a choice of law clause<sup>50</sup> and/or arbitration clause.<sup>51</sup> Hence, the disputes are non-arbitrable if the applicable law is the law of a non-European country.<sup>52</sup>

## II. A POLICY FAVORING ARBITRATION IN THE AREA OF DISTRIBUTION CONTRACTS

Contrary to the approach undertaken by several countries, other legal systems do not constrain the principle of freedom of the parties to submit their disputes to arbitration in the framework of distribution contracts; on the contrary they have followed a policy in favor of arbitration.

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<sup>48</sup> See *supra* Sections I.1, I.2.

<sup>49</sup> Council Directive 86/653, On Self-Employed Commercial Agents, art. 17 1986 O.J. (L 382) 17 (EC).

<sup>50</sup> C-381/98, *Ingmar v. Eaton*, 2000 E.C.R. I-09305 (in the case, the agent had his place of business in the United Kingdom, and there was no forum or arbitration clause agreed. In terms of applicable law, as we have mentioned, it is not only that the law of the third country might be disregarded but also, as the UNAMAR Case shows, the law of EU country in favor of the mandatory law of the forum).

<sup>51</sup> As interpreted by German Courts when facing art. 89b HGB (HANDELSGESETZBUCH, CCo), i.e., Art.17 of the Agency Directive. See Kröll, *supra*, note 18, at 16-55.

<sup>52</sup> For further details, see Kröll, *supra* note 17, at 16-55 et seq; see also Kleinheisterkamp, *supra* note 26, at 10. This doctrine does not extend to distribution contracts. See Oberster Gerichtshof [OGH] [Supreme Court] Jan. 27, 2010, docket No. 7 Ob 255/09i (Austria) (principal in USA, arbitration in California, distributor in Austria).



### A. Agency Contracts under Spanish Law

Spanish law bases its agency contract law on the EU Directive of 1986.<sup>53</sup> This law establishes that the competence to hear disputes related to agency contracts belongs to the judge of the agent's domicile, making null any contrary agreement of the parties.<sup>54</sup> This imperative provision<sup>55</sup> could have been interpreted as a rule that provides for the exclusion of arbitration. However, the majority of scholars and the case law agree that this provision does not provide for an exclusive jurisdiction of State Courts,<sup>56</sup> but only a territorial competence among State Courts,<sup>57</sup> and thus it does not exclude arbitration even if it has a seat in a foreign country.<sup>58</sup>

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<sup>53</sup> Ley Sobre Contrato de Agencia (B.O.E. 1992, 12) (Spain). *See also* Council Directive 86/653, On Self-Employed Commercial Agents, 1986 O.J. (L 382) 17 (EC).

<sup>54</sup> *Id.* "La competencia para el conocimiento de las acciones derivadas del contrato de agencia corresponderá al Juez del domicilio del agente, siendo nulo cualquier pacto en contrario

<sup>55</sup> *Id.* In general, most of the rules contained in the Agency Contract Law are imperative, see Article 3.1.

<sup>56</sup> Pilar Jiménez Blanco, *Nota al Auto AP Barcelona (sección 17ª) 28 mayo 2009*, 1 ARBITRAJE: REVISTA DE ARBITRAJE COMERCIAL Y DE INVERSIONES 270 (2010); Alejandro López Ortiz, *Interferencias y desajustes entre competencia judicial internacional y competencia territorial en los tribunales civiles españoles: la disposición adicional de la Ley Desajustes Entre Competencia Judicial Internacional y Competencia Territorial en los Tribunales Civiles Españoles: La Disposición Adicional de la Ley 12/1992, del contrato de agencia del Contrato de Agencia*, 14/157 DERECHO DE NEGOCIOS 17 (2003); Pilar Perales Viscasillas, *Algunos Problemas en Torno a la Arbitrabilidad: Insolvencia y Contrato de Agencia*, 5 FORO DE DERECHO MERCANTIL 7-29 (2004).

<sup>57</sup> *See* S.T.S.J. Murcia, Apr. 16, 2014 (R.O.J., 1035/2014) for a recent domestic agency contract (decision of The High Superior Court of Justice of Murcia).

<sup>58</sup> *See* Pilar Jiménez Blanco, *Nota al Auto AP Barcelona (sección 17ª) 28 mayo 2009*, 1 ARBITRAJE: REVISTA DE ARBITRAJE COMERCIAL Y DE INVERSIONES 266-272 (2010) (in relation with an international agency contract (Arbitration in Finland, Finnish principal, Spanish agent)); *see also* S.A.P. Barcelona, June 1, 2004 (R.O.J., 7108/2004); S.A.P. Barcelona, Feb. 7, 2006 (R.O.J., 14828/2006), S.A.P., Nov. 6, 2000 (R.O.J., 13153/2000) and S.A.P. Barcelona, Nov. 19, 2002 (R.O.J. 11552/2002); *see also* S.A.A.P. Lleida 28 Jan. 2009 (R.O.J. 98/2009).

Impliedly also, S.T.S., July 3, 2002 (R.O.J. 4928/2002); S.A.P. Barcelona, Nov. 6, 2000 (R.O.J. 13153/2000) considering the second look doctrine; and S.A.P. Córdoba, July 23, 2001 (R.O.J. 1013/2001). But *see* contrary stating that the arbitral agreement is null: Auto AP Alicante, May 28, 2008 (R.O.J. 76/2008).

In this regard, Spanish arbitration legislation follows a policy that favors arbitration and arbitrability of the disputes.<sup>59</sup> An example of this is that arbitration is provided for by the legislator even when the agent has a special protection as a special worker.<sup>60</sup>

#### B. Distribution Contracts under DR-CAFTA

The Dominican Republic-Central America Free Trade Agreement (DR-CAFTA) is the Free Trade Agreement (FTA) between the United States and Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic. As with other FTAs, such as NAFTA (United States, Canada and Mexico), the idea is to facilitate

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<sup>59</sup> Pilar Perales Viscasillas, *Arbitration in Spain, in* WORLD ARBITRATION REPORTER (WAR) 1-53 (Loukas A. Mistelis, Laurence Shore & Hans Smite eds., 2d ed., 2012). In regard to international distribution contracts, see considering enforceable arbitration agreements with a foreign seat, see S.A.P. Barcelona, Feb. 27, 2012 (R.O.J. 709/2012); see also ICC Arbitration in Düsseldorf. Also an international distribution contract with an exclusive licensing agreement: arbitration in a foreign country with an applicable foreign law (California) and included into the general terms and conditions was considered a valid agreement during the exequatur proceedings, see S.T.S.J. Cataluña, Mar. 25, 2013 (R.O.J. 184/2013). See also considering the equal bargaining power in international distribution contracts and the agreement to arbitrate included in general terms and conditions: S.T.S.J. Cataluña, Nov. 17, 2011 (R.O.J. 525/2011) also examining this question during the enforcement proceedings under The New York Convention. For a valid agreement in international distribution contracts of the option for arbitration or state Courts, Juz. de lo Mercantil, n°11 of Madrid, May 4, 2011 (R.O.J. 3738/2014), confirmed by S.A.P. Madrid, Oct. 18, 2013 (R.O.J. 1988/2011).

Also considering that franchising contracts are negotiated contracts between the parties as derived from the mandatory pre-contractual information and thus considering the arbitration valid as no proof of the non-negotiated agreement was duly provided: S.A.P. Zaragoza, Dec. 19, 2011 (R.O.J. 3211/2011). Contrary considering the arbitration clause null as was included in general terms and conditions: S.A.P. Barcelona, Sep. 28, 2012 (R.O.J. 7296/2012), that it is however a wrong decision based upon art. 63 Code of Civil Procedure that does not apply to arbitration.

<sup>60</sup> Ley del Estatuto del Trabajador Autónomo (LETA) (B.O.E. 20/2007) (Spain) (applies to commercial agents when they are considered economically dependant from the principal. Art.17 LETA establishes the competence of Labor courts but also in accordance with Art.18.4 LETA parties may submit their disputes to arbitration.).

trade and investment to foster regional integration and harmonization.<sup>61</sup>

DR-CAFTA is different than other FTAs in that it deals, among other issues, with distribution contracts (substantive rules), as well as arbitration in relation to these contracts. The more recent FTAs focus on arbitration as the ideal, efficient and fair method for resolving commercial disputes, and they are considered the best way to promote investment and trade.<sup>62</sup>

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<sup>61</sup> David A. Gantz, *Symposium: CAFTA and Commercial Law Reform in the Americas: International Legal Development: The Complex Problem of Customs Law and Administrative Reform in Central America*, 12 *Americas*, SW. J.L. & TRADE AM. 215, 220 (2006) (U.S.) (The agreement entered into force for the United States and El Salvador, Guatemala, Honduras, and Nicaragua during 2006. For the Dominican Republic on Mar. 1, 2007, and for Costa Rica on Jan. 1, 2009.) (U.S.).

<sup>62</sup> José A. Muñoz, *Symposium: CAFTA and Commercial Law Reform in the Americas: Dealing with Shadow Economy: Comments and Reflections*, *Southwestern*, 12 SW. J.L. & TRADE AM. 373, 378 (2006); Omar García Bolívar, *Symposium: CAFTA and Commercial Law Reform in the Americas: Dispute Resolution Process and Enforcing the Rule of Law: Is Arbitration a Viable Alternative to Solving Disputes in Central America*, 12 SW. J.L. & TRADE AM. 380, 381 et seq. (2006); Jeffrey Talpis, *Symposium: CAFTA and Commercial Law Reform in the Americas: Comments on Dispute Resolution Process and Enforcing the Rule of Law*, 12 SW. J.L. & TRADE AM. 409 et seq. (2006); Pilar Perales Viscasillas et al., *Derecho Uniforme del Comercio Internacional y Tratados de Libre Comercio en América*, in *EL DERECHO MERCANTIL EN EL UMBRAL DEL SIGLO XXI: LIBRO HOMENAJE AL PROF. DR. CARLOS FERNÁNDEZ-NÓVOA EN SU OCTOGÉSIMO CUMPLEAÑOS 63-76* (J. A. Gómez Segade and A. García, Marcial Pons eds., 2010).

See also for example, Agreement between the United States of America and the Socialist Republic of Vietnam on Trade Relations, U.S.-Viet., art. 7, July 13, 2000, Hein's No. KAV 5968, available at <http://photos.state.gov/libraries/vietnam/8621/pdf-forms/bta.pdf> (commercial Disputes, which means a dispute between parties to a commercial transaction which arises out of that transaction):

2. The parties encourage the adoption of arbitration for the settlement of disputes arising out of commercial transactions concluded between nationals or companies of the United States of America and nationals or companies of the Socialist Republic of Vietnam. Such arbitration may be provided for by agreements in contracts between such nationals and companies, or in a separate written agreement between them.

3. The parties to such transactions may provide for arbitration under any internationally recognized arbitration rules, including the UNCITRAL Rules of December 15, 1976, and any

Before DR-CAFTA, legislation in Central-American countries was imperative and very protective of the distributor, agent and franchisee.<sup>63</sup> Furthermore, arbitration was prohibited because the legislation provided for the exclusive jurisdiction of State courts to resolve disputes in the area of distribution contracts. However, those barriers to the principle of freedom of contract and arbitration were

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modifications thereto, in which case the parties should designate an Appointing Authority under said rules in a country other than USA or Vietnam.

4. The parties to the dispute, unless otherwise agreed between them, should specify as the place of arbitration a country other than USA or Vietnam that is a party to the New York Convention.

5. Nothing in this Article shall be construed to prevent, and the parties shall not prohibit, the parties from agreeing upon any other form of arbitration or on the law to be applied in such arbitration, or other form of dispute settlement which they mutually prefer and agree best suits their particular needs.

6. Each party shall ensure that an effective means exists within its territory for the recognition and enforcement of arbitral awards.”

<sup>63</sup> See the Preamble to the Law No. 173, the Protection of the Importers Agents of Goods and Products of 6th April 1966 (Dominican Republic) that was considered a Public Order Law (art. 8):

CONSIDERANDO que el Estado Dominicano no puede permanecer indiferente al creciente número de casos en que personas físicas o morales del exterior, sin causas justificadas, eliminan sus concesionarios agentes tan pronto como estos han creado un mercado favorable en la República, y sin tener en cuenta sus intereses legítimos.

CONSIDERANDO que se hace necesaria la adecuada protección de las personas físicas o morales que se dedican en la República Dominicana a promover y gestionar la importación, la distribución, la venta, el alquiler o cualquier otra forma de explotación de mercaderías o productos procedentes del extranjero o cuando los mismos sean fabricados en el país, actuando como agentes, o bajo cualquiera otra denominación contra los perjuicios que puedan irrogarles la resolución injusta de las relaciones en virtud de las cuales ejerzan tales actividades, por la acción unilateral de las personas o entidades a quienes representan o por cuya cuenta o interés actúan, a fin de asegurarles la reparación equitativa y completa de todas las pérdidas que hayan sufrido, así como de las ganancias legítimas percibibles de que sean privados.

considered by the contracting parties as contrary to the objectives of DR-CAFTA, i.e., among others, to:

CONTRIBUTE to the harmonious development and expansion of world trade and provide a catalyst to broader international cooperation;

CREATE an expanded and secure market for the goods and services produced in their territories while recognizing the differences in their levels of development and the size of their economies;

AVOID distortions to their reciprocal trade;

ESTABLISH clear and mutually advantageous rules governing their trade;

ENSURE a predictable commercial framework for business planning and investment;

FOSTER creativity and innovation, and promote trade in goods and services that are the subject of intellectual property rights (. . .).

As a consequence, the Central American countries (and the Dominican Republic) needed to assume several specific commitments in order to reduce the impact of mandatory rules,<sup>64</sup> as well as, to promote arbitration both in general terms<sup>65</sup> and particularly in relation

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<sup>64</sup> For the main characteristic of this legislation, see Cecilia Barrero, *Distribution Contracts in the Dominican Republic*, 2001 COMP. LAW Y.B. INT'L BUS. 27-32; Salvador Juncadella, *Agency, Distribution and Representation Contracts in Central America and Panama*, 6 U. MIAMI INTER-AM. L. REV. 35, 36(1974) (with references to Honduras, Costa Rica, El Salvador, Guatemala, Nicaragua and Panama).

<sup>65</sup> Central American Free Trade Agreement, U.S.-D.R., art. 20.22, Aug. 5, 2004, 43 I.L.M. 514:

1. Each Party shall, to the maximum extent possible, encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes between private parties in the free trade area. 2. To this end, each Party shall provide appropriate procedures to ensure observance of agreements to arbitrate and for the recognition and enforcement of arbitral awards in such disputes. 3. A Party shall

to distribution contracts by eliminating the exclusive jurisdiction of State Courts. Taking the example of Costa Rica, which assumed the following commitments in Annex 11.3 revolved around the principle of party autonomy and promotion of arbitration:

“1. Costa Rica shall repeal articles 2 and 9 of Law No. 6209, entitled *Ley de Protección al Representante de Casas Extranjeras*, dated 9 March 1978, and its regulation, and item b) of article 361 of the *Código de Comercio*, Law No. 3284 of 24 April 1964, effective on the date of entry into force of this Agreement.

2. Subject to paragraph 1, Costa Rica shall enact a new legal regime that shall become applicable to contracts of representation, distribution, or production, and:

(a) Shall apply principles of general contract law to such contracts;

(b) Shall be consistent with the obligations of this Agreement and the principle of Freedom of contract;

(c) Shall treat such contracts as establishing an exclusive relationship only if the Contract explicitly states that the relationship is exclusive;

(d) shall provide that the termination of such contracts either on their termination dates or in the circumstances described in subparagraph (e) is just cause for a goods or service supplier of another Party to terminate the contract or allow the contract to expire without renewal; and

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be deemed to be in compliance with paragraph 2 if it is a party to and is in compliance with the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the 1975 Inter-American Convention on International Commercial Arbitration [ . . ].

(e) Will allow contracts with no termination date to be terminated by any of the parties by giving ten months advance termination notice.

3. The absence of an express provision for settlement of disputes in a contract of representation, distribution, or production shall give rise to a presumption that the parties intended to settle any disputes through binding arbitration. Such arbitration may take place in Costa Rica. However, the presumption of an intent to submit to arbitration shall not apply where any of the parties objects to arbitration.

4. The United States and Costa Rica shall encourage parties to existing contracts of representation, distribution, or production to renegotiate such contracts so as to make them subject to the new legal regime enacted in accordance with paragraph 2.

5. In any case, the repeal of articles 2 and 9 of Law No. 6209 shall not impair any vested right, when applicable, derived from that legislation and recognized under Article 34 of the Constitución Política de la República de Costa Rica.

6. Costa Rica shall, to the maximum extent possible, encourage and facilitate the use of arbitration for the settlement of disputes in contracts of representation, distribution, or production. To this end, Costa Rica shall endeavor to facilitate the operation of arbitration centers and other effective means of alternative resolution of claims arising pursuant to Law No. 6209 or the new legal regime enacted in accordance with paragraph 2, and shall encourage the development of rules for such arbitrations that provide, to the greatest extent possible, for the prompt, low-cost, and fair resolution of such claims.

7. For purposes of this Section:

(a) Contract of representation, distribution, or production has the same meaning as under Law No. 6209; and

(b) Termination date means the date provided in the contract for the contract to end, or the end of a contract extension period agreed upon by the parties to the contract.

Costa Rica fulfilled those commitments by modifying Art.7 of Law n°6209 de Protección al Representante de Casas Extranjeras.<sup>66</sup> In the old Art.7, the exclusive competence of Costa Rican courts was established in addition to the imperative character of the substantive rules relating to distribution contracts. According to the new provision, arbitration is allowed despite the fact that the substantive rules that govern distribution contracts are imperative. Thereby recognizing an important principle in arbitration: the imperative character of the rules is not an obstacle for the settlement of disputes through arbitration.<sup>67</sup>

#### CONCLUSION: NO NEED TO LIMIT PARTY AUTONOMY IN

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<sup>66</sup> The modification took place by *Modificación De La Ley De Protección Al Representante De Casas Extranjeras, N° 6209, Y Derogación Del Inciso B) Del Artículo 361 Del Código De Comercio, Ley N° 3284, Ley No. 8629, Nov. 11, 2007 (Costa Rica)*, available at <http://www.crecex.com/asesoria-juridica/legislacion-consulta/repre-casas-ext/Ley8629.pdf>.

<sup>67</sup> *Modificación De La Ley De Protección Al Representante De Casas Extranjeras, N° 6209, Y Derogación Del Inciso B) Del Artículo 361 Del Código De Comercio, Ley N° 3284, Ley No. 8629, Art.7 Law n°6209 Nov. 11, 2007 (Costa Rica)* states that:

Los derechos del representante, distribuidor o fabricante, por virtud de esta Ley, serán irrenunciables. La ausencia de una disposición expresa en un contrato de representación, distribución o fabricación para la solución de disputas, presumirá que las partes tuvieron la intención de dirimir cualquier disputa por medio de arbitraje vinculante. Dicho arbitraje podrá desarrollarse en Costa Rica. No obstante, la presunción de la intención de someter una disputa a arbitraje no se aplicará cuando una de las partes objete el arbitraje.



## ARBITRATION

The comparison of the different approaches to deal with arbitration in relation to distribution contracts shows that the protection of a weaker party is the basis for limiting party autonomy in arbitration. However, such a general principle ought to be scrutinized against the different types of distribution contracts and even against each and any of the individual contracts since it is clear that not all, or even many, of the distribution contracts show an unequal bargaining power. Furthermore, if one were to consider that the principle of protection of the weaker party is the basis for limiting party autonomy in arbitration, then such a justification ought to be applied to any commercial contract in which such a disparity is to be observed. However, such an unbearable extension of this principle would raise more problems than it would tend to solve, among others, the need to specify the scope of its application.

It is true that certain pathologies might exist in few cases by the abuse of one of the contracting parties, but general rules on arbitration and contract law are enough to solve this problem without the need to adopt excessive rules prohibiting arbitration or limiting arbitrability of the dispute.

On the contrary, arbitration is considered an important factor in the development of investment and trade. The more the restrictions to party autonomy, the less attractive a country is for trade and investment.

The application of international mandatory rules is not enough to exclude arbitrability as shown by Spanish or Costa Rican Laws. In fact, even if the contract is silent, Costa Rica, when assuming an implied arbitration agreement, reinforces the value of arbitration as being contractual in nature and the normal way to solve commercial disputes.<sup>68</sup>

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<sup>68</sup> See Pilar Perales Viscasillas, *Contratos de distribución internacional y arbitraje*, in *DISTRIBUCIÓN COMERCIAL Y DERECHO DE LA COMPETENCIA* 70 et seq. (Jorge Viera González & Joseba Aitor Echevarría Sáenz eds., 2011); Pilar Perales Viscasillas, *La presunción legal de sometimiento al arbitraje*, in *TRATADO DE DERECHO ARBITRAL*, TOMO II EL CONVENIO ARBITRAL 145-164 (Carlos Alberto Soto ed., 2011); Pilar

Traditionally, it was held that matters subject to national mandatory rules of law were non-arbitrable. Unlike the field of commercial contracts where the will of the parties prevails as a general rule, in the area of distribution contracts certain rules are considered to be mandatory. This traditional position has been rejected in favour of a modern view of arbitrability. In modern arbitration practice, it is clear that even if a matter is subject to mandatory rules, it might be subject to arbitration.

As far as public policy and its relation to arbitrability is concerned, some arbitration laws consider that public policy issues cannot be subject to arbitration.<sup>69</sup> But even in those systems, new trends are also applicable: public order is no longer considered a limitation to arbitrability, but rules of that character have to be respected by the arbitrators in order to have an enforceable award.<sup>70</sup> Public policy, however, in certain situations can operate as a limit to arbitrability. Whether the public order impedes the submission of a dispute to arbitration is usually a question to be decided by the law.

The well-known second look doctrine in arbitration will provide for the appropriate remedy: the arbitrators should respect mandatory provisions of the relevant country –when they are to be considered as relevant and truly international<sup>71</sup> and not extravagant

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Perales Viscasillas & David Ramos Muñoz, *CISG & Arbitration*, 10 SPANISH ARB. REV. 63-84 (2011); PRIVATE LAW: NATIONAL - GLOBAL - COMPARATIVE: Festschrift for Ingeborg Schwenzer on the occasion of her 60th birthday 1355-1374. (Andrea Büchler; Markus Müller-Chen ed., 2011).

<sup>69</sup> CODE CIVIL [C. CIV.] art. 2059, 2060 (Fr.).

<sup>70</sup> See, e.g., Pilar Perales Viscasillas, *Arbitrabilidad de los Derechos de la Propiedad Industrial y de la Competencia*, 6 ANUARIO DE JUSTICIA ALTERNATIVA, DERECHO ARBITRAL 11-76 (2005) (for further references in the area of competition law).

<sup>71</sup> See HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW (HCCH), THE DRAFT HAGUE PRINCIPLES ON CHOICE OF LAW IN INTERNATIONAL COMMERCIAL art. 11 (2014), available at [http://www.hcch.net/upload/wop/gap2014pd06rev\\_en.pdf](http://www.hcch.net/upload/wop/gap2014pd06rev_en.pdf) (Overriding mandatory rules and public policy (ordre public)):

1. These Principles shall not prevent a court from applying overriding mandatory provisions of the law of the forum which apply irrespective of the law chosen by the parties.

rules<sup>72</sup> and thus the Courts will assess at the post-award stage if mandatory rules were respected by the arbitrators.<sup>73</sup>

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2. The law of the forum determines when a court may or must apply or take into account overriding mandatory provisions of another law.

3. A court may exclude application of a provision of the law chosen by the parties only if and to the extent that the result of such application would be manifestly incompatible with fundamental notions of public policy (*ordre public*) of the forum.

4. The law of the forum determines when a court may or must apply or take into account the public policy (*ordre public*) of a State the law of which would be applicable in the absence of a choice of law.

5. These Principles shall not prevent an arbitral tribunal from applying or taking into account public policy (*ordre public*), or from applying or taking into account overriding mandatory provisions of a law other than the law chosen by the parties, if the arbitral tribunal is required or entitled to do so.

<sup>72</sup> See Kleinheisterkamp, *supra* note 26, at 11 et seq.; see also Kröll, *supra* note 18, at 16-63, 16-63, 16-77, 16-79.

<sup>73</sup> Peter Schlosser, *Arbitration and the European Public Policy*, in *L'ARBITRAGE ET LE DROIT EUROPÉEN* 87, (Bruylant, 1997); Fabio Bortolotti, *International Commercial Agency Agreements and ICC Arbitration*, 10 *INT'L COURT ARB. BULLETIN* 48, 53-55, 59 (2001); Patrick M. Baron & Stefan Liniger, *A Second Look at Arbitrability*, 19 *ARB. INT'L.* 27-54 (2003); Case C-126/97, *Eco Swiss v. Benetton*, 1999 E.C.R I-1.

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## LESSONS AND BEST PRACTICES FOR DESIGNERS OF FAST TRACK, LOW VALUE, HIGH VOLUME GLOBAL E- COMMERCE ODR SYSTEMS\*

*Louis F. Del Duca<sup>†</sup>, Colin Rule, and Brian Cressman<sup>\*\*</sup>*

### ABSTRACT

*The momentum behind development of global online fast track low value high volume dispute resolution (hereafter ODR) continues to accelerate. Consumer and business groups around the world are promoting fair, proportionate, effective, online, fast track redress for low value high volume cross border e-commerce disputes. As a result, there will continue to be increasing demand for a variety of effective ODR systems design and procedural rules. Best practices developed by entities like eBay and lessons learned from the work of UNCITRAL Working Group III can*

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\* The beginning of this article addressing “Low Value Parameters” and “Limiting Types of Claims” was presented as a paper, authored by Louis F. Del Duca, Colin Rule, and Kathryn Rimpfel, entitled *eBay’s De Facto Low Value High Volume Fast Track Resolution Process: Lessons and Best Practices for ODR Systems Designers*, 6 Y.B.Arb. & Mediation 204 (2014) at the 17<sup>th</sup> Biennial Meeting of the International Academy of Commercial and Consumer Law held 16-19<sup>th</sup> July 2014 at the Istanbul Bilgi University in Turkey. We expand and update the earlier version with a discussion of eBay’s Automated Trustmark Evaluation/Feedback system and Private Enforcement of Settled Claims and Rulings of Neutrals system.

† Before this article could be published, Professor Del Duca passed away unexpectedly in November, 2015. This publication has been dedicated to his memory by his colleagues and this Journal.

\*\* Louis Del Duca is the Edward N. Polisher Distinguished Faculty Scholar Emeritus at the Penn State Dickinson School of Law. Colin Rule is formerly Director of Online Dispute Resolution for eBay and PayPal and presently CEO of Modria.com. Brian Cressman, The Penn State Dickinson School of Law, J.D. 2015. We wish to express thanks for the research assistance in preparation of this article to Kathryn Rimpfel, The Penn State Dickinson School of Law, J.D. 2014; Lina Ali, Research and Teaching Assistant, University of Basel, Switzerland; Jeremy O’Steen, The Penn State Dickinson School of Law, J.D. 2014; John Pokiniewski, The Penn State Dickinson School of Law, J.D. candidate 2016; Philip Reinhart, The Penn State Dickinson School of Law, J.D. candidate 2016; and Maureen Rostad, The Penn State Dickinson School of Law, J.D. candidate 2017.

be helpful in developing framework models for fast track low value high volume e-commerce ODR systems.

**E-commerce** ODR systems like eBay's provide a marketplace for e-commerce as well as an electronic system for fast track resolution of disputes which arise on their e-commerce marketplace.

**Ordinary** ODR systems do not provide an e-commerce marketplace but only provide for resolution of disputes. Accordingly, best practices developed by eBay's e-commerce ODR system discussed in this article are generally applicable and needed by e-commerce ODR systems, but generally inapplicable and not needed by ordinary ODR systems. This article addresses development by eBay of its highly successful fast track low value high volume e-commerce ODR system by application of the following four best practices:

**(i) Low Value Parameters:**

Adoption of a generally applicable de facto low value workable monetary "standard" (for example, the Purchase Price "Money Back Guarantee" discussed *infra*) rather than a "numeric" (i.e. \$15,000) monetary description for disputes which are eligible for resolution on the providers' platforms facilitates global development of fast track low value high volume ODR systems. A \$15,000, \$10,000 or \$5,000 monetary ceiling for low value disputes might constitute low value in a developed economy. It will not in an underdeveloped economy. **Hence the need for a low value workable monetary "standard" rather than an unworkable "numeric" monetary description.** As indicated, the eBay Purchase Price "Money Back Guarantee" cap on the amount of a permissible claim provides a workable standard in developed and underdeveloped economies. \*\*\*

**(ii) Limitation of Types of Claims:**

Leaving resolution of disputes involving high value and complicated legal issues to other forums,

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\*\*\* The eBay system combines general use of a "monetary standard" with a "numeric description" of low value for specific categories of goods. This article also notes the flexibility of eBay's system in responding to market developments by creating actual numeric ceilings for disputes pertaining to equipment and vehicle categories of purchases which also are deemed to be suitable and therefore eligible for resolution on eBay's ODR platform. Adjusting to market developments since the launch of its original dispute resolution system, eBay has added resolution platforms specifically dedicated to categories of purchases, including the (Vehicle Purchase Protection [hereinafter VPP] and Business Equipment Purchases Protection [hereinafter BEPP] programs which require vehicle claims to be more than \$100 and less than \$50,000 and equipment claims to be more than \$1000 and less than \$20,000. Based on the eBay Fast Track Low Value experience, therefore, an ODR Best Practice is to build the basic low value system (i.e., "Money Back Guarantee") as needed, and as market conditions mandate, customize resolution and protection programs specifically designed to address individual categories of disputes. For more on eBay's VPP and BEPP programs, see Purchase Protection Systems For Specific Categories of Goods – Maximum and Minimum Purchase Price Limits on the Amount in Controversy (discussion at Section II.3, *infra*).

General Electric's Oil and Gas Division has experimented with online resolutions for commercial conflicts, as detailed in Vanessa O'Connell, *At GE, Robo-Lawyers*, WALL ST. J.,

eBay's fast track ODR eligibility requirements also limit the complexity and scope of permissible claims (i.e. claims eligible for resolution on its platform) by giving buyers a "Money Back Guarantee," which, as noted *supra*, caps the amount a buyer may claim to recovery of purchase price paid, and also limits the types of claims to "Items not received" or "Items not as described." These limitations on the amount and types of claims permitted facilitate fast track and fair resolution of disputes and enables eBay to handle 60,000,000 e-commerce disputes annually averaging \$70-\$100 in value.

**(iii) Buyers' On-Demand Access to Automated Trustmark Evaluation/Feedback Information Needed to Identify Reliable Sellers:**

Vital to facilitating e-commerce between buyers and sellers, often in different parts of the world and speaking different languages, is developing trust between buyers and sellers to give them the confidence they need to enter into electronic transactions. eBay's solution to developing this trust between buyers and sellers is the Automated Trustmark Evaluation/Feedback System. This system enables buyers involved in electronically purchasing low value high-volume items to quickly identify on demand a reliable seller without doing extensive research. Buyers seeking to make purchases using the eBay platform are able to assess the reliability of sellers with whom they anticipate doing business based on ratings and feedback derived from performance data supplied electronically by previous buyers after each transaction they completed on the eBay platform.

**(iv) Private Enforcement**

After discussing (i) Low Value Parameters, (ii) Limitation of Types of Claims, and (iii) Buyers' On Demand Access to Automated Trustmark Evaluation/Feedback Information Needed to Identify Reliable Sellers, we address (iv) Private Enforcement measures available to enforce settled claims and rulings of neutrals to successfully implement fast track low value high volume e-commerce systems.

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<http://www.wsj.com/articles/SB10001424052970203633104576620902874155940>  
. This program focuses on disputes for less than 50,000 Euros.

## TABLE OF CONTENTS

I. ACHIEVING “LOW VALUE” PARAMATERS.....	247
A. eBay’s De Facto “Low Value” .....	247
II. LIMITING TYPES OF CLAIMS.....	250
A. Buyers’ Claims – “Item Not Received,” “Item Not as Described” .....	252
B. Sellers’ Claims – “Final Value Fee”.....	254
C. Maximum and Minimum Purchase Price Limits for Certain Categories of Goods .....	255
III. FACILITATING FAST TRACK RESOLUTION OF DISPUTES – COMBINING USE OF LOW VALUE PARAMETERS & LIMITING TYPES OF CLAIMS. ....	264
A. Lists of “Item Not Received” and “Item Not as Described” Claims.....	264
1. EBay Explicit Limitation of Types of Claims and List of Specific Claims – Consequential Damages Excluded by “Money Back Guarantee” .....	264
B. Comparison of Selected eBay Best Practices and the UNCITRAL Draft.....	265
IV. LESSONS AND BEST PRACTICES REGARDING DE FACTO PURCHASE PRICE “MONEY BACK GUARANTEE” LOW VALUE & LIMITATION OF TYPES OF CLAIMS PERMITTED.....	269
V. BUYERS’ ON DEMAND ACCESS TO INFORMATION NEEDED TO IDENTIFY RELIABLE SELLERS.....	271
A. Evaluation of Sellers and Ratings – Building Trust	271
VI. THE EBAY AUTOMATED TRUSTMARK EVALUATION/FEEDBACK SYSTEM.....	272
A. Importance of Making Seller Evaluations and Ratings Available to Foster Trust Between Buyers and Sellers and Facilitate Private Enforcement.....	272
B. “Percentage”, “Score”, and “Comment Feedback”	274
C. “Description”, “Communication”, and “Shipment”, - Detailed Seller Ratings .....	276
D. Transaction Defect Rate.....	279
VII. AWARDING OF EBAY’S AUTOMATED TRUSTMARKS USING THE EVALUATION/FEEDBACK SYSTEM.....	280
A. PowerSeller Designation - <u>Requirements and Benefits</u> .....	280

2015	<i>Penn State Journal of Law &amp; International Affairs</i>	4:1
	B. Top-Rated Seller Badge Designation - <u>Requirements and Benefits</u> .....	282
	C. Comparison of eBay Evaluation System with Other Evaluation Systems.....	285
VIII.	LESSONS & BEST PRACTICES REGARDING EBAY'S AUTOMATED TRUSTMARK SYSTEM & PRIVATE ENFORCEMENT.....	287
	A. eBay's Automated Trustmark System and Private Enforcement of Settled Claims and Rulings of Neutrals Through Voluntary Compliance, Termination of Trustmark Status, Use of Chargebacks, and Access to Escrow Accounts.....	287
	CONCLUSION.....	288



## I. ACHIEVING “LOW VALUE” PARAMETERS

## A. eBay’s De Facto “Low Value”

Among privately created online dispute resolution systems, the eBay Resolution Center stands alone. eBay’s process has resolved more disputes over a longer period of time than any other online dispute resolution process in the world. Launched in 1995, eBay was designed to be the largest global online marketplace, evolving from its roots in consumer-to-consumer (C2C) auctions into Business-to-Business and Business-to-Consumer (B2C) verticals. After it acquired PayPal in 2002, eBay set about building a robust, end-to-end Trust and Safety infrastructure. A core tenet of that infrastructure is the Resolution Center, an online redress process provided to every eBay and PayPal user in the world, customized to address most of the dispute volume that arises between buyers and sellers that utilize eBay’s services around the world.<sup>1</sup>

eBay is an e-commerce company which has developed a robust online marketplace facilitating low value high volume consumer to consumer, business to consumer, and business to business electronic commerce<sup>2</sup>, and also providing a fast-track low value high volume ODR system for resolving disputes arising from e-commerce transactions on its market place. The low value requirement for disputes eligible for resolution on its platform is needed for ODR systems like eBay which provide an online marketplace coupled with an ODR system for resolution of disputes which arise from e-commerce on its marketplace. The low value requirement generally is not needed for systems that only provide an ODR system for resolving disputes but do not provide an electronic market place, unless the provider is resolving low value high volume disputes arising from transactions conducted outside of its platform.

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<sup>1</sup> See ARNO R. LODDER & JOHN ZELEZNIKOW, ENHANCED DISPUTE RESOLUTION THROUGH THE USE OF INFORMATION TECHNOLOGY 8 (2010).

<sup>2</sup> See *We are one company*; EBAY INC., [http://www.ebayinc.com/who\\_we\\_are/one\\_company](http://www.ebayinc.com/who_we_are/one_company) (last visited Jan. 14, 2015).

Since its creation in 1995, eBay has expanded internationally at an increasing rate.<sup>3</sup> eBay's international growth continues with increased revenues and expansion into new countries abroad.<sup>4</sup> Currently, eBay has 149 million active buyers worldwide and 700 million total listings.<sup>5</sup> In 2013, eBay's worldwide revenues were \$8.3 billion and its Gross Merchandise Volume was \$77 billion.<sup>6</sup>

eBay's Resolution Center was created with the aim of addressing the typical disputes arising out of purchases within eBay's marketplaces, which usually average about \$70-\$100 in value.<sup>7</sup> The eBay platform currently handles over 60 million e-commerce disputes annually through a process that enables parties to resolve their problems amicably through direct communication. The number of disputes being resolved through eBay's online platform is expanding steadily as the transaction volume on the site increases at about 13% per year.<sup>8</sup>

Since the launch of its original dispute resolution system, which focused only on letting buyers report "fraud alerts," eBay has expanded to support dispute resolution in a variety of other problem types, such as "item not received," and "item not as described" disputes (where the buyer is the complainant), or "unpaid item" disputes (where the

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<sup>3</sup> Trefis Team, *eBay: The Year 2013 in Review*, FORBES (Dec. 26, 2013), <http://www.forbes.com/sites/greatspeculations/2013/12/26/eBay-the-year-2013-in-review/>.

<sup>4</sup> *Id.*; see *Corporate Fact Sheet: Q4 2010*, EBAY INC., (2010) (on file with author) (eBay.com identifies the following countries and Hong Kong as countries for which it has a website: Argentina, Austria, Australia, Belgium, Brazil, Canada, China, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, India, Ireland, Italy, Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Philippines, Poland, Portugal, Russia, Singapore, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and Vietnam).

<sup>5</sup> *Q2 Fast Facts*, EBAY, INC., <http://www.ebayinc.com/sites/default/files/eBay-q2-fast-facts.pdf> (on file with Journal).

<sup>6</sup> *Id.*

<sup>7</sup> See *Corporate Fact Sheet: Q4 2010*, *supra* note 4.

<sup>8</sup> *Id.*

<sup>9</sup> In the eBay system, buyers are required to pay for the item before the seller ships it. In cases of direct sales rather than auction sales, sellers are required to be paid prior to the shipment of the item. The seller is therefore unpaid only in the auction sale cases where a buyer who is the successful bidder does not forward the

seller is the complainant).<sup>10</sup> eBay has also added resolution platforms dedicated specifically to several categories of purchases, including the Vehicle Purchase Protection (VPP) and Business Equipment Purchase Protection (BEPP) programs, each with specific minimum and maximum price limitations.<sup>11</sup> These developments have enhanced eBay's initial programs focused on low value, high volume, B2C transactions, with more in-depth specialized claims processes relating to higher dollar value purchases.<sup>12</sup>

The eBay ODR system, from the outset, has had a de facto low-value framework because it has been packaged as a kind of money-back guarantee – *recovery is limited to the purchase price for the buyer, and reimbursement for the seller.*<sup>13</sup> This necessarily excludes an award of consequential damages. Higher dollar value purchases, however, require different kinds of protection and resolution. eBay's specialized procedures for vehicles and equipment disputes, for instance, require equipment claims to involve more than \$1,000 and less than \$20,000, and vehicle claims to be more than \$100 and less than \$50,000.<sup>14</sup> Only disputes involving vehicles or equipment that fall within the minimum and maximum requirements are eligible to be handled by these special ODR processes.

For example, in a traditional sale conducted through eBay's platform for a cell phone, Buyer pays through one of eBay's approved payment methods (such as PayPal), and Seller ships the phone and it

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bid amount to the seller. In this situation eBay allows the seller to recover for the "unpaid item" fee (This is a "Final Value Fee," usually 1 to 2% of the purchase price) paid by the seller to eBay for the use of the eBay platform. See discussion *infra* note 24.

<sup>10</sup> *eBay Money Back Guarantee*, EBAY INC., <http://pages.ebay.com/help/policies/money-back-guarantee.html> (last visited Jan. 15, 2015) [hereinafter "eBay Money Back Guarantee Policy"].

<sup>11</sup> *eBay Vehicle Purchase Protection*, EBAY INC., <http://pages.motors.ebay.com/buy/purchase-protection/index.html> (last visited Jan. 15, 2015) [hereinafter VPP Policy]; *Business Equipment Purchase Protection*, EBAY INC., <http://pages.ebay.com/help/buy/business-protection.html> (last visited Jan. 15, 2015) [hereinafter BEPP Policy].

<sup>12</sup> See *id.*

<sup>13</sup> For more information on limitations on the amount recoverable by the seller to the "Final Value Fee," see are discussion *infra* note 24.

<sup>14</sup> See VPP Policy, *supra* note 11; BEPP Policy, *supra* note 11.

arrives in the stated amount of time. However, due to a malfunction stemming from a defect in the cell phone battery, the phone causes a fire in Buyer's home and also results in serious burns to Buyer, his wife, and two children. Though this damage directly results from the deficiency of the item exchanged in the eBay sale, Buyer will have no recourse through the eBay ODR platform for consequential damages. Though Buyer can claim that the phone did not arrive as described – i.e. fully functional - the eBay Money Back Guarantee inherently limits recovery to the price of the item. Thus, although Buyer may seek to recover the consequential damages in a judicial proceeding or other fora, recovery of consequential damages is excluded from the ODR process. eBay has learned from extensive experience that this level of protection is adequate to reassure most eBay buyers that they will be protected.

The eBay system can serve as an example of best practices in limiting the types of claims and amount of recovery to place parameters to create a low-value framework to facilitate fast-track, fair, and low-cost ODR. We include in our discussion *infra* the differences in procedural details of resolving disputes of different types of products covered by the basic, equipment and vehicle protection programs.

## II. LIMITING TYPES OF CLAIMS<sup>15</sup>

In the basic eBay resolution system, administered in conjunction with PayPal, eBay provides both buyers and sellers a guided process for resolving disputes over purchases made through its site. In the initial step, eBay asks buyers to diagnose the specifics of their complaint, and to suggest a preferred resolution. eBay then encourages the buyers and sellers to negotiate directly through its messaging platform. If the matter cannot be resolved through negotiation, the dispute then can be escalated to the Resolution Services team within Customer Support. Unless a settlement

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<sup>15</sup> This section describes the ODR system from the perspective of both the buyer and the seller. This description is based on the information provided for the benefit of customers on the eBay website. See *eBay Money Back Guarantee Policy*, *supra* note 10. This section is citing to that source of authority, unless indicated otherwise.

agreement is reached, Resolution Services will evaluate the buyer's claim and make a ruling about who is right and who is wrong. While this ruling does not have *res judicata* effect,<sup>16</sup> the parties will generally voluntarily satisfy the Resolution Services ruling, and, in the absence of such voluntary compliance, the ruling is enforceable by use of applicable private enforcement procedures including chargeback on credit cards, deprivation of trustmarks, and access to escrow accounts.

The eBay Money Back Guarantee is outlined in a policy found on the eBay website that lists the types of claims that are and are not covered.<sup>17</sup> This policy again confines claims to situations where the item never arrived or the item was not as described in the seller's listing. Then, the policy places certain procedural restrictions on claims, such as: (1) the case must be opened no later than thirty days after the actual or latest estimated delivery date; (2) the purchase must have been made with the "Pay Now" option or an eBay invoice; (3) the buyer must have used one of the five designated payment methods<sup>18</sup>; and (4) the item must have been paid for in a single payment. The Money Back Guarantee specifically does not cover certain categories of sales and sales through eBay's affiliate sites, such

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<sup>16</sup> As a practical matter, once the eBay neutral decides the dispute, the buyer can proceed to seek private enforcement remedies. Alternatively, either the buyer or the seller can go to court to prove their case or contest the private remedy. However, in most cases it is not economically feasible to seek a judicial remedy. As discussed *supra* in the defective cell phone example, an eBay ruling also has no *res judicata* effect on other claims arising out of a transaction.

<sup>17</sup> See *eBay Money Back Guarantee Policy*, *supra* note 10.

<sup>18</sup> These five payment methods are those available to the buyer through the eBay platform. They include 1) PayPal; 2) ProPay; 3) Skrill; 4) Credit or debit card; and 5) Bill Me Later. PayPal, ProPay and Skrill are digital payment services that allow users to send and receive money without revealing personal financial details. See *About Skrill*, SKRILL, <https://www.skrill.com/en-us/about-us/> (last visited Apr. 29, 2014); *Company History*, PROPAY, <http://www.propay.com/propay-company/company-history/> (last visited Apr. 29, 2014); *About PayPal*, PAYPAL, <https://www.paypal-media.com/about> (last visited Apr. 29, 2014). Bill Me Later, a PayPal subsidiary, is also a digital payment option, however, it is a service that extends the user a line of credit. See *About Bill Me Later*, BILL ME LATER, <https://www.billmelater.com/about/index.xhtml> (last visited, Apr. 29, 2014). PayPal is owned by eBay, and Bill Me Later is a service provided by PayPal. ProPay and Skrill are third party, private online payment services. Credit or debit cards (such as Visa, MasterCard, and American Express) are payment systems administered by banks.

as half.com.<sup>19</sup> In addition, this guarantee prohibits duplication of claims through other dispute resolution methods, such as the PayPal Purchase Protection programs or requesting a chargeback from the payment provider.

A. Buyers' Claims – "Item Not Received," "Item Not as Described"

The current Resolution Center web page leads buyers and sellers through the process via a series of questions that: (i) set different claims on different tracks, and (ii) prevent the furtherance of claims that are outside the coverage of eBay's policy. The initial screening still adheres to the two primary bases for buyer claims: that the item did not arrive, or that the item did not match seller's description. The website then presents options for how to proceed, after the claimant has been funneled into a particular category of claims. Throughout the process, there are links to eBay's general policy, which outlines what claims are and are not qualified.

The Money Back Guarantee also limits the applicable disputes through specific exclusions from coverage, as listed in its policy:

- "Buyer's remorse or any reason other than not receiving an item or receiving an item that isn't as described in the listing."
- "Duplicate claims through other resolution methods."
- "Items shipped to another address after original delivery."
- Vehicles (instead, must be pursued through the eBay Vehicle Protection Program)
- Real Estate, Business & Websites for Sale, Classified Ads, services

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<sup>19</sup> An eBay subsidiary, half.com, specializes in the sale of books, textbooks, music, movies and games for fixed prices set by sellers, as opposed to eBay's bidding system.

- Some business equipment categories (instead, must be pursued through the eBay Business Equipment Purchase Protection Program)
- “Items purchased on half.com, eBay Wholesale Deals, or eBay Classifieds”<sup>20</sup>

Buyers have thirty days from the actual or estimated delivery date to make direct contact with the seller through the eBay platform.<sup>21</sup> If this direct contact does not resolve the problem within three business days of the buyer’s initial communication to the seller, the buyer can choose to escalate the case to eBay.<sup>22</sup> If the buyer escalates the case to the Resolution Center, eBay will review the case and contact

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<sup>20</sup> These parameters for applicable disputes under the basic eBay ODR policy have evolved as eBay gained experience with using the process. Previously, eBay provided more examples to guide the interpretation of “item not delivered” or “item not matching seller’s description in the listing.” In a version of the policy dating back to approximately 2010, the restrictions were phrased in checklist form as follows:

1. The buyer did not receive the items within the estimated delivery date; or
2. The item received was wrong, damaged, or different from the seller’s description. For example:
  - i. Buyer received a completely different item;
  - ii. The condition of the item is not as described;
  - iii. The item is missing parts or components;
  - iv. The item is defective during the first use;
  - v. The item is a different version or edition from the one displayed in the listing;
  - vi. The item was described as authentic but is not;
  - vii. The item is missing major parts or features, and this was not described in the listing;
  - viii. The item was damaged during shipment, or;
  - ix. The buyer received the incorrect amount of items.

This version of the policy was addressed in Louis Del Duca, Colin Rule, & Zbynek Loebel, *Facilitating Expansion of Cross-Border E-Commerce – Developing a Global Online Dispute Resolution System (Lessons Derived from Existing ODR Systems – Work of the United Nations Commission on International Trade Law)*, 1 PENN ST. J.L. & INT’L AFFAIRS 59, 65 (2012) (citing *Unpaid Item Policy*, EBAY INC., <http://pages.ebay.com/help/policies/unpaid-item.html> (last visited Mar. 9, 2015)).

<sup>21</sup> *eBay Money-back Guarantee, How to Help*, EBAY INC., <http://pages.ebay.com/ebay-money-back-guarantee/how-to-help.html> (last visited Mar. 9, 2015).

<sup>22</sup> *Id.*

the buyer within 48 hours with a determination of whether the case qualifies for a refund of the full purchase price plus original shipping.<sup>23</sup>

B. Sellers' Claims – "Final Value Fee"

Sellers' claims are handled somewhat differently than buyers' claims. Like the buyer resolution process, new disputes are reported through the Resolution Center. However, pre-transaction exposure is significantly smaller for sellers than for buyers. If a buyer has a dispute, they have likely already paid the seller the full purchase price for the item, which averages around \$75 for non-receipt cases and \$100 for not-as-described cases.<sup>24</sup> The buyer is concerned that they will not get their purchase price back, so their exposure is significant.

Sellers, on the other hand, are clearly instructed to not ship the item in question before payment is received from the buyer. So if a buyer wins an auction and does not follow through with payment, the seller is only out the "Final Value Fee" paid to eBay as part of the sale (usually less than 1-2% of the purchase price). For sellers, disputes are part of doing business on eBay (Unpaid auction bids are not uncommon), but they are more of a nuisance than a source of major risk exposure.

Once an auction bid is reported as unpaid, Buyer is contacted and given several response options:

- 1) pay for the auction bid
- 2) prove the auction bid is already paid for, or
- 3) request that the transaction be cancelled.

Once the buyer responds, the seller and buyer can communicate to attempt to resolve the issue through mutual agreement. However, if the buyer does not respond, or the seller is not satisfied, the seller has the unilateral right to give the buyer an "Unpaid

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<sup>23</sup> *Id.*

<sup>24</sup> *See eBay Money Back Guarantee, supra* note 10.



Item Strike.”<sup>25</sup> If a buyer receives too many Unpaid Item Strikes in too short a period of time, the buyer’s account on eBay will be suspended.

This process, which handles tens of millions of disputes every year, is entirely automated through technology, with no human involvement. The only human involvement that enters into the Unpaid Item resolution process is when the buyer decides to appeal an Unpaid Item (i.e. auction bid) Strike they have received. If it is the buyer’s first appeal of an Unpaid Item Strike, the appeal is automatically granted (and the vast majority of appeals are first appeals). However, if the appeal is for a second or later strike, an eBay Customer Service Representative will manually review the case to make a determination. In this fashion, an ODR system delivering tens of millions of resolutions per year requires only tens of thousands of human interventions to keep operating in a trusted and effective fashion.

#### C. Maximum and Minimum Purchase Price Limits for Certain Categories of Goods

As eBay’s Basic Money Back Guarantee program specifically prohibits claims relating to sales of certain categories of products – usually either intangibles or higher-cost items such as vehicles, real estate, and business equipment – this form of online dispute resolution is somewhat incomplete, or at least does not match the breadth of sales transactions taking place on eBay’s platform. In addition to the more

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<sup>25</sup> eBay provides information through its feedback system to facilitate identification of reliable sellers and buyers and keep market participants honest. eBay assigns parties a “star” based on how many positive reviews they have received. The feedback system, like the dispute resolution system, treats buyers and sellers differently. Buyers can leave positive, neutral or negative ratings, while sellers can only leave short comments and positive ratings. eBay is very clear that feedback extortion and manipulation is not allowed. Sellers can report buyers in violation of the buying practices policy, especially when successful auction bids are not paid by the buyer. This report can result in a “strike” against the buyer. *See* Del Duca, Rule, & Loebel, *supra* note 20, at 64-65 (citing *How do I leave Feedback?*, EBAY INC., <http://pages/ebay.com/help/feedback/questions/leave.html> (last visited Apr. 4, 2012)). eBay’s “Unpaid Item Policy,” detailing Unpaid Item Strikes (sometimes called “unpaid item violations” or “excessive unpaid items”) is detailed at <http://pages.ebay.com/help/policies/unpaid-item.html>. As the policy page states, “eBay may record the unpaid item on the buyer’s account . . . excessive unpaid items on a buyer’s account may result in a range of consequences, including limits on or loss of buying privileges.”

basic ODR system provided as part of the Money Back Guarantee, eBay has developed two category-specific ODR systems to expand dispute resolution options for those using its services. These new systems include the Vehicle Purchase Protection (VPP) and the Business Equipment Purchase Protection (BEPP) programs. The VPP serves as the dispute resolution forum for the sale of vehicles priced at more than \$100 and less than \$50,000, and purchased through certain designated categories within eBay's site. The BEPP applies to sales with a final price of at least \$1,000 but no more than \$20,000, again through certain designated categories (such as Business and Industrial) within eBay's website.

Just as with the traditional eBay Money Back Guarantee, the VPP and BEPP both limit the types of claims that are covered – i.e. the claims that can be pursued through their ODR process. However, due to the higher price of the items involved, eBay's policies defining those claims are much more detailed than the simple choice between an item never being delivered or not being as described in the seller's listing. The following chart details the limitation of claims in both the VPP and BEPP systems:

EBay's Vehicle Purchase Protection (VPP) and Business Equipment Purchase Protection (BEPP) Programs Chart

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
Situations Covered	<ul style="list-style-type: none"> <li>• You pay for a vehicle and never receive it.</li> <li>• You send a refundable deposit for a vehicle and never receive it.</li> <li>• You pay for a vehicle and receive it but suffer losses because:</li> </ul>	<ul style="list-style-type: none"> <li>• Paying for an eligible item and never receiving it.</li> <li>• Sending a deposit for an eligible item and never receiving the item.</li> <li>• Paying for and receiving an eligible item the buyer</li> </ul>

<sup>26</sup> The information in this column was quoted from the VPP Policy, *supra* note 11.

<sup>27</sup> The information in this column was quoted from the BEPP Policy, *supra* note 11.

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<ul style="list-style-type: none"> <li>○ The vehicle was determined by a law enforcement agency to have been stolen at the time of the end of the listing.</li> <li>○ The vehicle has an undisclosed or unknown lien against its title.</li> <li>○ The vehicle make, model or year is different than what was described in the seller’s listing at the time you placed your bid or offer.</li> <li>○ A title is required for the vehicle by your state and the seller’s state but you did not receive a title from the seller and it is not possible to obtain a title from the appropriate DMV.</li> <li>○ The vehicle has a title with an undisclosed salvage, rebuilt/rebuildable, unrebuildable, reconstructed, scrapped/destroyed, junk, lemon, manufacturer buyback, or water damage brand at the</li> </ul>	<p>can’t legally own because:</p> <ul style="list-style-type: none"> <li>○ It’s stolen property</li> <li>○ It’s subject to an undisclosed or unknown lien</li> <li>● Paying for and receiving an eligible item that’s a different type, make, or model than what was described in the listing, provided the amount of devaluation to the item due to the misrepresentation exceeds \$1,500.</li> <li>● Paying for and receiving an eligible item with undisclosed damage, provided the cost of necessary repairs exceeds \$1,500 and the item was advertised as being less than 10 years old. The program covers only defects and damages that prevent the equipment from functioning, not defects or damage that are cosmetic or not critical to operate the equipment.</li> </ul>

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<p>time of the end of the listing. (This protection is not available for vehicles listed in the Dune Buggies, Race Cars or Trailers categories.)</p> <ul style="list-style-type: none"> <li>○ The vehicle is less than 20 years old and has more than a 5,000 mile odometer discrepancy from the mileage as stated in the seller’s listing. (This protection is only available for vehicles listed in the Cars &amp; Trucks and RVs &amp; Campers categories.)</li> <li>○ In addition, the VPP also provides protection against certain undisclosed damage for vehicles that are less than 10 years old (10 year threshold is based on model year): The vehicle had undisclosed engine, body, transmission, and/or frame damage at the time of purchase that will cost more than \$1,000 to repair. The cost of</li> </ul>	

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<p>repair to any one of those components must exceed \$1,000. For vehicles in the Boats (engine and hull only), Buses, Commercial Trucks, and RVs &amp; Campers categories, the cost of the undisclosed engine, body, transmission, or frame damage must exceed \$1,500. Race Cars are not eligible for this protection. Vehicles that are subject to a recall for this type of damage are not eligible for VPP.</p>	
<p>Situations Not Covered</p>	<p>Vehicle Condition</p> <ul style="list-style-type: none"> <li>• Any damage on vehicles 10 years old or older (10 year threshold is based on model year)</li> <li>• Regular maintenance and fluid levels.</li> <li>• Normal wear and tear, including but not limited to belts, hoses, tires, brakes, bushings, joints, spark plugs and wires, interior features, minor dents, paint chips and scratches.</li> </ul>	<ul style="list-style-type: none"> <li>• Any damage on an item that's more than 10 years old. If the model year is not specified in the eBay listing, then the item isn't eligible for any undisclosed damage.</li> <li>• Regular maintenance</li> <li>• Normal wear and tear, including but not limited to rust, dents, and scratches, or cosmetic damage that doesn't impair the item</li> <li>• Sending a non-refundable</li> </ul>

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<ul style="list-style-type: none"> <li>• Certain components - Damage to any component other than the engine, transmission, frame or body, including but not limited to the vehicle’s interior, exhaust, air conditioner, electrical, suspension, cooling system, turbo charger, fuel system, differential, clutch/torque converter, and/or pollution control devices.</li> <li>• Damage threshold - Damage to an eligible component that does not exceed \$1,000 (or \$1,500 for boats, buses, commercial trucks, RVs and campers).</li> <li>• Damage after purchase- Damage or loss arising during shipping or otherwise after purchase.</li> <li>• Cosmetic damage, such as paint or external surface rust.</li> <li>• Unverifiable damage.</li> </ul> <p><b>Deposit issues</b> Sending a non-refundable deposit for a vehicle and not receiving the vehicle, or a refund, because you chose to not complete the transaction or pay the remaining balance for any reason.</p>	<p>deposit and not receiving the item or a refund, because the buyer chooses to not complete the transaction or to not pay the remaining balance</p> <ul style="list-style-type: none"> <li>• Any damage or defect that was explained to or noticed by the buyer prior to purchase, or (if the buyer picked up the item from the seller in person) that could have been noticed upon reasonable inspection by the buyer</li> <li>• Items not listed on eBay Business in one of the capital equipment categories</li> <li>• Items purchased for less than \$1,000</li> <li>• Items damaged or lost in shipping</li> <li>• Inspection costs, warranty fees, and other related expenses</li> <li>• Buyer’s remorse</li> <li>• Any repairs or alterations made to the item after the listing end date, that were not authorized by the third-party provider of the Business Equipment Purchase Protection program</li> </ul>

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<p><b>Ancillary losses</b> Punitive claims, lost profits, loss of work, travel expenses, or restocking costs.</p> <p><b>Title / ownership issues</b></p> <ul style="list-style-type: none"> <li>• Failure to disclose a title brand if another title brand was disclosed in the listing, or if the title was described in the listing as anything but “clear”.</li> <li>• Failure to receive a certificate of title for a vehicle that was listed with a title brand or with the title being described as anything but “clear”.</li> <li>• Receiving a title that is not signed, is improperly assigned, or receiving a title but not being able to register the □ vehicle.</li> <li>• Any damage on a vehicle that was listed with a title brand or with the title being described as anything but “clear.”</li> <li>• Losses based on a vehicle classified as “theft recovery” or “previously stolen” but recovered by a law enforcement agency prior to being listed on eBay.</li> </ul> <p><b>Other</b></p> <ul style="list-style-type: none"> <li>• Differences in sub-</li> </ul>	

	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	<p>model, trim packages, special editions, or options if you have received the year, make, and model described in the listing.</p> <ul style="list-style-type: none"> <li>• Buyer’s remorse.</li> <li>• Any damage or listing discrepancies that were disclosed to you prior to acceptance of the vehicle.</li> <li>• Any damage that could have been discovered upon a reasonable inspection before you paid for and picked up <input type="checkbox"/> the vehicle in person.</li> <li>• Any damage that does not impact the safety or operability of the vehicle.</li> <li>• Repairs or alterations made by you to the vehicle without the consent of the VPP Administrator.</li> <li>• Inspection costs, warranty fees, taxes paid, or any other fees or expenses that are not expressly covered under these Terms and Conditions.</li> <li>• Transactions occurring directly between the parties (i.e. phone, email, mail, in person, by overnight messenger, etc</li> </ul>	



	Vehicle Purchase Protection <sup>26</sup>	Business Equipment Purchase Protection <sup>27</sup>
	. . .) and/or on another website rather than through the eBay website.	

This extensive detailed list of types of permissible claims *actually limits* the types of claims that eBay will handle under these two new programs. In addition, for these Vehicle (VPP) and Equipment (BEPP) programs, only claims that are within the specified minimal and maximum permissible amounts are handled by eBay. While both the VPP and BEPP place limits on the permissible amount of a claim (\$50,000 maximum and \$100 minimum for the VPP, and \$20,000 maximum and \$1,000 minimal for the BEPP), the “Money Back Guarantee” further limits the amount of the permissible claim to the amount of the purchase price of the item(s) involved.

For example, a dispute involving a vehicle sold for \$30,000 falls within the \$50,000 maximum/\$100 minimum requirement and, therefore, would be handled by eBay, with application of the “Money Back Guarantee” policy limiting the amount of the claim actually recoverable to the \$30,000 purchase price. A dispute involving a vehicle sold for \$150,000 would not be handled by eBay because the vehicle’s price exceeds the \$50,000 maximum.

In a BEPP case, a dispute involving sale of equipment for \$10,000 would fall within the \$20,000 maximum and \$1,000 minimum requirement and would be handled by eBay. A dispute involving equipment which was sold for \$40,000 would not be handled by eBay because it exceeded the \$20,000 maximum.

The eBay money-back guarantee, i.e. purchase money return guarantee, effectively limits the amount in controversy. The BEPP and VPP programs are in recognition by eBay, as the platform administrator, that the marketing practices within the dollar limits provided for the vehicle and equipment categories can be effectively administered by the eBay ODR low-value high volume system. eBay also concludes that disputed involving purchase prices not within the indicated parameters cannot be effectively and efficiently handled

within the fast-track low-value high volume ODR system. The decision as to the practicability and desirability of creating such special platforms, which can successfully operate within the framework of its low-value high volume ODR system, is a judgment which the platform administrator is best able to make.

III. FACILITATING FAST TRACK RESOLUTION OF DISPUTES –  
COMBINING USE OF LOW VALUE PARAMETERS & LIMITING  
TYPES OF CLAIMS.

A. Lists of “Item Not Received” and “Item Not as Described”  
Claims

1. *EBay Explicit Limitation of Types of Claims and List of Specific Claims – Consequential Damages Excluded by “Money Back Guarantee”* – While eBay’s explicit limitation of types of claims has already been addressed, the “Money Back Guarantee” is discussed further here.<sup>28</sup> The “Money Back Guarantee” purchase price limited remedy, with its built-in exclusion of consequential damages, produces a de facto low value framework for all three eBay dispute resolution programs. This approach facilitates fast track, fair, and low-cost online dispute resolution of low value claims across the board for ODR systems generally, including the “negotiation—facilitated negotiation” and the “negotiation—facilitated negotiation—mandatory arbitration” two-track model considered by the UNCITRAL ODR Working Group III.<sup>29</sup>

EBay’s VPP program achieves the equivalent of this “Money Back Guarantee” by its explicit exclusion of claims relating to

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<sup>28</sup> See discussion *supra* note 20.

<sup>29</sup> At the twenty-sixth session, November 5-9, 2012, Working Group III identified the need for a two-track system to accommodate differences in the substantive law of jurisdictions in which pre-dispute arbitration agreements are valid and binding in business to consumer (B2C) contracts, and the substantive law of jurisdictions in which pre-dispute arbitration agreements in business to consumer (B2C) contracts are invalid and not binding. Under the two-track system, Track I provided an online negotiation stage between the parties, followed by a facilitated negotiation stage in which a neutral is added to the deliberations, and a third arbitration phase if the dispute is not resolved in phase one or two.

“ancillary losses,” such as “punitive claims, lost profits, loss of work, travel expenses, or restocking costs.”<sup>30</sup> The equivalent of the “Money Back Guarantee” is achieved in eBay’s BEPP eBay program by explicitly permitting recovery “only up to the devaluation or repair amount of the item or the final purchase price, whichever is lower.”<sup>31</sup>

The “Money Back Guarantee” purchase price limited remedy and its VPP and BEPP equivalents also will self-adjust with the fluctuation in the value of currencies in the marketplace over time, as well as between developed, developing, and underdeveloped economies at any single point in time. EBay sets the coverage thresholds specifically in policies so that all buyers and sellers understand the coverage eligibility guidelines and maximum refunds prior to engaging in any purchase in the first place. There are slight differences in the coverage and eligibility levels by broad geographic region, but the levels change very rarely and are intended to cover 95% of transactions within a given geography and category.

#### B. Comparison of Selected eBay Best Practices and the UNCITRAL Draft

The UNCITRAL Draft Rules explicitly limited types of permissible claims by providing that:

“These rules shall *only* (emphasis applied) apply to claims:

[“(a) that goods sold or services rendered were not delivered, not timely delivered, not properly charged or debited, and/or not provided in conformity with the agreement made at the time of the transaction; or

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The proposed Track II involved comparable negotiation and facilitated negotiation phases, but did not require arbitration in the event the dispute did not resolve in the negotiation or facilitated negotiation phases. UNCITRAL, Mar. 24-28, 2014, *Online Dispute Resolution for Cross-Border Electronic Commerce Transactions: Draft Procedural Rules: Note by the Secretariat*, 2 U.N. Doc. A/CN.9/WG.III/WP.127 (Jan. 17, 2014) [hereinafter *Secretariat Note*].

<sup>30</sup> VPP Policy, *supra* note 11.

<sup>31</sup> BEPP Policy, *supra* note 11.

“(b) that full payment was not received for goods or services provided.]”<sup>32</sup>

This language in Article 1(2) incorporated the eBay basic ‘item not received’ and ‘item received but not as described’ types of claims for buyers and a full payment remedy for sellers, and also allows, unlike eBay for recovery for services. While this is not the forum to discuss in detail the similarities and differences between the eBay and UNCITRAL Draft types of claims covered, we note in passing that the UNCITRAL Draft, in addition to permitting claims arising from the sale of goods types of claims permitted by eBay, also permitted claims pertaining to rendition of services.<sup>33</sup> Service related disputes are much more complicated to resolve, because (i) a return of the goods in question is not an option, and (ii) the evaluation of item condition or service quality is often opinion based and difficult to evaluate. The eBay platform does not provide for sale of services, consequently, services are not a type of transaction included in its ODR system.

Unlike the eBay program, which at the outset clearly limits recovery to the Money Back Guarantee for buyers, the UNCITRAL Draft did not clearly set forth this limited remedy.<sup>34</sup>

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<sup>32</sup> See *Secretariat Note, supra* note 29, at 7. eBay’s specific “seller unpaid” and “unpaid item fee” remedy is not incorporated into the UNCITRAL draft. See discussion of eBay “unpaid item” *supra* at note 24. The UNCITRAL draft also did not incorporate an auction type of transaction into its program.

<sup>33</sup> *Secretariat Note, supra* note 29, art. 1 ¶ 2.

<sup>34</sup> Under the eBay policies, as described above and *infra*, consequential damages are not specifically excluded or included, but are clearly excluded by the limited Money Back Guarantee. Similarly, for example, the Mexican Consumer Protection Code provides: “At their choice, consumers shall be entitled to the substitution of the product or the return of the amount paid against the delivery of the product acquired . . .” *Ley Federal de Protección al Consumidor [LFPC] [Federal Consumer Protection Act]*, *Diario Oficial de la Federación* el 24 de diciembre de 1992 (Mex.), available at [http://www.profeco.gob.mx/juridico/pdf/l\\_lfpc\\_06062006\\_ingles.pdf](http://www.profeco.gob.mx/juridico/pdf/l_lfpc_06062006_ingles.pdf) (English translation).

The Mexican platform Concilianet, which is the Mexican agency handling its ODR system also advises the public that no recovery is possible for consequential damages and informs the public of the consumer’s right to recover such damages in court. *What is it?*, CONCIANET,

The detailed list of specific claims of ‘item not received’ or ‘items received but not as described by seller,’ comparable to detailed eBay lists discussed *supra*<sup>35</sup> had not been developed and incorporated into the Drafts or elsewhere, perhaps in the document on Substantive Legal Principles<sup>36</sup> envisaged by the text of the Preamble.

The Preamble to the Draft Rules reads as follows:

“1. The UNCITRAL online dispute resolution rules (“the Rules”) are intended for use in the context of disputes arising out of cross-border, low-value transactions conducted by means of electronic communication.

“2. The Rules are intended for use in conjunction with an online dispute resolution framework that consists of the following documents [which are attached to the Rules as an Appendix]:

[“(a) Guidelines and minimum requirements for online dispute resolution providers/platforms/administrators;]

[“(b) Guidelines and minimum requirements for neutrals;]

[“(c) Substantive legal principles for resolving disputes;]

[“(d) Cross-border enforcement mechanism;]

[“. . .];”<sup>37</sup>

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[http://concilianet.profeco.gob.mx/concilianet/faces/que\\_es.jsp](http://concilianet.profeco.gob.mx/concilianet/faces/que_es.jsp) (last visited Sept. 19, 2011).

<sup>35</sup> See eBay lists, *supra* note 20, for vehicles see note 26, *supra* and accompanying text, for equipment see note 27, *supra* and accompanying text.

<sup>36</sup> See *Secretariat Note*, *supra* note 29, at 6.

<sup>37</sup> *Secretariat Note*, *supra* note 29, at 5-6

These four documents envisaged by the Preamble<sup>38</sup> had not been drafted by the Working Group at the time UNCITRAL instructed the Working Group to prepare a non-binding descriptive document on elements of the ODR process on which the Working Group had reached consensus.

Documents one and two were to provide “guidelines and minimum requirements” for (a) dispute resolution *providers/platforms/administrators*<sup>39</sup> and (b) neutrals. Documents three and four were to provide (c) substantive legal principles for resolving disputes and (d) cross-border enforcement mechanisms (presumably private and public).<sup>40</sup> Whether these documents would be merely persuasive in implementing the Draft, or annexed as legally part of the Draft, had also not yet been determined by the Working Group.<sup>41</sup>

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<sup>38</sup> In earlier drafts, the “documents” were referred to as annexes. See UNCITRAL, Mar. 24-8, 2014, *Online Dispute Resolution For Cross-Border Electronic Commerce Transactions: Draft Procedural Rules: Note by the Secretariat*, 2 U.N. Doc. A/CN.9/WG.III/WP.128, (Jan. 22, 2014).

<sup>39</sup> At its March 24 – 28, 2014 New York meeting, UNCITRAL ODR Working Group III agreed that the term “ODR provider” and all references thereto would be deleted from its Rules. The following definitions of “ODR Administrator” and “ODR Platform” would replace earlier definitions in the Rules:

“ODR ‘Administrator’ means the entity that administers and coordinates ODR proceedings under these Rules, including where appropriate, by administering an ODR platform, and which is specified in the dispute resolution clause.”

“ODR ‘Platform’ means a system for generating, sending, receiving, storing, exchanging or otherwise processing communications under these Rules.”

The Secretariat’s official report of this meeting is pending at the time this article is printed.

<sup>40</sup> *Secretariat Note, supra* note 29.

<sup>41</sup> The Secretariat recently indicated that it might be advisable not to annex guidelines to the Rules. The Secretariat had suggested to the working group that it might wish to consider “(i) the purpose of guidelines that address various stakeholders in the online dispute resolution process, and bearing in mind that purpose, (ii) the relationship of the guidelines with the Rules.” He further noted the suggestion in Document A/CN.9/WG.III/WP.114 that guidelines ought to set out best practices for ODR providers and neutrals, while the Rules aim to establish a procedure for online dispute resolution. He also might be advised not to annex

IV. LESSONS AND BEST PRACTICES REGARDING DE FACTO PURCHASE PRICE “MONEY BACK GUARANTEE” LOW VALUE & LIMITATION OF TYPES OF CLAIMS PERMITTED.

The momentum behind global ODR continues to increase. Consumer and business groups around the world are unanimous in promoting fair, proportionate, effective, online, cross-border redress for low value cross-border disputes. As a result, there will continue to be increasing demand for effective ODR systems design and procedural rules.

It is vital for the continued expansion of e-commerce that consumers and small-to-medium size businesses have access to fast and fair resolution processes. Because of this commercial imperative, the private sector is stepping in to provide manifold solutions to this problem. On balance, market-based approaches facilitate the development of optional solutions for the problem of online redress. This was the experience in the eBay marketplace. Market-based approaches require a lot of experimentation and evolution to get right, and eBay was always tweaking and evolving their ODR systems to account for lessons learned. As such, any ODR systems design should not be too prescriptive, because this may hinder the innovation required to effectively solve this problem over the longer term.

eBay has generally managed to limit the complexity and scope of claims through categorization of claims limiting the types of permissible claims and providing a list of specific claims, coupled with its purchase price “Money Back Guarantee.” However, as previously noted, for “vehicle” (VPP) and “equipment” (BEPP) sales, it also imposes the additional condition that the dispute will not be handled by the eBay ODR system if the purchase price of the vehicle is more than \$50,000 or less than \$100, or in the case of equipment if the purchase price is more than \$20,000 or less than \$1000. This maximum and minimum purchase price limitation on “vehicle” and “equipment” cases handled by the eBay system ensures its efficient operation as a low-value dispute resolution process. It allows eBay, in

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guideline to the Rules, as the legal nature and addressees of Rules and guidelines differ. See UNCITRAL, May 21-25, 2012, *Proposal on Principles Applicable to Online Dispute Resolution Providers and Neutrals*, ¶ 28 U.N. Doc. A/CN.9/WG.111/WP.127.

responding to market conditions, to design specific resolution processes and rules for special categories of such goods. It also permits eBay to exclude from the special categories the sales of such goods involving a high value purchase price, which it deems inappropriate for resolution in the fast-track low-cost high-volume eBay system.

In both the basic and specialized “Money Back Guarantee” cases, purchase price will adjust as changes in currency values occur from time to time and adjust around the world to differences in the value of currencies in advanced, advancing, and underdeveloped economies at any given time. It also removes a major source of complexity and controversy in the eventual deliberative resolution process, because the law and jurisdiction to which the parties have agreed is specifically addressed and resolved in the governing policy adopted by the parties in their agreement to utilize the procedural rules.

ODR administrators, marketplaces, and payment providers need the flexibility to design, build, and deploy both non-binding and binding ODR systems. eBay learned this lesson through extensive interactions with the global community of millions of sellers and merchants: each seller must have the flexibility to design their own resolution processes and policies, which are backed up by a standardized escalation process. This is the only way to enable ODR designs to adjust to the many different types of potential disputes and resolutions around the world, while also providing final, definitive resolutions in all cases.

The eBay experience makes very clear that ODR systems designs should avoid specific requirements that constrain the flexibility of disputants and administrators to evolve ODR systems that best meet the needs of various dispute types, marketplaces, and consumer communities. Where possible, ODR rules should articulate higher-level process requirements and values (e.g. due process, transparency, impartiality) as opposed to detailed procedural requirements (e.g. three neutrals per case, seven days to respond).



V. BUYERS' ON DEMAND ACCESS TO INFORMATION NEEDED  
TO IDENTIFY RELIABLE SELLERS

A. Evaluation of Sellers and Ratings – Building Trust

A buyer conducting a search for a product to purchase on eBay can obtain information about the reliability of a seller from the Best Match search results page. If a seller has achieved a Top Rated Seller Status (discussed *infra*), under the Evaluation System hereafter discussed, this is displayed in its listing on the Best Match search results page. A lesser trustmark, the PowerSeller status (discussed *infra*), is also available on eBay, however it is not visible from the Best Match search results page. In this way the eBay system provides a reward for the most reputable sellers, the Top Rated Sellers.

A buyer who selects Best Match search results for an item is taken to a page listing that. On this page, a seller's information is conspicuously gathered in the upper right hand corner of the listing page for buyers to consult. From here, a buyer can clearly determine whether a Top Rated Seller badge or PowerSeller insignia is displayed. Additionally, eBay provides two feedback performance metrics on the listing page, the seller's Feedback Score (discussed *infra*) and Feedback Percentage (discussed *infra*). From the listing page a buyer can begin to determine the reputation of sellers that do not qualify for Top Rated Seller status.

Additionally, from the listing page, a buyer can click on the Feedback Score and is hyperlinked to the seller's feedback profile. The seller's feedback profile lists both eBay's feedback performance metrics, including the Feedback Score, feedback percentage, detailed seller ratings, Top Rated Seller status, and also subjective ratings in the form of comments left by former buyers of products offered by the seller. Feedback Comments are listed in reverse chronological order, thus a buyer is prompted to read the most recent Feedback Comments first.

Finally, the seller's feedback profile also lists the number of revised feedbacks the seller has been given. A revised feedback occurs when a buyer first left a negative or neutral feedback and then, after having the issues remedied by the seller, revises the feedback left to

positive. Thus, the buyer can get a feeling for the customer service a seller provides if a buyer is unhappy with a transaction.

After a buyer successfully wins an auction or purchases an item they must pay for the item on eBay.<sup>42</sup> Payment under the eBay system is usually by credit card. However, payment may also be made through the eBay approved escrow service ([www.Escrow.com](http://www.Escrow.com)). Under this procedure, the parties may agree that the buyer place the price in the escrow fund by either wire transfers or through credit card payments (i.e. American Express, MasterCard, Visa, PayPal), United States drawn money orders, United States drawn personal or company checks, or United States drawn cashier's checks. The buyer controls the time of payment from the escrow fund to the seller and will not release the payment from the escrow fund to the seller until he is satisfied that the goods "have been delivered and are as described."<sup>43</sup> Thereafter, the item is required to be shipped in accordance with the listing details by the seller. Under a non-escrow transaction, once the item is received, the transaction is complete. After a transaction, a buyer or seller may voluntarily leave feedback; however, a seller may only leave positive feedback for a buyer. A buyer, on the other hand may leave negative, neutral, or positive feedback for a seller. If a buyer hasn't left timely feedback, the seller is permitted to e-mail the buyer a limited number of times to request that the buyer do so.

## VI. THE EBAY AUTOMATED TRUSTMARK EVALUATION/FEEDBACK SYSTEM

### A. Importance of Making Seller Evaluations and Ratings Available to Foster Trust Between Buyers and Sellers and

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<sup>42</sup> Alibaba has a similar escrow system. For example, Alibaba Secure Payment, a service offered by Alibaba akin to eBay's Paypal, is an escrow service. The steps are as follows: 1) a buyer places an order online; 2) a buyer makes payment to Alibaba Secure Payment; 3) supplier ships the order; 4) buyer receives the order and confirms the order online (matches description, not damaged, etc.); and then 5) Alibaba Secure Payment releases payment to the supplier. *Secure Payment*, ALIBABA.COM, [http://activities.alibaba.com/alibaba/secure-payment.php?tracelog=beacon\\_payment\\_150114](http://activities.alibaba.com/alibaba/secure-payment.php?tracelog=beacon_payment_150114) (last visited Mar. 9, 2015).

<sup>43</sup> See *Escrow Services for Vehicle Purchases*, EBAY INC., <http://pages.ebay.com/help/pay/escrow.html> (last visited Mar. 9, 2015).

### Facilitate Private Enforcement

The eBay evaluation system is limited to transactions on the eBay site between a buyer and seller. In other words, the eBay evaluation system is tied to the eBay site, and a buyer can only rate a seller, or vice versa, regarding a specific transaction between the two users. Following a transaction on eBay, buyers and sellers can choose to leave feedback about the transaction.<sup>44</sup> As previously indicated, whereas buyers can leave positive, neutral, or negative feedback, or no feedback at all, sellers can only leave positive feedback or opt to not leave feedback.<sup>45</sup>

By allowing buyers to choose between positive, neutral, or negative evaluation, eBay transforms a qualitative judgment into one of three specified categories. In doing so, eBay can now easily quantify an inherently qualitative judgment: whether a user's experience was good, indifferent, or bad. The effect of quantifying a buyer's experience is to create an objective metric with which a future buyer can evaluate a prospective seller. Thus, evaluations are transformed into numerical data, easily interpreted by a buyer regardless of the language they speak.

eBay additionally provides for a user to leave comments along with an evaluation. By allowing a user to leave a detailed comment, a future buyer has access to a purely qualitative evaluation component regarding a seller's prior transactions. Therefore, the qualitative aspect of a positive, neutral, or negative experience is preserved.

Through a combination of analytical data and express comments provided by former buyers, a current buyer can verify the trustworthiness of a seller that they have never met, and perhaps couldn't communicate with, or have any other way to facilitate the trust a buyer needs to transact with the seller. We next discuss the eBay trustmark system in detail, with an eye to a best practices model in facilitating trust in international commercial transactions.

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<sup>44</sup> *How it works*, EBAY INC., <http://pages.ebay.com/help/feedback/howitworks.html> (last visited Mar. 9, 2015).

<sup>45</sup> *Id.*

## B. “Percentage”, “Score”, and “Comment Feedback”

As indicated *supra*, a seller’s Feedback Rating can be positive, neutral, or negative. A user’s Feedback Percentage is the ratio of positive Feedback Ratings received out of all of the ratings received, in other words the percentage of positive ratings. The higher a user’s feedback percentage, generally speaking, the more trustworthy an eBay member is.<sup>46</sup> However, it is important to note that a high feedback percentage does not dictate that a user has a significant track record on eBay. For example, User A may have had ten transactions all with positive feedback, therefore resulting in a feedback percentage of 100%. Now consider a second user, User B may have had 1,000 transactions with 980 positive feedbacks given, thereby having a feedback percentage of 98%. As you can see, User A has a higher feedback percentage, but User B is a much more experienced seller. Whereas eBay’s other feedback system components require a number of transactions, the feedback percentage system applies to initial users. The feedback percentage, therefore is an important representation of trustworthiness for a user that has not yet had enough transactions to achieve a Feedback Score warranting a star rating, or other trustmarks, discussed below.

A user’s Feedback Score is measured by subtracting the total number of negative ratings from unique trading partners from the total number of positive ratings from unique trading partners.<sup>47</sup> For example, if Seller A had ten transactions with ten different buyers that resulted in seven positive and three negative feedbacks being left than Seller A’s Feedback Score would be four (7-3=4). Now consider if Seller A had ten transactions, again with seven positive ratings and three negative, however three of the positive ratings were left by the same buyer. In this case, the duplicative positive ratings left by the

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<sup>46</sup> The feedback system is linked only to transactions where users actually leave feedback. Many completed transactions result in a buyer simply not leaving feedback for a seller. These transactions are not encompassed in the feedback evaluation system.

<sup>47</sup> *eBay Buying Feedback Quick Guide*, EBAY INC., [http://ebay.about.com/od/buyingeffectivel1/a/be\\_feedquick.htm](http://ebay.about.com/od/buyingeffectivel1/a/be_feedquick.htm) (last visited Jan. 14, 2015).

buyer would be excluded from Seller A's Feedback Score. Thus, Seller A's Feedback Score would be two (5-3=2).

By limiting the Feedback Score to ratings from unique trading partners the eBay system has a built-in safeguard against disproportionate Feedback Ratings on the basis of repeat buyers,<sup>48</sup> both positive and negative, skewing a user's score. Besides trustworthiness, a user's Feedback Score measures their experience. The higher a seller's score, the more transactions with unique trading partners that seller has had. A user's Feedback Score is displayed in parenthesis whenever a member ID or member name is displayed in the eBay site. The score is also accompanied by a corresponding star rating, giving a buyer a visual representation matching the score.<sup>49</sup>

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<sup>48</sup> eBay additionally has specific policies against Feedback Extortion, a buyer threatening poor feedback to extort something that wasn't part of the listing or a seller demanding positive feedback from buyers; Feedback Manipulation, exchanging feedback for the purpose of inflating Feedback Scores, gaining eBay privileges, or enhancing reputation, or trying to damage a seller's feedback through a series of repeat purchases; and Feedback in Seller Terms and Conditions, a seller cannot include terms and conditions limiting a buyer's right to leave feedback. *Feedback Policies*, EBAY INC., <http://pages.ebay.com/help/policies/feedback-ov.html#basics> (last visited Jan. 14, 2015).

<sup>49</sup> Below is an example of a user profile with Feedback Score and star rating, followed by an infographic description of the star ratings.

**Here's what the different stars mean:**

Yellow Star (★) = 10 to 49 points

Blue Star (★) = 50 to 99 points

Turquoise Star (★) = 100 to 499 points

Purple Star (★) = 500 to 999 points

Red Star (★) = 1,000 to 4,999 points

Green Star (★) = 5,000 to 9,999 points

Yellow Shooting Star (★) = 10,000 to 24,999 points

Turquoise Shooting Star (★) = 25,000 to 49,999 points

Purple Shooting Star (★) = 50,000 to 99,999 points

Red Shooting Star (★) = 100,000 or higher

Buyers are more likely to transact with established sellers. The Feedback Score performance metric provides buyers with a statistic speaking to a seller's track record as a merchant. Since the rating is numerically based, many linguistic issues arising from transacting with buyers and sellers worldwide are avoided.

As part of the eBay feedback system, every Feedback Rating must be accompanied by a user comment.<sup>50</sup> A comment is required regardless of whether the feedback left is positive, neutral, or negative.<sup>51</sup> A Feedback Comment is the first instance where a buyer can leave a qualitative evaluation of a transaction with a seller. As a result, a Feedback Comment is often where a seller can learn a buyer's dissatisfaction with a transaction. If sellers receive a negative feedback eBay allows the seller an opportunity to remedy the buyer's grievance.<sup>52</sup> If a seller resolves an issue they can also request a feedback revision from the formerly aggrieved buyer.<sup>53</sup>

C. "Description", "Communication", and "Shipment", -  
Detailed Seller Ratings

eBay allows buyers to rate specific aspects of their transaction experience via a detailed seller rating.<sup>54</sup> Detailed Seller Ratings are only viewable by buyers for sellers with ten or more detailed seller ratings by buyers within the last year. Buyers rate sellers according to four

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*eBay Feedback Points*, EBAY INC., <http://www.ebay.com/gds/eBay-Feedback-Points-/10000000176715987/g.html> (last visited Mar. 9 2015). It is unclear to me how effective the star rating is as a quick-look reference to a user's Feedback Score. The effectiveness of the star rating is directly tied to a user's understanding of what each star means. Without the above chart, or an understanding thereof, I suspect the star-system is of minimal import in garnering the trust of a user to facilitate a transaction.

<sup>50</sup> *Feedback*, EBAY INC., <http://pages.ebay.com/services/forum/feedback.html> (last visited Jan. 14, 2015).

<sup>51</sup> *Id.*

<sup>52</sup> *Revising Feedback*, EBAY.COM, <http://pages.ebay.com/help/feedback/revise-feedback.html> (last visited Jan. 14, 2015).

<sup>53</sup> *Id.*

<sup>54</sup> *Detailed Seller Ratings*, EBAY.COM, <http://pages.ebay.com/help/feedback/detailed-seller-ratings.html> (last visited Mar. 9, 2015).

categories<sup>55</sup> as follows, from a rating of five stars (highest) to one star (lowest):

- Accuracy of item description;
- Satisfaction with communication;
- Expediency of shipping; and
- Reasonableness of shipping and handling charges.

Buyers are requested to evaluate the sellers for the adherence to the four categories through a series of specific tips for rating as indicated in the chart that follows.

<b>What you rate</b>	<b>Tips for rating</b>
How accurate was the item description?	<ul style="list-style-type: none"> <li>• Review the item title, description, and condition to see if they match the item you received.</li> </ul>
How satisfied were you with the seller's communication?	<ul style="list-style-type: none"> <li>• Recall whether the seller addressed any questions or concerns that you had, and did so in a professional manner.</li> <li>• Consider only business days when evaluating the timeliness of the seller's communication (sellers might not check email on weekends and holidays).</li> <li>• If the seller meets specific requirements, we give the seller a 5-star communication detailed seller rating automatically, and you won't be able to change the rating.</li> </ul>
How quickly did the seller ship the item?	<ul style="list-style-type: none"> <li>• Rate the seller only on the time it took to mail the item, not the time it took you to receive the item.</li> </ul>

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<sup>55</sup> *Id.* Certain transactions aren't rated according to all four categories. For example, Motor Vehicle transactions are not rated on shipping time and shipping and handling charges.

	<ul style="list-style-type: none"> <li>• Don't hold sellers responsible for delays in mail services, international custom delays, or for the time it takes for your payment to clear. If you picked up the item locally, you won't be able to provide a rating for this category.</li> <li>• If the seller met specific shipping time requirements, we give the seller a 5-star shipping time detailed seller rating automatically, and you won't be able to change the rating.</li> <li>• If we determine at a later date that the seller met the requirements for an automatic 5-star shipping time rating, we may adjust the rating to 5 stars.</li> </ul>
How reasonable were the shipping and handling charges?	<ul style="list-style-type: none"> <li>• Remember that sellers can charge for the cost of the actual packaging materials, along with a reasonable handling fee to cover their time and direct costs associated with shipping.</li> <li>• If the seller provided free shipping, we give the seller a 5-star shipping and handling charges detailed seller rating automatically, and you won't be able to change the rating.</li> <li>• For international transactions, you as a buyer are expected to pay duties, taxes, and customs clearance fees as required by country laws.</li> <li>• If you picked up the item locally, you won't be able to provide a rating for this category.<sup>56</sup></li> </ul>

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<sup>56</sup> *Detailed Seller Ratings*, *supra* note 47.



#### D. Transaction Defect Rate

Starting with the August 20, 2014 monthly seller evaluation, eBay instituted an additional metric to evaluate seller performance.<sup>57</sup> The new metric, the transaction defect rate (hereinafter “defect rate”) is measured as a percentage of a seller’s successful transactions that have one of a specified number of defects.<sup>58</sup> These defects, according to eBay, are the top predictors that a buyer will either leave eBay all together or buy less on the marketplace.<sup>59</sup> The specified defects are as follows:

- Detailed seller rating of 1, 2, or 3 for item as described;
- Detailed seller rating of 1 for shipping time;
- Negative or neutral feedback;
- Return initiated for a reason that indicates the item was not as described;
- eBay Money Back Guarantee or PayPal Purchase Protection case opened for an item not received or an item not as described; and
- Seller-cancelled transactions.<sup>60</sup>

The new defect rate policy mandated changes in the eBay Seller Ratings system. Following the update, to qualify as a Top Rated Seller a defect rate of up to 2% is tolerated.<sup>61</sup> For purposes of Seller Ratings, however, only transactions with US buyers count towards the defect

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<sup>57</sup> *Seller Standards*, EBAY INC., <http://pages.ebay.com/sellerinformation/news/springupdate2014/sellerstandards.html> (last visited Jan. 14, 2015).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

rate.<sup>62</sup> Buyers cannot see a seller's defect rate, however a seller with a high defect rate will not show favorably in Best Match search results.<sup>63</sup>

VII. AWARDING OF EBAY'S AUTOMATED TRUSTMARKS USING THE EVALUATION/FEEDBACK SYSTEM

As indicated, *supra*, eBay employs a Top Rated Seller automated Trustmark, granted only for highest-level performances, and a PowerSeller Trustmark granted for quality performance but not of the top level. We first discuss the PowerSeller Trustmark and subsequently the Top Rated Seller.

A. PowerSeller Designation - Requirements and Benefits

The PowerSeller designation is handed out on the basis of volume of sales and customer service requirements. As a PowerSeller, the seller must:

- be registered with eBay for at least 90 days and have an account in good standing;<sup>64</sup>
- follow all eBay policies;<sup>65</sup>
- may have no more than three tenths of one percent of transactions result in Money Back Guarantee or PayPal Purchase Protection cases closed without seller resolution;<sup>66</sup> and
- have a minimum of 100 transactions and \$3,000 in sales with US buyers over the past 12 months.<sup>67</sup>

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<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Powersellers*, EBAY.COM, <http://pages.ebay.com/help/sell/sell-powersellers.html> (last visited Mar. 9, 2015).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

Further, the PowerSeller System is linked to Detailed Seller Ratings in two ways, as follows:

- the seller must have an average of at least 4.60 from US buyers across all four detailed seller rating categories;<sup>68</sup> and
- a seller must have no more than 1% of their transactions with low DSRs (1 or 2 ratings) on the category “item as described,” and no more than 2% of transactions with low DSRs in the “communication,” “shipping time,” and “shipping and handling cost” categories.<sup>69</sup>

The above listed requirements qualifies a seller as a “Bronze” level PowerSeller.<sup>70</sup> Depending on the volume of sales, in either number of items or in dollar amount, a seller may improve their PowerSeller level above Bronze to either Silver, Gold, Platinum or Titanium levels.<sup>71</sup> EBay has a designated insignia for PowerSellers across the various levels. Pictured below, the insignia only changes by reference to the appropriate PowerSeller level.



Notably, a user may advertise their PowerSeller status, however, whether a user is a PowerSeller or not is not apparent from search results, whereas a Top Ratedseller status is visible in a search listing.<sup>72</sup> If a user looks at a particular seller’s eBay store they can find

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<sup>68</sup> *Id.*; see *Bay Buying Feedback Guide*, *supra* note 47, *eBay Feedback Policies*, *supra* note 48, *ebay Feedback Points*, *supra* note 49, and *eBay Feedback*, *supra* note 50.

<sup>69</sup> *Powersellers*, *supra* note 64.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> For example, search any major product, such as an iPad, on [eBay.com](http://www.ebay.com). *iPad*, EBAY.COM, [http://www.ebay.com/sch/i.html?\\_from=R40&\\_trksid=p2050601.m570.11313.TR0.TRC0.H0.Xipad&\\_nkw=ipad&\\_sacat=0](http://www.ebay.com/sch/i.html?_from=R40&_trksid=p2050601.m570.11313.TR0.TRC0.H0.Xipad&_nkw=ipad&_sacat=0) (last visited Mar. 9, 2015).

a seller's PowerSeller insignia located there.<sup>73</sup> From a practical perspective, the PowerSeller status requires more search time from a buyer and, thus, is less accessible than the Top Rated insignia. For this reason, a PowerSeller insignia is a less efficient trustmark than the Top Rated insignia.

Similar to the Top Rated Seller system, the PowerSeller rating includes discounted shipping, including United States Postal Service Savings Program and United Parcel Service rate discounts.<sup>74</sup> A PowerSeller also gains access to eBay protection for unpaid items,<sup>75</sup> receives promotional offers and opportunities to participate in research,<sup>76</sup> and gains access to resources from eBay that regular members cannot access.<sup>77</sup> These resources include a separate, more easily accessible customer service team for PowerSellers and access to marketing and sales tools directly from eBay.<sup>78</sup> Finally, the PowerSeller status is a step toward Top Rated Top Rated Seller status and the benefits discussed *infra* associated with the Top Rated Top Rated Seller status.<sup>79</sup>

#### B. Top-Rated Seller Badge Designation - Requirements and Benefits

A Top-Rated Seller is a PowerSeller that has maintained high performance and customer service standards.<sup>80</sup> The PowerSeller designation then is a precursor to a Top-Rated Seller designation. Thus, the Top-Rated Seller badge can be viewed as a more significant trustmark than the PowerSeller status. In order to qualify as a Top-Rated Seller, an eBay user must meet several requirements related to customer service. For example, if a seller offers one-day or same day handling, the seller must upload tracking information in at least 90%

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<sup>73</sup> For example, see *Titanium Powerseller Status*, EBAY.COM, <http://stores.ebay.com/irecrafts/Titanium-PowerSeller-Status.html> (last visited Mar. 9, 2015).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Powersellers*, *supra* note 64.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Glossary of Terms – Top Rated Seller*, EBAY INC., <http://pages.ebay.com/help/account/glossary.html> (last visited Mar. 9, 2015).

of their transactions in the prescribed time according to the relevant eBay policies.<sup>81</sup> Additionally, a seller must meet the eBay Money Back Guarantee promise and PayPal Purchase Protection requirements.<sup>82</sup> The case requirements under these programs state that at most three tenths of a percent of cases brought by a buyer may be closed without seller resolution.<sup>83</sup> In terms of feedback requirements, to meet Top Rated Seller requirements, a seller can only have a transaction defect rate of 2% at most.<sup>84</sup>

EBay offers a second status of Top Rated Seller seals, the Top Rated Plus Seal.<sup>85</sup> In order to garner a Top Rated Plus Seal, a Top Rated Seller must offer listings that provide a 14-day or longer money-back return policy and provide same-day or one business day handling time.<sup>86</sup> Further, listings meeting the Top Rated Plus requirements must include extended holiday returns on listings.<sup>87</sup>

Currently, a user can become a Top Rated Seller in the United States, United Kingdom, and Germany.<sup>88</sup> The U.S. Top Rated Seller system, discussed *infra*, is based only on sales through eBay.com.<sup>89</sup> A seller can become a Top Rated Seller in the United Kingdom or Germany through their associated eBay sites, <http://www.ebay.co.uk/> and <http://www.ebay.de/>, respectively.<sup>90</sup> The Top Rated Seller designation in those countries is based only on transactions with buyers in those countries.<sup>91</sup> A seller need not be from the United States, United Kingdom, or Germany to qualify as a Top Rated Seller in that country. For example, a United States seller may become a Top Rated Seller in the United Kingdom if they meet the requirements of

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<sup>81</sup> *Top Rated Seller*, EBAY INC., <http://pages.ebay.com/help/sell/top-rated.html#what> (last visited Mar. 9, 2015).

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

the U.K. Top Rated Seller Program.<sup>92</sup> For associated eBay sites in countries other than the U.K. and Germany, a U.S. seller can become a Top Rated Seller in that country based on the eBay global seller performance standards.<sup>93</sup> Unlike the United States, United Kingdom and Germany Top Rated Seller systems, the Top Rated Seller designation in all other countries is based on transactions with buyers in all countries and not just native buyers.<sup>94</sup>

Once a seller qualifies as a Top Rated Seller they receive a 20% discount on final value fees charged by eBay and access to United States Postal Service Commercial Plus Pricing on shipping.<sup>95</sup> As soon as a seller qualifies, sometimes immediately but at most in a matter of hours,<sup>96</sup> a seal is displayed on any of the seller's listings which offer same-day or 1-day handling and extended holiday returns identifying them as a Top Rated Seller.<sup>97</sup> Additionally, a seller receives preferential search results, or in eBay's terms, improved search standing in eBay's Best Match search results.<sup>98</sup> The Top Rated Seller and Top Rated Plus seal, pictured below, appear both in eBay search results and in an individual item's listing page.<sup>99</sup>

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<sup>92</sup> *Id.*; For the United Kingdom requirements, see *Top Rated Seller*, EBAY.UK <http://pages.ebay.co.uk/help/sell/top-rated.html> (Mar. 9, 2015).

<sup>93</sup> *Top Rated Seller*, *supra* note 81; for global seller performance standards, see *Global Seller Performance*, EBAY.COM, <http://pages.ebay.com/help/policies/global-seller-performance.html> (last visited Mar. 9, 2015). Even though a U.S. buyer can become a Top Rated Seller in the United Kingdom and Germany they do not qualify for discounts through those sites. Likewise, only U.S. and Canadian sellers are eligible for the 20% final value fee discount on eBay.com.

<sup>94</sup> *Top Rated Seller*, *supra* note 81.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Build your Business*, EBAY.COM, <http://pages.ebay.com/sellerinformation/build-your-business-online/status-standards/top-rated-seller.html> (last visited Mar. 9, 2015).

<sup>98</sup> *Id.*

<sup>99</sup> For an example of search results, see eBay "iPad" search, *supra* note 72; for an example of a listing page, see: Apple iPad Mini, EBAY [http://www.ebay.com/itm/NEW-Apple-iPad-Mini-16GB-Wi-Fi-7-9-Tablet-White-MD531LL-A-or-Gray-MF432LL-A-/181511708378?pt=US\\_Tablets&var=&hash=item2a42f0deda](http://www.ebay.com/itm/NEW-Apple-iPad-Mini-16GB-Wi-Fi-7-9-Tablet-White-MD531LL-A-or-Gray-MF432LL-A-/181511708378?pt=US_Tablets&var=&hash=item2a42f0deda) (last visited Mar. 9, 2015).



C. Comparison of eBay Evaluation System with Other Evaluation Systems

There are two important observations to be made regarding the exclusivity of the eBay system. First, the eBay feedback system is a closed system, that is, the system is tied only to transactions conducted on the eBay website. Second, a trustmark earned through transactions on eBay cannot be used by a merchant outside of the eBay website. Each of these observations has important implications regarding the practical use of such a system universally for international transactions.

Since its inception, eBay has developed and refined its feedback system. Thereby engendering trust in transactions on its platform and facilitating trade. In doing so, eBay has gained a reputation as a safe and secure global marketplace. There are clear incentives for eBay to protect their investment in the feedback system. It comes as no surprise then that eBay's system remains closed. Thus, eBay does not allow their feedback system to be outsourced to transactions occurring off the eBay site. As an added level of protection, ensuring sellers continue using eBay, the trustmarks earned through the eBay feedback system cannot be utilized by a seller on another platform. Thus, an eBay seller may not advertise their reputation on eBay elsewhere.

As an e-commerce site, the eBay feedback system provides evaluations of buyers and sellers for transactions on its platform. Each feedback left is tied to a particular transaction, for a particular item, between a particular buyer and seller. eBay's system then provides objective scores, based on observable and quantifiable elements as provided by the parties to a transaction to evaluate buyers and sellers

in the aggregate of all of their transactions.<sup>100</sup> From a perspective of reliability in collecting data and enforcement of the rules and regulations related to the feedback system, a closed system, that is a system tied to a particular platform, is the only practical option.

Under the open system model, in comparison to the closed system model the seller conducts transactions on more than one platform rather than a single platform. However, the evaluation system and its feedback and ratings are, hosted on a single platform. Another difference is that the open system model has to rely on subjective feedback as opposed to the quantitative feedback of the eBay closed system.

There are relatively few open systems on the market. However earlier research uncovered iKarma, which regrettably is no longer in operation and its website is no longer in existence. However, we can nevertheless use the iKarma system to illustrate the open system model. An iKarma user first created an iKarma account, and then they were awarded an iKarma seal. The user placed this seal on their website, in emails, etc. that linked to their iKarma profile. The user's iKarma profile contained ratings and comments from previous buyers of their goods or services. At its core, the iKarma site was more or less just a place to host reviews. This stands in stark contrast to eBay's platform driven, empirical evaluation and trustmark system. iKarma was essentially a place to evaluate a seller's reputation, the seal acted less as a trustmark than as an access point to see what, if anything, other people had said about a seller. A seller could advertise their iKarma profile and ratings, but again the site acted more as a place to host reviews and less as a trustmark. Because sites like iKarma are not tied to specific platforms or even to specific types of transactions, i.e. a lawyer and a company selling electronics can both have an iKarma type profile, the open system does not lend itself to objective evaluations. Thus, because evaluations are based largely on subjective, qualitative comments, there is not objective data to base metrics off or

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<sup>100</sup> eBay's use of numerical rather than verbal ratings reduces misunderstandings and improves communication regarding ratings, particularly in cross-border transactions involving use of different languages by parties to the transaction.



to base an automated trustmark on. The automation and efficiency of the eBay closed system is therefore lost in the iKarma open system.

The SquareTrade seal provides evaluation and feedback of past transactions and also gives guarantees as to performance obligations regarding a current listing. The SquareTrade system also verifies a seller's identity, requires the seller to commit to the SquareTrade dispute resolution process, and generates info pages to provide a buyer with information regarding a seller's past transactions.<sup>101</sup> Therefore, the SquareTrade seal provides a retrospective trustmark, similar to the eBay system. SquareTrade centrally monitors a user's compliance with its trustmark and can remove the trustmark from a seller's site or auction listings.<sup>102</sup> The SquareTrade seal is not linked to one site or platform, and seems to be a middle ground from the eBay completely closed system to the open systems such as iKarma.

### VIII. LESSONS & BEST PRACTICES REGARDING EBAY'S AUTOMATED TRUSTMARK SYSTEM & PRIVATE ENFORCEMENT

#### A. eBay's Automated Trustmark System and Private Enforcement of Settled Claims and Rulings of Neutrals Through Voluntary Compliance, Termination of Trustmark Status, Use of Chargebacks, and Access to Escrow Accounts

The eBay "Automated Electronic Trustmark System" enables buyers on demand to obtain evaluations and performance ratings of sellers from whom they anticipate making purchases. These ratings are obtained electronically and cumulatively from the reports supplied by prior buyers after each purchase they made on the eBay platform.<sup>103</sup>

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<sup>101</sup> SquareTrade Criteria for Trusted Business Seal Membership, SQUARETRADE, [https://www.squaretrade.com/htm/pop/popup\\_busCriteria.html](https://www.squaretrade.com/htm/pop/popup_busCriteria.html) (last visited Mar. 9, 2015).

<sup>102</sup> SquareTrade Standards, SQUARETRADE, [https://www.squaretrade.com/htm/pop/popup\\_ST\\_standards.html](https://www.squaretrade.com/htm/pop/popup_ST_standards.html) (last visited Mar. 9, 2015).

<sup>103</sup> eBay's use of numerical rather than verbal ratings reduces misunderstandings and improves communication regarding ratings, particularly in cross-border transactions involving use of different languages by parties to the transaction.

The eBay automated system is efficient and cost-effective and does not depend on cumbersome and costly third-party evaluations to determine who is or is not entitled to trustmark status.

Under the eBay Trustmark Evaluation/Feedback System sellers' desire to obtain favorable performance evaluations in order to establish their reputation and reliability, and increase their sales, motivates them to perform their contract obligations well, facilitate fair resolution of disputes, and voluntarily satisfy the rulings of neutrals following unsuccessful negotiations and facilitated negotiations. In most cases voluntary private satisfaction and enforcement of settled claims and rulings of neutrals will occur. In the absence of such voluntary compliance, use of private enforcement procedures including chargebacks on credit card payment, access to escrow accounts, and termination of trustmark status are available to achieve private enforcement of rulings. As noted the rulings of neutrals do not have res judicata effect but are enforceable by use of applicable private enforcement procedures.<sup>104</sup>

#### CONCLUSION

Development of fast-track low-value high-volume ODR systems which provide a marketplace for e-commerce, as well as an ODR system for fast-track resolution of disputes arising from e-commerce on its electronic marketplace is facilitated by application of the following four best practices used by eBay in creating its highly successful system:

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<sup>104</sup> Much discussion has occurred in UNCITRAL Working Group III sessions on the subject of whether the ruling made by the neutral at the end of the facilitated negotiation second stage of the resolution process should be termed a "recommendation," "decision," "ruling" or some other yet to be discovered term. Proponents of the "recommendation" term are concerned that the neutral's ruling does not have res judicata effect and therefore are not comfortable with using the term "decision." Proponents of the term "decision" are concerned that the term "recommendation" could be interpreted to mean that the ruling has no legal effect. These concerns can be addressed by clarifying the definition of whatever term is used in the definition section of the Preliminary Rules by specifying that the "[term] does not have res judicata effect, but is enforceable by use of applicable private enforcement procedures."

- 1) Using a de facto purchase price “Money Back Guarantee” definition of low value to limit the amount of each permitted claim;<sup>105</sup>
- 2) Limiting the Types of Permitted Claims to “item not received” and “item not as described”;<sup>106</sup>
- 3) Making Available to Buyers’ On-Demand Access to Automated Trustmark Evaluation/Feedback Information Needed to Identify Reliable Sellers;<sup>107</sup> and
- 4) Providing For Private Enforcement of Settled Claims and Rulings of Neutrals through facilitation of voluntary compliance, termination of trustmark status, and using charge backs on credit card payments and access to escrow funds to satisfy claims and rulings of neutrals in the absence of voluntary compliance.<sup>108</sup>

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<sup>105</sup> See discussion at *supra* note 10.

<sup>106</sup> See discussion at *supra* note 15.

<sup>107</sup> See discussion at *supra* note 43, 41 (read in stated order).

<sup>108</sup> See text at note 103, *supra*.

**PARTY AUTONOMY AND CONSUMER  
ARBITRATION IN CONFLICT: A “TROJAN  
HORSE” IN THE ACCESS TO JUSTICE IN  
THE E.U. ADR-DIRECTIVE 2013/11?**

*Norbert Reich*<sup>†\*</sup>

ABSTRACT

*Arbitration clauses in consumer contracts have been subject to controversy in many jurisdictions; recent U.S. and Canadian Supreme Court case law have been used as examples. European Union (E.U.) law, which originally excluded arbitration in general from the Brussels/Rome regimes, has recently taken a mixed, and to some extent limited, approach by including Alternative Dispute Resolution (ADR) entities “imposing” a solution in its recent ADR Directive 2013/11. There seems to be an indirect encouragement to develop consumer arbitration schemes in E.U. Member States as a second route to justice. It is too early to evaluate this new and somewhat clandestine policy of the E.U. The paper insists on some additional procedural guarantees should consumer arbitration schemes become more popular among Member countries, even though Dir. 2013/11 already contains some “minimum protection” provisions on “specific acceptance” and applicable law. The basic reference for such additional protection is in Article 47 of the E.U. Charter of Fundamental Rights, viewed together with Article 19(1) para. 2 of the Treaty on the European Union (TEU) whereby “Member States shall “provide remedies sufficient to ensure effective legal protection in the fields covered by Union law”. At the time of writing, the implementation measures of Member States concerning Dir. 2013/11 have to be awaited before making any final judgment as to their conformity with E.U. law and efficiency. The paper seeks to provide some guidelines for this coming debate.*

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<sup>†</sup> Before this article could be published, Prof. Dr. Norbert Reich passed away. This publication has been dedicated to his memory by his colleagues and this Journal.

\* Dr. Dr. H.C. Mult., Emeritus Professor of Law, University of Bremen; Visiting Professor, University of Groningen/NL (2013/2014). This paper was presented at the 17<sup>th</sup> Biennial Meeting of the International Academy of Commercial and Consumer Law, July 16-19, Istanbul Bilgi University. This paper was finalized with the help of Professor Hans-W. Micklitz.

## TABLE OF CONTENTS

INTRODUCTION.....	292
I. A LIBERAL APPROACH: ADR IN THE UNITED STATES.....	294
II. A MIXED APPROACH: ADR IN CANADA.....	300
III. TO “PROPOSE” OR “IMPOSE” A SOLUTION: THE QUESTION OF E.U. LAW .....	303
IV. A FIRST ATTEMPT TO SOLVE THE CONUNDRUM ON CONSUMER ARBITRATION CREATED BY DIRECTIVE 2013/11 .....	305
V. THE LIMITS OF CONSUMER ARBITRATION: <i>CLARO</i> AND <i>ASTURCOM</i> .....	306
VI. WHAT ABOUT CONSUMER PROTECTION UNDER THE BRUSSELS MECHANISM OF JURISDICTION? .....	308
VII. THE “SPECIFIC ACCEPTANCE” OF THE ARBITRATION AGREEMENT BY THE CONSUMER .....	310
VIII. E.U. STANDARDS BEYOND “SPECIFIC ACCEPTANCE” ..	313
IX. APPLICABLE LAW: (LIMITED) FREE CHOICE BY ARBITRATORS OR RESERVATION OF MANDATORY PROVISIONS? .....	314
X. “SOFT” LEGAL PROTECTION.....	317
XI. THE CONSTITUTIONAL DIMENSION: DIRECTIVE 2013/11 ARTICLE 47 CHARTER.....	318
XII. IMPACT OF DIRECTIVE 2013/11 ON MEMBER STATE LAW ON CONSUMER ARBITRATION IN GERMANY .....	321
XIII. THE SPANISH APPROACH .....	325
XIV. A REGULATED APPROACH: FRANCE .....	326
XV. A COMPROMISE: U.K. LAW .....	327
XVI. STATE MONITORED ADR SYSTEMS WITHOUT BINDING ARBITRATION: SCANDINAVIAN COUNTRIES .....	328
XVII. A SEEMINGLY UNKNOWN EXPERIENCE: POLAND .....	329
CONCLUSIONS .....	330

## INTRODUCTION

This paper discusses an important new development in conflict regulation between consumers and businesses in the E.U.—a subject matter which has kept me busy for some time. This paper will address the question of how a regime of extra-legal conflict management by ADR mechanisms, which are based on voluntary cooperation between consumers and traders, supplements, but does not replace, judicial court proceedings. This paper argues that a more intrusive regime to solve consumer complaints by binding arbitration will become increasingly popular. Justice will be more or less privatized under an efficiency rhetoric, which criticizes lengthy, costly, and highly discretionary court proceedings that exist in many Member States to the detriment of consumers and the working of justice in general. For many legal scholars, binding arbitration based on contractual agreements is regarded as an alternative; however, it is not always clear what the legal and consumer policy costs of an extension of ADR mechanisms are, and whether there is a fair balance between the supposed efficiency gains on the one hand and the requirements of effective legal protection on the other.

The paper will proceed as follows. First, it will give an overview of liberal and mixed regimes concerning the promotion of binding consumer arbitration, namely in the United States (Section I) and Canada (Section II) where the legitimacy and limits of consumer arbitration have been subject to controversial Supreme Court judgments. These judgments show the complexity of this issue and provide insight into future E.U. developments of ADR mechanisms in E.U. countries. Section III will analyze new trends in E.U. law provoked by the recently adopted ADR Directive 2013/11/EU,<sup>1</sup>

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<sup>1</sup> Directive 2013/11, of the European Parliament and of the Council of 21 May 2013 on Alternative Dispute Resolution for Consumer Disputes 2013, 2014 O.J. (L 165/63) [hereinafter Directive 2013/11]. See Horst Eidenmüller & Martin Engel, *Die Schlichtungsfälle: Verbraucherrechtsdurchsetzung nach der ADR-Richtlinie und ODR-Verordnung der EU*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1704 (2013) for a critical appreciation of those who are not concerned with consumer arbitration specifically, but who fear not without justification a *de facto* denial of justice to consumers even if they take proceedings with a non-binding outcome; it is unrealistic to expect consumers to pursue their claim if rejected by the ADR-entity before courts

where consumer arbitration has found a place of its own in regulating ADR-entities “imposing solutions” on consumers. Section IV concerns the scope of application of Dir. 2013/11. Section V examines prior E.U. law in the form of two important, and in the opinion of this author, still valid precedents set by the Court of Justice of the E.U. (CJEU, then called ECJ), namely *Claro*<sup>2</sup> and *Asturcom*.<sup>3</sup> Sections VI through X propose some standards on valid consumer arbitration by reference to Dir. 2013/11 and other E.U. law instruments. These standards are then measured under a fundamental rights perspective contained in Article 47 of the E.U. Charter and Article 19(1)(a) Treaty of the European Union (TEU), namely the principle of effective judicial protection of rights granted to consumers under E.U. law.<sup>4</sup> Then, Section XI argues that these standards limit party-autonomy with regard to binding arbitration clauses in consumer contracts and require the adoption of additional mechanisms to curb an eventual abuse of arbitration clauses by traders or trade associations. Finally, Sections XII through XVII examine E.U. countries that must adapt their arbitration legislation to new E.U. standards. Some preliminary conclusions will follow.

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of law. The authors also question the legal basis of Article 114 of the Directive, although such discussion is beyond the scope of this paper.

<sup>2</sup> Case C-168/05, *E.M.M. Claro v. Centro Movil Milenium*, 2006 E.C.R. I-10421; *see also* Reich, *More clarity after “Claro”?*, *supra* note 1, at 41.

<sup>3</sup> Case C-40/08, *Asturcom Telecomunicaciones v. Rodríguez Noguera*, 2009 E.C.R. I-9579 ¶ 54-55. *See* Jules Stuyck, *Note to Pannon and Asturcom*, 47 COMMON MKT. L. REV. 879 (2010); Christopher Hodges, *Consumer Protection and Procedural Justice*, in LANDMARK CASES OF EU CONSUMER LAW: IN HONOUR OF JULES STUYCK 615 (Evelyn Terry et al. ed. 2013); Chantal Mak, *Judgment of the Court (First Chamber) of 6 October 2009, Asturcom Telecomunicaciones SL v Cristina Rodríguez Nogueira, Case C-40/08, Commentary*, 6 EUR. REV. CONTRACT L. 437 (2010); Martin Ebers, *ECJ (First Chamber) 6 October 2009, Case C-40/08, Asturcom Telecomunicaciones SL v. Cristina Rodríguez Nogueira – From Océano to Asturcom: Mandatory Consumer Law, Ex Officio Application of European Union Law and Res Judicata* 18 EUR. REV. PRIVATE. L. 823 (2010). *See also* ALEXANDER J. BĚLOHLÁVEK, B2C ARBITRATION: CONSUMER PROTECTION IN ARBITRATION 7, 117, 133 (2012).

<sup>4</sup> *See* NORBERT REICH, GENERAL PRINCIPLES OF EU CIVIL LAW ch. IV (2014).

## I. A LIBERAL APPROACH: ADR IN THE UNITED STATES

In the words of the Supreme Court in *Southland Corp. v. Keating*, the Federal Arbitration Act (FAA)<sup>5</sup> “declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.”<sup>6</sup> U.S. law generally takes a very liberal view toward arbitration clauses without making a distinction between commercial and consumer arbitration.<sup>7</sup> This view was confirmed in the Court’s controversial decision of *Green Tree Fin. Corp. v. Randolph*.<sup>8</sup>

In *Green Tree Fin. Corp. v. Randolph*, Larketta Randolph signed a financing agreement for the purchase of a mobile home with Green Tree Financial. The agreement bound any disputes arising from the agreement to arbitration. When Randolph sued Green Tree for violating the Truth in Lending Act (TILA), the district court compelled arbitration. However, on appeal the Eleventh Circuit overturned the district court’s decision, finding that the arbitration agreement was unenforceable because the steep arbitration costs would negatively affect Randolph’s ability to vindicate her statutory rights. The Supreme Court disagreed and held that consumers bear the burden to prove that the arbitral forum is financially inaccessible to them.<sup>9</sup> This opinion was challenged by a strong dissent by Justices Ginsburg, Stevens, Souter, and Breyer (in part), who argued that, “as a repeat player in the arbitration required by its form contract, Green Tree has superior information about the costs to consumers of pursuing arbitration.”<sup>10</sup> This approach by the Supreme Court means that ADR mechanisms in favor of consumers can easily be avoided by arbitration clauses entered into by standard form contracts with consumers as in *Green Tree*.

Recent state court cases, however, show a somewhat more nuanced approach toward arbitration clauses. For example, *Comb v.*

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<sup>5</sup> The Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2014) [hereinafter FAA].

<sup>6</sup> *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984).

<sup>7</sup> LARS WEIHE, DER SCHUTZ DER VERBRAUCHER IM RECHT DER SCHIEDSGERICHTSBARKEIT 116, 205-06 (2005) (for a critique from a consumer policy point of view with regard to “informed consent”).

<sup>8</sup> *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79 (2000).

<sup>9</sup> *Id.* at 92.

<sup>10</sup> *Id.* at 96.



*Paypal*<sup>11</sup> concerned a class action against an electronic disbursement service alleging illegal removal of funds.<sup>12</sup> The defendant, Paypal, argued that the case should have been submitted to arbitration because the contract contained an arbitration clause.<sup>13</sup> The District Court held that, despite its wide use and recognition in relevant California law, the arbitration clause was substantively unconscionable for several reasons.<sup>14</sup> First, there was a lack of mutuality whereby arbitration was imposed on the weaker party while the stronger party was allowed the choice of forum.<sup>15</sup> Second, the clause contained a prohibition against consolidation of claims.<sup>16</sup> Third, the costs of arbitration and venue were unconscionable because the “place or manner” in which arbitration was to occur unreasonably took into account “the respective circumstances of the parties.”<sup>17</sup>

*Cruz v. PacifiCare Health Systems*<sup>18</sup> concerned an action for false advertising and deceptive business practices of the defendant PacifiCare for inducing persons to subscribe to health plans.<sup>19</sup> PacifiCare claimed that the plaintiff, who obtained health coverage through his employer, was required to arbitrate his claim because of the subscriber agreement between PacifiCare and the plaintiff’s employer.<sup>20</sup> The California Supreme Court held that the arbitration clause was unenforceable.<sup>21</sup> The Court’s reasoning was similar to the decision in *Comb*, at least insofar as injunctive relief is concerned, but not with regard to restitution and unjust enrichment. Therefore, in California, claims for unjust enrichment are arbitrable, while claims for injunctions against deceptive advertising practices are not arbitrable because they are undertaken “in the public benefit.”

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<sup>11</sup> *Comb v. Paypal, Inc.*, 218 F. Supp. 2d 1165 (N.D. Cal. 2002).

<sup>12</sup> *Id.* at 1166.

<sup>13</sup> *Id.* at 1169-70.

<sup>14</sup> *Id.* at 1172.

<sup>15</sup> *Id.* at 1173-75.

<sup>16</sup> *Id.* at 1175-76.

<sup>17</sup> *Id.* at 1177 (quoting *Bolter v. Superior Court*, 104 Cal. Rptr. 2d 888, 894-95 (Ct. App. 2001)).

<sup>18</sup> *Cruz v. PacifiCare Health Sys., Inc.*, 66 P.3d 1157 (Cal. 2003).

<sup>19</sup> *Id.* at 1159.

<sup>20</sup> *Id.* at 1160.

<sup>21</sup> *See generally id.*

The Supreme Court in *Buckeye Check Cashing Corp. v. Cardegna* seemed unconcerned by attempts to limit the effects of arbitration clauses in consumer contracts.<sup>22</sup> The litigation in *Cardegna* concerned a class action suit brought against usurious terms in a consumer credit agreement containing a broad arbitration clause.<sup>23</sup> The case was an appeal from a decision by the Florida Supreme Court, which set aside the arbitration clause.<sup>24</sup> The Florida Supreme Court reasoned that to enforce an agreement to arbitrate in a contract challenged as unlawful “could breathe life into a contract that not only violates state law, but is criminal in nature . . .”<sup>25</sup> The U.S. Supreme Court, per Justice Scalia, reversed the Florida Supreme Court and distinguished two causes in which arbitration clauses can be challenged in court:

- 1) The arbitration clause is unlawful as such; and
- 2) The entire contract from which the arbitration clause cannot be severed is invalid, which was not the case in a usurious credit agreement.

The Supreme Court held that, “regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.”<sup>26</sup>

Consumer protection depends on the willingness of arbitrators to apply and enforce consumer protection provisions in particular of state law. Arbitration awards, however, are not published, and therefore are not subject to critical public and academic debate. It seems that there is no remedy under U.S. law against an arbitration award disregarding mandatory consumer protection provisions, unless the consumer can prove the existence of the narrow defenses

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<sup>22</sup> See generally *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006).

<sup>23</sup> *Id.* at 442-43.

<sup>24</sup> *Cardegna v. Buckeye Check Cashing, Inc.*, 894 So. 2d 860, 862 (Fla. 2005).

<sup>25</sup> *Id.* (quoting *Party Yards, Inc. v. Templeton*, 751 So. 2d 121, 123 (Fla. Dist. Ct. App. 2000)).

<sup>26</sup> *Buckeye Check Cashing, Inc.*, 546 U.S. at 449.

enumerated in the 1958 New York Convention.<sup>27</sup> Arbitration clauses have become a prominent and popular instrument to avoid the application of consumer protection provisions, at least in contract litigation between business and consumers, and particularly in class action suits.

An arbitration clause may be considered “substantially unconscionable,” as in the Pennsylvania case of *Bragg v. Linden Research*,<sup>28</sup> if an arbitration clause is either one-sided or non-transparent, or if there are additional costs to the consumer to arbitrate.

In *AT&T v. Concepcion*, the Supreme Court addressed the relationship between arbitration clauses in cellular telephone contracts between respondents (the Concepcions) and petitioner (AT&T) and the prohibition of classwide arbitration.<sup>29</sup> After the Concepcions were charged sales taxes on the retail value of phones provided free under their service contract, they sued AT&T in the United States District Court for the Southern District of California. Their suit was consolidated with a class action alleging, inter alia, that AT&T had engaged in false advertising and fraud by charging sales tax on “free phones”. The Supreme Court in rejecting the consolidation claim took the opposite view of the California Supreme Court,<sup>30</sup> which had ruled that consumers must have the right to proceed with a class action and shall not be forced into arbitration. Justice Scalia, writing for the majority, framed AT&T as a clash of two policies, namely, the policy

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<sup>27</sup> Defenses under the convention include: lack of proper notice, arbitration decision contrary to public policy of the forum country, manifest disregard of the law. United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3 [hereinafter New York Convention], [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html).

<sup>28</sup> *Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593 (E.D. Pa. 2007). See GREG LASTOWKA, *VIRTUAL JUSTICE: THE NEW LAWS OF THE ONLINE WORLDS* 95 (2010) for a discussion of U.S. practice on enforcing contractual provisions containing an arbitration clause where the *Bragg* decision was found to be “rather surprising (to many legal commentators) and presume that other courts looking at the contracts of other virtual words will be more likely to find them enforceable.”

<sup>29</sup> See generally *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011).

<sup>30</sup> *Discover Bank v Superior Ct.*, 113 P.3d 1100 (Cal. 2005).

of California courts favoring consumers' decision to opt for class actions, and the policy of the FAA favoring arbitration. The Supreme Court held that the FAA preempts the state court class action rule, so the dispute must be submitted to arbitration and shall not proceed as a class action.<sup>31</sup> In his dissent, Justice Breyer insisted that, due to the small amount of the individual claim (\$30.22), a denial of class actions practically means a denial of justice. This argument was rejected by the majority, who reasoned that class actions in arbitration proceedings are not useful and manageable remedies. As Justice Scalia said: "Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."

*American Express Co. v. Italian Colors*, decided by the Supreme Court on June 20, 2013, concerned an arbitration clause that disallowed anti-trust claims to be brought by a class.<sup>32</sup> Again, the Court's majority reiterated its liberal view favoring arbitration as a "matter of contract," even against mandatory provisions of federal anti-trust laws. Justice Kagan's dissent, in my opinion, correctly insists on the "effective vindication" rule established in prior case law, which limits arbitration clauses where they effectively prevent enforcement of "congressionally created rights."<sup>33</sup> This is accomplished by arbitration clauses that de facto prevent compensation of anti-trust claims and undermine the deterrent effect of compensation for anti-trust infringements.

The case law of the Supreme Court limits effective consumer protection as provided by federal (anti-trust) and state law (the California Discover Bank rule<sup>34</sup>). The Court also seems to contradict the plain meaning of section 2 of the FAA, which reads:

[a] written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, . . . shall be valid, irrevocable and

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<sup>31</sup> *Id.* at 1750-51.

<sup>32</sup> *Am. Express Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2308 (2013).

<sup>33</sup> *Id.* at 2313.

<sup>34</sup> *Discover Bank*, 113 P.3d 1100.

enforceable, save upon such grounds as exist at law or equity for the revocation of any contract.<sup>35</sup>

Therefore, the FAA would seem to allow limits to arbitration in consumer (and commercial) matters based on defenses such as fraud, duress, unconscionability, and mandatory (federal and/or state) law, which was in part developed by state courts but had been regarded with hostility by the Supreme Court majority. This practice creates, as the dissent in *American Express* pointed out, areas of de facto immunity from law: “[the FAA] reflects a federal policy favoring actual arbitration—that is, arbitration as a streamlined ‘method of revolving disputes,’ not as a foolproof way of killing off valid claims.”<sup>36</sup> However, the Supreme Court’s message in *American Express* is unequivocal: courts are required to enforce arbitration agreements, including class action waivers, in accordance with their terms.

Legal practitioners and scholars have criticized the Supreme Court’s liberal view on arbitration as an “excessive use” of arbitration clauses in consumer contracts.<sup>37</sup> The disadvantages of excessive use of arbitration for consumers seem to outweigh the advantages of arbitration for service and goods providers, namely:

- no possibility of a rational decision for or against arbitration before the dispute arises;

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<sup>35</sup> FAA, 9 U.S.C. § 2 (2014).

<sup>36</sup> *Am. Express Co.*, 133 S. Ct. at 2315.

<sup>37</sup> See WEIHE, *supra* note 8, at 43-45; Richard M. Alderman, *The Future of Consumer Law in the United States – Hello Arbitration, Bye-Bye Courts, So-Long Consumer Protection* (Univ. Hous. L. Ctr., Working Paper No. 2008-A-09, 2007); Richard M. Alderman, *Consumer Arbitration: The Destruction of the Common Law*, 2 J. AM. ARB. 1 (2003); Gerhard Wagner, *Dispute Resolution as a Product: Competition between Civil Justice Systems*, in REGULATORY COMPETITION IN CONTRACT LAW AND DISPUTE RESOLUTION 347, 394 (Horst Eidenmüller ed. 2013). With regard to then existing smalls claims procedures, see NORBERT REICH, STAATLICHE REGULIERUNG ZWISCHEN MARKTVERSAGEN UND POLITIKVERSAGEN 129 (1988). See also GRAF-PETER CALLIESS, GRENZÜBERSCHREITENDE VERBRAUCHERVERTRÄGE 308-14 (2006) (providing a critical view (without citing the harsh case law of the U.S. Supreme Court)).

- the trader can always amend the arbitration clause unilaterally;
- no legal representation, no class actions, limited possibilities for bringing evidence, no legal dispute insurance;
- arbitrators cannot be formally obliged to apply state consumer protection legislation;<sup>38</sup>
- only limited access to documents (which are usually in the hand of the trader), no pre-trial discovery procedure;
- no jury, only limited appeal possibilities;
- frequently excessive costs, compared with existing small claims procedures; and
- the place of arbitration may be geographically distant from residence of consumer.

## II. A MIXED APPROACH: ADR IN CANADA

In terms of Canadian law on arbitration, a lively discussion existed among scholars in Canada on whether pre-contractual arbitration clauses could be enforced in consumer contracts, and whether they could eventually be used to avoid class actions similar to the United States.<sup>39</sup>

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<sup>38</sup> The American Arbitration Association (AAA) Consumer Due Process Protocol contains such an obligation, while the rules of the ICC (International Chamber of Commerce) are silent on that point. CALLIESS, *supra* note 39, at 359.

<sup>39</sup> See Shelley McGill, *The Conflict between Consumer Class Actions and Contractual Arbitration Clauses*, 43 CAN. BUS. L.J. 359 (2006); Jonnette Watson Hamilton, *Pre-Dispute Consumer Arbitration Clauses: Denying Access to Justice?*, 51 MCGILL L.J. 693 (2006). *But see* David T. Neave & Jennifer M. Spencer, *Class Proceedings: The New Way to Trump Mandatory Arbitration Clauses?*, 63 THE ADVOCATE 495 (2005) (favoring of the use of arbitration clauses in consumer contracts, according to the U.S. model which is said to strike the “right balance”).

In *Dell Computer Corp. v. Union des Consommateurs*, the Canadian Supreme Court held that arbitration clauses in an electronic consumer contract for the purchase of computers from a U.S. company by a citizen of Quebec were also enforceable<sup>40</sup> against a class action brought by the Quebec “Union des consommateurs”. The Court reasoned that the consumer had access to the arbitration clause via a hyperlink on the website of the company, and that he agreed to be bound by the clause when he clicked on the link.<sup>41</sup> The Court also reasoned that “the clause was no more difficult for the consumer to access than would have been the case had he or she been given a paper copy of the entire contract on which the terms and conditions of sale appeared on the back of the first page.”<sup>42</sup> Further, the Court stated that any challenge to the arbitration agreement must be resolved first by the arbitrator who has *Kompetenz-Kompetenz* under international agreements and Canadian law.<sup>43</sup> This doctrine is a traditional doctrine in (commercial) arbitration under which the arbitrator, and not a court of law, has the “competence-competence,” or the final say over the legality of arbitration proceedings, including the choice of the arbitrator.<sup>44</sup>

The dissenting judges disagreed with the majority, arguing that the arbitration and jurisdiction clauses, which are, according to the Quebec law, forbidden, are similar if they refer the consumer case to a non-Quebec authority. This is the case with the reference to the U.S. arbitrator as foreseen in the contract clause; the arbitration clause is therefore unenforceable.

A more recent case decided by the Canadian Supreme Court, *Seidel v. TELUS*, seems to take a more critical view on arbitration clauses in consumer contracts aimed at excluding class action proceedings against the supplier of cellular telephone services.<sup>45</sup> In

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<sup>40</sup> *Dell Computer Corp. v. Union des Consommateurs*, [2007] 2 S.C.R. 801 (Can.).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Case C-190/89, *Marc Rich & Co. AG v. Societa Italiana Impianti PA*, 1991 E.C.R. I-3855 (expressly finding that the arbitrator had this authority); see Norbert Reich, *Zur Wirksamkeit von Schiedsklauseln in Grenzüberschreitenden Börsentermingeschäften*, 12 Z. Eur. Pro. 981 (1996).

<sup>45</sup> *Seidel v. TELUS Commc'ns Inc.*, [2011] 1 S.C.R. 531 (Can.); Shelley McGill, *Consumer Arbitration After Seidel v. TELUS*, 51(2) CAN. BUS. L.J. 187 (2011).

*Seidel*, the contract contained a clause with the supplier referring disputes to “private and confidential arbitration,” as well as a waiver by the consumer of the right to pursue a class action claim.<sup>46</sup> Among the questions before the Supreme Court were whether this clause was unconscionable under the British Columbia Business Practices and Consumer Protection Act (BPCPA), and whether the waiver was in conformity with section 3 of the BPCPA, which provides: “Any waiver or release by a person of the person’s rights, benefits or protections under this Act is void except to the extent that the waiver or release is expressly permitted by this Act.”<sup>47</sup>

One of the questions before the Court was whether this prohibition had to be enforced by the arbitrator under the Canadian (and U.S.) *Kompetenz-Kompetenz* rule, or whether it could also be enforced by a court of law. The majority relied on section 172 of the BPCPA, which allows any person without “a special interest” to bring a class action for injunctive and declaratory relief.<sup>48</sup> The plaintiff in *Seidel* relied on this provision for her action against TELUS to avoid the arbitration clause and class action waiver. In interpreting the scope of section 172, the majority—against a strong dissenting opinion defending traditional principles of arbitration law—relied on the objective of the BPCPA, which is to confer consumer protection and enhance consumers’ access to justice.<sup>49</sup> This objective implicitly limits the *Kompetenz-Kompetenz* principle at least with regard to declaratory and injunctive relief. Therefore, the Court held that the class action waiver was dependent on the (annulled) arbitration clause; it could not be separated from it and could not exist without a valid arbitration clause.<sup>50</sup> The decision, however, made no reference to compensation or restitution where section 172 (3) is applicable only to a much more limited extent.

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<sup>46</sup> *Id.* ¶ 44.

<sup>47</sup> Business Practices and Consumer Protection Act, S.B.C. 2004, c. 2 (Can.).

<sup>48</sup> *Id.* § 172. The BPCPA also seems to contain broad standing provisions not dependent on the violated rights.

<sup>49</sup> *Seidel*, [2011] 1 S.C.R. 531.

<sup>50</sup> *Id.* ¶ 46.



### III. TO “PROPOSE” OR “IMPOSE” A SOLUTION: THE QUESTION OF E.U. LAW

EU Dir. 2013/11 provides for a two-tier mechanism for the out-of-court settlement of consumer disputes, which are described in Art. 2(1):

This Directive shall apply to procedures for the out-of-court resolution of domestic and cross-border disputes concerning contractual obligations stemming from sales contracts and service contracts between a trader established in the Union and a consumer resident in the Union through the intervention of an ADR-entity which proposes or imposes a solution or brings the parties together with the aim of facilitating an amicable solution.<sup>51</sup>

“Propose” and “impose” are nearly identical terms, so they likely went nearly unnoticed in the (scant) debate of the Commission proposal of 20 November 2011 on the Directive,<sup>52</sup> which was adopted in the record time of little more than one and a half years. Both elements of the proposal and the final Directive were based on the internal market provision of Article 114<sup>53</sup> of the Treaty on the Functioning of the European Union (TFEU). The question of the correct legal basis will be further discussed in Section XII.

However, to “propose” a solution is quite different than to “impose” a solution. “Proposing” a solution is in line with the earlier initiatives by the Commission, which were based on Recommendations 98/257/EC of 30 March 1998 and 2001/310/EC

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<sup>51</sup> Directive 2013/11, art. 2(1) (emphasis added).

<sup>52</sup> Commission Proposal for a Directive on Alternative Dispute Resolution for Consumer Disputes, COM (2011) 793 final (Nov. 20, 2011).

<sup>53</sup> Art. 114 (1) TFEU gives the European Union jurisdiction “to adopt measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment or functioning of the internal market.” Consolidated Version of the Treaty on the Functioning of the European Union art. 114 (1), May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].

of 4 April 2001.<sup>54</sup> These Recommendations were not applicable to entities who tried to “impose” a solution on consumers, e.g., binding consumer arbitration. In contrast, arbitration, including consumer arbitration, was expressly excluded from the scope of E.U. instruments concerning jurisdiction (Art. 1(2)(d) Regulation (EC) No. 44/2001 and now Art. 1(2)(d) of Regulation (EU) No. 1215/2012.<sup>55</sup> and applicable law (Art. 1(2)(e) of the Rome I-Regulation (EU) No. 593/2008).<sup>56</sup> These Regulations, however, were not based on the internal market competence of the E.U., but on its provisions of judicial cooperation in civil matters, which are limited to cross-border disputes under now Art. 81(2) of the TFEU.<sup>57</sup> The same is true of the Regulation (EC) No. 861/2007 of 11 July 2007 on a European Small Claims Procedure.<sup>58</sup>

Why this sudden extension of ADR procedures to consumer arbitration? How does this extension relate to the seemingly contradictory statement in Article 2(4) of Directive 2013/11, which reads: “This Directive acknowledges the competence of Member States to determine whether ADR entities established on their territories are to have power to impose a solution.”<sup>59</sup> An additional reservation is made in Recital (20) whereby an “out-of-court procedure which is created on an ad hoc basis for a single dispute between a consumer and a trader should not be considered as an ADR procedure.”<sup>60</sup> This excludes the commercial practice of setting up

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<sup>54</sup> Commission Recommendation 98/257, of 30 March 1998 on the Principles Applicable to the Bodies Responsible for Out-of-Court Settlement of Consumer Disputes 1998 O.J. (L 115) 31; Reich, *supra* note 1, ¶ 8.19, 8.22.

<sup>55</sup> Commission Regulation 1215/2012, of the European Parliament and the Council of 12 December 2012 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2012 O.J. (L 351) 1; Council Regulation 44/2001, of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2001 O.J. (L 12) 1 (EC).

<sup>56</sup> Regulation 593/2008, of the European Parliament and the Council of 17 June 2008 on the Law Applicable to Contractual Obligations (“Rome I”), 2008 O.J. (L 176) 6.

<sup>57</sup> TFEU art. 81(2).

<sup>58</sup> Council Regulation 861/2007, of 11 July 2007 on a European Small Claims Procedure, 2007 O.J. (L 199) 1.

<sup>59</sup> Directive 2013/11, art. 2(4).

<sup>60</sup> *Id.* at Preamble Directive 20.

special arbitration panels for more complex individual disputes as an option for consumer arbitration falling under Directive 2013/11.

#### IV. A FIRST ATTEMPT TO SOLVE THE CONUNDRUM ON CONSUMER ARBITRATION CREATED BY DIRECTIVE 2013/11

Dir. 2013/11 shows a certain contradiction concerning consumer arbitration: Member States are free to set it up, to continue existing instruments, or to completely abstain from doing so. If, however, Member States take an active view toward consumer arbitration, they are bound by the requirements of Directive 2013/11 in general, and Articles 10 and 11 in particular, which will be discussed in greater detail later in Sections VII and IX.

Article 10 and 11 only apply in cases where the plaintiff consumer is bound by an arbitration agreement, not if the trader himself initiates a claim in arbitration.<sup>61</sup> According to Article 2(1) and (2)(c) it is limited to actions in contract (with the exception of non-economic services of general interest), and excludes actions in tort and restitution with some doubts concerning borderline cases not to be discussed here. Injunctions against illegal behavior of traders sought by consumer associations are also excluded; they come under other E.U. law instruments, in particular Directive 2009/22/EU on injunctions.<sup>62</sup>

The principles contained in Directive 2013/11 are obviously minimum requirements under Art. 2(3). Within these limits, Member States are free to regulate consumer arbitration, e.g., regarding competence, costs, choice of arbitrators, etc. This is part of Member States' so-called "procedural autonomy," which has been recognized by the CJEU as a general principle of E.U. law.<sup>63</sup> On the other hand,

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<sup>61</sup> If the trader initiates a claim in arbitration, Directive 2013/11 is not applicable. *See* Directive 2013/11, art. 2(2)(g).

<sup>62</sup> Directive 2009/22, of the European Parliament and of the Council of 23 April 2009 on Injunctions for the Protection of Consumers' Interests (recast), 2009 O.J. (L 110) 30.

<sup>63</sup> For an overview see REICH, *supra* note 5, ¶ 4.4; Norbert Reich, Hans-W. Micklitz, Peter Rott and Klaus Tonner, *Negotiation and Adjudication – Class Actions and Arbitration Clauses in Consumer Contracts*, in *EUROPEAN CONSUMER LAW* ¶ 8.3 (2d ed. 2014).

Member States must respect the principles of effectiveness and equivalence, which are now part of Article 47 of the E.U. Charter of Fundamental Rights—a subject matter to be discussed in Section XI.

V. THE LIMITS OF CONSUMER ARBITRATION: *CLARO* AND  
*ASTURCOM*

In *Claro*,<sup>64</sup> the CJEU goes quite far in the degree to which the national court of an E.U. Member State must engage in investigations on its own motion in arbitration proceedings.<sup>65</sup> When the consumer has agreed to an arbitration clause—the unfairness of which must be determined by national law, as could be seen from clause 1(q) of the Annex of the Unfair Terms Directive 93/13<sup>66</sup>—the consumer still cannot be drawn into arbitration against his will if this clause may be regarded as unfair. Annex 1 reads:

Terms that may be regarded as unfair . . .

(q) excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract.<sup>67</sup>

The unfairness may also be invoked against traditional principle of the law of arbitration on the *Kompetenz-Kompetenz* of the arbitrator and not the national court having jurisdiction to determine the unfairness.

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<sup>64</sup> Case C-168/05, E.M.M. Claro v. Centro Movil Milenium, 2006 E.C.R. I-10421.

<sup>65</sup> Hans-W. Micklitz & Norbert Reich, *The Court and the Sleeping Beauty – The Revival of the Unfair Contract Terms Directive (UCTD)*, 51 Common Mkt. L. Rev. 771 (2014).

<sup>66</sup> Council Directive 93/13, of 5 April 1993 on Unfair Terms in Consumer Contracts, 1993 O.J. (L 095) 29 (EC).

<sup>67</sup> *Id.*

In *Asturcom*, the CJEU quite adroitly used the principle of “equivalence” to guarantee a sort of “last resort” protection to the consumer: if national law allows the reopening of arbitration proceedings on the basis of public policy, the judge must consider the defenses available under E.U. consumer protection provisions which take the place of public policy.<sup>68</sup> Advocate General Trstenjak, who is in line with the Hungarian and the Spanish Governments<sup>69</sup> as well as the European Commission,<sup>70</sup> went even further in arguing that effective consumer protection requires the removal of *res judicata* in execution proceedings.<sup>71</sup>

The facts in *Claro* and *Asturcom* are somewhat different, as the consumer was drawn into arbitration proceedings by the trader that contained arbitration clauses. Directive 2013/11 expressly excludes this situation where the trader, not the consumer, takes his case to an entity that administers ADR. However, it seems that the principles developed in *Claro* and *Asturcom* can be generalized, especially concerning their challenges to the *Kompetenz-Kompetenz* doctrine.

Such a situation could arise under Directive 2013/11 where the consumer takes his complaint to a court of law, and the trader invokes the arbitration clause as a defense<sup>72</sup> to compel arbitration, provided the arbitration clause meets the requirements of Article 10 after the implementation of the Directive. The situation in *Asturcom* where a final arbitration award against a consumer can be challenged only under the limited requirements of the public policy (*ordre public*)

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<sup>68</sup> Case C-40/08, *Asturcom Telecomunicaciones v. Rodríguez Noguera*, 2009 E.C.R. I-9579. The extension of the public policy concept to “mere” mandatory law has remained controversial in doctrine. See the skeptical remarks by Vanessa Mak, *Harmonisation through “Directive Related” Case Law: the Role of the ECJ in the Development of European Consumer Law* 136-37 (Tilburg Inst. of Comparative & Transnational Law, Working Paper No. 2008/8, 2008); Mak, *supra* note 4, at 446. See also BÉLOHLÁVEK, *supra* note 4, at 32 (insisting on the difference between “public policy” and “public interest”: “consumer protection is associated with *public interest*; it is not subject to *public policy*). This distinction between public interest and public policy seems artificial and cannot be maintained under E.U. law autonomous interpretation principles.

<sup>69</sup> See Hungarian and Spanish Gov’t. Br. in *Asturcom* (on file with author).

<sup>70</sup> See European Com. Br. in *Asturcom* (on file with author).

<sup>71</sup> Advocate Gen. Trstenjak in *Asturcom*, *supra* note 4, at 58 et seq.

<sup>72</sup> “Schiedseinrede” in German. See Section XII, *infra*.

provision must be reshaped under the effectiveness test and not merely under the equivalence principle. This discussion illustrates that Directive 2013/11 does not address the real problems of consumer arbitration, and that the gaps left by E.U.-legislation must therefore be amended by recourse to general principles of E.U. law, namely the principle of effective legal protection.<sup>73</sup>

#### VI. WHAT ABOUT CONSUMER PROTECTION UNDER THE BRUSSELS MECHANISM OF JURISDICTION?

A consumer who wishes to have his claim against a trader located in another E.U. country arbitrated cannot rely on the jurisdiction of his home country, as would be the case under the Brussels regime. Directive 2013/11 does not contain rules on jurisdiction in cross-border conflicts, nor does it refer to the Brussels regime in a similar way as Art. 11 to the consumer protective provisions of Art. 6 of the Rome I-Regulation 593/2008 (see Section IX, *infra*).

Art. 7(1)(a) only requires ADR-entities to “make publicly available on their websites . . . clear and easily understandable information on . . . their contact details, including postal address and e-mail address.”<sup>74</sup> This provision—including the submission of claims online<sup>75</sup>—may be acceptable for optional complaint handling, but not for arbitration which may “impose solutions” to consumers. The impact of the risk to the consumer to lose his case is much more far-reaching because of the binding nature of the (non-)award by the arbitrator.

Article 15(1) lit c) of Regulation (EC) No. 44/2001 (Article 17(1) lit c) Regulation 1215/2012) provides that the consumer may sue the trader either at the trader’s place of domicile or at the business seat if “the contract has been concluded with a person who pursues commercial or professional activities in the Member State of the consumer’s domicile or, by any means, directs such activities to that

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<sup>73</sup> For further discussion of the principle of effective legal protection, see Section XI, *infra*.

<sup>74</sup> Council Directive 2013/11, art. 7(1)(a).

<sup>75</sup> Council Directive 2013/11, art. 5(2)(a).

Member State or several States including that Member State.”<sup>76</sup> There has been intense debate concerning this provision due to the issues raised by e-commerce, since the provision may be interpreted in such a way that the mere accessibility of the website of a company situated in one Member State by a consumer domiciled in another Member State may give such consumer the right to sue the company in the consumer’s domicile—a result which makes marketing by e-commerce subject to different and divergent jurisdictions. Therefore, the CJEU in *Pammer* distinguished between the mere accessibility of a website, which does not qualify as “directing activities,” and a non-exclusive list of criteria for determining “directing activities” where such a qualification is possible and must be established by competent national courts.<sup>77</sup> The trader may avoid being subject to multiple jurisdictions by making clear his intention to market his product or service only in certain countries to the exclusion of others, or by not making available his website in those excluded countries.

Jurisdiction clauses are regulated by Article 17 of Regulation 44/2001 resp. Article 19 of Regulation 1215/2012.<sup>78</sup> The rationale behind this provision is that such clauses in consumer contracts cannot be enforced before the litigation has commenced. A consumer does not lose privileged access to courts under Articles 15 and 16 by the jurisdiction clause.<sup>79</sup> This is in contrast to the general rule in Article 23 (Article 25 of Regulation 1215/2012), which allows jurisdiction clauses to be enforced if entered into in writing or by electronic means.<sup>80</sup> However, Article 23 is not applicable to consumer arbitration.

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<sup>76</sup> Council Regulation 44/2001, of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters art. 15(1)(c), 2000 O.J. (L 012) 1 (EC).

<sup>77</sup> Joined Cases C-585/08 and C-144/09, Peter Pammer et al. v. Reederei Karl Schlüter et al., 2010 E.C.R. I-12527; Eva-Maria Kieninger, *Grenzenloser Verbraucherschutz?*, in LIBER AMICORUM U. MAGNUS 449, 455 (2014) (interpreting “direct activities” as “activity directed at a certain objective” (“Zielgerichtete Tätigkeit”).

<sup>78</sup> Council Regulation 44/2001, of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, art. 17, 2001 O.J. (L 012) 1 (EC).

<sup>79</sup> *Id.* art. 15-16.

<sup>80</sup> *Id.* art. 23; see also Case C-322/14, Jaouad El Majdoub v CarsOnTheWeb.Deutschland GmbH, [2015] W.L.R.(D) 222.

The gap left by the—insufficient—provisions on consumer arbitration in Directive 2013/11 must be filled by reference to the general fairness standards as developed under Directive 93/13, which will be discussed in Section IX. In my opinion, no difference should be made whether the action is brought by the consumer or the trader, or whether the two are joined in a single case.

#### VII. THE “SPECIFIC ACCEPTANCE” OF THE ARBITRATION AGREEMENT BY THE CONSUMER

The most important provision for consumer protection in Directive 2013/11 follows the classical paradigm of the “informed EU consumer.”<sup>81</sup> Article 10 explicitly requires specific acceptance by the consumer for arbitration clauses in consumer to business (C2B) disputes, which may be extended by Member States both horizontally to a business to consumer (B2C) conflict and vertically by imposing additional requirements on this specific acceptance. Article 10 reads:

(1) Member States shall ensure that an agreement between a consumer and a trader to submit complaints to an ADR entity is not binding on the consumer if it was concluded before the dispute has materialised and if it has the effect of depriving the consumer of his right to bring an action before the courts for the settlement of the dispute.

Member States shall ensure that in ADR procedures which aim at resolving a dispute by imposing a solution the solution imposed may be binding on the parties only if they were informed of its binding nature in advance and specifically accepted this. Specific acceptance by the trader is not required if national rules provide that solution are binding on traders.<sup>82</sup>

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<sup>81</sup> See STEPHEN WEATHERILL, *EU CONSUMER LAW AND POLICY* 92 (2d ed. 2013); HANS W. MICKLITZ ET AL., *UNDERSTANDING EU CONSUMER LAW* ¶ 1.35 (2d ed. 2013).

<sup>82</sup> Directive 2013/11, art. 10.



It seems as though the intention of the E.U.-legislator was to exclude pre-dispute arbitration clauses, which are common in the U.S.<sup>83</sup> The wording of Art. 10(1) refers to a “dispute” having “materialised.”<sup>84</sup> Before that event, the clause would not be binding on the consumer. Can the same strict interpretation of this concept of non-binding be applied similar to Article 6 of the Unfair Terms in Consumer Contracts Directive (UTCC) 93/13 where, according to case law of the CJEU, the court must *ex officio* disapply the unfair contract term?<sup>85</sup> This will have to be decided by the CJEU, but such analogy seems reasonable given the similarity of the formulation in Article 6 of the UTCC and Directive 2013/11.

Under a strict literal construction of Article 10, there is no “dispute” to be resolved before the conclusion of a contract. This is only the case once consumer complaints arise during contract execution. Consumer arbitration clauses therefore only operate once a specific dispute has arisen between the trader and the consumer. Both parties may have good reasons to take their conflict to arbitration, e.g., because of the speed or lower costs of getting a (binding) decision, but the consumer should not be forced to do so before a “dispute has materialised.”<sup>86</sup>

What does “specific acceptance” mean? Recital 43<sup>87</sup> does not provide an answer. A similar provision, however, is contained in Article 8(2) of the Draft Regulation of a Common European Sales Law (CESL), which requires an “explicit statement which is separate from the statement indicating the agreement to conclude a contract.”<sup>88</sup> This statement may be concluded in electronic form, but the trader must notify the consumer of its binding nature on a durable medium, e.g., a

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<sup>83</sup> According to BĚLOHLÁVEK, *supra* note 4, at 385, this was not the case with EU law before Dir. 2013/11.

<sup>84</sup> Directive 2013/11, art. 10(1).

<sup>85</sup> See Micklitz & Reich, *supra* note 66 at 780.

<sup>86</sup> Directive 2013/11, art. 10(1).

<sup>87</sup> Recital 43 of the Preamble to Directive 2013/11.

<sup>88</sup> Commission Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law, COM (2011) 635 final, art. 8(2), (Oct. 22, 2011); Hans-W. Micklitz & Norbert Reich, *The Commission Proposal for a Regulation on a Common European Sales Law (CESL) – Too Broad or not Broad Enough?* 29 (LAW, EUI Working Papers No. 4, 2012).

mere hyperlink would not be enough.<sup>89</sup> On the other hand, the statement must be clearly separated from the contract terms, even if it is contained in a “term not . . . individually negotiated” according to Article 3(2) of Directive 93/13.<sup>90</sup> A mere button solution, or so called “click-wrap clauses,”<sup>91</sup> which are popular in U.S. licensing agreements, are not acceptable in E.U. law, which in Article 10(2) of Directive 2013/11 has set a minimum standard not to be undermined by Member States’ law.

“Specific acceptance” has imposed an E.U. standard, subject to CJEU’s interpretation. However, under *Guy Denuit*, an arbitration panel or ADR-entity authorized to “impose” solutions cannot make reference to the CJEU under Article 267 of the TFEU.<sup>92</sup> This paradoxical result warrants a critical assessment of the traditional rule of (commercial) arbitration that the arbitrator, not the court, has *Kompetenz-Kompetenz* concerning the validity of the arbitration agreement, at least in consumer matters, to be scrutinized under fundamental rights aspects later discussed in Section XII.

Since the requirements for “specific acceptance” in Article 3(2) of Directive 2013/11 are minimal, Member States can increase these requirements, e.g., by requiring written form or signature requirements, or can limit the scope of arbitration clauses, e.g., by prohibiting them for certain risky financial transactions<sup>93</sup> or imposing a financial cap on

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<sup>89</sup> Case C-49/11, *Content Services Ltd. v. Bundesarbeitskammer*, 2011 EUR-Lex CELEX LEXIS 660 (Feb. 3, 2011).

<sup>90</sup> Council Directive 93/13, of 5 April 1993 on Unfair Terms in Consumer Contracts, art. 3(2) 1993 O.J. (L 095) 29 (EC).

<sup>91</sup> Click-wrap clauses are defined as “another form of creating an electronic agreement, except that the license is included on the computer screen before installation rather than on the box. By clicking on a button that says “I agree” or “I accept,” the licensee agrees to the terms of use of the contract. An important difference between click-wrap agreements and shrink-wrap agreements is the fact that the user actually has an opportunity to read the contract before using or installing the program.” See Reich, *A ‘Trojan Horse’ in the access to Justice? – Party Autonomy and Consumer Arbitration in Conflict in the ADR-Directive 2013/11/EU? supra* note 1, and now Case C-322/14 *Jaoud El Majdoub v CarsOntheWeb.Deutschland GmbH*, [2015] W.L.R.(D) 222..

<sup>92</sup> Case C-125/04, *Guy Denuit et al v. Transorient voyages et Culture SA* 2005 E.C.R. I-925.

<sup>93</sup> This was done in Germany. See the discussion *infra* Section XII.

their use.<sup>94</sup> Member States can also introduce rules on territorial or local jurisdiction, which are not precluded by the Brussels regime not applicable to arbitration.

#### VIII. E.U. STANDARDS BEYOND “SPECIFIC ACCEPTANCE”

The above-mentioned *Claro* and *Asturcom* cases did not concern the validity of the arbitration agreement, but left this issue to applicable Member States. This will change once Directive 2013/11 is implemented by Member States into their national law, which should occur by July 9, 2015. Can E.U. unfair terms legislation be applied beyond the mere information model<sup>95</sup> of Directive 2013/11? Would a national court be required to control *ex officio* under the unfairness test arbitration clauses, which impose substantial inconveniences on the consumer since arbitration is likely to result in excessive costs or will force the consumer to take the case to an ADR-entity far away from his residence (similar to the *Bragg* case)? It is well-known that E.U. law is strict in banning jurisdiction clauses which force the consumer to take his case to a court away from his habitual residence resulting in a *de facto* denial of access to justice.<sup>96</sup> On the other hand, the trader may have an efficiency interest to concentrate arbitration proceedings at his place of business.

Article 3(1)<sup>97</sup> is not clear on how a possible relationship between Directive 2013/11 and Directive 93/13 can be reconciled. The provision is only concerned with “conflicts,” not with additional requirements imposed by national law under the minimum protection clause,<sup>98</sup> even if based on CJEU practice obliging Member States’ courts to control *ex officio* the fairness of pre-formulated contract terms. If the “specific acceptance” is contained in such a pre-formulated (yet separate) term, it is therefore subject to the *ex officio* control doctrine of the CJEU. Much will depend on the circumstances of the arbitration

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<sup>94</sup> This was done by the U.K. See the discussion *infra* Section XV.

<sup>95</sup> See Reich et al, *supra* note 65, ¶ 1.11.

<sup>96</sup> See Case C-137/08, VB Pénzügyi Lízing Zrt. V. Ferenc Schneider 2010 E.C.R. I-847; Wulf-Henning Roth, *Case 137/08 VB Pénzügyi Lízing Zrt v Ferenc Schneider*, 7 Eur. Rev. Contract L. 425 (2011); Micklitz & Reich, *supra* note 66, at 789.

<sup>97</sup> See Directive 2013/11.

<sup>98</sup> Council Directive 93/13, of 5 April 1993 on Unfair Terms in Consumer Contracts, art. 8 1993 O.J. (L 095) 29 (EC).

agreement. The main issue will always be whether the agreement makes the enforcement of consumer rights easier and less burdensome, which is the very objective of Directive 2013/11 under Article 1. In other words, the issue is whether such agreement puts additional constraints on the consumer's enforcement of his rights under E.U. and national law that contradict the fairness criteria of Article 3 of Directive 93/13. It cannot be presumed that Article 3(1) Directive 2013/11 intended to preclude the unfairness test as a general standard of E.U. civil law.

An open question remains as to how cross-border arbitration clauses can be controlled under the unfairness concept. As a general rule, arbitration is exempted from the applicability of Regulation 44/2001, Article 1(2) lit d). On the other hand, the effect of jurisdiction clauses in consumer contracts has been severely limited by the Regulation. Should these principles be applied per analogiam under the unfairness standard to arbitration clauses, which may have a similar effect on the consumer's right to have his case heard in his home jurisdiction if the conditions of Article 17 of Regulation 44/2001 (in the future: Article 19 Regulation 1215/2012) are met? There is indeed no reason to argue against such analogy because, for the consumer, it does not make any difference whether the denial of his home jurisdiction before litigation is effected through a jurisdiction or arbitration clause.<sup>99</sup> The exemption of arbitration from the scope of application of the Brussels instruments is intended to privilege commercial arbitration, but not to deprive the consumer of his right to a defense and a fair hearing. This reasoning limits the use of arbitration clauses in cross-border contracting.

#### IX. APPLICABLE LAW: (LIMITED) FREE CHOICE BY ARBITRATORS OR RESERVATION OF MANDATORY PROVISIONS?

Under traditional arbitration law, in particular in commercial matters, the parties are free to determine the applicable law, including commercial usages or principles of equity. Article 7(1)(i) of the Directive 2013/11 put this problem under the heading of "transparency" for all ADR entities, including consumer arbitration:

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<sup>99</sup> Reich, *More clarity after "Claro"?*, *supra* note 1, at 45.

Member States shall ensure that ADR entities make publicly available on their websites, on a durable medium . . . , and by any other means they consider appropriate, clear and easily understandable information on . . . the types of rules the ADR entity may use as a basis for the dispute resolution (for example legal provisions, considerations of equity, codes of conduct).<sup>100</sup>

In addition, Article 6(1)(a) provides that the arbitrator need not be a lawyer or a person trained in law, but should at least have a “general understanding of law.”<sup>101</sup> These are minimum standards, which can be enhanced by Member State laws on consumer arbitration, e.g., by restricting the reference to equity or codes of conduct or by demanding that arbitrators have legal training. The application of mandatory provisions of consumer law is regulated by provisions on “legality” in Article 11. Article 11 concerns two situations: (a) purely internal situations where mandatory consumer law provisions must be applied, even if parties expressly opted out in the contract; and (b) cross-border disputes where the rules on applicable law in Regulation 593/2008<sup>102</sup> are normally excluded for arbitration agreements. Article 11 (1)(a)-(b) provides:

Member States shall ensure that in ADR procedures which aim at resolving the dispute by imposing a solution on the consumer: (a) in a situation where there is no conflict of laws, the solution imposed shall not result in the consumer being deprived of the protection afforded to him by the provisions that cannot be derogated from by agreement by virtue of the law of the Member State where the consumer and the trader are habitually resident, (b) in a situation involving conflict of laws, where the law applicable to the sales or service contract is determined in accordance with Article 6(1) and (2) of Regulation (EC) No 593/2008, the solution imposed by the ADR entity shall not result

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<sup>100</sup> Directive 2013/11, art. 7(1)(i).

<sup>101</sup> *Id.* art. 6(1)(a).

<sup>102</sup> Commission Regulation 593/2008, 2008 O.J. (L 177) 6 (providing regulations on the law applicable to contractual obligations (Rome I)).

in the consumer being deprived of the protection afforded to him by the provisions that cannot be derogated from by agreement by virtue of the law of the Member State in which he is habitually resident.<sup>103</sup>

This provision will be welcomed by E.U. lawyers if compared with the traditional arbitration principles contained in U.S. law where the arbitrator can be exempted from applying mandatory provisions, and where legality control is only possible in final recognition proceedings under a narrow *ordre public* and related concepts.<sup>104</sup> Although the CJEU has tried to extend this concept to mandatory E.U. law both in commercial<sup>105</sup> and consumer<sup>106</sup> disputes, case law has remained unsettled and may not cover the entire scope of mandatory E.U. consumer law. It also comes late after the entire arbitration proceedings have been terminated, and it requires additional activity (and costs!) by the consumer.

In my opinion, the legality requirement of consumer arbitration can only be fulfilled if Member States grant a remedy to the consumer to challenge an incorrect application of mandatory provisions by the arbitrator. The following situations may arise:

- The consumer (or a group of consumers) brings a claim against the trader before a court of law, but the trader falsely invokes the arbitration agreement (the so-called *Schiedsseinrede*).
- The claim of the consumer is rejected (or reduced) by the arbitrator based on a false application of mandatory consumer law against Article 11 of Directive 2013/11; the consumer wants to challenge this rejection before a court of law, which may be impossible under existing arbitration legislation.

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<sup>103</sup> Citation to the quoted provision.

<sup>104</sup> See discussion of U.S. law *supra* Section I.

<sup>105</sup> See Case C-126/97, *Eco Swiss China Time Ltd. v. Benetton Int'l N.V.*, 1999 E.C.R. I-3055.

<sup>106</sup> See Case C-40/08, *Asturcom Telecomm. v. Rodríguez Noguera*, 2009 E.C.R. I-9579.

In practice, the most frequent situation is concerned with the trader—particularly in a long-term contract—using the arbitration mechanism to adjudicate his claims, as in *Claro* and *Asturcom*. These situations, however, are not covered by Directive 2013/11.

A fundamental rights analysis will help to resolve these situations to avoid the fact that arbitration clauses are sometimes abused, as in the U.S., by traders to restrict consumers' access to class claims for their individual claims. Section XI will provide a further discussion of the fundamental rights analysis.

#### X. “SOFT” LEGAL PROTECTION

Article 8 of Directive 2013/11 also contains some protective provisions. However, Article 8 does not have the force of law, and instead provides standards for good ADR practice subject to the monitoring and reporting requirements in Article 20:

the ADR procedure is free of charge or available at a nominal fee for consumers, lit (c); and

the outcome of the ADR procedure is made available within a period of ninety calendar days from the date of which the ADR entity received the complete complaint file. In the case of highly complex disputes, the ADR entity in charge may, at its own discretion, extend the ninety calendar day time period. The parties shall be informed of any extension of that period and of the expected length of time that will be needed for the conclusion of the dispute.<sup>107</sup>

These standards are standards flexible formulations applicable to consumer arbitration. Member States have discretion as to whether and how they implement them. Article 20 contains basic rules for sound ADR systems as an alternative to going to court and provide for inexpensive and quick adjudication. If practice in one Member State shows that this objective cannot be obtained by the existing consumer arbitration mechanism, it would be unfair to force the consumer to

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<sup>107</sup> Directive 2013/11, art. 20.

refer his claims to such arbitration even if the standards of “specific acceptance” under Article 10(2) of Directive 2013/11 are met. Of course, the requirements in Article 20 can be used as recommendations on how to interpret Member State law implementing E.U. law under the *Grimaldi* doctrine.<sup>108</sup>

XI. THE CONSTITUTIONAL DIMENSION: DIRECTIVE 2013/11  
ARTICLE 47 CHARTER

The constitutional dimension of ADR proceedings has been expressly included in Recital 61 of Directive 2013/11, which reads: “[t]his Directive respects fundamental rights and observes the principles recognised in particular by the Charter of Fundamental Rights of the European Union and specifically Articles 7, 8, 38 and 47 thereof.”

Recital 45 refers to Article 47 concerning access to courts of law—a principle reiterated in Article 12(1) of Directive 2013/11.<sup>109</sup> This conforms to *Alassini*, which concerns a requirement in Italian law for consumer complaints against telecommunication operators to first make use of ADR/ODR proceedings, as foreseen in Directive 2002/22,<sup>110</sup> before going to court.<sup>111</sup> The Court discussed this requirement, considering both the equivalence and the effectiveness principle, but did not find a violation of either principle. At the same time, the CJEU insisted on the consumer’s right to take his case to court:

Nor do the principles of equivalence and effectiveness or the principle of effective judicial protection preclude national legislation which imposes, in respect of such disputes, prior implementation of an out-of-court settlement procedure, provided that that procedure does not result in a decision which is binding on the parties, that it does not cause a substantial delay for the purposes of bringing legal

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<sup>108</sup> Case C-322/88, *Grimaldi v. Fonds des Maladies Professionnelles*, 1989 E.C.R. I-4497. This case involves the indirect relevance of Commission recommendations in interpreting E.U. or national law.

<sup>109</sup> *Id.* at recital 45, art. 12(1).

<sup>110</sup> Directive 2002/22, *Universal Service Directive*, 2002 O.J. (L 108) 51 (EC).

<sup>111</sup> Case C-317/08, *Alassini v. Telecom Italia*, 2009 E.C.R. I-2214.



proceedings, that it suspends the period for the time-barring of claims and that it does not give rise to costs – or gives rise to very low costs – for the parties, and only if electronic means is not the only means by which the settlement procedure may be accessed and interim measures are possible in exceptional cases where the urgency of the situation so requires.<sup>112</sup>

*Alassini* concerned ADR proceedings, which could only “propose,” not “impose,” solutions on the consumer. The wording of the decision, however, certainly shows hostility against ADR proceedings resulting in unreviewable and binding decisions. This wording—even though not discussed in detail in the judgment itself—is inconsistent with the traditional principles of arbitration under the New York Convention, namely that the arbitrator has the *Kompetenz-Kompetenz* to decide whether he has adjudicatory authority over the case, and that an award can usually only be refused recognition on the very narrow ground of “public policy (*ordre public*),” excluding the non-observance of mandatory rules of procedure or substantive consumer protection.

Can these traditional principles of arbitration law be upheld under the rules of consumer arbitration as provided by Directive 2013/11, particularly Articles 10 and 11? I do not think so. This directive is also concerned with a specific aspect of the constitutionalization of civil law, namely, the principle of effectiveness of Article 47 of the E.U. Charter, which provides: “[e]veryone whose rights and freedoms guaranteed by the law of the Union are violated has the right to an effective remedy before a tribunal in compliance with the conditions laid down in this Article.”<sup>113</sup>

Article 19(1) of the TEU puts the responsibility for “providing remedies sufficient to ensure effective legal protection in the fields covered by Union law” on Member States through the status of their courts of law as “Union courts.”<sup>114</sup> The agreement to arbitrate, as a private matter decided by parties, cannot waive the constitutional

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<sup>112</sup> *Id.* ¶ 67.

<sup>113</sup> Charter of Fundamental Rights of the European Union, art. 47, Dec. 18, 2000, 2000 O.J. (C 364) 1.

<sup>114</sup> Treaty on the European Union, Dec. 7, 2007, 2012 O.J. (C 326) 1 [hereinafter TEU].

requirements of effective legal protection by access to national courts of law. The remedies, which are provided indirectly by arbitration concerning the *Kompetenz-Kompetenz* of the arbitrator, do not suffice to fulfill these constitutional requirements of E.U. law. The consumer must always have the possibility to challenge a decision of the arbitrator even if he has in principle agreed to the arbitration proceedings by respecting Article 10(2) of Directive 2013/11 or an equivalent national provision. Agreement by “specific acceptance” does not mean a total preclusion of the right to effective legal protection, which the national judge must guarantee under the *ex-officio* doctrine. Under the “remedial function” of Article 47 of the E.U. Charter and Article 19(1)(2) of the TEU,<sup>115</sup> Member States must establish remedies protecting the legitimate interests of the consumer that ensure that the mandatory requirements of consumer arbitration are met.<sup>116</sup> The freedom of Member States to regulate consumer arbitration under Article 2(4) of Directive 2013/11 should be limited by the fundamental rights protected by E.U. law. Therefore, it is reasonable to conclude that:

- The validity of an arbitration agreement both from a formal and a substantive view is ultimately a matter to be decided by courts, not the arbitrator.
- In consumer arbitration, the *Kompetenz-Kompetenz* belongs to the competent court, not the arbitrator.
- Decisions of the arbitrator to reject or limit a claim of the consumer under Directive 2013/11 can be challenged before courts of law, in particular in case of breach or non-observance of mandatory provisions.
- The national judge hearing a case involving consumer arbitration must *ex officio* apply the mandatory provisions of E.U. and national law, even if not raised by the consumer.

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<sup>115</sup> See REICH, *supra* note 5, at 4-10.

<sup>116</sup> *Id.* (this seems to be recognized by the Court in *Claro* and *Asturcom*, even though not based on Article 47 of the E.U. Charter or Article 19 of the TEU, which were not in force at the time of decisions, but rather the traditional principles of effectiveness and equivalence).

- The scope of Article 47 of the E.U. Charter and Article 19(1)(2) of the TEU is not limited to arbitration under Directive 2013/11, but can be extended to any consumer arbitration, in particular in cases brought by the trader against the consumer before an arbitrator (B2C—the *Claro/Asturcom* situations).

## XII. IMPACT OF DIRECTIVE 2013/11 ON MEMBER STATE LAW ON CONSUMER ARBITRATION IN GERMANY

The German law on arbitration clauses in consumer contracts<sup>117</sup> begins with a “form model” of consumer protection.<sup>118</sup> Sections 1029 and 1031 of the *Zivilprozessordnung* (ZPO, Code on Civil Procedure), as amended in 1997, allow arbitration clauses if they have been documented sufficiently well. Arbitration agreements which involve consumers “must be contained in a document signed by the parties themselves.”<sup>119</sup> The signature of an agent is not enough.<sup>120</sup> The written form can be substituted by the electronic form according to Section 126a of the *Bürgerliches Gesetzbuch* (BGB, Civil Code), as amended.<sup>121</sup> The written or electronic document may not contain any other contractual clauses. Germany has not made any reservation under the New York Convention of 1958 to exclude consumer contracts. Therefore, the legal regime for arbitration in Germany is the

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<sup>117</sup> See generally CHRISTOPHER HODGES, IRIS BENÖHR & NAOMI CREUTZFELDT-BANDA, CONSUMER ADR IN EUROPE: CIVIL JUSTICE SYSTEMS 73 (2012) (explaining the German “arbitration” system, but is more concerned with conciliation and mediation (*Schlichtung* in German), not with binding arbitration as understood here); Norbert Reich, *Consumer ADR in Europe: Civil Justice Systems*, 50 Common Mkt. L. Rev. 913 (2013) (reviewing CHRISTOPHER HODGES, IRIS BENÖHR, & NAOMI CREUTZFELDT-BANDA, CONSUMER ADR IN EUROPE: CIVIL JUSTICE SYSTEMS (2012)).

<sup>118</sup> WEIHE, *supra* note 8, at 155-58.

<sup>119</sup> ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE], Jan. 30, 1877, REICHSGESETZBLATT [RGL.] 83, as amended, § 1031(5) (Ger.) [hereinafter ZPO].

<sup>120</sup> *Id.*

<sup>121</sup> BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, REICHSGESETZBLATT [RGL.] 195, as amended, § 126a (Ger.).

same whether or not a consumer is part of an arbitration agreement meeting the form requirements.<sup>122</sup>

The provision in Section 1031(5) of the ZPO is similar to Article 10(2) of Directive 2013/11,<sup>123</sup> although the latter does not require signature or an electronic equivalent. However, Article 2(3) of Directive 2013/11 allows Member States to impose more stringent provisions on consumer arbitration,<sup>124</sup> including a requirement that the document should only contain clauses concerning the arbitration agreement as such. German law does not use the term “specific acceptance,” but it seems that this is exactly what is meant by the German legislature in an E.U.-conforming interpretation. It is obvious that the arbitration agreement must be separated from other contract clauses; however, there is no prior notification requirement which must be included in the arbitration document.

Concerning the *Kompetenz-Kompetenz* of the arbitrator, German law contains a compromise solution somewhat different from Directive 2013/11. Under Section 1032(1) of the ZPO, the arbitration agreement precludes any action before a court of law (*Schiedseinrede* in German), unless it is “void, ineffective or inoperative” (*nichtig, unwirksam oder undurchführbar*).<sup>125</sup> However, this “*Schiedseinrede*” must be expressly raised by the defendant before oral proceedings in court. This provision is not in line with the case law of the CJEU, which requires an *ex officio* intervention of the court who does not have to wait for an action of the consumer.<sup>126</sup>

On the other hand, Section 37h of the WpHG (*Wertpapierhandelsgesetz*, law on securities transactions), as amended, restricts arbitration clauses concluded before litigation to persons acting in commerce (“*Kaufleute*”) and legal persons of public law, thus excluding consumer transactions in investment services from

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<sup>122</sup> Jürgen Samtleben, *Zur Wirksamkeit von Schiedsklauseln bei grenzüberschreitenden Börsentermingeschäften*, ZEITSCHRIFT FÜR EUROPÄISCHES PRIVATRECHT [ZEUP] 974, 975 (1999) (Ger.).

<sup>123</sup> ZPO, § 1031(5).

<sup>124</sup> Directive 2013/11, art. 2(3).

<sup>125</sup> ZPO, ¶ 1032(1).

<sup>126</sup> REICH, *supra* note 5, ¶¶ 4, 16.

arbitration clauses.<sup>127</sup> Its legislative rationale is controversial<sup>128</sup> and beyond the scope of this paper. According to an earlier opinion of Samtleben,<sup>129</sup> the WpHG's international sphere of application is determined by the normal place of residence of the private investor. If the place of residence is Germany, the arbitration clause is not effective, and the consumer will be able to take his claim to the courts of his country of residence according to Articles 15 and 16 of Regulation 44/2001 (Article 17 and 18 of Regulation 1215/2012). The arbitration clause prohibition contained in Section 37h of the WpHG is consistent with the general power of Member States to regulate consumer arbitration in Article 2(4) of Directive 2013/11, including prohibiting it with regard to certain transactions (investment services). This prohibition is also enforceable against a foreign arbitration agreement, which need not be respected by the German *judex a quo* under the provision concerning the application of "overriding mandatory provisions" under Article 9 of Rome I-Reg.<sup>130</sup>

This rather liberal and generous approach to arbitration clauses in consumer contracts (with the exception of investment services) taken by the ZPO was confirmed by the German Bundesgerichtshof (BGH) with regard to the admissibility arbitration clauses under the special legislation on unfair contract terms, now included in the

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<sup>127</sup> Wertpapierhandelsgesetz [WpHG] [Law on Securities Transactions], Sep. 9, 1998, REICHSGESETZBLATT [RGLB.] 1842, as amended, § 37h (Ger.).

<sup>128</sup> For different views on German legal literature, see Rolf Sethe, § 37h WpHG (*Schiedsabreden*), in WERTPAPIERHANDELSGESETZ (WPHG) ¶ 7, (Heinz-Dieter Assmann & Uwe H.Schneider eds., 6th ed. 2012) (examining "excessive investor protection"); Rainer Hausmann, *Schiedsvereinbarungen*, in INTERNATIONALES VERTRAGSRECHT ¶ 3469 (Christoph Reithmann & Dieter Martiny eds., 7th Ed. 2014); Jürgen Samtleben, *Das Börsentermingeschäft ist tot – es lebe das Finanztermingeschäft?*, 15 Zeitschrift für Bank- und Börsenrecht 69, 76 (2003) (taking a more neutral approach). Compare WEIHE, *supra* note 8, at 141 (arguing that § 37h WpHG expresses a general principle of consumer protection), with Klaus Peter Berger, *Schiedsgerichtsbarkeit und Finanztermingeschäfte – Der "Schutz" der Anleger vor der Schiedsgerichtsbarkeit durch § 37h WpHG*, 15 Zeitschrift für Bank- und Börsenrecht 77, 85 (2003) (taking a more liberal approach). The author agrees with Weihe because of the particular risks of transactions for the consumer covered by this provision, which may not be adequately addressed by the arbitrator.

<sup>129</sup> WEIHE, *supra* note 8, at 77.

<sup>130</sup> See generally Case C-184/12, *United Antwerp Maritime Agencies (Unamar) NV v. Navigation Maritime Bulgare*, 2013 EUR-Lex CELEX Lexis 4306 (Oct. 17, 2013) (interpreting Rome I-Reg).

BGB.<sup>131</sup> According to the BGH, an arbitration clause cannot impose an unfair disadvantage on the consumer.<sup>132</sup> The consumer is protected by the form requirement of Section 1031(5) of the ZPO, which should warn him against the risk of an arbitration clause.<sup>133</sup> It is, in the opinion of the BGH, not necessary that the user of the arbitration clause shows a special interest in it. Unlike jurisdiction clauses, arbitration clauses in consumer contracts may be concluded before the dispute arises. The BGH also refers to Point 1(q) of the indicative list of the Annex of Directive 93/13,<sup>134</sup> where arbitration clauses are only condemned if they concern disputes taken to arbitration “not covered by legal provisions;” the rules of the ZPO, in the opinion of the BGH, must be regarded as such provisions.<sup>135</sup> The BGH also insists that the arbitration clause regulates access to arbitration in a fair and impartial manner.<sup>136</sup>

Even if in the case before the BGH the arbitration clause may not have been unfair (the litigation concerned disputes involving losses out of a speculative investment scheme of about 125.000 euro), the judgment should not be generalized as allowing arbitration clauses in any type of consumer dispute if the mere form requirements of Section 1031(5) of the ZPO are met. This is particularly true if the costs of arbitration are substantial in relation to the sum in litigation and amount to a de facto denial of justice. The same is true with regard to the choice of the arbitrator, which gives an unfair advantage to one party against the consumer.<sup>137</sup> These questions will now have to be measured against the requirements set up in Articles 10 and 11 of Directive 2013/11 in the interpretation advanced in this paper (*supra* VII/VIII). The BGH may have to reconsider its liberal opinion towards arbitration clauses in future cases.

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<sup>131</sup> Bundesgerichtshof [BGH] [Federal Court of Justice], Jan. 10, 2005, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1125, 2005 (Ger.); WEIHE, *supra* note 8, at 278.

<sup>132</sup> *See id.*

<sup>133</sup> WEIHE, *supra* note 8, at 187 (regarding existing German practices).

<sup>134</sup> *Id.* at 1127.

<sup>135</sup> *Id.* at 1127.

<sup>136</sup> *Id.*

<sup>137</sup> Oberlandesgericht Düsseldorf (OLGDü) [Higher Regional Court of Düsseldorf] June 1, 1995, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 400, 1996 (Ger.).

## XIII. THE SPANISH APPROACH

As Claro shows, arbitration clauses in consumer contracts may be declared void by Member States according to the so-called indicative list,<sup>138</sup> even though there is no formal obligation to do so.<sup>139</sup> This has been done in Spain. However, arbitration clauses in pre-formulated consumer contracts are always possible where the dispute is referred to “arbitration bodies established by statutory provision in respect of a specific sector or circumstances.”<sup>140</sup> Spanish Law has established a “Sistema Arbitral de Consumo” in Article 31 of the Consumer Protection Law of 1984, implemented by the Real Decreto 636/1993, modified by Decreto 60/2003.<sup>141</sup> It provides for arbitration panels (colegio arbitral) to be established by national and regional “Juntas Arbitrales de Consumo.”<sup>142</sup> These panels are composed of a President (representing the competent administration), a consumer representative, and a business association representative. Hence, Spanish law prioritizes certain recognized consumer arbitration bodies<sup>143</sup> to which the arbitrator “agreed to” by Ms. Claro in her dispute with a mobile telephone company did not belong.

The Spanish system was modified by Real Decreto 231/2008, which defines the functions, composition, competences, and procedures of consumer arbitration boards.<sup>144</sup> The use of the arbitration system is voluntary for the parties. First, an arbitration

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<sup>138</sup> Council Directive 93/13, of 5 April 1993 on Unfair Terms in Consumer Contracts, Annex 1 lit. q, 1993 O.J. (L 095) 29 (EC).

<sup>139</sup> See Case C-478/99, *Comm’n v. Sweden* 2002 E.C.R. I-4147 ¶ 20.

<sup>140</sup> See Case C-184/12, *United Antwerp Maritime Agencies (Unamar) NV v. Navigation Maritime Bulgare*, 2013 EUR-Lex CELEX LEXIS 4306 (Oct. 17, 2013).

<sup>141</sup> See MANUEL-ANGEL LOPEZ SANCHEZ ET AL., *SERVICIOS FINANCIEROS, PROTECCION DEL CONSUMIDOR Y SISTEMAS EXTRAJUDICIALES DE RESOLUCION DE CONFLICTOS IN ESPAÑA* 119-170 (1995); see also WEIHE, *supra* note 8, at 119; Cavier Favre-Bulle, *Arbitrage et règlement alternatif des litiges (ADR): une autre justice pour les consommateurs?*, in *DROIT DE LA CONSOMMATION*, LIBER AMICORUM BERND STAUDER 95, 113 (2006).

<sup>142</sup> LOPEZ-SANCHEZ, *supra* note 142, at 142-48.

<sup>143</sup> See Ewoud Hondius, *Towards a European Small Claims Procedure?*, in *LIBER AMICORUM BERND STAUDER*, 135 fn 36 (Luc Thévenoz & Norbert Reich, eds. 2006).

<sup>144</sup> HODGES ET AL., *supra* note 118, at 213.

request form must be filled out by a consumer, his lawyer, or a consumer association. This form requirement conforms to Article 10(2) of Directive 2013/11. Usually the arbitration board correlates to the consumer's residence. The use of arbitration is free of charge for both consumers and businesses, with the exception of discovery, and procedures usually do not take longer than six months. As with a court judgment, the parties can appeal an arbitration decision within two months. In addition, appeals can be brought based on decisions by the Junta Arbitral del Consumo to accept or reject requests for arbitration of consumer disputes. As an overall principle, Spanish law does not recognize the *Kompetenz-Kompetenz* of the arbitrator, and therefore is consistent with the approach advanced in this paper based on Article 47 of the E.U. Charter and Article 19 of the TEU.

The Spanish consumer arbitration system has created a second tier of legal protection for consumers and is similar to a court system, including the necessary guarantees of legality and effective legal protection. It could serve as a model for other E.U. countries wanting to implement the consumer arbitration provisions of Directive 2013/11 in a way suggested in this paper.

#### XIV. A REGULATED APPROACH: FRANCE

According to French law, an arbitration clause (*clause compromissoire*) in a consumer contract is invalid and cannot be enforced against the consumer. This is derived from Article 2061 of the French Civil Code, modified by Law of 15.5.2001, whereby “la clause compromissoire est valable dans les contrats conclus à raison d’une activité professionnelle.”<sup>145</sup> However, in cross-border transactions Article 2061 is not applicable, so the French Cour de Cassation<sup>146</sup> has taken a more liberal approach. French scholars criticize this approach as “paradoxale” because the consumer enjoys less protection in cross-border relations even though such relations are more dangerous. French scholars also refer to legislation on unfair contract terms,

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<sup>145</sup> HENRI TEMPLE & JEAN CALAIS-AULOY, DROIT DE LA CONSOMMATION ¶ 497 (9th ed., 2015) (“the arbitration clause is valid in a contract concluded because of a professional activity”).

<sup>146</sup> Cour de cassation [Cass.] [supreme court for judicial matters] 1e civ., Jan. 5, 1999, Bull. Civ. I, no. 31 (Fr.).



namely to the above mentioned Point 1(q) of the indicative list of the Annex of Directive 93/13; this is interpreted as a blacklist, even though the French legislature formally did not go so far.<sup>147</sup> This argument, however, was not considered by the ECJ in *Claro*.<sup>148</sup>

It unclear whether and how French law will be modified in implementing Directive 2013/11. However, the prohibition of the arbitration clause in B2C contracts can be maintained according to Article 2(4) of Directive. 2013/11 since “[t]his Directive acknowledges the competence of Member States to determine whether ADR entities established on their territories are to have the power to impose a solution.”

#### XV. A COMPROMISE: U.K. LAW

U.K. law takes a nuanced approach to arbitration clauses in consumer contracts. The Arbitration Acts of 1996 permit only a limited right of appeal from an arbitrator’s decision to courts of law.<sup>149</sup> In particular, clauses binding consumers in advance to arbitration for sums less than £5,000 are not allowed.<sup>150</sup> The original provision under the Consumer Arbitration Agreements Act of 1988 exempted “non domestic arbitration agreements” from the requirements of this rule; however, the Court of Appeal extended it to consumers from other E.C. countries to avoid a discrimination based on nationality.<sup>151</sup>

Arbitration has been frequently included in Codes of Practice as a low cost dispute resolution scheme, but abuses of arbitration led to the 1996 Spanish arbitration law amendments, which imposed a cap on pre-formulated arbitration clauses. Therefore, ombudsmen

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<sup>147</sup> TEMPLE & CALAIS-AULOY, *supra* note 146, at 72.

<sup>148</sup> See generally Reich, *More clarity after “Claro”?*, *supra* note 1.

<sup>149</sup> GERAINT G. HOWELLS & STEPHEN WEATHERILL, CONSUMER PROTECTION LAW ¶ 14.7.1 (2d ed. 2005).

<sup>150</sup> *Id.* ¶ 13.9.5.2. (iv).

<sup>151</sup> Norbert Reich, *Zur Wirksamkeit von Schiedsklauseln bei grenzüberschreitenden Börsentermingeschäften*, ZEITSCHRIFT FÜR EUROPÄISCHES PRIVATRECHT [ZEUP] 981, ¶ 14.6 (1998) (Ger.).

schemes<sup>152</sup> are preferred because they are binding only on businesses and not on consumers.<sup>153</sup>

The Association of British Travel Agents (ABTA) has initiated a separate arbitration scheme,<sup>154</sup> which is administered by CEDR-solve.<sup>155</sup> The arbitrator's award is issued in writing and provides a summary of the facts, conclusions, and reasons for the decision. The arbitrator's decision is legally binding on both parties and is enforceable directly through the courts. Any party can ask for a review of the arbitrator's decision, on paying a non-reimbursable £ 350 review fee, although there are limited grounds on which this can be challenged.<sup>156</sup>

#### XVI. STATE MONITORED ADR SYSTEMS WITHOUT BINDING ARBITRATION: SCANDINAVIAN COUNTRIES

Most Scandinavian countries have taken a specific approach concerning the handling of consumer disputes, namely, by instituting state complaint boards in which business and consumer associations participate. This makes arbitration an out-of-court instrument of dispute settlement more or less superfluous.

The institution of the Danish consumer complaint boards<sup>157</sup> may serve as a model. Article 8(3) of the Danish *Lov om Forbrugerklagenævnet* of 1974/1988<sup>158</sup> provides for a priority of proceedings before the complaint board—even if the matter is already in arbitration—if the consumer wants to take his complaint before the board. The consumer can take his complaint before the board at any

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<sup>152</sup> An ombudsman scheme is a voluntary ADR system set up by the industry and approved by the government.

<sup>153</sup> Howells & Weatherill, *supra* note 150, ¶ 14.6.

<sup>154</sup> See HODGES ET AL., *supra* note 118, at 328.

<sup>155</sup> *Dispute Resolution Services*, CEDR, <http://www.cedr.com/solve/dispute-resolution-services/> (last visited Dec. 6, 2015).

<sup>156</sup> HODGES ET AL., *supra* note 118, at 331.

<sup>157</sup> Danish consumer complaint boards have been analyzed in detail by Jens M. Scherpe, *Außergerichtliche Streitbeilegung*, in VERBRAUCHERSACHEN (2002); the German translation of the law is at pages 285-289.

<sup>158</sup> Art. 8(3) Lov om Forbrugerklagenævnet (Lovebeholdtgoerelse Nr. 282 of 10.5.1988) (Den.).

time during the complaint proceedings; there is no time limit or other formal requirement. In this case, the arbitration proceedings will be staid until the board has handled the matter. This rule implies that arbitration clauses in consumer contracts are not void as such, but also do not preempt proceedings before the complaint board and thus avoid the limited remedies for the consumer against arbitration clauses in the above-mentioned “Einredesituation” under Article II(3) of the New York Convention of 1958 as a defense against an arbitration clause.

A similar situation in Sweden concerning the *Allmänna Reklamationsnämnden* (ARM) has been described in some detail in a study by this author on financial regulation in the E.U.<sup>159</sup> As a result of the procedure, the ARM issues a written proposal for the settlement (*beslut*), which in most cases will be accepted by the parties. If the parties do not agree, they can take the case to court.

The Scandinavian system is said to work well both in the interests of consumers and of business. It avoids lengthy court proceedings and reaches a high rate of successful settlements.

#### XVII. A SEEMINGLY UNKNOWN EXPERIENCE: POLAND

Poland has established—mostly before becoming member of the E.U. in 2004—a detailed arbitration system. Nevertheless, if we consider a recent paper of Polish scholar Kinga Flaga-Gieruszynska, “the awareness of [the arbitration system’s] existence still reaches very few consumers.”<sup>160</sup> There is a general scheme that “imposes” solutions upon traders and consumers alike. This scheme, which is administered by the State Trade Inspection, which has general jurisdiction in all consumer matters except those which are specifically excluded and must be submitted to specialized institutions. These excluded consumer matters are:

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<sup>159</sup> INSTITUTIONELLE FINANZMARKTAUFSICHT UND VERBRAUCHERSCHUTZ (INSTITUTIONAL SUPERVISION OF FINANCIAL MARKETS AND CONSUMER PROTECTION) 165 (Keßler, Micklitz, Reich eds. 2010).

<sup>160</sup> Kinga Flaga-Gieruszynska, *The Model of Consumer Arbitration Courts in Poland*, INT. J. ON CONSUMER L. & PRAC., 28, 39 (2013).

- Permanent arbitration courts with the President of the Office of Electronic Communications concerning claims against telecom and postal operators.
- The Arbitration Court at the Insurance Ombudsman handling disputes concerning insurance contracts and occupational pension schemes.
- Consumer Banking Arbitration at the Polish Banking Association (the Banking Arbitrator) whose decisions are binding on banks, but not on consumers.

There is no obligation for consumers to take their disputes to arbitration, unless a binding agreement has been concluded. This is determined by the general provisions of the Polish Civil Code (Article 385(1), which has implemented the E.U. Directive 93/13 on Unfair Terms in Consumer Contracts.<sup>161</sup> As Flaga-Gieruszynska writes:

Thus, the status of consumer arbitration courts is determined on the one hand by the decision making act of a public authority . . . which is a unique situation with regard to arbitration, and on the other hand—the act of will of the parties, which is the foundation of the creation of arbitration courts (the arbitration clause). Without the latter, it is impossible to speak of the existence of forms of dispute resolution of a voluntary nature.<sup>162</sup>

#### CONCLUSIONS

Arbitration clauses in consumer contracts have been subject to controversy in many jurisdictions. U.S. law has strongly favored arbitration clauses in consumer contracts. Even among law and economics scholars there is no disagreement that “indeed arbitration restricts access to lawsuits and recovery”. This is justified by law and economics scholarship because “it removes the disproportionate benefit (to the ‘sophisticated elite’) and thus eliminates a regressive

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<sup>161</sup> *Id.* at 30.

<sup>162</sup> *Id.* at 31.

cross-subsidy.”<sup>163</sup> It remains however an open question whether this supposed redistributive effect suffices to impose binding arbitration clauses on consumers. In my opinion this is not the case because denial of individual access to justice cannot be justified by overall efficiency arguments.

As the overview of the law on consumer arbitration clauses in some (not all!) E.U. Member countries has shown, the situation is quite different; one may call it even rather “chaotic”. It ranges from a simple prohibition of such clauses (France) to their permission under certain procedural (Germany, Spain, Poland) or substantive limitations (UK), to state monitored ADR systems (Scandinavian countries) which are not formally binding on the consumer but have similar effects in practice.

Directive 2013/11, if implemented by Member State legislation before 9 July 2015 (which does not seem to be the case anyhow!), has not brought about any consistent E.U. practice, unlike the U.S. Federal Arbitration Act. Following a more “access to justice” approach, E.U. law has taken a mixed and to some extent limited approach in including ADR entities that “impose” a solution in its recent ADR Directive 2013/11. There seems to be an indirect encouragement to develop consumer arbitration schemes in Member States as a second route of access to justice. It is too early to evaluate this new and somewhat clandestine policy of the E.U.

This paper therefore has insisted on some additional procedural guarantees should consumer arbitration schemes become more popular among E.U. Member countries, even though Directive 2013/11 already contains some “minimum protection” provisions on “specific acceptance” and applicable law. The basic reference for such additional protection seems to be Article 47 of the E.U. Charter of Fundamental Rights in conjunction with Article 19(1) paragraph 2 of the TEU whereby Member States must “provide remedies sufficient to ensure effective legal protection” of E.U. consumers.<sup>164</sup> At the time of writing, Member States must wait to implement measures

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<sup>163</sup> Omri Ben-Shahar, *Arbitration and Access to Court: Economic Analysis*, in REGULATORY COMPETITION IN CONTRACT LAW AND DISPUTE RESOLUTION 447, 458 (Horst Eidenmüller ed., 2013).

<sup>164</sup> TEU, art. 19(1) ¶ 2.

concerning Directive 2013/11 and to make any final judgments as to their E.U.-law conformity and efficiency. This paper sought to provide some guidelines for this upcoming debate.

**THE ROLE OF PARTY AUTONOMY IN  
THE ENFORCEMENT OF SECURED  
CREDITOR'S RIGHTS: INTERNATIONAL  
DEVELOPMENTS**

*Anna Veneziano\**

INTRODUCTION

The need to provide sound and clear rules regarding the enforcement of a secured creditor's rights upon the debtor's default is expressly recognized in the most recent international instruments dealing with secured transactions. Such instruments all contain a well-developed and specific regulation of enforcement measures, applicable (also) outside insolvency proceedings. While additional steps may be required to exercise said rights when qualified third parties are involved (e.g., perfection requirements), or other rules may have to be applied to determine the outcome of conflicts among holders of conflicting proprietary interests on the same collateral, the existence of a security agreement is generally sufficient to trigger the application of the rules on enforcement.

In this paper, I will look at uniform law texts regarding this topic, with a view to assess whether it is possible to detect common directions and to understand the reasons for any divergent approach. The term 'uniform law' is used here to refer to a variety of instruments, be they hard law or soft law as well as global or regional. In particular, I will focus on three well-known examples that are representative of

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\* The Author is Professor of Comparative Law at the University of Teramo (Italy) and Professor of European Property Law at the University of Amsterdam. She is currently serving as Deputy Secretary-General of the International Institute for the Unification of Private Law (UNIDROIT). The opinions expressed in the present paper do not purport to reflect an official position of UNIDROIT.

such a variety: (a) the Cape Town Convention on International Interests in Mobile Equipment<sup>1</sup> and its Aircraft Protocol<sup>2</sup> (as an example of a highly successful<sup>3</sup> hard law text with global application but in a very specialized sector,<sup>4</sup> which creates an autonomous international interest recognized and enforceable in contracting States);<sup>5</sup> (b) the UNCITRAL Legislative Guide on Secured

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<sup>1</sup> Convention on International Interests in Mobile Equipment, Nov. 16, 2001, 2307 U.N.T.S. 285 [hereinafter Cape Town Convention]. The text of the Convention in English is available at <http://www.unidroit.org/instruments/security-interests/cape-town-convention>.

<sup>2</sup> Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Nov. 16, 2001), available in English at <http://www.unidroit.org/english/conventions/c-main.htm> [hereinafter Aircraft Protocol]

<sup>3</sup> Until now as many as sixty-nine States around the world have ratified or otherwise acceded to the Cape Town Convention, while sixty-one States have adhered to the Aircraft Protocol (the Protocol entered into force in 2006). UNIDROIT, *Status - Convention on International Interests in Mobile Equipment (Cape Town, 2001)* (December 3, 2015), <http://www.unidroit.org/status-2001capetown>; UNIDROIT, *Status - Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (December 3, 2015), <http://www.unidroit.org/status-2001capetown-aircraft>. The European Union has also acceded to the Convention and the Aircraft Protocol as a Regional Economic Integration Organization, thus permitting (but not imposing) ratification by Member States. See ROY GOODE, CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND PROTOCOL THERETO ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT, OFFICIAL COMMENTARY 142 et seq. (3d ed. UNIDROIT, 2013). Furthermore, the International Registry for Aircraft Equipment (operated under the supervision of International Civil Aviation Organization (ICAO) by Aviareto has reached more than 500,000 entries since its establishment in 2006. SITA, *Aircraft Equipment Registry Passes Half Million Milestone* (Oct. 9, 2014), <http://www.sita.aero/content/Aircraft-equipment-registry-passes-half-million-milestone>.

<sup>4</sup> Two additional Protocols to the Cape Town Convention, the 2007 Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock (Rail Protocol) and the 2012 Protocol on Matters Specific to Space Assets (Space Protocol) were approved but have not yet entered into force.

<sup>5</sup> The Cape Town Convention and the Aircraft Protocol were jointly approved by UNIDROIT and ICAO on the basis of a project drafted within UNIDROIT. See GOODE, *supra* note 3, at 13 et seq. (describing the nature and purpose of the Convention system).



Transactions<sup>6</sup> (as an example of a policy-oriented soft law instrument with global scope of application, primarily addressed to national legislators considering a reform of their general domestic secured transaction laws);<sup>7</sup> (c) Book IX of the Draft Common Frame of Reference on a European Private Law (DCFR)<sup>8</sup> (as an example of a regional soft law instrument on secured transactions in general, developed within the DCFR European academic project, which creates an autonomous European security right with cross-border enforceability).<sup>9</sup>

There are other examples of uniform law texts concerning secured transactions that emphasize the importance of enforcement measures, but they will not be specifically analyzed here.<sup>10</sup>

## I. COMMON TRENDS IN THE RULES ON ENFORCEMENT OF

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<sup>6</sup> U.N. COMM. ON INT'L TRADE LAW, UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS, U.N. Sales No. E.09.V.12 (2010) [hereinafter UNCITRAL Legislative Guide].

<sup>7</sup> On the nature and purpose of the UNCITRAL Legislative Guide, see Spiradon V. Bazinas, *The utility and efficacy of the UNCITRAL Legislative Guide on Secured Transactions*, in AVAILABILITY OF CREDIT AND SECURED TRANSACTIONS IN A TIME OF CRISIS 133 et seq. (Orkun Akseli ed., 2012).

<sup>8</sup> *Book IX - Proprietary Security in Movable Assets*, in PRINCIPLES, DEFINITIONS AND MODEL RULES OF EUROPEAN PRIVATE LAW: DRAFT COMMON FRAME OF REFERENCE (DCFR), 5389 et seq. (Christian von Bar et al., eds. 2009) [hereinafter Book IX DCFR]. Book IX DCFR was prepared by a team led by U. Drobnig and was subsequently approved within the DCFR project by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group).

<sup>9</sup> On the nature and purpose of the DCFR, see *Introduction*, in PRINCIPLES, DEFINITIONS AND MODEL RULES OF EUROPEAN PRIVATE LAW, DRAFT COMMON FRAME OF REFERENCE (DCFR), 1 et seq. (Christian von Bar et al., eds. 2009).

<sup>10</sup> For an additional example, see the Model Law on Secured Transactions (1994 and 2004) of the European Bank for Reconstruction and Development (EBRD), which provides a basic framework for domestic legal reform tailored to transition economies: "The Model allows the person taking security to enforce the charge immediately after a failure to pay the secured debt. . . It is vital that appropriate provisions on enforcement be included. Without a clear right to enforce, the charge-holder is deprived of his remedy and a charge becomes valueless." MODEL LAW ON SECURED TRANSACTIONS: PART IV – ENFORCEMENT AND TERMINATION, EBRD, at art. 22-30 (1994, 2004) [hereinafter EBRD Model Law].

## SECURED CREDITORS' RIGHTS

Not surprisingly, due to the different nature, purpose, and particularly the different scope of application of the international instruments that are considered, the legal regime of enforcement that they provide cannot be the same. I believe, however, that it is possible to find a number of elements that are common and point to a convergence in the international approach to the topic. In line with the general theme of the International Academy of Commercial and Consumer Law (IACCL) conference, the analysis will center on the role played by party autonomy and the mechanisms used to control it. Thus, I will not offer a systematic description of the respective legal regimes of enforcement, but will specifically focus on examples of common trends (and any divergences) that relate to the scope of parties' self-regulation and its limitations.

By way of a more general observation, each of the above-mentioned texts begins with the assumption that clear and predictable rules regarding secured creditors' enforcement rights are advantageous for all parties involved, and that an easy, less costly, and speedy implementation of such rights is a key element for a well-functioning secured transactions system.<sup>11</sup> It may facilitate (cross-border) financing with better conditions, since the likelihood of obtaining recovery in case of default may well be one of the factors influencing creditor's decisions in this respect. Furthermore, the backdrop of an efficient, rapid, and cost-effective system of recovery will also be important to shape parties' willingness to avoid formal insolvency proceedings through cooperation by entering into out-of-court arrangements

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<sup>11</sup> "The availability of adequate and readily enforceable default remedies is of crucial importance to the creditor, who must be able to predict with confidence its ability to exercise a default remedy expeditiously." GOODE, *supra* note 3, at 58. Similarly, the efficient enforcement of secured creditors' rights is listed among the key objectives of a modern secured transactions regime in the UNCITRAL Legislative Guide: "A security right will . . . have little value to a secured creditor unless it can be enforced effectively and efficiently. A modern secured transactions regime will include procedures that precisely describe the rights and obligations of grantors and secured creditors upon enforcement." UNCITRAL Legislative Guide, *supra* note 6, at § 56. The need for speedy and cost-effective enforcement is also the underpinning principle of Chapter 7 of Book IX DCFR and its preference towards extra-judicial enforcement. Book IX DCFR, *supra* note 8, at 5618.

(which are often considered an advantageous alternative, especially in the case of cross-border transactions).

The enhancement of parties' self-regulation is one of the mechanisms that is put into place to achieve the result of ensuring a rapid and less costly enforcement of creditors' rights. Strengthening the role of parties' autonomy is indeed one of the most evident traits in all three instruments that are considered here. At the same time, there is still the need to find a good balance between party autonomy on the one hand, and the protection of various interests, those of the debtor but also of third parties, on the other hand. It is in the balance of such different interests that the three instruments diverge, which in my view (at least partly) is justified in light of the difference in their respective scope of application.

#### A. The Enhancement of Party Autonomy and its Role(s)

Parties' self-regulation is reinforced by limiting the impact of mandatory formal proceedings (such as the need for a court decision before enforcement or the imposition of a formal procedure like a public sale). Thus, all three instruments favor extra-judicial enforcement, which is considered an option that should always be available to the creditor<sup>12</sup> if agreed upon in the contract or at some other point in time,<sup>13</sup> or unless otherwise provided by the parties.<sup>14</sup> Moreover, the creditor, if all required conditions are met, can exercise a wide array of out-of-court measures, including using the value of the collateral other than by selling it and being satisfied with the proceeds (e.g., lease the collateral or collect or receive any income of profits

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<sup>12</sup> See UNCITRAL Legislative Guide, *supra* note 6, at 283-84, recommendation 142. "[I]n order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option of proceeding either judicially or extra judicially when enforcing their security rights."

<sup>13</sup> See Cape Town Convention, *supra* note 1, at art. 8(1); GOODE, *supra* note 3, at 278. For the additional layers of complexity of the Cape Town Convention system that derive from the interplay between main Convention, asset-specific Protocols, States' power to issue declarations, and market incentives; see *infra* p. 10.

<sup>14</sup> See Book IX DCFR, *supra* note 8, at Art. IX-7:103(1). "Unless otherwise agreed, the secured creditor may carry out extra-judicial enforcement of the security right". Chapter 7:217 makes it clear that the creditor retains the option to make recourse to judicial enforcement.

arising from the management of the encumbered asset).<sup>15</sup> Furthermore, even within court proceedings there is a preference for speedy relief measures,<sup>16</sup> though this point is not emphasized in the same way in each text due to their different nature and scope of application.<sup>17</sup> Therefore, there is a degree of uniformity at least in the general approach chosen by all three instruments.

If we turn from the general to the particular, however, we must take a series of additional factors into account. We will focus here on some factors that show that the role played by party autonomy is more complex than may appear at first sight.

The first important element to be considered is that a decision on the default rule (i.e., the rule applicable “unless otherwise agreed”) may change the purpose of allowing a contrary agreement between the parties. Book IX DCFR can be used as a good example in this respect, since party autonomy is present in several provisions but does not always play the same role. The principle underlying the whole Chapter on enforcement is that its rules are mandatory, unless otherwise provided within the text.<sup>18</sup> Several provisions allow for an express derogation by the parties, but said derogation fulfills different purposes. For instance, as mentioned above, the commercial creditor may generally exercise extra-judicial enforcement, unless exclusive

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<sup>15</sup> Cape Town Convention, *supra* note 1, at art. 8(1); UNCITRAL Legislative Guide, *supra* note 6, at 312, recommendation 141; Book IX DCFR, *supra* note 8, at Art. IX-7:207.

<sup>16</sup> See UNCITRAL Legislative Guide, *supra* note 6, at 311, recommendation 138. The possibility to obtain, in particular, *advance speedy relief* by courts pending final determination of a dispute is one of the cornerstones of the Cape Town Convention and Aircraft Protocol’s enforcement system, as provided in Art. 13 Convention and Art. X Protocol. See *supra*, Cape Town Convention, note 1, and *Aircraft Protocol*, *supra* note 2.

<sup>17</sup> In particular, Chapter 7 of Book IX DCFR expressly focuses on *extra-judicial enforcement*, leaving court enforcement proceedings to national law. See Book IX DCFR, *supra* note 8, at Cmt. A to Art. IX-7:101. Thus, Book IX does not attempt to lay down rules for judicial enforcement. It does, however, stress the need for an expeditious court decision on a recourse against an enforcement measure or against resistance to an enforcement measure. *Id.* at 7:104. The same approach regarding judicial supervision of enforcement when a conflict arises is found in the UNCITRAL Legislative Guide. UNCITRAL Legislative Guide, *supra* note 6, at 280, § 19, and recommendation 137.

<sup>18</sup> Book IX DCFR, *supra* note 8, at Art. IX-7:102.

recourse to a court or other competent authority is agreed in the contract.<sup>19</sup> On the other hand, a private sale by the creditor is only admitted if parties stipulate otherwise (or if a published market price for the collateral exists).<sup>20</sup>

In these two examples, party autonomy serves divergent purposes. In the first case, a higher degree of formality in the proceedings may be imposed by modifying the default rule; in the second instance, the contrary agreement allows the creditor to exercise an additional remedy.<sup>21</sup> Failing such an agreement, the default rule does not allow that particular remedy (or it does so only if specific requirements are met). It must be pointed out that bargaining to exclude a default rule presupposes that the debtor be in a position to accept, or reject, the contrary agreement. The situation is clearly different where the instrument applies in a highly specialized and professionalized market (as in the case of aircraft financing, for example) or more generally (thus, in Book IX DCFR consumers are always entitled to court proceedings, unless they agree to extra-judicial enforcement after default, and are subject to additional safeguards, see Section III, *infra*).

Another element that should be mentioned is the degree of formality that is required of the “contrary agreement” between the parties. For example, parties’ agreement on the exercise of extra-judicial remedies under the Cape Town Convention need not be in writing, nor should it refer specifically to the Convention’s provisions or specific remedies.<sup>22</sup> On the other hand, a pre-default agreement on appropriation of encumbered assets by the creditor under Article IX-7:105 DCFR will need to be more formal since parties are obliged to indicate a method which allows for a ready determination of a reasonable market price. Failing such an indication, the agreement is

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<sup>19</sup> *Id.* at Art.IX-7:103(1).

<sup>20</sup> *See id.* at Art.IX-7:211(2).

<sup>21</sup> In particular, when a published market price for the collateral exists, *see id.* at Art. IX-7:211(2).

<sup>22</sup> GOODE, *supra* note 3, at 280 (“an agreement in general terms, for example, ‘all remedies under the Convention,’ suffices. . . . [S]uch terms would cover remedies under the Protocol as well as under the Convention.”).

void, unless the collateral is a fungible asset that is traded on a recognized market with published prices.<sup>23</sup>

The different nature of the instrument gives rise to interesting additional layers of complexity in the case of the Cape Town Convention system, that is, a multilateral treaty approved in a diplomatic Conference<sup>24</sup> with participation of States' representatives and later subject to ratification by States. Following a widely used technique, in order to reach international consensus within the formal setting of the diplomatic Conference, the possibility for contracting States to opt out of specified provisions through a declaration<sup>25</sup> was introduced. With particular regard to enforcement, according to the main Convention contracting States must make a declaration for or against extra-judicial enforcement as default rule,<sup>26</sup> and may make additional declarations in relation to the applicability of specific enforcement measures.<sup>27</sup>

This balance was already modified by the Aircraft Protocol<sup>28</sup> where some of the Convention rules on enforcement were displaced,

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<sup>23</sup> Book IX DCFR, *supra* note 8, at Art.IX.-7:105(1) and (2).

<sup>24</sup> Or better said, diplomatic Conferences, since the Aircraft Protocol was approved together with the main Convention in Cape Town in 2001 whilst the other two Protocols, Rail and Space, were separately approved, respectively, in Luxembourg in 2007 and in Berlin in 2012.

<sup>25</sup> The Cape Town Convention does not contain the classical "reservations," but introduced "declarations" that allow for more flexibility and choices regarding their content. *See generally* ROY GOODE, HERBERT KRONKE, EWAN MCKENDRICK, *TRANSNATIONAL COMMERCIAL LAW* 418-419 (2d ed. 2015).

<sup>26</sup> Article 54(2) requires a contracting State to declare whether or not any remedy, which under the Convention does not require application to the court, is to be exercisable only with leave of the court. It is a mandatory declaration.. Cape Town Convention, *supra* note 1, at art. 54(2).

<sup>27</sup> For example, lease of collateral is permitted unless a contracting State declared that the charge (debtor) shall not grant a lease of the object while it is situated within or controlled from that State's territory. *Id.* at art. 8(1)(b), 54(1).

<sup>28</sup> For the enforcement provisions in the Rail and Space Protocols, see ROY GOODE, *CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND LUXEMBOURG PROTOCOL THERETO ON MATTERS SPECIFIC TO RAILWAY ROLLING STOCK*, OFFICIAL COMMENTARY 71 et seq. (2d ed., UNIDROIT, 2014); ROY GOODE, *CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT AND PROTOCOL THERETO ON MATTERS SPECIFIC TO SPACE ASSETS*, OFFICIAL COMMENTARY 189 et seq. (UNIDROIT, 2013).

additional specific remedies were introduced (in particular, deregistration and export and physical transfer of the aircraft object from the territory where it is situated) and a mechanism of opting in specific provisions was chosen.<sup>29</sup> The modification went in the direction of allowing increased predictability and a greater scope for parties' self-regulation both outside and within court proceedings.

The evolution of the system, however, did not stop with the approval of the treaties but was further influenced by the relevant credit market. Under the Organization for Economic Co-operation and Development (OECD) Aircraft Sector Understanding,<sup>30</sup> a reduced fee or interest rate for export credit may be applied if a contracting State to both the Convention and the Aircraft Protocol has made so-called "qualifying declarations," among which the declarations with respect to enforcement measures are counted. In particular, a State may qualify if it either adheres to the default provision on extra-judicial enforcement or it opts in to the Aircraft Protocol rules regarding advance relief measures during court proceedings. This development shows that, when a uniform law text applies to a specialized, highly sophisticated, and integrated market and has the potential to trigger economic benefits for both creditors and debtors, subsequent market incentives may indirectly influence contracting States' decisions and as a consequence the international regulation in the field.

#### B. A Shift from Traditional Control Mechanisms to Ex-Post Evaluation and Transparency Rules

As noted earlier, while all three instruments considered give more weight to party autonomy, rules protecting the debtor and/or other parties are not abandoned. The tendency, however, is to reduce the impact of certain traditional remedies that are perceived to be inefficient or unnecessary. The shift towards out-of-court enforcement as opposed to mandatory formal proceedings was already mentioned. Additionally, control mechanisms that work ex ante through the

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<sup>29</sup> For a detailed overview of the enforcement provisions in the Aircraft Protocol and their relation to the main Convention, see GOODE, *supra* note 3, at 447 et seq.

<sup>30</sup> Organization of Economic Co-operation and Development (OECD), Aircraft Sector Understanding on Export Credits for Civil Aircraft, TAD/ASU(2011)1 (Aug. 31, 2011).

sanction of invalidity of parties' agreement are restricted in their application. This is true, for example, if we look at the well-known prohibition of *pactum commissorium* (typically found in civil law jurisdictions).<sup>31</sup> Such a development is hardly surprising in light of the fact that even the most traditionally oriented national laws in this respect show a clear tendency to move away from a strict interpretation of this requirement, and this appears not only in very specialized areas, such as financial collateral,<sup>32</sup> but even generally.<sup>33</sup>

It is probably more relevant to see how the need to balance competing interests (with particular regard to interests of third parties) is pursued through alternative and more modern means. The mechanisms that can be found in all three instruments are fourfold: (1) reliance on parties' agreement (as noted above, the exercise of specific remedies may be subject to the contract expressly allowing them and sometimes to additional limitations and conditions); (2) use of ex-post evaluation of the exercise of all enforcement rights; (3) transparency provisions introducing information duties; and (4) upholding of the traditional principle of avoiding creditor's enrichment.

As to the shift to ex-post evaluation, all three instruments expressly refer to the parameter of 'commercial reasonableness' (or other general standard) to achieve a fair realization value when self-help measures are executed. The Cape Town Convention states that

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<sup>31</sup> See Book IX DCFR, *supra* note 8, at Art. IX.-7:105, according to which a pre-default agreement on appropriation of encumbered assets is void, unless the encumbered asset is a fungible asset that has a published price or parties agree in advance on some method to ensure objectivity of evaluation. For a brief justification of this rule, see *Book IX*, *supra* note 8, at 5622. According to the Cape Town Convention, however, an agreement whereby ownership is vested in the creditor cannot be made in advance of default, but only after default and at the conditions set forth in Article 9 Convention. GOODE, *supra* note 3, at 283. Article 11 Convention, however, leaves the parties free to determine what constitutes "default" under their agreement. Those rules do not apply to retention of title devices. See *infra* at section II(C).

<sup>32</sup> For E.U. member States, this results from the implementation of the Financial Collateral Directive. See Council Directive 2002/47, 2002 OJ (L 168) 43 (EC) as amended by Council Directive 2009/44, art. 4, 2009 OJ (L 146) 37 (EC).

<sup>33</sup> See CODE CIVIL [C. CIV.] art. 2348 (Fr.) as modified by the 2006 French secured transactions' law reform, which considers such agreements valid. For commentary, see LAURENT AYNES & PIERRE CROCQ, DROIT CIVIL: LES SURETES, LA PUBLICITE FONCIERE 239 et seq. (4th ed. 2009).



any out-of-court remedy of a secured creditor “shall be exercised in a commercially reasonable manner.”<sup>34</sup> The UNCITRAL Legislative Guide recommends that national legislators “provide that a person must enforce its rights and perform its obligations under the provisions on enforcement in good faith and in a commercially reasonable manner.”<sup>35</sup> According to Article IX.-7:103(4) DCFR, “enforcement must be undertaken by the secured creditor in a commercially reasonable way.” Once again, however, the different role played by party autonomy bears an influence on how the same principle is concretely applied. Thus, according to the Cape Town Convention, a remedy exercised in conformity with the security agreement will be deemed commercially reasonable unless the contractual provision is “manifestly unreasonable.” The benchmark for the standard of conduct is therefore parties’ self-regulation, interpreted against the background of international practice.<sup>36</sup> On the other hand, according to the UNCITRAL Legislative Guide, the recommended general standard of conduct should be mandatory and not subject to unilateral waiver or contrary agreement at any time,<sup>37</sup> while Book IX DCFR puts more emphasis on good faith by requiring that creditors exercise enforcement measures, as far as possible, in cooperation with the security provider and any third party.

With regard to transparency, there is a tendency to introduce information duties of the secured creditor toward the debtor and specific third parties (particularly, other secured creditors).<sup>38</sup> It should

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<sup>34</sup> Cape Town Convention, *supra* note 1, at art. 8(3).

<sup>35</sup> UNCITRAL Legislative Guide, *supra* note 6, at 310.

<sup>36</sup> “The phrase ‘manifestly unreasonable’ is a signal to courts that they should not lightly disturb the bargain made by the parties. Established commercial practice is relevant to whether a provision in a security agreement is ‘manifestly unreasonable’. A provision that is in line with accepted international practice will normally be regarded as not manifestly unreasonable”: GOODE, *supra* note 3, at 280.

<sup>37</sup> UNCITRAL Legislative Guide, *supra* note 6, at 311.

<sup>38</sup> See *e.g.*, Cape Town Convention, *supra* note 1, at art. 8(4) (reasonable prior notice in writing to specified interested persons); UNCITRAL Legislative Guide, *supra* note 6, at recommendation 149 (on the creditor’s duty to give notice of its intention to exercise extra-judicial sale, granting of lease or license or other disposal of the collateral); Book IX DCFR, *supra* note 8 at Arts. IX.-7:208 to 7:210 (notices of extra-judicial disposition). A brief overview of the rules on notices in Book IX is provided in Comment A to Art. IX.-7:107. Book IX DCFR, *supra* note 8, cmt. A to Art. IX.-7:107.

be noted that the cost-effectiveness of such rules will depend on the degree of the formalities that are imposed for the notice.<sup>39</sup> In this respect, the Cape Town Convention's language ("reasonable prior notice in writing") is less exacting than the regime suggested in the UNCITRAL Legislative Guide or envisaged in Book IX DCFR, both of which impose more precise time, content, and language constraints.<sup>40</sup>

Another element worth considering is that the functionality of the notice system is strictly related to the existence of a public electronic registry based on a notice-filing approach (according to which a statement containing select information as to creditor, debtor and collateral should be filed in a publicly accessible registry for the purpose of ensuring that the security right is effective as against other secured creditors, execution creditors, and the administrator of debtor's insolvency). Such a general policy choice is made in all three instruments<sup>41</sup> and permits a clearer identification of the most relevant third parties to which the notice should be given.<sup>42</sup>

Another protection mechanism is the avoidance of enrichment. The question is whether, should there be any surplus from the sale or alternative use of the value of the collateral, it should return to (other lower ranking creditors and finally to) the debtor. All three instruments clearly retain this solution.<sup>43</sup> A different regime is introduced, however, for those transactions that are based on retention

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<sup>39</sup> "The law should provide rules ensuring that the notice . . . can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential net realization value of the encumbered assets." UNCITRAL Legislative Guide, *supra* note 6, at recommendation 150.

<sup>40</sup> *See id.* at recommendation 151(b); Book IX DCFR, *supra* note 8, at Art. IX.-7:210.

<sup>41</sup> Cape Town Convention, *supra* note 1, at Chapter IV; UNCITRAL Legislative Guide, *supra* note 6, at 110 et seq.; Book IX DCFR, *supra* note 8, at ch. 3.

<sup>42</sup> Interestingly, the EBRD Model Law provides that the enforcement notice to the debtor (which has to contain specific information) must be registered in the Charges Registry as supplementary information to be effective. See EBRD Model Law, *supra* note 10, at arts. 22.2, 22.4, and 33.

<sup>43</sup> *See* Cape Town Convention, *supra* note 1, at arts. 8(5) and (6); UNCITRAL Legislative Guide, *supra* note 6, at recommendation 152 (distribution of proceeds of disposition of an encumbered asset); Book IX DCFR, *supra* note 8, at Art. IX.-7:215 (distribution of proceeds of extra-judicial enforcement).

of title instead of consisting in the creation of a limited security right or the transfer of collateral by way of security, which topic will be now discussed.

C. A Differentiated Regime for Enforcement of Retention of Title Devices

In all the international instruments considered, the policy decision was taken to include within their general scope of application not only security rights on movables granted by the debtor to the creditor, but also transactions where title to the collateral is retained by the financier (e.g., a conditional sale or a leasing agreement). In principle, such transactions are subject to the same basic legal framework that governs the more traditional limited rights in rem.<sup>44</sup> In relation to a few specific issues, however, different rules (may) apply.

An exception shared by all three instruments is found in enforcement. The creditor (seller or lessor) is not accountable for any surplus and may terminate the agreement upon debtor's default and take possession or control of the collateral as a full owner, without being subject to all conditions and limits that are envisaged for a secured creditor in general<sup>45</sup>

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<sup>44</sup> For the Cape Town Convention, see GOODE, *supra* note 3, at 267 (“Most of the . . . provisions of the Convention apply to all three forms of agreement [security agreement, conditional sale and lease].”). The UNCITRAL Legislative Guide recommends an integrated scheme, giving national legislators the option between a unitary and non-unitary approach to acquisition financing. UNCITRAL Legislative Guide, *supra* note 6, 57 et seq., § 111 et seq. Even under the latter approach, however, most of the rules applicable to security rights are extended to retention of title devices. Finally, see Art. IX. – 1:104 DCFR and Comment A, Book IX DCFR, *supra* note 8, at 5401 (“the regime of retention of ownership devices, while partly autonomous, is in most respects identical with that for security rights.”).

<sup>45</sup> See Cape Town Convention, *supra* note 1, at art. 10; See also Art. IX.-7:301 DCFR. Concerning the Cape Town Convention, it must be noted that the qualification of an agreement as “retention of title” or “lease” for the purposes of Article 10 is left to the applicable domestic law, so that in those legal systems where such devices (or specific types of such devices) are qualified as security rights Article 10 would not apply. GOODE, *supra* note 3, at 267 et seq. The UNCITRAL Legislative Guide, on the other hand, suggests that acquisition finance devices (a functional category including retention of title devices) be subject to the same regime that is applied to non-acquisition finance devices, but allows for deviations “to the extent

It is interesting to note that this specific derogation from the general rules is not justified on the basis of the economic function of the device as acquisition financing tool (otherwise it would apply to all agreements pursuing the same function regardless of which party holds title in the collateral).<sup>46</sup> It expressly relies on the *formal structure* of the agreement.<sup>47</sup> While this solution may have had the purpose of making the inclusion of retention of title less objectionable in the eyes of European jurists and/or governmental representatives, it raises doubts as to whether the justification for a different treatment based on the formal structure of the transaction only is sufficiently well founded. This all the more so because recent reforms in national secured transaction laws opted for the application of a functional approach in this respect.<sup>48</sup>

## II. CONSUMER PROTECTION AND PARTY AUTONOMY

Another interesting issue with regard to the role of party autonomy in the enforcement of creditor's rights arises when one of

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necessary to preserve the coherence of the regime applicable to sale and lease" (UNCITRAL Legislative Guide, *supra* note 6, 380-381, recommendation 200).

<sup>46</sup> Which is what is envisaged for another important exception to the general rules contained in both the UNCITRAL Legislative Guide and in Book IX DCFR is the special priority (so-called "super-priority") as against previously registered security rights on the same collateral, granted to all acquisition finance devices regardless of their formal structure. *See* UNCITRAL Legislative Guide, *supra* note 6, at 377, recommendations 187-188; Art. IX. – 4:102 DCFR.

<sup>47</sup> For the Cape Town Convention, *see* GOODE, *supra* note 3, at 66 ("The provisions are much simpler because in contrast with the chargee, who has merely a security interest, the conditional seller or lessor retains full rights in the equipment."). *See also* Book IX DCFR, *supra* note 8, at 5664, cmt. A to Art. IX. – 7:301 DCFR ("The chief reason why the special features of retention of ownership become relevant in this area is that, since the seller, supplier or lessor as secured creditor had retained ownership, it had remained the owner of the supplied assets."). A more thorough treatment of this issue is found in the UNCITRAL Legislative Guide, *supra* note 6, at 367 et seq., §§ 188-196, where the respective merits of a unitary and non-unitary approach to retention of title devices, as well as the need to preserve a functionally integrated approach whichever choice is made are discussed with specific regard to enforcement.

<sup>48</sup> For the 2013 reform in Belgium, *see* ERIC DIRIX, LA RÉFORME DES SÛRETÉS RÉELLES MOBILIÈRES 11 et seq. (2013) (in relation to both sales with retention of title and leasing). *See also* CODE CIVIL [C. CIV] art. 2371(2) (Fr.); AYNÈS & CROCQ, *supra* note 31, at 375 et seq.

the parties is a consumer, or is more generally qualified as a “weaker” party entitled to a stronger protection. The question is here to what extent general rules favorable to a wider application of parties’ self-regulation should be modified to take this situation into account. It must be pointed out that for two of the instruments that we considered this question is either irrelevant or has only marginal importance. It goes without saying that the scope of application of the Cape Town Convention implies a high level of sophistication of all professional parties involved. As to the UNCITRAL Legislative Guide, although it includes many forms of consumer transaction, it is not intended to override consumer-protection laws or to elaborate consumer-protection policies, and defers to national law on this matter.<sup>49</sup>

On the other hand, the scope of application of Book IX DCFR is not limited to professional parties but extends to consumers. In this regard, however, the drafters expressly downplayed the importance of specific consumer protection in the field of secured transactions as opposed to that of personal security. In fact, there are only a few special rules on consumers in the whole Book.<sup>50</sup> If we look at enforcement, the most interesting aspect is that parties’ autonomy is not entirely excluded but still plays a relevant role. Thus, a security right over an asset of a consumer can only be enforced by a court or another competent authority, but after default the consumer security provider can agree to extra-judicial enforcement.<sup>51</sup> Further, a pre-default agreement on appropriation would be void even if the parties agreed in advance on an objective evaluation method, but it is still possible when the encumbered asset is a fungible asset traded on a recognized market with published prices.<sup>52</sup> All other rules of the Chapter apply to

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<sup>49</sup> “To the extent that a rule of the regime envisaged in the Guide conflicts with consumer protection law, the Guide defers to consumer protection law. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the Guide would affect the rights of consumers and would thus require the introduction of consumer protection legislation.” UNCITRAL Legislative Guide, *supra* note 6, at 34, § 11. *See also id.* at recommendation 2(b).

<sup>50</sup> *See* Book IX DCFR, *supra* note 8, Comments to Art. IX.–2:107.

<sup>51</sup> *Id.* at Art. IX.–7:103(2).

<sup>52</sup> *Id.* at Art. IX.–7:105 (1)-(3).

consumers with no differentiation, except for a more stringent provision on advance notice of enforcement.<sup>53</sup>

#### CONCLUSIONS

When looking at the above-mentioned general common tendencies in uniform law as regards enforcement measures, one should consider that the rules on enforcement contained in international instruments are embedded in a more general unitary architecture that simplifies and rationalizes the entire regulation of secured transactions. In other words, in each of the three examples such rules form part of a coherent reform strategy that strives towards both greater clarity and efficiency. The trend towards a simplification and rationalization of enforcement proceedings for security rights is, however, convincing in its own right, also independently of a more general reform of secured transactions law, and should be welcomed. A look at the most recent legislative interventions in Europe seems to confirm that the availability of a more predictable system, and less costly and swifter extra-judicial enforcement measures as well as of alternative mechanisms for the creditor to realize the value of the collateral is perceived as an important element of any well-functioning secured transactions regime, however structured.

But consider that the effectiveness on any enforcement measure in a given jurisdiction should be strongly linked to the rules of general procedural law and the administration of justice. It may also be connected to the role played by, and the effect given to, extra-judicial settlements and/or alternative dispute resolution mechanisms. It would not be realistic, nor even appropriate, to try to reach full harmonization through an instrument concerning secured transactions. I would surmise that the more specialized and circumscribed the regulation, the easier it is to accept rules that introduce changes not only to enforcement proceedings in general, but also to judicial proceedings (such as advance relief remedies for the creditor) in particular, provided that a cost-benefit analysis gives a positive result. In devising a general regime with wider application, the approach should be more cautious (as shown by the different solutions that are found in the examples of Cape Town Convention and Aircraft

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<sup>53</sup> *Id.* at Art. IX.-7:107.

Protocol on the one hand, and the UNCITRAL Legislative Guide and Book IX DCFR on the other hand).

Furthermore, I believe that more thought should be given to the question of how to treat retention of title devices in enforcement, and especially as to whether a differentiated regime would be appropriate. If retention of title devices were to be included in an instrument on secured transactions, a differentiated treatment solely on the basis of the formal structure of the agreement would not, in my opinion, be sufficiently justified.

I would finally suggest that the question of whether, and to what extent, consumer transactions should be subject to a special regime, as regards enforcement, deserves thorough consideration.

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**JUSTIFICATIONS FOR UCC ARTICLE 9'S  
TREATMENT OF DEPOSIT ACCOUNTS: A  
COMPARATIVE NOTE**

*Catherine Walsb\**

INTRODUCTION

Debtor-creditor and insolvency laws in western legal traditions generally treat a defaulting debtor's assets as subject to liquidation by its creditors or their insolvency representative, with the proceeds then distributed among them in proportion to their claims. Secured creditors seek to escape this baseline principle by bargaining in advance for the right to have assets of their debtors in which they have contracted for security preferentially appropriated to the payment of their debts. Thus, a contract for security has been described as a private bargain "between A and B that C take nothing"<sup>1</sup> with C representing the collectivity of the collateral-giver's other creditors.

In view of the distributional consequences, legal systems traditionally have found it necessary to impose certain limitations on party autonomy in security agreements. In recent decades, these constraints have been increasingly dismantled for creditors who take security in what is popularly referred to as "cash collateral" — meaning not just cash in the strict sense of hard currency but also intangible rights that are highly liquid in the sense that the secured creditor can almost immediately acquire their cash value.

This article focuses on cash collateral in the form of a right to payment of money credited to an account with a bank or other

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\* Professor, Faculty of Law, McGill University.

<sup>1</sup> Lynn M. LoPucki, *The Politics of Article 9: The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1899 (1994).



financial institution (deposit account). Secured transactions regimes in effect in the Canadian provinces and territories traditionally have subjected deposit accounts to the same public notice and temporal priority rules that apply to security agreements covering other intangible assets in the form of a monetary obligation owed to the debtor. In contrast, deposit accounts under Article 9 of the Uniform Commercial Code in the United States are governed by a special set of rules organized around the concept of “control.”

The Article 9 deposit account regime is increasingly promoted internationally. The UNCITRAL Legislative Guide on Secured Transactions is particularly notable.<sup>2</sup> It represents the first attempt at the international law level to articulate a comprehensive regime of security for movable assets. The close affinity between U.C.C. Article 9 and the Guide’s recommendations is such that, in the words of Tomáš Richter, it “could be called the ‘New York/ Vienna consensus.’”<sup>3</sup> Certainly, with respect to the treatment of deposit accounts,<sup>4</sup> the recommendations of the Guide replicate almost completely the Article 9 rules.<sup>5</sup>

Reforms aimed at aligning the treatment of deposit accounts in Canadian secured transactions law with the Article 9 (and UNCITRAL) control approach have recently been proposed. As will

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<sup>2</sup> See UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS, U.N. Sales No. E.09.V.12 (2010), available at [http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670\\_Ebook-Guide\\_09-04-10English.pdf](http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf) (hereinafter UNCITRAL LEGISLATIVE GUIDE). For ease of reference, the terminology and recommendations of the Guide are published in a separate publication: UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS: TERMINOLOGY AND RECOMMENDATIONS, U.N. Sales No. E.09.V.13 (2010), available at <http://www.uncitral.org/pdf/english/texts/security-lg/e/Terminology-and-Recs.18-1-10.pdf> (hereinafter UNCITRAL TERMINOLOGY AND RECOMMENDATIONS).

<sup>3</sup> Tomáš Richter, *The Uneasy Case for the Priority of Secured Credit: A Minskian Sequel* 4 (Oct. 1, 2013) (unpublished article), available at <http://ssrn.com/abstract=2390013>.

<sup>4</sup> Instead of “deposit account,” the UNCITRAL LEGISLATIVE GUIDE uses the conceptually more accurate, but also more cumbersome, term “right to payment of funds credited to a deposit account.” For an explanation of this term, see UNCITRAL TERMINOLOGY AND RECOMMENDATIONS, *supra* note 2.

<sup>5</sup> *Id.* at 49, 103-04, 125-26, 173-75.

be seen, adoption of the control approach will in effect exempt secured creditors who obtain control of a deposit account from the public notice and temporal priority rules that until now have applied to security rights in all types of monetary obligations. It will also result in a departure from the basic premise of secured creditor equality implicit in the traditional temporal priority rule by privileging the depository bank over other secured credit providers.

The principal aim of this article is to explore the justification for the exceptional treatment of deposit accounts under the Article 9 control approach. Parts I and II summarize the current Canadian rules and compares them with the Article 9 regime. Part III reviews the official justifications for the Article 9 approach and finds them less than persuasive. Part IV explores the relatively recent push to import the Article 9 treatment of deposit accounts into Canadian secured transactions law and locates the reform pressure in the desire to facilitate the use of cash collateral in the form of deposit accounts by financial actors, notably in the derivatives and securities lending markets. In light of that finding, Part V concludes by asking whether privileging the extension of credit to the financial sector represents wise policy if it comes at the potential expense of reducing the availability of and increasing the cost of credit to the real economy.

#### I. THE TRADITIONAL CANADIAN APPROACH TO THE TREATMENT OF DEPOSIT ACCOUNTS IN SECURED TRANSACTIONS LAW

Funds deposited to a bank account are not set aside as belonging to the customer. Rather, they become the property of the bank and are replaced by the obligation of the bank to pay the equivalent amount to the customer. Thus, in general property law, a deposit account has come to be characterized simply as a debt owed by the bank to its customer. It constitutes a sub-species of pure intangible property since its value is not reified in any tangible document capable of being negotiated, such as a cheque or a certificated investment security.<sup>6</sup>

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<sup>6</sup> See, e.g., Benjamin Geva, *Rights in Bank Deposits and Account Balances in Common Law Canada*, 28 *BANKING FIN. L. REV.* 1, 2-3 (2012); Clayton Bangsund, *The*

Consistent with this general conceptualization, the secured transactions regimes in effect in the Canadian provinces and territories<sup>7</sup> traditionally have subjected deposit accounts to the same general rules that apply to other intangible assets that take the form of a monetary obligation owed to the grantor. Thus, a security right in a deposit account must be “perfected” by public registration of a notice of the security right to take effect against third parties<sup>8</sup> and priority among secured creditors is ordered temporally according to the order of registration.<sup>9</sup> On the debtor’s default, the secured creditor is entitled to collect payment of the value of the deposit account directly from the bank with whom the deposit account is held and may then apply the proceeds of collection in satisfaction of the obligation secured by its security interest.<sup>10</sup>

If the bank with whom the deposit account is held wishes to take a security interest in its customer’s account to secure an obligation owing to it by the customer, it does not enjoy any special exemption from these rules. Thus, the bank must register notice of its security right and its priority against outside secured creditors who have previously acquired a perfected security interest in the deposit account generally will be subject to the first-to-register priority rule. The application of that rule is subject, however, to the bank’s right, in its capacity as the debtor on the deposit account, to set-off any obligations owing to it by its customer that arise before it receives notice of a

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*Deposit Account & Chose in Action at Common Law & Under the PPSA: A Historical Review*, 30 BANKING FIN. L. REV. 1, 22-23 (2014); Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 966-67 (1999).

<sup>7</sup> In the province of Quebec where the civil law tradition prevails, secured transactions law is primarily found in the Civil Code rules governing hypothecary security. *See* Civil Code of Québec, S.Q. 1991, c. 64, bk. 6 (Can.). While the common law tradition prevails in the other nine provinces and the three territories, secured transactions law is primarily found in the Personal Property Security Acts (PPSAs) proclaimed in force between 1976 and 2001. *See, e.g.*, Ontario Personal Property Security Act, R.S.O. 1990, c. P.10 (Can.) [hereinafter Ontario PPSA]. *See generally* R.C.C. CUMING, CATHERINE WALSH & RODERICK WOOD, PERSONAL PROPERTY SECURITY LAW (2d ed. 2012).

<sup>8</sup> *See, e.g.*, Ontario PPSA, *supra* note 7, at §§ 19, 20, 23.

<sup>9</sup> *Id.* at § 30(1)(1).

<sup>10</sup> *Id.* at § 61(1).

security right that otherwise would have priority.<sup>11</sup> The bank's set-off right, whether arising by operation of law or contractually, may be exercised regardless of whether or not it concurrently holds a security interest in the deposit account.<sup>12</sup>

## II. THE ARTICLE 9 "CONTROL" REGIME

Under Article 9, the concept of control by a secured creditor plays a key role in the rules governing the perfection and priority of a security right in a deposit account. Control is not a unitary concept—its meaning varies according to whether the secured creditor is the bank with whom the grantor maintains the deposit account or an outside creditor.<sup>13</sup> If the bank is the secured creditor, it automatically has control upon its customer's grant of security to it.<sup>14</sup> If the secured creditor is an outside creditor, it can obtain control either by becoming the bank's customer with respect to its debtor's deposit account or by entering into a control agreement with the bank and the debtor under which the bank agrees that it will comply with instructions originated by the secured creditor directing disposition of the funds in the deposit account without further consent by the debtor.<sup>15</sup>

Obtaining control is an alternative to registration as a mode of perfecting a security interest in deposit accounts. This is so even though control does not give public notice of the potential existence of the security right to creditors and other potential competing claimants. The secured creditor's control need not be exclusive: a secured creditor has control even if the debtor retains the right to direct the disposition of funds from the deposit account as if it were unencumbered.<sup>16</sup> Outside parties cannot require the bank to disclose whether a security right exists in the deposit account: a bank that has entered into a control agreement is not required to confirm the existence of the agreement to another person unless requested to do

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<sup>11</sup> CUMING, WALSH & WOOD, *supra* note 7, at 664.

<sup>12</sup> *Id.* at 666-67. And *see infra*, Section IV, for the distinction between a mere set-off right and a set-off right that, when combined with other terms, amounts to a security interest in substance.

<sup>13</sup> U.C.C. § 9-104(a) (2014).

<sup>14</sup> *Id.* at § 9-104(a)(1).

<sup>15</sup> *Id.* at § 9-104(a)(2)-(3).

<sup>16</sup> *Id.* at § 9-104(b).

so by its customer.<sup>17</sup> The result is a “secret lien,” the very mischief that the general requirement for perfection was intended to alleviate.<sup>18</sup>

A secured creditor who obtains control of a deposit account has priority over a secured creditor who perfects its security right by registration even if registration preceded the obtaining of control.<sup>19</sup> The privileged status accorded to security rights perfected by control at the level of priority carries over to enforcement on default. If the secured creditor has control by virtue of its status as the depository bank, it may simply apply the funds credited to the deposit account to the obligation secured by the deposit account.<sup>20</sup> If the secured creditor is an outside creditor who has obtained control by virtue of a control agreement or because it has become the bank’s customer on the account, it may instruct the bank to pay the balance on deposit.<sup>21</sup> If, however, the secured creditor is relying on perfection by registration as opposed to control, it may enforce its security right only by obtaining a court order under other law compelling the bank to pay the funds to it.<sup>22</sup> The secured creditor has no right to demand payment simply on notification to the bank. In contrast, the depository bank, in its capacity as secured creditor with automatic control, is entitled to simply pay itself out of the funds in the account, and outside secured

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<sup>17</sup> *Id.* at § 9-342.

<sup>18</sup> Lynn M. LoPucki, Arvin I. Abraham & Bernd P. Delahaye, *Optimizing English and American Security Interests*, 88 NOTRE DAME L. REV. 1785, 1800 (2013); Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 426 (2005).

<sup>19</sup> Under Article 9, control is the only method available for perfecting a security right in a deposit account as original collateral: U.C.C. § 9-312(b)(1) (2014). However, a security right in a deposit account perfected by control may come into conflict with one perfected by registration where the deposit account is claimed as proceeds of collateral perfected by public registration pursuant to U.C.C. § 9-315(c) and (d). In that event, the security interest perfected by control has priority under U.C.C. § 9-327(1). Under the UNCITRAL Legislative Guide, while a security right in a deposit account may be made effective against third parties by registration even when the deposit account is original collateral (recommendation 49), the secured creditor who has obtained control has priority even against a prior registered secured creditor (recommendation 103). *See* UNCITRAL LEGISLATIVE GUIDE, *supra* note 2.

<sup>20</sup> U.C.C. § 9-607(a)(4) (2014).

<sup>21</sup> *Id.* at § 9-607(a)(5).

<sup>22</sup> *Id.* at § 9-607, cmt. 7.

creditors who have obtained control are likewise entitled to self-help collection rights without the need for judicial intervention.

As between the depository bank and outside secured creditors who seek to perfect a security right in a deposit account by control, the control regime privileges the depository bank. The depository bank is not obligated to enter into a control agreement with an outside secured creditor, even if its customer so requests, and even if it does not itself hold a security right in the account.<sup>23</sup> If the bank does agree to enter into a control agreement, any security right the bank obtains in the deposit account has priority even if the control agreement was concluded before the bank acquired its security right.<sup>24</sup> So in practice the outside secured creditor will also need to obtain the agreement of the depository bank to waive its priority.

In theory, an outside secured creditor can be assured of priority over the depository bank by relying on the alternative method of control: becoming the bank's customer with respect to the deposit account.<sup>25</sup> This method of control gives it priority over any security interest acquired by the bank<sup>26</sup> and terminates the bank's set-off right for any claims it has against the debtor.<sup>27</sup> However, this method of control requires the cooperation of the bank, so in practice the bank's consent to waive its priority is needed.<sup>28</sup> Nor is this method of control a feasible one for operating accounts to which the debtor needs regular access.<sup>29</sup>

### III. OFFICIAL JUSTIFICATIONS FOR SPECIAL CONTROL RULES

The official justifications for the Article 9 control rules are not particularly convincing. With respect to the priority enjoyed by control secured creditors over those who have perfected by registration, the

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<sup>23</sup> *Id.* at § 9-342.

<sup>24</sup> *Id.* at § 9-327(3).

<sup>25</sup> *Id.* at § 9-104(a)(3).

<sup>26</sup> *Id.* at § 9-327(4).

<sup>27</sup> *Id.* at § 9-340(c).

<sup>28</sup> See, e.g., Willa E. Gibson, *Banks Reign Supreme Under Revised Article 9 Deposit Account Rules*, 30 DEL. J. CORP. L. 819, 844 (2005).

<sup>29</sup> Markell, *supra* note 6, at 987; see also G.R. Warner, *Deposit Accounts as Collateral under Revised Article 9*, AM. BANKR. INST. J. 18 (Aug. 2000).

Official Comment states that secured creditors “for whom the deposit account is an integral part of the credit decision will, at a minimum, insist upon the right to immediate access to the deposit account upon the debtor’s default (i.e., control)” whereas those “for whom the deposit account is less essential will not take control.”<sup>30</sup> The implication here seems to be that a secured creditor who demonstrates special reliance by taking the extra steps needed to obtain control should be rewarded for its efforts by a special priority.<sup>31</sup> But this justification is predicated on circular reasoning, since a secured creditor would not have to take these extra steps if priority were instead predicated on the basis of the order of registration of the security rights.

With respect to the priority generally enjoyed by the bank over outside secured creditors, the Official Comment explains that a “rule of this kind enables banks to extend credit to their depositors without the need to examine either the public record or their own records to determine whether another party might have a security interest in the deposit account.”<sup>32</sup> But this is a conclusory statement, not a justification. After all, all secured creditors would wish to be assured of receiving an automatic super-priority over prior-perfected secured creditors. Why privilege depository banks over other suppliers of secured credit?

With respect to the automatic control enjoyed by the depository bank by virtue of its status, the official comment states that public notice is unnecessary since all actual and potential creditors are always on notice that the bank may assert a claim by virtue of its set-off rights against the deposit account.<sup>33</sup> The implication here is that awarding automatic control and a special priority to a depository bank’s security right does not put third parties in a more

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<sup>30</sup> U.C.C. § 9-327, cmt. 3 (2014).

<sup>31</sup> For an argument suggesting that this is the justification for control super-priority, see Randal C. Picker, *Perfection Hierarchies and Nontemporal Priority Rules* 74 CHI.-KENT L. REV. 1157 (1999).

<sup>32</sup> U.C.C. § 9-327, cmt. 4 (2014).

<sup>33</sup> *Id.* at § 9- 104, cmt. 3 (“No other form of public notice is necessary; all actual and potential creditors of the debtor are always on notice that the bank with which the debtor’s deposit account is maintained may assert a claim against the deposit account.”).

disadvantageous position than they already occupy. It is true that set-off is not a security interest and as such is not subject to any public registration or other public notice requirement. However, a bank can only set-off obligations already owing to it by its customer at the time it receives notice of a competing claim.<sup>34</sup> The concept of automatic control, combined with the special priority accorded to the depository bank's security right, dispenses with the need for the bank to first ascertain whether notice has been received before extending credit and eliminates the potential for litigation concerning the relative timing of the receipt of notice and the extension of credit.<sup>35</sup> It follows that the concept of automatic control without the need for public notice cannot be explained simply as a neutral and logical application of the consequences of set off. Rather, it enhances the bank's position relative to the set-off rights of other obligors.

With respect to the right of the bank to refuse to disclose whether control has been obtained by an outside secured creditor, the Official Comment explains that this protects banks "from the need to respond to inquiries from persons other than their customers."<sup>36</sup> But requiring outside secured creditors to register notice of their security rights would equally relieve the bank from that burden while also serving to ensure public notice to competing creditors and other claimants.

#### IV. JUSTIFICATIONS FOR IMPORTING THE ARTICLE 9 CONTROL REGIME INTO CANADIAN LAW

Writing in 2000, some Canadian commentators concluded that there was no justification for importing the Article 9 regime for deposit accounts into Canadian law.<sup>37</sup> Why, they asked, should depository institutions be exempt from the general registration requirements and first-to-register priority rules applicable to the holders of security rights in other intangible obligations? And why should they enjoy what

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<sup>34</sup> See, e.g., CUMING, WALSH & WOOD, *supra* note 7, at 664.

<sup>35</sup> See UNCITRAL LEGISLATIVE GUIDE, *supra* note 2, at 139, ¶ 144.

<sup>36</sup> U.C.C. § 9- 342, cmt 2 (2014).

<sup>37</sup> Ronald C.C. Cuming & Catherine Walsh, *Revised Article 9 of the Uniform Commercial Code: Implications for the Canadian Personal Property Security Acts*, 16 BANKING FIN. L. REV. 339, 364-68 (2001).



amounts in effect to a veto over the ability of a debtor to give an effective security interest in its deposit account to an outside creditor when the existing law, including the depository bank's rights of set-off, would seem to offer it adequate protection against interference with ordinary banking practices?

In recent years, the tide of opinion in Canada has swung heavily in favor of adoption of the Article 9 control approach.<sup>38</sup> Indeed, the province of Quebec already has introduced legislation to that end, and reforms are pending in the other provinces and territories.<sup>39</sup>

A significant catalyst for the pending reforms was the 2009 decision of the Supreme Court of Canada in *Caisse populaire Desjardins de l'Est de Drummond v. Canada*.<sup>40</sup> In that case, a customer had deposited \$200,000 with a credit union subject to contractual terms that prevented the customer from withdrawing the deposit before the expiry of a five-year term and entitled the credit union to set-off any obligations owing under the line of credit it had extended to the customer and to refuse repayment of the deposit for the duration of the line of credit agreement.<sup>41</sup>

The Supreme Court of Canada concluded that, while a mere contractual set-off right without more is not a security interest, the arrangement must be characterized as a security agreement in substance when a contractual set-off right is combined with other contractual terms designed to prevent the customer from withdrawing or otherwise dealing with the funds in its account until its own

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<sup>38</sup> See Ontario Bar Association, *Perfecting Security Interests in Cash Collateral* (Feb. 6, 2012), available at <https://www.oba.org/CMSPages/GetFile.aspx?guid=c020380c-6c0a-496f-b4b1-b44d6ac07eb5>.

<sup>39</sup> See Michel Deschamps, Mathieu Dubord & Mary Jeanne Phelan, *New Regime in Quebec for Security on Bank Deposits and Other Monetary Claims*, MCCARTHY TETRAULT (May 15, 2015), [http://http://www.mccarthy.ca/article\\_detail.aspx?id=7105](http://http://www.mccarthy.ca/article_detail.aspx?id=7105). See also ONTARIO MINISTRY OF GOVERNMENT AND CONSUMER SERVICES, BUSINESS LAW AGENDA: PRIORITY FINDINGS AND RECOMMENDATIONS REPORT 9 (2015).

<sup>40</sup> *Caisse populaire Desjardins de l'Est de Drummond v. Canada*, [2009] 2 S.C.R. 94 (Can.).

<sup>41</sup> *Id.*

obligations to the bank are satisfied.<sup>42</sup> Although the decision related to the concept of security for the purposes of income tax legislation, it was widely seen as jeopardizing the use of “cash collateral” in the form of a customer’s right to the payment of money credited to a deposit account in the context of derivatives and securities lending transactions.<sup>43</sup> Participants in these markets had thought they might protect their priority in “cash collateral” transactions by relying on “flawed asset” contractual arrangements under which the customer agrees that money deposited by the customer is not repayable until the occurrence of specified events. If these arrangements, as the *Drummond* case correctly implied,<sup>44</sup> are characterized as giving rise to a security right in substance, it follows that they are required to be perfected by registration, and will be subordinated to any prior-registered competing security right unless the secured creditor obtains a subordination agreement.<sup>45</sup> In contrast, adoption of an Article 9 control approach would enable secured creditors and particularly banks to obtain a first ranking security right to deposit accounts in cash collateral transactions without the need to register and without any risk of subordination to prior-registered secured creditors. Consequently, in the wake of the *Drummond* decision, the financial industry stepped up its lobbying efforts to import the Article 9 treatment of deposit accounts into Canadian law<sup>46</sup> with success now imminent.

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<sup>42</sup> *Id.*

<sup>43</sup> See, e.g., Anthony Duggan, *The Australian PPSA From a Canadian Perspective: Some Comparative Reflections* 11-13 (U. Toronto Law, Working Paper No. 2014-03, 2014), available at [http://www.law.utoronto.ca/utfl\\_file/count/documents/Duggan/WPS%202014-3.pdf](http://www.law.utoronto.ca/utfl_file/count/documents/Duggan/WPS%202014-3.pdf).

<sup>44</sup> CUMING, WALSH & WOOD, *supra* note 7, at 667, 143-46.

<sup>45</sup> Duggan, *supra* note 43, at 12.

<sup>46</sup> See, e.g., INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA), ISDA LETTER TO ALBERTA AND ONTARIO GOVERNMENTS RE PROPOSAL FOR AMENDMENTS TO THE TREATMENT OF DEPOSIT ACCOUNTS UNDER THE PPSA (Apr. 13, 2010), available at <http://www2.isda.org/regions/canada/page/3>.

## CONCLUSION

Whatever the official explanation for the Article 9 control approach, the recent Canadian experience suggests that its primary purpose is to facilitate the use of deposit accounts in cash collateral transactions in derivatives and other financial markets. Dispensing with the public registration requirements and registration based temporal priority rules that traditionally have informed Canadian secured transactions law will come at a cost to creditors in the real economy. For example, secured creditors who finance a commercial debtor's operating costs, including its acquisition of inventory, will no longer be able to rely on registration to give them an enforceable security right in the debtor's deposit account. They will need to undergo the additional expense and effort of obtaining control, including negotiating the agreement of the bank with which the account is maintained to waive its own priority. Unsecured creditors are also disadvantaged. At present, they can determine whether it is worth their time and expense to obtain a judgment and garnish their debtors' deposit accounts by searching the registry to verify whether any security rights have been granted in those accounts. While these creditors still would be subject to any set off rights enjoyed by the bank, they would at least know that those set off rights would be limited to the credit extended to the bank at the time of enforcement against the bank.

Recent scholarship argues that, while facilitating the extension of secured credit has a positive impact on economic growth when it is directed to the real economy, its effect when channeled to the financial economy may be destructive, generating price bubbles and subsequent debt deflation.<sup>47</sup> If that argument is correct, we may yet come to regret dismantling the general requirements of secured transactions law in order to facilitate the extension of credit based on deposit account collateral in financial markets<sup>48</sup> while increasing the cost of and thereby

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<sup>47</sup> For an analysis of the scholarship, see Richter, *supra* note 3.

<sup>48</sup> *Id.* at 10-11 (discussing the Financial Collateral Directive in the European Union, which, in a similar vein to the Article 9 control regime, seeks to exempt financial collateral from most of the formal requirements traditionally imposed on security arrangements).

diminishing the extension of credit to financiers of real economy services and products.<sup>49</sup>

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<sup>49</sup> This is not to reject altogether the proposition that some protection of the finality of ‘cash collateral’ transactions in financial markets may be justified to contain systemic risk. Rather, it is a plea for a more nuanced and targeted modality. In this respect, consider, for example, the amendments effected to the Canadian *Payment Clearing and Settlement Act* (S.C. 1996, c. 6, Sch.) in 2012 to add a provision (s. 8(1)(c)) to protect the finality of payments made or property delivered or transferred “in accordance with the settlement rules of designated clearing and settlement systems” notwithstanding anything in any Canadian or provincial statute (including provincial secured transactions statutes).

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**THE NATURAL PERSON, LEGAL ENTITY  
OR JURIDICAL PERSON AND JURIDICAL  
PERSONALITY**

*Elvia Arcelia Quintana Adriano\**

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\*J. D. Degree awarded by the National Autonomous University of Mexico (Universidad Nacional Autónoma de México, UNAM). Regular professor in Commercial Law, Economic Law and Thought Economic History degree by competitive examination at the Faculty of Law. She is also a Commercial Law Professor in the Postgraduate Studies Division at the Faculty of Law and Financial Law Professor in the Accounting and Administration Faculty at UNAM. UNAM Lecturer. Regular Researcher by competitive examination in the Commercial Law field at the Legal Research Institute, UNAM. She earned the National University Award 2006 in Teaching of Economic and Administrative Sciences field. She's the author of the following works: "Science of Commercial Law. Doctrine, Theory and Institutions"; "Mexico's External Commerce. "Legal Framework, Structure and Politics"; "Commercial Contests. Doctrine, Law and Jurisprudence"; "Commers Institutions. Anthology"; "Commercial Law, Historical Evolution, Mexico 1325 – 2005". Member of the Researchers National System at the National Council of Science and Technology (CONACYT), Mexico.

## TABLE OF CONTENTS

INTRODUCTION.....	365
I. PERSON.....	366
A. Etymology.....	367
B. Doctrine.....	367
III. ELEMENTS THAT SHAPE THE LEGAL ENTITY.....	373
A. Doctrine.....	373
B. Personal opinion of the author.....	375
C. Juridical personality.....	376
1. <i>Theories of personality</i> .....	376
(1) <i>The patrimony appropriation theory</i> .....	377
(2) <i>Theory of the apparent subject</i> .....	378
(3) <i>Atomistic theory of the state</i> .....	378
(4) <i>Theory of fiction</i> .....	379
(5) <i>Theory of the legal act</i> .....	380
(6) <i>Theory of veil</i> .....	380
2. <i>Requirements for the legal personality</i> .....	383
IV. PERSONALITY IN THE COMMERCIAL LEGISLATION.....	384
V. THE PERSONALITY IN JURISPRUDENCE.....	385
VI. ELEMENTS OF THE LEGAL ENTITY IN MEXICAN LEGISLATION.....	386
VII. ELEMENTS OF JURISPRUDENCE.....	388
VIII. DEFINITION OF THE JURIDICAL PERSON OR LEGAL ENTITY FROM THE PERSONAL POINT OF VIEW.....	389

## INTRODUCTION

In order to ease the study of the science of commercial law, the subject has been classified in four large universes: (1) persons, (2) objects of commerce, (3) legal instruments derived from business relations, and (4) administrative and jurisdictional procedures. The administrative procedures are held in front of administrative courts and the jurisdictional procedures in front of judicial courts.

Within the universe of commercial relations, where persons and objects converge, all legal instruments are, and operate as, a support for commercial exchanges. An example of this is commercial contracts, which due to their nature are known in this universe as atypical contracts<sup>1</sup>.

In the large world of business transactions, the central aspect that stands out is the commercial enterprise, that is, the “juridical person.” To ensure that enterprises may conduct their activity they require a “juridical personality,” which allows for the exercise of rights and fulfillment of obligations that lead us to the study of legitimation.

The legal instruments most widely used by corporations are the atypical contracts. These legal instruments lead us to analyze the juridical person, taking into consideration that it implies another extensive field of study known as the “delimitation of competence of the parties” who participate in the contract, as generating entities of rights and duties, that revolves around legitimation of personality, which, at the same time, could be a point of dispute in business transactions.

The problem about the legitimation of personality, notwithstanding that apparently accepted the terms juridical person and juridical personality, the scope of legal consequences for both, provoke incalculable and diverse conflicts (the lack of legitimation for act in name of a company, when the legal representative acts without authorization of the part involved) not only at domestic level, but also

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<sup>1</sup> Atypical contracts are those whose content has no control or the discipline does not exist in the legislation regarding to the relationship in private law between individuals who contract

at regional and global levels. This can be positive, in that it can enrich the rules of the International Chamber of Commerce and improve model laws that provide cross-border judicial support. However, this can also have a negative impact, giving rise to large and spiraling expenses, when one of the parties must ask for consultant support because they do not know the language (procedural rules and regulations of the proceedings), in the administrative or judicial proceedings.

To analyze the subject matter of this study, the “juridical person,” which has been a topic for discussion since the 19th century up to the 21st century, a consultation among authors including Bonnacase, Carnelutti, Savigny, Hans Kelsen, Nicolai Hartman, Ferrara, De Benito, Garcia Maynez, Rudolph Von Ihering, has been a strict scientific commitment, concluding with the personal contribution provided by Arcelia Quintana, has been updated.

## I. PERSON

A person is juridically classified in two groups: natural persons and juridical persons.<sup>2</sup> The first group refers to a human being, who is an individual being capable of assuming obligations and capable of holding rights. The second group refers to those entities endowed with juridical personality who are usually known as a collective person,<sup>3</sup> social person,<sup>4</sup> or legal entity. In this paper, the term “entity” will be often used when referring to this second group.

## II. GENERAL CONCEPT

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<sup>2</sup> ARCELIA QUINTANA, *COMMERCIAL LAW SCIENCE* 270 (2d ed. 2004).

<sup>3</sup> The term collective legal entity is used by Francisco Carnelutti and it has been the subject of studies in various areas of general law. *See* FRANCISCO CARNELUTTI, *GENERAL THEORY OF LAW* 153 (1955).

<sup>4</sup> *See* JOSE L. DE BENITO, *THE LEGAL PERSONHOOD OF COMPANIES AND* 32 (1955).



A. Etymology.

Beginning with an etymological understanding of “person,” we must reconcile the juridical fiction with what the law defines as a juridical person.

The word “person” has multiple meanings.<sup>5</sup> From an etymological sense this word is derived from *personare*,<sup>6</sup> a term that denotes *larva histrionalis*, meaning “mask.” In this manner, the person acted as the mask covering the face of an actor who recited verses during a scene in a play because the purpose of the mask was to make the actor’s voice resonant and loud. Later, people used the term “person” in reference to the masked actor himself. In view of the above, it is quite understandable to associate the person as a natural being of the human species.<sup>7</sup>

B. Doctrine.

The term “person” has been an important concept in the general scope of law, in civil matters.

In order to determine what should be understood by “person,” diverse legal scholars have created varied studies attempting to clarify its origin.

These studies described below express and analyze diverse positions developed by different legal scholars<sup>8</sup> whose ideas have served as a model to identify the different trends of thought explaining the juridical person. In the intelligence that we exclusively expect to establish for science of commercial law effect, the relevant items that

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<sup>5</sup> See EDUARDO G. MAYNEZ, INTRODUCTION TO LAW 273 (Porrúa 31st ed. 1980).

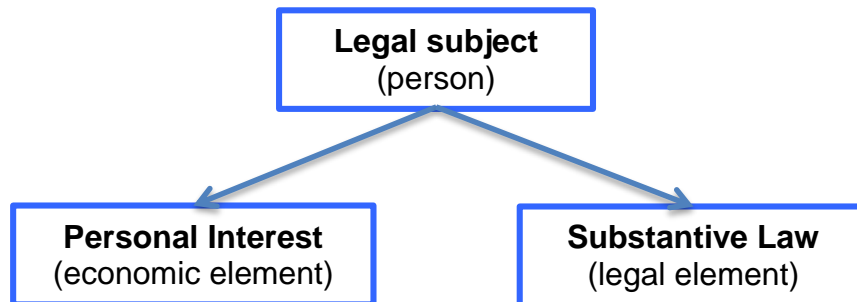
<sup>6</sup> See *id.* (Aulo Gelio quoted by Garcia Maynez, determined through their glossological research that the origins of the word “person” are unclear but most likely derives from the word “pesonare”).

<sup>7</sup> ROYAL SPANISH ACADEMY, DICTIONARY OF SPANISH LANGUAGE, voice, person (Espasa, 1593).

<sup>8</sup> Among the authors who have devoted themselves to the study of the “person” are Francisco Ferrara, Hans Kelsen, Francisco Carnelutti, M.F.C. de Savigny, Joseph L. Benito, and Eduardo Garcia Maynez, whose works are reviewed in this paper.

allow us to specify on the commercial matter what we should understand by “legal entity” or “juridical person” as an entity capable of having obligations and rights.

Francisco Carnelutti<sup>9</sup> understands “person” in a triangular sense. He views the subject as the vertex in which the personal interest (economic element) and the subjective right (legal element) coincide in a legal relationship.



For Carnelutti, the person is the “meeting point of these two elements, that is, the crux of the matter where both converge.”<sup>10</sup> Carnelutti clarifies that the juridical person is not only the man considered in his individuality. Instead, Carnelutti affirms that where collective interest exists, i.e. leading several men as one, unity is allowed to emerge, and personality as a unit will be acquired.

The collective juridical person, as Carnelutti expresses, is created when the economic element and the juridical element of the relationship is the meeting point of more than one man, which is the fundamental principle of this unification of the collective interest.

For Carnelutti, a juridical person is a natural or individual person as well as a collective or compound person,<sup>11</sup> and both hold a common characteristic: they are the meeting point of the economic and juridical element. The latter differs from the fact that it is not a single individual in that position, instead it is two or more individuals who are united by a collective interest.

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<sup>9</sup> See FRANCISCO CARNELUTTI, *GENERAL THEORY OF LAW* 149 (1955).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 143.

Julien Bonnecase<sup>12</sup> on the other hand, defines the juridical personality law as a set of rules and institutions that apply to the person itself, in its individuation and its power of action. For him, the personality law is classified in three parts:

1. The existence and individuation of persons, which means the set of elements that allow on one hand social distinction of the person, and on the other hand, a determination of juridical effect. The elements that allow for further distinction are its name, its legal status, and its address.
2. The legal capacity of natural persons and their variations: on one hand the guidelines of the organization in regard to capacity of natural persons and their variations (capacity to enjoy and exercise capacity with their limits), and on the other hand the study of the legal bodies which substitute for the incapacity of natural persons.
3. The existence, individuation, and capacity of legal entities or juridical persons, which is the subject matter of this paper.

M.F.C. de Savigny<sup>13</sup> is the strongest proponent of the traditional theory, better known as the theory of fiction.

From the analysis of Savigny's proposed theories, it is understood that the legal entity is an artificially-created being, capable of having a patrimony, but distinguished by its lack of will. Savigny concludes that a "person" is any entity capable of having obligations and rights because the juridical persons are legal fictions, therefore they do not have free will and are not subjects of law. According to this trend of thought, the term "person" applies only to the human being

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<sup>12</sup> See 1 JULIEN BONNECASE, ELEMENTS OF CIVIL LAW 281 (Jose M. Cajica trans., 1945).

<sup>13</sup> His book, *Modern Roman Law System*, elaborated on the foundations of his theory of fiction, which dominated from the mid-nineteenth and twentieth centuries. See M.F.C. SAVIGNY, MODERN ROMAN LAW SYSTEM 304 (Jacinto Mesía & Manuel Poley trans., 2009).

because it holds the will to acquire rights and duties, and for the same reason, becomes a subject of law.

Hans Kelsen<sup>14</sup> argues that according to the traditional theory, a “subject of law” refers to the object of a legal obligation or subjective right. This is known as the juridical power to claim an action for the enforcement of an obligation. In view of this juridical power, the subject participates in the production of the court judgement considered as an individual norm that will rule on the enforcement of the penalty derived from that default.

In sum, for Kelsen<sup>15</sup> the natural person and the juridical person are merely a set of rights and obligations which, when taken together, are metaphorically expressed as the concept of “person.” In this way, the natural or juridical person as a holder has legal obligations and subjective rights which are metaphorically expressed in the concept of person, which is nothing more than the personification of that unity.

Garcia Maynez<sup>16</sup> defines a “person” as “any being capable of having powers and duties.” He maintains that juridical persons are classified as either natural persons or legal entities. While the first group refers to human beings as a subject of rights and obligations, the second group focuses on those associations endowed with personality such as unions or commercial corporations. Maynez prefers to distinguish between the two groups by using the terms “individual juridical person” and “collective juridical person”<sup>17</sup> with the purpose of distinguish them.” In a moral or ethical sense, a “person” is a subject endowed with free will and reason, capable of establishing its own purposes freely as well as finding means to complete them.

Maynez affirms from an ethical point of view, and in accordance with the thesis of the German philosopher Nicolai Hartmann,<sup>18</sup> that a “person” is the subject whose conduct is able to

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<sup>14</sup> See HANS KELSEN, *PURE THEORY OF LAW* 178 (Robert J. Vernengo trans., 2000).

<sup>15</sup> *Id.* at 183.

<sup>16</sup> See EDUARDO G. MAYNEZ, *INTRODUCTION TO LAW* 21 (31st ed., 1980).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 274-275.

express moral values. He clarifies that those values do not necessarily determine its conduct, in such a manner that ethically speaking, free will is one of the essential attributions of personality.

The juridical meaning of a natural person is related with determination if the juridical personality is the necessary consequence of its quality as a human being; in a sense that the juridical personality of the individual does not derive from his human existence.

In respect to the concept of legal entity, Maynez states that it should be viewed through the “theories of juridical personality of collective beings.”<sup>19</sup>

- Theory of Fiction (Savigny). Savigny sustains that a person is any being capable of obligations and rights, and rights are only for beings who are endowed with will, therefore, the juridical subjectivity of collective persons is a result of this fiction, since such beings do not have a free will.<sup>20</sup>
- Theory of Rights without Subject (Brinz). Brinz classifies the patrimony in two categories: personal and non-personal, also known as patrimonies attached to a destination or purpose. In the first category they belong to a subject, while in the second category they do not have an owner, but their destination is addressed by a particular purpose and enjoys special legal guarantees. Here, although the rights exist, they do not belong to anyone but to something.<sup>21</sup>
- Realist Theories. The realist theories affirm that private and public juridical persons are realities, therefore, the concept of subject of law is not limited to man, and does

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<sup>19</sup> *Id.* at 278-94.

<sup>20</sup> *Id.* at 278.

<sup>21</sup> *Id.* at 282–83 (stating that, “[t]he rights and obligations of collective persons are not, according to the Brinz thesis, the obligations and rights of a subject, but of its assets. The acts carried out by the former’s agents are not exactly those of the legal person but rather those of the agents that carry out the objectives and reach the goal toward which the assets are dedicated. Despite this, all rights are, *a fortiori*, the legal power of someone and any obligation necessarily implies the existence of an obligee.”).

not exclusively refer to beings endowed with will. These theories also include the “organicism,”<sup>22</sup> the collective soul theory,<sup>23</sup> and the thesis of the social organism.<sup>24</sup>

- Theory of Francisco Ferrara. For this author, the word “person” has three meanings: a biological sense, which is equal to a man; a philosophical sense, which is identified with a rational being capable of proposing and carrying out purposes; and the juridical sense which understands the person as a subject with rights and obligations.<sup>25</sup> Specifically for this juridical sense Ferrara states that it is a way things are, because behind the person there is not any other thing but associations and corporate organizations.<sup>26</sup>

Maynez<sup>27</sup> expressed a critique to Ferrara’s ideas, stating that the recognition of juridical personality by the substantive law does not have constitutive effectiveness. That is to say, the juridical person is not born at the discretion of the legislator, the only thing the legislator does is to recognize its existence.

The diversity of the approaches around the concept of person make it necessary to contemplate the following comparative table to clearly understand the concept:

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<sup>22</sup> *Id.* at 287 (organicism is based on the notion that “collective entities are real entities compared to the human individual.”).

<sup>23</sup> According to this school of thought, in every society there exists a soul or collective spirit that is different than the individual souls of those who make up the group, which is why it is not problematic that collective legal entities coexist alongside physical persons.

<sup>24</sup> *Id.* at 287 (The chief proponent of the theory of social organism is Otto Gierke, who says that “the collective person is not like a third party compared to its members, it is the organic link that binds them together, from which stems the possibility of connecting the rights of the unit and the whole. The corporative person is undoubtedly above, but not separate from, the collective group of persons who make it up; . . . it is an entity that is both unique and collective.”).

<sup>25</sup> *Id.* at 288.

<sup>26</sup> See FRANCISCO FERRARA, THEORY OF LEGAL PERSONS 342 (Eduardo Shepherd & Maury trans., 1929).

<sup>27</sup> See EDUARDO G. MAYNEZ, INTRODUCTION TO LAW 294 (31st ed. 1980).

Person	Doctrinal Concept
FRANCISCO CARNELUTTI	Is the meeting point between the economic element and the juridical element.
M.F.C. DE SAVIGNY	Person is any being capable of obligations and rights, who is endowed with will.
HANS KELSEN	The object of a legal obligation or subjective right.
EDUARDO GARCÍA MÁYNEZ	Any being capable of having powers and duties.
EDUARDO GARCÍA MÁYNEZ	As a subject with rights and obligations.

In this study, the first authors are from the classical theory and the last authors are from modern theory, demonstrating that the theory itself has not changed. Thus, the comparative analysis of classical theory and modern theory becomes more explicit.

### III. ELEMENTS THAT SHAPE THE LEGAL ENTITY

As the concept of “person” has been analyzed in its etymological sense and by the main exponents of the doctrine, it is now necessary to study the elements that contribute to the juridical person.

#### A. Doctrine

As mentioned, for Kelsen both natural persons and legal entities hold physical rights and obligations. In principle, only the human being is considered a person, because it is exactly its conduct that may infer a right, comply with or fail an obligation. Both natural and juridical persons express conduct which is understood as the

content of juridical obligations and subjective rights that conform to this unity.

In reference to the duties of the juridical person, its bylaws, as internal regulations, determine or constrain the conduct of the individual who-as a body of the same-fulfills or violates the obligation. This circumstance of non-fulfilment in the juridical person is known as the “fictitious attribution”<sup>28</sup> which allows for the consideration of the legal entity as capable of being bound by obligations.

As to the subjective rights of the juridical person, Kelsen believes that they are exercised by a body of administration contained in the bylaws, and shall be conferred to the legal entity according to the bylaws.<sup>29</sup> According to this author, the bylaws acquire validity by means of a juridical transaction determined by state order.

Finally, Kelsen<sup>30</sup> defines the juridical personality of the legal entity, which means that the legal order provides obligations and rights and their content is the conduct of human beings who are the bodies or members of the corporation organized by its bylaws and may be described with advantages by means of a personification of the corporation’s charter.

The elements of the legal entity deduced from the theory of Kelsen are the following:

- The being or artificial person;
- Conduct;
- Legal capacity;
- Subjective rights;
- Obligations;

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<sup>28</sup> See HANS KELSEN, *PURE THEORY OF LAW* 196 (Robert J. Vernengo trans., 2000).

<sup>29</sup> *Id.* at 191.

<sup>30</sup> *Id.* at 199.



- The will; and
- Juridical personality.

José L. De Benito,<sup>31</sup> from his point of view, sets forth the following as “conditions” for the existence of a juridical or corporate person:

- Plurality of individuals;
- Cooperation;
- Organization;
- Exclusive patrimonial capacity; and
- Corporate purpose.

The elements of a juridical person defined by Carnelutti are as follows:

- Legal capacity;
- Juridical personality;
- Economic element; and
- Juridical element.

B. Personal opinion of the author

- The elements that contribute to the formation of a legal person are the following:
- Existence of a being or subject: A subject of law is any being capable to act as holder of powers, or liable with

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<sup>31</sup> Professor of the National Academy of Legislation and Jurisprudence of the National Association of Historians of the Spanish Science. De Benito refers to the personality not as an element of the legal person, but as the result of a combination of the five elements. For him, that personality is the recognition the person expresses in front of the public.

obligations in a juridical relationship. The term subject of law or juridical being alludes to an unspecified person in terms of strict law.

- Will of the subject or being. The action of a subject with the intention of producing certain legal effects, and should be highlighted its importance for the law, since this will should be also expressed in an appropriate manner to produce legal consequences.
- Subjective rights. This refers to the power of the juridical norms which is granted to express or omit certain conduct that ensures the judicial protection.
- Juridical personality. This section requires a study to be discussed separately.
- Obligations. The obligation is understood as the existing juridical bond between the demand of a subjective right by its holder and the duty to fulfill the conduct based on the norm that is imposed on the other subject who belongs to the relationship.
- Economic interests.

### C. Juridical personality.

In the juridical field, the word personality has several meanings. It is often used to indicate the quality of a person to be considered as a center of juridical norms or as a subject of rights and obligations.

For the purpose of taking part of juridical relationships, the legal entity needs the so-called personality as an element that individualizes the entity. It is helpful to distinguish the legal entity from a different subject of law with a will that may be found in a similar factual circumstance.

*1. Theories of personality* - This study analyzes the most emblematic theories of personality that intended to explain personality in relation to business corporations, such as the patrimony appropriation theory, the theory of the apparent subject, the atomistic

theory of the state, the theory of fiction, the theory of the legal act, and the controversial theory of veil.

We have mentioned that, except for the theory of the legal act which establishes the difference between “person” and “personality,” none of these theories explains what personality is, but analyze the juridical person in general. Even so, these theories have been described by authors such as Garcia Maynez<sup>32</sup> and Cervantes Ahumad, among others, as “theories of personality” even when considering the juridical person itself rather than its personality.

Finally, we should emphasize the exposure of the reference theories can be viewed through Franciscos Ferrara<sup>33</sup> in his work “Theory of Legal Persons.” This author developed, in an objective and systematic way, the study of the doctrinal ideas now discussed, which in turn have been studied by several authors such as Garcia Maynez<sup>34</sup>, Mantilla Molina<sup>35</sup> and Antonio Brunetti.<sup>36</sup>

(1) *The patrimony appropriation theory.* - This theory considers that there exists the same legal protection to one good and one person in a legal relationship than such created between patrimony and purpose. In this manner, the purpose receives rights and obligations, that is to say, a patrimony appropriated or earmarked for certain purpose.

In this theory there are no elements to identify what personality is, even when intending to put on the same level one subject of law with a “purpose” with rights, understood as patrimony that is able to generate rights and obligations; however, an inert patrimony is not susceptible of creating de jure relationships. For such effects, a volitive being or person is required, whether it is natural or juridical, because juridical relationships presuppose the expression of a conduct that produces consequences of law. At the time one subject expresses or

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<sup>32</sup> EDUARDO G. MAYNEZ, INTRODUCTION TO LAW 278 (31st ed. 1980).

<sup>33</sup> It is worth mentioning that Ferrara is located, by temporality, very close to the time that such doctrinal positions were exposed. *See* FRANCISCO FERRARA, THEORY OF LEGAL PERSONS 122 (Eduardo Shepherd & Maury trans., 1929).

<sup>34</sup> MAYNEZ, *supra* note 32, at 274, 280, 293.

<sup>35</sup> ROBERTO L. MANTILLA MOLINA, COMMERCIAL LAW 207 (29th ed. 2002)

<sup>36</sup> ANTONIO BRUNETTI, JOINT STOCK COMPANY 45 (1960).

personifies himself juridically, it is required that this subject has will because only in that way is it possible to produce consequences of law, which also allows individualization of the volitive subject in respect to other persons who intervene in those relationships.

(2) *Theory of the apparent subject.* - The theory of the apparent subject was developed by Rudolph Von Ihering,<sup>37</sup> who argues that the law consists of two elements. One element is substantial, which resides in the practical end that produces utility or enjoyment of the things that have economic or moral value, and, the other element, formal, is only related to this aim as a means of enjoyment protection; so this author asserts: “the rights are interests juridically protected; the law is the legal certainty of enjoyment.”<sup>38</sup>

For Ihering, only the natural person has personality because it is the sole recipient of the protected interests (the above mentioned), contrary to juridical persons who do not enjoy said prerogative. The juridical personality of legal entities is something that is not inherent to the quality of man because personality does not derive from the will of natural persons.

Although the legal entity has its own legal interests, this does not mean that personality resides essentially in norms. This is because even when law is effectively “a set of substantive and adjective norms”<sup>39</sup> used to regulate the life of man; these norms by themselves do not create personality, in contrast, they only recognize a situation can be useful as a factor of individualization for the volitive subject, even when this subject suffers a reduction in its capacity.

(3) *Atomistic theory of the state.* - This theory stems from the idea that the creation of the State is grounded in the conception of

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<sup>37</sup> Rudolf Von Ihering was born in Aurich, Germany in 1818. His legal training took place at the universities of Heidelberg, Munich, Göttingen, and Berlin. He served as a teacher in Basel, Rostok, Kiel, Gissen, Vienna, and Göttingen, where he died in 1892. His methodological points of view had a great impact on the field of historical legal research and the science of law in general.

<sup>38</sup> RUDOLF VON IHERING, *THE SPIRIT OF ROMAN LAW* 1033, 1040 (1998).

<sup>39</sup> ARCELIA QUINTANA, *COMMERCIAL LAW SCIENCE* 6 (2d ed. 2004) (the law is “a set of substantive and procedural rules issued by the state and that govern, during the time in which they are in effect, members of a society in a given territory.”).

Ihering. This means that only men are a reality and are able to act, therefore, personality is an attribution for individuals only, not for the State.

The juridical person in private law is conceived as a fact ruled by the legal order. A personality, then, is when the law recognizes the pursuit of a common purpose by a collection of individuals, as if the pursuit was done by a single person. This emerges when personality is linked with a situation of fact<sup>40</sup> recognized by the juridical norm, as a factor of individualization of the volitive being, and it does not imply that a sole statement defines the personality, because the recognition of the norm is a requirement as well as the will of the being whose norm should be individualized.

(4) *Theory of fiction.* - Friedrich Karl Savigny<sup>41</sup> supported the theory of fiction, which is considered the most disseminated and the oldest since it prevailed until the first half of the 19th century in Germany, and the middle of the 20th century in Italy and France<sup>42</sup>. In conformity with this stance, only man has capacity to be a holder of rights and obligations.

The theory of fiction sets forth the idea that the juridical person or legal entity represents an exception to the principle that only the natural person has capacity to act as holder of rights and obligations. This is a result of a legal fiction that recognizes the artificial capacity for possession or ownership of property<sup>43</sup> by a fictitious being.

Savigny defines the juridical person as a subject of goods who was created artificially, by virtue of the fact that said being only develops his capacity or juridical personality within the limit of the domain of goods, which are the only means to reach the purposes it was created for.

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<sup>40</sup> The expression "situation of fact" is used in strict law way, understood as factual circumstance which necessarily produce legal consequences.

<sup>41</sup> Karl Friedrich Savigny (1779-1861) was born in Frankfurt, Germany. He studied at the University of Göttingen and University of Marburg, and was a professor of law in University of Marburg, University of Landshut and at University of Berlin. He was a leader in the field of legal history.

The theory of fiction confuses personality with the capacity to act; likewise, this theory puts in the same level the natural persons, who are incapable juridically, with collective juridical persons. When considering that fictitious subjects of law and those affected by a *capitis deminutio*, are not able to personify themselves or express their will in juridical relationships by themselves, in consequence, they require a representative to exercise the personality – capacity to act – that law provides them in a fictitious manner.

(5) *Theory of the legal act.* - Ferrara,<sup>44</sup> when referring to the juridical personality of the legal entity, argues that juridical personality is not a thing, but instead a way things are. The juridical personality is the organic vestment used by certain groups of men or establishments to introduce themselves in the life of law, it is the legal configuration certain groups of men assume in order to participate in commerce. The personality is a juridical seal that comes from the outside to superimpose on these phenomena of association and social order, which may facilitate, vary, or change the substratum of the substance subject to this juridical seal which is always a collectivity or a social organization. For this reason, there is not a substantial difference between corporations and non-recognized associations. Both have an identical substratum, and the recognition of personality does not have value other than granting to these pluralities of individuals' variables, which are the most appropriate form of a juridical unit.<sup>45</sup>

As derived from the theory subject matter of this section, the legal order does not create juridical person; it only recognizes them as individualized subjects with pre-existing rights and duties in the social reality. This legal recognition is the element that comes to construct its personality.

Juridical personality is a juridical fiction due to juridical person exists by rule of law and it is necessary emphasizes it. It is necessary to understand the rights and duties applicable to the juridical person; as they are still the origin of legal disputes.

(6) *Theory of veil.* - This stance arises from the argument that it is possible to “penetrate” the legal entity raising its “formal veil”

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<sup>44</sup> See FRANCISCO FERRARA, THEORY OF LEGAL PERSONS 342 (Eduardo Shepherd & Maury trans., 1929).

<sup>45</sup> *Id.*

up. The theory covers the same in situations where a determined corporate form confers directly to partners the legal consequences from acts this entity executed to disregard it or set said legal entity aside, with the purpose that partners respond to corporate transactions they made with personal purposes under the protection of the corporate structure in question, causing a patrimonial detriment to third parties or evading legal prohibitions, that as a natural person, they could have not overcome.

The legal scholar Rolf Serick is recognized as the pioneer in the systematization of the study based on the analysis of diverse court decisions. The theory of veil has its origin in United States law, having as a frame of reference the precedent of diverse judicial resolutions issued by United States courts, as well as opinions from different legal scholars. This trend of thought is known as the “theory of disregard” or doctrine of the “disregard of legal entity”.

The argument supporting this theory begins from the “abuse” by partners of the juridical personality by commercial corporations when they use it as “screen” for a personal benefit. These partners hide behind “the veil” that covers them with a corporate structure, failing contractual obligations that infringe third parties interests and evading the law.

Frederick James Powell is considered one of the most representative proponents of the theory of disregard in the United States. He has defined this theory as “the non-recognition of the juridical personality of a commercial corporation in a concrete case, which allows said legal entity to reach natural or juridical persons behind the same, including the underlying economic reality, in order to apply them the corresponding positive law for the concrete situation.”<sup>46</sup>

In English law, Laurence Cecil Bartlett Gower<sup>47</sup> classifies the cases in which partners are permitted to “prescind” from the legal personality of a commercial corporation into four categories: 1) cases related to tax matters; 2) cases of sole partner corporations; 3) cases in

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<sup>46</sup> *Id.* at 30 (citing Nicolas H. Oreggia).

<sup>47</sup> *Id.* at 21.

which corporations develop their activity with fraudulent purposes; 4) holdings and subsidiaries.

On the other hand, when making a severe critique to the concept of juridical person, the supporters of the contractual theory assure there are not absolute and invariable concepts, and the juridical person should be subject to an examination; especially, if under its scope there is an abuse of the legal personality.

Now then, the applicability of this theory has used the technique of disregard of a legal entity, which consists of setting aside the juridical personality of the being, penetrating in the personal substratum of the partners (shareholders), “raising the veil up” of the legal entity.

In Mexican Positive law<sup>48</sup>, which also involves in an implied manner, the non-recognition of said personality, as an essential element of the legal entity which will cause to deny that commercial corporations are subjects or rights different to those granted to partners who gave rise to its foundation.

The above would contradict the principle contained in Article 2 of the Law of Commercial Corporations, which recognizes a personality in legal and illegal corporations, with the requirement for the latter to reveal themselves as such before third parties.

As a conclusion, we may affirm that juridical personality is conceived as a “veil” that covers the legal entity, which may be raised up or uncovered in case of its abuse and use by the partners for their personal benefit in prejudice of third parties or to evade the applicability of legal provisions, which, as individual persons would fail to observe, provided, however, that making use of said person and its personality they do overcome such obstacles for their personal benefit.

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<sup>48</sup> The theory of the abuse of the juridical personality, the theory of the underestimation of the personality, the raising up of the veil (to mention only some of the names given to this theory).



2. *Requirements for the legal personality.* - The requirements that help to construct or concrete the legal personality, and, at the same time, establish its juridical concept are the following:

First of all, the patrimony appropriation theory, the theory of the apparent subject, the atomist theory of the State and the theory of fiction identify personality as something innate to man, therefore they use as synonyms the terms person and personality, even when there are different juridical figures. Likewise, they associate personality with will or capacity. For that reason, these theories affirm that only the natural person holds a real personality, since a human being exclusively has a will, the collective beings are only a fiction or an appearance.

Different from the theories cited above, the theory of legal act recognizes the own will to the legal entity, and it also distinguishes person and personality.

In order to produce the individualization of the subject of law, three requirements must be fulfilled. These refer in a certain manner to the real factor and the formal factor:

1. The existence of a being or a subject of law. To specify the personality we require the existence of a being or a subject of law, a volitional entity considered *legally real*, that could be expressed in juridical relations.
2. A situation of fact that individualizes it in the holdership of rights and the fulfillment of obligations. Juridical relations, who can be established as a result of a natural phenomenon, achieve this or the will externalized by that subject. In such a way that this one is situated or has a *status* which allows to differentiate it from the other volitive subjects; that is, it is legally individualized.
3. The recognition of individualization by the normative legal order. This third requirement refers to legitimation<sup>49</sup> of the

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<sup>49</sup> Legitimacy comes from –legitimo- that, in turn derives from the Latin *legitimus* (-a, um). In common language it means “under the rules”. In the legal literature, *legitimus* means, “according to law”, “fair”. For the Romans, “designate

volitive subject as a holder of determined rights or certain obligations in a juridical relationship. It is necessary that the being or volitive subject and the situation of fact are under a legal rule in order to individualize that person, that is, acquire a certain legal status.

In conclusion, personality is established when a legal assumption is updated in reality as long as it is foreseen in a general norm of law that describes a determined situation of fact where the subject or undetermined person is, with the purpose to individualize it as a holder of determined rights or certain obligations in a specific juridical relationship.

#### IV. PERSONALITY IN THE COMMERCIAL LEGISLATION.

In Mexican commercial legislation there is no precept that defines juridical personality, even when the term is also used by said legislation; especially in adjective or procedural aspects. Thus, the legal provisions that refer to the juridical person generally do it in function of the necessary quality that one person shall have to intervene in certain legal act or legal transaction of a commercial nature.<sup>50</sup>

In other commercial laws,<sup>51</sup> the term is used in reference to the fact that certain beings who belong to the State, in charge of regulating

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something practiced or maintained as correct; produces a favorable reaction, approval.”

<sup>50</sup> Código de Comercio [CCo.], *as amended*, art. 391, Diario Oficial de la Federación [DO], 17 de abril de 2012 (Mex.) (unless the otherwise agree, the assignor of goodwill will answer only for the legitimacy of the credit and for the personality from who made the assignment).

<sup>51</sup> Among these bodies of regulatory law are the Ley de Cámaras Empresariales y sus Confederaciones y del Código de Comercio [Law of Chambers of Commerce and their Confederations], *as amended* art. 4, Diario Oficial de la Federación [DO], 30 de abril de 2009 (Mex.); Ley de la Casa de Moneda de México [Law of the Mint of Mexico], art. 2, Diario Oficial de la Federación [DO], 20 de enero de 1986 (Mex.); Ley Federal de Protección al Consumidor [LPC] [Federal Consumer Protection Law], Diario Oficial de la Federación [DO] 24 de diciembre de 1992 (Mex.); Ley General de Sociedades Mercantiles [LGSM] [General Law for Commercial Corporations], Diario Oficial de la Federación [DO], 4 de agosto de 1934 (Mex.).

several aspects of the commercial activity, have juridical personality of their own, without expressing what it means.

The reference to personality cited in said legal systems is generally in a negative way, that is, it refers to the inexistence or loss of the same; it is a *contrario sensu* circumstance that allows to affirm that persons shall demonstrate the existence of that element to execute certain juridical acts.

The adjective precepts of the Commercial Code<sup>52</sup> that rule this juridical figure, do not provide a definition thereof; however, its meaning is understood when determining that judges shall examine *ex officio* the personality of the parties. They even foresee that litigants may challenge such of their counterpart, when it is considered that the plaintiff or defendant does not have the juridical quality he holds and appears in court.

It is possible to conclude derived from the analysis above, related to several commercial provisions in which it is proven the concept of legal personality that we expressed as a personal opinion, it is the appropriate because such element holds a practical applicability.

#### V. THE PERSONALITY IN JURISPRUDENCE.

The criteria that has been established in federal courts does not provide a clear concept of what personality is, because the courts are limited to produce the text of the law with some variations, when establishing that “personality is a matter that shall be examined in any status of a trial and even *ex officio* since it is the fundamental basis of the procedure.”<sup>53</sup>

In reference to a commercial corporation that appears at a trial, it is necessary to show two personalities. First, from the juridical as a legal entity who is legitimated in the legal cause. Second, as the one from its representative, being understood that the latter shall prove it

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<sup>52</sup> Código de Comercio [CCo.], art. 1056–62 (regulating personhood and the legal capacity of the parties).

<sup>53</sup> See Jurisprudential Thesis II, *Personhood: Its Study can be made in any Stage of Trial, Even Officiously*, Semanario Judicial de la Federación 1917-1995 41.

has sufficient powers to act on behalf of the other, which should have been granted by the corporate body authorized for said purposes. The above has been considered by the jurisprudential criteria by the Second Courtroom of the Supreme Court of Justice of the Nation.<sup>54</sup>

However, there are other criteria<sup>55</sup> in which the personality of a representative of a legal entity is still being considered as a derivation of its principal.

Thus, the topic related to the personality of juridical persons is controversial in the field of jurisprudence, because there is not uniformity of criteria in the final judgements pronounced in that sense.

#### VI. ELEMENTS OF THE LEGAL ENTITY IN MEXICAN LEGISLATION

The Political Constitution of the United Mexican States in its federal nature, in Articles 5, 13, 14, 16, 20 of sections V and IX, among others, use the term person to refer to natural persons and legal entities, and the Magna Carta considers them as subjects of law in generic hypothesis that rule said precepts. From such normative assumptions, it may be confirmed that the constitutional text alludes to those who are holders of constitutional individual guarantees that include the legal entity and the natural person as well. Afterwards, it is deduced that the principal element that recognizes to the juridical person is such of the subjective rights expressed as guarantees.

On its part, the Federal Civil Code in the First Book known as “Book for Persons” includes natural persons in its First Title, in the Second Book includes the legal entities. This Law details that legal entities are the following: the Nation, the States and the Municipalities, the other corporations of public nature recognized by this Law, professional associations and others cited by Section XVI of Article 123 of the Federal Constitution, the mutual cooperative companies,

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<sup>54</sup> See Jurisprudential Thesis, *Personhood in the Labor Process, Requirements that Notarial Testimony must Satisfy Regarding Corporations*, XII Federation Judicial Weekly and its Gazette 112 (2000).

<sup>55</sup> See Thesis 892, *Personhood Derived Representation or Support*, VI Semanario Judicial de la Federación 1917-1995 613.

those associations who are different to the above mentioned (natural person and legal entity or juridical person) that propose political, scientific, artistic, recreational purposes or any other legal purpose, as long as they are recognized by law, as well as foreign legal entities of a private nature.

From the above we conclude in conformity to the provisions of the Federal Civil Code that rule the person subject matter of this study, the following elements are deducted: subjective rights, obligations and will.<sup>56</sup>

The commercial legislation<sup>57</sup> also refers to the natural person and the legal entity or juridical person, to qualify them as merchants, applying for such affects an objective and subjective criteria as to the first of them, and one formal for the second.<sup>58</sup>

Now then, the qualification as merchant that is provided by the Commercial Code in respect to the juridical person, commercial corporation, is an effect related to its juridical personality as it happens in the Federal Labor Law that qualifies the worker to the individual that provides a personal service who is subordinated to another, whether it is a natural person or legal entity by means of the payment of a salary. Accordingly, the element that is deducted from the Commercial Code is the juridical personality of the legal entity that allows it to individualize itself as merchant.

From the General Law of Commercial Corporations, the other element that is deducted is concerned with the will of the juridical person. However, this will is referred to the activities of the juridical

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<sup>56</sup> See section V.1 *supra*, the legal entity defined by doctrinal elements.

<sup>57</sup> Código de Comercio [CCo.], *as amended*, art. 391, Diario Oficial de la Federación [DO], 17 de abril de 2012 (Mex.).

<sup>58</sup> ARCELIA QUINTANA, COMMERCIAL LAW SCIENCE 258 (2d ed. 2004) (according to the subjective criterion, those who conduct themselves according to law are merchants, regardless of whether or not they have a fixed place of business. According to the objective criterion, merchants are persons with legal capacity to enter into contracts and bind a business, engage in commercial transactions, and make this their ordinary job. According to the formal criterion, merchants are the *personas morales* formed upon satisfaction of the requirements of commercial statutes or and other applicable laws).

person itself which are reflected in the juridical relationships that are established or created as a consequence of that conduct, from which necessarily gathers subject rights and obligations for the juridical person, as the case may be.

The elements of the legal entity which come from the legislation are the juridical personality, the will, subjective rights and obligations referred to a being or subject, which are coincident with those detailed in the personal opinion.

## VII. ELEMENTS OF JURISPRUDENCE.

The legal entity as a subject of law has also been a topic for its reference in the different criteria issued by the tribunals of the federation.

In this way, as provided in an isolated jurisprudential criteria, the Full Circuit Tribunals refer to the nature and to the juridical personality of the legal entity, considering that “a legal entity is a fictitious entity, whose juridical personality is expressed and exercised by means of its representatives; since due to its nature, the juridical persons need individuals, managers or administrators to represent them, to act in their behalf because fictions do not operate by themselves.” At the time of analyzing these criteria, we may deduct other elements of juridical persons:

- One of them identifies the faculties or subjective rights of the juridical person;<sup>59</sup>
- The other is considered as the will of the being of social will; and another are<sup>60</sup>

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<sup>59</sup> See Thesis, *Directors, The Inherent Powers of a Trustee are Governed by the General Law of Business Corporations*, XVI Judicial Weekly of the Federation and its Gazette 1237 (2002).

<sup>60</sup> See Thesis, *Legal Representation and Corporate Manager, Differences Between Functional or Organic Representation and Mandates*, XII Judicial Weekly of the Federation and its Gazette 759 (2001).

- Obligations of the legal entity.<sup>61</sup>

From the above, we may also conclude that jurisprudence establishes the following elements of the legal entities:

1. The existence of a juridical being.
2. A will from said being which shall be foreseen in its bylaws contained in the incorporation deed and expressed in its representation bodies.
3. The legal entity is holder of rights and susceptible of acquiring obligations, which the legal entity exercises and fulfills.
4. It has a juridical personality of its own that distinguish the same from the partners who incorporate and convert it in a subject of law.

#### VIII. DEFINITION OF THE JURIDICAL PERSON OR LEGAL ENTITY FROM THE PERSONAL POINT OF VIEW

A legal entity is a juridical construction that is given with the following five elements: the being or subject, its will, the subjective rights, the obligations and the juridical personality.

In the specific case, the legal entity is individualized through the recognition of the juridical personality that allows the same to acquire the holdership of rights and being susceptible of obligations.

In consequence, the conduct of a juridical person implies its will. The importance of the personality, in addition to individualizing the subject as holder of rights and obligations, is also that it is the suitable means to allow the legal entity to exteriorize itself juridically.

The factual circumstance that individualizes the legal entity and the recognition made by the legal order is the essence that provides the legal entity with a juridical personality, since it is a factor of legal

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<sup>61</sup> See Thesis, *General Managers, cases in Which They Lack Standing to Obtain an Amparo Remedy*, III Judicial Weekly of the Federation and its Gazette 846 (1996).

exteriorization that distinguishes it from other subjects who also have a will and are capable of exercising rights and fulfilling obligations.

From the ideas above expressed it is asserted that juridical personality is a creation of law, which function is to individualize the subjects with rights and obligations, granting them legitimacy in the ownership of said rights to exercise them, and fulfill its corresponding obligations.

After we have established the arguments that support the present research, it is possible to assert that the juridical figure subject matter of the present study is not innate to the natural person, therefore, may be applied to legal entities, ideal beings for the real world, but real for the world of Law.

In effect, in juridical persons concur the five elements:

The first is related to the being or subject of law, that contrary to what we may think, it does not need a physical body to legally exist, and it is enough to have existence for the purpose of law.

The second element is the will of the subject, which is detailed in its bylaws.

The third and fourth elements, related to the subjective rights and obligations, are updated in the legal entity because the juridical person holds a will. However, there are cases in which it is not necessary the will in order to produce rights and obligations, since there are facts that determine it even if the volitive aspect concurs.

As to the juridical personality, as the fifth element, we may establish that the juridical personality also requires the conjunction of diverse requirements for its conformation. One of the other requirements that help to concretize the juridical personality is the factual situation that individualizes that subject. This occurs when the legal entity adopts one of the corporate structures foreseen in the General Law of Commercial Corporations, which individualizes it as a determined commercial corporation.

Besides, due to the recognition of those types of corporations in the legal order above cited, we obtain other of the elements



applicable to personality, which is the juridical recognition of such individualization, at the same time, as a result of the concurrence of said elements, the legal entity acquires a legitimate legal personality to consider it as holder of rights and obligations.

In summary, we may conclude that, joining the five elements that shall be met to conform said person, this is defined in the following terms:

The legal entity is a subject of an abstract existence, legally constructed with a will of its own, including rights, obligations and a juridical personality that individualizes it in the relationships of law and make it a center that generates rights and obligations of an economic, financial and commercial nature.

Following the order of ideas set out above, the legal personality is also susceptible to having a concept which will allow it to distinguish this from the legal entity.

Personality is the individualization of the juridical person by means of a factual situation in which it is placed, foreseen by a legal norm that allows personality to distinguish it from other volitive beings in the commercial-legal relationships in an environment of law where the concrete case develops.

**THE COLOMBIAN SIMPLIFIED  
CORPORATION: AN EMPIRICAL  
ANALYSIS OF A SUCCESS STORY IN  
CORPORATE LAW REFORM**

*Francisco Reyes\**

INTRODUCTION

On December 5, 2008, the Colombian government enacted Law 1258.<sup>1</sup> Over the five years since it was enacted, the country has witnessed a revolutionary turnaround in its corporate law.<sup>2</sup> Law 1258 introduced a new type of business entity to the Colombian system, which is referred to as a *Sociedad por Acciones Simplificada* (SAS).<sup>3</sup>

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\* Chairman of the United Nations Commission for International Trade Law (UNCITRAL) 2015-2016. Author on the draft for the Colombian legislation on Simplified Corporations and of the OAS proposed Model Act on Simplified Corporations. Law Professor at Los Andes University School of Law in Colombia. Visiting professor at University of Arizona, Stetson University College of Law, Louisiana State University, University of Fribourg, University of Tilburg, and Universidade Agostinho Neto de Angola.

<sup>1</sup> L. 1258, diciembre 5, 2008, DIARIO OFICIAL [D.O.] (Colom.) [hereinafter Law 1258].

<sup>2</sup> See *Data: Colombia*, THE WORLD BANK, <http://data.worldbank.org/country/colombia> (last visited Nov. 12, 2014) (Colombia is a Latin American developing country. It has a mid-size economy, the fourth in Latin America after Brazil, Mexico, and Argentina. According to the World Bank, its GDP for 2012 was U.S. \$369.8 billion and its ranked 30th within 214 countries on the GDP 2012 index).

<sup>3</sup> The entity's name was taken from French legislation enacted in 1994 concerning the *Société par Actions Simplifiée*. Additional legal provisions of the Colombian SAS were also transplanted from the French model. However, the entity also derives its inspiration from U.S. and Colombian sources. In fact, certain reforms initiated in Colombia almost twenty years ago (L. 222 diciembre, 20 1995, DIARIO OFICIAL [D.O.] (Colom.)) which had a limited impact in the business community, were reviewed and incorporated within the SAS law.

Consistent with a progressive approach, this law reduced cumbersome incorporation formalities to a filing before the Mercantile Registry.<sup>4</sup> Moreover, the law streamlined operations, reduced costs, and minimized formalistic requirements.<sup>5</sup> Importantly, Law 1258 made it clear that shareholders would be shielded from any liability concerning obligations arising from corporate business. It also reduced old-fashioned prohibitions pertaining to shareholders and managers activities and, most significantly, it reinforced an effective principle of freedom of contract. Furthermore, Law 1258 introduced an innovative enforcement environment where arbitration and administrative adjudication superseded inefficient judicial procedures<sup>6</sup>.

The Colombian SAS legislation is a simple but comprehensive legal system that governs relationships between shareholders and other corporate participants and outsiders, and also between the participants themselves. It is endowed with legal personality, inventor ownership, and full-fledged limited liability. All these features are available to corporate participants at the outset through an expeditious incorporation system. Concerning relationships with outsiders, the law provides a system of exceptional shareholder liability through the

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<sup>4</sup> Pursuant to L. 1258 art. 5, “the simplified corporation shall be created through a contract or a unilateral decision, that must be consigned in a private document filed before the Mercantile Registry . . . .” All traditional forms of business entities that existed before the SAS are still subject to Article 110 of the Commercial Code, whereby a company can only be created through a public deed granted before a notary public. Such deed must contain at least the clauses referred to in already quoted Article 110 (paragraphs 1 to 14), and fulfill the requirements set forth in L. 960, junio 20, 1970 [D.O.] (Colom.), for any instrument to be granted before a Notary Public. For additional information on the proceedings required to create a traditional type of business association in Colombia, see NÉSTOR HUMBERTO MARTÍNEZ, CÁTEDRA DE DERECHO CONTRACTUAL SOCIETARIO 96 et seq. (Abeledo Perrot ed., 2010).

<sup>5</sup> See L. 1258, art. 5-8; see also *Menos Trámites*, REVISTA SEMANA, Jan. 11 2009, at 68; see also *Las Sociedades por Acciones Simplificadas*, REVISTA DINERO, Mar. 25, 2010, at 20. See also Ignacio Sanín Bernal, *La ley SAS Remoja las Sociedades Comerciales (y Crea, También, Nuevos Retos)*, in ESTUDIOS SOBRE LA SOCIEDAD POR ACCIONES SIMPLIFICADA 47 (Francisco Reyes Villamizar ed., 2010).

<sup>6</sup> See L. 1258, art. 40 (stating that all differences arising among the corporation, shareholders, officers and directors can be submitted to arbitration); see also Alejandra Buitrago, *Colombia Simplifica Creación de Sociedades*, PORTAFOLIO, Dec. 18, 2008, at 6 (“Conflicts in the SAS can be resolved at the Superintendency of Companies or through private arbitration . . .”).

application of the disregard of the legal entity theory, although restricted to the events of abuse or fraud. As a result of the SAS revolution, there is increasing awareness concerning the need to revise anachronistic legal institutions that still hinder commerce and represent an obstacle to economic development.

The creation of this successful entity has changed the manner in which people do business in Colombia. The SAS has contributed vigorously to the regulation of thousands of businesses that in the absence of the benefits afforded by the new law would have never been formalized. It has also permitted local and national governments to collect millions of dollars in taxes.<sup>7</sup> At the same time, the SAS has fostered an exponential growth in franchise fees charged by mercantile registries all over the country.<sup>8</sup> Social security contributions, as well as other payments to governmental agencies, have increased over the last five years thanks to this new type of business entity.<sup>9</sup> Furthermore, several accounting, legal, and managing services have flourished along with the new business realities that the SAS has brought about.<sup>10</sup>

Even more significant is the impact that the SAS has had in the creation of new jobs. Statistical analysis suggests that the unemployment rate may have gone down after the introduction of this new type of business entity. According to statistical analysis rendered by the National Office of Corporations (*Superintendencia de Sociedades*),

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<sup>7</sup> According to a report rendered on September 2013 by the Deputy Superintendent for Economic and Accounting Matters at the Superintendence of Companies (on file with author) for the years 2010 to 2012, the SAS paid significant amounts of income taxes. In fact, the report states the following figures: Col\$ 1.311.589.000 for income taxes on 2010, Col\$70.784.132.000 for 2011, and Col\$176.571.054.000 for 2012. For franchise taxes (i.e., registration fees) and State registry tax see Table 6 below.

<sup>8</sup> See report rendered by the Colombian Confederation of Chambers of Commerce, March 2015 (on file with author).

<sup>9</sup> *Id.*

<sup>10</sup> See *El Último Grito*, REVISTA DINERO, Feb. 21, 2012 (stating that the SAS is broadly use for all sorts of undertakings involving foreign investment). See also Miguel Ramírez, *Sociedades por Acciones Simplificadas (SAS) y sus Ventajas para los Emprendedores*, COLUMBIA LEGAL CORPORATION, (Sept. 1, 2013), <http://www.colombialelegalcorp.com/sociedades-por-acciones-simplificadas-sas-ventajas-para-emprendedores/> (holding that this type of business entities are intended to promote entrepreneurial and technological creativity and innovation).

at least two and a half million people all over the country are employed through the existing SAS.<sup>11</sup>

Furthermore, the SAS has displaced almost all traditional business forms that existed during the 1971 Colombian Commercial Code rule.<sup>12</sup> Today these outdated forms represent 3.4% of business entities that file articles of association before the country's fifty-two Mercantile Registries.<sup>13</sup> Not surprisingly, the remaining 96.6% of new incorporations corresponds to the formation of new Simplified Corporations.<sup>14</sup> This is probably due to the formalistic nature of the previous regulation and the SAS' reduced transaction costs, simplified structure, and contractual flexibility. Moreover, the new type of entity has sparked legal innovation and fostered new business structures that were difficult to design in the recent past.

Law 1258 also sought to curtail opportunistic behavior by controlling shareholders, directors, and officers. By replacing *ex ante* directory rules with *ex post* legal standards, it has allowed for more nuanced scrutiny of the insiders' activities. Standards such as good faith and fiduciary duties of directors and officers (also applicable to controlling shareholders)<sup>15</sup> are intended to promote honest behavior in the day-to-day affairs of the corporation.<sup>16</sup> In order to make these new

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<sup>11</sup> See *supra* note 7.

<sup>12</sup> Those types of entities were: (1) The General Partnership (*Sociedad Colectiva*), (2) The Corporation (*Sociedad Anónima*), (3) The Limited Liability Company (*Sociedad de Responsabilidad Limitada*), (4) The Limited Partnership by Quotas (*Sociedad en Comandita Simple*), and (5) The Limited Partnership by Stocks (*Sociedad en Comandita por Acciones*).

<sup>13</sup> See Graph 2.

<sup>14</sup> *Id.*

<sup>15</sup> Through the legal concept of "Shadow Directors" all the rules governing fiduciary duties of directors and officers can also be applicable to controlling corporations. According to Article 27 of Law 1258, "natural persons or legal entities that shall intrude in any positive managing or administrative activity in the corporation will be subject to the same liabilities and penalties applicable to managers."

<sup>16</sup> The now famous case of Finagro against Mónica Semillas SAS is a good example of the application of *ex post* standards in a specific case of abusive behavior. In this case a number of sham corporations were used to unduly obtain governmental agricultural subsidies. The Superintendence decided that this was a form of "deputization" and, therefore, reversed the illegal transactions. See

standards workable, an innovative enforcement system has been put in place. A highly sophisticated and efficient corporate law has replaced an inefficient judicial system.

Within this advanced legal framework, it is expected that the usually high consumption of private benefits of control by majority shareholders will decrease overtime. This qualitative change would allow for a more reasonable allocation of economic benefits among all shareholders. Likewise, it is expected that in the future minority shareholders will be able to profit from the controlling shareholders' monitoring and managerial efforts without being exposed to the exponential risk of expropriation.<sup>17</sup> In this manner, the conceivable distributional effects that may stem from a more flexible regulatory business environment will be timely enabled by the efficient application of the above-mentioned standards.

The starting point for the Simplified Corporation's original proposal was the idea of facilitating the formalization of business entities and updating the legal system in order to introduce forward-looking approaches to corporate law. For that purpose, a thorough and critical revision of the company law framework was required. This analysis was made under a functional Comparative Law methodology along with the application of relevant notions of Economic Analysis of Law. As expected, the results of such evaluation revealed the inadequacy of most company law provisions and the need to carry out an overhaul of both the legal and the institutional frameworks.<sup>18</sup>

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SUPERINTENDENCIA DE SOCIEDADES, JURISPRUDENCIA SOCIETARIA 335 et seq. (vol. I, 2014).

<sup>17</sup> The higher level of protection that can be attained with the SAS regulation is clearly demonstrated in the amount of cases being brought before the Court at the Superintendence of Companies. Several cases involving Simplified Corporations have been adjudicated within the last 3 years. Such cases are consistently reported by the Superintendence as can be seen in the publication entitled *Jurisprudencia Societaria* edited by the same governmental entity. The first volume was published in Bogotá in March 2014. The second one was published by the same institution in July 2015. *See supra* SUPERINTENDENCIA DE SOCIEDADES note 16; SUPERINTENDENCIA DE SOCIEDADES, JURISPRUDENCIA SOCIETARIA (vol. II, 2015).

<sup>18</sup> *See* FRANCISCO REYES, LATIN AMERICAN COMPANY LAW, A NEW POLICY AGENDA: RESHAPING THE CLOSELY HELD ENTITY LANDSCAPE (2013).

Soon after the law was passed, the business community reacted eagerly to the new legal realities. The SAS has not only changed the manner in which people do business in Colombia, but it can also be credited for a significant change in the legal culture. This new type of business association has fostered additional legal reforms to other traditional institutions that were still present in old codes and statutes in Colombia.<sup>19</sup> Surprisingly, until 2008, legal scholars found these outdated laws appropriate for the local business environment, and had unanimously hailed this antiquated legislation as a virtuous body of law.<sup>20</sup>

Also, Law 1258 of 2008 represents a step forward in the manner in which corporate documents can be written. Notably, the law permits corporations to choose the type of clauses to be included in their own bylaws. However if the corporation's bylaws are silent on a matter, default provisions of general corporate law apply. Yet, despite the option for corporations to create unique bylaws, the default rules contain provisions, which are particularly useful for those parties who lack the expertise, time, or resources needed to negotiate tailor-made corporate contracts and shareholders agreements.<sup>21</sup> To this effect, the Colombian Mercantile Registry offices have designed and implemented model bylaws that are extensively used by Micro Small and Medium Entities (MSMEs)<sup>22</sup> across the country. In this manner

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<sup>19</sup> For instance, Law 1429 of 2010 introduced substantial changes to the processes of dissolution and liquidation of corporations. Following the trend initiated with the SAS, this new law reduced unnecessary formalities and created hasty proceedings to wind up a business corporation. L. 1429, diciembre 29, 2010, DIARIO OFICIAL [D.O.] (Colom.).

<sup>20</sup> CUBEROS DE LAS CASAS FELIPE, SOCIEDAD POR ACCIONES SIMPLIFICADA: NOVEDADES, ACIERTOS Y DESACIERTOS 43 (2012) (quoting Gabino Pinzón holding that the types of business entities regulated in the commercial codes were sufficient to satisfy the needs of business people). The author goes as far as holding that the idea of single member simplified corporations such as the SAS is a “conceptual mistake.” *Id.* at 49.

<sup>21</sup> *See* L. 1258, art. 45 (stating that the by-laws are fully enforceable if there is no specific rule to the contrary on the statute).

<sup>22</sup> Colombian law provides rules to define the concept of MSMEs on the grounds of the amount of assets, income and number of employees. Accordingly, for a company to be classified as a small or medium size business it has to meet the requirements set forth in Laws 590 of 2000, L. 590, julio 10, 2000, DIARIO OFICIAL [D.O.] (Colom.), and 905 of 2004, L. 905, agosto 2, 2004, DIARIO OFICIAL [D.O.]

entrepreneurs can significantly reduce transaction costs and may incorporate without the aid of costly advisors.<sup>23</sup>

Naturally, the SAS' opt out approach also allows for private parties to step out of the standard provisions contained in model bylaws and to draft sophisticated agreements that are appropriate for more complex undertakings. The enabling non-directory provisions of Law 1258 have fostered private ordering and sparked innovation in corporate law across the country. Aside from the boilerplate type of agreements that are used by most start-ups, practicing attorneys are becoming skillful at developing new legal models suitable for a more sophisticated business environment. A survey conducted by the Bogotá Chamber of Commerce, in the capital city, has allowed for the identification of several types of business in which one or more SAS can be properly used for an unlimited number of business purposes.<sup>24</sup>

The Colombian SAS represents a substantial improvement in reducing transaction costs and providing contractual flexibility to business parties. In accordance with this approach, Law 1258 of 2008 requires formalities to be applied only with regard to those matters that have a functional effect on the marketplace.<sup>25</sup> It also promotes private ordering, fosters the drafting of innovative shareholders agreements, and facilitates corporate capitalization through the issuance of all types of securities.

This new type of business entity is also intended to dramatically alter the inefficient enforcement landscape by aiding in the development of a specialized jurisdiction in which matters are rapidly resolved by proficient and honest judges. The deterrence effect of decisions rendered by this jurisdiction in a short period of time has

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(Colom.), which refer to the number of employees and the total assets, as measured in current legal minimum monthly wages.

<sup>23</sup> See, e.g., CÁMARA DE COMERCIO DE BOGOTÁ, <http://www.ccb.org.co>.

<sup>24</sup> See CÁMARA DE COMERCIO DE BOGOTÁ, *PERFIL ECONÓMICO Y JURÍDICO DE LA SAS EN SU PRIMER AÑO 19-38* (2010).

<sup>25</sup> See, for example, L. 1258, art. 5 requiring registration of the private document of incorporation in order to provide publicity concerning basic data on the corporation. Likewise, art. 22 sets forth minimum standards for quorum and majorities at shareholders' meetings.



impacted the business community in an unprecedented manner.<sup>26</sup> Knowing that justice will be on the side of those who play by the rules and that wrongdoers will be rapidly punished signals that Corporate Governance mechanisms work<sup>27</sup> at least in the context of closely held corporations. It remains to be seen, however, if in the long run this enforcement system will have a direct impact on the cost of capital. It is foreseeable that this will be the case, as the system is rapidly migrating from personal to impersonal exchanges. It is also expected that this new legal reality will have an impact in the reduction of the usually high control premium in closed corporations, and also in incentivizing local and foreign investment by minority shareholders in this type of business.

Six years after the enactment of Law 1258 of 2008, the success of the Simplified Corporation has surpassed all expectations. The empirically measured success of the Colombian SAS in both the legal and business environment can be attributed to the simplified nature of the substantive provisions that govern its incorporation and operation, and to the efficient results of the specialized jurisdiction put in place immediately following the enactment of the SAS.<sup>28</sup>

The Colombian SAS can become an export product. It is a blend of common law and civil law approaches to business associations. Instead of adhering to dogma or established tradition, it

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<sup>26</sup> In fact, before the enactment of Law 1258, conflicts between shareholders had to be brought before the ordinary courts. After the creation of the Corporate Court at the Superintendence of Companies litigators have found a significant opportunity to get their cases decided in a reasonable period of time. *See* Graph 8. The expeditious nature of the processes handled before the Superintendence. Along with this significant development the periodical publication of decisions rendered by the new court provide predictability and legal certainty both to practitioners and parties alike. *See* SUPERINTENDENCIA DE SOCIEDADES, vols. I & II *supra* note 17.

<sup>27</sup> A good example of this sort of effect can be seen in the case of Serviucis S.A. vs. Clínica Sagrado Corazón SAS reported by the Superintendence of Companies. In this case the breach of a shareholders agreement along with an abusive exercise of the voting right by the defendant gave rise of the application of a remedy of specific performance by the Court. In this case the enforcement of the agreement as well as the decision rendered against the defendant's wrongdoing have signaled to the business community that this sort of behavior shall not be tolerated. *See* SUPERINTENDENCIA DE SOCIEDADES, *supra* note 16, at 385-420.

<sup>28</sup> *See* Graph 2.

reflects the economic needs of common business people and successfully offers clear and sensible solutions to reduce entry barriers, ameliorate organizational problems, and provide expedited dispute resolution mechanisms. This legislation is also an attempt to deal with agency problems that are common in most countries without taking into account each jurisdiction's ownership pattern.<sup>29</sup> For this reason, the Organization of American States' (OAS) Legal Committee has recommended the adoption of a Model Act on Simplified Corporations for all countries in the Americas on the grounds that it represents a "very credible case in favor of legislative reforms to permit such innovative business forms" to promote economic growth.<sup>30</sup>

This paper briefly analyzes the evolution of the Colombian SAS over the first five years following the enactment of Law 1258 of 2008. It provides an empirical evaluation based on statistical data collected at the Colombian Confederation of Chambers of Commerce, the Mercantile Registry of Bogotá, and the National Office of Corporations.

#### I. EMPIRICAL DEMONSTRATION CONCERNING THE COLOMBIAN

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<sup>29</sup> The success of legal transplants in the area of closely held firms is significantly facilitated by the homogeneity of agency problems that are present in non-listed firms everywhere. Therefore, the dichotomy between diffuse and concentrated ownership and the resulting differences in the identification of the relevant agency problems become irrelevant in the context of non-listed firms. Additionally, incentives to neutralize agency problems in closely held companies could be applied in different jurisdictions, without regard to the economic circumstances prevailing in each country. *See* REYES, *supra* note 18, at 60.

<sup>30</sup> *See* David P. Stewart, *Recommendations on the Proposed Model Act on the Simplified Stock Corporation*, in ANNUAL REPORT OF THE INTER-AMERICAN JURIDICAL COMMITTEE TO THE FORTY-SECOND REGULAR OF THE GENERAL ASSEMBLY 50 (2012) (the OAS Legal Committee Model Act was crafted after Law 1258. It is not intended to serve as a partial amendment to be introduced to traditional business forms regulated in national codes and statutes. Instead, what is recommended is that the enactment takes place on a separate legislation that could be linked to the existing system).

## SAS

The enactment of Colombian Law 1258 of 2008 has been by far the most successful recent company law reform in Colombia.<sup>31</sup> The implementation of the SAS corporation model has given rise to a certain degree of competition among the different types of business associations that exist within the country's commercial legislation. The creation of this new business form allows entrepreneurs to choose between a traditional legal regime, and a new modern corporate entity. The comparative inferiority of traditional business association types formerly used to structure closely-held companies make their future use unnecessary. The preference of business people for the recent legislation is evident in light of the exponential growth of the Simplified Corporation in Colombia.<sup>32</sup>

The following empirical analysis is divided into three parts. Part A refers to data gathered at the Colombian Confederation of Chambers of Commerce,<sup>33</sup> and corresponds to the evolution of SAS in Colombia. Part B relates to information obtained by the Bogotá Chamber of Commerce and, naturally, is restricted to the urban perimeter of Colombia's capital city. Part C relates to the empirical analysis undertaken by the Superintendence of Companies concerning the operation of the new specialized Corporate Law Court<sup>34</sup> that operates in the same Office.

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<sup>31</sup> See FRANCISCO REYES, REFORMA AL RÉGIMEN DE SOCIEDADES Y CONCURSOS (1996) (certainly, previous reforms such as the one introduced by Law 222 of 1995, L. 222, diciembre 20, 1995, DIARIO OFICIAL [D.O.] (Colom.), had a more restricted impact than the SAS. This law constituted only a "patch up" reform to traditional corporate rules contained in the Colombian Commercial Code. Such approach limited the scope of legislative changes that otherwise could have been made under a more progressive orientation).

<sup>32</sup> See *Editorial*, PORTAFOLIO.CO (Feb. 3, 2011), <http://www.portafolio.co/archivo/buscar?producto=portafolio&q=febrero+3+de+2011&a=2011&pagina=1&m=02&d=03>.

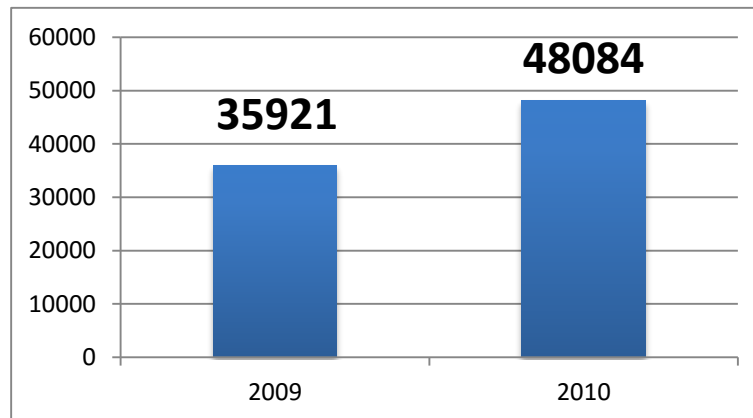
<sup>33</sup> Confederación de Cámaras de Comercio (CONFECAMARAS), Bogotá, 2013 (Colom.).

<sup>34</sup> This court is the Delegatura para Procedimientos Mercantiles de la Superintendencia de Sociedades.

### A. National Data on SAS

1. *Formalization of economic activities and number of SAS compared to other types of business entities.* – The SAS structure has been useful for thousands of business that today confront lower entry barriers for their regular operation. As can be observed in Graph 1, the number of incorporations filed before the Colombian Mercantile Registries has increased exponentially since the enactment of Law 1258 on December 5 of 2008.

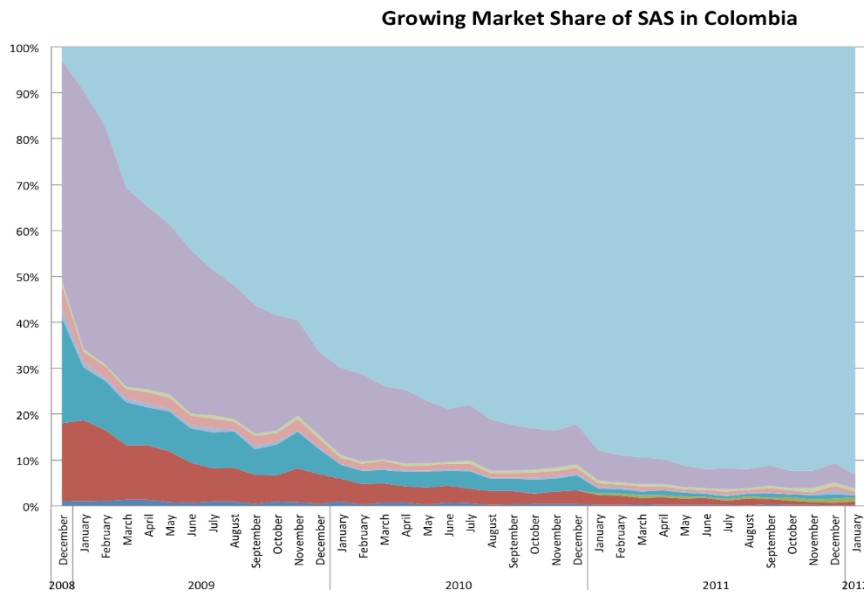
The reaction of the business community to the new legislation on Simplified Corporations has surpassed all expectations.<sup>35</sup> As Graph 2 shows, the SAS has acquired a level of significant importance for local business associations of all dimensions. The data not only shows the impressive acceptance of the SAS during this five-year period, but also the progress made by this company type *vis-à-vis* the previously existing ones.



Graph 1. Growth in formalization of business entities between 2009 and 2010 (25.3%)

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<sup>35</sup> See CONFECAMARAS, *supra* note 33 (data for this section (consolidated for the entire country) has been obtained directly from the CONFECAMARAS).



Graph 2. Evolution of the SAS Compared to Other Company Types (2008-2012).

2. *SAS incorporations.* - In the period between December 2008 and September 2013, 206,704 business associations were incorporated before Colombia’s Mercantile Registries under the type of Simplified Corporations. In September 2013 alone, 5,804 business entities were incorporated before the country’s Mercantile Registries. Out of this number, 5,595 were Simplified Corporations (SAS). While in December 2008 the percentage of SAS only reached 7.42% of the total registration of business associations, by September 2013 this type of business corporation represented 96.4% of all registered companies (Table 1).

	2008		2009		2010		2011		2012		2013	
	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%
<b>Jan.</b>			293	11	2422	70	3697	88	5203	93	4846	95.6
<b>Feb.</b>			629	19.8	3091	71	4302	90	6224	93	5443	94.5
<b>Mar.</b>			1019	33.8	3364	74	5204	89.6	6875	94	4456	95.3
<b>Apr.</b>			1184	39.4	2817	74	4271	91	4637	93.7	5130	95.1
<b>May</b>			1424	47.6	2879	77	4961	93.5	4935	93.5	5358	95.1
<b>June</b>			1544	53.6	3069	79	4712	91.1	4509	93.5	4458	95.1
<b>July</b>			2052	59.4	2923	78	4318	91.5	4955	93.5	6259	95.7
<b>Aug.</b>			1773	62.4	348	81	4734	91.9	4692	94.1	5405	95.8
<b>Sept.</b>			2316	66.5	3734	82	4772	91.1	4577	93.7	5595	96.4
<b>Oct.</b>			2183	67.8	3414	83	4073	92.3	4665	93.9		
<b>Nov.</b>			1872	70.2	3275	84	4160	92.4	4087	93.1		
<b>Dec.</b>	160	7.42	1151	74.2	2935	82						

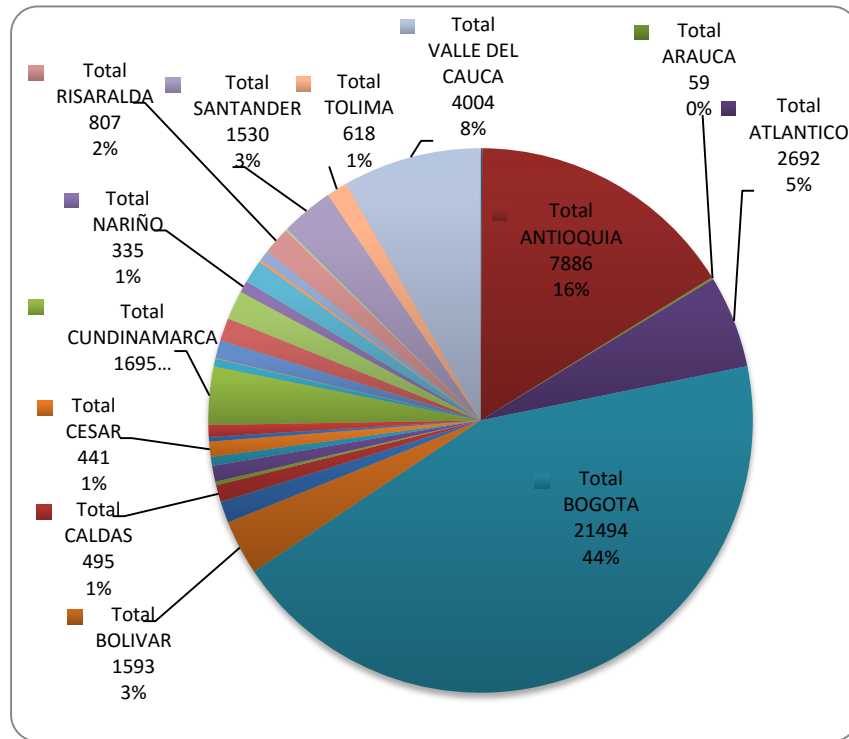
Table 1. Incorporation of SAS between December 2008 and September 2013, by number and percentage.

3. *SAS' regional distribution.* - Naturally, most SAS incorporations take place in regions and cities where there is a significant economic activity, such as in the capital city of Bogotá and the State of Antioquia. However, it is noteworthy that the penetration of this business entity is also noticeable in less developed areas where the economy is based on agricultural and extractive business activities, such as in Arauca.<sup>36</sup> In these less economically active regions, the increasing importance of SAS is evidenced by the growth of this type of business entity within the last two years. In fact, whereas in 2011 the SAS incorporations in Bogotá represented 44% of the total amount of business entities formally set up in Colombia (see Graph 3), in 2012, such percentage had decreased to 39%, showing a correlative increase of incorporations in the other regions (see Graph 4).

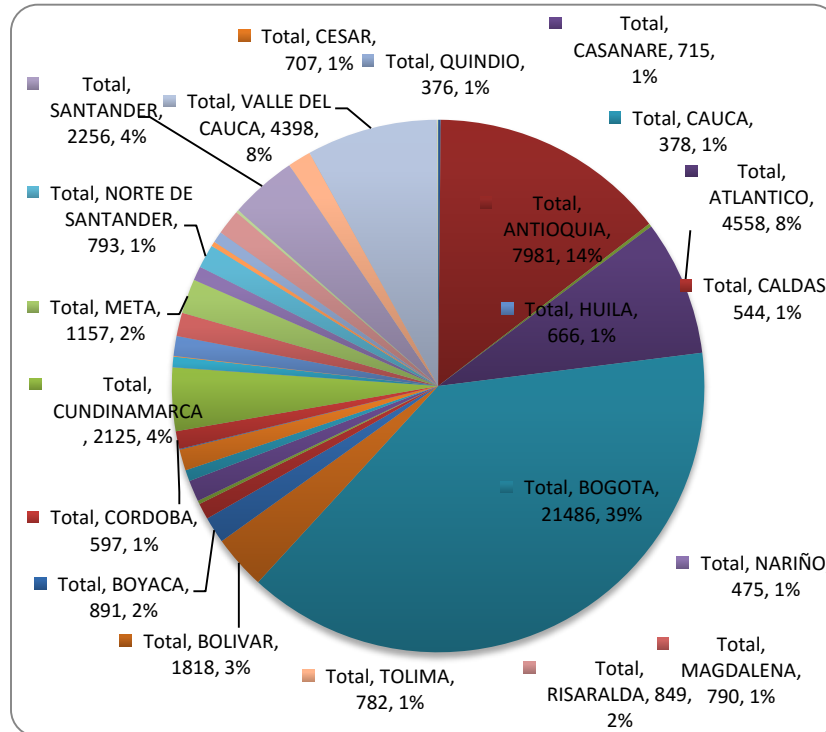
For the years 2011, 2012, and 2013, the number of Simplified Corporations has been distributed regionally according to Graphs 3, 4, and 5 below.

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<sup>36</sup> See Graphs 3, 4, 5.

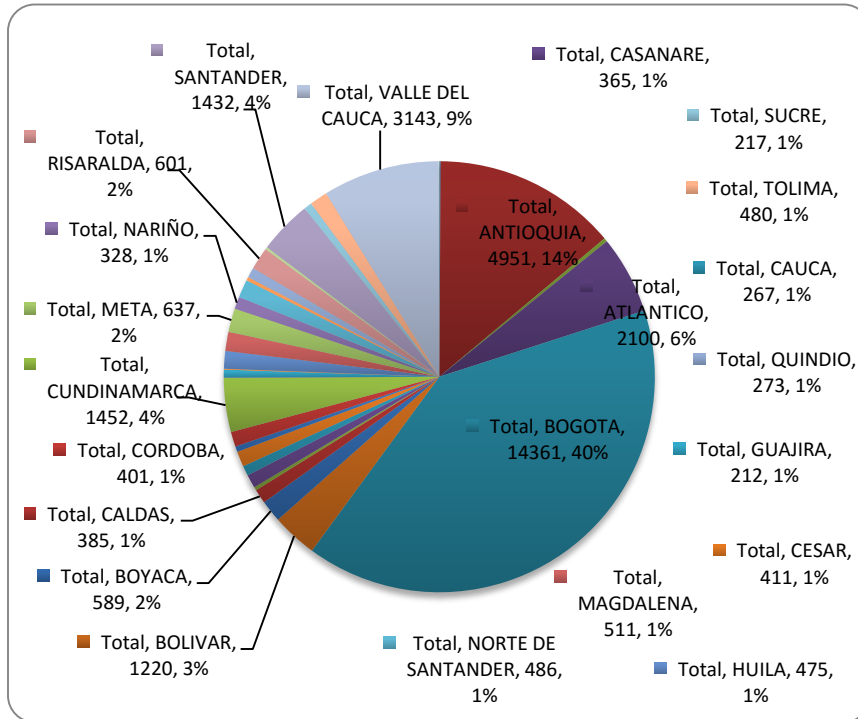


Graph 3. Regional Distribution of SAS in 2011.



Graph 4. Regional Distribution of SAS, 2012.





Graph 5. Regional Distribution of SAS 2013 (until September).

4. *Economic activities of SAS.* - Although according to the regulation governing the SAS there is no need to define any specific business purpose in the corporation’s purpose clause, the Mercantile Registry keeps a record of these entities’ main economic activity. The statistical data shows that the SAS model is mostly used for agricultural economic activities, manufacturing undertakings, construction business, and commercial activities (wholesale and retail) (see Table 2).

CIU_Sector	2011	2012	2013	Total
A Agriculture, cattle breeding, hunting, fish breeding	1682	390	1050	3122
B Mining	927	294	540	1761
C Manufacturing Industries	5652	3474	4067	13193
D Electricity, gas, steam and air conditioning	121	53	68	242
E Water and Sewer and environmental cleaning activities		180	297	477
F Construction Businesses	5203	3397	4067	12667
G Wholesale commerce and retail; vehicle and motorcycle repair	13100	7472	8651	29223
H Transportation and Storage	3047	1248	1596	5891
I Hotels and Restaurants	1287	643	1102	3032
J Information and Communications		1146	1787	2933
K Financial and Insurance Activities	821	560	485	1866
L Real Estate	13733	1533	1659	16925
M Professional, Scientific and technical Activities		4102	5390	9492
N Administrative services and logistics		2356	2043	4399
O Public Administration and Defense, Social Security Plans and Mandatory Health Insurance	171	49	59	279
P Education	381	292	576	1249
Q Health and Social Assistance Businesses	1510	791	1371	3672
R Artistic, entertainment and recreational activities		218	486	704

S Other services	1154	320	344	1818
T Home business activities	4	4	5	13
Z Unlisted business activities (CIU V4)	229	26837	234	27300

Table 2. Economic activities of SAS.

5. *Dimension of SAS undertakings in the country.* - One of the most significant observations in this empirical investigation is the success of the Simplified Corporation for all types of undertakings irrespective of the size segment to which the entrepreneur belongs. In fact, the Simplified Corporation is not only important in the micro and small business segments, but also has proven useful for large corporations.

In Colombia, as in other developing economies, Micro Small and Medium Entities are responsible for a significant number of jobs and income for the economy.<sup>37</sup> The Colombian Government has created certain criteria to define the various sizes of business enterprises.

Table 3 shows the allocation of SAS according to the size criteria described above for the period between January 2011 and September 2013. The table relates to the *number* of SAS that can be classified in each segment. These data demonstrate the significant relevance of SAS to the formalization of micro and small businesses.

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<sup>37</sup> See Thorsten Beck, Asli Demirguc-Kunt, Ross Levine, *SMEs, Growth, and Poverty: Cross-Country Evidence*, 10 J. OF ECON. GROWTH 199 (2005).

Company Size	Number of Employees	Total Assets (CLMMW)	2011	2012	2013
<b>Micro</b>	1-10	Under 501	96831	13739	167061
<b>Small</b>	11-50	501-5000	14827	23341	31818
<b>Medium</b>	51-200	5001-30000	3709	5797	8073
<b>Large</b>	Over 200	Over 30000	875	1398	2008

Table 3. Dimension of SAS according to legal criteria.

Table 4 provides the *percentage* of SAS in each of the dimension brackets referred to above. It is noteworthy that this type of entity only represents 4.85% of the total amount of micro businesses. This is due to the fact that most entrepreneurs in this segment carry out their business activities in their individual capacity (i.e., the vast majority are natural persons). Obviously, on a different scale, the SAS represents the broad majority of “incorporated” micro-business. As can be observed in Table 4, the micro-business segment represents the broad majority in terms of the number of SAS incorporated in Colombia.

Total No. Of Businesses	No. Of SAS	Percentage	Dimension
2,374,086	115,157	4.85%	MICRO
66,792	15,635	23.40%	SMALL
15,116	3,928	25.98%	MEDIUM
4,99	921	18.79%	LARGE

Table 4. Percentage of SAS (as compared to total number of business participants including natural persons).

6. *Cancellation of SAS registrations.* - Table 5 below depicts the number of SAS cancellations for the period between January 2011 and July 2013. The empirical data show that the number of Simplified Corporations formally going out of business is very low in comparison to the ones that remain active and in good standing.

Month	2011	2012	2013
	Total	Total	Total
<b>January</b>	165	232	324
<b>February</b>	172	277	383
<b>March</b>	389	562	545
<b>April</b>	214	302	496
<b>May</b>	177	275	354
<b>June</b>	186	295	425
<b>July</b>	174	274	511
<b>August</b>	173	322	N.A.
<b>September</b>	237	311	N.A.
<b>October</b>	215	402	N.A.
<b>November</b>	213	417	N.A.
<b>Total</b>	2315	3669	3038

Table 5. Cancellation of SAS registrations

#### B. Empirical Analysis of Data Obtained at the Bogota Chamber of Commerce

In the period between January 2009 and August 2 2013, 86,861 Simplified Corporations were registered before the Bogota Chamber of Commerce. Although the majority of SAS registrations correspond to new incorporations a small percentage relates to conversion of traditional business forms, which existed before the enactment of Law 1258, into simplified corporations.

1. *Franchise fees and registration taxes.* - The figures in Table 6 include two types of economic resources that are collected by the Offices of the Mercantile Register. The first is a State registration tax that was levied by Law 225 of 1995,<sup>38</sup> Decree 650 of 1996,<sup>39</sup> and Resolution No. 24 of 1997.<sup>40</sup> The amount collected is charged at a 0.7% rate over the value of the subscribed capital. This tax is paid to the State of incorporation. The second amount relates to a franchise or registration fee established by Decree 393 of 2002,<sup>41</sup> and corresponds to a variable percentage that is applied to the amount of subscribed capital. This fee

<sup>38</sup> L. 225, diciembre 20, 1995, DIARIO OFICIAL [D.O.] (Colom.).

<sup>39</sup> L. 650, abril 3, 1996, DIARIO OFICIAL [D.O.] (Colom.).

<sup>40</sup> L. 24, 1997, DIARIO OFICIAL [D.O.] (Colom.).

<sup>41</sup> L. 393, marzo 4, 2002, DIARIO OFICIAL [D.O.] (Colom.).

is updated every year to adjust to the legal minimum monthly wage for each year. The amounts collected through this franchise or registration fee go directly to the Chamber of Commerce that operates each Mercantile Registry.

Amount	2009	2010	2011	2012	2013
<b>Registry Tax</b>			440,247,089		
<b>Franchise Fee and Registration</b>	1,854,524	5,982,308	12,692,596	20,573,988	23,444,806

Table 6. Franchise Fees and State Registry Taxes (Figures above are in thousands of U.S. dollars)

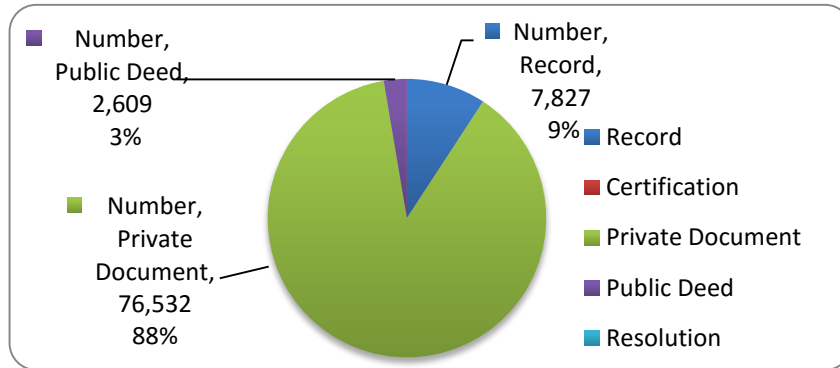
2. *Public deed of incorporation versus private document.* - Articles 5 and 6 of Law 1258 of 2008 allow for the incorporation of SAS to be made either by private document or by public deed granted before notary public.<sup>42</sup> The latter is only required where real estate is turned in as an in-kind contribution. It is not surprising that the majority of incorporations (88.12%) are undertaken through a private document. In fact, only 9% of the business parties that set up a SAS use the public deed as a means for its incorporation (see Graph 6 and Table 7). These figures also may suggest that most capital contributions in the SAS are made in assets different to real estate.

Furthermore, it is important to stress that a public deed is not needed for a business entity to convert into a SAS (see Article 31 of Law 1258 of 2008).<sup>43</sup> It is also noteworthy that according to this law, it is viable for a SAS to be incorporated online. In accordance with data provided by the same Chamber of Commerce, only for the year 2009, 1,077 corporations were incorporated online.

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<sup>42</sup> L. 1258, art. 5, 6.

<sup>43</sup> *Id.* at art. 31.



Graph 6. Incorporation method.

Table 7. Incorporation Method.

Document	Number	Percentage
<b>Record</b>	8,001	9.21
<b>Certification</b>	1	0
<b>Private Document</b>	76,532	88.12
<b>Public Document</b>	2,314	2.66
<b>Resolution</b>	1	0
<b>Total</b>	86,861	

3. *SAS' life span.* - The empirical research shows that the registration of most of the Simplified Corporations formed during the last years have not been cancelled. This data may suggest the long breadth nature of a substantial majority of the entities operating under the SAS structure. This analysis is based on two sets of data: first, the renovation of corporate registration that is made every year; and second, the filing before the Mercantile Registry of corporate decisions for the dissolution and liquidation of simplified corporations.

Table 8 shows figures concerning the annual renovation of mercantile registration for the years 2009 to 2013.

Year of Registry Renovation	Number of SAS	PERCENTAGE
<b>2009</b>	1394	1,60
<b>2010</b>	4246	4,89
<b>2011</b>	8648	9,96
<b>2012</b>	17750	20,43
<b>2013</b>	54823	63,12
<b>TOTAL</b>	86861	100

Table 8. Renovation of mercantile registration of SAS.

The data presented above implies that there is a high conservation rate for the SAS. This is supported by the fact that the registration of dissolution and liquidation proceedings for Simplified Corporations represents a very low percentage in comparison with the total amount of active SAS. In the Bogota's Mercantile Registry, only 4,031 out of 86,861 registered SAS, filed for dissolution before the Mercantile Registry (representing 4.61% of the sample). Out of the 4,031 that filed for dissolution, 2,919 (72%) registered the termination of the liquidation proceeding.

4. *Management.* - The SAS law allows for a simplified organic structure, where the board of directors is not a mandatory organ. In the absence of a clause providing otherwise, one or more managers will conduct the day-to-day affairs of the corporation.<sup>44</sup> The empirical research concerning the preference for a simplified organic structure

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<sup>44</sup> Referred to in L. 1258, art. 26 as legal representatives.



in which there is no appointment of a board of directors is conclusive.<sup>45</sup> In fact, only 921 of the total amount of analyzed SAS registered the appointment of a board (i.e., a figure close to 1% of the total sample) (see Table 8). This finding is interesting, because the data suggests that the traditional regulation, which required a mandatory board of directors to do business under the corporate form, did not match the preferences of business people. The legal framework imposed a burden to the parties, which represented undesirable transaction costs.

A similar situation is observable concerning the appointment of fiscal auditors. The SAS law only requires an internal auditor to be appointed if the corporation surpasses certain thresholds (determined in the amount of assets or annual income). Only 3,023 fiscal auditors were appointed. This figure represents 3.5% of all registered companies in Bogota (see Table 9). The conclusion provided for the board of directors is equally applicable to the fiscal auditors. It is obvious that if businesspersons are given the opportunity to opt out of the relevant clause, they will do so.

Shareholder managed SAS	Percentage	Board managed SAS	Percentage
<b>85,949</b>	98.93	921	1.07

Table 9. Shareholder Managed SAS versus Board Managed SAS.

Appointment of Internal Fiscal Auditor for SAS	Percentage	Shareholder monitored SAS	Percentage
<b>83,838</b>	96.50	3,023	3.50

Table 10. Appointment of Fiscal Auditor.

5. *Unrestricted purpose clause.* - Law 1258 does not require the parties to provide for a restricted purpose clause in the corporation's bylaws.

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<sup>45</sup> An empirical study conducted by the Bogota Chamber of Commerce concluded that only 14% of the SAS created during the first year after the enactment of Law 1258, provided for a mandatory board of directors in their by-laws. See CÁMARA DE COMERCIO DE BOGOTÁ, PERFIL ECONÓMICO Y JURÍDICO DE LAS SAS EN EL PRIMER AÑO 28 (2010).

Accordingly, as a default rule, the law allows for the corporation to be set up for any lawful purpose. According to previous research conducted by the Bogotá Chamber of Commerce in 2011, most of the simplified corporations set up in the capital city prefer the flexibility afforded by the unlimited purpose clause to the rigidities of self-imposed restricted objects.<sup>46</sup> A smaller percentage of SAS opted for limited purpose clauses by specifying restricted business activities in the corporation's bylaws. Interestingly, during the period between January 2009 and July 2013, a total of 2,162 amended their internal rules in order to insert in their objects the phrase "any lawful activity." This move again represents a preference for flexibility and demonstrates that the traditional system was inconsistent with entrepreneurs' needs and preferences.

Dimension of SAS undertakings in the country. - As already explained the size of a business undertaking can be legally classified in four separate categories on the grounds of their employee population and aggregate assets. The following table shows the size of SAS incorporated in the city of Bogotá.

Size of the company	Number of Employees	Total Assets (CLMMW)	2009	2010	2011	2012	2013
<b>Micro</b>	1-10	Under 501	86,362	84,776	81,744	77,954	75,679
<b>Small</b>	11-50	501-5000	443	1,736	4,095	7,060	8,508
<b>Medium</b>	51-200	5001-30,000	46	297	849	1,484	2,097
<b>Large</b>	Over 200	Over 30,000	10	52	173	363	577

Table 11. Dimensions of SAS in Colombia.

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<sup>46</sup> See CÁMARA DE COMERCIO DE BOGOTÁ, EL PRIMER AÑO DE LA SAS (2011).

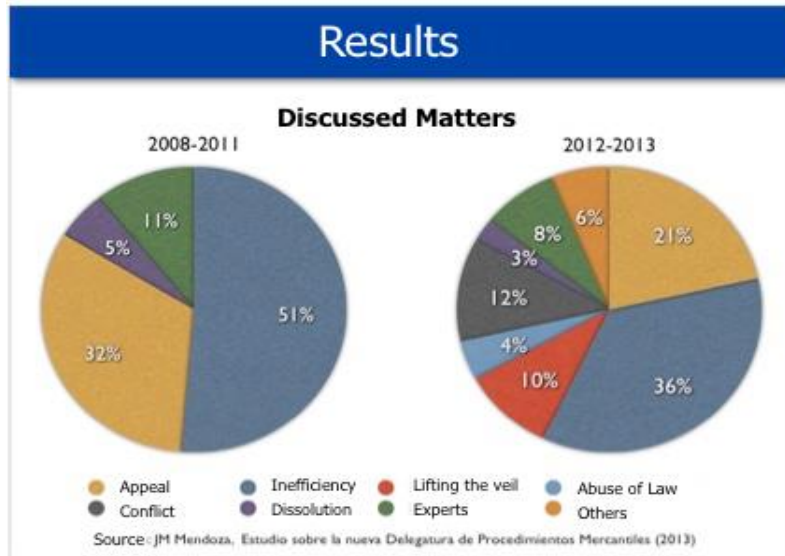
### 3. Empirical Observations on Enforcement

The relevance of the specialized jurisdiction created by Law 1258 of 2008 can be empirically demonstrated under several variables that measure the efficiency of the new court to adjudicate complex corporate law cases in a short period of time. The data collected by the National Office of Corporations demonstrates the increasing confidence with which private parties appear before the specialized court to litigate all kinds of legal matters.<sup>47</sup> It is relevant to observe that during the period from 2008 to 2011, the complaints filed before this court related exclusively to four different issues (appeals of previous decisions, intra-corporate disputes, actions to set aside resolutions of the shareholders meeting, and requests for dissolution). Alternatively, between 2012 and 2013, the types of legal disputes were significantly broadened to encompass additional matters (including, *inter alia*, processes for lifting the corporate veil, the appointment of experts to provide appraisals of shares of stock, and actions arising from the abuse of rights).<sup>48</sup> The increased scope of matters resolved at the Specialized Corporate Court has begun to provide credibility to the Government's ability to enforce substantive law provisions contained in the SAS legislation. It is probably the first time in which *law in the books* is very close to *law in action* in Colombia.

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<sup>47</sup> See JOSÉ MIGUEL MENDOZA, ESTUDIO SOBRE LA NUEVA DELEGATURA DE PROCEDIMIENTOS MERCANTILES (2013).

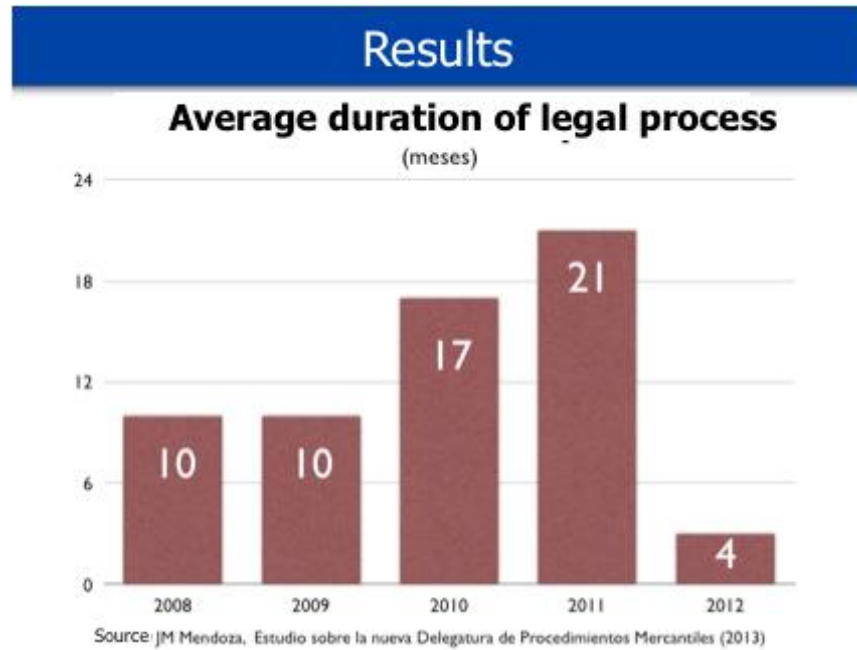
<sup>48</sup> See SUPERINTENDENCIA DE SOCIEDADES, vols. I and II, *supra* note 17.



Graph 7. Type of Corporate Law disputes litigated before the specialized court.

In a country accustomed to protracted litigation, endless formalities, and corruption in the judicial system, it is a great achievement to have a jurisdiction in which these vices are absent. The high quality of the decisions rendered by the Specialized Corporate Court and the short time required to obtain a final judgment are eloquent evidence concerning the great success of this legal experiment. Graph 8 shows the efficient operation of the new jurisdiction in terms of the average term employed by the court to render a final decision. As it can be observed, on average, the Deputy Superintendent produces final judgments in a reasonable four-month term.

## CONCLUSION



Graph 8. Duration of legal processes at the Specialized Corporate Court.

The Colombian SAS legislation has proven to be an appropriate framework for the operation of all types of closely held corporations. The law that gave rise to this business entity was the result of a combination of common law and civil law types of modern business corporations. Five years after the enactment of Colombian Law 1258 of 2008, it seems clear that it is possible to achieve high impact changes from a relatively simple reform of outdated corporate law provisions.

The incorporation of more than 200,000 Simplified Stock Corporations in the first five years following the enactment of this law eloquently shows the usefulness of new corporate vehicles endowed with flexibility and simplified incorporation features. Through the SAS, Colombia has achieved higher levels of economic formalization, access to credit and investment, increased collection of taxes, and the creation of new jobs.

The SAS experiment may be beneficial in other countries if appropriately transplanted. It could be particularly useful in developing and emerging economies where there is an increasing need for flexible and user-friendly corporate vehicles. The success of the SAS clearly suggests that business people prefer flexibility to old-fashioned, misguided paternalism.

Welfare enhancement reforms such as the introduction of the Simplified Corporation would require, however, breaking up path dependence and overcoming certain pressure groups and backward looking legal traditions. For this purpose it would be extremely useful to prepare and promote a model act on Simplified Corporations. An instrument such as this could serve as a starting point in legislative processes for the amendment of corporate laws in several countries.

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**HIGH-TECH COMPANIES AND THE  
DECISION TO “GO PUBLIC”: ARE  
BACKDOOR LISTINGS (STILL) AN  
ALTERNATIVE TO “FRONT-DOOR”  
INITIAL PUBLIC OFFERINGS?**

*Erik P.M. Vermeulen\**

INTRODUCTION

Financial and capital markets play a key role in the funding of high growth technology companies. There is little doubt that companies in highly capital-intensive, often volatile, and disruptive sectors will eventually have to float their shares on a stock exchange to obtain access to capital to grow and expand their operations, enhance the company’s reputation and visibility, attract and retain talented employees, and provide liquidity to shareholders. The traditional path to a listing in an equity market is an initial public offering (IPO). However, the companies that consider a first sale of stock to the public are often overwhelmed by the costly and time-consuming legal and financial regulations that must be complied with while pursuing an IPO.

These costly and lengthy regulatory barriers, together with sluggish IPO markets and their unavailability to smaller firms, have been reasons for high-tech companies and their shareholders to look for alternatives to IPOs.<sup>1</sup> A popular alternative is to pursue a backdoor

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\* Erik P.M. Vermeulen, Professor of Business and Financial Law at Tilburg Law School, Tilburg Law & Economics Center, the Netherlands. Senior Counsel Corporate at Philips, Amsterdam, the Netherlands.

<sup>1</sup> See Stephen Bell, *As IPOs Struggle in Australia, Reverse Takeovers Shine*, WALL ST. J.: DEAL J. AUSTL. (Jan. 23, 2013, 11:52 AM),

listing, most often accomplished through a reverse merger or reverse takeover.<sup>2</sup> Both alternatives “transform” a private company into a publicly traded company by combining directly or indirectly with a listed company (whether through a merger, exchange offer, or otherwise). A backdoor listing has not only allowed companies to focus more on their business and less on compliance with “going public” rules and regulations, but also to gain access to more liquid and robust stock markets. In addition to the cheaper and quicker access to capital and liquidity, backdoor listings have also been employed to receive tax benefits that stem from “tax loss carry-forwards” in the public shell. If the reverse merger or takeover involves a public company that operates in the same or complementary industry or sector as the private company, synergies are often the reason for the backdoor listings. Moreover, besides the fact that a private company becomes instantly “listed” on a stock exchange, a backdoor listing usually gives shareholders of the private company the opportunity to receive the majority of the shares of the public entity, allowing them a tight grip on control (as if they still run a private company).<sup>3</sup>

Recently, backdoor listings have become increasingly popular among high-tech companies in the United States. Consider venture capital-backed RMG Networks, a Chicago-based global provider of smart visual solutions (particularly advertisements on airplanes and airport lounges), which went public through a reverse merger in the United States in April 2013, bypassing the IPO procedures. RMG Networks was first acquired by SCG Financial Acquisition Corporation. As a result, the shareholders of RMG Networks received

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<http://blogs.wsj.com/dealjournal/australia/2013/01/23/as-ipo-struggle-reverse-takeovers-shine/>.

<sup>2</sup> The terms “backdoor listing,” “reverse merger,” and “reverse takeover” are used interchangeably. These three approaches, mostly distinguished by legal differences at their implementation stage, are alternatives to an IPO.

<sup>3</sup> See David N. Feldman, *Comments on Seasoning of Reverse Merger Companies Before Uplisting to National Securities Exchanges*, 2 HARV. BUS. L. REV. 140 (2012). See also DAVID N. FELDMAN, REVERSE MERGERS: TAKING A COMPANY PUBLIC WITHOUT AN IPO (2006).



stock in SCG. Subsequently, the listed company's profile was changed from SCG to RMG.<sup>4</sup>

Australia also experienced a surge in high-tech backdoor listings in 2014.<sup>5</sup> For instance, Australian Bitcoin focused company digitalBTC (which was acquired by the already listed Macro Energy and renamed to DigitalCC Limited) is another example of a high-tech (and disruptive) company that turned to a backdoor listing to go public in 2014.

Backdoor listings are also a common "IPO alternative" in the real estate development sector. For instance, in October 2013, the Hong Kong Parkview Group Limited acquired the commercial property portfolio in China from the non-listed subsidiary of Cofco Corporation and changed its name to Cofco Land Holdings Ltd.<sup>6</sup>

Since backdoor listings are often not excessively burdened by complex listing rules and regulations, they are prone to fraud and abuse. Certainly, there are probably more examples of instances where a backdoor listing has been a prudent and effective alternative to an IPO. However, there is also evidence suggesting that lower quality firms pursue listings through a reverse merger. It is therefore not surprising that policymakers and regulators have recently introduced (or are considering) special rules and regulations that govern backdoor listings. These rules and regulations vary depending on each country's respective experience with this "going public" alternative.

This paper attempts to shed light on the question of whether and when a backdoor listing is still a sustainable alternative to the "front door" IPO. There is no clear-cut answer to this question. For instance, stringent and complex rules and procedures for reverse

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<sup>4</sup> See Sean Ludwig, *Digital Signage Biz: RMG Networks Goes Public at \$10 a Share in Reverse Merger*, VENTUREBEAT (Apr. 8, 2013, 1:36 PM), <http://venturebeat.com/2013/04/08/rmg-networks-goes-public-reverse-merger/>.

<sup>5</sup> See Paul Garvey, *ASIC Snarls at Backdoor Listings*, AUSTL. BUS. REV. (July 31, 2014, 12:00 AM), <http://www.theaustralian.com.au/business/asic-snarls-at-backdoor-listings/story-e6frg8zx-1227007785116>.

<sup>6</sup> See Esther Fung, *Chinese Developers Take the Backdoor to Hong Kong Listings*, WALL ST. J.: MONEYBEAT (July 1, 2013, 10:00 PM), <http://blogs.wsj.com/moneybeat/2013/07/01/chinese-developers-take-the-backdoor-to-hong-kong-listings/>.

mergers can be found in the United States due to the scandals surrounding backdoor listings involving Chinese companies, significantly reducing the attractiveness of backdoor listings. Sweden, which has minimal experience with the backdoor listing phenomenon, has adopted a more moderate (hybrid) approach that combines a case-by-case determination of the applicable rules with a system designed to create awareness among investors about suspicious backdoor listing activities. More specifically, the NASDAQ OMX Stockholm has the potential to give a reverse merger company a temporary “observation status” to alert investors about the risks and uncertainties associated with a backdoor listing. Theoretically, Swedish companies that are unable or unwilling to conduct an IPO (for instance, due to eligibility issues and/or a sluggish IPO market) would still have access to capital and/or liquidity more quickly and with fewer costs compared to their U.S. counterparts.

The paper proceeds as follows. Section I provides an overview of the general trends and facts regarding backdoor listings in countries with a history of alternative public offerings, such as the United States, the United Kingdom, and Australia. Section II discusses the general perception of backdoor listings from the perspective of high-tech companies. Since the availability of the IPO alternative also depends on the applicable rules and regulations, Section III compares regulatory responses to backdoor listings in the United States, Australia, and Sweden. Section IV provides a glimpse into the future of backdoor listings by taking into account the changing policy and regulatory landscape designed to make it easier for young high-tech companies to trade on stock exchanges. In fact, in an effort to spur economic growth and job creation, policymakers, regulators, and exchange operators are increasingly unveiling measures to relax rules and regulations governing IPOs. This is illustrated by the signing of the Jumpstart Our Business Startups Act (JOBS Act) in the United States on April 5, 2012. The Act introduces the Emerging Growth Company (EGC) status. Companies that are able to secure EGC status will be offered a transition period (or an “on-ramp” period) during which they are exempted from a number of regulatory requirements associated with going public. Such speedier and cheaper IPO process will have a reductive effect on the total number of backdoor listings, but will not make them completely obsolete.

## I. TRENDS AND FACTS REGARDING BACKDOOR LISTINGS

Companies need capital as they go through the stages of their life cycles. These life cycles typically start with turning an idea into a start-up company. The start-up company attempts to raise capital from venture capital funds and other private investors. These investors support the start-up by contributing money and services, which brings the company to the next stage in its development. Ideally, this continues until the moment the company seeks to raise capital from the “public” by pursuing an IPO, giving private investors and venture capitalists an opportunity to gradually exit their investment.

The IPO, however, triggers the obligation to comply with a plethora of rules and regulations required by regulators to protect the shareholders (and other stakeholders) in listed companies and prevent managerial misbehavior. These rules and regulations can be divided into three categories: (1) listing requirements to determine whether a company is eligible to go public; (2) disclosure and transparency rules to provide financial and other information to the market and to enhance investor confidence; and (3) corporate governance requirements to ensure that the company’s affairs are conducted in the interests of all concerned. Clearly, the regulatory framework makes the process of an IPO expensive and time-consuming. The costs of an IPO include the fees paid to investment banks, accountants, auditors, lawyers, and other service providers and consultants for advice and for preparing the registration statements, prospectus, and other legal documents. Low valuations and disappointing IPO performances are also reasons for companies to forego the IPO route.<sup>7</sup>

It is therefore probably not surprising that companies that need capital to fund growth and/or provide liquidity to investors have always been looking for quicker, cheaper, and more flexible alternatives to get access to stock markets. When it comes to floating the shares, the idea of avoiding the costs and complexities associated with IPOs is certainly very appealing, particularly to companies that operate in volatile, frequently changing, and quickly evolving markets,

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<sup>7</sup> See Stacy Lawrence, *Reverse Mergers Attract Top-Tier Biotechs in Sluggish IPO Market*, 24 NATURE BIOTECHNOLOGY 598 (2006).

such as the Bitcoin industry.<sup>8</sup> Moreover, control over the timing of the listing and the information released about the IPO process is usually very important to these companies. Clearly, control over both the timing and the information not only enables a smoother transition from the non-listed status to being listed on public markets, but also provides these companies with the opportunity to withdraw their plans without alerting the public. Backdoor listings, particularly through reverse mergers or reverse takeovers, are examples of these alternatives to IPOs that have gained popularity in recent decades. These alternatives, however, are often subject to controversy because an increasing number of alternative listings fail to meet the expectations of investors in the post-listing period.

Indeed, the growing trend of using backdoor listings is not necessarily the consequence of a shift toward a more preferable listing option. Literature denouncing reverse mergers as a suitable substitute to IPOs is plentiful, and some venture so far as to say that they are not even comparable. For instance, a recent empirical study argues that going public via an IPO is simply not feasible for many companies that do not exhibit significant growth potential, do not meet minimum revenue and income levels, or are unable to convince an investment bank (typically the gatekeepers to the public) to underwrite its offering. The study also shows that most reverse merger companies begin trading in over-the-counter (OTC) markets.<sup>9</sup> It should be noted that gaining access to traditional forms of additional capital and ensuring a liquid market for shares that typically come along with an IPO listing are virtually non-existent when pursuing a reverse merger. Therefore, a backdoor listing does not always facilitate a large infusion of new capital from new investors because it is inherently not a capital-raising endeavor where there is exchange of cash for shares in the transaction.<sup>10</sup> This observation raises the question of why a high-tech company should pursue a backdoor listing.

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<sup>8</sup> See Peter Brown, Andrew Ferguson & Peter Lam, *Choice between Alternative Routes to Go Public: Backdoor Listing versus IPO*, in HANDBOOK OF RESEARCH ON IPOs, 503, 503-30 (Mario Levis and Silvio Vismara eds., 2010).

<sup>9</sup> See Charles M. C. Lee, Kevin K. Li & Ran Zhang, *Shell Games: Are Chinese Reverse Merger Firms Inherently Toxic?* (Working Paper No. 3063, 2014).

<sup>10</sup> See William K. Sjoström, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743 (2008).

In this respect, it is remarkable that although backdoor listings occur on a global scale, there are significant differences between the characteristics, motivations, and implications of these listing options. These differences can be explained to a large extent by differences in the legal framework applicable to backdoor listings, and also by supply-demand dynamics (the market for backdoor listings). For instance, backdoor listings through reverse mergers have become an attractive alternative to an IPO in the United States throughout the previous decade. The number of reverse mergers was even higher than the number of regular IPOs in 2008.<sup>11</sup>

In a reverse merger, a private company that wishes to go public through the “backdoor” merges with a public shell. Clearly, in order to maintain the trading status, the public shell must survive the merger, which explains the term “reverse.” As mentioned above, trades in the public shell companies are usually carried out through electronic quotation venues such as the Over-the-Counter Bulletin Board (OTCBB) or the “Pink Sheets” system (referring to the color of the paper the quotations were printed on). This over-the-counter (OTC) market mainly deals in low-grade securities issued by firms in economic distress or in “microcap” issues that fail to qualify for a regular listing on a stock exchange. Most of the shares traded in these OTC markets are of such low value—many of which are “penny stock” shares trading under U.S.D. \$1 each—that they become perfect targets for reverse mergers.

It should be noted that backdoor listings in the United States are often accomplished through a reverse triangular merger instead of a direct merger. This form of merger enables the parties to circumvent expensive and time-consuming disclosures under the listing rules and securities regulations. Under reverse triangular mergers, the publicly listed company typically creates a new wholly owned subsidiary, which subsequently merges into the private company. The merger must be approved by the public shell (as shareholder of its new subsidiary) and the shareholders of the private company. Approval from the shareholders of the public shell company can be avoided if the

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<sup>11</sup> The number of reverse mergers was even higher than the number of regular IPOs in 2008. See Igor Semenenko, *Reverse Merger Waves, Market Timing and Managerial Behavior*, 2 INT'L RES. J. OF APPLIED FIN. 1453 (2011).

company trades on the OTCBB. As a result of the merger, the private company becomes the wholly owned subsidiary of the public shell, which in return issues shares to the shareholders of the private company. At the final stage, the name of the shell is usually changed to the name of the private company, and the directors and officers of the listed shell are replaced by those of the private company. Regardless of how effective reverse mergers might be for meeting the needs of a broad range of companies, the lack of regulatory scrutiny has clearly caused increasing concerns about the degree to which these mergers are used as a means of committing fraud or other securities violations, particularly in terms of misleading financial statements.

In other jurisdictions, supply and demand dynamics, rather than the lack of rules and regulations, explain the popularity of backdoor listings strategies and arrangements. Consider the Australian Stock Exchange (ASX), which is dominated by the volatile mining and high-tech sectors. Companies seeking access to the capital market have almost always been able to find a financially distressed listed vehicle that could serve as a shell for a backdoor listing. For instance, high-tech companies in Australia are often able to obtain the listed status through shell companies that are active in the mining industry. Undoubtedly, some of these high-tech companies have or will become targets themselves and are thus fundamental in attaining the backdoor listing aspirations of new mining companies.<sup>12</sup> Recent data on backdoor listings confirms this cycle: while seventy-six percent of the Australian backdoor listings were conducted by mining companies in 2012,<sup>13</sup> there was a surge in backdoor listings by high tech companies (using unloved mining shells) in the first half of 2014.

Finally, in the United Kingdom, backdoor listings are often used by companies that (1) are mainly interested in the synergies that can be achieved by merging with (or taking over) a listed operating company (this is often combined with raising new capital), and (2) seek access to a wider exposure to investors and liquidity when the IPO market is weak. What is interesting about the experience of the United

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<sup>12</sup> See Owen Richards, *How Primary and Secondary Markets Work*, ASX INVESTOR UPDATE (2012) (on file with author).

<sup>13</sup> See Stephen Bell, *'Back Door' May Be Closing for Miners*, WALL ST. J.: DEAL JOURNAL (Jan. 30, 2013, 5:36 PM), <http://blogs.wsj.com/deals/2013/01/30/back-door-may-be-closing-for-miners/>.

Kingdom is that it shows that specific rules and regulations do not necessarily make backdoor listings less attractive. On the contrary, the “backdoor listing” practice in the United Kingdom was more widespread than in the United States.<sup>14</sup> However, alleged irregularities at subsidiaries of Bumi, an Indonesian company that listed on the London Stock Exchange through a reverse merger in the summer of 2011,<sup>15</sup> quickly gave a negative notion to backdoor listings. This, together with the fact that the Financial Services Authority (FSA)—now the Financial Conduct Authority (FCA)—introduced new rules with the aim to prevent reverse takeovers of companies that are not eligible for listing, explains the sudden decline in the use and popularity of backdoor listings in 2012.<sup>16</sup> The experiences in the three countries show that, besides the applicable rules and regulations, the general perception regarding backdoor listings also appears to play a role in determining whether a backdoor listing provides a viable alternative to high-tech companies that seek to float their shares.

## II. THE GENERAL PERCEPTION OF BACKDOOR LISTINGS

It is a common refrain that backdoor listings are prone to abuse and inappropriate transactions. In the early days of the reverse merger practice (1970s and 1980s) in the United States, a number of opportunistic promoters were fraudulently establishing new shell companies that subsequently raised capital through their IPOs.<sup>17</sup> After the shell company was established, they leaked speculative information about an upcoming (reverse) merger to the market in the hope that the stock price would rise, which would then give them the opportunity to sell shares and make a significant profit. In response to this fraudulent

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<sup>14</sup> See Peter Roosenboom & Willem Schramade, *Reverse Mergers in the United Kingdom: Listed Targets and Private Acquirers*, in INTERNATIONAL MERGERS AND ACQUISITIONS ACTIVITY SINCE 1990: RECENT RESEARCH AND QUANTITATIVE ANALYSIS 181, 182 (Greg N. Gregoriou & Luc Renneboog eds., 2007).

<sup>15</sup> See David Oakley, *City Watchdog to Tighten Listing Rules*, FIN. TIMES (Oct. 2, 2012, 9:11 PM), <http://www.ft.com/cms/s/0/a2709378-0c8c-11e2-a73c-00144feabdc0.html#axzz3myolCy8a>.

<sup>16</sup> Sylvia Pfeifer, *Genel Faces Delay to Premium Listing Plan*, FIN. TIMES (Feb. 23 2012, 7:05 PM), <http://www.ft.com/intl/cms/s/0/6dedca2c-5e44-11e1-85f6-00144feabdc0.html#axzz3myolCy8a>.

<sup>17</sup> See Aden R. Pavkov, *Ghouls and Godsenders – A Critique of Reverse Merger Policy*, 3 BERKELEY BUS. L.J. 475 (2006).

practice, the Securities and Exchange Commission (SEC) passed a number of amendments to the Securities Act 1933 in 1992. The most important rule in this context is Rule 419. This Rule introduced a “blank check company,” which is defined as a company that: (i) is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person; and (ii) is issuing “penny stock.” Rule 419 introduced special rules for blank check companies. For instance, Rule 419 required virtually all cash raised during the IPO to be placed in escrow. Furthermore, under Rule 419, blank check companies were prohibited from trading in the shell’s stock prior to a reverse merger. Rule 419 also introduced a time limit of eighteen months to complete a transaction, and failure to do so would lead to a return of the invested cash to the shareholders.<sup>18</sup>

The regulatory restrictions on blank check companies are the reason for the emergence of Special Purpose Acquisition Vehicles (SPAC). Interestingly, SPACs largely mirror the blank check companies of the 1980s that caused Congress to adopt Rule 419. The business plan for a SPAC is simple. A SPAC is a shell company without historical operations that was taken public through an IPO solely for the purpose of acquiring an operating business, which is typically not pre-determined prior to listing, within an eighteen to twenty four month timeline. For entities looking to list through a reverse merger, a SPAC can be a favorable partner by offering the operating company an immediate cash infusion directly from the proceeds of the SPAC’s IPO as well as a liquid trading market for its securities. Though a merger with a SPAC eliminates the primary downsides associated with a traditional reverse merger, this type of merger is often only a pipe dream for less than exceptional operating companies, and the likelihood of such a deal is at the whim of the SPAC’s management group.

Despite the introduction of Rule 419 and the restrictions on the use of SPACs, the reverse merger or reverse takeover was utilized at a greater frequency as a mechanism to list publicly in the lead up to 2010. In fact, the number of reverse mergers eclipsed the IPO count

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<sup>18</sup> Offerings by Blank Check Companies, 17 C.F.R. § 230.419 (1992).



in 2008 for the first time in the United States. Clearly, there exists a cohort of promulgating instances where the use of a reverse merger has been effective. For instance, a reverse merger can be a viable mechanism to tap into previously untapped sources of additional capital for companies that have exhausted other financing options and do not meet the demanding performance criteria necessary to pursue an IPO. In such instance, the access to Private Investment in Public Equity (PIPE) financing, which is excluded as a financing source for private companies, becomes an important potential source of invaluable capital for entities with no other viable alternatives.<sup>19</sup> A track record of institutional investments in underperforming public companies with relatively illiquid stocks makes this financing option not only a realistic avenue for smaller, less reputable entities, but also a means to eventually obtain a listing in a higher segment of one of the major stock exchanges.<sup>20</sup>

In addition to access to additional avenues of capital, a reverse merger tends to be both a quicker and cheaper listing option relative to its IPO counterpart. On average, a backdoor listing through a reverse merger can be completed in as little as a couple of weeks and is unquestionably timelier than an IPO, which can take months. This is recently confirmed by the CEO of Bitcoin Shop, a U.S. company that operates a Bitcoin-based e-commerce website, who stated (after successfully concluding a reverse merger through which the company raised U.S.D. \$1.875 million in a private placement in February 2014) that the reverse merger only took three weeks.<sup>21</sup> From a cost standpoint, IPOs can run a bill north of the six-figure mark while reverse mergers can be done for a significantly lower amount under the standard circumstances. However, it is important to qualify the speed and cost effectiveness of a reverse merger as it is often touted as

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<sup>19</sup> See David N. Feldman, *Reverse Mergers + PIPEs: The New Small-Cap IPO*, in *PIPEs: REVISED AND UPDATED EDITION—A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY* (Steven Dresner & E. Kurt Kim eds., 2005), reprinted in 3 BUS. L. BRIEF 34 (2007).

<sup>20</sup> See Helen Luk & Heda Bayron, *Sneaking in Through the Back: Chinese Companies that have used Reverse Mergers to List on U.S. Regulators are Finally Taking Notice and Cosing the Door*, A PLUS, May 2011, at 18.

<sup>21</sup> See Bill Meagher, *Bitcoin Retailer Raises \$1.9M in Reverse Merger*, THE DEAL PIPELINE, (Feb. 10, 2014, 4:03 PM), <http://www.thedeal.com/content/consumer-retail/bitcoin-retailer-raises-19m-in-reverse-merger.php>.

a surefire benefit in favor of reverse mergers when that is not always the case. In fact, reverse mergers on the slower end of the spectrum (more than four months) can take as long as some IPOs. Additionally, the cost argument in favor of a reverse merger becomes questionable after factoring for the expenses associated with a backdoor listing along with the consideration paid to shell promoters in the form of cash and sometimes an equity stake.

High-tech companies that face difficulties in accessing domestic capital markets and attracting funding to help them reach the next stage in their development also use backdoor listings to enter a foreign market. This is particularly true if stock exchanges have a competitive interest in encouraging foreign listings. Consider the Chinese companies that listed in the United States via reverse mergers. According to data collected by the Public Company Accounting Oversight Board (PCAOB), 159 Chinese companies completed a reverse merger between January 1, 2007 and March 31, 2010.<sup>22</sup> Because taking the reverse merger route let these companies avoid the scrutiny that would otherwise be required by state and federal rules and regulations in the United States, the reverse merger count outnumbered the number of Chinese companies that completed an IPO in the United States in the same period. Clearly, even though legally accepted, this trend was only possible with the help of a network of U.S. advisors and consultants, such as underwriters, investment banks, lawyers, and auditors.<sup>23</sup>

Despite the benefits of reverse mergers, there is a notion of adverse selection in the pool of entities pursuing a listing through the “alternative” listing route. This notion is supported by the delisting of forty-two percent of the entities listed via the backdoor within its first three years.<sup>24</sup> Reverse takeovers are typically exercised by smaller and

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<sup>22</sup> See PCAOB Issues First Research Note on Chinese Reverse Mergers, PUB. CO. ACCOUNTING OVERSIGHT BD., (Mar. 14, 2011), [http://pcaobus.org/News/Releases/Pages/03152011\\_ResearchNote.aspx](http://pcaobus.org/News/Releases/Pages/03152011_ResearchNote.aspx).

<sup>23</sup> David Barboza & Azam Ahmed, *China to Wall Street: The Side-Door Shuffle*, N.Y. TIMES (July 23, 2011), [http://www.nytimes.com/2011/07/24/business/global/reverse-mergers-give-chinese-firms-a-side-door-to-wall-st.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2011/07/24/business/global/reverse-mergers-give-chinese-firms-a-side-door-to-wall-st.html?pagewanted=all&_r=0).

<sup>24</sup> See Frederick Adjei, Ken B. Cyree & Mark M. Walker, *The Determinants and Survival of Reverse Mergers vs IPOs*, 32 J. OF ECON. & FIN. 176, 189 (2008).

lesser-known entities relative to their larger, more reputable counterparts that list through an IPO, giving rise to a negative signaling effect for those that elect to pursue a backdoor listing.<sup>25</sup> This notion of an adverse selection in entities pursuing a reverse merger is echoed in the literature that showcases the decision tree that lay ahead of Chinese companies, which account for a large majority of the reverse mergers in the late 2000s, when pursuing a public listing.<sup>26</sup> Empirical data reveals that, despite the benefits of reverse mergers, the most well-known and profitable Chinese companies generally elect to pursue an IPO. By contrast, there are many examples of smaller Chinese entities that listed through a reverse merger that are subject to a greater frequency of class action lawsuits, are less profitable, exude lower balance sheet liquidity, and are highly leveraged.<sup>27</sup>

Indeed, many of these Chinese companies ended up being sued for securities law violations, particularly related to financial misrepresentation, failure to disclose material facts, and/or deficient internal control systems. Academic research reveals that U.S. listed Chinese companies that pursued a reverse merger were not always in compliance with the internationally accepted accounting standards.<sup>28</sup> Customarily, the adoption of these standards is a prerequisite as well as a requirement to maintain a public listing for entities pursuing a reverse merger, regardless of the accounting practices employed in local jurisdictions. This listing obligation underscores the growing

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<sup>25</sup> See Augusto Arellano-Ostoa & Sandro Brusco, *Understanding Reverse Mergers: A First Approach* (Bus. Econ. Series 11, Working Paper No. 02-17, 2002), available at <http://orff.uc3m.es/bitstream/handle/10016/66/wb021711.pdf?sequence=1>.

<sup>26</sup> See Jan Jindra, Torben Voetmann & Ralph Walkling, *Reverse Mergers: The Chinese Experience* (Working Paper No. 2012-03-018, 2014).

<sup>27</sup> The 159 Chinese firms that pursued a reverse merger in the United States in the period between January 1, 2007 and March 31, 2010 had a combined market capitalization of U.S.D. \$12.8 billion (which is less than fifty percent of the market capitalization of the fifty-six Chinese companies that completed a U.S. IPO). See *Reverse Mergers: A Looming U.S.-China Showdown over Securities Regulation?*, WHARTON UNIV. OF PA. (March 5, 2013), <http://knowledge.wharton.upenn.edu/article/reverse-mergers-a-looming-u-s-china-showdown-over-securities-regulation/>.

<sup>28</sup> See Katherine T. Zuber, *Breaking Down a Great Wall: Chinese Reverse Mergers and Regulatory Efforts to Increase Accounting Transparency*, 102 GEO. L.J. 1307 (2014).

importance of audits and places a tremendous amount of responsibility on the auditors of these (often times) foreign entities because they usually serve as the only safeguard between the foreign entity and ensuring that domestic investors receive reliable statements.

What is remarkable in this respect is that filings with the SEC reveal that Chinese reverse mergers tended to retain their own auditors post-merger as opposed to those of the former shell company.<sup>29</sup> Audit quality concerns in these mergers were only to be expected when compliance with PCAOB accounting standards increasingly faltered. The large majority of accounting firms employed by Chinese reverse mergers were only inspected by the PCAOB on a triennial basis rather than the typical annual basis, which had only compounded concerns over fraud whirling around Chinese reverse mergers. The questionable audit quality and non-compliance has stemmed partially from added difficulty for U.S. registered accounting firms to conduct comprehensive audits on companies based abroad due to language barriers, accounting standard discrepancies, use of under qualified assistants, the lack of enforcement of accounting laws in China, and additional expenses as well.

The negative attention regarding backdoor listings has caused companies to look at other financing alternatives, such as direct private placements or private sales.<sup>30</sup> However, although poor performing Chinese reverse merger companies are inextricably tied to the general perception of reverse mergers, as they account for a large proportion of entities pursuing backdoor listing through public shell companies, research indicates that the negative spillover effects of fraudulent activity or reporting by Chinese companies have not always harmed other non-Chinese companies' backdoor listing activities. Reverse mergers involving non-Chinese entities appear to largely escape the wrath of investors, as the stock market reaction to news of fraud is focused on Chinese companies as opposed to questioning reverse

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<sup>29</sup> See Benjamin A. Templin, *Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China*, 34 T. JEFFERSON L. REV. 119 (2011).

<sup>30</sup> See David Thomas, *The IPO Road Less Traveled: Form 10, BIOTECHNOW* (Feb. 25, 2013) <http://www.biotech-now.org/business-and-investments/inside-bio-ia/2013/02/the-ipo-road-less-traveled-form-10>.

mergers in general as a viable mechanism to list publicly.<sup>31</sup> Still, the global turbulence in the credit markets, triggered by the turmoil in the subprime mortgage market in 2007-2008, largely brought an end to the laissez-faire era in the backdoor listing process. For instance, in response to the scandals, U.S. policymakers introduced legislation that subjects reverse mergers to registration requirements and provisions targeted at improving the companies' accountability. The backdoor listings rules and regulations—and their impact on high-tech companies—will be discussed in the next Section.

### III. REGULATORY IMPACT ON BACKDOOR LISTINGS

Regulatory responses to the increase in backdoor listings vary significantly from country to country based on a country's respective experience in this area. These responses can be roughly split into three distinct approaches.<sup>32</sup> On one end of the spectrum, the United States has undertaken a number of initiatives spearheaded by organizations such as the SEC and the PCAOB to curb issues stemming from reverse mergers in the form of issuing investor warnings and more stringent listing rules for these transactions. On the other end of the spectrum, Sweden has only limited experience with backdoor listings (and has yet to express concern similar to that of the United States). However, to ensure that investors have sufficient information to distinguish between prudent and imprudent backdoor listings, the Rule Book of OMX NASDAQ Stockholm contains a light touch signaling system that enables regulators to give companies involved in backdoor listings a temporary "observation status."<sup>33</sup> Regulatory responses worldwide to the widely publicized backdoor listings/reverse mergers waver between the approaches taken by the United States and Sweden, as

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<sup>31</sup> See Masako N. Darrough, Rong Huang & Sha Zhao, *The Spillover Effect of Chinese Reverse Merger Frauds: Chinese or Reverse Merger?* (Working Paper, 2012).

<sup>32</sup> Rather than making a strict distinction between the different regulatory approaches, this Section argues that regulatory measures undertaken by national level regulators are best seen in terms of a spectrum of possible regulatory paths. It ranges from countries that introduced special rules and regulations for backdoor listings via countries that implemented rules and regulations that treat backdoor listings as IPOs to jurisdictions that adopted a more flexible regulatory approach.

<sup>33</sup> See NASDAQ OMX STOCKHOLM, RULE BOOK FOR ISSUERS 17 r. 2.7 (2015), available at [http://www.nasdaqomx.com/digitalAssets/96/96156\\_nasdaq-stockholm-s-rule-book-for-issuers—1-january-2015.pdf](http://www.nasdaqomx.com/digitalAssets/96/96156_nasdaq-stockholm-s-rule-book-for-issuers—1-january-2015.pdf).

evidenced by the changes (or lack thereof) in the respective listing rules following these developments in Australia.

#### A. Special Rules and Regulations for Backdoor Listings

In light of the string of alleged fraudulent activity and accounting gaffes concentrated within entities that have undertaken reverse mergers in the latter portion of the 2000s, the SEC and the PCAOB acted swiftly in an attempt to halt further incidents. In addition to issuing an investor bulletin highlighting the additional potential risks associated with investing in companies that were engaged in a backdoor listing process,<sup>34</sup> the SEC imposed a wave of more stringent listing rules for determining if and when companies are eligible to list publicly through the “backdoor.” Additional listing requirements include maintaining a closing share price beyond a certain threshold, complying with all periodic filing requirements of financial reports, and having been traded in the United States on the OTC market or another regulated exchange for at least one year prior (“seasoning rules”).<sup>35</sup> These amendments, which were ultimately approved by the SEC in November 2011, aim to address the concerns surrounding the inaccuracies of financial statements produced by reverse merger companies.<sup>36</sup>

In addition, the PCAOB proposed to implement a set of supplementary auditing standards in the fall of 2011 by requiring audit reports to disclose and identify the names of audit firms or individuals that provided more than three percent of the total hours spent on the most recent audit.<sup>37</sup> The rationale for this additional requirement is

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<sup>34</sup> See generally *Investor Bulletin: Reverse Mergers*, SEC. & EXCH. COMM’N (June 2011), <http://www.sec.gov/investor/alerts/reversemergers.pdf>.

<sup>35</sup> See David N. Feldman, *Comments on Seasoning of Reverse Merger Companies Before Uplisting to National Securities Exchanges*, 2 HARV. BUS. L. REV. 140 (2012).

<sup>36</sup> See Press Release, Sec. & Exch. Comm’n, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011), available at <http://www.sec.gov/news/press/2011/2011-235.htm>.

<sup>37</sup> Moreover, the PCAOB and China entered into a cooperative agreement in October 2012 under which PCAOB inspectors are allowed to observe the oversight activities of Chinese regulators. In return, the agreement allows the Chinese regulators to observe the work of the PCAOB. See *PCAOB Taking Steps to Work with China*, NASBA STATE BOARD REP., Oct. 2012, at 2, available at [http://www.nasba.org/files/2012/10/OctoberSBR\\_2012.pdf](http://www.nasba.org/files/2012/10/OctoberSBR_2012.pdf).

twofold. First and foremost, such a standard helps fulfill consistent requests from investors for further information about the firms that are performing audits on their investments. Second, the names of auditing firms that are located in jurisdictions beyond the PCAOB's current investigatory scope is publicized under this mandate and hence allows investors to be better informed about the quality of firms conducting a company's auditing. This is particularly relevant in China where the PCAOB and other foreign regulatory bodies are currently barred from inspecting China-based audit firms on grounds of sovereignty and state secrecy. Though the PCAOB has been trying to further cooperation with jurisdictions, such as China, which are particularly salient and which make up almost five percent of the PCAOB registered firms, additional measures, including the publication of the names of foreign auditing firms, are useful steps toward greater transparency in audit practices in favor of investors.

The impact of the seasoning rules and regulatory scrutiny on "backdoor listings" is significant. Data provider PrivateRaise recorded 257 reverse mergers in 2010. After the introduction of the rules, the number decreased to "only" 124 companies in 2013.<sup>38</sup> Interestingly, U.S. healthcare and biotech companies are increasingly willing to pursue a backdoor listing despite the seasoning rules. The benefits of the informal and flexible reverse merger process often outweigh the costs of applying the more cumbersome seasoning rules. According to data provider PrivateRaise, at least sixty-nine companies have availed themselves of the reverse merger option during the first half of 2014, and most of these companies were healthcare and biotech companies.<sup>39</sup> Surprisingly (recall that a backdoor listing is inherently not a capital-raising endeavor), twenty-eight companies in these reverse merger

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<sup>38</sup> See Bill Meagher, *Alternative Public Offering Market Is Booming*, THE DEAL PIPELINE (Feb. 24, 2014, 1:58 PM), <http://www.thedeal.com/content/healthcare/alternative-public-offering-market-is-booming.php>.

<sup>39</sup> Bill Meagher, *Investment in Reverse Mergers Doubled in Second Quarter*, The Deal Pipeline (July 21, 2014, 2:43 PM), <http://www.thedeal.com/content/healthcare/investment-in-reverse-mergers-doubled-in-second-quarter.php>.

transactions were also able to raise a respectable total of U.S.D. \$85.6 million in private placements.<sup>40</sup>

#### B. Re-Compliance Regulation

In contrast to the United States, the financial regulatory body in Australia has had a rather tepid response to the wave of fraudulent backdoor listings. In fact, the Listing Rules of the Australian Stock Exchange (ASX) makes no specific references to backdoor listings or reverse takeovers. However, ASX Listing Rules Guidance Note 12, which was published in December 2013 and revised in October 2014, provides legal certainty for the companies and their advisors by explaining how backdoor listings are regulated under Listing Rules 11.1 (including 11.1.2 and 11.1.3), 11.2, and 11.3.<sup>41</sup> The Australian Securities Exchange generally compels a listed entity involved in a backdoor listing to re-adhere to listing requirements under ASX Listing Rule 11.1 (proposed change to nature or scale of activities).<sup>42</sup> Non-compliance with the listing rules could lead to a suspension of the quotation.

Exceptions to the re-admission process exist only if the backdoor listing does not constitute a significant change to the nature or scale of the activities of the listed company. However, a close reading of the previously mentioned Guidance Note 12 shows that the most common backdoor listings will lead to a significant change in the nature of an entity's activity.<sup>43</sup> The following activities (associated with the mining industry) are explicitly mentioned in the Guidance Note: (1) an entity whose main business activity is manufacturing consumer goods deciding to switch its main business activity to mining exploration (or vice versa); and (2) an entity whose main business activity is exploring for minerals deciding to switch its main business activity to exploring for oil and gas.<sup>44</sup> As for the scale of the activities, the ASX considers a twenty-five percent change to the size of an entity's operations to be significant. It therefore comes as no surprise that empirical research found that approximately seventy-nine percent

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<sup>40</sup> *Id.*

<sup>41</sup> ASX Listing Rules, ch. 12 (Austl. Sec. Exch. 2014).

<sup>42</sup> *Id.* at ch. 11.1.

<sup>43</sup> *Id.* at ch. 12.

<sup>44</sup> *Id.*



of the backdoor listings that took place between 1992 and 2007 would have been required to re-comply with ASX's listing requirements.<sup>45</sup>

However, the recently revised Guidance Note 12 arguably makes backdoor listings more appealing to high-tech companies by giving the ASX more flexibility and leeway in interpreting the re-admission rules. For instance, Guidance Note 12 includes more flexible policies on the requirements regarding the minimum spread of security holders (usually 400 shareholders each holding shares with a minimum value of AUD \$2,000). Guidance Note 12 also has a "20 cent rule," which requires—with few exceptions—that shares (or other securities) offered as part of a backdoor listing should have a minimum issue price or sale price of A.U.D. twenty cents or more per share. Clearly, the ASX Guidance Notes not only increase the compliance rate with the regulatory requirements, but also enhance legal certainty and limit possible abuse of the rules, while taking the specifics of backdoor listings into account.

#### C. A Light Touch—Flexible—Regulatory Approach to Backdoor Listings

The Listing Rules of NASDAQ OMX Stockholm also embrace flexibility in assessing backdoor listing processes. First, Rule 3.3.8 requires listed companies to disclose information to the market about significant changes in its identity.<sup>46</sup> The information must be equivalent to what is required under the IPO regulations. In order to determine whether there is a significant change in identity, the Swedish regulator typically takes the following criteria into account: (1) changes in ownership structure, (2) the acquisition of a new business, and (3) the change in market value of the listed company following an acquisition. What is interesting is that the exchange has the possibility to give a company's shares a temporary "observation status" if the disclosed information is insufficient. The rationale behind this status is straightforward: it provides information to the market and warns investors and potential investors of the risks and uncertainties associated with the company or its shares. The observation status is a flexible, but powerful mechanism to remind investors to be cautious

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<sup>45</sup> See Philip Brown, Andrew Ferguson & Peter Lam, *supra* note 8.

<sup>46</sup> NASDAQ OMX Stockholm, *supra* note 33, at r. 3.3.8.

about investing in companies that are subject to a reverse takeover.<sup>47</sup> The observation status can only be granted for a limited period of time, usually not more than six months.

Clearly, other measures in backdoor listing procedures available to the Swedish regulator are the cancellation or suspension of the trading in the shares of a listed company. However, if the regulator is of the opinion that more drastic interventions are necessary, flexibility remains an important element in the regulator's decision-making process. Consider Immune Pharmaceuticals Inc., the byproduct of a reverse merger between a privately held Israeli based bio-pharmaceutical company (Immune Pharmaceuticals Limited) with a listed American developer in pain and cancer treatment (EpiCept Corporation).<sup>48</sup> The newly merged entity hoped to achieve a public listing on the NASDAQ OMX in Sweden following the transaction.<sup>49</sup> It also intended to list on a U.S. securities exchange. Daniel Teper, Immune Pharmaceuticals Inc. Chairman and CEO, highlighted the limitations for Israeli capital markets to fulfill the financing needs of companies operating within the life sciences space that are not concurrently listed in the United States as the primary cause for pursuing a public listing.<sup>50</sup> A reverse merger was ultimately elected as the mechanism to list, since an IPO was initially not a feasible option at the time of the consummation of the merger.

However, even though an active listed company (such as EpiCept), as opposed to a shell company, was involved in the reverse merger, the newly merged Immune Pharmaceuticals Inc. was not immediately allowed to maintain its listing on the regulated NASDAQ OMX market in Sweden. Instead, the regulators approved trading of the shares of Immune Pharmaceutical Inc. on NASDAQ OMX First

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<sup>47</sup> *Id.* at r. 2.7(v).

<sup>48</sup> See Immune Pharmaceuticals, Inc., *Immune Pharmaceuticals' Common Stock Approved for Trading on NASDAQ OMX First North Premier*, NASDAQ GLOBALNEWswire (November 26, 2013, 00:38 AM), <http://globenewswire.com/news-release/2013/11/26/592383/0/en/Immune-Pharmaceuticals-Common-Stock-Approved-for-Trading-on-NASDAQ-OMX-First-North-Premier.html?parent=591162>.

<sup>49</sup> *Id.*

<sup>50</sup> See Gali Weinreb, *Immune Pharmaceuticals Lists in US, Sweden After Reverse Merger*, GLOBES (Oct. 5, 2015 8:30 PM), <http://www.globes.co.il/en/article-1000870466>.

North Premier, a market for high growth companies that are in the process of preparing for a listing at the main market.<sup>51</sup> This decision reflects the importance of the introduction of less regulated and more accessible segments to smaller high-tech companies that would otherwise consider entering the market through the backdoor. The impact of segmented stock markets on high-tech companies and backdoor listings will be discussed in Section IV.

#### IV. SPECIAL LISTING SEGMENTS FOR HIGH GROWTH COMPANIES AND BACKDOOR LISTINGS

The Swedish experience indicates that the outlook for backdoor listings is dismal when high-tech companies can list on an accessible, vibrant, liquid, and high-growth market. The question, however, is whether the benefits of such a market are large enough for high-tech companies to completely turn away from the backdoor listing route to the stock market. What is important in this respect is the gradually changing regulatory landscape for companies that consider floating their shares on a stock exchange. Policymakers and regulators have introduced (or plan to introduce) more flexible listing rules and regulations to stimulate IPO activity by high-tech companies.<sup>52</sup> These initiatives appear to be successful. For instance, the increase of the number of high tech IPOs in the United States in 2013 and the first half of 2014 could arguably be attributed to the possibility of a firm to qualify as an emerging growth company (EGC) under the JOBS Act.<sup>53</sup>

The EGC label offers several benefits to high growth companies in the pre- and post-IPO period. In the pre-IPO period, an EGC will only be required to include two years—instead of the usually

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<sup>51</sup> Immune Pharmaceuticals, Inc., *supra* note 48.

<sup>52</sup> For example, in February 2015 the European Commission started a consultation process expected to evolve into a E.U.-wide Capital Markets Union. The idea is that a small company's access to financing would be significantly improved in a more harmonized capital market. *See Commission Green Paper on Building a Capital Markets Union*, COM (2015) 63 final (February 18, 2015).

<sup>53</sup> *See generally* Gillian Tett, *Investors Enjoy a Sweet Aftertaste to the Candy Crush Crunch*, FIN. TIMES (Mar. 27, 2014, 5:30 PM), <http://www.ft.com/intl/cms/s/0/39e3e9ba-b418-11e3-a102-00144feabdc0.html>.

required three years—of audited statements in its IPO registration.<sup>54</sup> More importantly, the special status introduces “testing-the-waters” provisions, which allow EGCs to communicate with professional investors (qualified institutional buyers or institutional accredited investors) to determine investors’ interest in the company prior to or following the date of the IPO registration statement.<sup>55</sup> Moreover, the JOBS Act provides these companies with the possibility to confidentially submit a draft of its IPO registration statement for review to the SEC.<sup>56</sup>

Also, the “on-ramp” provisions grant important reliefs in the post-IPO period. For example, EGCs are exempted from the obligations under Sarbanes-Oxley Act Section 404(b) to provide an auditor attestation of internal control.<sup>57</sup> Furthermore, the Act excludes EGCs from (1) complying with the full range of executive compensation disclosures and (2) say-on-pay votes on executive compensation.<sup>58</sup> Finally, EGCs need not comply with any new or revised accounting standards until the date on which private companies are required to apply these standards to their organization. The success of the JOBS Act is reflected by the significant increase in the number of EGCs that have pursued a listing after having used the option to confidentially file their registration statements. According to data provider Renaissance Capital, approximately seventy to eighty percent of the 222 IPO companies (including non-venture capital backed companies) in 2013 have availed themselves of the JOBS Act’s confidential filing provision.<sup>59</sup> This is not surprising since high-tech companies value increased control over the timing of the IPO, which is arguably provided by a confidential filing, more than the likely

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<sup>54</sup> Jumpstart Our Business Startups Act (JOBS Act), H.R. 3606, 112th Cong. § 102 (2012) (enacted).

<sup>55</sup> *Id.* at §105.

<sup>56</sup> *Id.* at §106.

<sup>57</sup> Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 404(b) (2002) (codified at 15 U.S.C. § 7262 (2002)).

<sup>58</sup> Investor Protection and Securities Reform Act of 2010, Pub. L. No. 111-203, § 953(b)(1) (2010) (codified in 15 U.S.C. 781 note).

<sup>59</sup> See David Gelles & Michael J. De La Merced, *The New Normal for Tech Companies and Others: The Stealth I.P.O.*, N.Y. TIMES: DEAL BOOK (February 9, 2014: 8:58 PM), [http://dealbook.nytimes.com/2014/02/09/the-new-normal-for-tech-companies-and-others-the-stealth-i-p-o/?\\_r=0](http://dealbook.nytimes.com/2014/02/09/the-new-normal-for-tech-companies-and-others-the-stealth-i-p-o/?_r=0).

discount in the stock price due to the reduced disclosure and reporting requirements for EGCs.

Clearly, the JOBS Act is a success, but will it send the backdoor listing option to oblivion? It is already evident that high-tech companies have started to consider the IPO option again in the United States. In 2014, 116 high-tech (and venture capital-backed) companies floated their shares, compared to eighty-five companies in 2013.<sup>60</sup> However, despite the booming high growth market segment in the United States, there has been a surge in reverse mergers, particularly conducted by companies that operate in volatile industries. As discussed, despite the need to comply with onerous special reverse merger regulation, these companies still find that a reverse merger is quicker and easier than conducting a traditional IPO (even under the JOBS Act).

#### CONCLUSION

In the previous decade, backdoor listings became increasingly popular as a mechanism to list publicly in the United States, the United Kingdom, and Australia. However, empirical studies indicate that backdoor listing activity has significantly decreased due to negative publicity, the introduction of more stringent rules and regulations, and increased regulatory scrutiny. Therefore, the question is whether measures employed to strengthen the rules and regulations governing backdoor listings will eventually put an end to this alternative option of going public. The evidence is mixed. The number of and amount raised by Chinese reverse mergers has plunged approximately fifty-three percent and ninety-five percent respectively in 2011 (compared to 2010). In contrast, we observe a backdoor listing boom in the high-tech industry in the United States and Australia in 2014.

The answers to the question of whether backdoor listing is still a sustainable alternative for high-tech companies compared to the “front door” IPO vary depending on a country’s respective experience with backdoor listings. These answers can be divided into four categories. In the first category, there are countries such as the United States that have a vibrant, accessible, and liquid stock market for high-

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<sup>60</sup> See PitchBook, 2Q 2015 U.S. VENTURE INDUSTRY REPORT (2015).

tech companies as well as a long history with backdoor listings. In such countries, high-tech companies are willing to accept more stringent rules, such as the seasoning rules, if the backdoor listing strategy still offers them flexibility as well as low-cost and timing advantages compared to the regular IPO route.

Second, in countries such as Australia, which has no special high-tech segment on the stock exchange but has an active market for alternative listings, backdoor listings are there to stay even during the gloomiest days of the economy. Policymakers and regulators seem to understand the importance of alternative public offerings by allowing flexibility in the application of the “re-admission” rules.

The third category includes countries that have a robust and liquid high-tech stock market, but no recent experience with backdoor listings. The Swedish experience shows that, even though backdoor listings are permitted, high-tech companies rarely employ this alternative option. This can partly be explained by the lack of available shell companies.

Fourth, even if countries have no history with backdoor listings, policymakers and regulators should be wary of the fact that entrepreneurial high-tech companies may start to explore alternative public offerings if the high-tech segment of the stock market is not accessible through relatively cheap and fast means. They should realize that backdoor listings continue to provide a viable and legitimate listing option for high-tech companies that are always in search for capital and liquidity.

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## COMMERCIAL LAW AND THE PUBLIC INTEREST

*Jay Lawrence Westbrook\**

In commercial law policy debates in the United States, the consideration of public interests has been muted. The success of “contractualist” ideas (along with “public choice” theory) has forced to the background notions of broader social interests and the significant secondary effects of commercial law rules, leaving the policy debates focused largely on competing claims of efficiency and injustice to the immediate parties to an activity or transaction. In this essay, I want to explore this phenomenon in a preliminary way. My long-term objective is to understand the reasons for this move away from considerations of public interests and perhaps to find a way to return those interests to their proper place.

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\* Benno Schmidt Chair of Business Law, The University of Texas School of Law. I am grateful to Patrick Wolfgang, Texas ‘15, and William Langley and Kelsi Stayart, Texas ‘16, for their help in research for my public-interest project, starting with this article. This paper was delivered in the summer of 2014. While its principal points continue to reflect my views and the nature of my current academic project, those views and the world have moved on in some respects. In particular, I have become more careful to say “public interests” (plural). I also note that the American Bankruptcy Institute Commission has now delivered recommendations about bankruptcy reform that provide a rich medium for critiques based on public interests. See AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11 (2014).

How did the notion of a public interest in commercial law questions get elbowed aside when it had long been a staple of American academic and political discourse? The primary reason has been the rise of “public choice” theories<sup>1</sup> and “contractualism.”<sup>2</sup> This essay focuses on the contractualists as its primary example. For the most part, the contractualists are content to identify one public interest—freedom of contract in a free market—as the singular public interest to be served in commercial law, primarily on the basis of efficiency.

One of the reasons that other public interest considerations have been elbowed aside is that those who are concerned with public interest factors do not have a church as do the public choice and contractualist scholars. That is, these scholars have a set of institutions—conferences, centers, and the like—and a common set of intellectual “moves” and terminology combined with a deep sense that their approach is almost always the best approach to any legal policy question.

In my field of insolvency, Professor Douglas Baird has attempted a distinction between “proceduralists” and “traditionalists” to mark these scholars from the rest,<sup>3</sup> but the labels are not very helpful and the foundation for them is weak. I think it is more useful to focus on the contractualists versus the “regulators” (both of which are defined below).

I try in this essay to explain how and why public interests have been ignored. The essay form permits suggestion and speculation to substitute for precision and detailed references in these early stages of my developing project. Many points are uncertain at this stage. I am unclear, for example, whether the relative decline of arguments about

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<sup>1</sup> See, e.g., JAMES M. BUCHANAN, PUBLIC CHOICE: THE ORIGINS AND DEVELOPMENT OF A RESEARCH PROGRAM (2003).

<sup>2</sup> See, e.g., ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, KATHERINE PORTER & JOHN POTTOW, THE LAW OF DEBTORS AND CREDITORS (7th ed. 2014) [hereinafter DEBTORS AND CREDITORS].

<sup>3</sup> See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576-77 (1998). For a critique of his position, see Jay Lawrence Westbrook, *Empirical Research in Consumer Bankruptcy*, 80 TEX. L. REV. 2123 (2002).



the public interest is primarily an American phenomenon or one found in many parts of the academic world.

The most challenging element in the analysis is the definition of the public interest as distinct from an individual or aggregate interest. An example may help at the start. In debates about the enforcement of form (boilerplate) contracts against consumers, those favoring enforcement generally speak of freedom of contract in a market society and rely on the consumer's consent as the central reason for enforcement. Those who would limit enforcement generally argue (a) that the consumer does not really consent in a meaningful sense; and (b) that, even with consent, enforcement of some or all of the form provisions would be unjust or unfair to the consumer party.

The arguments on each side have considerable power, but my point here is that each argument is rights-based—that is, limited to the rights of one of the parties to the contract. The arguments may apply to many sellers that issue form contracts and to millions of consumers against whom they might be enforced, but this aggregation of instances does not amount to an argument about the public interest. No doubt the sellers' advocates would claim that society generally is benefitted by enforcement, and the consumers' champions would make the same claim about nonenforcement, but each would be speaking of the aggregation of individual results, not a distinct collective interest that should be included in determining an appropriate legal policy.

By contrast, other sorts of arguments—whether good or bad on the merits—would be based on a notion of the public interest. As a first approximation, a public interest may be defined as a concern about the positive and negative effects of a policy on most of the people in society, including those whose individual interests are not directly implicated by a given transaction or activity. In our pending example, the public interest in boilerplate might include factors different from freedom of contract or an unjust result for the consumer party.

There are a number of public interest concerns in the context of form contracts. One category might be called “secondary effects.” Consider the consumer advocate's argument that courts or regulators should be more ready than they have been to strike down unreasonable and oppressive contract terms. One aspect of that claim would be the

benefit to the consumers thus spared from enforcement of those terms. But another would be the assertion that judicial activism would serve the public interest by arming the sellers' lawyers with tools to convince their clients to draft form contracts with a more even hand. That result might benefit society generally by giving everyone more confidence in entering into form contracts and creating a pervasive sense of fairness in the market place. This sort of argument differs from the individual rights argument because it rests upon costs and benefits to society generally rather than arguments about "true" consent or normative beliefs about fairness. This sort of argument is also less subject to claims of individual consent or waiver. My sense is that this sort of shift in the focus of the argument would be important, albeit sometimes subtle in the abstract.<sup>4</sup>

For the purposes of this paper, I have no interest in how these arguments come out or in the numerous counter and counter-counter arguments that would arise. The necessary point is that there may be a public interest to be identified and that interest may have a significant influence on the nature and direction of the debate. It can have that effect even though it must be conceded that the importance of the distinction is sometimes masked by the difficulty in making it. It must also be conceded that aggregate and public interest benefits/harms may overlap considerably, but that ambiguity does not necessarily make the public interest less salient.

#### I. THE DISAPPEARANCE OF THE PUBLIC INTEREST

In recent years, discourse in many legal fields has been "privatized" by the assumption that the stakes—the benefits and costs—at play in a given activity are limited to the private parties who are individually interested in possible outcomes. Commercial scholars are prominent among those committed to this view. Such scholars are

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<sup>4</sup> These sorts of arguments are often about "externalities," positive or negative, that are recognized in principal in contractualist presentations, but are often omitted or subordinated. Externalities sometimes effect only a certain group of people and therefore are not public interest questions in the sense that I am using the phrase. But a fair number of public interest arguments are about ignored externalities.

generally found among those who embrace “public choice” theory and among those whom I have characterized as “contractualists.”<sup>5</sup>

Loosely speaking, scholars who embrace the “public choice” theory might claim that there is rarely such a thing as a public interest that is relevant to a legal issue, only an aggregation of private ones that become expressed in law largely as a matter of interest group wins, losses, or compromises.

Next door live the contractualists, who believe that commercial policies are best understood as a series of contracts, rather than sovereign commands. For them, the ideal society consists of a web of contracts freely adopted by each person. (Locke meets the Uniform Commercial Code.) Because public law is sometimes a practical necessity, that law should be defined by the results that private contracts would produce if they were feasible. The contractualists are in turn divided between those who view the contractual approach as a useful metaphor for determining the correct legal result and others who argue for commercial laws that facilitate actual bargains that would replace substantive legislative rules to the maximum extent, often by enabling the legal contortions necessary to attempt to avoid the problem of third-party effects. Each of these views privatizes legal thought by banishing traditional notions of a societal or collective interest. Their opponents I will call the “regulators”: scholars who are more sympathetic to mandatory legal rules and government regulation in the public interest.

Both public choice and contractualism are closely related to neoclassical economic theory and to the Law and Economics “movement” in the U.S. and elsewhere, with its emphasis on increasing efficiency in the generation of wealth and its disinterest in questions of wealth distribution. They also parallel a reductionism in political science, where the literature has been dominated by interest group influence and legislator self-interest, rather than the actors’ beliefs and perceptions about the public interest. In recent years, this approach has been extended to scholarship about judges, seeking patterns of decision-making related to political affiliations and personal

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<sup>5</sup> See Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1199 (2005); DEBTORS AND CREDITORS, *supra* note 2.

backgrounds. Much of this scholarship is useful, but like the rhododendron it has too often exterminated valuable competitors.

These and other factors have contributed to a focus on individual rights and obligations and thus on individual benefits and harms. This focus has had a major impact on policy debates. American examples of affected policy issues include the existence *vel non* of private rights of action based on statutory provisions that do not explicitly grant such rights; the nature of fiduciary and other management duties owed to investors and creditors in corporate law; the proper scope of arbitration clauses in both consumer and international commercial arbitration; and the emergence of secured creditor domination of the reorganization of distressed businesses. In this essay, I want to address just the last one as an illustration.

## II. AN EXAMPLE: THE PUBLIC INTEREST IN REORGANIZATION CASES

Chapter 11 reorganization lies at the heart of United States insolvency law, and it is the primary feature of our law that has influenced legal reformers all over the world. Yet it seems to me that some of the central policies that drove its adoption in the United States and its influence elsewhere in the world have become obscured in modern scholarship. Obviously, the achievement of a law's goal should be the touchstone for every aspect of its implementation, yet often in the United States goals are merely assumed and these assumptions often change *sub silencio*. For example, there is considerable discussion currently about the control of Chapter 11 proceedings by secured creditors, but relatively little attention to the goals of Chapter 11 in relation to control rights. Because secured creditor control effectively converts Chapter 11 to a vehicle for a version of contractualism, it is congenial to that school but unattractive to those who see a larger role for protective rules in the Bankruptcy Code. The correct result of the contention between them ultimately turns on convictions about the proper goals for reorganization law.

I do not attempt here to make the case for or against creditor control or to answer the larger predicate question, which is the purpose of reorganization procedures. Instead I want to put on the table some of the public interest issues that should be part of those discussions.

It is striking that the debate has become almost entirely rights based, ignoring any suggestion of public interests in the outcome, just as with the form consumer contract example discussed earlier. The debate has been conducted by scholars committed to a private-sector, free-market view versus those more concerned with normative values like protecting weak parties and nonparticipating parties. As with form contracts, the lack of apparent concern with a public interest is often found on both sides.<sup>6</sup>

Most of the scholars who favor secured creditor control are contractualists or quasi-contractualists. Dean Robert Rasmussen is a pure contractualist who would use a company's articles of incorporation as a standard contract with creditors:

When a firm is formed, it would be required to select what courses of action it wishes to have available if it runs into financial difficulties down the road. . . . By offering a discrete set of choices, the menu would enable banks and other creditors to anticipate the interest-rate adjustments that would be made for each option. They could then communicate to those establishing the firm the true cost of selecting one bankruptcy provision over another.<sup>7</sup>

His fellow contractualists propose various other techniques for producing contractual agreement, but all support their position with arguments that rest on benefits to the individual firms as debtors or creditors and consider any possible harms in the same way. Underlying their approach is only one contention that could be read as invoking the public interest. Professor Lynn LoPucki, a frequent opponent of the contractualists, summarizes that argument as follows:

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<sup>6</sup> A nice example of the absence of the public interest argument is found in the Detroit bankruptcy where little of the legal debate seems to have addressed the public interest benefits arising from the availability to the public of a remarkable collection of art at very low cost. Yet that interest had a major impact on the results of the case. See Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. (forthcoming 2016) (importance to the public of preservation of art museum).

<sup>7</sup> Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 66-67 (1992).

The case for freedom of contract rests squarely on the assumption that each party chooses the contract because the contract makes that party better off. Because each party is better off, all parties are better off in the aggregate. That aggregate then becomes a proxy for “social welfare.” In the bankruptcy context, this theory holds that thousands of correct decisions by a debtor and each of its creditors and shareholders will generate one correct decision—the bankruptcy contract—in the aggregate. That decision will maximize social welfare.<sup>8</sup>

Other contractualists hedge their commitment to contract a bit more than Dean Rasmussen, but their caveats serve to emphasize their concern with individual rights and obligations. Thus Professor Steven Schwarcz limits enforceability of contract deviations from the “default” rules of the Bankruptcy Code to those that do not offend the principle of equality of distribution nor create an externality that would be unenforceable as a matter of contract law.<sup>9</sup> The former limit is protective of the rights of claimants in a specific case, while the latter amounts to a public policy exception, something rarely found in American contract law and quite different from the broader and much more common instance of a relevant public interest.

Only one contractualist article has seemed to me to rely importantly on a public interest other than the general ground of freedom of contract. It was written by Professor Alan Schwartz who supported a contractualist approach with the claim that it would further the only legitimate goal of reorganization, which for him is generation of the lowest possible interest rate on debt capital.<sup>10</sup> Whatever the merits of that interesting assertion, it does make a claim about a public interest. It is probably significant that no other contractualist scholar has taken up that argument.

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<sup>8</sup> Lynn LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317, 341 (1999).

<sup>9</sup> Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542-44 (1999).

<sup>10</sup> Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 343 (1999).

What is more surprising is that fairly often scholars who are regulators also focus on private concerns rather than public ones. For example, I wrote an article directly attacking the contractualist position on secured creditor control of reorganization, but devoted it almost entirely to the negative effects of that approach on the maximization of value and fair distribution to the claimants rather than any considerations beyond those immediate parties.<sup>11</sup> Elizabeth Warren and I launched a direct attack on the contractualists based on empirical data, but the entire thrust of the article was that a contractualist approach would result in disadvantage to various parties to a reorganization proceeding.<sup>12</sup> The principal exception was a small section dealing with transaction costs, and even that had a focus on the contracting parties rather than society in general.

Only two major articles on the rule maker side in the debates about bankruptcy seem to have squarely addressed an alleged public interest. Professor Susan Block-Lieb pointed to the adoption of various statutes regarding pensions and retiree benefits as establishing a public interest that should have weight in making bankruptcy policy.<sup>13</sup> She insisted that Congressional action to support pension benefits represented a Congressional determination that pension protection was a general interest of our society and therefore required the consideration of that public interest in forming bankruptcy policy.

Her discussion illustrated an important aspect of the conflict between party-oriented arguments and public interest arguments. She explicitly rejected the standard contractualist argument that substantive public policy should have no place in bankruptcy, viz any concerns about pensions must be cabined in pension law discussions, concerns about financial speculation must be resolved in legislation directed at financial speculation, and so on. The effect is to prevent many public interest factors from being given weight in making bankruptcy law. The compartmentalization of legal policy contributes substantially to a focus on the interests of the immediate parties to a particular economic relationship and away from a more general social or economic

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<sup>11</sup> See Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 837-52 (2004).

<sup>12</sup> See Warren & Westbrook, *supra* note 5.

<sup>13</sup> See Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (2001).

perspective. By taking on the argument against policy balkanization, Professor Block-Lieb staked out a position for substantive public interests in bankruptcy policy.

The second major article pointing out public interest considerations in reorganization policy was written by Professor (now Senator) Elizabeth Warren. In an article responding to the contractualist approach, Professor Warren listed the goals of bankruptcy as follows:

*Enhance Value.* By creating specialized collection rules to govern in the case of multiple default and by requiring collective rather than individual action, the value to be gleaned from the failing business can be increased while the expenses of collecting that value are decreased. Bankruptcy rules can also preserve going concern value while they can cabin many forms of strategic behavior that would otherwise waste collective resources.

*Establish an Orderly Distribution Scheme.* By moving away from the race of the diligent at state law, there can be a considered judgment of who should receive preferences in the event that not all parties' expectations can be met. Distributions to parties with different legal rights can be settled in a legislative arena. Parties with no formal rights to the assets of the business, such as employees who will lose jobs and taxing authorities that will lose ratable property, may profit from a second chance at restructuring debt and giving the business a chance to survive in situ.

*Internalize the Costs of Default.* A viable Chapter 11 system reduces the pressure on the government to bail out failing companies, thus forcing creditors to make market-based lending decisions and to monitor their debtors more closely.

*Establish a Privately Monitored System.* The initiation decision in bankruptcy is one of the hardest. A system that provides sufficient incentives for debtors to choose bankruptcy voluntarily or for creditors to force their debtors into it avoids the high costs that come with a publicly monitored system, both in terms of the costs of errors (decisions to place a company in bankruptcy that come too quickly or



too slowly) and the costs of monitoring. Such a system also avoids the potential politicization of such decisions.<sup>14</sup>

I have underlined portions of this list that reflect public interest factors. It is important to note that Warren was not often able to cite specific provisions protecting such values. Public interest factors are often hard to tie to particular legal rules. In effect, legislators rely on the courts to have those factors in mind, along with the structure of a statutory system as a whole, when construing a rule.

Generally, however, the debates about secured creditor control of reorganization and its relation to reorganization goals have settled into a rights argument with little attention to public interest factors. That is so despite the fact that the discussions surrounding the proposal and adoption of the Bankruptcy Code in 1978 were filled with public interest factors supporting reorganization. Jobs, community stability, and a second chance for company owners were high on the legislators' lists of statutory goals. For example:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's financings so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.<sup>15</sup>

Taking the preservation of jobs as an example, there is evidence that public officials continue to be deeply concerned with the preservation of jobs, but jobs have virtually disappeared from the reorganization conversation in the United States.

This point is illustrated when competing reorganization plans are presented to the courts. Under some circumstances, the Bankruptcy Code permits more than one reorganization plan to be submitted to creditors. If the necessary majorities vote in favor of both plans, which sometimes happens, the court must decide which plan to

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<sup>14</sup> See Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344-76 (1993) (emphasis added).

<sup>15</sup> H.R. Rep. No. 95-595, at 220 (1977).

adopt. There is no statutory standard for making that choice, so the courts are free to consult such policy grounds as they think relevant. In the reported decisions on this point, there is little sign that the better preservation of jobs is a legitimate tie-breaker, despite the legislative history and despite the professed concerns of nearly all our political leaders. The interests of communities are also ignored, despite widespread state-level legislation in the United States designed to protect communities against hostile takeovers.

In addition to jobs and community stability, both mentioned by Warren, there was in 1978 an underlying theme of helping equity owners as well. The new Chapter 11 arose from the old Chapter XI, which was designed to permit small business owners to keep their businesses alive through negotiating a payout plan with their creditors. Congress intended to extend this idea by permitting management of all businesses, large and small, to remain as the “Debtor in Possession.” Thus we have the view of Chapter 11 reflected in the United Kingdom terminology: “rescue” proceedings.<sup>16</sup> That view of reorganization is reflected in the legislative history quoted above and continued to be a part of the culture and folklore of the new Chapter 11 well into its first decade.

Given that history, it is far from evident that only bondholders and other creditors are entitled to consideration while shareholders are not. Yet at some point the focus of scholarship and practice narrowed to the interests of the immediate parties and their statutory entitlements. Although the abolition in 1978 of the “absolute priority” rule (which puts shareholders at the bottom of the priority waterfall) in its strictest form<sup>17</sup> was intended to permit more flexibility in protecting the interests of shareholders, a number of articles continued to call the rule “absolute” and to decry any departure from it, which in turn obscured the legislators’ evident interest in “rescue.”

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<sup>16</sup> See, e.g. Vanessa Finch, *Re-Invigorating Corporate Rescue*, 2003 J. BUS. L. 527, 536-39 (2003); see also Gabriel Moss, *Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Trends in National Law—England*, 23 BROOK. J. INT’L L. 115, 121 (1997).

<sup>17</sup> John D. Ayer, *Rethinking Absolute Priority After Ablers*, 87 MICH. L. REV. 963 (1989).

The issue is whether interest of specific owners in a specific publicly held company is worthy of consideration, especially if equity is “under water” or “out of the money.” The contractualists consider that equity investors at that point cease to be parties in any real sense because of the absolute priority rule. Thus, the law’s concern should be solely with the interests of those who remain in the hunt. But the public interest in ensuring that shareholder interests are appropriately considered remains an important one, beyond recoveries in particular cases. Is a quick exit for equity sound business policy, given the importance of equity investing in the capital markets? That sort of public interest should be considered in deciding, for example, whether case law should give shareholders more protection against undervaluation of their company and other financial maneuvers. Little evidence can be found of an appreciation that there may be a public interest in the resolution of that question.

The lack of consideration of a possible public interest in these decisions—a public interest in jobs, in community stability, and in promoting and protecting equity interests—seems especially anomalous because they played an important part in the adoption of the most important single reform in the 1978 Code. That reform replaced a trustee in bankruptcy with a Debtor-in-Possession (“DIP”), conferring extraordinary power and flexibility on the managements of distressed businesses in Chapter 11.<sup>18</sup> Yet the notion of protecting owners of companies provided important support for that reform. If they are now replaced by an assumption, often explicit, that only the interests of creditors are important, and that the maximization of value for creditors is the only aim of bankruptcy law, then the idea of putting old management in charge of a company’s Chapter 11 case needs comprehensive review. Indeed, because nowadays the result is often to put a secured creditor in control despite its conflict of interest with the rest of the creditors, the DIP concept seems ripe for revisiting.<sup>19</sup> It is in consideration of the public interest in protecting equity investors that puts that question on the table.

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<sup>18</sup> 11 U.S.C. §1107.

<sup>19</sup> See generally A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875 (2009).

## III. A POSSIBLE RESPONSE

The nature and weight of these public interest factors in the evolution of reorganization is a long discussion far beyond the boundaries of this essay. What I do want to suggest are possible reasons for the lack of concern for the role of the public interest in commercial law debates. No doubt part of the answer is political. Regulation is not popular in the abstract, despite the recent reminders of the effects of deregulation provided by the Great Recession. But another reason for this lack of concern is that the regulators in academia have been too long on the defensive and have had too little new to offer. The contractualists have proclaimed “The End of Bankruptcy”<sup>20</sup> (via secured creditor control, which they embrace) and devised ever more clever and intricate ways for contract to replace legal provisions. All these have provided much fuel for academic reflection, tinkering, and debate. The regulators have been “traditionalists” defending the eroding status quo. Professors Warren and Block-Lieb published their public interest articles a decade ago, but little new has been done to explain or vindicate the interests they identified. Although the contractualists have largely run out of intellectual steam themselves, until the regulators resume a positive reform agenda at the conceptual level the public interest will remain behind the door when bankruptcy policy is made. The same is true throughout commercial law.

One step that courts might be encouraged to take would be to try to identify (or encourage the parties to identify) any public interest factors in a commercial dispute. In an appropriate case, they could even invite governmental agencies or NGOs to submit views and arguments if those submissions would not unduly delay the case or increase the expense for the private parties. Pointing out those opportunities would be a major step forward in rediscovering the public interests we have somehow misplaced.

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<sup>20</sup> See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 754-55 (2002) (describing a fundamental shift in Chapter 11 bankruptcy from a reorganization vehicle to a means of liquidation driven in large part by secured creditors who increasingly view the sales value of a firm’s current assets as greater than the going-concern value of those assets in the future).

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## JUDICIAL IMPLEMENTATION OF SOUTH AFRICA'S NEW BUSINESS RESCUE MODEL: A PRELIMINARY ASSESSMENT\*

*Patrick C. Osode\*\**

### INTRODUCTION

One of the most exciting and innovative aspects of South Africa's New Companies Act<sup>1</sup> ("the 2008 Companies Act" or "the Act") is the creation of a new business rescue model in Chapter Six of the Act ("Chapter Six"). The scheme of Chapter Six of the 2008 Companies Act<sup>2</sup> replaces the judicial management model that was contained in the 1973 Companies Act,<sup>3</sup> which is the predecessor of the current Act. Like most major pieces of legislation enacted in post-apartheid South Africa, the 2008 Companies Act in general, and Chapter Six in particular, are intended by the legislature to significantly enlarge the capacities of both the government and the private sector

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\*\* LLB (Hons); BL; LLM; SJD. Professor and Head, Department of Mercantile Law, University of Fort Hare, South Africa.

<sup>1</sup> Companies Act 71 of 2008 (S. Afr.). Unless otherwise indicated, all references to statutory provisions are references to provisions of this Act. Although enacted in 2008, the Act only came into force on May 1, 2011. Pursuant to powers conferred under the Act, the Minister of Trade and Industry has enacted The Companies Regulations, 2011 which are expected to assist both the application and implementation. See GN R351 in GG 34239 of 26 April 2011 (S. Afr.).

<sup>2</sup> Companies Act 71 of 2008 Chapter Six (S. Afr.).

<sup>3</sup> Companies Act 61 of 1973 (S. Afr.). The 1973 Companies Act has now been repealed by the 2008 Companies Act.

to preserve existing jobs, create new employment opportunities, and make the country's economy competitive relative to its contemporaries.<sup>4</sup> But beyond the purely economic policy objectives, the 2008 Companies Act was also intended to infuse the regulatory framework governing companies with the treasured democratic values of equality, non-racialism, and human dignity enshrined in South Africa's post-apartheid Constitution.<sup>5</sup>

The fact that both social and economic objectives impelled the enactment of the 2008 Companies Act and Chapter Six can be gleaned from the twelve objects of the Act set out in section 7. With particular respect to Chapter Six, it is specifically stated that part of the policy intent behind the enactment of the Act is "to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders."<sup>6</sup> Especially significant is the provision of section 5(1) of the 2008 Companies Act, which explicitly enjoins the courts to interpret and apply the provisions of the Act in a manner that gives effect to the purposes set out in section 7. Based on the provisions of sections 5, 7, and Chapter Six, both judges and academics<sup>7</sup> are in agreement that the legislature has unequivocally signalled its preference for the rescue of financially distressed companies as against liquidation.<sup>8</sup> Both the 2008 Companies Act and Chapter Six constitute another glaring example of South Africa's attempt to use commercial legal regulatory instruments

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<sup>4</sup> SOUTH AFRICAN COMPANY LAW FOR THE 21<sup>ST</sup> CENTURY: GUIDELINES FOR CORPORATE LAW REFORM, GENERAL NOTICE 1183, ¶ 1.2 (2004), available at [http://www.gov.za/sites/www.gov.za/files/26493\\_gen1183a.pdf](http://www.gov.za/sites/www.gov.za/files/26493_gen1183a.pdf).

<sup>5</sup> S. AFR. CONST., 2008.

<sup>6</sup> Companies Act 71 of 2008 § 7(k) (S. Afr.).

<sup>7</sup> CONTEMPORARY COMPANY LAW 861-64 (Farouk H.I. Cassim et al. eds., 2d ed. 2012); 1 HENOCHSBERG ON THE COMPANIES ACT 71 OF 2008 44-46 (Piet Delpont et al. eds. 2012) [hereinafter "DELPORT"].

<sup>8</sup> This point was made most distinctly by the court in *Koen and Another v. Wedgewood Village Golf and Country Estate Ltd.* 2012 (2) SA 378 (WCC) at para. 14 (S. Afr.) as follows: "It is clear that the Legislature has recognised that the liquidation of companies more frequently than not occasions significant collateral damage, both economically and socially, with attendant destruction of wealth and livelihoods. It is obvious that it is in the public interest that the incidence of such adverse socioeconomic consequences should be avoided where reasonably possible. Business rescue is intended to serve that public interest by providing a remedy directed at avoiding the deleterious consequences of liquidations . . . ."

to boost socio-economic transformation by creating conditions that will enable significantly increased participation of the formerly disenfranchised black majority in the mainstream economy. These reforms will help the society overcome the multiple legacies of apartheid with which South Africa continues to struggle twenty years into the democratic era.

The quality of real or tangible outcomes achieved by statutory regulatory instruments generally, and commercial law-related instruments in particular, may depend in part on their interpretation and application by the courts.<sup>9</sup> To be sure, the adoption of an interpretive approach that is conservative, largely textual or literal, and purpose-neutral will significantly undermine the prospect of Chapter Six achieving the public policy goals intended by law and policymakers. Indeed, such an approach may by itself lead to regulatory failure.<sup>10</sup> The plausibility of this concern is clearly borne out by the experience of “judicial management” in the courts. In this respect, it is especially noteworthy that virtually all of the academic and judicial post-mortem done on the judicial management scheme of the 1973 Companies Act suggest that one of the main reasons for the dismal failure of that scheme was the conservative judicial approach to the interpretation and application of the requirement of “reasonable probability” (of successful financial rehabilitation of the debtor company), which was a prerequisite for the granting of a judicial management order under section 417 of that Act.<sup>11</sup> The risk of business rescue suffering the same

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<sup>9</sup> COMPARATIVE COMPANY LAW: A CASE-BASED APPROACH 378-79 (Mathias Siems & David Cabrelli eds. 2013).

<sup>10</sup> Such failure would almost certainly become reality if the courts adopt a disposition and develop a jurisprudence that is generally “creditor-friendly,” as was the case in the judicial management era and as is still the case under the country’s insolvency law and related processes. It should be noted here that judicial management was first introduced into South African law through the Companies Act of 1926 and only became consigned to history when the 2008 Companies Act came into force. See Richard Bradstreet, *The New Business Rescue: Will Creditors Sink or Swim?*, 128 SALJ 352, 353-56 (2011); Anneli Loubser, *The Role of Shareholders during Corporate Rescue Proceedings: Always On the Outside Looking In?*, 20 SAMLJ 372, 372-73 (2008).

<sup>11</sup> See, e.g., David Burdette, *Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa (Part 1)*, 16 SAMLJ 249 (2004); CONTEMPORARY COMPANY LAW, *supra* note 7, at 2; Pieter Kloppers, *Judicial Management Reform – Steps to Initiate a Business Rescue*, 13 SAMLJ 358 (2001); *Koen and Another v. Wedgewood Village Golf and Country Estate Ltd.* 2012 (2) SA 378 (WCC) at 2

fate in the courts as its judicial management predecessor is significantly heightened by the deficiencies of the 2008 Companies Act generally and of Chapter Six in particular.<sup>12</sup>

Against the above background, it is clear that the interpretive approach and attitude of the courts will be critical to the efficacy of the Chapter Six rescue mechanism and, therefore, to the attainment of the underlying public policy objectives. Without doubt, if they adopt an

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(S. Afr.); Anneli Loubser, *Judicial Management as a Business Rescue Procedure in South African Corporate Law*, 16 SAMLJ 137 (2004); *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 (S. Afr.); *Propspec Investments Ltd. v. Pacific Coast Investments 97 Ltd.* 2013 (4) SA 539 (S. Afr.). Other factors that have been identified include the absence of a business rescue culture among all the various role players (creditors, judges, etc.) and the fact that judicial managers were usually chosen from the ranks of liquidators who have neither the skill nor experience in rehabilitating businesses. See Richard Bradstreet, *The Leak in the Chapter 6 Lifeboat: Inadequate Regulation of Business Rescue Practitioners May Adversely Affect Lenders' Willingness and the Growth of the Economy*, 22 SAMLJ 195, 195 (2010). It would seem that there were also historical factors that lay behind the spectacular impotence and ultimate failure of judicial management. See Anneli Loubser, *Tilting at Windmills? The Quest for an Effective Corporate Rescue Procedure in South African Law*, 25 SAMLJ 437, 438 (2011).

<sup>12</sup> In this respect, the following points are noteworthy. First, consisting of a total of 225 sections and 5 schedules, the 2008 Companies Act is about the shortest contemporary companies' legislation. It can in this respect be sharply contrasted with the United Kingdom 2006 Companies Act, which consists of 1300 sections and 16 schedules; Australia's Corporations Act 2001 made up of 1516 sections and 4 schedules; Hong Kong's Companies Ordinance 2012, which consists of 921 sections and 11 schedules; and India's Companies Act 2013 consisting of 470 sections and 7 schedules. However, the interpretation and application of the Act is supported by the Companies Regulations of 2011 made by the Minister of Trade and Industry pursuant to powers conferred by Companies Act 71 of 2008 § 223 (S. Afr.). As already pointed out by some academic commentators and as the emerging case law is beginning to show, the result of this extreme minimalist approach and economy of content is that several important issues of company law are either not covered at all or are addressed in significantly inadequate detail. See CONTEMPORARY COMPANY LAW, *supra* note 7, at 2; PIET DELPORT, THE NEW COMPANIES ACT MANUAL 3-4 (2009); Loubser, *Judicial Management as a Business Rescue Procedure in South African Corporate Law*, *supra* note 11, at 137. Second, the deficit in the width of regulatory coverage is exacerbated by the poor quality of legislative drafting apparent in several parts of the 2008 Companies Act. This has already been the subject of judicial lamentation in the emerging case law. See also *DH Brothers Industries v. Gribnitz NO and Others* 2014 (1) SA 103 (S. Afr.) and *Tuning Fork Ltd. t/a Balanced Audio v. Greeff and Another* 2014 (4) SA 521, ¶ 90 (S. Afr.).



approach and attitude similar to that which was consistently visited on “judicial management,” there is a real likelihood that the rescue mechanism will fail at the judicial altar. Cognisant of this possibility, this paper examines some of the Chapter Six related decisions and pronouncements made by South African courts in the last three years, with a view to assessing the practical or policy implications of those decisions and pronouncements. The analysis will determine whether the decisions are ultimately favourable to the emergence of Chapter Six as an effective corporate rescue mechanism in South Africa.

## I. BRIEF SUMMARY OF THE MAIN FEATURES OF SOUTH AFRICA’S CORPORATE RESCUE MODEL

The scheme of Chapter Six can be activated in either one of two ways. The first is by way of a resolution adopted by the board of directors of a “financially distressed company” where the directors genuinely believe that the company is “financially distressed”<sup>13</sup> and that there is a reasonable prospect of rescue.<sup>14</sup> Alternatively, where the board of such a company appears reluctant to adopt such a resolution, and thereby activates business rescue proceedings voluntarily, any “affected person”<sup>15</sup> may apply to the court for an order placing the

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<sup>13</sup> In terms of Companies Act 71 of 2008 § 128(1)(f) (S. Afr.), a company is “financially distressed” if, within the immediately ensuing six-month period, (a) it appears reasonably unlikely that the company will be able to pay all of its debts as they become due and payable; or (b) it appears reasonably likely that the company will become insolvent.

<sup>14</sup> “Rescuing a company” is defined as the achievement of either one of two goals, namely, (a) the restructuring of the affairs, business, property, equity, debt, and other liabilities of a financially distressed company in a manner that maximizes the likelihood of the company continuing in existence on a solvent basis or, (b) if it is not possible for the company to continue in existence, results in a better return to the company’s creditors or shareholders than would result from the immediate liquidation of the company. *See* Companies Act 71 of 2008 §§ 128(1)(b)(iii), 128(1)(h) (S. Afr.).

<sup>15</sup> In relation to a company, the term “affected person” refers to the shareholders or creditors, trade unions representing the company’s employees, the employees themselves, or their representatives where they are not represented by a trade union. *See* Companies Act 71 of 2008 §§ 128(1)(a), 144 (S. Afr.). The recognition of trade unions and employees and the vesting of significant rights on them in the corporate rescue context is one of the innovations introduced by the 2008 Companies Act and is consistent with South African law and policymakers’

company under rescue.<sup>16</sup> Irrespective of how the proceedings are commenced, the first major consequence is that the business and affairs are placed under the supervision and control of a “business rescue practitioner” to whom all the “affected persons” must now look for the possible rehabilitation of the company.<sup>17</sup>

The second major legal consequence flowing from the commencement of business rescue proceedings is the moratorium on legal proceedings, executions, and claims (secured and unsecured) against the company.<sup>18</sup> This effectively insulates a company undergoing rescue from legal or enforcement proceedings either pending or in prospect.<sup>19</sup> The moratorium, which is general in its reach, arises both immediately and automatically upon the proper commencement of the said proceedings.<sup>20</sup> While the effect of the moratorium does not extend to an alteration of existing rights acquired by the company’s creditors in the period preceding business rescue, it does effectively freeze those rights “in the sense that creditors may not enforce their rights while the company is under the rescue process without the written consent of the business rescue practitioner or in certain circumstances, the court[.]”<sup>21</sup>

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conviction that these particular stakeholders deserve stronger protection in processes and transactions aimed at resolving challenges posed by financially distressed employers. *See* CARL STEIN & GEOFF EVERINGHAM, *THE NEW COMPANIES ACT UNLOCKED 411* (2011).

<sup>16</sup> Companies Act 71 of 2008 § 129(1) (S. Afr.).

<sup>17</sup> In this respect, although the South African business rescue scheme shares several features with the famous 11 U.S.C. § 1101 corporate bankruptcy management regime, it also differs sharply in that it adopts what Professor McCormack has described as a “management displacement model” when compared to the “debtor-in-possession” model of 11 U.S.C. § 1101. *See* GERARD MCCORMACK, *CORPORATE RESCUE LAW: AN ANGLO-AMERICAN PERSPECTIVE* 80-83, 152-54 (2008). *See also* CONTEMPORARY COMPANY LAW, *supra* note 7, at 861, 866; STEIN & EVERINGHAM, *supra* note 15, at 409.

<sup>18</sup> Companies Act 71 of 2008 § 133 (S. Afr.).

<sup>19</sup> This feature appears common to most of the corporate rescue schemes in Anglo-American jurisdictions. MCCORMACK, *supra* note 17, at 156-175.

<sup>20</sup> CONTEMPORARY COMPANY LAW, *supra* note 7, at 878-79.

<sup>21</sup> *Id.* 878-79. In the recent case of *Moodley v. On Digital Media (Pty) Ltd.* 2014 (6) SA 279 (GJ) (S. Afr.), the court held that the scope of the said general moratorium does not extend to legal proceedings brought against a company under business rescue and its business rescue practitioner in connection with the rescue plan,

Perhaps the most crucial part of the business rescue process consists of the development, approval, and implementation of a competent rescue plan.<sup>22</sup> Inevitably, exclusive responsibility for this part of the process is imposed on the practitioner who must begin his tenure by simultaneously investigating the company's affairs and consulting with the creditors, management, employees or their trade unions, and other stakeholders.<sup>23</sup> Following development of the plan, it must be presented for approval of the creditors at a meeting which is also open to participation by other groups of "affected persons."<sup>24</sup> A rescue plan is only "approved" if it is supported by seventy-five percent of the creditors out of which fifty percent must be claimants who qualify as "independent creditors."<sup>25</sup> Implementation of the plan can only be properly embarked upon by the business rescue practitioner if approval has been given in accordance with the requirements of the 2008 Companies Act.<sup>26</sup> If the required level of creditor support for the plan is not received, the rescue proceedings automatically terminate, unless the practitioner or an "affected person" pursues the very limited recourse available to him under the Act.<sup>27</sup>

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including its interpretation and execution towards implementation. In reaching this decision, the court declined to follow an earlier high court decision to the contrary handed down in *Redpath Mining South Africa (Pty) Ltd. v. Marsden No and Others* 2013 ZAGPJHC 148 (GSJ) (S. Afr.).

<sup>22</sup> Companies Act 71 of 2008 § 140(1) (S. Afr.).

<sup>23</sup> *Id.* § 141(1). However, there is an obligation imposed on directors by Companies Act 71 of 2008 § 142 (S. Afr.) to provide assistance and cooperation to the business rescue practitioner.

<sup>24</sup> *Id.* § 152 (S. Afr.). For a detailed discussion of the various stakeholders' participatory rights, see CONTEMPORARY COMPANY LAW, *supra* note 7, at 899-905; and DELPORT, *supra* note 7, at 500-14.

<sup>25</sup> The term "independent creditor" is defined by Companies Act 71 of 2008 § 128(1)(g) (S. Afr.) as a creditor, including an employee, who is not related to the debtor company. It specifically excludes the company's directors as well as the business rescue practitioner.

<sup>26</sup> *Id.* § 152(5), (6). These provisions impose a mandatory obligation on the debtor company, under the direction of the business rescue practitioner, to take all steps necessary to satisfy any conditions on which the rescue plan is contingent and to implement the plan.

<sup>27</sup> Where a plan is rejected by the creditors, there are essentially two options available under Companies Act 71 of 2008 § 153(1) (S. Afr.). The first is for either the business rescue practitioner or an "affected person" to make an application to court for an order setting aside the creditors' negative vote on the basis that it was

## II. ASSESSMENT OF THE EMERGING JURISPRUDENCE

Since the 2008 Companies Act came into operation on the May 1, 2011, there have been no less than fifteen reported judicial decisions on business rescue applications and resulting or related proceedings. For the purposes of this paper, it is especially significant that business rescue appears to have been granted in only one of the cases that have come before the courts.<sup>28</sup> Consistent with sound judicial practice, the courts have taken the opportunity in each case to make decisions and pronouncements on several questions pivotal in the context of the interpretation, application, and implementation of Chapter Six. In the discussion that follows below, this paper discusses the judicial decisions and pronouncements on some of those questions.

### A. What Constitutes a “Reasonable Prospect of Rescue”

The most recurring questions in the emerging case law pertain to the provision empowering a court to grant an order, at the behest of an “affected person,” placing a company under business rescue where, *inter alia*, “there is a reasonable prospect for rescuing the company.”<sup>29</sup> Not surprisingly, this provision also featured prominently in the two cases on business rescue that have thus far reached the Supreme Court of Appeal (“SCA”).<sup>30</sup> The first question that the courts have had to confront in this context, is as to what exactly the legislature meant by the words “reasonable prospect of rescue.” Indeed, most of the applications for business rescue made thus far have failed mainly on the ground that the applicants were unable to meet the evidentiary

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“inappropriate.” The second option is for an “affected person” or “combination of affected persons” to make an offer to purchase the voting interests of one or more of the opposing creditors at a value independently and expertly determined to be a fair and reasonable estimate of the return to the said creditor(s) if the company were to be liquidated.

<sup>28</sup> That solitary case is *African Banking Corp. of Botswana Ltd. v. Kariba Furniture Manufacturers (Pty) Ltd. and Others* 2013 (6) SA 471 (S. Afr.).

<sup>29</sup> *Id.* § 131(4)(a).

<sup>30</sup> See *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 (S. Afr.); and the very recent (and yet to be reported) decision in *Newcity Group (Pty) Ltd. v. Allan David Pellow NO and Others* 2014 ZASCA 162. The SCA of South Africa is the highest court in South Africa for all matters except those raising constitutional questions for which the Constitutional Court (where the Chief Justice sits) is the apex court.

burden implicit in this requirement.<sup>31</sup> For supporters and enthusiasts of business rescue in South Africa, these “pioneering” High Court and SCA judgments<sup>32</sup> must be troubling, partly because of the overwhelmingly negative findings and conclusions which point to the possibility that the courts might be unwittingly setting the bar too high for the applicants and in the process unfairly denying access to the remedial potential of the Chapter Six statutory scheme for financially distressed companies and their stakeholders.<sup>33</sup> In this regard the decision in *Southern Palace Investments (Pty) Ltd. v. Midnight Storm Investments 386 Ltd.*<sup>34</sup> stands out. Here the court began the articulation of the basis for its decision by noting that the 2008 Companies Act clearly requires something less than that the debtor company’s rehabilitation should be a reasonable probability. This, in the court’s view, is an inference that must be drawn from the difference in language between the 1973 Companies Act which used the words “reasonable probability” in its s 417 and the 2008 Companies Act where the words used in section 131(4) are “reasonable prospect”. In other words, the legislature must have intended to set the rehabilitation bar at a level lower than that prescribed under the 1973 Companies Act. The court was especially critical of the judicial approach to applications for “judicial management” when it stated that, “the mindset reflected in various cases dealing with judicial management

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<sup>31</sup> See E.P. Joubert, “Reasonable Possibility” versus “Reasonable Prospect”: Did Business Rescue Succeed in Creating a Better Test than Judicial Management?, 76 J. Contemp. Roman-Dutch L. 550, 562 (2013) (observing that, based on the recent case law, “the single most problematic factor that stands in the way of the granting of business rescue orders, is the uncertainty experienced by the courts regarding the meaning of ‘reasonable prospect.’”).

<sup>32</sup> See *Swart v. Beagles Run Investments 25 (Pty) Ltd., (Four Creditors Intervening)* 2011 (5) SA 422 (S. Afr.); *AG Petzetakis International Holdings Ltd. v. Petzetakis Africa (Pty) Ltd. and Others* 2012 (5) SA 515 (S. Afr.); *Engen Petroleum Ltd. v. Multi Waste (Pty) Ltd. and Others* 2012 (5) SA 596 (S. Afr.); *Cape Point Vineyards (Pty) Ltd. v. Pinnacle Point Group Ltd. and Another, (Advantage Projects Managers) (Pty) Ltd. Intervening* 2011 (5) SA 600 (S. Afr.); *Essa and Another v. Bestvest and Another* 2012 (4) SA 103; *Investec Bank Ltd. v. Brynns* 2011 (5) SA 430 (WCC) (S. Afr.); *Nedbank Ltd. v. Bestvest 153 (Pty) Ltd.* 2012 (5) SA 497 (S. Afr.); *Zoneska Investments (Pty) Ltd. t/a Bonatla Properties (Pty) Ltd. v. Midnight Storm Investments 386 Ltd.* 2012 (4) SA 590 (WCC) (S. Afr.).

<sup>33</sup> Joubert, *supra* note 31, at 563.

<sup>34</sup> *Southern Palace Investments (Pty) Ltd. v. Midnight Storm Investments (Pt) Ltd.* 2012 (2) SA 423 (WCC) (S. Afr.). The decision and reasoning in this case was followed in *Koen and Another v. Wedgenwood Village Golf and Country Estate Ltd.* 2012 (2) SA 378 (WCC) (S. Afr.).

applications in respect of the recovery requirement was that, *prima facie*, the creditor was entitled to a liquidation order, and that only in exceptional circumstances would a judicial management order be granted.”<sup>35</sup>

Having made the above points regarding the significance of the difference in the wording of sections 131(4) and 417, the court in *Southern Palace Investments* seems to have lost its course when it not only held that, in order to satisfy the lower threshold, the business rescue applicant must provide a business plan that:

Addresses the cause of the demise or failure of the debtor company’s business and offers a remedy that has a reasonable prospect of being sustainable;

Provides concrete and objectively ascertainable details of:

The likely costs of making the company able to resume its business;

The likely availability of the necessary cash resources to enable the debtor company to meet its day-to-day expenses upon resumption of its operations;

The availability of any other resources; and

The reasons why the applicant suggests that the proposed business plan would have a reasonable prospect of success.<sup>36</sup>

Having indicated that the legislative intent behind the wording of section 131(4) was to set the bar lower than was the case in the “judicial management” era, the court in *Southern Palace Investments* ended up setting the bar even higher. But perhaps more troubling is the fact that the court’s reasoning, with due respect, drifted into the realm of blatant error when it decided to impose, by implication, the duty to develop and present a sound and detailed rescue plan upon the applicant—for this is a duty that is expressly imposed on the business

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<sup>35</sup> See *Southern Palace Investments*, 2012 (2) SA 423 at para. 21.

<sup>36</sup> *Id.*

rescue practitioner by the pertinent provisions of Chapter Six.<sup>37</sup> Furthermore, in terms of the minimum three months timeline that the Act allows for the practitioner to attempt successful rehabilitation of a financially distressed company, a careful reading of the pertinent provisions<sup>38</sup> would seem to suggest that the practitioner has a minimum of four weeks, subsequent to her appointment, within which to develop the rescue plan. But perhaps more worrisome is the fact that the courts in *Southern Palace Investments* and *Koen v. Wedgewood*<sup>39</sup> found that it was fair and realistic to require an applicant for business rescue to furnish a complete business rescue plan laden with the level of detail spelled out in their judgments as part of the minimum required to persuade a court to exercise its discretion in favour of an application for corporate rescue. This is because a careful reflection on the profile of stakeholders included in the definition of “affected persons” should suggest that such business rescue applicants would have neither the company-specific information nor the resources required to produce a competent rescue plan at the time of making the application under section 131 of the 2008 Companies Act. The view and attitude adopted by the courts in the above two cases smacks of judicial apathy towards business rescue applicants which does not bode well for the future of the Chapter Six rescue mechanism.

It is against the above background that the SCA’s decision in *Oakdene Square Properties*<sup>40</sup> really does make a welcome entry into the corpus of the emerging South African business rescue jurisprudence.<sup>41</sup> In *Oakdene Square Properties*, the applicants for business rescue, having failed in the high court, argued before the SCA that the requirement of a “reasonable prospect” for rescuing the company in section 131(4) demands no more than a reasonable prospect of development and delivery of a rescue plan (by a business rescue practitioner). According

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<sup>37</sup> Companies Act 71 of 2008 § 140(1)(d)(i) (S. Afr.). It is both surprising and unfortunate that the decision in *Southern Palace Investments* was followed without reservation in *Koen and Another v. Wedgewood Village Golf and Country Estate Ltd.* 2012 (2) SA 378 (WCC) (S. Afr.).

<sup>38</sup> Companies Act 71 of 2008 at § 132. The court is conferred with discretion to allow a longer time on application made to it by the practitioner. *See* Companies Act 71 of 2008 § 132(3) (S. Afr.).

<sup>39</sup> CONTEMPORARY COMPANY LAW, *supra* note 7, at 861-64.

<sup>40</sup> *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 (S. Afr.).

<sup>41</sup> Joubert, *supra* note 31, at 562-63.

to them, an applicant for business rescue is therefore not required to show a reasonable prospect of achieving one of the two goals contemplated in section 128(1)(b). On this reasoning, all that the applicant is obliged to show is that “a plan to do so is capable of being developed and implemented regardless of whether or not it may fail.”<sup>42</sup> Furthermore, according to the applicants’ contention, once it is established that a business rescue applicant’s intention is to develop and implement a plan whose purpose is the rescue of the debtor company, the court should grant the application even if it is skeptical regarding the potential of the applicant’s plan to achieve the intended outcome.<sup>43</sup>

The SCA rejected the applicants’ arguments *in toto*. It held that the words “rescuing the company”—as used in section 128(1)(b)—require the achievement of one of the alternative goals of business rescue. To that extent, the Court found that the argument advanced by the applicants “is in direct conflict with the express wording of s[ection] 128(1)(h).”<sup>44</sup> According to the SCA, on a careful reading of section 128(1)(b), it is evident that the development of a plan cannot be a goal in itself, but rather it can only be the means to an end which “must be either to restore the company to a solvent going concern, or at least to facilitate a better deal for creditors and shareholders than they would secure from a liquidation process.”<sup>45</sup> Therefore, the evidentiary burden in the view of the SCA clearly lies on the business rescue applicant to establish grounds for the reasonable prospect of achieving one of the twin goals of section 128(1)(b).

Fraught with greater uncertainty, and therefore more worrisome, is the practical question as to how the business rescue applicant ought to discharge the said evidentiary burden. Should this applicant present the court with a detailed business rescue plan? Or should the applicant provide details of the likely costs enabling the company to recommence its business? Or should the applicant present

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<sup>42</sup> *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 at para. 31 (S. Afr.).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* It should be noted that while Companies Act 71 of 2008 § 128(1)(b) (S. Afr.) defines the term “business rescue,” Companies Act 71 of 2008 § 128(1)(h) (S. Afr.) provides the definition of the term “rescuing the company.”

<sup>45</sup> *Id.*



details pertaining to the likely availability of the cash resources required to enable the company to meet its day-to-day expenses? Or yet still, is the applicant required to provide concrete factual details of the source(s), nature, and extent of the resources that are likely to be available to the company as well as the terms on which such resources will be made available? In its decision on this practical question,<sup>46</sup> the SCA made it crystal clear that a business rescue applicant is not required to present a detailed rescue plan. However, an applicant must present “more than a mere prima facie case or an arguable possibility.”<sup>47</sup> In this respect, mere speculative suggestions and vague averments will not suffice.<sup>48</sup> According to the SCA, what is required of an applicant is to establish the “reasonable grounds” on which she believes that there is a possibility of rescuing the company. Implicit in the court’s decision here is that the applicant must provide a factual basis for the said grounds. Very significantly, however, the SCA held that it would be both impractical and imprudent to prescribe the manner in which business rescue applicants must meet this evidentiary burden in every case. Accordingly, to the extent that the courts in *Southern Palace Investments*<sup>49</sup> and *Koen v. Wedgewood*<sup>50</sup> sought to do so, they erred.

In setting the bar for the applicant regarding what is required to discharge the said evidentiary obligation, much judicial caution and circumspection is required. This is because if the bar is set too high, the practical effect will be devastating for the new business rescue regime and the achievement of policy goals it has been enacted to promote. Clearly, such a judicial approach will severely limit the availability of business rescue proceedings through section 131 of the 2008 Companies Act. It is noteworthy that this particular danger and the underlying concern has already been recognized by the high court

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<sup>46</sup> *Id.* ¶¶ 29-31. The SCA here approved and applied the approach adopted by the High Court in *Propspec Investments Ltd. v. Pacific Coast Investments 97 Ltd.* 2013 (4) SA 539 (S. Afr.).

<sup>47</sup> *Id.* ¶ 29.

<sup>48</sup> *Id.* See also *Propspec Investments Ltd. v. Pacific Coast Investments 97 Ltd.* 2013 (4) SA 539 at para. 11 (S. Afr.).

<sup>49</sup> *Southern Palace Investments (Pty) Ltd. v. Midnight Storm Investments (Pt) Ltd.*, 2012 (2) SA 423 (WCC) (S. Afr.).

<sup>50</sup> *Koen and Another v. Wedgewood Village Golf and Country Estate Ltd.* 2012 (2) SA 378 (WCC) at para. 14 (S. Afr.).

in *Propspec Investments Ltd.* and by the SCA in *Oakdene Square Properties* where it essentially endorsed the approach and related comments of van der Merwe J in *Propspec Investments Ltd.* The judges in both cases were of one mind in the view that the bar ought to be set fairly low for business rescue applicants, with a view favorable to maximizing the availability and use of business rescue proceedings. In this respect, the court in *Propspec Investments Ltd.*<sup>51</sup> and the SCA in *Oakdene Square Properties*<sup>52</sup> seem to both recognize that a contrary judicial approach would be effectively tantamount to judicial frustration of the real prospects of attaining the legislative and policy objectives behind the enactment of the Chapter Six provisions.<sup>53</sup>

The risk of business rescue becoming a victim of a judicial approach that is not predisposed to magnanimity towards those seeking to access the scheme is not far-fetched. This is because such a judicial attitude may be easily justifiable as an appropriate response to the real risk of abuse of business rescue proceedings by debtor companies and/or their controllers involved in a pattern of conduct clearly aimed at improperly defeating or delaying legitimate claims and rights of innocent creditors.<sup>54</sup>

In some cases, such patterns of behavior have been accompanied by evidence of misappropriation or abuse of company funds, assets, and/or opportunities by the controller(s) of the debtor company.<sup>55</sup> In such cases, business rescue proceedings are simply activated *mala fides* to allow the wrongdoing to continue for as long as

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<sup>51</sup> Bradstreet, *supra* note 10, at 353-56; Loubser, *Tilting at Windmills? The Quest for an Effective Corporate Rescue Procedure in South African Law*, *supra* note 11, at 372.

<sup>52</sup> *Id.*

<sup>53</sup> In this respect it is pleasing to note the recent SCA decision in *Newcity Group (Pty) Ltd. v. Allan David Pellow NO and Others* 2014 ZASCA 162, where the court confirmed its approach and reasoning in *Oakdene Square Properties*.

<sup>54</sup> This risk of abuse by company directors, majority shareholders and other stakeholders has been recognized by other academic commentators. *See, e.g.*, Anneli Loubser, *The Business Rescue Proceedings in the Companies Act of 2008: Concerns and Questions (Part 1)*, 3 J. SOUTH AFRICAN L 501, 505 (2010); DELPORT, *supra* note 7, at 446; Michael Steiner, *The Insolvency Bill 2000: Rescue Culture in the new Millennium*, 15 J. Int'l Banking L. 61, 62 (2000).

<sup>55</sup> *See, e.g.*, *Swart v. Beagles Run Investments 25 (Pty) Ltd., (Four Creditors Intervening)* 2011 (5) SA 422 (S. Afr.); *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 at para. 29 (S. Afr.).

possible to the maximum detriment of the company, creditors, shareholders and other stakeholders. Such undesirable behavior and tendencies on the part of directors and company controllers are readily apparent from the factual findings of the courts in the cases of *Oakdene Square Properties*,<sup>56</sup> *Newcity Group (Pty) Ltd. v. Allan David Pellow and Others*<sup>57</sup> and *Swart v. Beagles Run*.<sup>58</sup> Naturally, the public would expect the courts to be very vigilant in ensuring that the Chapter Six provisions are not invoked by company controllers or stakeholders acting *mala fides* for purposes that have little to do with achieving the underlying policy objectives but, instead, have all to do with wanting to co-opt business rescue proceedings into premeditated elaborate and illegal self-aggrandizing schemes capable of being perpetrated in the corporate context.

It is in their zeal to prevent the abuse of the Chapter Six provisions and related judicial processes that the courts may adopt principled positions leading to an unintended consequence, namely, a severe restriction of the availability of business rescue proceedings and frustration of the underlying legislative and policy intent. This could in turn lead to the business rescue model suffering the same fate as that which befell judicial management under the 1973 Companies Act. Against this background, the SCA decision in *Oakdene Square Properties* and the pronouncements on the applicable legal principles in *Propspec Investments Ltd.* must be applauded. Clearly, business rescue-related matters brought before the courts in the coming years will be guided by the pronouncements of legal principle made on this critical issue by the SCA in *Oakdene Square Properties*.

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<sup>56</sup> In *Oakdene Square Properties*, there was evidence of management deadlock and related paralysis at the level of the board of directors resulting from the active conduct of the two director-shareholders who were the applicants for business rescue. In addition, the company had apparently been stripped of its sources of income through questionable dealings with its main assets, which were done by one of the said directors acting unilaterally without board approval but with the apparent tacit support and collusion of his co-applicant.

<sup>57</sup> Companies Act 71 of 2008 § 131(4)(a) (S. Afr.).

<sup>58</sup> Here, the facts accepted by the court showed that in the months immediately preceding the business rescue application, the company had been involved in a pattern of insolvent and fraudulent trading while under the control of the sole director-shareholder who was the stakeholder behind the application.

## B. What Constitutes “Business Rescue” Under the Act

According to section 128, which is the opening definition section of Chapter Six, “business rescue” means “proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for”<sup>59</sup> among others:

the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.<sup>60</sup>

In the academic discussions of this particular provision, there seems to be consensus that business rescue proceedings are intended by the legislature to have both a primary and a secondary objective—rehabilitating the company so that it is able to continue to operate as a solvent going concern being the primary goal, while rehabilitation for the very limited purpose of securing better returns for creditors and shareholders being secondary.<sup>61</sup> The suggestion implicit in the academic commentaries is that the proceedings must be initiated solely for the attainment of the said primary purpose; and may only turn to the pursuit of the secondary purpose after a realization *bona fides* in the course of implementing a properly adopted business rescue plan that the primary purpose is unattainable. This was one of the key issues that the SCA had to confront in *Oakdene Square Properties* where the court had to pronounce itself on whether a business rescue application under section 131 of the 2008 Companies Act could succeed where the proposed rescue plan only provides for the pursuit of the so-called secondary objective. In other words whether the requirement of “rescuing the company” as contemplated in section 131(4)(a) is satisfied where it is clear from the outset that there is no real chance

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<sup>59</sup> Companies Act 71 of 2008 § 128(1)(b) (S. Afr.).

<sup>60</sup> *Id.* § 128(1)(b)(iii).

<sup>61</sup> CONTEMPORARY COMPANY LAW, *supra* note 7, at 864-65; DELPORT, *supra* note 7, at 445-47.

of the company being saved from immediate liquidation and that the best the stakeholders can hope for is a better return to creditors and shareholders than that which would result from liquidation.<sup>62</sup>

Before the SCA, the respondents (who were creditors opposed to the business rescue application) relied on the dictionary meanings of the words “rescue” and “rehabilitate” to argue that the statutory definition of “business rescue” in section 128(1)(b) contemplates proceedings aimed at the rehabilitation of a company which in turn requires that the proceedings must be aimed at achieving the primary goal in section 128(1)(b)(iii), which is to restore the company to the normal healthy state of solvency.<sup>63</sup> In the respondents’ view, the so-called secondary objective, to provide a better deal for creditors and shareholders than liquidation, can only be an alternative goal of the proposed business rescue plan. Accordingly, they submitted that a proposed plan, such as that in this case, that holds out no hope of a return of the company to a state of solvency, but provides at best for achievement of the secondary goal, does not amount to “rescuing the company” as required by the Act.<sup>64</sup>

The SCA held that Chapter Six of the Act, in section 128(1)(b) provides its own meaning for the terms “rescue” and “rehabilitate,” neither of which coincide with the dictionary meanings of the words upon which the respondents sought to rely. In the SCA’s view, “business rescue” under the Act means “to facilitate ‘rehabilitation’ which in turn means the achievement of one of two goals: (a) to return the company to solvency, or (b) to provide a better deal for creditors than what they would receive through liquidation.”<sup>65</sup> Accordingly, the SCA concluded that the achievement of either one of the two goals

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<sup>62</sup> *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 at para. 23 (S. Afr.).

<sup>63</sup> In this respect, the respondents urged the court to endorse the approach followed by the High Court in the earlier case of *AG Petzetakis International Holdings Ltd. v. Petzetakis Africa (Pty) Ltd. and Others* 2012 (5) SA 515 (S. Afr.).

<sup>64</sup> *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 at para. 25 (S. Afr.).

<sup>65</sup> *Id.* ¶ 26.

referred to in section 128(1)(b) qualify as “business rescue” under the Chapter.<sup>66</sup>

The argument of the opposing creditors in *Oakdene Square Properties* invited the court to adopt a narrow construction of the meaning of “business rescue” under the 2008 Companies Act. If accepted, such an interpretation would effectively limit the availability of business rescue proceedings to those cases where there is at least a reasonable prospect of the company being restored to continuation as a going concern. Considering the policy goals and public interests behind the enactment of South Africa’s business rescue scheme—especially those pertaining to employment preservation and creation as well as protection of vulnerable non-shareholder constituencies such as employees, customers, and communities—the restriction of the availability of business rescue only to those scenarios where there is at least some chance of saving the debtor company as a going concern would seem to be *prima facie* plausible. Indeed, it is arguable that the primary public interest rationale behind law and policymakers’ decision to establish the business rescue model is to make it available for use by companies and stakeholders who find themselves with a financially distressed company that has a chance of being restored to its *status quo* prior to its financial woes.<sup>67</sup>

However, there are sound reasons why the SCA should be applauded for shunning a narrow interpretation of the meaning of “business rescue”—preferring instead to adopt a broad, generous construction that will ensure the availability of the rescue provisions

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<sup>66</sup> *Id.*

<sup>67</sup> The socio-economic policy goals and public interests at the heart of modern statute-based corporate rescue schemes can be readily gleaned from the pertinent primary and secondary sources, including the multiple reports issued or commissioned by relevant government departments. *See, e.g.*, CONTEMPORARY COMPANY LAW, *supra* note 7, at 861-64; CHAIRMAN SIR KENNETH CORK, INSOLVENCY LAW AND PRACTICE, REPORT OF THE REVIEW COMMITTEE, CMND 8558 (1982); SOUTH AFRICAN COMPANY LAW FOR THE 21ST CENTURY: GUIDELINES FOR CORPORATE LAW REFORM, GENERAL NOTICE 1183, *supra* note 4; Anneli Loubser, *Business Rescue in South Africa: A Procedure in Search of a Home*, 40 COMP. INT’L L. J. S. AFR. 152, 152-54 (2007); MCCORMACK, *supra* note 17, at 18-25.

even in those scenarios where liquidation is inevitable.<sup>68</sup> In the first place, creditors and shareholders, as company stakeholders, are not inherently undeserving of judicial sympathy and assistance when faced with a debtor that has no reasonable prospect of survival as a solvent going concern. Indeed, their role in the sustainable development of an enabling environment for companies and entrepreneurs to thrive cannot be overemphasized.<sup>69</sup> Limiting the availability of business rescue by excluding it from scenarios where there is only a likelihood of creditors and shareholders receiving better returns than on immediate liquidation would amount to adopting a statutory interpretation that is patently hostile to these two groups of stakeholders, both of whom are indispensable to the sustainable growth and survival of the modern company. This is so because the narrow definition for which the respondents argued in *Oakdene Square Properties* amounted to stating that business rescue ought not to be available where the primary beneficiaries will be creditors and shareholders. Clearly, such anti-creditor, anti-shareholder interpretation cannot be consistent with the underlying intention of the legislature.<sup>70</sup>

Furthermore, as the SCA itself pointed out,<sup>71</sup> a narrow interpretation seeking to limit the availability of business rescue to cases where there is a reasonable prospect of restoring the debtor

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<sup>68</sup> See Richard Bradstreet, *Business Rescue Proves to be Creditor-Friendly: CJ Claasen's Analysis of the New Business Rescue Procedure in Oakdene Square Properties*, 130 SALJ 44, 49-52 (2013).

<sup>69</sup> See Bradstreet, *supra* note 11, at 195.

<sup>70</sup> It should be recalled here that Companies Act 71 of 2008 § 7(k) (S. Afr.) specifically states that one of the objects of the Act is to provide for the efficient rescue of financially distressed companies in a manner that balances the rights and interests of "relevant stakeholders." To the extent that creditors and shareholders are "relevant stakeholders," any interpretation of a provision of Companies Act 71 of 2008 Chapter Six that is hostile to their rights and interests without compelling justification, including being necessary for the protection of other relevant stakeholders' interests, would actually be inconsistent with the legislative intent encapsulated in the wording of Companies Act 71 of 2008 § 7(k) (S. Afr.). To the extent that the broad interpretation of the meaning of "business rescue" adopted by the SCA in *Oakdene Square Properties* is more consistent with the legislative prescription to balance the various stakeholder rights and interests, such an interpretation is highly plausible. See Bradstreet, *supra* note 68, at 49-52.

<sup>71</sup> *Oakdene Square Properties Ltd. and Others v. Farm Bothasfontein (Kyalami) Ltd. and Others* 2013 (4) SA 539 at para. 26 (S. Afr.).

company to financial health as a going concern would be one that effectively ignores the historical context out of which the Chapter Six provisions originate. Central to that context is the “judicial management” model. The pertinent provisions of the 1973 Companies Act made the proper granting of a judicial management order conditional upon a finding of a *reasonable probability* that implementation of the order will result in the debtor regaining its ability to meet its financial obligations in the normal course of things. As indicated above, it is now widely acknowledged in both academic and judicial commentaries that it was the narrow restrictive meaning attributed by the judiciary to those key words that largely led to the abysmal failure of judicial management and its replacement with the business rescue model under the 2008 Companies Act. As the SCA concluded, it is unlikely that the legislature would have intended to repeat the mistakes of the past.<sup>72</sup>

#### C. Status of the Tax and Public Revenue Collection Authorities in Business Rescue Proceedings

The fascinating question of whether the South African Revenue Service (“SARS”) enjoys special status in business rescue proceedings, as a preferent creditor, has come before the court in *Commissioner, South African Revenue Service v. Beginsel NO and Others*.<sup>73</sup> In this case, SARS contended that there was no reason why it could not have been specified as a preferent creditor in the proposed business rescue plan seeing that section 150(2)(b) of the 2008 Companies Act permits such a plan to create and specify the order of preference, in which proceeds of property sold pursuant to the plan will be applied subject to preferences conferred by the Act in section 135 upon different classes of post-commencement creditors.<sup>74</sup> The critical issue for determination was whether SARS ought to be treated as a preferent

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<sup>72</sup> *Id.* ¶¶ 27-28.

<sup>73</sup> *Commissioner of South African Revenue Services v. Beginsel NO and Others* 2012 (1) SA 307 (WCC) at para. 20 (S. Afr.).

<sup>74</sup> In requiring that every business rescue plan contain all information reasonably required to enable affected persons to decide whether or not to accept or reject a plan, Companies Act 71 of 2008 § 150(2)(b) (S. Afr.) prescribes a division of the plan into three parts: Part A providing a background; Part B setting out the debt and business restructuring proposals; and Part C setting out the assumptions and conditions on which the plan is based. See DELPORT, *supra* note 7, at 516-21.



creditor for purposes of reckoning its voting interest,<sup>75</sup> as well as for purposes of distributions of proceeds from disposals of company property by the business rescue practitioner. In advancing its case, SARS relied heavily on the provisions of sections 96 to 103 of the Insolvency Act No. 24 of 1936<sup>76</sup> (“Insolvency Act”), arguing that it is a preferent creditor whose claim ranks ahead of ordinary concurrent creditors. Based on section 103(1)(a) of the Insolvency Act, SARS further contended that because ordinary concurrent creditors are included in the class of concurrent creditors who would be subordinated in a liquidation referred to in section 145(4)(b) and because they would receive nothing on liquidation of the company in the instant matter, they (ordinary concurrent creditors) had no voting interest at the creditors’ meeting.<sup>77</sup>

According to the court, the meaning and practical implication of the argument advanced by SARS is that while SARS, as preferent unsecured creditor, would have had a voting interest equal to the value of its claim against the company, the remainder of the (non-preferent) concurrent creditors representing eighty-seven percent of all creditors present at the particular meeting would have been disenfranchised concurrent creditors under section 145(4)(b). The obvious and inevitable result is that the vote of SARS alone would have ensured the rejection of the business rescue plan notwithstanding the wishes of the substantial majority of the creditors.<sup>78</sup> The court held that the construction of section 145(4) urged on it by SARS would lead to an illogical result that would fail to balance the rights and interests of all relevant stakeholders as envisaged in section 7(k) of the Act. In any event, according to the court, that interpretation is contrary to the ordinary grammatical meaning of the words used in the provisions of section 145(4). In the court’s view, it is “wholly inconsistent with the

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<sup>75</sup> Creditors of a debtor company are conferred with voting interests in accordance with Companies Act 71 of 2008 § 128(1)(j) (S. Afr.) read together with Companies Act 71 of 2008 §§ 145(4) and (5) (S. Afr.). These provisions effectively fix a creditor’s voting interest at the value of her claim against the company. Some academic commentators have taken the view that, at least for this purpose, it is immaterial whether a creditor’s claim is secured or unsecured. *See* CONTEMPORARY COMPANY LAW, *supra* note 7, at 903.

<sup>76</sup> Insolvency Act No. 24 of 1936 (S. Afr.), as amended.

<sup>77</sup> *Commissioner of South African Revenue Services v. Beginsel NO and Others* 2012 (1) SA 307 (WCC) at para. 20 (S. Afr.).

<sup>78</sup> *Id.* ¶ 21.

purpose and scheme of the Act, to include all concurrent creditors under s[ection] 145(4)(b) of the Act, thereby almost certainly having their voting interests reduced and quite possibly entirely emasculated.<sup>779</sup> In this regard, the court agreed with the authors of Henochsberg<sup>80</sup> that such an interpretation of section 145(4) is grossly unfair to concurrent creditors, especially given that they have a greater level of interest in the debtor company's rescue than the secured creditors who can fall back on their security interest if the attempt at business rescue turned out to be a failure.<sup>81</sup>

The practical implications of judicial acceptance of the principle advanced by SARS would have been devastating, not only for non-preferent creditors generally, but also for the viability and attractiveness of business rescue proceedings in scenarios where the debtor company is substantially indebted to SARS. By adopting a legal position that is consistent with the principles of fairness and equality of creditors as against one that unduly places a particular creditor in a dominant position by enabling it to wield a casting or controlling vote (and thereby allowing it to predetermine the outcome of creditors' meetings), the court clearly signalled its discomfort with positions of legal principle that are certain to have the effect of undermining inclusive and egalitarian character of the rescue scheme that the legislature has established in Chapter Six of the Act. The court in *SARS v Beginsel* deserves to be applauded in this regard considering the fact that, under South Africa's tax and insolvency laws and related jurisprudence, granting preference to the claims or legal position of SARS is the norm rather than the exception. In this respect it would again have been easily defensible for the court to have aligned itself to the claim for preference by SARS ostensibly in defense of the public interest in maximizing legal protection of claims and monies owing to the national fiscus. It was therefore bold and courageous for the court to refuse preferential treatment for SARS in business rescue proceedings. The practical significance of this legal position is

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<sup>79</sup> *Id.* ¶ 32.

<sup>80</sup> DELPORT, *supra* note 7, at 509.

<sup>81</sup> See *Commissioner of South African Revenue Services v. Beginsel NO and Others* 2012 (1) SA 307 (WCC) at para. 35 (S. Afr.); See also Okkie Blom & William Maodi, *Demoting SARS, WITHOUT PREJUDICE* (Sept. 2013), [http://www.withoutprejudice.co.za/index.php/issues/item/demoting-sars?category\\_id=1](http://www.withoutprejudice.co.za/index.php/issues/item/demoting-sars?category_id=1).

enhanced by the likelihood that it will serve to discourage the granting of preference to other state-related claims that may be outstanding against debtor companies, such as monies due under municipal and environmental legislation.

D. Judicial Review and Setting Aside of Resolution of Board of Directors Commencing Business Rescue

As indicated above, the board of a financially distressed company may voluntarily place the entity under business rescue by adopting a resolution to that effect.<sup>82</sup> The Act provides recourse to unhappy stakeholders by stipulating that an “affected person” may apply to the court for an order setting aside the board’s resolution on either one of three grounds:<sup>83</sup>

1. That there is no reasonable basis for believing that the company is financially distressed;
2. That there is no reasonable prospect for rescuing the company; or
3. That the company has failed to satisfy the procedural requirements set out in section 129 of the Act.

However, in adjudicating over an “affected person’s” challenge against the board’s resolution, the Act provides that the resolution may be set aside where, “having regard to all of the evidence, the court considers that it is otherwise just and equitable to do so.” An interesting and important question that arose in the case of *DH Brothers Industries*<sup>84</sup> was whether the above provision constituted an additional (fourth) ground for invalidating the said resolution of the board on

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<sup>82</sup> It is required that the resolution be supported by a majority of the board. Accordingly, the absence of clear and credible evidence that the majority of directors were behind the resolution is fatal. See *DH Brothers Industries v. Gribnitz NO and Others 2014 (1) SA 103* at para. 16 (S. Afr.) (holding that adoption of the resolution by one of two directors constituted a failure to satisfy the procedural requirements of section 129—which is one of the bases on which the resolution may be set aside).

<sup>83</sup> Companies Act 71 of 2008 § 130(1)(a) (S. Afr.).

<sup>84</sup> *DH Brothers Industries v. Gribnitz NO and Others 2014 (1) SA 103* (S. Afr.).

which an “affected person” could rely.<sup>85</sup> What seems apparent from the text of sections 130(1)(a) and 130(5)(a) is that while the court is empowered to set aside the board resolution on four grounds, an “affected person” is only entitled to premise the application on one or more of the three grounds. According to the court in the *DH Brothers Industries* case, it would seem that “an application cannot be based on this fourth ground because the application then would not qualify as one brought in terms of section 130(1)(a).”<sup>86</sup> Given that section 130(5)(a) essentially empowers the court to grant relief on a cause of action which cannot, on its face, be relied upon by an applicant seeking to set aside the board resolution in question, the court concluded that the said provision creates an anomaly. Taking the view that “the distinction between s 130(1)(a) and s 130(5)(a) clearly arises from a drafting error,” the court in *DH Brothers Industries* held that, “the only sensible meaning which avoids the absurdity which would otherwise result is to construe the just-and-equitable basis as an additional ground to the three listed in s 130(1)(a).”<sup>87</sup> The result is that it can be relied upon as a fourth ground or cause of action by an “affected person” seeking relief under section 130(1)(a).<sup>88</sup>

Section 130(5)(a) specifically requires a court to consider all of the evidence before reaching a decision on the just and equitable ground. In the *DH Brothers Industries* case, the court held that the following were factors that must be considered:

- Whether the business rescue plan was properly adopted; and
- The terms of the plan and, in particular, whether it contains any offensive provision.<sup>89</sup>

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<sup>85</sup> This issue was addressed by the court in *DH Brothers Industries*, 2014 (1) SA 103, because the applicant-creditor specifically relied on the “just and equitable provision” of Companies Act 71 of 2008 § 130(5)(a)(ii) (S. Afr.).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* ¶ 18.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* ¶ 19. It is submitted that there are at least two additional factors that courts should in this context recognize as relevant, namely: (a) whether there are any real prospects of a successful rescue given the debtor-company’s circumstances; and (b) whether there is any evidence of the directors acting *mala fides*.

The manner in which the court in *DH Brothers Industries* resolved the anomaly and potential conflict created by the provisions of sections 130(1)(a) and 130(5)(a) is jurisprudentially significant in more ways than one. First, the court's decision effectively enlarged the provisions of section 130(1)(a) by explicitly making available a fourth additional ground that may be invoked by company stakeholders seeking to prevent a financially distressed company from being voluntarily placed under business rescue by its directors. Second, given the omnibus, open-ended (catch-all), and amorphous nature of the just-and-equitable ground, the decision in *DH Brothers Industries* significantly strengthens the hands of creditors who comprise the stakeholder group more likely to be opposed to business rescue while similarly weakening the prospects of such a board resolution surviving judicial scrutiny. It is submitted that, at least on the face of it, this decision is not supportive of the institution of business rescue.

E. Legality of Contents of Plan: Appropriateness and Validity of a Provision Effecting Compulsory Cession of Part of Creditors' Claims

In the *DH Brothers Industries* case, part of the fact complex was that the opposing creditor who sought an order setting aside the board's resolution placing the debtor company under business rescue was owed a debt of approximately R 5,000,000, which was secured by deeds of suretyship provided by the company's two directors (who were also the only shareholders). The plan put forward by the business rescue practitioner provided for the creditor to (a) receive 12.25% of the face value of its claim as a dividend; and (b) cede (transfer) 75.75% of its claim to a share trust established for the exclusive benefit of the company. The applicant creditor contended that, to the extent that the plan provided for a compulsory cession of a substantial part of its claim, it was not the kind of plan envisaged under the Act, especially given that the applicant would be rendered unable to recover the ceded portion of its claim from the directors who acted as sureties for the company.<sup>90</sup>

It is noteworthy that none of the provisions of the now famous Chapter Six speaks to the effect, if any, of business rescue proceedings

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<sup>90</sup> *Id.* ¶ 64.

on the liability of persons who had in the period preceding the commencement of the proceedings furnished deeds of suretyship on the debtor company's behalf.<sup>91</sup> Interestingly, section 155(9) of the Act, which is located in the same Chapter Six, specifically provides that the adoption of a scheme of arrangement or compromise has no effect on the liability of a person who is a surety of the company.<sup>92</sup> In this respect, the applicant submitted that, given that all creditors are bound by an adopted plan irrespective of whether or not they voted in favor, the legislature would have included a provision similar to section 155(9) if it had been within its contemplation that compulsory cessions of creditors' claims could properly form part of a business rescue plan.

With respect to compulsory partial or total forfeiture of creditors claims and/or related rights, the court in *DH Brothers Industries* noted that Chapter Six of the 2008 Companies Act only provided for (a) partial deprivation or forfeiture on the part of creditors who consented to the discharge of their debt in whole or in part<sup>93</sup> and (b) enforcement of pre-business rescue debts to the limited extent permitted by the terms of an adopted rescue plan.<sup>94</sup> Against the background of these two provisions, the court held that "any provision in a plan which goes beyond a voluntary discharge of the whole or part of a debt is not competent."<sup>95</sup> After noting that the plan in this case went far beyond what was permitted by the pertinent provisions of sections 152 and 154 and emphasizing the well-established presumption in South African law against any deprivation of rights by legislation, the court concluded that "it must follow as night follows

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<sup>91</sup> Interestingly, Companies Act 71 of 2008 § 155(9) (S. Afr.), which section is located in the same Companies Act 71 of 2008 Chapter Six (S. Afr.), specifically provides that the adoption of a scheme of arrangement or compromise has no effect on the liability of a person who is a surety of the company.

<sup>92</sup> Companies Act 71 of 2008 Chapter Six (S. Afr.) consists of twenty-eight sections laid out in five parts (A-E). It is interesting to note that only part E, consisting of only one section, deals with the subject of "compromise between company and creditors."

<sup>93</sup> *See id.* § 152(4).

<sup>94</sup> *Id.* § 154(2).

<sup>95</sup> *DH Brothers Industries v. Gribnitz NO and Others 2014* (1) SA 103 at para. 67 (S. Afr.).

day that a plan which deprives non-acceding creditors of the right to enforce a claim against a surety does not pass muster.”<sup>96</sup>

Most interestingly, this is one issue on which the court in *DH Brothers Industries* agreed with the reasoning and conclusions of the court in the earlier case of *African Banking Corporation of Botswana Ltd. v. Kariba Furniture Manufacturers (Pty) Ltd.*<sup>97</sup> In the latter case, the applicant creditor bank maintained that the fact that the board of the debtor company resolved to place it under business rescue could not deprive it of its right to pursue the directors as sureties pursuant to the suretyships they provided in the period preceding commencement of business rescue. However, the practitioner took a different view, similar to that of the shareholders who happened to be the same directors and sureties in question. Accordingly, the bank sought a declaratory order that the adoption of a business rescue plan, with respect to a company placed under business rescue, would not affect the rights a creditor has under suretyships executed with respect to amounts owed by the company under business rescue. The court held that there was no express provision in Chapter Six providing that the adoption of a business rescue plan will deprive creditors of the company of their rights as against sureties for the company’s debts.<sup>98</sup> The court concluded that there need be no connection between a surety and either the company in financial distress or the stakeholders, and that whether or not a creditor is entitled to pursue a surety will, in the ordinary course, have no bearing on the prospects of rescuing the company. Thus, in the court’s view, the interests of sureties do not fall within the scope of the objectives of the business rescue regime. In this regard, it relied on the sentiments of Rogers AJ in *Investec Bank Ltd. v. Bryuns*,<sup>99</sup> where the court decided that section 133 (2) explicitly referred to the stay of suretyship undertaken by the company and not a suretyship undertaken by a third person for the indebtedness of the

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<sup>96</sup> *Id.* ¶ 67.

<sup>97</sup> *African Banking Corp. of Botswana Ltd. v. Kariba Furniture Manufacturers (Pty) Ltd. and Others* 2013 (6) SA 471 (S. Afr.).

<sup>98</sup> *Id.* ¶¶ 68-69. The court also opined that: “If the legislature intended that the adoption of a business rescue plan would have such a far-reaching consequence, the legislature would have expressly provided for this consequence . . . . There is, furthermore, no basis to suggest that such a provision could be read into the business rescue regime.”

<sup>99</sup> *Investec Bank Ltd v. Bryuns* 2012 (5) SA 430 (WCC) (S. Afr.).

company. Accordingly, the court in *African Banking Corporation* held that the adoption of the plan would not affect the opposing creditor bank's claim against the debtor company's directors as sureties for the debts of the company.

The overwhelmingly pro-creditor position and perspective adopted by the courts in the three cases mentioned above are both plausible and justifiable on a number of grounds. First, it prevents abuse and opportunism in the context of business rescue proceedings. This is because, as observed by the court in *African Banking Corporation*, there is no functional link between the policy goal of ensuring success for the process of rescuing a financially distressed company and the continuation or cessation of the liability assumed by persons who provided suretyships in support of the company's pre-business rescue debts. Allowing such sureties to essentially "free-ride" on the business rescue proceedings to abandon their contractual obligations (as was attempted by the two directors in *DH Brothers Industries*) smacks of opportunism and unjust enrichment, which is the kind of conduct or behavior that the courts are expected and indeed duty bound to discourage.<sup>100</sup> Second, it is required of the courts to strive to maintain a careful balance between the relevant stakeholders' interests in the business rescue context.<sup>101</sup> The development of jurisprudence that is accepting of business rescue plan provisions aimed at advantaging sureties by terminating their obligations under the suretyships merely because the debtor company has been successfully placed under business rescue inappropriately skews that balance against company creditors and their interests. This is especially problematic given that the impugned terms of the rescue plans in *DH Brothers Industries* and *African Banking Corporation* sought to effectively negate existing contractual rights of company creditors and actually did so in a manner that was akin to "expropriation" of property rights without compensation. Such jurisprudence does not belong in the corpus of contemporary South African company law. Third, permitting terms in

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<sup>100</sup> Not surprisingly, the court in *DH Brothers Industries* found the provisions of the business rescue plan aimed at the compulsory, non-consensual nullification of the two shareholder-directors' obligations under suretyships held by a number of the creditors to be both offensive and constitute a basis on which it could be properly concluded that it was "just and equitable" to set aside the proceedings. *See DH Brothers Industries v. Gribnitz NO and Others* 2014 (1) SA 103 at para. 68 (S. Afr.).

<sup>101</sup> Companies Act 71 of 2008 § 7(k) (S. Afr.).



business rescue plans that seek to, *inter alia*, terminate suretyship obligations could undermine the integrity and credibility of the entire corporate rescue regime by creating space and incentives for collusion between business rescue practitioners and sureties aimed at improperly benefiting the latter.

#### CONCLUSION

*Prima facie*, the fact that there have been significantly more adverse judicial decisions on business rescue applications than those in favor may be troubling for law and policy makers and their supporters desperate to see the firm establishment of South Africa's corporate rescue model as well as the rapid entrenchment of a similarly supportive judicial culture. Obviously, such a culture would be one that is hostile to the idea of liquidating companies that have the slightest prospects of rehabilitation, especially where, as in *DH Brothers Industries*, there is no evidence of fraud or bad faith on the part of either the business rescue practitioner or the "affected persons" supporting the business rescue plan.<sup>102</sup> Shareholders, employees, trade unions, and the Companies and Intellectual Property Commission are certain to be among those stakeholders already getting concerned about the very poor success rate of business rescue applications thus far.

This apparently poor start to the tenure of Chapter Six can be considered problematic from another perspective, namely, that it may lead to the proliferation of a perception among stakeholders that the courts are generally not supportive of, or favorably disposed toward, business rescue applications. This perception may in turn create a chilling effect through the under-utilization of the mechanism due to the emergence of widespread belief that applications for business rescue proceedings by "affected persons" are not worth the inevitable investment of time and resources because of their limited prospects of success. Perhaps more importantly, the resulting decline in enthusiasm and support for the business rescue mechanism could significantly

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<sup>102</sup> In this respect the unmistakable pro-rescue disposition of the courts in India is of great interest and, from a South African perspective, probably worth emulating. See Kristin Van Zwieten, *Corporate Rescue in India: The Influence of the Courts*, 1 J. CORP. L. STUD. (Forthcoming 2015).

undermine the prospects of Chapter Six achieving the socio-economic public policy goals intended for it by the legislature.

However, it is arguable that, notwithstanding the fact that the courts' decisions on business rescue applications have been generally negative, the rulings and interpretive positions they have taken on most of the pivotal questions and issues can be said to be business rescue-friendly and therefore supportive of the future development of the mechanism. In this respect, the decisions and reasoning in the cases of *Oakdene Square Properties*, *Beginsel NO v. SARS*, and *African Banking Corporation* should be applauded in the hope that courts will enthusiastically follow them in future cases.

Finally, judgments are also beginning to clearly show that there are significant gaps in the framework and provisions of Chapter Six in terms of both the omission to make express provisions on what are important and foreseeable business rescue-related issues and the poor drafting quality of those provisions.<sup>103</sup> The result is that in the coming years South Africa is likely to see sharply contrasting judicial decisions as already appears from cases dealing with the question of “reasonable prospect of rescue.” Accordingly, for the early years of the regime's implementation, company stakeholders, business rescue practitioners, and their legal advisers will have to contend with a significant degree of uncertainty in this area of contemporary South African company law.<sup>104</sup>

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<sup>103</sup> This has come out most starkly in the context of the litigation around the “binding offer” provisions of Companies Act 71 of 2008 § 153(1)(b) (S. Afr.) in the two cases of *African Banking Corp. of Botswana Ltd. v. Kariba Furniture Manufacturers (Pty) Ltd. and Others*, 2013 (6) SA 471 (S. Afr.) and *DH Brothers Industries v. Gribnitz NO and Others 2014 (1) SA 103 (S.Afr.)*. In the latter case, Gorven, J. lamented the drafting-related weaknesses of the Chapter Six provisions in no less than two paragraphs of his judgment.

<sup>104</sup> See DELPORT, *supra* note 7, at 5 (predicting, two years before the 2008 Companies Act came into operation, that it will pose multiple problems that are likely to “cause uncertainty in its application”); Anneli Loubser, *The Business Rescue Proceedings in the Companies Act of 2008: Concerns and Questions (Part 2)*, 4 J. SOUTH AFRICAN L. 689, 701 (2010) (calling for legislative intervention by way of amendment of the pertinent provisions as a matter of urgency because of “the many unclear, confusing and sometimes alarming provisions.”).

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## THE PROTECTION OF INTELLECTUAL PROPERTY LICENSES IN INSOLVENCY: LESSONS FROM THE *NORTEL* CASE

*Anthony Duggan and Norman Siebrasse\**

### INTRODUCTION

Intellectual property-based industries have become an increasingly vital part of the economy, but firms in these industries are not immune from economic distress. Prominent Canadian illustrations include the *Nortel* proceedings and Blackberry's recent financial woes. Nortel filed for protection under Canada's Companies' Creditors Arrangement Act<sup>1</sup> (CCAA) in January 2009. At the same time, various Nortel affiliates commenced parallel proceedings under Chapter 11 of the U.S. Bankruptcy Code<sup>2</sup> and the Insolvency Act 1986 (U.K.). In *Re Nortel Networks Corp.*, the Canadian court approved Nortel's application to sell its assets in a series of going concern business sales. The assets included a substantial patent portfolio, and many of the patents were subject to current licensing agreements. Nortel developed an elaborate strategy to ensure as far as possible that licensees' interests

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\* Hon. Frank H. Iacobucci Chair, Faculty of Law, University of Toronto; Professor of Law, University of New Brunswick. Research assistance provided by Sarah Kitai (JD, 2015, University of Toronto). This article is adapted from a report prepared for Industry Canada, *The Treatment of Intellectual Property Rights in Insolvency* (September, 2013). The views expressed in this article are the authors' own and do not necessarily reflect the views of Industry Canada. We are grateful to Joe Pascuariello, Goodmans, LLP, counsel to the monitor in the Nortel proceedings, for providing us with background information and court documents relevant to the issues discussed in this article. This article has also been published in Canada in the *Annual Review of Insolvency Law* (2014). We are grateful to Carswell, the publisher of the *Annual Review of Insolvency Law*, for permission to republish.

<sup>1</sup> Canada's Companies' Creditors Arrangement Act (CCAA), R.S.C., 1985, c. C-36.

<sup>2</sup> 11 U.S.C. (2014).

would not be affected by the sale of the patents, but the broader question raised by the case was whether a transferee of intellectual property acquires title subject to, or free of, outstanding licenses. If those licenses are not enforceable against a transferee, the licensee may find itself in the unenviable position of having to re-license rights which it had already paid for, after having invested substantial sunk costs in reliance on those rights. The question can arise whether the sale takes place in the course of insolvency proceedings (as with Nortel) or whether it takes place outside the insolvency system (as Blackberry had been planning).

In principle the answer to this question should be the same in both contexts; otherwise outcomes may vary arbitrarily depending on the circumstances of the sale, which in turn may skew the choice between selling inside or outside the insolvency system. In other words, the priority rules that apply in insolvency proceedings should mirror the rules that apply outside insolvency. There are two main problems in this connection. The first is that in Canada the priority rules governing competing claims to intellectual property outside insolvency are remarkably unsettled. The second is that while the Canadian insolvency laws permit a debtor to sell its assets outside the ordinary course of business, subject to court approval, they do not specifically import the priority rules that apply outside insolvency proceedings to determine the purchaser's rights relative to those of third party claimants.

In both respects, the Canadian and United States positions are very different. By and large, the law outside bankruptcy in the United States is that a transferee of intellectual property is bound by prior licenses. This rule is imported into bankruptcy by section 363(f) of the U.S. Bankruptcy Code, which provides that, in the case of an asset sale, the purchaser acquires title free and clear of competing interests "if . . . applicable nonbankruptcy law permits sale of such property free and clear of such interest."<sup>3</sup> The concern U.S. laws address is that the licensee may have made substantial investments in reliance on the license, which would be lost if the license was subordinate to third party claims. The potential damage to its reliance interest would increase the upfront risk to prospective licensees, which in turn would

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<sup>3</sup> 11 U.S.C. § 363 (2014).

have a chilling effect on the licensing of intellectual property. This policy is also reflected in section 365(n) of the U.S. Bankruptcy Code which, in general terms, limits the right of an intellectual property owner in bankruptcy to reject (disclaim) license agreements.<sup>4</sup> There is a similar restriction in the Canadian insolvency law provisions governing disclaimer of agreements,<sup>5</sup> suggesting that the importance of protecting the intellectual property licensee's reliance interest has been recognized in Canada too. The problem in Canada is that this policy has not been carried over into the asset sale context.

The purpose of this article is to compare and contrast the protection given to intellectual property licensees in Canada and the United States, using the *Nortel* case as the focus for the discussion. Part I expands on the underlying policy considerations. The strategy Nortel developed for addressing licensees' interests revolved around section 365(n) of the U.S. Bankruptcy Code. In Part II, we provide a fuller account of section 365 at large and section 365(n) in particular, and of the corresponding Canadian provisions. We discuss the *Nortel* case in Part III. In Part IV, we turn to the rules governing asset sales in both countries, making the point that in Canada, as the law currently stands, while a debtor may be effectively precluded from disclaiming intellectual property licenses in insolvency proceedings, it might nevertheless be able to achieve the same result by selling the underlying intellectual property. This possibility did not surface in the *Nortel* case itself, because the sale process in *Nortel* was largely driven by United States, not Canadian, law; but it is likely that in some future case the issue will arise. In Part V, we discuss possible reforms. We conclude that reform of Canadian law relating to the rights of licensees on assignment of the licensed rights is urgently required, both outside and inside of insolvency.

## I. THE POLICY CONSIDERATIONS

Protection against termination of licenses as a result of the licensor's financial distress has become a pressing concern with the rise of "patent assertion entities," pejoratively referred to as "patent trolls," whose business model consists of buying and asserting patents against

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<sup>4</sup> 11 U.S.C. § 365 (2014) (discussed *infra* Part II, Section A).

<sup>5</sup> See, e.g., CCAA, R.S.C., 1985, c. C-36; see *infra* Part II, Section B.

other firms without exploiting the technology themselves.<sup>6</sup> The \$612.5 million settlement entered into by Research in Motion in consequence of its litigation with the patent assertion entity NTP is the best known example of trolling involving a Canadian firm, but any firm doing business in the United States is exposed.<sup>7</sup> At present, trolls are most active in the United States, but at least one patent assertion entity is already active in Canada, and there is concern that trolling will spread further in Canada and other jurisdictions as the business model matures.<sup>8</sup>

There are two broad types of trolling behavior.<sup>9</sup> One is litigation of poor quality patents to obtain litigation cost settlements, in which the defendant finds it cheaper to settle than to challenge the validity of the patent in court.<sup>10</sup> The more problematic variety involves opportunistic litigation, which takes advantage of the defendant's investment in the technology at issue.<sup>11</sup> The well-known *NTP v. Research in Motion, Ltd.* litigation is a classic example.<sup>12</sup> *NTP* held broad patents covering the use of cell phone frequencies for email access.<sup>13</sup> While this idea itself was no doubt valuable, there is no question that the large investment made by RIM (Research in Motion) in implementing the concept also made a major contribution to the success of the company; indeed, it is not unlikely that RIM's contribution very substantially exceeded the value of the idea itself. However, RIM did not obtain a license from NTP at the outset, apparently because it developed the concept independently and it was not aware of the patent at the time of its investment.<sup>14</sup> Independent creation is not a defense to patent infringement however, and as a

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<sup>6</sup> See generally Norman Siebrasse, *Business Method Patents and Patent Trolls*, 54 CAN. BUS. L.J. 38 (2013).

<sup>7</sup> See *NTP, Inc. v. Research in Motion, Ltd.* (Fed. Cir. 2005); and see *Coastal Contacts Inc. v. Elastic Path Software Inc.* (2013) B.C.S.C. 133 (Can.) for an example of a smaller Canadian firm caught by a U.S. troll.

<sup>8</sup> Dovden Investments Ltd. has filed approximately one third of patent infringement actions in Canada in 2013. See Alan Macek, *Patent Trolls in Canada?*, SLAW (June 21, 2013), [www.slaw.ca/2013/06/21/patent-trolls-in-canada/](http://www.slaw.ca/2013/06/21/patent-trolls-in-canada/).

<sup>9</sup> See generally Norman Siebrasse, *supra* note 6.

<sup>10</sup> *Id.* at 42.

<sup>11</sup> *Id.*

<sup>12</sup> See *NTP*, 418 F.3d 1282.

<sup>13</sup> See *id.*

<sup>14</sup> *Id.*

patent is a property right, injunctive relief is normally granted to a successful patentee.<sup>15</sup> After succeeding in its U.S. infringement action against RIM, NTP was awarded \$53.7 million in damages, but armed with a permanent injunction, it was able to extract a settlement of over \$600 million.<sup>16</sup> This illustrates the general problem of opportunism; if bargaining between the parties takes place after the user of the patented technology has invested sunk costs in reliance on that technology, the amount which the owner of the patent can extract is not merely the value of the technology, but also the value of that additional investment, which would have to be abandoned if no settlement can be reached. The higher price that can be extracted because of sunk costs is known as the “hold-up” value of the patent, and correspondingly, the problem is commonly known as “patent hold-up.” To use a simple analogy, if you are going to buy land to build your retirement home, you want to negotiate the price with the landowner before you build your house, not afterwards.

The potential for opportunism arises in patent cases because independent creation is not a defense, and patent rights are often poorly defined, so it may be difficult for a technology user to know in advance whether it is infringing any patent rights. The problem of patent trolls appears to be greatest with respect to software patents and business methods patents, both of which are said to be particularly poorly defined.<sup>17</sup> More generally, however, the problem of opportunism arises whenever the user of technology has to bargain after investing sunk costs in reliance on that technology.<sup>18</sup> This is pervasive in the case of licensees. It is normal for a business user of almost any technology to invest in its implementation. Even basic office productivity software requires training staff in its use, and any more specialized technology requires commensurately more specific investment. Licensees, by definition, protect themselves against opportunism by licensing the technology on reasonable terms before investing in it. But the opportunism will be a threat if the license is terminated, even though the licensee is living up to its terms and wants

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<sup>15</sup> This has changed in the United States since the decision of the U.S. Supreme Court in *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006), which held that injunctions should no longer be granted routinely to prevailing patentees.

<sup>16</sup> NTP, 418 F.3d at 1287, 1325-26.

<sup>17</sup> Siebrasse, *supra* note 6 at 47.

<sup>18</sup> *Id.* at 42-43.

to continue using the technology. This is exactly the problem that arises if the license can be terminated on insolvency of the licensor, or if a licensor can effectively terminate the license simply by assigning the intellectual property rights to a third party. Opportunism of this type can arise with respect to trademarks or copyright just as well as with patents, because it does not depend on features of the intellectual property peculiar to patents.

The problem is illustrated by the recent *Qimonda* decision in the United States.<sup>19</sup> A major German semiconductor manufacturer, Qimonda, became insolvent, and the insolvency administrator sent letters to the licensees of Qimonda's patents declaring that their licenses were unenforceable under the German Insolvency Code.<sup>20</sup> The insolvency administrator intended to re-license the patents back to the existing licensees for the benefit of Qimonda's creditors.<sup>21</sup> That is, the existing licensees would have had to pay again for licenses that they already had. Moreover, the licensees were apparently largely other semiconductor manufacturers who would have had to negotiate the licenses in the face of very large sunk costs invested in their semiconductor designs in reliance on the licensed technology, and the re-negotiated licenses would have been substantially more expensive than the original licenses.<sup>22</sup>

The United States litigation arose because the insolvency administrator appointed by the Munich court sought an order from the U.S. courts recognizing the German proceeding in order to obtain administration of Qimonda's U.S. patents. The U.S. courts ultimately granted the order, but subject to the condition that licensees of Qimonda's U.S. patents be given the same treatment that they would have received under the U.S. Bankruptcy Code, which, as described below, provides substantial protection to existing licensees.

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<sup>19</sup> *Jaffé v. Samsung Elecs. Co.*, 737 F.3d 14 (4th Cir. 2013) (known as *Qimonda* after the name of the debtor, for which Jaffé was the insolvency administrator) [hereinafter *Qimoda*].

<sup>20</sup> *Insolvenzordnung* [InsO] [German Insolvency Code], Oct. 5, 1994, BUNDESGESETZBLATT [BGBl.] 2082.

<sup>21</sup> *Qimonda*, 737 F.3d 14.

<sup>22</sup> *Id.* (The original licenses were largely paid for in-kind with cross-licenses, which is common practice in the semi-conductor industry.).



*Qimonda* illustrates the threat to the licensee's reliance interest, which may emerge from unilateral termination of licenses as a result of insolvency. We will see that the recent amendments to the Canadian insolvency laws provide some protection to licensees from termination by the insolvency administrator, as in *Qimonda*, but that protection can potentially be circumvented by termination of the rights on an assignment of the technology by the insolvency administration, rather than disclaimer of the license by the insolvency administrator itself. This is a major concern because patent trolls often obtain their patents on the insolvency of a technology company. This means that if *Qimonda* were to arise in Canada, the licensees might have to re-negotiate their licenses from trolls who had purchased the patent rights from the insolvency administrator. Moreover, the rights of a licensee outside of bankruptcy are unclear; remarkably it may well be that license rights are unenforceable against an assignee. This means that an intellectual property owner in financial distress might be able to monetize its rights by assigning them to a troll prior to any insolvency, and the troll would be able to re-negotiate with the licensee free of the licenses, which bound the original owner.

## II. The Rejection (Disclaimer) of Executory Contracts

### A. The United States' Position

Section 365 of the U.S. Bankruptcy Code provides for the rejection, assumption, and assignment of executory contracts in bankruptcy proceedings.<sup>23</sup> All three options require court approval, and the courts generally apply a business judgment test in determining whether to grant approval.<sup>24</sup> The purpose of the provisions is to maximize the value of the bankruptcy estate for the benefit of the creditors by allowing the trustee to cherry-pick the debtor's uncompleted contracts, rejecting contracts that would be unprofitable for the estate to perform and assuming contracts where the returns to the estate from performance are likely to exceed the cost. The Bankruptcy Code does not define "executory contract," but the term is generally accepted to mean "a contract under which the obligation[s] of both the bankrupt and the other party to the contract are so far

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<sup>23</sup> 11 U.S.C. § 365 (2014).

<sup>24</sup> The provision imposes various other restrictions on assumption and assignment, which are not presently relevant.

unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other” (the “Countryman definition”).<sup>25</sup> The key feature of the Countryman definition is that to qualify as an executory contract, an agreement must remain at least partially unperformed *on both sides*.

Some intellectual property license agreements may fall outside the scope of the provision for this reason. The outright sale of a product coupled with a non-exclusive license to use the intellectual property embodied in the product is case in point. A particular example is where the debtor or counter-party distributes “a mass-marketed computer software product . . . in conjunction with a ‘shrink wrap’ end user license agreement granting the user nonexclusive rights to use the software.”<sup>26</sup> “The end user makes a one-time payment and receives the software product. . . . [T]he end user may have ongoing responsibilities under [the] license based on the restrictions in the license,” but the licensor’s performance is complete upon delivery of the product.<sup>27</sup> Another example is where an “author . . . licenses a completed copyrighted work to a publisher in exchange for either a lump sum payment or an ongoing royalty stream.”<sup>28</sup> Here the “licensor’s obligations are complete upon delivery of the work” and, since the contract is not still at least partially unperformed on both sides, section 365 of the U.S. Bankruptcy Code may not apply.<sup>29</sup>

On the other hand, many intellectual property licenses do fall within the Countryman definition because there are outstanding obligations on both sides. For example, in the case of a patent license, the licensee will typically have “an ongoing obligation to . . . pay royalties for the life of the agreement” and may have “[o]ther material ongoing . . . obligations [as well,] such as sharing [the] technology with the licensor . . . and marking all products sold under the license with [the appropriate] patent notice.”<sup>30</sup> For its part, the licensor will

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<sup>25</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973).

<sup>26</sup> Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 759 (2007).

<sup>27</sup> *Id.* at 766.

<sup>28</sup> *Id.* at 762.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 761.

commonly have ongoing obligations such as giving a “nonexclusive licensee notice of any patent infringement suit or any other use or licensing of the process, refraining from licensing the technology to anyone else at a lower royalty rate . . . , approving grants of sublicenses . . . , indemnifying licensees for losses, and defending claims of infringement.”<sup>31</sup>

Some courts in the United States have held that the licensor’s forbearance from suing the licensee for infringement is an ongoing obligation and that the license agreement is an executory contract on that basis, regardless of whether the licensor is subject to any other ongoing obligations.<sup>32</sup> However, this view has been disputed on the ground that by granting the license, the licensor gives up the right to sue the licensee for infringement and the licensor’s performance is complete at that point.<sup>33</sup> A copyright license will satisfy the Countryman definition if it relates to a work yet to be created or that is still to be edited, revised, or otherwise adapted.<sup>34</sup> In such cases, the creative artist is subject to ongoing obligations and so the contract remains at least partly unperformed on her side, while the publisher’s obligation to publish the work represents an unperformed obligation on its side.<sup>35</sup> A trademark license will nearly always satisfy the Countryman definition because the licensor has continuing quality control obligations and the licensee typically has payment, reporting, marketing, and other continuing performance obligations.<sup>36</sup> Business-to-business software licensing agreements typically involve ongoing performance obligations on both sides and so satisfy the Countryman definition, but, as indicated above, business-to-consumer (end user)

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<sup>31</sup> *Id.* at 761-62; *see also* Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 2-10 (2013).

<sup>32</sup> *See, e.g.*, *Everex Sys. v. Cadtrak Corp.* (*In re CFLC, Inc.*), 89 F.3d 673 (9th Cir. 1996).

<sup>33</sup> *Id.*; *Cf.* Madlyn Gleich Primoff & Erica G. Weinberger, *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including Intellectual Property Agreements, and Related Issues Under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code*, 8 AM. BANKR. INST. L. REV. 307, 316.

<sup>34</sup> Menell, *supra* note 26 at 763.

<sup>35</sup> *Id.* at 763; Gilhuly et al., *supra* note 31, at 8-9.

<sup>36</sup> Menell, *supra* note 26 at 764; Gilhuly et al., *supra* note 31, at 9-10.

license agreements typically do not involve ongoing performance obligations on the licensor's part.<sup>37</sup>

In *Lubrizol Enterprises v. Richmond Metal Finishers*, the U.S. Court of Appeals for the Fourth Circuit held that a technology license was an executory contract to which section 365 of the U.S. Bankruptcy Code applied, entitling the debtor-licensor's trustee to reject the agreement, subject to the court's approval.<sup>38</sup> The *Lubrizol* case was widely criticized on both doctrinal and policy grounds and, in 1988, Congress enacted section 365(n) to reverse the decision.<sup>39</sup> Section 365(n) provides that "[i]f the trustee rejects an executory contract under which the debtor is the licensor of a right to intellectual property, the licensee" may either: (1) treat the contract as terminated if the rejection would constitute a repudiatory breach outside bankruptcy; or (2) elect to retain its basic rights under the contract for the duration of the term, including the right to enforce any exclusivity provision, subject to a continuing obligation to make royalty payments.<sup>40</sup> If the licensee exercises the second option, it retains its right to the intellectual property itself, effectively limiting the trustee's rejection to ancillary aspects of the agreement (for example, obligations relating to the provision of training, maintenance, or update facilities).

#### B. The Position in Canada

Section 65.11 of the Bankruptcy and Insolvency Act (BIA), which applies in BIA proposal proceedings, and CCAA, section 32, which applies in CCAA proceedings, provide for the disclaimer or resiliation (rejection) of agreements.<sup>41</sup> The provisions were enacted in

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<sup>37</sup> Menell, *supra* note 26 at 765-66.

<sup>38</sup> See generally *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985).

<sup>39</sup> Jay Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts* (1997) 5 AM. BANKR. INST. L. REV. 463, 470-72. See also *Sunbeam Prods. v. Chi. Am. Mfg.*, 686 F.3d 372 (7th Cir. 2012) (rejecting the *Lubrizol* reasoning); Jarrod N. Cone, *A "Sunbeam" of Hope: The Seventh Circuit's Solution Overcoming Disparaging Treatment to Trademark Licensees Under the Bankruptcy Code*, 20 J. INTELL. PROP. L. 347 (2013).

<sup>40</sup> 11 U.S.C. § 365(n) (2014).

<sup>41</sup> Bankruptcy and Insolvency Act (BIA), R.S.C. 1985, c. B-3.

2005, amended in 2007, and came into force in 2009.<sup>42</sup> The main features are:

- the trustee (monitor) must first approve the proposed disclaimer;
- following this, the debtor must notify the counter-party, and the counter-party has fifteen days to apply to the court for disallowance of the disclaimer;
- in hearing an application by either the counter-party or the debtor, the court must consider whether the disclaimer would enhance the prospects of a viable restructuring<sup>43</sup> and whether the disclaimer “would likely cause significant financial hardship to [the counter-party]”<sup>44</sup>;
- if the contract is disclaimed, the counter-party has a provable claim in the proceedings for any loss; and
- the following contracts cannot be disclaimed: eligible financial contracts, collective agreements, a financing agreement where the debtor is the borrower and a lease of real or personal property where the debtor is the landlord (lessor).

The provisions refer to “agreements” and, unlike their United States counterpart, they are not limited to “executory contracts.”<sup>45</sup> It is beyond the scope of the present discussion to explore the implications

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<sup>42</sup> Statute c. 47, enacted in November 2005; Statute c. 36, enacted in June, 2007.

<sup>43</sup> “[W]ould enhance the prospects of a viable proposal being made in respect of the debtor”, BIA, R.S.C. 1985, s. 65.11; “would enhance the prospect of a viable compromise or arrangement being made in respect of the company”, CCAA, R.S.C., 1985, s. 32. This wording presupposes restructuring proceedings, as opposed to liquidation proceedings. But it has been held that the provision should be interpreted expansively to cover liquidation proceedings as well: *Re Timminco Ltd.*, [2012] ONSC 4471 (Can. Ont. S.C.J.), at ¶¶. 51,52.

<sup>44</sup> CCAA, R.S.C., 1985, s. 32.

<sup>45</sup> See David Ullmann & Melissa McCready, *Licensed to Steal: The Rights of IP Licensors and Licensees in an Insolvency*, ANN. REV. INSOLVENCY L. 201, 203 (2010).

of this point;<sup>46</sup> for present purposes, it is sufficient to note that the provisions clearly apply to intellectual property license agreements.

BIA section 65.11(7) and CCAA section 32(6) are loosely based on section 365(n) of the U.S. Bankruptcy Code. They provide that if the debtor has granted to a party to an agreement a right to use intellectual property, the disclaimer or resiliation does not affect the party's right to use the intellectual property during the term of the agreement, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.<sup>47</sup>

BIA section 65.11 applies in BIA proposal proceedings and CCAA section 32 applies in CCAA proceedings.<sup>48</sup> There is, inexplicably, no corresponding provision for disclaimer in bankruptcy proceedings. However, the courts have held that there is a common law power of disclaimer.<sup>49</sup> The common law power of disclaimer derives from the trustee's freedom not to perform the contract. Non-performance is a breach of contract which entitles the counter-party to the normal contract remedies. However, unless the counter-party has a right of specific performance or a similar right, the counter-party cannot compel the trustee to perform the contract and it will be limited to a damages claim for which it will have to prove in the debtor's bankruptcy.<sup>50</sup> In *Re Thomson Knitting Co.*, the court held that the trustee must elect to affirm or disclaim within a reasonable time and, failing an election, the counter-party is entitled to assume that the trustee has disclaimed the contract.<sup>51</sup> BIA, section 121(1) defines "provable claim" to mean "debts and liabilities . . . to which the bankrupt is subject" on the date of the bankruptcy or "to which the bankrupt may become subject during" the bankruptcy by reason of an obligation incurred

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<sup>46</sup> For discussion, see Anthony Duggan & Norman Siebrasse, *The Disclaimer, Affirmation and Assignment of Intellectual Property Licences in Insolvency*, J. INSOLVENCY INST. CAN. 163, 166-69.

<sup>47</sup> BIA, R.S.C. 1985, s. 65.11(7); CCAA, R.S.C., 1985 s. 32(6).

<sup>48</sup> BIA, R.S.C. 1985, s. 65.11(7); CCAA, R.S.C., 1985 s. 32(6).

<sup>49</sup> *Re Thomson Knitting Co.* (1924), 5 C.B.R. 189 (Can. Ont. S.C. in Bankruptcy)(aff'd (1925) 5 C.B.R. 489 (Can. Ont. S.C. in Bankruptcy App. Div.)); *New Skeena Forest Products v. Don Hull Sons Contracting* (2005), 251 D.L.R. 4th 328 (Can. B.C. C.A.); *In the Matter of the Bankruptcy of North American Steamships Ltd.* 2007 B.C.S.C. 267.

<sup>50</sup> *Id.*

<sup>51</sup> See generally *Re Thomson Knitting Co.* (1924), 5 C.B.R. 189.

before the date of the bankruptcy.<sup>52</sup> In other words, generally speaking, only pre-filing claims are provable claims. However, the counterparty's claim, which arises when the trustee disclaims a contract, is a provable claim even though it arises post-filing. This is an exception to the general rule.<sup>53</sup>

It is unsettled whether the common law right of disclaimer extends to intellectual property licenses. In *Re Erin Features No. 1 Ltd.*, the court denied the right of a trustee in bankruptcy to disclaim a license agreement giving the licensee exclusive rights to market a film in Canada.<sup>54</sup> The decision was based on the proposition that the right of disclaimer cannot be used to disturb established property rights. On the other hand, in *Re T. Eaton Co.*, the court allowed the debtor in CCAA proceedings to disclaim an agreement giving a credit card company an exclusive license to supply credit card services to the debtor's customers.<sup>55</sup> The court decided the case mainly on the basis that restricting the debtor's right to disclaim unprofitable contracts

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<sup>52</sup> BIA, R.S.C. 1985, s. 121(1).

<sup>53</sup> The exception is provided for in BIA, R.S.C. 1985, s. 121(1), which provides as follows:

“All debts and liabilities, present or future, to which the bankrupt is subject on the da[te] on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.” (Emphasis added).

Duncan explains the meaning of the italicized words as follows:

“The class of claims covered by [these words] include[s] cases of contract where the trustee either disclaims or ceases to perform the contract. In such case[s] the creditor may prove against the estate for the damages occasioned by the breach of the contract, and this is his only remedy.”

See Roderick J. Wood & David J. Bryan, *Creeping Statutory Obsolescence in Bankruptcy Law*, 3 J. INSOLVENCY INST. CAN. 1, 14-15 (2014) (citing LEWIS DUNCAN, THE LAW AND PRACTICE OF BANKRUPTCY IN CANADA 428-29 (Carswell ed., 1922).

<sup>54</sup> See generally *Re Erin Features No. 1, Ltd.* (1991), 8 C.B.R. 3d 205 (Can. B.C. S.C.).

<sup>55</sup> *Re T. Eaton Co.*, (1999) 14 C.B.R. 4th 288 (Can. Ont. S.C.J.).

would threaten the viability of restructuring arrangements.<sup>56</sup> But the court also held, relying on English authority and contrary to *Erin Features*, that a license does not confer property rights on the licensee. Therefore, there is no reason for treating the disclaimer of licenses any differently from contracts at large.<sup>57</sup>

It may be a mistake to think of the issue in terms of property rights. Disclaimer of a contract in insolvency proceedings amounts to a breach of the contract, not rescission. The essence of a license agreement is that the licensor promises not to sue the licensee for infringement provided the licensee observes the terms of the license. Outside bankruptcy, if the licensor sued the licensee for infringement even though the licensee was in compliance with all its obligations under the license agreement, the licensor would be in breach of its primary obligation under the license agreement and the court would disallow the action. In principle, the position should be the same in bankruptcy, given that the rights of the trustee or debtor in bankruptcy are no larger than the debtor's rights outside bankruptcy. In other words, disclaimer of a license should not prevent the licensee from using the intellectual property: if the trustee or debtor sues the licensee for infringement, the court should disallow the action, just as it would have done if the action had been brought outside bankruptcy.

CCAA section 32 had been enacted but had not been brought into force at the time of the *Nortel* proceedings. It follows that at the time of the proceedings the right of a debtor to disclaim agreements in CCAA proceedings was governed by the common law as outlined above and at common law it was unclear whether a licensor could disclaim a license agreement.

### III THE NORTEL CASE

In *Re Nortel Networks Corp.*,<sup>58</sup> the court approved Nortel's application to sell its assets, which included a substantial patent portfolio, in a series of going concern business sales. The proposed

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<sup>56</sup> See generally *id.*

<sup>57</sup> See *Heap v. Hartley* (1889), 42 Ch.D. 461 (C.A.).

<sup>58</sup> *Re Nortel Networks Corp* (2009), 56 C.B.R. 5th 224 (Can. Ont. S.C.J. [Commercial List]).



patent sales were complicated by the fact that Nortel had entered into numerous license agreements respecting the patents and it did not have records for all of them. In other words, some of the patents were subject to licenses Nortel could not identify. To avoid potential disputes, which would have detracted from the value generated by the sales, Nortel decided that the patents would be sold subject to certain classes of licenses, including “known licenses” and “commercial licenses.” Known licenses were licenses of which Nortel was aware; commercial licenses were licenses Nortel had granted in the ordinary course of its business, including end-user licenses, whether or not they were specifically known to Nortel or the purchasers.

To deal with licensees whose rights would not be preserved by the terms of sale (the “unknown licensees”), Nortel devised a strategy based on section 365(n) of the U.S. Bankruptcy Code. As indicated above, section 365(n) provides that if the trustee rejects an executory contract, under which the debtor is an intellectual property licensor, the licensee has a choice either to: (1) treat the contract as terminated; or (2) elect to retain its basic rights under the contract for the duration of the term. The Nortel strategy gave unknown licensees this choice. Notices of the proposed sales were widely published, in newspaper advertisements and elsewhere, inviting unknown licensees to identify themselves and establish their claims by a specified date. The interests of licensees who responded in time would continue following the patent sales and all such licenses would be enforceable against the patent transferee. In effect, unknown licensees who came forward by the specified date would transform themselves into known licensees. On the other hand, unknown licensees who failed to identify themselves by the claims bar date would be deemed to have elected, under section 365(n), to have their contracts terminated.

It should be noted that there was no particular class of unknown licensees that were suspected to exist but could not be tracked down, and it may well be that there were no unknown licensees at all. The problem was that Nortel’s records were not sufficiently complete to confirm this. In summary, the sale was to be subject to all known licenses and also unknown licenses that were commercial licenses, but the purchaser would take the patents free and clear of unknown licenses other than commercial licenses. The objective was to maximize the sale price while protecting the reliance interests of

essentially all licensees. The patent sale procedure was approved at a joint hearing of the Canadian and United States courts in the CCAA and Chapter 11 proceedings, and the sale took place in late June 2011.<sup>59</sup> The patents were bought by a consortium of technology companies for “a record price of \$4.5 billion.”<sup>60</sup>

Given the cross-border nature of the proceedings, Nortel’s patent sale process needed to satisfy the requirements of both United States and Canadian law. As indicated above, Canadian law at the time of the case was unsettled. The Nortel patent sale process was designed to ensure compliance with the United States requirements—specifically, section 365(n) of the Bankruptcy Code—on the assumption that these were more stringent than Canadian law, so that if the sale process complied with the United States requirements it would also necessarily comply with Canadian law.<sup>61</sup> The picture may have changed with the subsequent coming into force of CCAA, section 32. Section 32 is similar to section 365 of the U.S. Bankruptcy Code, with section 32(6) being loosely based on section 365(n). However, there are some potentially significant differences. First, CCAA section 32 clearly requires the debtor to identify the specific agreement it wants to disclaim, whereas section 365 is more open to interpretation on this point. The difference matters in cases like *Nortel*, because if the debtor’s objective is to disclaim licenses it is unaware of, it will not be in a position to provide details of individual agreements.<sup>62</sup> Second, in contrast to section 365(n), section 32(6) does not give the counterparty licensee a choice when the license is disclaimed between treating the agreement as terminated and retaining its rights under the

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<sup>59</sup> Following the joint hearing, the U.S. court and Canadian court made separate orders: see *In re Nortel Networks, Inc.*, No. 09–10138 (KG), 2011 WL 4831218 (Bankr. D. Del. July 11, 2011); *Re Nortel Networks Corporation (Certain Patents and Other Assets Bidding Procedures Order)* (unreported, Can. Ont. Ct. Justice, 2 May 2011).

<sup>60</sup> Joseph Pasquariello and Chris Armstrong, *The Nortel Stalking Horse Sales: Maximising Value Via CCAA Flexibility*, 1 J. INSOLVENCY INST. CAN. 123, 137 (2012). The consortium comprised Apple, Ericsson, Microsoft, Research in Motion, EMC Corporation, and Sony.

<sup>61</sup> *Id.* at 135.

<sup>62</sup> *But see id.* at 136 (arguing that a court might be prepared to accept less specific characteristics, such as a description of the general nature or type of agreement, so long as the details were sufficient to enable counter-parties to identify the agreements the debtor is proposing to disclaim).

agreement to use the intellectual property for the duration of the term. Section 32(6) simply provides that disclaimer does not affect the licensee's right to use the intellectual property for the duration of the term.<sup>63</sup>

In the *Nortel* case, the debtor relied on the rejection (disclaimer) rules to avoid the unknown licenses. What might the result have been if it had relied on the asset sale provisions instead? Section 363 of the U.S. Bankruptcy Code permits a debtor to sell its assets free and clear of third party interests, but only if "applicable nonbankruptcy law permits sale of such property free and clear of such interest."<sup>64</sup> As a matter of U.S. patent law, the transferee of a patent acquires title subject to any prior license, whether or not it knew of the license.<sup>65</sup> Therefore, if Nortel had proceeded under section 363, it could not have sold the patents free and clear of the unknown licenses. In the *Nortel* case, given the cross-border nature of the proceedings, the sale process had to comply with the requirements of both U.S. and Canadian law. But, assume that Canadian law alone had been in play and Nortel had sold the patents pursuant to CCAA, section 36. Would the sale have extinguished the licenses? It is to this question that we now turn.

#### IV. ASSET SALES

Assume an intellectual property owner, A, assigns the intellectual property to B and subsequently assigns the same intellectual property a second time to C. Which assignment prevails? Or suppose A grants B a license to use the intellectual property and subsequently assigns the intellectual property to C. Can B enforce the license against C? Parallel questions can arise in insolvency proceedings. For example, assume A assigns its intellectual property to

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<sup>63</sup> *But see id.* at 155-56, note 22 (arguing that the counter-party should be free to waive its rights under section 32(6), even though the provision does not expressly allow for this).

<sup>64</sup> 11 U.S.C. § 363(f).

<sup>65</sup> *See* *Keystone Type Foundry v. Fastpress Co.*, 272 F. 242, 244-45(2d Cir. 1921) ("it ha[s] long passed into the text-books that . . . an assignee acquired title subject to prior licenses of which the assignee must inform himself as best he can, and at his own risk"). *See also, e.g.*, *Armstrong Pump, Inc. v. Hartmann*, 745 F. Supp. 2d 227, 233 (W.D.N.Y. 2010).

B and later files for CCAA protection; A wants to transfer the intellectual property to C, perhaps as part of a going concern sale of A's business. Can A sell the intellectual property to C free and clear of B's interest? Likewise, suppose A licenses the intellectual property to B and subsequently files for CCAA protection; can A sell the intellectual property to C free and clear of B's license?

In principle, priorities in insolvency proceedings should be the same as the priorities outside insolvency proceedings. In other words, as a general rule, the insolvency laws should not change the priority order that applies outside insolvency proceedings, because otherwise parties will have an incentive to use the insolvency laws opportunistically as a means of improving their priority position.<sup>66</sup> It is therefore necessary to understand the priority rules governing competing intellectual property interests outside insolvency proceedings to establish the contours of the priority regime inside insolvency proceedings. Unfortunately, in Canada the law outside insolvency proceedings is remarkably uncertain. The intellectual property statutes each provide for registration of assignments or transfers, but the priority consequences are not clear. We will consider first priority as between assignees and then priorities in respect of licenses.

#### A. Priorities Outside Insolvency Proceedings

1. *Competing intellectual property assignments.* – The Trade-marks Act provides that a mark is transferable and the transfer may be registered, but it is entirely silent as to the priority consequences, which therefore presumably would be determined by provincial law.<sup>67</sup> In common law provinces, the rule of *nemo dat quod non habet* would apply,

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<sup>66</sup> See Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW chs. 1-2 (1986).

<sup>67</sup> Trade-marks Act, R.S.C. 1985, c. T-13, s. 48. The same is true of the Industrial Design Act, R.S.C. 1985, c.I-9, s. 13, and the Integrated Circuit Topography Act, S.C. 1990, c. 37, s. 21. "Where the ownership of a trade-mark is transferred, failure to register the change of ownership could lead to the loss of the distinctiveness of the mark. Thus a delay in the registration of an assignment does not negate the transfer, but failure to register in due course may threaten the validity of the mark." TERESA SCASSA, CANADIAN TRADEMARK LAW 123 (2010).

and a first assignee of legal title, or any property interest, would prevail over all subsequent interests, regardless of registration.<sup>68</sup>

The Copyright Act does have a priority provision. Section 57(3) of the Act provides:

Any assignment of copyright, or any licence granting an interest in a copyright, shall be adjudged void against any subsequent assignee or licensee for valuable consideration without actual notice, unless the prior assignment or licence is registered in the manner prescribed by this Act before the registering of the instrument under which the subsequent assignee or licensee claims.<sup>69</sup>

On its face this provision might seem to provide for a first-to-register priority scheme. However, in *Poolman v. Eiffel Productions*,<sup>70</sup> Pinard J. in the Federal Court construed the provision very narrowly. The plaintiff claimed to have obtained an assignment of copyright from the author in 1964.<sup>71</sup> The defendant obtained an assignment of the copyright from the author in 1989.<sup>72</sup> The defendant had no knowledge of the purported prior assignment to the plaintiff.<sup>73</sup> In 1991, the plaintiff presented for registration at the Copyright Office the assignment that had been executed in 1964.<sup>74</sup> The plaintiff claimed priority on the basis either of prior assignment or prior registration.<sup>75</sup> Pinard J. held for the defendant.<sup>76</sup> There are two points of interest. First, Pinard J. held that section 57(3) does not establish a first-to-register priority regime. Indeed, it does not establish any priority regime at all: “the registering of the instrument under which an interest in a copyright is granted is not compulsory and, except as expressly

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<sup>68</sup> Roderick J. Wood, *Security Interests in Intellectual Property: Rationalizing the Registries*, in SECURITY INTERESTS IN INTELLECTUAL PROPERTY 699, 671 (Howard Knopf, ed., 2002).

<sup>69</sup> Copyright Act, R.S.C., 1985, c. C-42 s. 57 (2014).

<sup>70</sup> *Poolman v. Eiffel Productions* (1991), 35 C.P.R. 3d ¶384 (Can. Fed. Ct.).

<sup>71</sup> *Id.* ¶ 2.

<sup>72</sup> *Id.* ¶ 6.

<sup>73</sup> *Id.* ¶ 16.

<sup>74</sup> *Id.* ¶ 2.

<sup>75</sup> *Id.* ¶ 4.

<sup>76</sup> *Id.*

provided . . . in s.57(3) above, creates nothing more than a presumption of ownership of such interest that can be rebutted.”<sup>77</sup> Second, Pinard J. held that ownership was to be determined as a matter of provincial law, which in this case was the law of Quebec, where all the transactions had taken place.<sup>78</sup> On the facts, and relying on the Quebec Civil Code, Pinard J. held that, even if the plaintiff had in fact taken an assignment of the copyright from the author in 1964, the defendant’s later assignment prevailed as being a “commercial sale” without notice of the prior assignment.<sup>79</sup> The defendant was therefore the owner of the copyright.<sup>80</sup>

As Professor Vaver has remarked, *Poolman* effectively “subordinated the whole federal scheme” to provincial law.<sup>81</sup> *Poolman* implies that in a common law province, therefore, the rule of *nemo dat quod non habet* would apply, as discussed above, and a first assignee would prevail whether or not it was the first to register.<sup>82</sup> Indeed, even a first assignee who failed to register at all would prevail, so long as they could prove the assignment, since registration “creates nothing more than a presumption of ownership.”<sup>83</sup>

Vaver describes *Poolman* as “doubtful” on the basis that “[t]he *Copyright Act* provides its own national registration and priority scheme for copyrights. Little room seems left for the different provincial

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<sup>77</sup> *Id.* ¶ 24.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* ¶ 27

<sup>81</sup> DAVID VAVER, COPYRIGHT LAW 248 (2000).

<sup>82</sup> Wood, *supra* note 68.

<sup>83</sup> It is not clear what independent effect Pinard J. would give to s. 57(3). He stated that “This provision of the Copyright Act states only that a prior assignment of an interest in a copyright must be adjudged void as against any subsequent assignee unless such prior assignment is duly registered before the registering of the instrument under which the subsequent assignee claims.” But, it is not clear what this means if it does not apply on the facts of *Poolman* itself. *But cf.* Apotex Inc. v. Wellcome Foundation Ltd., [2002] (2001) 1 F.C. 495, ¶ 100 (Can. Fed. Ct.) (where Rothstein J., in *obiter*, read s.51 of the Patent Act as establishing a first to register priority rule. Patent Act, R.S.C. 1985, c. P-4, s. 51 is in similar terms to Copyright Act, R.S.C., 1985, s. 57(3) (2014)).

schemes to operate.”<sup>84</sup> In his view, under the priority scheme established by section 57(3), registrable interests

usually take priority in order of registration. If the grants are unregistered, the later grant has priority if taken for valuable consideration without actual notice of the prior grant. Otherwise unregistered grants are subordinated to later registered grants, except perhaps where reliance on the registration is fraudulent.<sup>85</sup>

Vaver’s interpretation is a straightforward reading of the provision, and to date *Poolman* has not been judicially re-considered. It is entirely possible that a different court would view the Copyright Act as enacting a complete code, as Vaver suggests.

The priority provision in the Patent Act is section 51:

Every assignment affecting a patent for invention, whether it is one referred to in section 49 or 50, is void against any subsequent assignee, unless the assignment is registered as prescribed by those sections, before the registration of the instrument under which the subsequent assignee claims.<sup>86</sup>

This is in slightly different terms than section 57(3) of the Copyright Act, but it is sufficiently similar that the same problem will arise as to whether it constitutes a complete code.<sup>87</sup> One difference between the two provisions is that section 57(3) specifically subordinates interests taken with actual notice of a prior interest, while section 51 of the Patent Act does not. Nonetheless, it has been held in the patent context that a party taking with actual notice of a prior

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<sup>84</sup> VAVER, *supra* note 81, at 248.

<sup>85</sup> *Id.* at 248-49

<sup>86</sup> Patent Act, R.S.C. 1985, s. 51.

<sup>87</sup> The registration provision of the Plant Breeders’ Rights Act, S.C. 1990, c. 20, s. 31(3), is also in similar terms. The Patent Act priority provisions have recently been amended. . In particular, t s. 51 has been renumbered s. 49(4), and it has been redrafted to read as follows: “A transfer of a patent that has not been recorded is void against a subsequent transferee if the transfer to the subsequent transferee has been recorded.” The new wording does not appear to affect the substance of the provision.

interest will be subordinated, so this difference on the face of the Acts does not amount to a difference in the law.<sup>88</sup>

2. *Priorities relating to licenses.* - Given the uncertainty regarding priority between assignees, it should not be surprising that the priority of licensees is also uncertain. The traditional view is that a license is non-proprietary in nature and that it gives the licensee a mere contractual right against the licensor. Consequently, at common law the *nemo dat* rule of priorities would not apply to give a licensee priority against a subsequent transferee of the intellectual property. On the contrary, the position is that, since equity will not order specific enforcement of the license against a party who was not in privity, a subsequent transferee of the intellectual property will have priority over a prior licensee, even if the subsequent transferee had actual knowledge of the license.<sup>89</sup>

Intellectual property licenses have traditionally been assimilated to licenses generally, as not giving a proprietary interest.<sup>90</sup> The Supreme Court of Canada has said that, under the Copyright Act, an exclusive licensee has “a limited property interest in the copyright,”<sup>91</sup> at least to the extent that an exclusive licensee can sue in its own name, though at the same time the Court confirmed that the interest of a non-exclusive intellectual property licensee is entirely non-proprietary.<sup>92</sup> The Patent Act is even broader; it gives any subordinate interest holder the right to sue in its own name, though the patent owner must be joined.<sup>93</sup> Similarly, under the Trade-marks Act, any licensee can sue in its own name if the owner fails to institute an action at the licensee’s request.<sup>94</sup> In *Heap v. Hartley*, the leading case for the general proposition that an intellectual property license is not proprietary in nature, the question at issue was whether an exclusive

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<sup>88</sup> *Colpitts v. Sherwood* (1927), 3 D.L.R. 7 (Can. C.A.).

<sup>89</sup> *King v. Allen* (1916), 2 A.C. 54 (H.L.); see Richard E. Gold, *Partial Copyright Assignments: Safeguarding Software Licensees Against the Bankruptcy of Licensors*, 33 CAN. BUS. L.J. 193, 206-07 (2000).

<sup>90</sup> *Heap v. Hartley* (1889), 42 Ch.D. 461 (C.A.); *Euro-Excellence Inc. v. Kraft Canada Inc.*, [2007], 3 S.C.R. 20, 28 (Can.).

<sup>91</sup> *Euro-Excellence*, 3 S.C.R. 2 at 22.

<sup>92</sup> *Id.* at 28.

<sup>93</sup> Patent Act, R.S.C. 1985, s. 55.

<sup>94</sup> Trade-marks Act, R.S.C. 1985, s. 50(3).



licensee could sue in its own name.<sup>95</sup> The specific holding in *Heap v. Hartley*, that it cannot, has therefore been legislatively reversed.<sup>96</sup> However, the ability to sue in one's own name is only one indication of a proprietary interest, and it is doubtful that this characteristic would make an exclusive license proprietary for priority purposes as well.<sup>97</sup> In other words, the fact that an exclusive license is proprietary for the purposes of bringing suit probably does not suffice to make it proprietary for priority purposes.

The question, therefore, is the extent to which the statutory priority provisions operate to affect the priority of licensees. As the Trade-marks Act has no priority provisions, the priorities of licenses will depend on provincial law.<sup>98</sup> If *Poolman* is good law, the same is true with respect to patent and copyright licenses, notwithstanding any registration.

If, on the other hand, the statutory provisions of the Copyright Act and the Patent Act do provide a complete code, the priority of licenses will turn on the interpretation of those provisions. Under the Copyright Act, any "licence granting an interest in [a] copyright" is registrable<sup>99</sup> and treated in exactly the same manner as an assignment for priority purposes under section 57(3). It is clear that an interest in a copyright includes an exclusive license, and Professor Vaver has

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<sup>95</sup> *Heap*, 42 Ch.D. at 464-65.

<sup>96</sup> *See generally id.*

<sup>97</sup> The Supreme Court in *Euro-Excellence*, referred to the property interest as "limited" and it cited statutory provisions, inferring that these granted the exclusive licensee the right to sue in its own name; so it may be that the reference to a "limited proprietary interest" was no more than a label for a conclusion regarding the interpretation of the Act on this point, with no wider implications. The Court also stated that the property interest of the exclusive licensee "does not include an interest that defeats the ownership interest of the licensor." *Euro-Excellence*, 3 S.C.R. ¶ 34. This implies, without stating directly, that it could not defeat the ownership interest of a party claiming under the licensor.

<sup>98</sup> The Canadian Intellectual Property Office now allows registration of security interests under that provision; James G. Fogo, *Assignment and Licensing of Trade-marks*, in *TRADE-MARKS LAW OF CANADA* 165, 175 (Gordon F. Henderson, ed., 1993). (The registration provisions of the Trade-marks Act provide for the registration of the "transfer" of any registered mark. At one time "transfer" was interpreted by the Canadian Intellectual Property Office to mean only the outright assignment in full of all rights.)

<sup>99</sup> Copyright Act, R.S.C., 1985, s. 53(2.2) (2014).

argued that it also includes an irrevocable non-exclusive license, especially if the licensee has invested in reliance on the license.<sup>100</sup> If that is so, then irrevocable non-exclusive licenses are both registrable and subject to the same priority rules as assignments.

The Patent Act priority provision is not entirely clear. Exclusive licenses are clearly registrable: section 50(2) provides that every “assignment of a patent, and every grant. . . of any exclusive right. . . shall be registered.”<sup>101</sup> However, the priority provision, section 51, refers only to “every assignment,” and makes no mention of exclusive licenses. On the one hand, it would seem logical that if it is possible to register an exclusive license in the same manner as an assignment, the priority consequences of registration should be the same; on the other hand, the failure to mention exclusive licenses in the priority provision, when they are expressly mentioned in the registration provision, suggests a legislative intent to treat them differently.<sup>102</sup>

Non-exclusive licenses are clearly not registrable at all under the Patent Act. Non-exclusive licenses may also not be registrable under the Copyright Act, as Professor Vaver’s interpretation has never been judicially tested. It is not clear which priority rules apply to unregistrable non-exclusive licenses. If, as Vaver argues, the federal statutes provide a complete code, then federal law and not provincial law should determine the priority of unregistrable interests. But there is no case law as to what such a priority scheme might be. Alternatively,

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<sup>100</sup> David Vaver, *The Exclusive Licence in Copyright*, 9 INTELLECTUAL PROP. J. 163, 189 (1995).

<sup>101</sup> Patent Act, R.S.C. 1985, s. 50(2).

<sup>102</sup> As indicated in note 87, *supra*, the Patent Act priority provisions have recently been amended. Section 50(2) has been renumbered s.49(3), and it has been reworded to read as follows: “The Commissioner shall, subject to the regulations, record the transfer of a patent on the request of the patentee or . . . of a transferee of the patent.” The proposed new provision omits the reference to “any exclusive right.” Consequently, an exclusive license may no longer be registrable, unless the courts read the reference to a “transfer” as including an exclusive license.

provincial law might apply to fill the gaps in the federal priority scheme.<sup>103</sup>

Even if they are registrable, it is generally not practical to register non-exclusive licenses, such as end-user licenses. The result is that a subsequent assignee will probably take clear of non-exclusive licenses. If non-exclusive licenses are not registrable at all, and provincial law applies, then under the common law at least the assignee will take clear, even if it has knowledge of the prior licenses. If they are registrable, but unregistered, then the assignee will take clear unless it has knowledge, as a matter of the statutory priority rules.

As a matter of policy, the basic assimilation of intellectual property licenses to licenses of real or personal property is questionable. An exclusive license of intellectual property is functionally very similar to an assignment, as the licensee's rights are normally exclusive even of the rights of the owner. On the other hand, a non-exclusive license relating to intellectual property is different from a license relating to tangible property. A license relating to tangible property will affect the licensor's ability to make use of the property itself; a license granted to allow the licensee to post advertisements on the wall of a building will prevent the licensor from doing the same. However, this is not true of intellectual property. A non-exclusive license does not prevent the licensor from making use of the intellectual property in any way; it simply prevents the licensor from suing the licensee for infringement. In this respect, giving recognition to the license-holder's rights against a third party assignee does not prejudice the assignee. On the other hand, failing to uphold the license in these circumstances may significantly prejudice the licensee who may have made substantial investments in reliance on the license. Even a non-exclusive licensee may rely heavily on a license, as where a large corporation trains its employees in the use of a suite of office productivity software. The vulnerability of non-exclusive licensees to having their interests defeated by an assignment outside of bankruptcy is therefore problematic as a matter of policy. The unsatisfactory state of the current non-bankruptcy laws in this respect

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<sup>103</sup> This is implied by *Poolman v. Eiffel Productions* (1991), 35 C.P.R. 3d ¶384 (Can. Fed. Ct.), though the point in that case was that the Copyright Act does not provide a priority system at all.

creates a challenge for insolvency law reform: to what extent is it possible or desirable to protect the intellectual property licensee's reliance interest inside bankruptcy without simultaneously undertaking a wholesale reform of the applicable non-bankruptcy rules? We pursue this question below.

## B. Priorities Inside Insolvency Proceedings

1. *Assignments.* - Assume an intellectual property owner, A, assigns its intellectual property to B and later applies for CCAA protection. As part of the CCAA proceedings, A wants to sell its intellectual property to C, perhaps as part of a going concern sale of A's business. Can A sell the intellectual property to C free and clear of B's interest? The starting point is CCAA, section 36, which deals with the sale of assets in CCAA proceedings. CCAA, section 36(1) provides that the debtor may not sell assets outside the ordinary course of business without court approval.<sup>104</sup> Section 36(3) provides that in hearing the case, the court must take account of various factors, including the effects of the proposed sale on creditors and other interested parties.<sup>105</sup> Section 36(6) provides:

The court may authorize a sale . . . free and clear of any security, charge or other restriction and, if it does, it shall also order that other assets of the company or the proceeds of the sale . . . be subject to a security, charge or other restriction in favour of the creditor whose security, charge or other restriction is to be affected by the order.<sup>106</sup>

The provision appears to have been drafted with security interests and the like specifically in mind, and it does not seem to contemplate other third party interests such as the prior assignee of an intellectual property right. However, section 36 would presumably be read subject to the relevant non-bankruptcy law outlined above.<sup>107</sup> On

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<sup>104</sup> CCAA, R.S.C., 1985, s. 36(1).

<sup>105</sup> *Id.* s. 36(3).

<sup>106</sup> *Id.* s. 36(6).

<sup>107</sup> CCAA, R.S.C., 1985, s. 36 is similar to U.S. Bankruptcy Code, 11 U.S.C. § 363; § 363(f) provides specifically for a free and clear sale if "applicable non-bankruptcy law permits sale of such property free and clear of such interest."

this basis, a purchaser of intellectual property in a CCAA, section 36 sale would acquire title subject to any interest which would have priority under applicable non-bankruptcy law. BIA, section 65.13, which applies to BIA proposals, is in similar terms to CCAA, section 36, and so the same analysis applies. There are no corresponding provisions governing the sale of assets in bankruptcy proceedings or receiverships but, in principle, the capacity of a trustee in bankruptcy or a receiver to sell intellectual property free and clear of a prior assignee's claim should be determined by reference to non-bankruptcy law, as described above.

2. *Licenses.* - Now assume that A grants B a license to use its intellectual property and A subsequently applies for CCAA protection. Can A, as part of the CCAA proceedings, sell the intellectual property to C free and clear of B's license? Again, the starting point is the proposition that a purchaser of intellectual property in a CCAA, section 36 sale takes subject to any competing claim that would have priority outside insolvency proceedings. As indicated above, the applicable law outside insolvency proceedings is unsettled. The answer depends on whether the license is registrable so that one or other of the statutory priority rules applies. If not, then applying provincial law, C, who is not party to the license agreement between A and B, is not bound even if C was aware of the license at the date of the transfer.<sup>108</sup> This appears to be the result for trademark licenses and non-exclusive patent licenses, which are not registrable. A different result may follow if the license is registrable and registered, as in the case of an exclusive patent or copyright license. But, as discussed above, there is considerable uncertainty as to application of the Patent Act priority provision and the scope and application of the Copyright Act registration and priority provisions.

As noted above, U.S. law is significantly different in this respect. In the United States, as a general rule, outside bankruptcy an intellectual property transferee is bound by prior licenses.<sup>109</sup> This rule is imported into bankruptcy law by section 363(f) of the Bankruptcy Code, which provides that the trustee may sell assets free and clear of

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<sup>108</sup> See generally *Royal Bank of Canada v. Body Blue, Inc.* (2008), 42 C.B.R. 5th 125 (Can. Ont. SCJ).

<sup>109</sup> See *Keystone Type Foundry v. Fastpress Co.*, 272 F. 242 (2d Cir. 1921).

an interest subject to certain restrictions, including a requirement that “applicable nonbankruptcy law permits sale of such property free and clear of such interest.”<sup>110</sup> One problem with the current Canadian position is that, if the transferee of intellectual property takes free and clear of outstanding licenses, a licensor debtor in CCAA proceedings can do an end run around the restriction in CCAA, section 32(6) on disclaimer of intellectual property licenses: instead of directly disclaiming the license, the debtor can avoid it indirectly by assigning the underlying intellectual property to a third party purchaser. The result may be to seriously compromise the licensee’s reliance interest, which was the very concern CCAA, section 32(6) was enacted to address.<sup>111</sup>

### C. *Nortel* Revisited

As discussed earlier, the terms of Nortel’s patent sale were that buyers would take the patents subject to known licenses and commercial licenses, but free of unknown licenses. The debtor also developed a procedure aimed at giving unknown licensees an opportunity to assert their rights under section 365(n) of the U.S. Bankruptcy Code. Licensees who responded before the specified date became admitted to the “known licenses” fold, which meant that, under the terms of the proposed sale, their rights were enforceable against the purchaser. On the other hand, licensees who failed to respond in time, or at all, were deemed to have elected under section 365(n) to treat their license agreements as terminated. Consequently, the purchaser acquired title to the patents free and clear of licenses in this category.

In *Nortel*, the sale process had to comply with the requirements of both Canadian and U.S. law and, given section 363(f) of the U.S. Bankruptcy Code read in conjunction with U.S. patent law, Nortel would not have been able to sell the patents free and clear of the unknown licenses. This explains why it was forced to take the more round-about route of relying on section 365(n) instead. But if only Canadian law had applied, Nortel could have proceeded under CCAA section 36 (the asset sale provision), in which case the court would

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<sup>110</sup> 11 U.S.C. § 363(f)(1).

<sup>111</sup> The same point applies with respect to BIA, R.S.C. 1985, s. 65.11(7) in relation to BIA proposal proceedings.

probably have applied the priority rules discussed above to determine the rights of the unknown licensees. It is instructive to compare the result in *Nortel* with the result that would have followed if the Canadian priority rules had applied.

In short, the Nortel plan put the licensees in a substantially better position than they would have been in otherwise. First, under the plan the sale was subject to all known and unknown commercial licenses, including end-user license agreements. By contrast, if the Canadian priority rules had applied, the purchasers would have taken free of any such license unless—perhaps—the license was registered or the purchasers had knowledge of it. Second, while the plan provided that the purchasers were to take free and clear of any unknown license other than a commercial license, it gave unknown licensees the opportunity to identify themselves and to avoid extinguishment of their claims. Licenses in this category might have included exclusive licenses—these would certainly have been of the greatest concern to a purchaser—and so, under Canadian law, they would have been registrable, and a registered license probably has priority over the claim of a subsequent transferee. In effect, the plan excused the holders of registrable licenses for their failure to register by giving them a second chance to publicize their claims.

The generosity of the Nortel plan brings into sharp relief the inadequacy of current Canadian law in terms of protecting intellectual property license holders both inside and outside insolvency proceedings. BIA section 65.11(7) and CCAA section 32(6) protect the licensee against extinguishment of its interest following disclaimer by the licensor-debtor. As noted above, however, these reforms are compromised to the extent that the licensor-debtor can sell the underlying intellectual property interest free and clear of current licenses. As it happens, the Nortel plan avoided this concern, but the Nortel plan was substantially shaped by the requirements of United States law, and there can be no guarantee that licensees will be as generously provided for in future cases.

## V. POSSIBLE REFORMS

In the interests of economy, the following discussion focuses mainly on patents.<sup>112</sup> A partial response to the problem identified in Part IV above, would be to amend CCAA, section 36 and the corresponding provision in BIA, section 65.13 to make it clear that the court may authorize a sale of assets, including patents and other intellectual property, free and clear of third party claims, but only if the laws that apply outside insolvency proceedings allow for free and clear sales. This measure would bring the Canadian rules relating to asset sales in insolvency proceedings more closely into line with the U.S. position.

However, in the United States, the laws that apply outside bankruptcy to the enforceability of a patent license against a transferee of the intellectual property are well-established, and they favor the licensee. By contrast, the corresponding Canadian laws are uncertain, under-developed, and outdated. It follows that a comprehensive solution to the issue in *Nortel* requires reform of not only the insolvency laws, but the patent laws as well. Specifically, the patent registration system should be expanded and modernized, and the Patent Act itself should be amended to provide comprehensive and coherent priority rules for competing claims. These new priority rules would apply in insolvency proceedings in the same way they apply outside insolvency, with the result that it would make no difference to the parties' relative entitlements whether the priority issue arises in the context of insolvency proceedings or outside the insolvency system.<sup>113</sup>

A simpler and quicker response might be to amend BIA, section 65.13 and CCAA, section 36 to make it clear that, while the provisions extend to the sale of patents and other intellectual property, the court may not authorize the sale of intellectual property free and

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<sup>112</sup> Somewhat different considerations may apply to other types of intellectual property for which registration is not a requirement.

<sup>113</sup> See INTELLECTUAL PROPERTY INSTITUTE OF CANADA, POSSIBLE AMENDMENTS TO THE PATENT ACT AND PATENT RULES 13 (2013) (the Intellectual Property Institute of Canada has recognized the need for reforms more or less along these lines: “[c]larify interplay between registrations under the *Patent Act/Personal Property Security Act* and bankruptcy proceedings under the *Bankruptcy and Insolvency Act/Companies’ Creditors Arrangement Act*.”).



clear of current licenses.<sup>114</sup> While a quick fix like this might be tempting, given the challenges that would be involved in overhauling the intellectual property laws, the temptation should be resisted. Taking this approach would create a discrepancy between insolvency law and the law that applies outside insolvency proceedings in the treatment of intellectual property licenses. Specifically, the reforms would put the intellectual property licensee in a stronger position, relative to a transferee of the intellectual property, in the transferor's insolvency proceedings than it would be outside insolvency. As a general rule, priority flips of this nature are inadvisable because they encourage parties to use the insolvency laws opportunistically to improve their priority position. Furthermore, the proposed reforms would create a discrepancy between cases where the financially troubled debtor's asset sale takes place in insolvency proceedings and cases where the asset sale is conducted outside the insolvency system. In *Nortel*, the patent sale took place in the course of CCAA and Chapter 11 proceedings. By contrast, Blackberry, another financially troubled technology company, was until recently planning to sell its patent portfolio without relying on the insolvency laws. Had the Blackberry sale gone ahead, licensees' interests would have been governed by the non-bankruptcy priority rules described above. But there is no principled reason why the parties' entitlements, relative to one another, should vary depending on whether the sale happens to take place inside or outside insolvency proceedings.<sup>115</sup>

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<sup>114</sup> Or at least: (1) a prior registered license; (2) a prior unregistered licensee of which the purchaser has knowledge; or (3) a license granted in the ordinary course of the licensor's business (for example, to an end-user).

<sup>115</sup> The reforms proposed above may have conflict of laws implications, for example, where a patent is registered in Jurisdiction A and the patent sale takes place in Jurisdiction B. The conflict of laws issues are complex and require separate study. See LEGISLATIVE REVIEW TASK FORCE (COMMERCIAL) OF THE INSOLVENCY INSTITUTE OF CANADA AND THE CANADIAN ASSOCIATION OF INSOLVENCY AND RESTRUCTURING PROFESSIONALS, REPORT ON THE STATUTORY REVIEW OF THE BANKRUPTCY AND INSOLVENCY ACT AND THE COMPANIES' CREDITORS ARRANGEMENT ACT 8 (2014) (identifying some of the issues). See also UNCITRAL, LEGISLATIVE GUIDE ON SECURED TRANSACTIONS: SUPPLEMENT ON SECURITY RIGHTS IN INTELLECTUAL PROPERTY, Part X., U.N. Sales No. E.11.V.6 (2011).

## CONCLUSION

The Canadian insolvency laws, similar to the U.S. Bankruptcy Code, limit an intellectual property owner's freedom in insolvency proceedings to disclaim licenses it has granted. The purpose of this limitation is to protect the licensee's reliance interest and to prevent disruption of the licensee's business. If the insolvency laws freely allowed disclaimer of intellectual property licenses, they would increase the up-front risk to prospective licensees and might have a chilling effect on the licensing of intellectual property to the detriment of both licensors and licensees.

Logically, this policy should also be reflected in the provisions governing asset sales so that at least as a general rule, it should not be possible for an intellectual property owner in insolvency proceedings to sell the intellectual property free and clear of current licenses. However, while this appears to be the law in the United States, the position in Canada is much less certain. In principle, a Canadian bankruptcy court should approach the issue with reference to the rules which apply outside bankruptcy to priority disputes between competing claims to intellectual property. But the applicable non-bankruptcy laws, as they currently stand, are fragmented, complex, and unsettled. The laws are badly in need of reform.

It might be possible to amend the insolvency laws without also reforming the intellectual property laws. However, this would be a second-best solution. The problem is that it would make the licensee's position stronger or weaker, relative to a transferee of the intellectual property, depending on whether the sale takes place inside or outside insolvency proceedings. In other words, tackling the problem *via* the insolvency laws, without reforming the intellectual property laws, may result in arbitrary case outcomes and may induce debtors to favor asset sales outside the insolvency system with a view to defeating licensees' interests.

In any event, there is some urgency about the need for reform because sales of intellectual property, and patent portfolios in particular, are becoming increasingly common. The uncertain state of the law threatens to reduce the returns from such sales because it means parties must take expensive and time-consuming steps, as in

*Nortel*, to clarify the purchaser's title. It also threatens to reduce the returns from the licensing of intellectual property because, as matters presently stand, a prospective licensee cannot be sure that its license will still be valid if the underlying intellectual property is subsequently transferred.<sup>116</sup>

In today's economy almost every business depends on licensed intellectual property rights to a greater or lesser extent, and consequently every business is potentially exposed to the threat of "hold-up" by patent assertion entities which have acquired intellectual property rights from a licensor in financial distress. This is not a remote or theoretical problem; it is happening regularly around the world. There is no question that the problem will come to Canada, if it has not already. The only question is whether we will be ready when it does arrive.

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<sup>116</sup> See NATIONAL RESEARCH COUNCIL OF THE NATIONAL ACADEMIES, PATENT CHALLENGES FOR STANDARD-SETTING IN THE GLOBAL ECONOMY: LESSONS FROM INFORMATION AND COMMUNICATIONS TECHNOLOGY (2013) (see Chapter 5 dealing with transfers of patents with licensing commitments, and especially Chapter 5.2 discussing recent cases from around the world, including *Nortel*).

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## ONE MORE BRICK IN THE WALL: THE IMPACT OF PERSONAL JURISDICTION OF *EX JURIS* DEFENDANTS ON THE RELATIONSHIP BETWEEN THE UNITED STATES AND CANADA

*Matthew Johnson*

“When I have been in Canada, I have never heard a Canadian refer to an American as a “foreigner.” He is just an “American.” And, in the same way, in the United States, Canadians are not “foreigners,” they are “Canadians.” That simple little distinction illustrates to me better than anything else the relationship between our two countries.”<sup>1</sup>

### INTRODUCTION

The United States and Canada have a lengthy and historical development of their common law and statutory standards for obtaining personal jurisdiction of *ex juris* defendants in civil litigation.<sup>2</sup> The United States’ doctrine has been developing since the mid-nineteenth century.<sup>3</sup> Canada, however, followed a rigid common law

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<sup>1</sup> Sarah Lipkis, *United States of Canada*, WORLD POLICY BLOG (Oct. 22, 2013, 10:18 AM), <http://www.worldpolicy.org/blog/2013/10/22/united-states-canada>(quoting Franklin Delano Roosevelt).

<sup>2</sup> *See generally* Pennoyer v. Neff, 95 U.S. 714 (1878) (stating the proposition that *in personam* jurisdiction cannot be had over an absent defendant, but *in rem* jurisdiction can be had over the absent defendant’s property); *see also* Moran v. Pyle Nat’l (Can.) Ltd., [1975] 1 S.C.R. 393 (discussing *in personam* jurisdiction in tort cases over a foreign defendant).

<sup>3</sup> *See, e.g.,* Pennoyer, 95 U.S. at 727, 731; *see also* J. McIntyre Machinery, Ltd. v. Nicastro, 131 S. Ct. 2780 (2011) (holding a court may not exercise jurisdiction over a defendant that has not purposefully availed itself to doing business within the jurisdiction).

system until the end of the twentieth century.<sup>4</sup> Since 1990, there have been five important cases altering the current Canadian doctrine on personal jurisdiction of *ex juris* defendants.<sup>5</sup> Most recently, the 2012 decision of *Club Resorts Ltd. v. Van Breda* marked a notable shift from its predecessor, *Muscutt v. Courcelles*.<sup>6</sup>

Today, the United States' greatest ally and biggest trading partner is Canada.<sup>7</sup> As China continues to establish itself as a global economic power, retaining close ties is important for both nations.<sup>8</sup> Though executives, legislatures, and judiciaries exercise comity<sup>9</sup> between nations,<sup>10</sup> the judiciary has the ability to influence and control the other branches' exercise of comity through its decisions and interpretations.<sup>11</sup> Because of this significant judicial power, this

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<sup>4</sup> *Muscutt v. Courcelles*, 2002 CanLII 44957 (ON CA).

<sup>5</sup> *Id.* ¶ 14-17 (citing *Tolofson v. Jensen* [1994] 3 S.C.R. 1022; *Amchem Prod. Inc. v. B.C. (Workers' Comp. Bd.)*, [1993] 1 S.C.R. 897; *Hunt v. T&N plc.*, [1993] 4 S.C.R. 289; *Morguard Inv. Ltd. v. De Savoye*, [1990] 3 S.C.R. 1077).

<sup>6</sup> Tanya J. Monestier, *(Still) A "Real and Substantial" Mess: The Law of Jurisdiction in Canada*, 36 *FORDHAM INT'L L.J.* 396, 402 (2013).

<sup>7</sup> *See U.S. Relations with Canada*, U.S. DEPT. OF STATE (Aug. 23, 2013), [www.state.gov/r/pa/ei/bgn/2089.htm](http://www.state.gov/r/pa/ei/bgn/2089.htm) (noting the U.S. and Canada trade \$1.6 billion worth of goods, daily, and three hundred thousand people cross their shared border, daily); *see also*, Doug Lamborn, U.S. Rep. from Colorado, *Building Keystone Pipeline will Cement U.S.-Canadian Relations*, *THE HILL* (Mar. 6, 2013), <http://thehill.com/opinion/op-ed/286669-building-keystone-pipeline-will-cement-us-canada-relations> (describing Canada as the United States' most important trading partner, sharing "close ties in culture, language and values").

<sup>8</sup> *See* Lipkis, *supra* note 1 (discussing the potential benefits of the United States and Canada forming an E.U.-like relationship to combat the efficiency of China's form of capitalism); *When Giants Slow Down*, *ECONOMIST* (July 27, 2013), <http://www.economist.com/news/briefing/21582257-most-dramatic-and-disruptive-period-emerging-market-growth-world-has-ever-seen> (discussing the slowing but steady growth of Brazil, Russia, India, and China).

<sup>9</sup> Comity is defined as "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895).

<sup>10</sup> *See* *Hartford Fire Ins. Co. v. Cal.*, 509 U.S. 764, 817 (1993) (Scalia, J., dissenting) (explaining legislatures practice "prescriptive comity" by limiting the reach of their laws when enacting them).

<sup>11</sup> *See* Donald Earl Childress III, *Comity as Conflict: Resituating International Comity as Conflict of Laws*, 44 *U.C. DAVIS L. REV.* 11, 14 (2010).

comment recognizes the important role courts play in maintaining and increasing comity between the United States and Canada.

This comment will argue that the *Van Breda* decision has moved Canadian courts closer to United States courts on the issue of personal jurisdiction over *ex juris* defendants, which in turn has created increased comity among the two nations. Part II of this comment will introduce the history of personal jurisdiction over *ex juris* defendants in the United States and Canada. Furthermore, Part II will briefly discuss comity and its international role. Part III analyzes the current state of jurisdiction in the United States and compares it with the new Canadian standard set forth in *Van Breda*. Through this comparison, this comment will explore the opportunity for increased comity between the two nations. Part IV proposes that the current positions of both nations regarding personal jurisdiction over *ex juris* defendants allows for greater comity between the two nations, increasing their economic partnership and individual international strength.

- I. Historical Background of Personal Jurisdiction Over *Ex Juris* Defendants in the United States and Canada and the Role of International Comity
  - A. Personal Jurisdiction Over Ex Juris Defendants in the United States

The United States' modern day jurisdiction found its roots in *Pennoyer v. Neff*,<sup>12</sup> but has undergone substantial change, culminating in *Goodyear Dunlop Tires Operations, S.A. v. Brown*.<sup>13</sup>

1. *Pennoyer to International Shoe*. — In *Pennoyer v. Neff*, the United States Supreme Court determined due process does not give a state the authority to assert in personam jurisdiction over an out-of-state defendant who does not personally assent to jurisdiction.<sup>14</sup> In reaching this determination, the Court focused on two “principles of

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<sup>12</sup> *Pennoyer*, 95 U.S. at 730.

<sup>13</sup> See *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S. Ct. 2846 (2011); see generally Michael H. Hoffheimer, *General Jurisdiction After Goodyear Dunlop Tires Operations, S.A. v. Brown*, 60 KAN. L. REV. 549 (2012) (discussing the evolution of Supreme Court rulings on personal jurisdiction).

<sup>14</sup> *Pennoyer*, 95 U.S. at 730 (citing *D’Arcy v. Ketchum*, 52 U.S. 165 (1851)).

public law.”<sup>15</sup> First, every state has jurisdiction over persons and property within its jurisdiction. Second, a state does not have jurisdiction over persons or property beyond its jurisdiction.<sup>16</sup>

Relying on previous state and federal court decisions, however, the *Pennoyer* Court reiterated that a plaintiff who is unable to subject a foreign defendant to *in personam* jurisdiction may attach a defendant’s property within the court’s jurisdiction to hail the defendant into court.<sup>17</sup> But, if the defendant fails to appear, any judgment may “only bind [the defendant] to the extent of such property.”<sup>18</sup> The Court noted the burdens a state may impose upon foreign persons.<sup>19</sup>

In the courtroom, *Pennoyer v. Neff* has essentially become irrelevant.<sup>20</sup> As legal scholar Michael Hoffheimer states, “[i]t is late in the day to argue . . . *Pennoyer*.”<sup>21</sup> However, the court’s reasoning is still relevant to understanding and discussing the connection between due process and personal jurisdiction.<sup>22</sup> With increasing global complexity, the United States Supreme Court found itself needing to shift toward a new doctrine, which could better adjudicate the increased mobility of citizens between different states.<sup>23</sup>

Nearly five decades after *Pennoyer v. Neff* was handed down, the Supreme Court, in an attempt to expand the reach of *Pennoyer*,<sup>24</sup> actually began to subtly shift away from its precedent.<sup>25</sup> The Court in *Hess v.*

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<sup>15</sup> *Id.* at 722.

<sup>16</sup> *Id.* (citing Story, J., Confl. Laws, sect. 539) (emphasis added).

<sup>17</sup> *Id.* at 724-25 (citing *Cooper v. Reynolds* 77 U.S. (10 Wall.) 308 (1870); *Picquet v. Swan*, 5 Mas. 35 (1828)).

<sup>18</sup> *Pennoyer*, 95 U.S. at 724 (citing *Picquet*, 5 Mas. 35).

<sup>19</sup> *Id.* at 734-35 (conditions for marriage/divorce, requiring foreign persons to appoint an agent to receive service of process when entering into a partnership within the state, and conditions for enforcing obligations against corporate officers other than personal service).

<sup>20</sup> See Carol Andrews, *Another Look at General Personal Jurisdiction*, 47 WAKE FOREST L. REV. 999, 1007 (2012).

<sup>21</sup> Hoffheimer, *supra* note 13, at 554.

<sup>22</sup> *Id.* at 554-55.

<sup>23</sup> See Andrews, *supra* note 20, at 1003.

<sup>24</sup> *Id.*

<sup>25</sup> See *Hess v. Pawloski*, 274 U.S. 352, 356-57 (1927) (asserting the power of a state to exclude a non-resident confers upon the state a power to imply appointment of an agent through use of state highways, rendering physical presence

*Pawloski* allowed the state of Massachusetts to serve an out-of-state defendant, who was involved in an accident, pursuant to a Massachusetts statute.<sup>26</sup> The statute stated that in using Massachusetts' highways, a driver appoints the registrar as his agent for service of process.<sup>27</sup> Thus, once a driver enters Massachusetts, he impliedly consents that a state official may act as his agent, thereby making it possible for the state to obtain jurisdiction over him in the event he is involved in an accident or collision within the State's borders.<sup>28</sup> Despite citing numerous authorities,<sup>29</sup> all of which appeared to direct the court toward a strict *Pennoyer* ruling, the Court opted to base its decision on public policy reasons.<sup>30</sup> By using this type of analysis, as well as relevant case law,<sup>31</sup> the Court determined that whether the appointment of a state officer is formal or implied is "not substantial" so far as the Fourteenth Amendment is concerned.<sup>32</sup> Thus, by allowing an implied appointment of an agent by non-resident drivers, the Court had a manner in which it could obtain jurisdiction over the non-resident driver, and despite not having attachable property it could enforce a judgment as *Pennoyer* would allow.

While *Hess* helps illustrate the difficulties courts faced in applying *Pennoyer* to modern America, it did not address the difficulties associated with determining jurisdiction over corporations.<sup>33</sup> Courts formulated different rules to define when a state could and could not claim jurisdiction over a corporation doing business within its boundaries.<sup>34</sup> The Supreme Court tried to settle the split in 1945 and

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in the territory unnecessary for service); see also Wendy Collins Perdue, *What's "Sovereignty" Got to Do with It? Due Process, Personal Jurisdiction, and the Supreme Court*, 63 S.C. L. REV. 729 (2012) (noting the court shifted the analysis from whether Massachusetts lacked authority to serve the defendant, rendering any judgment as contrary to the Due Process Clause, to whether enactment of the statute violated the Due Process Clause).

<sup>26</sup> 90 Gen. Laws Mass. as amended by Stat. 1923, c. 431, § 2.

<sup>27</sup> See *Hess*, 274 U.S. at 356-57.

<sup>28</sup> *Id.* at 356-57.

<sup>29</sup> See *id.* at 355 (citing e.g. *Flexner v. Farson*, 248 U.S. 289 (1918); *Goldey v. Morning News*, 156 U.S. 518 (1894); *Pennoyer*, 95 U.S. 714).

<sup>30</sup> See *Hess*, 274 U.S. at 356.

<sup>31</sup> See *id.* at 356 (quoting *Kane v. New Jersey*, 242 U.S. 160, 167 (1916)).

<sup>32</sup> *Hess*, 274 U.S. at 357.

<sup>33</sup> See *Andrews*, *supra* note 20, at 1007.

<sup>34</sup> *Id.*



provide a universal standard in determining jurisdiction over corporations.<sup>35</sup>

2. *International Shoe*. — In *International Shoe Company v. Washington*, the Supreme Court ruled that the Due Process Clause of the Fourteenth Amendment embodies substantive criteria for deciding personal jurisdiction issues.<sup>36</sup> Criticism has been levied against the Court, however, for its vagueness in defining what general jurisdiction entails.<sup>37</sup>

*International Shoe Company* was a St. Louis-based company, which sent sample shoes to approximately eleven agents located in the state of Washington *et alibi*.<sup>38</sup> Washington wanted to collect employment taxes, which were due from *International Shoe*.<sup>39</sup> Notice was served to *International Shoe*'s agent in Washington and by certified mail to its home office.<sup>40</sup> *International Shoe* argued that its activities in Washington were not “sufficient to manifest its ‘presence,’” and thus, the state of Washington violated its due process rights in subjecting it to suit.<sup>41</sup>

In his majority opinion, Chief Justice Stone analyzed *Pennoyer*-era decisions<sup>42</sup> and determined that the satisfaction of due process in personal jurisdiction “depend[s] rather upon the quality and nature of the activity . . . .”<sup>43</sup> Based on this principle, Chief Justice Stone announced what is known as the “minimum contacts” doctrine.<sup>44</sup> As stated by Chief Justice Stone, “due process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present

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<sup>35</sup> See *Int'l Shoe Co. v. Wash.*, 326 U.S. 310 (1945).

<sup>36</sup> Perdue, *supra* note 25, at 733.

<sup>37</sup> See *Int'l Shoe*, 326 U.S. 310 (Black, J., concurring); Hoffheimer, *supra* note 13; Kevin C. McMunigal, *Desert, Utility, and Minimum Contacts: Toward a Mixed Theory of Personal Jurisdiction*, 108 YALE L.J. 189, 189 (1998); Perdue, *supra* note 25 at 734-35.

<sup>38</sup> *Int'l Shoe*, 326 U.S. at 313.

<sup>39</sup> *Id.* at 312-13. The commissions received by the salespersons were in excess of \$31,000.

<sup>40</sup> *Id.*

<sup>41</sup> *Int'l Shoe*, 326 U.S. at 315.

<sup>42</sup> Andrews, *supra* note 20, at 1008.

<sup>43</sup> *Int'l Shoe*, 326 U.S. at 319.

<sup>44</sup> *Id.* at 316.

within the territory of the forum, he have certain minimum contacts with it. . . .”<sup>45</sup> Chief Justice Stone continued to rule that, “the maintenance of the suit [can] not offend ‘traditional notions of fair play and substantial justice.’”<sup>46</sup>

Chief Justice Stone’s “minimum contacts” doctrine provides no real guidance on how courts are to determine a corporation’s presence within a certain jurisdiction.<sup>47</sup> To better substantiate its new standard, the Court returned to the *Pennoyer* era and sorted cases into one of four categories.<sup>48</sup> The categories assist in determining whether a corporation has sufficient minimum contacts with a forum state to allow jurisdiction.<sup>49</sup> Chief Justice Stone asserts that those cases involving continuous and systematic activities related to the claim at bar, and cases involving isolated incidents not related to the claim at bar are obvious cases in which jurisdiction could be conferred and not conferred, respectively.<sup>50</sup> Conversely, those cases involving continuous activities not related to the claims at bar or single occasional acts by a corporate agent make the jurisdictional determination more difficult.<sup>51</sup>

The “minimum contacts” doctrine has served as an expansion of the basic principles set forth in *Pennoyer v. Neff* and its progeny.<sup>52</sup> The new test serves as a policy-based and flexible analytical approach,

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<sup>45</sup> *Id.*; *but see, id.* at 322 (Black, J., concurring) (the Court went too far by announcing its new due process rule).

<sup>46</sup> *Int’l Shoe*, 326 U.S. at 316 (quoting *Miliken v. Meyer*, 311 U.S. 457, 463 (1940)); *see also* *McDonald v. Mabee*, 243 U.S. 90, 91 (1917)).

<sup>47</sup> *See* Hoffheimer, *supra* note 13, at 561 (“the court’s new ‘minimum contacts’ requirement added little more than the appropriate label when a court decided that a case satisfied constitutional requirements.”); *See also* Douglas D. McFarland, *Drop the Shoe: A Law of Personal Jurisdiction*, 68 MO. L. REV. 753, 761 (2003) (criticizing the minimum contacts test).

<sup>48</sup> *See* Hoffheimer, *supra* note 13, at 558-61 (describing the four categories as cases involving: (1) a corporation’s continuous and systematic contacts within a state; (2) the casual presence of a corporate agent, or an isolated incident unrelated to the claims at bar; (3) continuous and systematic contacts distinct from the causes of action; and (4) single occasional acts by an agent in the state).

<sup>49</sup> *See id.*

<sup>50</sup> *Int’l Shoe*, 326 U.S. at 317.

<sup>51</sup> *Id.* at 318.

<sup>52</sup> Hoffheimer, *supra* note 13, at 561.

taking into consideration concerns like fairness, to both states and corporations.<sup>53</sup>

3. *Onward Ho!: Development of the “Minimum Contacts” Doctrine.* — Since the ruling of the “minimum contacts” doctrine in *International Shoe Co. v. Washington*, the United States Supreme Court has proceeded to split personal jurisdiction into two categories. These categories are 1) specific, “case-linked” jurisdiction, and 2) general jurisdiction.<sup>54</sup>

The specific, case-linked category of cases has been bifurcated to examine, first, the minimum contacts of a corporation within the forum, and second, the fairness of hailing the corporation into such forum.<sup>55</sup> Furthermore, the Court has continued to apply this analysis to the realm of products liability cases, adopting a “stream of commerce” doctrine.<sup>56</sup>

The second category, general jurisdiction, involves the two categories of cases proffered in *International Shoe* in which personal jurisdiction determinations are obvious.<sup>57</sup> The following subsections will discuss each of the categories with more detail.<sup>58</sup>

a. *Stream of commerce and fairness.* — In *World Wide Volkswagen Corp. v. Woodson*, the Supreme Court set forth a “stream

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<sup>53</sup> See *Int’l Shoe*, 326 U.S. 310; see also Hoffheimer, *supra* note 13, at 561; McFarland, *supra* note 47, at 761; McMunigal, *supra* note 37, at 195-96.

<sup>54</sup> Taylor Simpson-Wood, *In the Aftermath of Goodyear Dunlop: Oyez! Oyez! Oyez! A Call for a Hybrid Approach to Personal Jurisdiction in International Products Liability Controversies*, 64 BAYLOR L. REV. 113, 116 (2012).

<sup>55</sup> *Id.* at 117.

<sup>56</sup> See *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980).

<sup>57</sup> See *Int’l Shoe*, 326 U.S. at 317 (cases involving continuous and systematic activities related to the claim at bar are cases in which jurisdiction could obviously be conferred, while cases of isolated incidents not related to the claim at bar are situations in which jurisdiction could obviously not be conferred); see also Simpson-Wood, *supra* note 54, at 118 (describing these cases as those in which “a foreign defendant’s contacts with the forum do not relate to the cause of action, but are “so ‘continuous and systematic’ as to render them essentially at home in the forum state”) (citing *Goodyear Dunlop Tires Operations, S.A.*, 131 S. Ct. at 2851 (quoting *Int’l Shoe*, 326 U.S. at 317)).

<sup>58</sup> The “minimum contacts” portion of category one will not be discussed, as it was expounded upon in the previous section.

of commerce” standard by determining whether a corporation “purposefully availed” itself to the forum.<sup>59</sup> The Court based this doctrine on fairness.<sup>60</sup> In doing so, the Court listed five factors to be considered in determining whether it is fair to hail a defendant into court in a particular forum: (1) the defendant must have a relationship with the forum which would make it “reasonable . . . to require the corporation to defend the particular suit which is brought there,” (2) the interest of the forum state in adjudicating the dispute, (3) “the plaintiff’s interest in obtaining convenient and effective relief,” (4) the interest of the entire interstate judicial system in the most efficient resolution of controversies, and (5) the interest of States in “furthering fundamental substantive social policies.”<sup>61</sup>

*World Wide Volkswagen* involved New York residents who were injured when their car, purchased in New York, exploded in Oklahoma.<sup>62</sup> The plaintiffs brought suit against the vehicle’s regional distributor, World-Wide Volkswagen, and its retail dealer, Seaway, *inter alia*.<sup>63</sup> Seaway only sold cars in Massena, New York, and World-Wide’s market only extended to New York, New Jersey, and Connecticut.<sup>64</sup>

In determining the defendants could not be brought into court in Oklahoma, the Court founded its reasoning in fairness.<sup>65</sup> It did so through a two-prong approach based in the Due Process Clause of the Fourteenth Amendment.<sup>66</sup>

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<sup>59</sup> See *World-Wide Volkswagen*, 444 U.S. at 297-98; See also *Gray v. American Radiator & Standard Sanitary Corp.*, 22 Ill. 2d 432, 441 (1961) (that stream of commerce was originally espoused in this case).

<sup>60</sup> See *World-Wide Volkswagen*, 444 U.S. at 292.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 288.

<sup>63</sup> See *id.* (The plaintiffs argued that it was foreseeable that cars sold by World-Wide and Seaway would travel to Oklahoma. From this the plaintiffs asserted World-Wide and Seaway had minimum contacts necessary to attain personal jurisdiction).

<sup>64</sup> See *id.* at 298.

<sup>65</sup> See *World-Wide Volkswagen*, 44 U.S. at 294.

<sup>66</sup> See *id.* at 292, 297-99; see also *Andrews*, *supra* note 20, at 1010-11.

Professor Carol Andrews<sup>67</sup> explains that the first prong ensures protection to foreign defendants by limiting the ability of states to exceed their jurisdiction as “coequal sovereigns in a federal system.”<sup>68</sup> This is evident when Justice White writes, “[we] stress[] that the Due Process clause ensures not only fairness, but also the ‘orderly administration of the laws.’”<sup>69</sup>

The second prong protects the defendant from litigating in an inconvenient forum by examining facts within the five factors listed by the court.<sup>70</sup> In applying the second prong, Justice White notes that fairness under the Due Process Clause does not turn on a defendant’s ability to foresee that its product may end up in a specific forum.<sup>71</sup> Rather, a defendant’s “conduct and connection with the forum state” must be “such that . . . [through its] purposeful[] avail[ment] . . . it has clear notice that it is subject to suit there, and can act to alleviate the risk of burdensome litigation.”<sup>72</sup>

Professor Wendy Perdue<sup>73</sup> has argued that the *World Wide Volkswagen* Court’s interpretation of the Due Process Clause shifted the Clause away from a procedural jurisdiction safeguard to a substantive “defendant-focused approach.”<sup>74</sup> This criticism certainly carries some merit, as Justice White writes that even when fairness is not lacking, the Due Process Clause may “divest the State of its power to render a valid judgment.”<sup>75</sup> Regardless of Professor Perdue’s, and other scholars’, critical view of the Court’s reasoning in *World Wide Volkswagen*, gaining *in personam* jurisdiction over a foreign defendant

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<sup>67</sup> Douglas Arant Professor of Law, University of Alabama School of Law.

<sup>68</sup> See Andrews, *supra* note 20, at 1010 (quoting *World-Wide Volkswagen*, 44 U.S. at 292).

<sup>69</sup> *World-Wide Volkswagen*, 44 U.S. at 293-94 (quoting *Int’l Shoe*, 326 U.S. at 319).

<sup>70</sup> See Andrews, *supra* note 20, at 1010-11.

<sup>71</sup> See *World-Wide Volkswagen*, 44 U.S. at 297.

<sup>72</sup> *Id.*

<sup>73</sup> Dean, University of Richmond School of Law.

<sup>74</sup> See Perdue, *supra* note 25, at 733-34 (commenting that the Court incorrectly restates the holding from *Pennoyer v. Neff* allowing it to shift the Due Process Clause from a mechanism for a procedural challenge of jurisdiction to a substantive standard by which to assess a jurisdictional challenge).

<sup>75</sup> *World-Wide Volkswagen*, 44 U.S. at 294.

requires a fairness examination under the Due Process Clause.<sup>76</sup> However, prior to the fairness examination, the defendant had to purposefully avail himself to that jurisdiction by introducing his product into that jurisdiction's stream of commerce; the mere possibility of the product entering the foreign jurisdiction was not enough.<sup>77</sup>

Later cases have followed the fairness standard established in *World-Wide Volkswagen*.<sup>78</sup> In *Keeton v. Hustler Magazine Inc.*, the plaintiff sought jurisdiction in New Hampshire to bring suit against Hustler Magazine.<sup>79</sup> In holding that New Hampshire had jurisdiction to hear the plaintiff's claim, the Supreme Court reasoned Hustler Magazine had sufficient minimum contacts in New Hampshire<sup>80</sup> such that it was fair to compel the magazine to face suit in New Hampshire.<sup>81</sup> Beyond the extent of Hustler's sales in New Hampshire, the Court based its reasoning of fairness on the second *World Wide Volkswagen* factor, stating that New Hampshire had a strong interest in holding Hustler accountable for libel committed within its jurisdiction.<sup>82</sup> This interest is created because Hustler's libel of Keeton harms both Keeton and New Hampshire's own citizens who read Hustler's publication.<sup>83</sup>

*Burger King Corp. v. Rudzewicz*<sup>84</sup> made a very subtle but important change to the original two-prong standard established in *World-Wide*

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<sup>76</sup> See *id.* at 294-95.

<sup>77</sup> See *id.* at 297-98.

<sup>78</sup> See *Keeton v. Hustler Magazine, Inc.*, 465 U.S. 770 (1984); see also *Asahi Metal Indus. Co. v. Superior Court of Cal.*, 480 U.S. 102 (1987); see also *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

<sup>79</sup> Plaintiff Keeton assisted in the production of Hustler Magazine. Her name appears in several places on the magazines. Hustler sold approximately 10,000-15,000 copies of Hustler Magazine in New Hampshire. Plaintiff sued Hustler, claiming Hustler libeled her in five separate issues of its magazine. Keeton brought suit in New Hampshire, claiming New Hampshire could exert personal jurisdiction over Hustler. Neither plaintiff nor defendant was a resident of New Hampshire. *Keeton*, 465 U.S. at 772.

<sup>80</sup> See *id.* (Hustler sold approximately 10,000 to 15,000 copies of its magazines each month in New Hampshire.).

<sup>81</sup> *Id.* at 781.

<sup>82</sup> See *Keeton*, 465 U.S. at 775-76.

<sup>83</sup> See *id.*

<sup>84</sup> Defendants Rudzewicz and MacShara entered into a franchising agreement with Burger King Corp. Burger King was headquartered in Miami,

*Volkswagen*.<sup>85</sup> Above the surface, the Court's holding was quite simple and aligned with its predecessors.<sup>86</sup> According to the Court, the contract between Rudzewicz and Burger King created a "continuing obligation" between himself and Burger King, a resident of Florida, thereby availing himself of the "privilege of conducting business there . . . [and being] shielded by [Florida's] laws."<sup>87</sup> Thus, it was foreseeable that he may be brought into court in Florida.<sup>88</sup>

Below the surface, however, Justice Brennan attempted to shift the Court away from a strong defendant-centered minimum contacts test by redefining the burden of proof required to defeat personal jurisdiction.<sup>89</sup> Brennan made clear that, once the plaintiff has proven the existence of a contact, the defendant has what Professor Richard Freer<sup>90</sup> calls a "strikingly onerous burden."<sup>91</sup> That burden requires the defendant to present a "compelling case" showing jurisdiction to be "so gravely difficult and inconvenient [he] . . . is at a severe disadvantage in comparison to his opponent."<sup>92</sup> As a result of the increased burden on the defendant, much of the Court's discussion in subsequent cases has focused on the contacts of a defendant with a forum more than the fairness of hailing a defendant into a particular forum.<sup>93</sup>

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Florida, but had a regional office in Michigan. The franchising agreement required payments over a twenty-year period, which would total more than one million dollars. Defendants fell behind on payments to Burger King and subsequently entered into negotiations with Burger King's Michigan and Florida offices to settle payment issues. After negotiations broke down, Burger King filed suit in Florida. *Burger King*, 471 U.S. at 464-68.

<sup>85</sup> See Richard D. Freer, *Personal Jurisdiction in the Twenty-First Century: The Ironic Legacy of Justice Brennan*, 63 S.C. L. REV. 551, 570-72 (2012).

<sup>86</sup> See *Burger King*, 471 U.S. at 462 (a Michigan defendant had contracted with a Florida corporation, which, according to the court, fairly availed him to Florida's jurisdiction since the contract had an abundance of requirements, all having a connection with Florida).

<sup>87</sup> *Id.* at 476.

<sup>88</sup> *Id.* at 474.

<sup>89</sup> See Freer, *supra* note 85, at 571-72.

<sup>90</sup> Robert Howell Hall Professor of Law, Emory University School of Law.

<sup>91</sup> *Id.* at 572.

<sup>92</sup> *Burger King*, 471 U.S. at 477-78 (quoting *Bremen v. Zapata-Off Shore Co.*, 407 U.S. 1, 18 (1972)).

<sup>93</sup> See Freer, *supra* note 85, at 574-76, 581, 589.

Interestingly, despite the increased burden of proof on the defendant, two years later, in *Asahi Metal Indus. Co. v. Superior Court of Cal.*,<sup>94</sup> the Court used the fairness standard to find that Asahi could not be brought into court in California.<sup>95</sup> Justice O'Connor and three other justices determined that, in addition to jurisdiction being unfair, California lacked sufficient contacts with Asahi.<sup>96</sup> The Court reasoned that "[t]he 'substantial connection' between the defendant and the forum State necessary for a finding of minimum contacts must come about by *an action of the defendant purposefully directed toward the forum State.*"<sup>97</sup> Simple awareness by a defendant that its product will be swept into a particular forum through a stream of commerce does not amount to purposefully directing its product toward that state by placing the product within such stream.<sup>98</sup>

Post-*Asahi*, to gain specific personal jurisdiction over a defendant, a forum must survive a two-prong approach.<sup>99</sup> First, it must prove minimum contacts between the defendant and the forum.<sup>100</sup> In the case of a corporation the Court will look to whether or not the defendant purposefully placed its product in the stream of commerce.<sup>101</sup> Second, it must prove that it is fair to hail the defendant into the forum.<sup>102</sup> With the post-*Burger King* increased burden of proof upon the defendant to rebut jurisdiction by arguing the forum is unfair,

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<sup>94</sup> Plaintiff was a California citizen whose wife died in a motorcycle crash after one of the tires blew out. Plaintiff brought suit against Cheng Shin Rubber Industrial Co., Ltd. Cheng Shin sought indemnification from Asahi Metal Indus. Co. Cheng Shin bought parts from Asahi and incorporated those parts in tires it sold. Cheng Shin did approximately twenty percent of its business in the United States. Asahi has no offices, property, or agents in California. Its offices were located in Japan. *Asahi*, 480 U.S. 102.

<sup>95</sup> See *Asahi*, 480 U.S. at 114; see also *Burger King*, 471 U.S. at 576 (*Asahi* is the only case in which fairness was used to reject jurisdiction).

<sup>96</sup> Freer, *supra* note 85, at 574-75.

<sup>97</sup> *Asahi*, 480 U.S. at 112.

<sup>98</sup> *Id.*

<sup>99</sup> See Freer, *supra* note 85, at 552-53; see also Andrews, *supra* note 20, at 1010-11.

<sup>100</sup> See *Int'l Shoe*, 326 U.S. 310.

<sup>101</sup> See *World-Wide Volkswagen*, 444 U.S. at 297-98.

<sup>102</sup> See *id.*



defendants' best chance of overcoming jurisdiction is proving a lack of contacts, and the case law has reflected this shift towards contacts.<sup>103</sup>

*b. Goodyear v. Brown: A look at general jurisdiction.* – As discussed earlier, Chief Justice Stone in *International Shoe* classified two categories of cases: those in which the alleged acts are tied directly to the contacts of the defendant and those in which the alleged acts are not tied to the contacts of the defendant.<sup>104</sup> Professor Carol Andrews has termed cases: in which the alleged acts are tied directly to the defendant's "continuous and systematic" contacts as "easy yes" cases; in which the defendant had "isolated" contacts with the forum or the alleged acts are not tied to those contacts as "easy no" cases; in which the defendant's contacts were extensive but the alleged acts were unrelated or instances where the defendant's contacts were "isolated" but the alleged act was tied to those contacts as "maybe" cases.<sup>105</sup>

Andrews further notes that the "easy yes" cases and the "maybe" cases involving isolated but related contacts have been termed by the court as specific jurisdiction.<sup>106</sup> Those cases were discussed above. This subsection seeks to inform the reader as to the Court's position on the "easy no" and continuous but unrelated contacts cases, now termed general personal jurisdiction.<sup>107</sup>

The most recent case involving general personal jurisdiction is *Goodyear Dunlop Tire Operations v. Brown*.<sup>108</sup> The defendant contested jurisdiction in North Carolina as improper.<sup>109</sup> The defendants had no connections to North Carolina outside of their parent company and a small fraction of tires they sold in North Carolina, typically custom ordered for specific vehicles.<sup>110</sup> According to the Court, the "paradigm forum for the exercise of general jurisdiction . . . for a corporation

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<sup>103</sup> See Freer, *supra* note 85, at 589.

<sup>104</sup> See *Int'l Shoe*, 326 U.S. at 317-18; see also Hoffheimer, *supra* note 13.

<sup>105</sup> See Andrews, *supra* note 20, at 1008-09.

<sup>106</sup> *Id.* at 1009.

<sup>107</sup> See *id.* at 1009-10.

<sup>108</sup> *Goodyear*, 131 S. Ct. at 2848 (subsidiaries of Goodyear U.S.A. were sued by the parents of children killed when a bus, using tires manufactured by the subsidiaries, rolled over near Paris, France).

<sup>109</sup> *Id.* at 2852.

<sup>110</sup> *Id.*

[is] . . . one in which [it] is fairly regarded as at home.”<sup>111</sup> Hoffheimer states that the Court understands “at home” as relating to the defendant’s state of incorporation, its principal place of business, and potentially anywhere in which it has “substantial, continuous, and systematic activity.”<sup>112</sup> Using the paradigmatic forum analysis, the Court determined that the defendant subsidiaries’ connections to North Carolina “fall far short of the ‘continuous and systematic general business contacts’ necessary” for jurisdiction over them on claims “unrelated to anything that connects them to the State.”<sup>113</sup>

In reaching its conclusion, the Court contrasted the prior case of *Perkins v. Benguet Consol. Mining Co.*<sup>114</sup> Perkins involved a Philippine mining company which ceased its operations to Ohio during World War II.<sup>115</sup> The company’s president maintained an office in Ohio and supervised its mining activities from the Ohio office.<sup>116</sup> The Court in *Perkins* found that, because Ohio was the principal place of business, even temporarily, general jurisdiction was proper in Ohio.<sup>117</sup>

The Court also compared another prior case, *Helicopteros Nacionales de Colombia, S.A. v. Hall*,<sup>118</sup> in which general jurisdiction in Texas was found improper when a Colombian helicopter operation company was sued in a wrongful death suit.<sup>119</sup> The defendant’s only ties to Texas were: acceptance of checks drawn on a Houston bank account; helicopters, equipment, and training services purchased from a Texas corporation; and personnel training in Texas.<sup>120</sup> The *Helicopteros* Court concluded “‘mere purchases [made in the forum State], even if occurring at regular intervals, are not enough [for general] jurisdiction

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<sup>111</sup> *Id.* at 2853-54.

<sup>112</sup> *See* Hoffheimer, *supra* note 13, at 551.

<sup>113</sup> *Goodyear*, 131 S. Ct. at 2857 (citing *Helicopteros Nacionales de Colombia S.A. v. Hall*, 466 U.S. 408, 416 (1984)).

<sup>114</sup> *See* *Perkins v. Benguet Consol. Mining Co.*, 342 U.S. 437 (1952).

<sup>115</sup> *Goodyear*, 131 S. Ct. at 2856.

<sup>116</sup> *Perkins*, 342 U.S. at 447-48.

<sup>117</sup> *See Goodyear*, 131 S. Ct. at 2856; *see also Perkins*, 342 U.S. 437.

<sup>118</sup> *Helicopteros*, 466 U.S. 408.

<sup>119</sup> *See id.* at 415-16.

<sup>120</sup> *See Goodyear*, 131 S. Ct. at 2856 (quoting *Helicopteros*, 466 U.S. at 416).

over a non-resident corporation” when the purchase transactions are not related to the cause of action.<sup>121</sup>

The *Goodyear* Court leaned towards the reasoning of *Helicopteros*, indicating that the only way in which systematic activity within a forum will allow for general jurisdiction is if such activity takes place at extremely high volumes.<sup>122</sup>

After *Goodyear*, the state of general jurisdiction is not fully known.<sup>123</sup> It appears that the Court stripped general jurisdiction down to the point that it is only applicable in cases in which the corporation is, literally, “at home” in the forum.<sup>124</sup>

Thus, to obtain jurisdiction over an *ex juris* defendant in the United States, a forum must be able to obtain either specific jurisdiction, which is focused on minimum contacts and fairness, or general jurisdiction, which is focused on whether the defendant is “at home.” The *Goodyear* court informed us that, since *International Shoe*, the Supreme Court has focused primarily on cases involving specific personal jurisdiction.<sup>125</sup> Nevertheless, general jurisdiction still exists as an option for plaintiffs who cannot obtain specific jurisdiction over a defendant.

Having surveyed the development of American jurisprudence on personal jurisdiction over *ex juris* defendants, we must proceed to survey such jurisprudence in Canada.

#### B. Personal Jurisdiction Over Ex Juris Defendants in Canada

Modern day personal jurisdiction in Canada is rooted in the English House of Lords, which developed a “real and substantial

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<sup>121</sup> See *id.* at 2856 (quoting *Helicopteros*, 466 U.S. at 418).

<sup>122</sup> See Hoffheimer, *supra* note 13, at 592; *but see* Freer, *supra* note 85, at 587-88 (arguing that even high levels of sales activity is unlikely to justify general personal jurisdiction).

<sup>123</sup> See Hoffheimer, *supra* note 13, at 551.

<sup>124</sup> See Hoffheimer, *supra* note 13, at 551; *see also* Freer, *supra* note 85, at 585.

<sup>125</sup> See *Goodyear*, 131 S. Ct. at 2854.

connection” test.<sup>126</sup> After *Indyka*, the real and substantial connection test was employed three more times before, in 1990, becoming “enshrined as a central jurisdictional principle” in *Morguard Investments Ltd. v. De Savoye*.<sup>127</sup>

In 1993, *Hunt v. T&N PLC*, made clear that the principles enunciated in *Morguard* were constitutionally founded.<sup>128</sup> Over the next nineteen years, the Supreme Court of Canada defined what a “real and substantial” connection was, culminating its efforts in its 2012 decision of *Club Resorts Ltd. v. Van Breda*.<sup>129</sup> This section will summarily track the Supreme Court of Canada’s development of the real and substantial connection test from its roots in *Indyka* to its current state following *Van Breda*.

1. *Early Development of the “Real and Substantial Connection” Doctrine.* — The real and substantial connection doctrine originated in the English case *Indyka v. Indyka*.<sup>130</sup> Prior to *Indyka*, an English woman’s ability to obtain a divorce was dependent upon a set of particular rules.<sup>131</sup> With the introduction of the real and substantial connection test, the previous rules were replaced by a general principle revolving around the strength of a person’s connection with a particular forum.<sup>132</sup> The Supreme Court of Canada expanded the use of the real and substantial connection test, in *Moran v. Pyle National (Canada) Ltd.*, to torts.<sup>133</sup>

In *Moran*, the Supreme Court of Canada held it reasonable to find a real and substantial connection with a forum, thereby allowing that forum to have jurisdiction, if a defendant could reasonably foresee that its product would cause injury and be used and consumed in the

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<sup>126</sup> Joost Blom, Q.C. & Elizabeth Edinger, *Conflicts of Law: The Chimera of the Real and Substantial Connection Test*, 38 U.B.C.L. REV. 373, 374-76 (2005)(stating that the English case *Indyka v. Indyka* established a more uniform system of divorce).

<sup>127</sup> *Id.* at 377-78.

<sup>128</sup> *Id.* at 378, 385.

<sup>129</sup> See generally, Blom, *supra* note 126; Peter J. Pliszka, *My Place or Yours? SCC Sets New and Improved Test for Jurisdiction in Canada*, 80 DEF. COUNS. J. 273 (2013).

<sup>130</sup> See Blom, *supra* note 126, at 375.

<sup>131</sup> *Id.* at 375-76.

<sup>132</sup> *Id.* at 376.

<sup>133</sup> See *Moran v. Pyle National (Can.) Ltd.*, [1975] 1 S.C.R. 393, 408-09; see also Blom, *supra* note 126, at 377.

foreign jurisdiction.<sup>134</sup> The Court's decision resembled its American counterpart's stream of commerce inquiry.<sup>135</sup> Like the Court in *World-Wide Volkswagen*, the *Moran* Court would require a strong enough relationship between the defendant and the forum to make it fair to require the defendant to litigate in the foreign forum.<sup>136</sup>

The *Moran* holding further compares with the American tort case of *Calder v. Jones*.<sup>137</sup> The United States Supreme Court held in *Calder* that California could assert jurisdiction over two Florida journalists, with essentially no contacts to California, because they wrote a libelous story about a California citizen with the knowledge and expectation that it would be widely circulated in California.<sup>138</sup> In both cases, the American and Canadian Supreme Courts showed they were willing to extend a stream of commerce-like analysis to tort cases.

Almost two decades after *Moran*, the Supreme Court of Canada once again relied on the real and substantial connection test.<sup>139</sup> In *Morguard v. De Savoye*, the Supreme Court of Canada addressed the issue of whether a judgment in one province could be recognized by another.<sup>140</sup> In determining that the Alberta judgment should be recognized in British Columbia, La Forest J. focused on balancing order and fairness.<sup>141</sup> Order, La Forest J. opined, dictates that a foreign provinces' judgment should be recognized across Canada for reasons

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<sup>134</sup> *Moran*, [1975] 1 S.C.R. (Can.) at 409.

<sup>135</sup> *See Asabi*, 480 U.S. 102; *World-Wide Volkswagen*, 444 U.S. 286 (1980); *see also Calder v. Jones*, 465 U.S. 783 (1984).

<sup>136</sup> *See World-Wide Volkswagen*, 444 U.S. at 292; *Moran*, [1975] 1 S.C.R. at (Can.) 409.

<sup>137</sup> *Calder*, 465 U.S. 783.

<sup>138</sup> *Id.* at 789-90.

<sup>139</sup> *Morguard Inv. Ltd. v. De Savoye*, [1990] 3 S.C.R. (Can.) 1077; Blom, *supra* note 23, at 378; Monestier, *supra* note 6, at 180-81.

<sup>140</sup> *Morguard*, [1990] 3 S.C.R. (Can.) at 1082. The Ontario Court of Appeal subsequently explained that, though *Morguard* explained the real and substantial connection test "from the perspective of recognition and enforcement, La Forest J. made it clear that precisely the same real and substantial connection test applies to the assumption of jurisdiction against an out-of-province defendant." *Muscutt v. Courcelles*, [2002] CanLII 44957, para. 38 (ON CA).

<sup>141</sup> *Morguard*, [1990] 3 S.C.R. at 1102-03; *see also* Blom, *supra* note 126, at 381.

of comity.<sup>142</sup> La Forest J. compared this idea to the United States' full faith and credit clause.<sup>143</sup>

Fairness, La Forest J. determined, was more important than order.<sup>144</sup> While order provided ample reasoning to support judgment recognition across Canada, fairness was a necessity.<sup>145</sup> La Forest J. described fairness as the relationship between the jurisdiction's contacts and the defendant or subject matter of the suit.<sup>146</sup> Accordingly, the *Morguard* court acknowledges three grounds upon which a court can claim jurisdiction over a defendant: 1) the defendant is served *in personam*; 2) the defendant consents to jurisdiction through agreement or attornment;<sup>147</sup> and 3) there is a real and substantial connection between the defendant or cause of action and the forum.<sup>148</sup> Though *Morguard* focused on the recognition of interprovincial judgments, La Forest J. provides undertones throughout his opinion which seem to relate the expressed principles to the realm of private international law.<sup>149</sup>

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<sup>142</sup> See *Morguard*, [1990] 3 S.C.R. (Can.) at 1096-97.

<sup>143</sup> See *id.* at 1100, 1102.

<sup>144</sup> See *id.* at 1102-03; see also Blom, *supra* note 126, at 381 (arguing the *Morguard* decision sacrificed order for fairness).

<sup>145</sup> See *Morguard*, [1990] 3 S.C.R. at 1103.

<sup>146</sup> *Id.*

<sup>147</sup> "Attornment occurs when a defendant, by his or her conduct consents or submits to a jurisdiction . . . without reserving its right to challenge the claimant's chosen jurisdiction at a later time." Melissa Kehrer & John A. Olah, *Trips, Traps and Jurisdiction Part 2*, CLAIMS CAN. (Feb. 2008), <http://www.claimscanada.ca/issues/article.aspx?aid=1000219849&cer=NA>; see also BLACK'S LAW DICTIONARY 147 (9th ed. 2009).

<sup>148</sup> *Morguard*, [1990] 3 S.C.R. at 1103-04. For a hypothetical example of all three grounds, see also Stephen C. Nadler, *Navigating the Litigation Landscape in Canada: Securing Evidence and Enforcing Judgments*, BUS. LAW TODAY, Jan./Feb. 2008, at 42; Cf. Monestier, *supra* note 6, at n. 2 (noting *Beals v. Saldanha*, 2003 SCC 72, places the most importance on whether there is a real and substantial connection, while other indicia (presence and consent) bolster the real and substantial connection).

<sup>149</sup> See *Morguard*, [1990] 3 S.C.R. at 1095 ("Modern states, however, cannot live in splendid isolation and do give effect to judgments given in other countries in certain circumstances"); *id.* at 1097 ("what must underlie a modern system of private international law are principles of order and fairness, principles that ensure security of transactions with justice"); *id.* at 1098 (noting that the United States and European countries have created more generous rules for recognition and enforcement of foreign judgments).

Shortly after *Morguard*, the Supreme Court of Canada, in *Hunt v. T & N plc.*,<sup>150</sup> reiterated the importance of order and fairness but chose not to further define the scope and application of the real and substantial connection test.<sup>151</sup> La Forest J. wrote that the real and substantial connection test was a flexible test which simply “captured the idea that there must be some limits on claims to jurisdiction.”<sup>152</sup> The *Hunt* opinion details some prior applications of the real and substantial connection test, concluding that “no test can perhaps ever be rigidly applied . . . [and] the assumption of . . . jurisdiction must ultimately be guided by the requirements of order and fairness, not a mechanical counting of contacts or connections.”<sup>153</sup>

The plaintiff in *Hunt*, a resident of British Columbia, alleged he was injured due to the tortious behavior of the defendants domiciled in Quebec.<sup>154</sup> The plaintiff brought action in British Columbia and sought production of various documents.<sup>155</sup> The defendants refused to produce the documents on the ground that they were not required to do so because they were protected by the Quebec *Business Concerns Records Act*.<sup>156</sup> On the basis of *Morguard*, the Supreme Court of Canada held that the Quebec Act was not applicable to the proceedings in British Columbia.<sup>157</sup>

The *Hunt* decision elevated the *Morguard* principles to constitutional status, indicating that they cannot be overridden by provincial courts.<sup>158</sup> The Court determined that the idea of Canadian

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<sup>150</sup> *Hunt v. T & N plc.*, [1993] 4 S.C.R. 289.

<sup>151</sup> Blom, *supra* note 126, at 385.

<sup>152</sup> *Hunt*, [1993] 4 S.C.R. at 325.

<sup>153</sup> *Id.* at 326; *cf. Calder*, 465 U.S. 783 (focusing on the fairness of California exercising jurisdiction despite a lack of contacts); *World-Wide Volkswagen*, 444 U.S. at 293-94 (stressing that the Due Process Clause ensures fairness and the orderly administration of the laws); *Hanson v. Denckla*, 357 U.S. 235, 250 (1958) (describing the evolution of American *in personam* jurisdiction from the rigid *Pennoyer v. Neff* to the more flexible *Int'l Shoe Co. v. Washington*).

<sup>154</sup> *Hunt*, [1993] 4 S.C.R. at 297.

<sup>155</sup> *Id.* at 298.

<sup>156</sup> *Id.* at 298; *see generally* Robert Wisner, *Uniformity, Diversity, and Provincial Extraterritoriality: Hunt v. T & N plc.*, 40 MCGILL L.J. 759, 762 (1995) (explaining the Quebec *Business Concerns Records Act* is a blocking statute, prohibiting the removal of business documents from the province for the purpose of litigation).

<sup>157</sup> *See Hunt* [1993] 4 S.C.R. at 331-32.

<sup>158</sup> *See id.* at 324; *see also* Blom, *supra* note 126, at 385.

provinces giving full faith and credit to the judgments of other provinces was a “constitutional imperative[],” and while provinces may enact legislation regarding the recognition of judgments of other provinces, *Morguard* established a minimum threshold for order and fairness which the provinces must respect.<sup>159</sup>

The international undertones of *Morguard* and its emphasis on the importance of order and fairness, subsequently echoed in *Hunt*, were expressed together in *McNichol Estate v. Woldnik*.<sup>160</sup> *McNichol Estate* involved a Florida chiropractor, Dr. Puentes, being sued in Ontario following the death of Louis McNichol, an Ontario resident who died in Florida.<sup>161</sup> Dr. Puentes was the only non-resident of Ontario named in the lawsuit.<sup>162</sup> Dr. Puentes argued to have the real and substantial connection test applied to him separately from the other defendants. The Ontario Court of Appeal refused to do so.<sup>163</sup>

Rationalizing why it chose not to apply the real and substantial test to Dr. Puentes separately, the Court argued to do so “would be a step backwards . . . away from the recognition of the increasingly complex and interdependent nature of the modern world community which lies at the heart of [*Morguard’s* and *Hunt’s*] reasoning.”<sup>164</sup> Further, the Court wrote, “it would mute the influence of the underlying requirements of order and fairness.”<sup>165</sup> The decision of the Court emphasizes that the order and fairness dictated by the real and substantial connection test extends beyond inter-provincial disputes to foreign disputes.

2. *What is a real and substantial connection?: The modern real and substantial connection doctrine.*- While the Canadian Supreme Court chose not to expand upon the real and substantial connection test in *Hunt*, the Ontario Court of Appeal did do so in *Muscutt v. Courcelles*.<sup>166</sup> The

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<sup>159</sup> *Hunt* [1993] 4 S.C.R. at 324.

<sup>160</sup> *McNichol v. Woldnik*, [2001] CanLII 5679 (ON CA).

<sup>161</sup> *Id.* at para. 1.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at para. 12-15.

<sup>164</sup> *McNichol*, 2001 CanLII at para. 12.

<sup>165</sup> *Id.*

<sup>166</sup> *See Muscutt*, (2002) CanLII. 44957. The Canadian Court system is similar to that of the United States. Provincial trial courts appeal to provincial courts of appeal, which appeal to the Supreme Court of Canada. Thus, just as American



Ontario court listed eight factors to consider when determining whether a forum can ascertain jurisdiction over a foreign defendant: the connection between the forum and the plaintiff's claim; the connection between the forum and the defendant; unfairness to the defendant in assuming jurisdiction; unfairness to the plaintiff in not assuming jurisdiction; the involvement of other parties to the suit; the court's willingness to recognize and enforce an extra-provincial judgment rendered on the same jurisdictional basis; whether the case is inter-provincial or international in nature; and comity and the standards of jurisdiction, recognition, and enforcement prevailing elsewhere.<sup>167</sup>

Legal Scholar Tonya Monestier notes that the Supreme Court of Canada never explicitly endorsed the *Muscutt* factors.<sup>168</sup> The Ontario Court of Appeal, following the rationale of the Supreme Court of Canada's opinion in *Morguard*, believed that fairness to both parties was important, and that the eight factors provided for fairness as well as flexibility, as *Morguard* discussed.<sup>169</sup> This led to the biggest criticism of the *Muscutt* factors: only the first two factors actually dealt with a connection of any sort between the forum and the claim or defendant.<sup>170</sup> Despite this criticism from scholars, the *Muscutt* factors were considered influential in other provinces.<sup>171</sup>

The eight factors were challenged in *Club Resorts Ltd. v. Van Breda*.<sup>172</sup> The Canadian Supreme Court found it necessary to more clearly articulate factors defining what a real and substantial connection

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appellate courts can act in the absence of action by the Supreme Court, so can provincial appellate courts in Canada.

<sup>167</sup> *Muscutt*, (2002) CanLII 44957 (Can.) at para. 75-104.

<sup>168</sup> Monestier, *supra* note 6, at 183.

<sup>169</sup> *See Muscutt*, (2002) CanLII 44957 at para. 72, 86-88; *see also* Monestier, *supra* note 6, at 193-94.

<sup>170</sup> *See* Monestier, *supra* note 6, at 184 (“[The final six factors] are not strictly concerned with the connection of the forum to the parties and the cause of action.”) (quoting Bastarache J., in *Castillo v. Castillo*, 2005 SCC 83, para. 45)); Stephen G.A. Pitel, *Reformulating a Real and Substantial Connection*, 60 U.N.B.L.J. 177, 182 (2010); *see also* Blom, *supra* note 123, at 394 (“Only the first two of the eight factors are strictly factual in nature”).

<sup>171</sup> *Club Resorts Ltd. v. Van Breda*, 2012 SCC 17, (Can.) para. 48-51 available at <http://scc-csc.lexum.com/scc-csc/scc-csc/en/item/8004/index.do>.

<sup>172</sup> *See Van Breda*, 2012 SCC 17 (Can.).

is, in line with current trends in Canadian jurisprudence.<sup>173</sup> The *Van Breda* Court acknowledged that this was the direction the Ontario Court of Appeal was heading in, but that the list of connecting factors should not include factors based on fairness, efficiency, and comity.<sup>174</sup>

As a result, the Canadian Supreme Court replaced the list of eight factors in *Muscutt* with four factors of its own: the defendant was domiciled in the province; the defendant carries on business in the province<sup>175</sup>; the tort was committed in the province; and a contract connected with the dispute was created in the province.<sup>176</sup> In creating these four connecting factors, the Court rejected the fairness and injury factors from *Muscutt* on the grounds that they are too attenuated and should not be separated from the factual factors announced in *Van Breda*.<sup>177</sup>

Of particular interest to this comment is the *Van Breda* court's removal of the *Muscutt* factor considering whether an action is inter-provincial or international in nature. The Court determined that issues relating to foreign law may remain helpful in determining jurisdiction.<sup>178</sup> However, it cautioned that focusing on juridical disadvantages in jurisdictional analysis is not "consonant with the principle of comity which should govern legal relationships between modern democratic states."<sup>179</sup>

The four connecting factors create a rebuttable presumption for the defendant, but do not create a rebuttable presumption in favor of the plaintiff.<sup>180</sup> Thus, the *Van Breda* Court moved from what it saw as an over-inclusive, unpredictable list of factors, to a more fact-based,

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<sup>173</sup> See *id.*, 2012 SCC 17 (Can.) at para. 75-79 (indicating that the CJPTA and other sources of jurisprudence need to be aligned with a set of rebuttable presumptive factors).

<sup>174</sup> *Id.* ¶¶ 74, 79, 82, 84.

<sup>175</sup> See *id.* ¶ 87 (recognizing that though carrying on business in the province may be a presumptive factor in favor of jurisdiction, there are some business activities such as advertising and web site access in the jurisdiction which cannot give rise to a presumption of jurisdiction).

<sup>176</sup> *Id.* ¶ 90(d).

<sup>177</sup> *Id.* ¶¶ 84-89.

<sup>178</sup> *Van Breda*, 2012 SCC 17 (Can.) at para. 63.

<sup>179</sup> *Id.*

<sup>180</sup> See *id.* ¶¶ 92-93; see also Pliszka, *supra* note 129, at 277.

clear set of factors for determining whether a real and substantial connection exists.<sup>181</sup> As an example of this rebuttable presumption, the Court posed the hypothetical situation in which the factor at issue is that a defendant carries on business in the forum.<sup>182</sup> According to the court, a possible rebuttal to this presumption is that the subject matter of the suit is unrelated to the defendant's business activities in the forum, similar to one of the categories of cases identified in *International Shoe*.<sup>183</sup>

*Van Breda* involved a couple who contracted in Ontario with Club Resorts Ltd. for sport services at a club in Cuba, managed by Club Resorts.<sup>184</sup> Shortly after the trip began, Ms. Van Breda was catastrophically injured on the beach when a metal contraption collapsed on her.<sup>185</sup> Upon return from Cuba, Ms. Van Breda and Mr. Berg moved to Calgary and British Columbia, but never returned to Ontario.<sup>186</sup>

Relying on the four presumptive factors created by the Canadian Supreme Court, the Court held that the Ontario court could exercise jurisdiction.<sup>187</sup> The Court reasoned that because the contract for services was created in Ontario, the Ontario court properly claimed jurisdiction.<sup>188</sup> According to the court the injury resulted from the obligations created by the contractual relationship which began in Ontario.<sup>189</sup>

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<sup>181</sup> See Pliszka, *supra* note 129, at 4.

<sup>182</sup> *Van Breda*, [2012] SCC 17, (Can.) at para. 96.

<sup>183</sup> *Id.*; *cf. Int'l Shoe*, 326 U.S. at 318 (continuous and systematic contacts may not be enough to support jurisdiction).

<sup>184</sup> *Van Breda*, [2012] SCC 17, (Can.) at para. 2-3 (The contract created an obligation for Mr. Berg to teach two hours of tennis per day at the resort in return for room and board at the resort for himself and Ms. Van Breda).

<sup>185</sup> *Id.* ¶ 4.

<sup>186</sup> *Id.*

<sup>187</sup> *Van Breda*, [2012] SCC 17 (Can.) at para. 118.

<sup>188</sup> *Id.* ¶ 117. The court determined that Club Resorts' advertising in Ontario was not sufficient to establish jurisdiction because advertising is often international or global, and allowing advertising to confer jurisdiction would subject large commercial organizations to jurisdiction almost anywhere in the world, *id.* ¶ 114.

<sup>189</sup> *Id.* ¶ 117.

Despite the shift in *Van Breda* to a more delineated set of factors, Monestier believes that the court too quickly discounted “fairness” to achieve “order.”<sup>190</sup> While Monestier acknowledges that the Canadian Supreme Court moved in the correct direction with its decision in *Van Breda*, she believes the Court moved to a system which is too rigid.<sup>191</sup> While this is a fair criticism of the *Van Breda* decision, the general consensus is that the change was a much needed one, as Ms. Monestier herself acknowledges.<sup>192</sup> The shift by the Canadian Supreme Court in *Van Breda* recognizes the Court’s desire to dissipate the attempt to balance “fairness” and “order” in favor of order.<sup>193</sup>

## II. ANALYSIS

As Ms. Monestier points out, the change in tide made by the Supreme Court of Canada in *Van Breda* ushers in a new understanding and era of *ex juris* jurisdiction in Canada.<sup>194</sup> Because of the new direction of Canadian *ex juris* jurisdiction, the Canadian Supreme Court has more closely aligned *ex juris* jurisdiction in Canada with that of the United States. As a result, the United States and Canada will be able to increase comity with one another resulting in greater cooperation in transnational cases. Further, greater cooperation between the two nations may further smooth the path for increasing economic ties with one another.

### A. A Fading Border: Closing the Gap Between Canadian Jurisdiction and American Jurisdiction

Professor Black acknowledges that recognition of foreign judgments is more likely when the two countries involved have similar

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<sup>190</sup> Monestier, *supra* note 6, at 398.

<sup>191</sup> *Id.* at 412.

<sup>192</sup> *Id.* at 410-11; *see also* Pliszka, *supra* note 129.

<sup>193</sup> *See* Monestier, *supra* note 6, at 410; *compare Van Breda*, [2012] SCC 17 (Can.) at para. 99 (stating that a court is not required to hear only the tort which could be connected with the jurisdiction when there are multiple torts at issue), *with McNichol*, (2001) CanLII 5679 at para. 12 (“I do not agree that where an action has some claims with an extra-territorial dimension, and others which have none, the former must be tested in isolation”).

<sup>194</sup> *See* Monestier, *supra* note 6, at 410-11.

or identical standards for personal jurisdiction.<sup>195</sup> As the new tide in Canadian *ex juris* jurisdiction commences, the *Van Breda* factors appear to align the new Canadian jurisdiction closer to that of the United States.<sup>196</sup>

1. *Van Breda Factors One and Two: A Defendant-Centric Approach.*  
 – The first *Van Breda* factor, whether or not the defendant was domiciled in the province, aligns itself well with the minimum contacts doctrine provided in *International Shoe*.<sup>197</sup> At the base of Justice Stone’s approach in *International Shoe* is the previous notion of personal jurisdiction dating back to *Pennoyer*, a defendant domiciled in a state is subject to personal jurisdiction.<sup>198</sup> This a very defendant-centric approach.

The first *Van Breda* factor has brought personal jurisdiction in Canada to a clear, defendant-centric approach as well.<sup>199</sup> The court stated that a plaintiff’s presence in a jurisdiction is not sufficient to create a relationship between the jurisdiction and the subject matter, but that a defendant may always be sued in a jurisdiction in which he resides.<sup>200</sup> This language has the same basic notion as that in *Pennoyer*, the defendant’s domicile is the important consideration.<sup>201</sup> Further, by looking at *Keeton*, the United States Supreme Court’s relative disinterest in the domicile of the plaintiff is just as clear as that of the Canadian Supreme Court.<sup>202</sup>

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<sup>195</sup> See Vaughan Black, *A Canada-United States Full Faith and Credit Clause?*, 18 SW. J. INT’L L. 595, 606-10 (2011).

<sup>196</sup> See *Burger King*, 471 U.S. 462; *Keeton*, 465 U.S. 770; *World-Wide Volkswagen*, 444 U.S. 286; *Int’l Shoe*, 326 U.S. 310; *Hess*, 274 U.S. 352; *Gray*, 22 Ill. 2d 432; *Van Breda*, [2012] SCC 17 (Can.).

<sup>197</sup> See *Int’l Shoe*, 326 U.S. at 316; *Van Breda*, [2012] SCC 17 (Can.) at para. 86.

<sup>198</sup> See *Int’l Shoe*, 326 U.S. at 316; see also *Pennoyer*, 95 U.S. at 720.

<sup>199</sup> See *Van Breda*, [2012] SCC 17 (Can.) at para. 86; see also Pliszka, *supra* note 129, at 5-6.

<sup>200</sup> See *Van Breda*, [2012] SCC 17 (Can.) at para. 86.

<sup>201</sup> See *Pennoyer*, 95 U.S. at 720.

<sup>202</sup> Compare *Keeton*, 465 U.S. at 780 (stating that a plaintiff’s “lack of residence will not defeat jurisdiction established on the basis of defendant’s contacts”), with *Van Breda*, [2012] SCC 17 at para. 86 (stating that a plaintiff’s presence in a jurisdiction “will not create a presumptive relationship between the forum and either the subject matter of the litigation or the defendant”).

*Van Breda*'s second factor, whether the defendant carries on business within the province, is linked to the idea of purposeful availment, originating in *Gray v. American Radiator*,<sup>203</sup> but first used by the United States Supreme Court in *Worldwide Volkswagen*.<sup>204</sup> Once again this factor, like its American counterpart, is defendant-centric.<sup>205</sup>

The Canadian Supreme Court determined that the broad announcement of a rule relating to the business activities of a defendant in a forum was ill-advised.<sup>206</sup> The United States Supreme Court came to this same conclusion in *World-Wide Volkswagen*.<sup>207</sup>

Additionally, the Canadian Supreme Court's explanation of this factor is similar to general jurisdiction in the United States.<sup>208</sup> Part of the Canadian Supreme Court's explanation states one way to satisfy this factor is through "maintaining an office [in the jurisdiction]."<sup>209</sup> Such reasoning is precisely what the United States Supreme Court used in *Perkins v. Benquet Consol. Mining Co.* to determine the defendant was domiciled in Ohio.<sup>210</sup>

While the first two *Van Breda* factors have aligned U.S. and Canadian personal jurisdiction as they relate to the domicile and business activities of the defendant, the last two factors revolve around the subject matter at dispute in a case.

2. *Van Breda* Factors Three and Four: Subject Matter Focus. - *Van Breda*'s third factor, whether the tort was committed in the province, finds an American counterpart in both *Pawloski* and *Keeton*.<sup>211</sup> This

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<sup>203</sup> See *Gray*, 22 Ill. 2d at 441.

<sup>204</sup> See *World-Wide Volkswagen*, 444 U.S. at 297-98.

<sup>205</sup> See Pliszka, *supra* note 129, at 5-6.

<sup>206</sup> See *Van Breda*, [2012] SCC 17 (Can.) at para. 87.

<sup>207</sup> See *World-Wide Volkswagen*, 444 U.S. at 297.

<sup>208</sup> See *Goodyear*, 131 S. Ct. at 2853-54; see also Hoffheimer, *supra* note 13, at 551.

<sup>209</sup> *Van Breda*, [2012] SCC 17 (Can.) at para. 87.

<sup>210</sup> See *Perkins*, 342 U.S. 437.

<sup>211</sup> See *Keeton*, 465 U.S. 770 (considering the desire of the jurisdiction in which the harm was incurred to resolve the case); see also *Hess*, 274 U.S. 352 (involving a car accident in a jurisdiction the defendant did not reside in); *Van Breda*, [2012] SCC 17 (Can.) at para. 88.

factor and the fourth factor both focus on the subject matter at dispute.<sup>212</sup>

While the minimum contacts doctrine focuses on the defendant's locale and actions, it also examines the impact of the tort action in the jurisdiction.<sup>213</sup> *Keeton* serves as the best example. The *Keeton* court focused attention on the idea that the state in which the tort took place has an interest in remedying the harm done within its borders.<sup>214</sup>

The *Van Breda* Court appears to be addressing the same concern through this factor. It describes *Tolofson v. Jensen*<sup>215</sup> as the common law starting point for serious consideration of the *situs* of a tort as a factor to consider in jurisdictional analysis.<sup>216</sup> *Tolofson* determined that in some tort cases, the *lex loci delicti* must apply to help preserve order.<sup>217</sup>

*Van Breda's* fourth factor, whether a contract connected with the dispute was made in the province, finds similarities to *Burger King*.<sup>218</sup> Both cases place upon their respective jurisdictional standards an impetus to consider the creation of a contract sufficient for recognizing jurisdiction over the parties.<sup>219</sup> In doing such both courts concerned themselves with addressing the impact of the subject matter at dispute in determining jurisdiction.

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<sup>212</sup> See Pliszka, *supra* note 129, at 5-6.

<sup>213</sup> See, e.g., *Keeton*, 465 U.S. 770.

<sup>214</sup> See *id.* at 776.

<sup>215</sup> *Tolofson v. Jensen; Lucas (Litigation Guardian of) v. Gagnon*, [1994] 3 S.C.R. 1022 available at <https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/1209/index.do> (then click on PDF document).

<sup>216</sup> See *Van Breda*, [2012] SCC 17 (Can.) at para. 88.

<sup>217</sup> *Tolofson*, [1994] 3 S.C.R. at 1058.

<sup>218</sup> See *Burger King*, 471 U.S. 462; *Van Breda*, [2012] SCC 17 (Can.) at para. 88.

<sup>219</sup> See *Burger King*, 471 U.S. at 480-81; *Van Breda*, [2012] SCC 17 (Can.) at para. 88.

## B. Recognition of Foreign Judgments

Since the decision in *Morguard*, Canada has been recognizing and enforcing United States' judgments with more consistency.<sup>220</sup> Justice LaForest wrote in *Morguard*, “[m]odern times [require that] the flow of wealth, skills, and people across boundaries be facilitated in a fair and orderly manner.”<sup>221</sup> Thus, while *Morguard* is limited to intra-provincial judgment disputes,<sup>222</sup> Canadian courts have expanded its mandate to include foreign judgments.<sup>223</sup>

The Canadian Supreme Court emphasized in *Van Breda* that jurisdiction and recognition of judgments are intertwined.<sup>224</sup> As a result, the framework used in determining a court's jurisdiction can have an impact on a court's recognition of judgments and vice versa.<sup>225</sup> Further, in *Muscutt*, the Canadian Supreme Court emphasized that one aspect of comity includes the consideration of jurisdictional standards as well as judgment recognition and enforcement in other countries.<sup>226</sup> Considering this, along with Black's observation that greater international judgment recognition occurs when countries have similar personal jurisdiction standards, the opportunity for increased comity between the United States and Canada is greater after *Van Breda*.

The choice by Canadian courts to expand recognition and enforcement to foreign judgments has not been applauded by all of Canada, its legal scholars, and even its courts and judges.<sup>227</sup> However, as Canadian attorney Allison Sears notes, “[i]t seems a fair assumption however, that the ease with which the Court embraced the extension

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<sup>220</sup> See Black, *supra* note 195, at 612; Ivan F. Ivankovich, *Enforcing U.S. Judgments in Canada: “Things are Looking Up!”*, 15 NW.J. INT'L L. & BUS. 491, 491 (1994-95).

<sup>221</sup> *Morguard*, [1990] 3 S.C.R. at 1078 (Can.).

<sup>222</sup> See Ivankovich, *supra* note 220, at 499.

<sup>223</sup> See Black, *supra* note 195, at 612.

<sup>224</sup> See *Van Breda*, [2012] SCC 17 (Can.) at para. 16.

<sup>225</sup> *Id.*

<sup>226</sup> See *Muscutt*, [2002] CanLII 44957 at para. 102.

<sup>227</sup> See, e.g., Foreign Judgments Act, R.S.N.B. (2011) c. 162; see also Civil Code of Quebec, S.Q., c. 64, arts. 3155-63 (1991); Allison M. Sears, *Beals v. Saldanha: The International Implications of Morguard Made Clear*, 68 SASK. L. REV. 223, 229-30 (2005) (stating Justice LeBel disagreed with the majority in *Beals v. Saldanha*, (2003) SCC 72, believing that the test should be focused more on fairness to the defendant).



of *Morguard* into the international realm was largely due to the similarity between the Canadian and American legal systems.<sup>228</sup>

Even more so than Canada, the United States recognizes and enforces Canadian judgments. To this effect, a majority of states have adopted statutes similar to the Uniform Foreign Money Judgments Recognition Act.<sup>229</sup> This act allows for recognition of foreign court judgments which are final, conclusive, and enforceable where rendered.<sup>230</sup>

One of the three requirements for non-recognition is that the foreign court lacks personal jurisdiction.<sup>231</sup> As a result, though Canada and the United States have much in common with one another and, to an extent, already recognize and enforce one another's judgments, bringing the two countries' standards for personal jurisdiction closer together will likely decrease the opportunity for this non-recognition requirement to materialize.

Because both countries currently recognize one another's judgments with very little friction, the impact of aligning the two standards for personal jurisdiction will not be all that substantial. However, though the impact seems minimal, it is an issue which is worthy of discussion.<sup>232</sup> Four Canadian provinces do not currently apply the *Morguard* standard to American judgments.<sup>233</sup>

Further, there is Canadian legislation limiting recognition in certain areas, most notably, antitrust and judgments rendered under the Cuban Liberty and Democratic Solidarity Act of 1996.<sup>234</sup>

While the LIBERTAD issue is substantially legislative, further aligning personal jurisdiction standards may encourage those

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<sup>228</sup> Sears, *supra* note 227, at 242.

<sup>229</sup> Todd J. Burke, *Canadian Class Actions and Federal Judgments: Recognition of Foreign Class Actions in Canada*, BUS. LAW TODAY, Sept./Oct. 2007, at 48.

<sup>230</sup> 13 U.L.A. 261 § 1(2) (1986).

<sup>231</sup> *Id.* § 4(a)(1)-(3).

<sup>232</sup> See Black, *supra* note 195, at 619.

<sup>233</sup> New Brunswick, Quebec, and British Columbia do not enforce foreign judgments, and Saskatchewan will only enforce the damages portion of a judgment, but not the punitive portions. See Black, *supra* note 192, at 613-14.

<sup>234</sup> See Black, *supra* note 195, at 614.

provinces which take issue with enforcing foreign judgments to become more cooperative with U.S. courts in recognizing judgments. Similarity between the two standards may provide greater assurance that the treatment parties in Canada receive is similar to that received by parties litigating in the United States.<sup>235</sup>

Are there other measures which would be more appropriate? Numerous authors have written about the idea of either a bilateral treaty or enforcement convention to assist the two countries in their recognition of one another's judgments.<sup>236</sup> However, as professor Black acknowledges, the chances of the legislatures of either country taking the required initiative to enact such a treaty or convention is not particularly likely.<sup>237</sup> With the floundering likelihood that these measures will be taken, bridging the gap between the two countries' personal jurisdiction standards seems to present itself as a more viable solution, or at the very least, a holdover until a more definite solution can be achieved.

### C. Van Breda's Implications for Foreign Class Action Suits

Moving beyond enforcement of one another's judgments, the new real and substantial framework defined in *Van Breda* has its greatest implications in cases that have yet to be decided. More specifically, in the future of transnational class action suits.<sup>238</sup>

When it comes to a Canadian court recognizing a class action judgment rendered in the United States, one of the major factors, and only one concerning this comment, in determining whether to enforce the judgment is whether there is a "real and substantial connection in favor of the foreign jurisdiction."<sup>239</sup> Canada and the United States

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<sup>235</sup> See *id.* at 610.

<sup>236</sup> See, e.g., Black, *supra* note 195 (discussing his view that an enforcement convention between the U.S. and Canada, while also evaluating other scholars' suggestions regarding conventions and treaties).

<sup>237</sup> See *id.* at 625.

<sup>238</sup> See Burke, *supra* note 229, at 51 (noting that proper jurisdiction is a major factor in recognition of class action judgments in Canada).

<sup>239</sup> Burke, *supra* note 229, at 50 (citing *Currie v. McDonald's Restaurants of Canada Ltd.*, (2005) CanLII 3360 (ON CA)).

differ from one another in certain aspects of class action litigation, including how classes are defined<sup>240</sup> and issue requirements.<sup>241</sup>

As *Currie* informs us, the presence of a real and substantial connection is important.<sup>242</sup> This requirement is also expressed in the United States in the Uniform Money Judgment Enforcement Act.<sup>243</sup> Thus, the movement towards similar standards of personal jurisdiction has the potential to increase the frequency of recognition of United States class actions which include Canadian citizens.

To what extent the new definition of the real and substantial connection standard will have on class actions is still unproven. More specifically, how many of the members in a class will have to meet the standards set forth in *Van Breda*?<sup>244</sup> The direction of Canadian courts is likely to lead to a requirement that only one of the class members meets one of the presumptive *Van Breda* factors.<sup>245</sup> This determination finds support in the Canadian focus on common issues class definition.<sup>246</sup>

However, this is the point at which a question arises regarding whether class actions based in Canada will be enforced in the United States since American courts define classes based on amount in controversy requirements.<sup>247</sup> The history of U.S. recognition of Canadian judgments and the importance put on a minimum contacts/real and substantial connection under the Uniform Act, along

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<sup>240</sup> The United States has a numerosity requirement for a class to be created. FED. R. CIV. P. 23. Canada only requires two persons to create a class. Class Proceedings Act, R.S.B.C., c. 50, §§ 4(1), 7, 27 (1996); Class Proceedings Act 1992, S.O., c. 6, §§ 5(1), 6, 25 (1992); *see also* *Western Canadian Shopping Centres Inc. v. Dutton*, [2001] SCC 46, at para. 37.

<sup>241</sup> The United States has an amount in controversy requirement to certify a class. 28 U.S.C. § 1332. Canada requires that there be a common issue to certify a class. *See, e.g.*, B.C. Class Proceedings Act, Division 3, Part 3, s. 20(3)(a).

<sup>242</sup> *See Currie*, [2005] [Can.] CanLII 3360 at paras. 11-2.

<sup>243</sup> *See Burke*, *supra* note 229, at 51.

<sup>244</sup> *See* David Paulson, Note, *Canada Update: A New Framework for Determining Jurisdiction, the Application of Forum Non Conveniens, and Limitations of the Solicitor-Client Privilege*, 18 LAW & BUS. REV. AM. 411, 416-17 (2012).

<sup>245</sup> *See id.* at 417.

<sup>246</sup> *See* B.C. Class Proceedings Act s. 20(3)(a); *see also* *Burke*, *supra* note 226, at 49.

<sup>247</sup> 28 U.S.C. § 1332.

with Justice Winkler's recognition that "practical differences [between U.S. and Canadian classes] are more apparent than real," leads to the belief that the new *Van Breda* factors are more likely to lead to greater cross-border enforcement than detract from it.<sup>248</sup>

D. What's to Become of Us?: The Implications of Van Breda on the U.S.-Canadian Trade Partnership

Finally, the implications of the *Van Breda* decision on comity and trade between the two nations is of significant importance. Justice LaForest noted the importance of movement of people, skills, and wealth.<sup>249</sup> In 2013 the U.S. exported 277,038.3 million dollars worth of goods to Canada while importing 305,384.8 million dollars worth of goods from Canada.<sup>250</sup> The staggering amount of trade that these two countries share illustrates the importance of the economic friendship between these nations. While that partnership has been in existence for decades and will likely continue for decades to come, what underlies those numbers is the sheer amount of interaction that U.S. and Canadian persons and companies have with one another. From interaction, conflict arises. That conflict must be directed toward the courts of either the U.S., Canada, or both. The increased efficiency that the *Van Breda* decision provides may be miniscule or large. Only time will tell. However, as Professor Black notes, to shrug off the minor differences between the U.S. and Canadian courts regarding personal jurisdiction would be a mistake.<sup>251</sup> Those differences do not produce much wake in the individual case, but in the aggregate the transaction costs become much more significant.<sup>252</sup> With a partnership as large as that of the U.S. and Canada, the alignment of their personal jurisdiction standards may have a positive effect on lessening those transaction costs and thus trade costs.<sup>253</sup>

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<sup>248</sup> See Burke, *supra* note 229, at 51 (quoting Justice Winkler in regards to the *Nortel Networks* litigation).

<sup>249</sup> *Morguard*, [1990] 3 S.C.R. at 1096.

<sup>250</sup> *Trade in Goods with Canada*, UNITED STATES CENSUS BUREAU, <http://www.census.gov/foreign-trade/balance/c1220.html>(last visited Jan. 26, 2014).

<sup>251</sup> See Black, *supra* note 195, at 619.

<sup>252</sup> See *id.* at 617, 624.

<sup>253</sup> See *id.* at 617.

## CONCLUSION

The development of personal jurisdiction over *ex juris* defendants has developed in the form of the minimum contacts test in the United States, and the real and substantial connection standard in Canada. Both tests value the importance of fairness and order.

The minimum contacts test has evolved into a test which focuses on the connection between the defendant and the forum. It was not until 2012 that Canada caught up. Prior to the *Van Breda* decision, the real and substantial connection standard focused on the plaintiff, defendant, and nature of the claim. *Van Breda* narrowed that focus to the defendant and subject matter of a claim, further aligning the U.S. and Canadian personal jurisdiction standards.

As a result, greater comity between the U.S. and Canada can ensue. While as of late there has not been large amounts of friction between these two countries, commentators have noted that even a small amount of friction is worth addressing, because aggregate transaction costs involved in a trade partnership as large as that the U.S. and Canada have can be large.

Any steps toward streamlining transactions, in this case judicial cooperation, comity, and judgment recognition, can help in reducing those costs. Reduced transaction costs leads to more efficient trade and a greater relationship between the U.S. and Canada.

Realistically, the impact of the *Van Breda* decision will likely be relatively small in respect to the relationship between the U.S. and Canada, but as Pink Floyd sang “[it’s] just another brick in the wall.”<sup>254</sup>

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<sup>254</sup> PINK FLOYD, *Another Brick in the Wall Part 2, on THE WALL* (Columbia Records 1979).

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**MAKING ENDS MEET: USING A MARKET-  
BASED APPROACH TO INCENTIVIZE  
FOREIGN VESSELS TO COMPLY WITH  
THE AIR EMISSION STANDARDS OF  
MARPOL ANNEX VI\***

*Xiaoxin Shi\*\**

INTRODUCTION

Annex VI of the International Convention for the Prevention of Pollution from Ships (MARPOL) sets mandatory air emission standards for ocean-going vessels. Ratifying countries are required to enact legislation to implement MARPOL Annex VI (Annex VI) within their jurisdictions. The United States adopted Annex VI through the Act to Prevent Pollution from Ships (APPS),<sup>1</sup> administered by the Environmental Protection Agency (EPA). Two

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\* The conclusions of this paper reflect the author's findings between late 2013 to early 2014, when the paper was completed. Since then, there have been new developments in the Chinese policies and regulations on air emissions from ships and vessels. The most significant development is the new Emission Control Area (ECA) Implementation Plan, promulgated by the Chinese Ministry of Transport on December 2, 2015 ([http://www.gov.cn/xinwen/2015-12/04/content\\_5019932.htm](http://www.gov.cn/xinwen/2015-12/04/content_5019932.htm)). The Plan establishes three ECAs along China's coast. Beginning on January 1, 2016, ports within the three ECAs will start to require ships to switch to 0.5% sulfur fuel while berthing. Starting on January 1, 2019, all ships will be required to switch to 0.5% sulfur fuel when operating in the three ECAs. Before December 31, 2019, the Ministry of Transport plans to evaluate the effectiveness of the fuel switching program and decide whether to mandate all ships operate within the ECAs to switch to 0.1% sulfur fuel and whether to extend the geographical scopes of the ECAs.

\*\* Master of Philosophy 2010, The Chinese University of Hong Kong; J.D. 2015, The Pennsylvania State University School of Law.

<sup>1</sup> The Act to Prevent Pollution from Ships, 33 U.S.C. §§ 1901-1915 (2008).

Emission Control Areas (ECAs) have been established under Annex VI in the U.S. territory.<sup>2</sup> All vessels of United States registry or nationality to which MARPOL applies, if found to have violated the emission standards of ECAs within the U.S. territory, are subject to criminal or *in rem* civil liabilities.<sup>3</sup>

The majority of the vessels calling at U.S. ports are registered in foreign countries, many of which have not yet fully enforced Annex VI through domestic legislation.<sup>4</sup> Employing judicial proceedings as the primary instrument to enforce the compliance of foreign flagged vessels, therefore, could be cumbersome and expensive administratively, especially considering the large number of calls at U.S. ports. This paper explores the perspectives of market-based mechanisms, as supplements to judicial enforcement, to incentivize the compliance of foreign flagged vessels when operating in ECAs in the United States, and ultimately, to foster the enforcement of Annex VI in all major destinies of international shipping.

This paper first introduces the regulative scheme to enforce MARPOL Annex VI standards on foreign ships operating in U.S. waters in Section II. Technological alternatives to achieve compliance and their constraints are also discussed, along with the review of

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<sup>2</sup> The North American Emission Control Area (ECA) was jointly proposed by the United States, Canada, and France, approved by the International Maritime Organization (IMO) in 2010 and came into effect on August 1, 2012. *See* Int'l Mar. Org. [IMO], *North American Emission Control Area*, Res. MEPC.190(60) (Mar. 26, 2010). The United States also proposed the United States Caribbean Sea ECA, which was adopted by the IMO in 2011 and will take effect on January 1, 2014. *See* Int'l Mar. Org. [IMO], *Designation of the United States Caribbean Sea Emission Control Area and Exemption of Certain Ships Operation in the North American Emission Control Area and the United States Caribbean Sea Emission Control Area under Regulations 13 and 14 and Appendix VII of MARPOL Annex VI*, Res. MEPC.202(62) (July 15, 2011).

<sup>3</sup> 33 U.S.C. § 1908.

<sup>4</sup> *See* U.S. DEP'T OF TRANSP., VESSEL CALLS SNAPSHOT, 2011 (2013). In 2011, foreign-flagged vessels accounted for 89% of calls at U.S. ports. The number of U.S.-flagged vessels calling at U.S. ports had a range of 6,869 to 7,356 between 2006 and 2011. *Id.* at 8; *see also* Sandra Y. Snyder, *EPA's Category 3 Marine Emission Standards: Mimicking MARPOL Annex VI or Mocking the Clean Air Act?* 71 BROOK. L. REV. 1065, 1089 (2005) (most vessels entering U.S. ports are foreign vessels).

relevant Annex VI provisions. Section III leads a comparison of Annex VI regulative schemes in the United States and a major marine trade partner, China. The comparison concludes that the United States and U.S. shipping companies are likely to bear unfair burdens administratively and financially in enforcing this multi-national convention due to the uneven regulative landscape globally. Having examined, from an economic perspective, the factors that could affect the effectiveness of enforcement measures, Section III recommends using incentive programs as an interim solution to solicit wider voluntary compliance while foreign countries such as China are yet to give effect to Annex VI through domestic legislation. Finally, Section IV discusses the feasibility of two main types of potential market-based incentive programs, cap-and-trade and emission credit trading, to provide non-complying foreign ships a “last offer” to avoid criminal penalties for violation of Annex VI while operating in U.S. waters. This paper favors an emission credit trading program, considering the increasing demand of international shipping service, in general, and the need to synergize technological developments in the ship building industry with the regulatory requirements of Annex VI.

#### I. ANNEX VI ENFORCEMENT SCHEME FOR FOREIGN FLAGGED VESSELS CALLING AT U.S. PORTS

Foreign flagged vessels, just as U.S. flagged vessels, are regulated under the APPS when they operate in U.S. waters. Vessels have to use low-sulfur fuels, the quality and quantity of which are documented in Bunker Delivery Notes, and provide engine certificates to prove compliance with Annex VI standards. Civil or criminal liabilities may be imposed for violations. The U.S. Coast Guard, under an agreement with the EPA, has the authority to undertake onboard inspections.



### A. MARPOL Annex VI and Its Adoption in the United States

MARPOL,<sup>5</sup> as modified by Protocol of 1978,<sup>6</sup> is the main international convention to prevent marine environment pollution from ocean-going vessels.<sup>7</sup> Annex VI of MARPOL sets limits for NO<sub>x</sub>,<sup>8</sup> SO<sub>x</sub>,<sup>9</sup> and particulate matter (PM)<sup>10</sup> emissions from ocean-

<sup>5</sup> International Convention for the Prevention of Pollution from Ships, Nov. 2, 1973, 1973 U.S.T. Lexis 322, 1340 U.N.T.S. 184 [hereinafter MARPOL Annex VI].

<sup>6</sup> Protocol of 1978, Feb. 17, 1978, 1978 U.S.T. Lexis 322, 1340 U.N.T.S. 61.

<sup>7</sup> *International Convention for the Prevention of Pollution from Ships (MARPOL)*, INT'L MAR. ORG., [http://www.imo.org/About/Conventions/ListOfConventions/Pages/International-Convention-for-the-Prevention-of-Pollution-from-Ships-\(MARPOL\).aspx](http://www.imo.org/About/Conventions/ListOfConventions/Pages/International-Convention-for-the-Prevention-of-Pollution-from-Ships-(MARPOL).aspx) (last visited Feb. 15, 2015).

<sup>8</sup> NO<sub>x</sub> (Nitrogen Oxides) forms through the diesel engine combustion process when the temperature reaches 2000 degrees Kelvin (equivalent to about 3140 Fahrenheit) and the nitrogen in the air reacts with oxygen. The amount of NO<sub>x</sub> emission is not strongly affected by the specific fuel consumption, but is dependent on the temperature, pressure, and duration of combustion time of the engine fuel. Most nitrogen is oxidized into nitric oxide (NO) in the early stage of combustion. Some of the NO will convert to nitrogen dioxide (NO<sub>2</sub>) and nitrous oxide (N<sub>2</sub>O) during the later expansion process and in the exhaust. NO<sub>x</sub> is the mixture of NO, NO<sub>2</sub>, and N<sub>2</sub>O. One way of measuring NO<sub>x</sub> emission is based on the main engine's rated speed, presented as revolutions per minute (rpm). See LAURIE GOLDSWORTHY, DESIGN OF SHIP ENGINES FOR REDUCED EMISSIONS OF OXIDES OF NITROGEN §2 (2002), available at <http://www.flamemarine.com/files/AMCPaper.pdf>. NO<sub>x</sub> emission is significantly higher when an engine operates at lower rpm (50 to 550); Lasse Johansson, Emission Estimation of Marine Traffic Using Vessel Characteristic and AIS-Data 19 (Sept. 19, 2011) (Master's thesis, Aalto University), available at [www.lib.tkk.fi/Dipl/2011/urn100529.pdf](http://www.lib.tkk.fi/Dipl/2011/urn100529.pdf). NO<sub>x</sub> are precursor components for a photochemical reaction through which ozone is formed, and catalysts for the formation of acid rain. *Id.* at 5. Exposure to NO<sub>x</sub>, even if for a short term from 30 minutes to 24 hours, would adversely affect the human respiratory system, including airway inflammation in healthy people and increased respiratory symptoms in people with asthma. *Nitrogen Dioxide*, U.S. ENV'T PROT. AGENCY, <http://www.epa.gov/air/nitrogenoxides/health.html> (last updated Feb. 14, 2013).

<sup>9</sup> SO<sub>x</sub> is the mixture of SO<sub>2</sub>, SO<sub>3</sub>, and SO<sub>4</sub>. The amount of SO<sub>x</sub> emission from vessels is directly related to the sulfur content of marine fuel burned. See Johansson, *supra* note 8; Zoi Nikopoulou et al., *The Role of A Cap-and-Trade Market in Reducing NO<sub>x</sub> and SO<sub>x</sub> Emissions: Prospects and Benefits for Ships Within the Northern European ECA*, 227(2) J. ENG'G FOR THE MARINE ENV'T 136, 136 (2013). Current world-wide average sulfur content in marine fuel is about 2.7% (27,000

going vessels that are of 400 gross tonnages or more, and general enforcement and monitoring procedures.<sup>11</sup> The International Maritime Organization (IMO), a United Nations specialized agency responsible for improving maritime safety and preventing pollution from ships, administers the enforcement of Annex VI worldwide.<sup>12</sup> Annex VI requires ratifying states to designate certain sea areas as ECAs where “mandatory measures” are required to control the emission of “NO<sub>x</sub> or SO<sub>x</sub> and [PM] or all three.”<sup>13</sup> These “mandatory measures” include limiting the sulfur content of fuel oil to reduce SO<sub>x</sub> and PM emissions through Regulation 14,<sup>14</sup> and prescribing three “tiers” of design standards for marine diesel engines

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ppm). DONALD DABDUB & SATISH VUTUKURU, AIR QUALITY IMPACTS OF SHIP EMISSIONS IN THE SOUTH COAST AIR BASIN OF CALIFORNIA 2 (2008). SO<sub>x</sub> can react with other compounds in the atmosphere to form small particles, which can penetrate deeply into lungs and cause or worsen respiratory diseases. *Sulfur Dioxide*, U.S. ENV'L PROT. AGENCY, <http://www.epa.gov/airquality/sulfurdioxide/health.html> (last updated June 28, 2013). The SO<sub>x</sub> particles usually spread up to a few hundred kilometers depending on weather and wind conditions. In the presence of catalysts such as NO<sub>x</sub>, SO<sub>x</sub> can form H<sub>2</sub>SO<sub>4</sub> causing acid rain. Johansson, *supra* note 8.

<sup>10</sup> PM (Particulate Matter), measured by PM<sub>2.5</sub> (diameters of the particulates are less than 2.5 μm) and PM<sub>10</sub> (diameters of the particulates are less than 10 μm), is produced during combustion in the form of soot, ash, organic and elemental carbon, SO<sub>4</sub> and its associated water molecules. The amount of PM emission from vessels is linearly dependent on the sulfur content of the fuel oil. *See* Nikopoulou et al., *supra* note 9, at 136-37; Johansson, *supra* note 8. PM contains microscopic solids and liquid droplets small enough to get into the lungs and cause a range of health problems to the lungs, respiratory systems, and heart. *Particulate Matter*, U.S. ENV'L PROT. AGENCY, <http://www.epa.gov/airquality/particlepollution/health.html> (last updated Mar. 18, 2013).

<sup>11</sup> *See* MARPOL Annex VI, *supra* note 5.

<sup>12</sup> *See Introduction to IMO*, ABOUT IMO, <http://www.imo.org/About/Pages/Default.aspx> (last visited Feb. 15, 2015).

<sup>13</sup> MARPOL Annex VI, *supra* note 5, Regulation 2, ¶ 8. Emissions of NO<sub>x</sub>, SO<sub>x</sub>, and particulate matter from ocean-going vessels could cause adverse impacts to the environment and public health, including premature mortality, cardiopulmonary disease, lung cancer, chronic respiratory ailments, acidification and eutrophication. *Id.*, Appendix III Criteria and Procedures for Designation of Emission Control Areas, ¶ 1.2.

<sup>14</sup> MARPOL Annex VI, *supra* note 5, Regulation 14. In ECAs, upper limits of the sulfur content of fuel oil used on board ships are 1.50% m/m before July 1, 2010; 1.00% m/m on and after July 1, 2010; 0.10% m/m on and after Jan. 1, 2015. *Id.* ¶ 8.

to control NO<sub>x</sub> emission through Regulation 13.<sup>15</sup> Depending on the vessel's operational area and the time when the vessel engine is installed, different levels of NO<sub>x</sub> emission standard apply: Tier I standard applies to engines that are installed on a ship constructed between 2000 and 2011;<sup>16</sup> Tier II standard applies to engines that are installed on ships constructed on or after January 2011, and if operating outside ECAs, ships constructed on or after January 1, 2016;<sup>17</sup> the most stringent Tier III standard applies to engines that are installed on ships constructed on or after January 1, 2016 if such ships operate in ECAs.<sup>18</sup> Notably, at the 65th session meeting held in May 2013, the IMO considered the proposal of delaying the implementation of Tier III standards in ECAs until January 1, 2021.<sup>19</sup> The IMO eventually made only a partial compromise. At the 66th session meeting in 2014, the IMO decided to uphold the original

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<sup>15</sup> Considering the long service life of ocean-going vessels that may last for decades, MARPOL Regulation 13 sets three “tiers” of NO<sub>x</sub> emission standards for marine diesel engines that are installed on ships constructed between 2000 and 2011, after 2011, and after 2016. These emission limits are relative, presented in formulas with the rated engine speed (rpm, revolutions per minute) as the variable. MARPOL Annex VI, *supra* note 5, Regulation 13.

<sup>16</sup> For engines that are installed on ships constructed on or after January 1, 2000 and before January 1, 2011, Tier I standard applies: NO<sub>x</sub> emission shall be under 17.0 g/kWh when the rated engine speed is less than 130 rpm; under  $45 \times n^{(-0.2)}$  with “n” being the rated engine speed is between 130 rpm and 2,000 rpm; under 9.8 g/kWh when the rated engine speed is above 2,000. MARPOL Annex VI, *supra* note 5, Regulation 13, ¶ 3.

<sup>17</sup> For engines that are installed on ships constructed on or after January 1, 2011, and ships constructed on or after January 2016 and operate outside ECAs, Tier II standard applies: NO<sub>x</sub> emission shall be under 14.4 g/kWh when the rated engine speed is less than 130 rpm; under  $44 \times n^{(-0.23)}$  with “n” being the rated engine speed is between 130 rpm and 2,000 rpm; under 7.7 g/kWh when the rated engine speed is above 2,000. MARPOL Annex VI, *supra* note 5, Regulation 13, ¶¶ 4, 5.1.3.

<sup>18</sup> Tier III standard applies to marine diesel engines that are installed on ships constructed on or after Jan. 1, 2016 and operate within ECAs. NO<sub>x</sub> emission from such ships shall be under 3.4 g/kWh when the rated engine speed is less than 130 rpm; under  $9 \times n^{(-0.2)}$  with “n” being the rated engine speed is between 130 rpm and 2,000 rpm; under 2.0 g/kWh when the rated engine speed is above 2,000. MARPOL Annex VI, *supra* note 5, Regulation 13, ¶¶ 5.1.1, 5.1.2.

<sup>19</sup> *IMO Marine Environment Protection Committee 65<sup>th</sup> Session Pushes Forward with Energy-Efficiency Implementation*, INT’L MAR. ORG. NEWS BRIEFS (May 21, 2013), <http://www.imo.org/MediaCentre/PressBriefings/Pages/18-MEPC65ENDS.aspx>.

2016 deadline for Tier III NO<sub>x</sub> requirement for marine diesel engines installed on new ships constructed on or after January 1, 2016, and accept the proposed delay until 2021 for engines installed on large yachts, viz. ships that are of less than 500 gross tonnage and 24 meters or more in length.<sup>20</sup>

Annex VI affords ratifying states with broad authority in enforcement. But such authority is qualified when the violation is caused by non-availability of low-sulfur fuels that are in compliance with MARPOL standards. To ensure compliance by ships, regardless of their country of registry, port states shall use “all appropriate and practicable measures of detection and environmental monitoring,” including inspection and bringing proceedings.<sup>21</sup> Port states “shall [also] take all reasonable steps” to provide low-sulfur fuel at ports and terminals in their jurisdictions.<sup>22</sup> If a ship furnishes evidence, primarily through documentation, of good faith attempts to secure compliant fuel yet no such fuel is available,<sup>23</sup> the port state shall consider “not taking control measures.”<sup>24</sup> Importantly, Annex VI explicitly provides that no deviation or delay of voyage should be required in order to achieve compliance.<sup>25</sup>

The United States ratified Annex VI in 2008<sup>26</sup> and implemented the mandatory air emission standards domestically

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<sup>20</sup> IMO, REPORT OF THE MARINE ENVIRONMENT PROTECTION COMMITTEE ON ITS SIXTY-SIX SESSION MEPC 66/21, 36 (2014), *available at* <http://www.uscg.mil/imo/mepc/docs/MEPC66-report.pdf>.

<sup>21</sup> MARPOL Annex VI, *supra* note 5, Regulation 11, ¶¶ 1, 2, 4.

<sup>22</sup> *Id.* Regulation 18, ¶ 1.

<sup>23</sup> *Id.* ¶¶ 2.11, 2.12.

<sup>24</sup> *Id.* ¶¶ 2.3, 2.5.

<sup>25</sup> *Id.* ¶ 2.2.

<sup>26</sup> Int’l Mar. Org. [IMO], *Status of Multilateral Conventions and Instruments in Respect of Which the International Maritime Organization or Its Secretary-General Performs Depositary or Other Functions* (2015), *available at* <http://www.imo.org/About/Conventions/StatusOfConventions/Documents/Status%20-%202015.pdf>. Seventy five countries have ratified MARPOL Annex VI. *Status of Conventions*, INT’L MAR. ORG., <http://www.imo.org/About/Conventions/StatusOfConventions/Pages/Default.aspx> (accessed by clicking on the “excel chart listing ratifications by State”). Ratifying parties “shall co-operate” in enforcement of the provisions of this Annex. MARPOL Annex VI, *supra* note 5, Regulation 11, §1.

through amendments made in 2008 to the APPS<sup>27</sup> and the Clean Air Act.<sup>28</sup> Currently, two ECAs have been established covering virtually all U.S. coastlines. The North American ECA came into force on August 1, 2012, extending up to 200 nautical miles from the Pacific coast, the Atlantic coast, the Gulf coast, and the eight Hawaiian Islands.<sup>29</sup> The United States Caribbean Sea ECA, covering coastal waters around Puerto Rico and the U.S. Virgin Islands, was approved by the IMO in 2011 and became enforceable starting January 1, 2014.<sup>30</sup> Emissions of SO<sub>x</sub>, NO<sub>x</sub>, and PM are all regulated in both ECAs.

B. Enforcement Measures of MARPOL Annex VI on Foreign Flagged Vessels Operating in U.S. Waters

MARPOL Annex VI affords no differentiated treatment of foreign flagged vessels and U.S. flagged vessels.<sup>31</sup> The APPS provides that Annex VI applies to all foreign flagged vessels “in” or bound for “a port, shipyard, offshore terminal, or the internal waters of the United States.”<sup>32</sup>

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<sup>27</sup> 33 U.S.C. §§ 1901-1915.

<sup>28</sup> Clean Air Act, 42 U.S.C. §§ 7401-7431 (2006).

<sup>29</sup> IMO, *North American Emission Control Area*, Resolution MEPC.190(60) (Mar. 26, 2010); OFFICE OF TRANSPORTATION AND AIR QUALITY, U.S. ENVIRONMENTAL PROTECTION AGENCY, EPA-420-F-10-015, DESIGNATION OF NORTH AMERICAN EMISSION CONTROL AREA TO REDUCE EMISSIONS FROM SHIPS (2010), available at <http://www.epa.gov/otaq/regs/nonroad/marine/ci/420f10015.pdf>.

<sup>30</sup> IMO, *Designation of the United States Caribbean Sea Emission Control Area and Exemption of Certain Ships Operation in the North American Emission Control Area and the United States Caribbean Sea Emission Control Area under Regulations 13 and 14 and Appendix VII of MARPOL Annex VI*, Resolution MEPC.202(62) (July 15, 2011); OFFICE OF TRANSPORTATION AND AIR QUALITY, U.S. ENVIRONMENTAL PROTECTION AGENCY, EPA-420-F-11-024, DESIGNATION OF EMISSION CONTROL AREA TO REDUCE EMISSIONS FROM SHIPS IN THE U.S. CARIBBEAN (2011)

<sup>31</sup> International Convention for the Prevention of Pollution from Ships (MARPOL), Art. 5(4) (with respect to the ship of non-parties to the convention, parties shall apply the requirements of the present convention as may be necessary to ensure that no more favorable treatment is given to such ships).

<sup>32</sup> 33 U.S.C. § 1902 (5)(A), (B).

Civil penalties would be imposed for failure to provide documentation to prove compliance with Annex VI and each day of non-compliance would be considered a separate violation.<sup>33</sup> For non-compliant vessels, the U.S. EPA requires a corrective action plan signed by the ship owner or operator, and would report the non-compliance to the ship's country of registry.<sup>34</sup> A class D felony is committed if a ship owner or operator "knowingly violates" Annex VI.<sup>35</sup> Up to one half of the criminal fines may be paid to the "person giving information leading to conviction."<sup>36</sup> The U.S. Coast Guard is responsible for conducting ship inspections to verify compliance and investigations to establish criminal liability.<sup>37</sup>

1. *Enforcement of Regulation 14 for SO<sub>x</sub> and PM emissions.* - To comply with Regulation 14, ships must use low-sulfur fuel,<sup>38</sup> be eligible for exemptions,<sup>39</sup> or use "equivalents."<sup>40</sup> Because the price

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<sup>33</sup> 33 U.S.C. § 1908 (2008); OFFICE OF COMMERCIAL VESSEL COMPLIANCE (CG-CVC), U.S. COAST GUARD, ECA JOB AID: DOMESTIC & FOREIGN VESSELS (2012).

<sup>34</sup> OFFICE OF COMMERCIAL VESSEL COMPLIANCE (CG-CVC), U.S. COAST GUARD, ECA JOB AID: DOMESTIC & FOREIGN VESSELS (2012).

<sup>35</sup> 33 U.S.C. § 1908, (a) (2008).

<sup>36</sup> *Id.*

<sup>37</sup> Memorandum of Understanding Between United States Coast Guard and United States Environmental Protection Agency Regarding Enforcement of Annex VI as Implemented by the Act to Prevent Pollution from Ships, June 27, 2011, available at <http://www2.epa.gov/sites/production/files/documents/annexvi-mou062711.pdf> (last visited Feb. 15, 2015).

<sup>38</sup> Regulation 14 of Annex VI specifies that ships operating within an Emission Control Area shall use fuel oil with sulfur content lower than 1.00% m/m on and after July 1, 2010, and lower than 0.10% m/m/ on and after January 1, 2015. MARPOL Annex VI, *supra* note 5, Regulation 14, ¶ 4. The term "low-sulfur fuel" in this paper is used broadly to include low-sulfur residual fuel, marine diesel oil, and marine gas oil. *See* Nikopoulou et al., *supra* note 9, at 141.

<sup>39</sup> Regulation 3 of Annex VI provides that ships on trial for emission control technology research could be exempted from certain Annex VI provisions if compliance would impede the technology development. MARPOL Annex VI, *supra* note 5, Regulation 3, ¶ 2. *See, e.g.,* Anna Lee Deal, *Liquefied Natural Gas as a Marine Fuel: A closer look at TOTE's Containership Projects* 12 (Nat'l Energy Policy Inst. Working Paper, May 7, 2013), available at <http://www.glmri.org/downloads/lngMisc/NEPI%20LNG%20as%20a%20Marine%20Fuel%205-7-13.pdf> (TOTE obtained a waiver from the EPA and Coast Guard allowing the company to operate its ships using distillate fuels above

of low-sulfur fuels is much higher than that of standard fuels,<sup>41</sup> a common practice to achieve compliance without splurging on cleaner fuel is to flush the fuel piping systems and fill the settling tanks with low-sulfur fuel only when approaching an ECA.<sup>42</sup> But fuel switching is less straightforward than it seems. Changing fuels when the fuel temperature is still very high causes loss of engine power.<sup>43</sup> Hence, vessels need to slow down when switching fuels to avoid malfunction.<sup>44</sup> Additionally, because the low viscosity of low-sulfur fuel<sup>45</sup> and the incompatibility of fuels<sup>46</sup> when mixed harms diesel

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regulative limit within the ECA during the conversion of these ships to liquefied natural gas so as to provide savings for the expensive environmental project).

<sup>40</sup> MARPOL Annex VI, *supra* note 5, Regulation 4, ¶ 1.

<sup>41</sup> See THEO NOTTEBOOM ET AL., ANALYSIS OF THE CONSEQUENCES OF LOW SULFUR FUEL REQUIREMENTS 16 (2010), available at [www.schone-scheepvaart.nl/downloads/rapporten/doc\\_1361790123.pdf](http://www.schone-scheepvaart.nl/downloads/rapporten/doc_1361790123.pdf).

<sup>42</sup> See DET NORSKE VERITAS (DNV), MARPOL 73/78 ANNEX VI REGULATIONS FOR THE PREVENTION OF AIR POLLUTION FROM SHIPS: TECHNICAL AND OPERATIONAL IMPLICATIONS 17 (2009), available at [www.dnv.com/binaries/marpol%20brochure\\_tcm4-383718.pdf](http://www.dnv.com/binaries/marpol%20brochure_tcm4-383718.pdf); Chengfeng Wang et al., *Cost-Effectiveness of Reducing Sulfur Emissions from Ships*, 41 (24) ENV'T SCI. TECH. 8233, 8234 (2007), available at <http://pubs.acs.org/doi/abs/10.1021/es070812w> (switching from high-sulfur marine fuels with a sulfur content of 2.7%, the worldwide average, to low-sulfur marine fuels with sulfur content not exceeding 1.5% can reduce about 44% of SO<sub>2</sub> emissions).

<sup>43</sup> DET NORSKE VERITAS (DNV), *supra* note 42.

<sup>44</sup> AMERICAN BUREAU OF SHIPPING, FUEL SWITCHING ADVISORY NOTICE 17 (2010), available at <http://www.eagle.org/eagleExternalPortalWEB/ShowProperty/BEA%20Repository/References/ABS%20Advisories/FuelSwitchingAdvisory> (operational manual for fuel switching and training for staff is necessary).

<sup>45</sup> Main operational problems caused by the low viscosity of low-sulfur fuel are the reduced effectiveness of the fuel as a lubricant, loss of capacity in fuel supply and circulation pumps, and increased chances of leakage of fuel through the fuel pump barrel and plunger, and suction and spill valve push rods, and less energy generated per volume of fuel. AMERICAN BUREAU OF SHIPPING, FUEL SWITCHING ADVISORY NOTICE 9, 10(2010).

<sup>46</sup> Incompatibility between different fuels would result in excessive sedimentation, sludging, and separator and filter problems. Hence, an additional set of fuel supply systems may be necessary. DET NORSKE VERITAS (DNV), *supra* note 42.

engines and boilers, modifications to the fuel system are often necessary.<sup>47</sup>

Annex VI encourages technological innovation by affording flexibilities in achieving compliance. Under Regulation 4, port states can allow “any fitting, material, appliance or apparatus . . . or other procedures, alternative fuel oils, or compliance methods” so long as such alternatives are as effective in terms of emission reductions as the measures provided by Annex VI.<sup>48</sup> If obtaining low-sulfur fuel is difficult, installing desulfurization units to achieve compliance is also technically feasible and permissible under MARPOL Annex VI.<sup>49</sup> But the high cost of such exhaust gas cleaning systems make this alternative unattractive.<sup>50</sup> Even if the cost of a desulfurization unit itself is justified, its installment would probably require re-designing the fuel system due to the limited space in the engine room, and therefore lead to additional investments in vessel retrofitting.<sup>51</sup> Another rapidly developing technology,<sup>52</sup> because of the heightened environmental standards driven by MARPOL Annex VI, is using

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<sup>47</sup> See AMERICAN BUREAU OF SHIPPING, FUEL SWITCHING ADVISORY NOTICE 11-14 (2010) (modifications that may be needed include installing separate purifier and piping system for the low-sulfur fuels, additional fuel coolers if the vessel operates in summer and tropical conditions, special fuel injection pumps); DET NORSKE VERITAS (DNV), *supra* note 42 (ship owners may consider upgrading the capacity of diesel tanks, or installing an additional set of service and settling tanks for low sulfur fuels).

<sup>48</sup> MARPOL Annex VI, *supra* note 5, Regulation 4, ¶ 1.

<sup>49</sup> AMERICAN BUREAU OF SHIPPING, FUEL SWITCHING ADVISORY NOTICE 7 (2010); DET NORSKE VERITAS (DNV), MARPOL 73/78 ANNEX VI REGULATIONS FOR THE PREVENTION OF AIR POLLUTION FROM SHIPS: TECHNICAL AND OPERATIONAL IMPLICATIONS 16 (2009) (exhaust gas cleaning alternatives will also reduce PM emissions); see Chengfeng Wang et al., *supra* note 42, at 8234.

<sup>50</sup> DET NORSKE VERITAS (DNV), *supra* note 49 (further technological developments or legislation are needed to lower the installation costs of a desulfurization unit, which is about \$1 million (USD) to \$2 million (USD), to make this alternative cost-beneficial).

<sup>51</sup> See AMERICAN BUREAU OF SHIPPING, FUEL SWITCHING ADVISORY NOTICE 12 (2010); DET NORSKE VERITAS (DNV), *supra* note 49, at 17-18.

<sup>52</sup> See, e.g., Bridget C. Brett, Potential Market for LNG-Fueled Marine Vessels in the United States 34 (June 2008) (Master’s thesis, Massachusetts Institute of Technology), available at <http://dspace.mit.edu/handle/1721.1/44920#files-area> (the four main manufactures who have the technology for LNG-fueled vessels are Rolls-Royce, GE, Wärtsilä, and MAN Diesel).



Liquefied Natural Gas (LNG) as a marine fuel.<sup>53</sup> The cost-effectiveness of conversion to LNG varies from vessel to vessel, and is affected, primarily, by three factors: (1) the amount of time the vessel operates in an ECA; (2) LNG tanker size relative to the vessel size; and (3) LNG fuel availability.<sup>54</sup>

However, Regulation 4 leaves the gap of identifying “equivalents,” i.e., alternative compliant measures, to the port states to fill in through bilateral negotiations. Currently, the United States requires foreign port states to submit to the U.S. Coast Guard proposals of equivalents for compliance.<sup>55</sup> The United States is seeking IMO’s coordination in identifying equivalents<sup>56</sup> to minimize the need for enforcement actions if the U.S. Government disagrees with the equivalents approved by other port states.<sup>57</sup> Absent IMO’s

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<sup>53</sup> Natural gas is a type of fossil fuel consisting mainly of methane (CH<sub>4</sub>). *Id.* Gaseous Natural gas transforms into liquid, called Liquefied Natural Gas (LNG), when the natural gas is cooled to -162 Celsius degrees. LNG creates the economics of scale by saving 99% of the space that natural gas with the same energy content in gaseous form would take. *Id.* at 15-16. NLG is considered the cleanest form of fuel because it contains no sulfur and thus all SO<sub>x</sub> emissions and most PM emissions are eliminated. Because LNG burns at lower temperatures than standard fuels, NO<sub>x</sub> emissions are also reduced significantly. Johansson, *supra* note 8. The use of LNG as marine fuel became economically attractive when natural gas became cheaper than residual oil in early 2006. Nikopoulou et al., *supra* note 9, at 143. But the cost of LNG-fueled systems is generally 12% higher than the capital investment for a standard diesel engine. Bridget C. Brett, *supra* note 52, at 57.

<sup>54</sup> Anna Lee Deal, *supra* note 39, at 12 (LNG facilities are being planned for Cameron Parish and Port Fourchon in Los Angeles, along the Mississippi River, and in the Great Lakes region).

<sup>55</sup> U.S. DEP’T OF HOMELAND SEC., 16711/CG-CVC Policy Letter, GUIDELINES FOR COMPLIANCE AND ENFORCEMENT OF THE EMISSION CONTROL AREAS ESTABLISHED WITHIN THE UNITED STATES JURISDICTION AS DESIGNATED IN MARPOL ANNEX VI REGULATION 14 (2012), § 5b(ii).

<sup>56</sup> *See* Letter from Jeffrey G. Lantz, Dir., Commercial Regulations and Standards, U.S. Coast Guard, and Margo Tsirigotis Oge, Dir., Office of Transp. and Air Quality, U.S. Env’tl. Prot. Agency, to Koji Sekimizu, Secretary-General of Int’l Mar. Org. (Mar. 12, 2012), *available at* <http://www.epa.gov/otaq/regs/nonroad/marine/ci/letter-epa-and-uscg-to-imo.pdf>.

<sup>57</sup> U.S. DEP’T OF HOMELAND SEC., 16711/CG-CVC Policy Letter, GUIDELINES FOR COMPLIANCE AND ENFORCEMENT OF THE EMISSION CONTROL AREAS ESTABLISHED WITHIN THE UNITED STATES JURISDICTION AS DESIGNATED IN MARPOL ANNEX VI REGULATION 14 (2012), § 5b(ii).

intervention, countries such as the United States, which are enforcing Annex VI in advance of the other countries, might have to act as the *de facto* global administrator of Annex VI.

The Bunker Delivery Note, where the quality and quantity of fuel oil supplied to vessels for combustion purposes is documented,<sup>58</sup> serves as the main evidentiary source for verifying compliance with Regulation 14. If the sulfur content of fuel oil exceeds Annex VI limits,<sup>59</sup> and no exemption or equivalents apply, the ship owner should provide documentation to prove that best efforts were made to procure compliant fuel oil and notify the EPA of the non-availability of such fuel oil before entering the ECA.<sup>60</sup> Taking together the regulative requirements and available technologies, owners of ships registered in countries where Annex VI is not fully enforced or no equivalents under Regulation 4 are formally established would probably have no choice but to change voyage plans, with the *hope*<sup>61</sup> of avoiding criminal charges in the United States.

2. *Enforcement of Regulation 13 for NO<sub>x</sub> emissions.* - The reduction of NO<sub>x</sub> emissions is a function of multiple factors, including: engine design, engine age, fuel type, operational mode, energy efficiency,<sup>62</sup> and any add-on emission reduction equipment.<sup>63</sup>

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<sup>58</sup> MARPOL Annex VI, *supra* note 5, Regulation 18, ¶ 6.

<sup>59</sup> *Id.* Regulation 14, ¶ 4.

<sup>60</sup> U.S. ENVTL. PROT. AGENCY, INTERIM GUIDANCE ON THE NON-AVAILABILITY OF COMPLIANT FUEL OIL FOR THE NORTH AMERICAN EMISSION CONTROL AREA (2012), 3-4; OFFICE OF COMMERCIAL VESSEL COMPLIANCE (CG-CVC), U.S. COAST GUARD, ECA JOB AID: DOMESTIC & FOREIGN VESSELS (2012), § 3.

<sup>61</sup> Evidence of good-faith attempt to secure low-sulfur fuel as required by Annex VI is only relevant in EPA's determination of the appropriate administrative actions, but does not necessarily remove the possibility of finding criminal liability. *See* U.S. ENVTL. PROT. AGENCY, *supra* note 60, at 4-5.

<sup>62</sup> NO<sub>x</sub> emission is actually a side effect of engine designs that aim to enhance energy efficiency by maximizing the completeness of fuel combustion, *i.e.*, increasing the pressure and temperature of combustion process. PER KÄGESON, MARKET-BASED INSTRUMENTS FOR NO<sub>x</sub> ABATEMENT IN THE BALTIC SEA 10 (2009), *available at* [http://www.cleanshipping.org/download/2009\\_11\\_nox\\_report\\_baltic\\_sea.pdf](http://www.cleanshipping.org/download/2009_11_nox_report_baltic_sea.pdf) (Air Pollution and Climate Series 24, the European Environmental Bureau and the European Federation for Transport and Environment).

To a certain extent, the level of compliance with the NO<sub>x</sub> emission standards of Annex VI reflects the sophistication of technological research and development in the shipbuilding industry.<sup>64</sup> The

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<sup>63</sup> See DAVID COOPER & TOMAS GUSTAFSSON, *METHODOLOGY FOR CALCULATING EMISSIONS FROM SHIPS: 1. UPDATE OF EMISSION FACTORS 13-15* (2004). The technical issues involved in restricting engine design to minimize air emissions are complex not only because the engine design has to fit various ship configurations but also because of safety concerns as ships must be able to depend on their sources of power in tough weather conditions and navigational hazards. See generally Int'l Mar. Org. [IMO], *Supplementary Information to the Final Report of the Correspondence Group on Assessment of Technological Developments to Implement the Tier III NO<sub>x</sub> Emission Standards under MARPOL Annex VI*, MEPC 65/INF. 10 (Feb. 8, 2013) (countries including the United States, Finland, Japan, Germany, Sweden, and the United Kingdom reviewing technology developments to achieve Tier III standards for NO<sub>x</sub> emission that is to be in force in 2016).

<sup>64</sup> Several technically feasible means exist to achieve the relative standards for NO<sub>x</sub> emission under Annex VI. For low-speed two-stroke engines, compliance can be achieved through replacing conventional fuel valves by low-NO<sub>x</sub> slide valves. For other engines, compliance is achieved through more complex engine modifications, including miller cycling, which achieves a lower temperature in the combustion chamber without a loss in power output; direct water injection, which rebuilds the engine to enable fresh water being sprayed into the combustion air to remove NO<sub>x</sub> from the exhaust gas; exhaust gas recirculation, where exhaust gases are filtered, cooled, and redirected into the engine to reduce the combustion temperature; selective catalytic reduction, a commercialized catalytic exhaust treatment system that is applicable to both new vessels and retrofit installations; humid air motor, which prevents NO<sub>x</sub> formation during combustion by adding water vapor to the engine's combustion air; and low-NO<sub>x</sub> engines, which employs techniques to control fuel injection, spray formation, and fuel-air mixture to reduce temperature throughout the combustion process. See KÄGESON, *supra* note 62, at 10-13 (Air Pollution and Climate Series 24, the European Environmental Bureau and the European Federation for Transport and Environment); Seita Akimoto et al., *Techniques for Low NO<sub>x</sub> Combustion on Medium Speed Diesel Engine*, 2(1) BULLETIN OF THE MECH. ENG'G SCIENTIFIC J., 8 (2000), available at <http://www.jime.jp/e/publication/bulletin/english/pdf/mv28n012000p08.pdf>; KÄGESON, *supra* note 62, at 10 (Air Pollution and Climate Series 24, the European Environmental Bureau and the European Federation for Transport and Environment). Tier I and II standards of Annex VI, Regulation 13 are achievable with relatively simple engine modifications. See Johansson, *supra* note 8, at 20 (some engine manufactures have already been producing Tier II compliant engines for the last decade). The international shipbuilding industry is more concerned with the compliance with the Tier III standards. See Int'l Mar. Org. [IMO], *Supplementary Information to the Final Report of the Correspondence Group on Assessment of Technological Developments to Implement the Tier III NO<sub>x</sub> Emission Standards under MARPOL Annex VI*, MEPC 65/INF. 10 (Feb. 8, 2013). Currently, only three technologies could

primary evidentiary source for verifying compliance is the International Air Pollution Prevention Certificate,<sup>65</sup> which should be issued to individual engines based on emission tests on the engine manufacturer's test bed.<sup>66</sup> Therefore, although ship owners or operators seem to be the directly affected parties, the underlying rationale of Regulation 13 is to urge manufacturers to design vessels that meet higher emission standards by creating market demand from the ship owners and operators.

In 2010, the EPA published a rule to regulate NO<sub>x</sub> emissions from new Category 3 engines with the same level of stringency as Annex VI, Regulation 13.<sup>67</sup> The EPA rule applies to Category 3 engines installed on U.S. vessels only.<sup>68</sup> The regulated parties are mainly the manufacturers of Category 3 marine diesel engines,<sup>69</sup> most of which are incorporated in Finland, Germany, and Japan.<sup>70</sup> The U.S. vessel manufacturing industry is affected only to the extent that domestic vessel manufacturers have to adapt vessel designs and manufacturing processes to the new engine designs.<sup>71</sup>

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meet Tier III standards: selective catalytic reduction, humid air motor, and liquefied natural gas engine. Jerzy Herdzik, *Emissions from Marine Engines Versus IMO Certification and Requirements of Tier 3*, 18 J. KONES POWERTRAIN & TRANS. 161, 165-66 (2011) (IMO's Tier III standards would require sharp increase in the development of new control systems adapted to the operation of compliant marine engines).

<sup>65</sup> MARPOL Annex VI, *supra* note 5, Regulation 1, ¶ 1; MARPOL Regulation 13, ¶ 7.3; MARPOL Appendix I, Form of International Air Pollution Prevention (IAPP) Certificate (Regulation 8).

<sup>66</sup> DET NORSKE VERITAS (DNV), *supra* note 49, at 9 (later onboard verification procedures are initially decided by the engine manufacturer).

<sup>67</sup> Category 3 engines refer to compression-ignition engines at or above 30 liters per cylinder. *See* 40 C.F.R. § 94, 1042 (2010).

<sup>68</sup> 40 C.F.R. § 94.1 (b)(2). *See also* *Bluewater Network v. EPA*, 372 F.3d 404, 412-13 (D.C. Cir. 2004) (upholding the EPA's decision not to regulate Category 3 on foreign-flagged vessels because of particular deference to agency decision under the Clean Air Act).

<sup>69</sup> U.S. ENVTL. PROT. AGENCY, REGULATORY IMPACT ANALYSIS: CONTROL OF EMISSION OF AIR POLLUTION FROM CATEGORY 3 MARINE DIESEL ENGINES (2009), pt. 1 at 5-6, pt. 8 at 3.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

For foreign vessels, the NO<sub>x</sub> emissions are instead controlled directly through implementing ECAs.<sup>72</sup> Hence, the compliance of foreign vessels with NO<sub>x</sub> emission standards relies largely on whether their countries of registry have given effect to Annex VI through legislation. The U.S. EPA plays only a secondary role in the sense that it has no direct control over the upstream regulatory necessities, *viz.*, engine designs of the vessels that are registered and manufactured in foreign countries. As such, an “administrative vacuum” exists in enforcing Regulation 13 on foreign vessels.<sup>73</sup>

## II. CHALLENGES OF ENFORCING ANNEX VI: AN UNEVEN GLOBAL REGULATIVE LANDSCAPE

In the United States, APPS sets a rather low threshold for finding criminal liability, risking the efficiency and economy of the administrative enforcement process. In most foreign countries that are major maritime trading partners with the United States, however, Annex VI has not been fully enforced. The disparity between the compliance environments at calling ports in different countries needs to be addressed to minimize the enforcement cost borne by the United States in implementing Annex VI.

### A. “Knowing Violation” as the Legal Threshold for Finding Criminal Liability

The owner or other parties involved in a non-compliant foreign flagged vessel who “knowingly violates” MARPOL would be criminally charged.<sup>74</sup> But APPS provides no other language to substantiate the threshold of “knowing violation.” The EPA guidelines indicate indirectly that criminal liability could be found if the ship has previously reported non-availability of compliant fuel oil, or if insufficient quantity of compliant fuel oil is obtained at U.S. ports even though the ship operator knows that the vessel will return

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<sup>72</sup> 40 C.F.R., Summary III, A.

<sup>73</sup> See generally Snyder, *supra* note 4, at 1072-80 (criticizing EPA’s Category 3 rule as inadequate for not extending to foreign vessels).

<sup>74</sup> 33 U.S.C. § 1908 (a) (2008).

to the ECA and complaint fuel oil is unavailable outside the ECA.<sup>75</sup> The EPA also refuses to consider the cost of compliant fuel oil as a relevant factor to establish “unavailability.”<sup>76</sup>

Recent cases regarding enforcement of MARPOL on foreign vessels indicate that federal courts are unlikely to limit finding criminal liability, especially when the violation is caused by an affirmative action, as opposed to omissions. In *United States v. Pena*, the court confirmed the conviction of a surveyor of an institute organized in Florida for failing to conduct the required survey under MARPOL Annex I of a Panamanian-flagged vessel.<sup>77</sup> The court found “knowing violation” was established when the non-compliant performance of the ship had been in place for months and the defendant surveyor did not test the parts of the ship that he knew were not functional.<sup>78</sup>

MARPOL Annex I was enforced in a more aggressive manner in *United States v. Sanford Ltd.*<sup>79</sup> Defendant Sanford is a fishing company incorporated in New Zealand and transports cargo to U.S. ports on a regular basis. Sanford was charged, *inter alia*, for not recording discharges of oily bilge water in the vessel’s Oil Record Book (ORB), even though such omission occurred in the high seas before entering U.S. water and would not necessarily result in criminal liability under the MARPOL enforcement regulations in New Zealand.<sup>80</sup> The court upheld the conviction on two grounds. First, although finding APPS does not intend to apply extraterritorially, the court reasoned that the triggering point of the violation is “at the moment a vessel enters a U.S. port with an

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<sup>75</sup> See U.S. ENVTL. PROT. AGENCY, INTERIM GUIDANCE ON THE NON-AVAILABILITY OF COMPLIANT FUEL OIL FOR THE NORTH AMERICAN EMISSION CONTROL AREA (2012), at 8.

<sup>76</sup> *Id.* at 5.

<sup>77</sup> *United States v. Pena*, 684 F.3d 1137, 1143-44 (11th Cir. 2012), *cert. denied*, 2013 U.S. LEXIS 573 (2013) (upholding U.S. jurisdiction over foreign flagged vessels).

<sup>78</sup> *Pena*, 684 F.3d, 1152-53.

<sup>79</sup> *United States v. Sanford Ltd.*, 880 F. Supp. 2d 9, 11 (D.C. 2012) (finding that the law-of-the-flag doctrine does not bar the U.S. Government from prosecuting defendants for their violations of MARPOL implemented by the Act to Prevent Pollution from Ships).

<sup>80</sup> *Id.* at 12.

inaccurate ORB” rather than when the omission occurred.<sup>81</sup> Second, the court held that the defense of being subjected unfairly to the peculiar rules of a foreign sovereign does not prevail when the U.S. and foreign regulations for implementing MARPOL are “on their face . . . functionally identical.”<sup>82</sup> However, the court narrowed this holding to cases where the regulations of the United States and the foreign country are unlikely to be in conflict.<sup>83</sup> The court noted implicitly that a “balancing of the delicate and important interests of comity and sovereignty” might be needed in some cases.<sup>84</sup>

In a similar case, *United States v. Ionia Mgmt. S.A.*,<sup>85</sup> defendant Ionia, incorporated in Liberia and headquartered in Greece, was convicted for making false entries in the ORB to conceal illegal discharges of oily wastewater and obstructing a federal investigation. The court upheld the order of forty-eight months of probation, a corrective ship management plan, and a fine of \$4.9 million (USD).<sup>86</sup> The court held that the amount of the criminal fine, although not calculated based on the sentencing guidelines, was nevertheless reasonable given the culpability of the violation.<sup>87</sup> The sentencing was enforced through several hearings during the subsequent three years.<sup>88</sup>

#### B. Enforcement of Annex VI Outside the United States: China as an Example

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<sup>81</sup> *Id.* at 14-15.

<sup>82</sup> *Id.* at 21-23 (finding the discrepancies as to the interpretation of “machinery space” insufficient to support a finding of material difference between the U.S. and New Zealand regulations).

<sup>83</sup> *Sanford Ltd.*, 880 F. Supp. 2d, 22.

<sup>84</sup> *Id.*

<sup>85</sup> *United States v. Ionia Mgmt. S.A.*, 555 F.3d 303, 305 (2d Cir. 2009).

<sup>86</sup> *Id.* at 310.

<sup>87</sup> *Id.*

<sup>88</sup> *See* *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134 (JBA), 2011 WL 5304117 (D. Conn. Nov. 1, 2011); *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134 (JBA), 2011 U.S. Dist. LEXIS 126089 (D. Conn. Oct. 28, 2011); *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134 (JBA), 2011 U.S. Dist. LEXIS 87122 (D. Conn. Aug. 3, 2011); *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134 (JBA), 2011 U.S. Dist. LEXIS 12996 (C. Conn. Feb. 9, 2011); *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134 (JBA), 2010 U.S. Dist. LEXIS 109063 (D. Conn. Oct. 11, 2010); *United States v. Ionia Mgmt. S.A.*, No. 3:07-CR-134(JBA), 2009 WL 3074727 (D. Conn. Sept. 22, 2009).

The benefits of implementing Annex VI will be fully realized only when both U.S. and foreign vessels *actually* operate under the same environmental standards.<sup>89</sup> Not all countries, however, perceive air emissions from marine vessels as a significant pollution source as the United States does.<sup>90</sup> A review of regulations and policies on air pollution control in China, an example of one of the largest waterborne trading partners with the United States,<sup>91</sup> shows that such foreign countries are unlikely to enact legislation in the near term to implement Annex VI as stringently as the United States.

China has not enacted particular laws or regulations to implement Annex VI,<sup>92</sup> and will not do so, at least, until after 2015.

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<sup>89</sup> See U.S. ENVTL. PROT. AGENCY, *supra* note 69, pt. 6 at 1.

<sup>90</sup> Although the prioritization of sectors targeted in a country's air pollution control strategy is not always "objective," numbers do found a persuasive basis. In the United States, the transport sector contributes to about 54% of total NO<sub>x</sub> emissions. ANDREW AULISI ET AL., GREENHOUSE GAS EMISSIONS TRADING IN U.S. STATES: OBSERVATIONS AND LESSONS FROM THE OZONE TRANSPORT COMMISSION (OTC) NO<sub>x</sub> BUDGET PROGRAM 3 (Margaret B. Yamashita ed., World Resources Institute, 2005), available at [http://www.wri.org/sites/default/files/pdf/nox\\_ghg.pdf](http://www.wri.org/sites/default/files/pdf/nox_ghg.pdf) (estimation based on inventory data released in EPA reports reviewing the performance of OTC NO<sub>x</sub> Budget Program); see also *The 2011 National Emissions Inventory*, U.S. ENVTL. PROT. AGENCY (last updated on Dec. 24, 2013), [http://www.epa.gov/ttn/chief/net/2011\\_inventory.html](http://www.epa.gov/ttn/chief/net/2011_inventory.html) (emission sources from transport sector contributes about 62% to the total NO<sub>x</sub> emissions from fuel combustion, gas stations, industrial processes, and road and non-road mobile sources). In other countries, the transport sector may contribute less to the total air pollutant emission by percentage than that in the United States due to the differences in industrial structure. In China, for example, the transport sector contributes only about 9% to the total NO<sub>x</sub> emissions in 2005. J. Xing et al., *Projections of Air Pollutant Emissions and Its Impacts on Regional Air Quality in China in 2020*, 11 *ATMOSPHERIC CHEMISTRY AND PHYSICS* 3119, 3129 (2011), available at <http://www.atmos-chem-phys.net/11/3119/2011/acp-11-3119-2011.html>. The major source of NO<sub>x</sub> emissions is instead power plants. *Id.* at 3128.

<sup>91</sup> The waterborne container trade between China and the United States was at 29,477,025 TEUs in 2012. U.S. Dep't of Transp., U.S. Waterborne Foreign Container Trade by Trading Partners (Sept 26, 2013), [http://www.marad.dot.gov/library\\_landing\\_page/data\\_and\\_statistics/Data\\_and\\_Statistics.htm](http://www.marad.dot.gov/library_landing_page/data_and_statistics/Data_and_Statistics.htm) (last visited Oct. 21, 2013).

<sup>92</sup> China ratified MARPOL Annex VI in 2010. *Status of Conventions*, INT'L MAR. ORG., <http://www.imo.org/About/Conventions/StatusOfConventions/Pages/Default.aspx> (last updated Sept. 30, 2012). Ratifying parties "shall co-operate" in enforcement the provisions of this Annex. MARPOL Annex VI, *supra* note 5, Regulation 11, ¶1.



Only a set of quasi-regulative rules promulgated by the Ministry of Transport in 2010 requires that ships should hold certificates issued by the Marine Administration in accordance with international treaties that the Chinese government entered into or ratified.<sup>93</sup> However, this 2010 rule does not make reference to MARPOL Annex VI or specify what certificates the ships should hold.<sup>94</sup> Provisions of the 2010 rule are so generally stated that its on-the-ground enforcement cannot be realized until the adoption of more specific regulations or plans.<sup>95</sup>

Moreover, the approach employed by Chinese policies is rather different from the MARPOL approach to control air emission from waterborne transport. Once the numbers of national emission caps and energy saving objectives are established<sup>96</sup> for every five-year planning period,<sup>97</sup> the air pollution control policies for different sectors and sub-sectors are essentially allocations of the national goal.<sup>98</sup> Hence, air emissions from the marine transport sector are

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<sup>93</sup> Zhonghua renming gongheguo chuanbo jiqi youguan zuoye huodong wuran haiyang huanjing fangzhi guanli guiding (中华人民共和国船舶及其有关作业活动污染海洋环境防治管理规定) [Management Provisions on Preventing Pollution of Marine Environment from Ships and Related Activities of the People's Republic of China] (promulgated by the Ministry of Transport, Oct. 8, 2010, effective Feb. 1, 2011), art. 1, 5, [http://www.gov.cn/flfg/2010-12/02/content\\_1758149.htm](http://www.gov.cn/flfg/2010-12/02/content_1758149.htm) (last visited Feb. 15, 2015).

<sup>94</sup> *Id.*

<sup>95</sup> See Nengye Liu & Frank Maes, *Prevention of Vessel-Source Marine Pollution: A Note on the Challenges and Prospects for Chinese Practice under International Law*, 42 OCEAN DEV. & INT'L LAW 356, 358-59 (2011), available at <http://www.tandfonline.com/doi/abs/10.1080/00908320.2011.619373> - .U5f9sRr8U5s.

<sup>96</sup> See Guowuyuan guanyu yingfa shi'erwu jieneng jianpai zonghexing gongzuo fang'an de tongzhi (国务院关于印发“十二五”节能减排综合性工作方案的 通知) [State Council's Notification on Promulgating the Integrated Work Plan for Energy Saving and Emission Reduction for the Twelfth Five Year] (promulgated by the State Council Aug. 31, 2011, No. 26), available at [http://www.gov.cn/zwgk/2011-09/07/content\\_1941731.htm](http://www.gov.cn/zwgk/2011-09/07/content_1941731.htm).

<sup>97</sup> See *The First Ten Five-Year Plans of the People's Republic of China*, THE CENTRAL PEOPLE'S GOV'T OF THE PEOPLE'S REPUBLIC OF CHINA (Mar. 20, 2006), [http://www.gov.cn/test/2006-03/20/content\\_231421.htm](http://www.gov.cn/test/2006-03/20/content_231421.htm).

<sup>98</sup> See Andrew C. Mertha, *China's "Soft" Centralization: Shipping Tiao/Kuai Authority Relations*, 184 CHINA QUARTERLY 791, 796-800 (2005), available at <http://falcon.arts.cornell.edu/am847/pdf/Soft%20Centralization%20Final.pdf>; see also Chenggang Xu, *The Fundamental Institutions of China's Reforms and Development*,

regulated based on the total amount of emissions for specified pollutants and reduction in energy consumption, rather than prescribing standards for marine fuels and diesel engines as MARPOL Annex VI does.<sup>99</sup> Currently, China is in the twelfth five-year planning period, which runs from 2011 until 2015.<sup>100</sup> The Twelfth Five-Year Plan for Energy Saving and Emission Reduction, one of the master national policies for this planning period, sets a target of reducing energy consumption of vessels for marine and inland waterway transportation by 10% to 6.29 kilograms of coal equivalent per ton of goods per 1,000 kilometers by 2015.<sup>101</sup>

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49(4) J. ECON. LITERATURE 1076, 1082-84, 1086-92 (2011), *available at* [www.sef.hku.hk/~cgxu/04\\_Xu.pdf](http://www.sef.hku.hk/~cgxu/04_Xu.pdf) (the functioning of Chinese government is not a mixture of de facto federal state and a centralized regime: regional decentralization exists as to economic governance, while other political and policy decision-making processes follows closer to an authoritarian regime).

<sup>99</sup> See Jiakuai tuijin luse xunhuan ditan jiaotong yunshu fazhan zhidao yijian (加快推进绿色循环低碳交通运输发展指导意见) [Guiding Principles on Promoting Green Low-Carbon Transport Development] (promulgated by the Ministry of Transport, No. 323, May 22, 2013) (“*Guiding principles (zhidao yijian)*” are less rigid policies than “*Opinions (yijian)*.”), *available at* Ministry of Transport website: [http://www.moc.gov.cn/2006/jiaotongjj/07jiaotjnw/wenjiangg/201305/t20130527\\_1417741.html](http://www.moc.gov.cn/2006/jiaotongjj/07jiaotjnw/wenjiangg/201305/t20130527_1417741.html); (2013年运输行业节能减排工作要点) [Key Tasks for Energy Saving and Emission Reduction in 2013 in Transport Sector] (promulgated by the Ministry of Transport, No. 37, Jan. 10, 2013), *available at* [http://www.moc.gov.cn/2006/jiaotongjj/07jiaotjnw/wenjiangg/201301/t20130118\\_1356606.html](http://www.moc.gov.cn/2006/jiaotongjj/07jiaotjnw/wenjiangg/201301/t20130118_1356606.html); Gonglu shuilu jiaotong yunshu jieneng jianpai shi'erwu guihua (公路水路交通运输节能减排“十二五”规划) [The Twelfth Five-Year Plan for Energy Saving and Emission Reduction in Road and Water Transportation] (promulgated by the Ministry of Transport, July 8, 2011), *available at* [http://www.moc.gov.cn/zhuzhan/zhengcejiedu/guihuajiedu/shierwuguihua/D/xianguanzhengcefaui/201110/t20111010\\_1064457.html](http://www.moc.gov.cn/zhuzhan/zhengcejiedu/guihuajiedu/shierwuguihua/D/xianguanzhengcefaui/201110/t20111010_1064457.html).

<sup>100</sup> See Guomin jingji he shehui fazhan di shierge wunian guihua gangyao (国民经济和社会发展第十二个五年规划纲要) [The Outline of the Twelfth Five-Year Plan for Social and Economic Development] (promulgated by the State Council, Mar. 16, 2011), *available at* [http://www.gov.cn/2011lh/content\\_1825838\\_2.htm](http://www.gov.cn/2011lh/content_1825838_2.htm).

<sup>101</sup> Jieneng jianpai shi'erwu guihua (节能减排“十二五”规划) [The Twelfth Five-Year Plan for Energy Saving and Emission Reduction] (promulgated by the State Council, No. 40, Aug. 6, 2012), Table 1, *available at* [http://www.gov.cn/gongbao/content/2012/content\\_2217291.htm](http://www.gov.cn/gongbao/content/2012/content_2217291.htm) (last visited Oct. 22, 2013).

Subsequently, the Ministry of Transport (MoT) announced in the sector's leading policy<sup>102</sup> that building green ports would be a major task during the twelfth five-year planning period. This "green port" policy trickles down to retrofitting port infrastructures to use alternative powers in place of diesel fuel, including upgrading rubber-tired gantry to use electricity instead of fuel,<sup>103</sup> scaling up the use of shorepower and solar power at ports, and establishing automatic management systems to monitor energy consumption on vessels.<sup>104</sup> Government funding for such projects generally shall be no more than ¥10 million (RMB), according to the Temporary Management Measures for Special Funding for Energy Saving and Emission Reduction Projects in the Transport Sector issued jointly by the MOT and the Ministry of Finance.<sup>105</sup>

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<sup>102</sup> Gonglu shuilu jiaotong yunshu jieneng jianpai shi'erwu guihua (公路水路交通运输节能减排"十二五"规划) [The Twelfth Five-Year Plan for Energy Saving and Emission Reduction in Road and Water Transportation] (promulgated by the Ministry of Transport, July 8, 2011), section 4, sub-section 7, *available at* [http://www.moc.gov.cn/zhuzhan/zhengcejiedu/guihuajiedu/shierwuguihuaJD/xiangguanzhengcefagui/201110/t20111010\\_1064457.html](http://www.moc.gov.cn/zhuzhan/zhengcejiedu/guihuajiedu/shierwuguihuaJD/xiangguanzhengcefagui/201110/t20111010_1064457.html) (last visited Oct 22, 2013)

<sup>103</sup> Rubber-tiered gantry (RTG), also called transtainer, is a mobile gantry crane used for stacking containers at container terminals. Diesel rubber-tired gantry (RTG) can represent a large percentage of a port's total fuel consumption. Electricity-powered RTGs offer a promising alternative in face of the increasing price of diesel fuel and more stringent ambient air standards. The cost of converting a diesel RTG to an electric cable reel connected one is approximately \$250,000. The effectiveness of such fuel-to-electricity conversion depends primarily on the availability of electrical infrastructures connecting to the port, the remaining service life of the RTG, and how much the RTG is used. ELEC. POWER RESEARCH INST., ELECTRIC CABLE REEL RUBBER-TIRED GANTRY CRANES: COSTS AND BENEFITS 1, 4 (2010), *available at* <http://www.epri.com/abstracts/Pages/ProductAbstract.aspx?ProductId=000000000001020646>.

<sup>104</sup> *Id.*

<sup>105</sup> Jiaotong yunshu jieneng jianpai zhuanxiang zijin guanli zhanxing banfa (交通运输部节能减排专项资金管理暂行办法) [Temporary Management Measures for Special Funding for Energy Saving and Emission Reduction Projects in the Transport Sector] (issued by the Ministry of Finance and Ministry of Transport, No. 374, June 20, 2011), chapter 2, art. 7, *available at* [http://jjs.mof.gov.cn/zhengwuxinxi/tongzhigonggao/201107/t20110704\\_570700.html](http://jjs.mof.gov.cn/zhengwuxinxi/tongzhigonggao/201107/t20110704_570700.html).

Recently, the Chinese government heightened the sulfur content standard for marine fuel oils. Under the new standard, the maximum sulfur content of fuel oils shall be 3.5% m/m,<sup>106</sup> which comports with Regulation 14 of Annex VI for ships operating outside ECAs.<sup>107</sup> Thus, even if all ships registered in China use fuel oils with less than 3.5% m/m sulfur content, many of them would still fail the U.S. standard since virtually all U.S. waters are in ECAs, where the sulfur content of fuel oils should be less than 1.00% m/m starting from July 1, 2010<sup>108</sup> and 0.10% m/m starting from 2015.<sup>109</sup>

The above review of policies and regulations shows that marine vessels have not moved to the top of the air-cleaning agenda of the Chinese government.<sup>110</sup> Any further legislation or policymaking to give effect to the terms of MARPOL Annex VI in China would probably only take place during the next planning period at the earliest, *viz.*, after 2015. Given this timing, China would have to implement the most stringent emission standards provided in Regulation 13 and 14 by the implementation schedule specified in Annex VI to be comparable with U.S. standards.<sup>111</sup>

### C. Deficiencies of the Current Enforcement Mechanism

1. *Deficiencies on a global scale.* - A compliance environment that exposes foreign ships with rotating crews, trading at different ports where the stringency of a treaty is approached differently, poses

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<sup>106</sup> Chuanyong ranliaoyou (船用燃料油) [Marine Fuel Oil Standard] (issued by the General Administration of Quality Supervision, Inspection and Quarantine, Standardization Administration, GB/T 17411-2012, July 1, 2013).

<sup>107</sup> MARPOL Annex VI, *supra* note 5, Regulation 14, ¶1.2.

<sup>108</sup> *Id.* ¶ 4.2.

<sup>109</sup> *Id.* ¶ 4.3.

<sup>110</sup> See also Qiang Zhang et al., *Cleaning China's Air*, 484 NATURE 161, 161-62 (2012) (curbing emissions from power plants and coal consumption in general remains the priority for tackling air emission for China given the country's continued rapid economic growth, even though tremendous governmental efforts have been made to raise the operational standards for coal-fired power plants).

<sup>111</sup> Recall that starting from January 1, 2015, the sulfur content of fuel oil used on board ships shall be less than 0.10% m/m and Tier III standard for NO<sub>x</sub> emission would start to apply in ECAs for engines installed on ships that are constructed on or after January 1, 2016. MARPOL Regulation 13, ¶ 5.1.2; MARPOL Regulation 14, ¶ 4.3. Again, MARPOL needs to be cited to earlier (see earlier notes) or if this is MARPOL VI it needs to be cited as such.

a daunting management challenge.<sup>112</sup> The uneven enforcement landscape for MARPOL Annex VI is the quintessence of a “prisoner’s dilemma” situation<sup>113</sup> for which international environmental conventions that are not self-executing are often criticized.<sup>114</sup> If ratifying countries do not take enforcement measures of similar stringency,<sup>115</sup> some countries could obtain economic

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<sup>112</sup> See, e.g., Claudia Copeland, *Cruise Ship Pollution: Background, Laws and Regulations, and Key Issues*, CONGRESSIONAL RESEARCH SERVICE, 26 (2010), <http://www.eoearth.org/view/article/51dac6ac5948612528000716/> (the General Accounting Office found that the process for referring cruise ship violations to other countries does not appear to be working and recommended that the IMO encourage member countries to respond when pollution cases are referred to them).

<sup>113</sup> The Prisoner’s Dilemma was initially developed by Merrill Flood and Melvin Dresher in 1950, later named by A.W. Tucker. Paul W. Grimm & Heather Leigh Williams, *The Judicial Beatings Will Continue Until Moral Improves: The Prisoner’s Dilemma of Cooperative Discovery and Proposals for Improved Morale*, 43 U. BALT. L.F. 107, 108-09 (2013) [hereinafter Grimm & Williams, *Judicial Beatings*] (citing to Robert Axelrod’s book “The Evolution of Cooperation”). The Prisoner’s Dilemma is one of the models in the game theory trying to explain how self-interested, rational individuals interact in a collective decision-making process. MARTIN J. OSBORNE & ARIEL RUBINSTEIN, *A COURSE IN GAME THEORY* 15-18 (1994). It involves a scenario where two prisoners, retained separately under interrogation, must decide whether to keep silent or to confess. Grimm & Williams, *Judicial Beatings*, 43 U. BALT. L.F. 107, 108 (2013). Under the theoretical model of Prisoner’s Dilemma, the rationality exercised by individuals for their best interests, instead of leading to a scenario where all individuals’ interests are maximized, instead tends to lead to inefficient resource allocation, suboptimal environmental standards, and hence harms the overall welfare of the group of individuals. See Kirsten H. Engle, *State Environmental Standard-Setting: Is There a “Race” and Is It “To the Bottom”?* 48 HASTINGS L.J. 271, 275-76 (1997).

<sup>114</sup> See ROSS A. KLEIN, *GETTING A GRIP ON CRUISE SHIP POLLUTION, FRIENDS OF THE EARTH*, 17-28 (2009), [http://www.foe.org/sites/default/files/CruiseShipReport\\_Klein.pdf](http://www.foe.org/sites/default/files/CruiseShipReport_Klein.pdf) (criticizing MARPOL for not being self-executing resulting in its low on-the-ground effectiveness); John Charles Kunich, *Fiddling Around While the Hotspots Burn Out*, 14 GEO. INT’L ENVTL. L. REV. 179, 191 (2001) (the Convention on Biological Diversity is another example where the Convention carries no real consequences for those ratifying countries which take no action, such as domestic legislation, to enforce the terms of this international agreement).

<sup>115</sup> See Robert W. Hahn & Kenneth R. Richards, *The Internationalization of Environmental Regulation*, 30 HARV. INT’L L.J. 421, 429 (1989) (country has incentive to develop a competitive advantage in industrial production by enjoying the benefits of the other countries’ environmental protection activities, while taking limited action at home country).

advantages by holding to more relaxed environmental standards intentionally.<sup>116</sup> This “race to the bottom” phenomenon, or “reluctance to move to the top” phenomenon, in response to regulations on maritime safety and pollution has already been observed in the international shipping industry.<sup>117</sup> Therefore, if land-based transport routes are available to replace certain sections of marine transport routes, the business interests of U.S. ports would likely be adversely affected by the heightened environmental standards, which often implicate increased operational cost for shipping.<sup>118</sup>

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<sup>116</sup> See Peter P. Swire, *The Race to Laxity and the Race to Undesirability: Explaining Failures in Competition Among Jurisdictions in Environmental Law*, 14 YALE L. & POL’Y REV. 67, 80-82 (1996) (states respond to the interstate competition for industry by lowering regulatory standards forming a “race to the bottom” phenomenon, which might be remedied by promulgating federal laws); *but see* Karen Palmer et al., *Tightening Environmental Standards: The Benefit-Cost or the No-Cost Paradigm*, 9(4) J. ECON. PERSP. 119, 129-30 (1995) (arguing generally that no clear evidence to establish the conclusion that higher environmental regulation in the United States has a large adverse effect on economic competitiveness on U.S. firms, especially considering that the stringency of U.S. environmental regulations is actually similar to that of European regulations).

<sup>117</sup> Alan Khee-Jin Tan, VESSEL-SOURCE MARINE POLLUTION: THE LAW AND POLITICS OF INTERNATIONAL REGULATION 7 (James Crawford & John S. Bell eds., 1st ed. 2006) (whenever any actor in the shipping industry tries to maintain safety and pollution prevention standards, he is faced with the prospect of losing business to cheaper standards; as a result, the proliferation of new rules and regulations confers a competitive advantage on sub-standard operators). But the other countries disadvantaged by the “race to the bottom” might push legislation to raise the environmental standard globally, when their firms already developed or have the capacity to develop the advanced manufacturing technologies to achieve such higher standards, to turn themselves back to the leadership in the industry. *See* RIMA MICKEVICIENE, THE ECONOMIC GEOGRAPHY OF GLOBALIZATION 202, 216 (Piotr Pachura eds. 1st ed. 2011) (a large part of technical innovations in the shipbuilding industry has to be presented in relation to the goal of reducing exhaust gas emissions).

<sup>118</sup> *See* Erin Tanimura, *Pacific Merchant II’s Dormant Commerce Clause Ruling: Expanding State Control over Commerce Through Environmental Regulation*, 47 U.C. DAVIS L. REV. 419, 421-26 (2013) (arguing that the court’s ruling in favor of California’s more stringent air emission standards on ships would disadvantage business and commercial interests as these standards would increase the operational cost by \$30,000 (USD) per call); Harilaos N. Psaraftis & Christos A. Kontovas, *Balancing the Economic and Environmental Performance of Marine Transportation*, TRANSPORTATION RESEARCH PART D 15, 458, 459 (2010) (a side-effect of

Theoretically, the threat of civil penalties and criminal punishment would induce the shipping industry, and eventually the shipbuilding manufacturing industry, to modify their practice as a whole to internalize the business externalities, *viz.*, the environmental and health impacts caused by air emissions from marine vessels.<sup>119</sup> But before reaching that point, the industries have to first internalize the increased shipping costs due to delays in voyages to obtain compliant fuels,<sup>120</sup> or otherwise face possible civil penalties. The industry tends to respond by using cost-saving measures that usually require less capital investment than new engine designs or ship retrofitting.<sup>121</sup> Generally speaking, under the pressure of both the higher environmental standards and continued preference of cheaper carriers from powerful clients such as oil companies,<sup>122</sup> ship owners would choose to register their international vessels in countries where MARPOL is implemented much less seriously,<sup>123</sup> even though no differentiated treatment based on flag state is afforded officially,<sup>124</sup> hire cheaper and usually ill-trained seafarers who are more likely to cause environmental violations, and demand standard quality ships to

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requiring speed reduction, a way to reduce ship emissions, in short but sometimes deep sea shipping may induce a shift to more environmentally intrusive land-based transport modes).

<sup>119</sup> See Stephen J. Darmody, *The Oil Pollution Act's Criminal Penalties: On a Collision Course with the Law of the Sea*, 21 B.C. ENVTL. AFF. L. REV. 89, 118-21 (1993).

<sup>120</sup> See *infra* text accompanying notes 127-34.

<sup>121</sup> See generally Nikopoulou et al., *supra* note 9, at 145 (for a Selective Catalytic Reduction system for NOx control, a 2.7 years of payback period is required for 100% return on investment; for a Humid Air Motor system for NOx control, a 3.8 years of payback period is needed for a 51% return on investment for a new ship, and a 4.2 years of payback period is needed for a 37% return on investment for retrofitting).

<sup>122</sup> KHEE-JIN TAN, *supra* note 117, at 40 (the volatile freight rates during the past few decades have caused oil companies to count for the cheapest available rate at any time, and therefore tend to favor sub-standard operators).

<sup>123</sup> See generally DEP'T OF TRANSP., COMPARISON OF U.S. AND FOREIGN-FLAG OPERATING COSTS 68-69 (2011), available at [http://www.marad.dot.gov/documents/Comparison\\_of\\_US\\_and\\_Foreign\\_Flag\\_Operating\\_Costs.pdf](http://www.marad.dot.gov/documents/Comparison_of_US_and_Foreign_Flag_Operating_Costs.pdf) (the higher environmental costs when operating in the United States is one main reason accounting for the higher operational costs incurred by U.S. flagged vessels than foreign-flagged vessels).

<sup>124</sup> See 33 U.S.C. § 1902 (5)(A), (B) (2008).

be delivered at the lowest price possible.<sup>125</sup> In response, shipbuilders often use cheaper materials, rendering ships more vulnerable.<sup>126</sup>

For different reasons, including the limited time and resources of administrative agencies to undertake thorough inspections or bring prosecutions, or simply “good luck,”<sup>127</sup> the number of vessels that operate in full contravention with MARPOL remains “unacceptably high,” both in the United States<sup>128</sup> and internationally.<sup>129</sup> Apparently, some vessels are still able to continue business as usual by taking the risk of being caught then implementing those cost-saving measures discussed above.<sup>130</sup> Arguably, one reason for the large number of violations could be that the punishment is not severe enough to carry a sufficient deterrence effect. However, given the precedents of imposing a criminal fine in the millions of dollars,<sup>131</sup> a more plausible inference should be that the MARPOL standards have not operated in synergy with the economics of the maritime transport sector.<sup>132</sup> In fact, this lack-of-

<sup>125</sup> KHEE-JIN TAN, *supra* note 117, at 6.

<sup>126</sup> *Id.*

<sup>127</sup> See ROSS A. KLEIN, *supra* note 114 (many reports of MARPOL violation have come from citizen observations and therefore detection of violations could be missed, unless the cruise ship staff and the company for which they work report voluntarily); Jeanne M. Grasso & Gregory F. Linsin, *United States: Current Trends in MARPOL Enforcement – Higher Fines, More Jail Time, The Banning of Ships, and Whistleblowers Galore*, MONDAQ (Oct. 7, 2011), <http://www.mondaq.com/unitedstates/x/148086/Marine+Shipping/Current+Trends+In+MARPOL+Enforcement+Higher+Fines+More+Jail+Time+The+Banning+Of+Ships+And+Whistleblowers+Galore> (more than 50% of the MARPOL cases in recent years stem from whistleblowers making reports to the Coast Guard). But the number of whistleblowers for Annex VI violations might decrease as it would be rather difficult to detect excessive air emission with naked eyes.

<sup>128</sup> David P. Keho, *United States v. Abrogar: Did the Third Circuit Miss the Boat?* 39 ENVTL. L. 1, 41 (2009).

<sup>129</sup> ORG. FOR ECON. CO-OPERATION AND DEV. (OECD), COST SAVINGS STEMMING FROM NON-COMPLIANCE WITH INTERNATIONAL ENVIRONMENTAL REGULATIONS IN THE MARITIME SECTOR 47 (2003).

<sup>130</sup> See generally *id.* at 4 (about 5,000 to 7,500 standard commercial vessels are engaged in international trade).

<sup>131</sup> *Ionia*, 555 F.3d at 310 (imposing a fine of \$4.9 million (USD)).

<sup>132</sup> This inference should not be simply rephrased as “the compliance cost is too high.” Virtually no regulated party would ever gratefully applaud the reasonableness or inexpensiveness of compliance measures. The meaning of “synergy” can be understood from two perspectives: monetary cost and the



synergy could well be the reason for IMO to finally consider and agree with delaying the implementation of Tier III standards for NO<sub>x</sub> emission for five years. The industry is frustrated with this expensive “green storm.”<sup>133</sup> More incentives in the enforcement regime for compliance with MARPOL seem to be needed.<sup>134</sup>

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prevalence of technologies to achieve compliance in the regulated industry. Of course, the rare availability of necessary technologies that can be commercialized in the market is accountable for the high monetary cost. *See* THEO NOTTEBOOM ET AL., *supra* note 41, at 70-71 (concluding based on analysis of European shipping industry that Annex VI requirements may be quite costly for the shipping industry, driving up the cost by 25.5% to 40% depending on the specific type of low-sulfur fuel used).

<sup>133</sup> Remarks of Christopher Koch, President & CEO of the World Shipping Council, World Trade Association of Philadelphia 2 (Nov. 8, 2013), *available at* [http://www.worldshipping.org/public-statements/CLK\\_Philadelphia\\_Speech\\_\\_November\\_8\\_2013.pdf](http://www.worldshipping.org/public-statements/CLK_Philadelphia_Speech__November_8_2013.pdf) (criticizing MARPOL Annex VI as “the single most expensive environmental regulation the shipping industry has ever faced”).

<sup>134</sup> *See* KHEE-JIN TAN, *supra* note 117, at 17 (MARPOL is far from really working).

2. *Deficiencies viewed from the perspective of foreign flagged vessels.* -

One chief concern has been the non-availability of low-sulfur fuels since IMO's adoption of Annex VI. In the final working group report to IMO Marine Environment Protection Committee (MEPC) at the 57th session meeting in 2008, the International Petroleum Industry Environmental Conservation Association<sup>135</sup> cautioned that the oil industry did not expect marine fuels at 0.10% and 0.50% sulfur content would be available to all regions by desired dates of 2015 and 2020, respectively.<sup>136</sup>

The availability of low-sulfur fuel under the scenario of full compliance with MARPOL Annex VI is too complex an issue to be generalized by a "yes" or "no" conclusion.<sup>137</sup> The prediction of availability depends on the combination of multiple factors including the enforcement area, fuel price, cargo load, volume of pre-purchased fuels under the contracts between vessel operators and fuel suppliers, projected capacity of refineries, shipping route, number of suppliers at specific ports, and the type of fuel used.<sup>138</sup> Although some

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<sup>135</sup> The Int'l Petroleum Industry Env'tl. Conservation Ass'n (IPIECA) is the global oil and gas industry association for environmental and social issues veering over half of the world's oil production, formed in 1974 following the launch of the United Nations Environment Program. IPIECA is the industry's principal channel of communication with the United Nations. *About Us*, IPIECA: THE GLOBAL OIL AND GAS INDUSTRY ASSOCIATION FOR ENVIRONMENTAL AND SOCIAL ISSUES (2013), <http://www.ipieca.org/about-us>.

<sup>136</sup> See IMO, *Prevention of Air Pollution from Ships: Report of the Working Group on Annex VI and the NO<sub>x</sub> Technical Code*, MEPC 57th Session Agenda Item 4, MEPC 57/WP.7 (Apr. 4, 2008); see also MARPOL Annex VI Revision Signals New Low-Emissions Era, Annex VI Special Report (May 19, 2008), available at [http://www.bunkerworld.com/news/magazine.download?magazine\\_item\\_id=120](http://www.bunkerworld.com/news/magazine.download?magazine_item_id=120) (Linda K. Wright, Global Director at ExxonMobil Marine Fuels, warned at the 29th International Bunker Conference held in April 2008 that there is no guarantee that sufficient low-sulfur fuel will be available and the oil industry's misgivings about the significant refinery investment cost associated with producing more low-sulfur fuels).

<sup>137</sup> See TETRA TECH, *LOW-SULFUR FUEL AVAILABILITY STUDY 2-3*, 11 (2008), [http://www.portoflosangeles.org/DOC/REPORT\\_Fuel\\_Availability\\_Study\\_Final\\_041408.pdf](http://www.portoflosangeles.org/DOC/REPORT_Fuel_Availability_Study_Final_041408.pdf).

<sup>138</sup> See *id.* at 53-60, 62-67, 76; MICHELLE KOMLENIC ET AL., *EVALUATION OF THE AVAILABILITY OF LOW SULFUR MARINE DISTILLATE FUEL FOR OCEAN-GOING VESSELS THAT VISIT CALIFORNIA 9-12* (2008), available at <http://www.arb.ca.gov/regact/2008/fuelogv08/appffuel.pdf>.

estimation findings are more optimistic than others, the common conclusion is that low-sulfur fuel (less than 0.5% m/m sulfur content) shortages exist mainly in Central and South America and Asia, especially in China,<sup>139</sup> Japan, and Korea.<sup>140</sup>

Ideally, port states should exercise their responsibilities under Annex VI to formally establish equivalents, such as add-on exhaust cleaning systems to reduce air emissions, which vessels shall use in case of non-availability of low-sulfur fuels.<sup>141</sup> Absent such formal recognition of alternative compliance measures, the solution to avoid regulative penalties would be to store up compliant fuels at ports along the voyage when compliant fuel is available. However, for foreign flagged ships which are registered in countries where low-sulfur fuel is likely to be unavailable and do not have predictable schedules to visit U.S. ports, they seem to have little incentive to purchase more low-sulfur fuel than what is necessary to sail out of the ECA.<sup>142</sup> When such vessels decide to visit U.S. ports again, they may have to change planned voyages to buy low-sulfur fuel since the compliant fuel is unlikely to be readily available at their departing terminals.<sup>143</sup> Otherwise, they would likely face criminal charges for a “knowing violation” in the United States.<sup>144</sup>

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<sup>139</sup> *Low-Sulfur Marine Fuel in the Pipeline*, CHINA DAILY (Sept. 4, 2010, 10:56 AM), [http://www.chinadaily.com.cn/business/2012-09/04/content\\_15731857.htm](http://www.chinadaily.com.cn/business/2012-09/04/content_15731857.htm) (PetroChina planned to expand its provision of low-sulfur bunker to Yangshan port near Shanghai to satisfy increased demand).

<sup>140</sup> See TETRA TECH, *supra* note 137, at 68-72; DET NORSKE VERITAS (DNV), *supra* note 49, at 15 (highly uncertain as to whether the availability of low sulfur fuel will be adequate in worldwide ports); KOMLENIC ET AL., *supra* note 138, at 57; Starcrest Consulting Grp., *Evaluation of Low Sulfur Marine Fuel Availability – Pacific Rim 3* (2005), *available at* [http://webcache.googleusercontent.com/search?q=cache:E8b1JJZr3g4J:www.portoflosangeles.org/DOC/RE-PORT\\_Fuel\\_Study\\_Pacific\\_Rim\\_Exec\\_Sum.pdf+&cd=1&hl=en&ct=clnk&gl=us](http://webcache.googleusercontent.com/search?q=cache:E8b1JJZr3g4J:www.portoflosangeles.org/DOC/RE-PORT_Fuel_Study_Pacific_Rim_Exec_Sum.pdf+&cd=1&hl=en&ct=clnk&gl=us).

<sup>141</sup> MARPOL Annex VI, *supra* note 5, Regulation 4, ¶ 1.

<sup>142</sup> See generally Deal, *supra* note 41, at 4 (ECA compliant fuel, blend of marine distillates and ultra low sulfur diesel, is about 25% to 30% more expensive than the marine distillate fuel that is currently used in TOTE ships).

<sup>143</sup> See *id.* (there is currently not enough distillate fuel to meet global demand for the world’s entire commercial fleet to switch from residual fuel oil to distillate fuel to meet fuel standards when operating in ECAs).

<sup>144</sup> See *supra* text accompanying notes 73-87.

Additionally, shipping companies have been using “slow-steaming,” a technique that emerged along with the soaring fuel prices in 2002 and global environmental movement for greenhouse gas reduction, to reduce fuel cost.<sup>145</sup> Some voyages now take longer than they used to.<sup>146</sup> The increased expenditure on fuels to comply with Annex VI would only make this practice more prevalent, at least in the short term. As such, an enforcement regime that structures itself around the “panacea” of criminal liability,<sup>147</sup> coupled with issues associated with the availability of low-sulfur fuel and the cost-saving culture of the shipping industry, is likely to operate contrary to the intent of Annex VI of preserving the freedom of navigation on the high seas.<sup>148</sup>

3. *Deficiencies viewed from the U.S. perspective.* - Litigation arising from the enforcement of Annex VI on specific vessels has been silent except for suits against the creation of ECA.<sup>149</sup> Given that the memorandum between the EPA and the Coast Guard to enforce Annex VI was only signed in 2012,<sup>150</sup> current enforcement venue can

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<sup>145</sup> See Remarks of Christopher Koch, *supra* note 133; RASMUS JORGENSON, SLOW STEAMING: THE FULL STORY, MAERSK 2, available at <http://www.maersk.com/Innovation/WorkingWithInnovation/Documents/Slow%20Steaming%20-%20the%20full%20story.pdf>.

<sup>146</sup> See Ronald D. White, *Ocean Shipping Lines Cut Speed to Save Fuel Costs*, L.A. TIMES (July 31, 2010), <http://articles.latimes.com/2010/jul/31/business/la-fi-slow-sailing-20100731> (some freighters were taking fifteen days to make a Pacific crossing that used to take eleven days).

<sup>147</sup> See Keho, *supra* note 128, at 41 (the U.S. Department of Justice has used a two-pronged approach that involves the prosecution of both the corporate ship operators and chief engineers or other supervisory crew members as the best way of changing the non-compliance culture and increasing deterrence in the shipping industry); Darmody, *supra* note 119, at 143.

<sup>148</sup> See MARPOL Annex VI, *supra* note 5, Regulation 18, ¶ 2.2 (no delay or change of planned voyages shall be required to achieve compliance).

<sup>149</sup> See *Alaska v. Kerry*, No. 3:12-cv-00142-SLG, 2013 U.S. Dis. LEXIS 133687, at 21-100 (D. Alaska 2013) (State of Alaska sued the Secretary of States and the EPA for the designation of ECA under the APPs and the Administrative Procedure Act but the suit was dismissed by the court).

<sup>150</sup> Memorandum of Understanding Between United States Coast Guard and United States Environmental Protection Agency Regarding Enforcement of Annex VI as Implemented by the Act to Prevent Pollution from Ships, June 27, 2011, available at <http://www2.epa.gov/sites/production/files/documents/annexvi-mou062711.pdf> (last visited Oct. 17, 2013).

be presumed to be primarily administrative.<sup>151</sup> But the effective administration of compliance by foreign flagged vessels, especially those registered in countries where Annex VI is not fully enforced and do not participate regularly in the U.S. commerce, is likely to become more difficult.

As the Annex VI enforcement scheme rolls out, incidents where “knowing violation” could be established are likely to increase, despite the deterrence effect of criminal charges. On the one hand, the number of foreign flagged vessels calling at U.S. ports is likely to increase continuously.<sup>152</sup> The total number of vessels of the top twenty-five flags of registry was 28,178 as of January 31, 2013, increased by 14% of the total in 2010.<sup>153</sup> This 14% increase comes almost entirely from countries and regions where no ECAs are designated.<sup>154</sup> On the other hand, the situation of low-sulfur fuel shortages and lack of regulation on engine designs is likely to continue due to some foreign countries’ reluctance to adopt regulations to enforce Annex VI during the next few years.<sup>155</sup> Many vessels might still choose to keep their businesses as usual, especially if they do not spend much time in ECAs. Furthermore, “knowing violation” is a low threshold for finding criminal liability,<sup>156</sup>

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<sup>151</sup> See generally KLEIN, *supra* note 114, at 17-28 (violations of MARPOL standards are largely revealed by reviewing of ship logs and reports from citizen observations; as such, a large number of violations may not be detected).

<sup>152</sup> See *America’s Ports: Gateways to Global Trade*, AMERICAN ASSOCIATION OF PORT AUTHORITIES (2013), <http://www.aapa-ports.org/Industry/content.cfm?ItemNumber=1022> (by 2020, the total volume of cargo shipped by water is expected to be double that of 2001 volumes).

<sup>153</sup> U.S. Dep’t of Transp., *Top 25 Flag of Registry* (Sept 27, 2013), [http://www.marad.dot.gov/library\\_landing\\_page/data\\_and\\_statistics/Data\\_and\\_Statistics.htm](http://www.marad.dot.gov/library_landing_page/data_and_statistics/Data_and_Statistics.htm) (last visited Oct. 21, 2013).

<sup>154</sup> *Id.* These countries and regions include Liberia, Marshall Islands, Hong Kong, Singapore, Malta, China, Japan, Antigua and Barbuda, and Malaysia. *Id.*

<sup>155</sup> See *supra* section III, C, 2.

<sup>156</sup> See David M. Uhlmann, *Environmental Crime Comes of Age: The Evolution of Criminal Enforcement in the Environmental Regulatory Scheme*, 2009 UTAH L. REV. 1223, 1235 (2009) (numerous commentators criticized that the Congress had reduced the mental state requirement for environmental crime when it changed the “willfulness” standard to the “knowingly” standard, and the number of environmental criminal cases surged because of the adoption of this standard); see also Wesley D. Sherman, *The Economics of Enforcing Environmental Laws: A Case for*

considering the practical difficulties for some vessels to obtain means to achieve compliance. Courts have also been relaxing the standard of proof to establish the required mens rea in environmental crime cases.<sup>157</sup> Such a relaxed threshold for finding criminal liability expands prosecutorial discretion,<sup>158</sup> which could counterbalance the deterrence effect of these environmental laws.

To deter crimes, one fundamental economic theory is that the expected cost of punishments on the violators should exceed the gains from violation.<sup>159</sup> If  $p$  is the possibility of being criminally charged and  $M$  is the monetary loss incurred because of the criminal charge and eventual penalties, the expected cost of punishments is  $p \times M$ .<sup>160</sup> For vessel owners, the gain from a violation is primarily the avoided capital investment in the air emission control measures to maintain the operational cost at the pre-regulation level. If such capital investment is  $C$ , non-compliance seems to be more attractive economically if  $C > p \times M$ .

To enhance the deterrence effect, enforcement agencies could try to increase  $p$ , the possibility of a criminal charge. A major

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*Limiting the Use of Criminal Sanctions*, 23 J. LAND USE & ENVTL. LAW 87, 95, 104 (2007) (culpability should be established based on a higher level of *mens rea* than “knowing” violation considering that courts do not require the knowledge of the environmental law at issue, the seriousness of the penalties, and the complexity of the environmental laws).

<sup>157</sup> See Darmody, *supra* note 119, at 122-26.

<sup>158</sup> Uhlmann, *supra* note 156, at 1242.

<sup>159</sup> Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76(2) THE J. OF POLITICAL ECON. 169, 180 (1968).

<sup>160</sup> This formula is adapted from Becker’s proposal. In Becker’s formula, the cost of punishments is the probability of conviction multiplied by costs to the offender. But deterrence should arguably take effect when an offender thinks of the possibility of being served by a court order. So the actual cost of punishments could be distorted since the actual conviction is also affected by many technicalities of the trial process, and tends to be smaller than the probability of being charged. These technicalities of the trial process might not play in the minds of offenders when they learn the charges through word of mouth and media exposure, and feel being deterred. Alternatively, the cost of punishment may be magnified if it is calculated based on the probability of detection, because the discretion of government agencies and whistleblowers tend to make the actual number of criminal proceedings brought against the offenders less than the number of detected violations.

implication is on agency budget because criminal convictions are generally more costly than agency adjudication.<sup>161</sup> Also, enforcing the implementation of corrective action plans, as in the *Ionia* case, could be lengthy.<sup>162</sup> If no additional budget is allocated, agencies might be left with wide prosecutorial discretion to decide whether to bring an enforcement proceeding.<sup>163</sup> Courts are generally deferential to prosecutor discretion<sup>164</sup> as it is a function of resource allocation, policy considerations, and the delegation of power from Congress to allow agencies to resolve the ambiguity of the statute.<sup>165</sup> However, even though foreign defendants are unlikely to prevail on claims challenging such agency discretion in prosecuting Annex VI violations, reputational criticisms from the public against such practices may emerge, ultimately compromising the integrity of the enforcement regime.

Alternatively, the severity of penalties could be raised through judicial discretion to increase the cost of punishment,  $p \times M$ . But, the shipping industry has been using a controversial arrangement called

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<sup>161</sup> See Roger Bowles et al., *The Scope of Criminal Law and Criminal Sanctions: An Economic View and Policy Implications*, 35(3) J. OF LAW AND SOCIETY 389, 405, 415 (2008) (raising the probability of detection is costly); see also Wesley D. Sherman, *The Economics of Enforcing Environmental Laws: A Case for Limiting the Use of Criminal Sanctions*, 23 J. LAND USE & ENVTL. LAW 87, 95 (2007) (a criminal justice system is more costly than using administrative law to protect the environment).

<sup>162</sup> See Sherman, *supra* note 161, at 85-88.

<sup>163</sup> See David A. Barker, *Environmental Crimes, Prosecutorial Discretion, and the Civil/Criminal Line*, 88 VA. L. REV. 1387, 1405 (2002) (prosecutorial discretion became a concern when the Environmental Crimes Section of the Department of Justice refused to prosecute a substantial number of referrals from EPA and refused to consent to some prosecutions sought by local U.S. Attorneys); see generally Charles J. Babbitt et al., *Discretion and the Criminalization of Environmental Law*, 15 DUKE ENVTL. L. & POL'Y F. 1, 3-4 (2004) (environmental administrators and the prosecutors to whom they refer criminal cases together enjoy very broad prosecutorial discretion, limited primarily by the Constitution and the rules of prosecutorial ethics).

<sup>164</sup> See *United States v. Mendoza*, 464 U.S. 154, 161-62 (1984) (holding non-mutual collateral estoppel does not apply to governmental litigant); see also *United States v. Dotterweich*, 320 U.S. 277, 285 (1943) (“the good sense of prosecutors, the wise guidance of trial judges, and the ultimate judgment of juries must be trusted”).

<sup>165</sup> See Richard J. Lazarus, *Meeting the Demands of Integration in the Evolution of Environmental Law: Reforming Environmental Criminal Law*, 83 GEO. L.J. 2407, 2453, 2456, 2460 (1995).

“one-ship” companies to limit their exposure to liability.<sup>166</sup> Under such arrangements, shipping carriers are shielded behind the corporate veil by organizing companies for the sole and explicit purpose of owning that ship.<sup>167</sup> The limited capital of such shell companies is likely to hinder the fulfillment of judgment, particularly concerning the payment of huge criminal fines. Moreover, unlike the compensation and penalty calculation in oil spill cases, the estimation of the economic harm to third parties caused by inhaling additional air pollutants such as SO<sub>x</sub> and NO<sub>x</sub> from a vessel tend to be more speculative, primarily because of the considerable lapse between exposure to air pollutants and actual formulation of diseases, numerous intervening causes, and the difficulties in measuring the scale of harmful level of exposure. Hence, non-monetary sanctions seem to be a more pragmatic redress to Annex VI violations.<sup>168</sup>

As to the capital investments by foreign vessels to achieve compliance, C, the EPA could play only a limited role except for trying to engage industries to provide sufficient low-sulfur fuels. Foreign manufacturers and buyers of ocean-going vessels<sup>169</sup> would have to decide together who should bear the up-front cost of advanced design<sup>170</sup> if the buyers intend that their ships meet Annex VI standards.<sup>171</sup> The buyers also need to take into account

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<sup>166</sup> KHEE-JIN TAN, *supra* note 117, at 34-35.

<sup>167</sup> *Id.*

<sup>168</sup> See Roger Bowles et al., *The Scope of Criminal Law and Criminal Sanctions: An Economic View and Policy Implications*, 35(3) J.L. & SOC'Y 389, 405 (2008).

<sup>169</sup> See generally MICKEVICIENE, *supra* note 117, at 207 (China has surpassed Japan in 2006 in ship building. South Korea, in 2009, became a main player in the global ship building industry, exporting ships to about 169 countries and regions, mainly to Asia and Europe).

<sup>170</sup> See generally ALAN E. BRANCH, *ELEMENTS OF SHIPPING* 28 (8th ed. 2007) (in choosing the type of ship to be built, the ship-owner must consider the primary trade in which she is to operate, which governs the size and propelling machinery, and the cost and availability of fuel, the length and duration of voyages, minimum carrying capacity required, and other technical and statutory considerations); see also Nikopoulou et al., *supra* note 9, at 136, 147 (switching to LNG would increase shipbuilding costs by 20 to 25%).

<sup>171</sup> See MICKEVICIENE, *supra* note 117, at 202, 214 (government subsidies and favorable loads, mandatory requirements on domestic ocean going ship buyers to order ships at domestic yards, and cheap labor are the main reasons for China's high-order book volumes).



technological developments and associated uncertainties<sup>172</sup> during the time lapse between the order and delivery.<sup>173</sup> In many countries, governments are extending generous credit facilities, subsidies, favorable tax treatment, and direct investment grants to maintain their national yards as competitive in the global market.<sup>174</sup> These financial instruments, at the discretion of foreign governments, could be powerful instruments to impose Annex VI compliance conditions. In contrast, the regulative authority of a U.S. government agency appears pale in these contract negotiations.

### III. MAKING “ENDS” MEET

#### A. The Need for Market-Based Requirements

Previous discussions on the deficiencies of the Annex VI enforcement regime indicate that certain additional elements may be necessary to change the weights of the two sides of the formula. An option that is within the control of the EPA is to provide incentives, so that  $C - I < p \times M$ , where  $I$  is the monetary incentives obtained from participating in governmental programs.

Programs that are initiated by the government and industry leaders to provide incentives to induce wider voluntary compliance based on market-based principles, often referred to as Market-Based Mechanisms (MBMs), are not new in the United States.<sup>175</sup> MBMs

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<sup>172</sup> See Frederick Adamchak & Amokeye Adede, LNG AS MARINE FUEL, 7 (Gas Technology Institute training materials, 2013) (one main problem with using LNG as marine fuel is the “chicken-and-egg” situation between ship owners. This is when developers for LNG fueling infrastructures and ports remain uncertain as to who would and should act first), available at [http://www.gastechnology.org/Training/Documents/LNG17-proceedings/7-1-Frederick\\_Adamchak.pdf](http://www.gastechnology.org/Training/Documents/LNG17-proceedings/7-1-Frederick_Adamchak.pdf).

<sup>173</sup> World Shipping Council, *The Liner Shipping Industry and Carbon Emissions Policy*, 17 (2009) (ships are often ordered in a set of four to ten. Moreover, they are ordered three or more years in advance of delivery), available at [http://www.worldshipping.org/pdf/liner\\_shipping\\_co2emissions\\_policy\\_september.pdf](http://www.worldshipping.org/pdf/liner_shipping_co2emissions_policy_september.pdf).

<sup>174</sup> BRANCH, *supra* note 170, at 481.

<sup>175</sup> See generally EPA CLEAN AIR MARKETS DIVISION, AN OVERVIEW OF THE REGIONAL CLEAN AIR INCENTIVES MARKET (RECLAIM) 1-2 (2006) (RECLAIM is the first trading program in the national created to reduce SO<sub>2</sub> and

provide business operators means to reduce compliance costs as much as possible<sup>176</sup> while the industrial standard is under transition in response to regulative changes.<sup>177</sup> MBMs would also likely reduce the practical disparities for shipping companies when they operate worldwide, and eventually help overcome the political difficulties in bringing comparable environmental standards to all voyages' end destinations.

MBMs are most suitable when the emission standards can be achieved through alternative technologies and the cost of emission abatement differs widely among regulated sources.<sup>178</sup> Both of these conditions are present in the case of enforcing Annex VI. In addition to fuel-switching,<sup>179</sup> the industry has also identified several alternative technologies including selective catalytic reduction systems, humid air motor systems, seawater scrubbers, and using LNG-fueled vessels.<sup>180</sup>

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NOx emissions in urban areas), *available at* [www.epa.gov/airmarket/resource/docs/reclaimoverview.pdf](http://www.epa.gov/airmarket/resource/docs/reclaimoverview.pdf).

<sup>176</sup> See ROBERT N. STAVINS, EXPERIENCE WITH MARKET-BASED ENVIRONMENTAL POLICY INSTRUMENTS 2-3 (Karl-Göran Mäler et al. eds., 2001) (holding all firms to the same environmental target/standard can be expensive and sometimes counterproductive).

<sup>177</sup> See Mel Davies, *Emissions Trading for Ships – A European Perspective*, 118(3) NAVAL ENG'G J. 131, 132 (2006) (ship emission trading could offer a way of complying on short notice, as a transition mechanism in the face of increasingly stringent regulations on a range of emissions from ship. The cost and long service life of cargo vessels may render regulations that require drastic changes of industrial standards within few years impracticable); See World Shipping Council, *The Liner Shipping Industry and Carbon Emissions Policy*, 17 (2009) (a container ship capable of carrying 8,500 TEU's costs approximately \$100 million (USD) and will be used for 20 to 25 years), *available at* [http://www.worldshipping.org/pdf/liner\\_shipping\\_carbon\\_emissions\\_policy\\_presentation.pdf](http://www.worldshipping.org/pdf/liner_shipping_carbon_emissions_policy_presentation.pdf).

<sup>178</sup> See James J. Corbett et al., AN EVALUATION OF PUBLIC-PRIVATE INCENTIVES TO REDUCE EMISSIONS FROM REGIONAL FERRIES: TECHNICAL MEMORANDUM TWO 14-15 (2004), *available at* <http://policy.rutgers.edu/vtc/documents/ProgEval.FerryEmissions.pdf>.

<sup>179</sup> See generally Theo Notteboom et al., ANALYSIS OF THE CONSEQUENCES OF LOW SULFUR FUEL REQUIREMENTS 2 (2010) (alternative fuels include low-sulfur fuel oil, marine gas oil, marine diesel oil), *available at* [www.schone-scheepvaart.nl/downloads/rapporten/doc\\_1361790123.pdf](http://www.schone-scheepvaart.nl/downloads/rapporten/doc_1361790123.pdf).

<sup>180</sup> Nikopoulou et al., *supra* note 9, at 141; see also ENNIO CODAN ET AL., IMO III EMISSION REGULATION: IMPACT ON THE TURBOCHARGING SYSTEM 2-3 (2010), *available at*

Studies show that depending on the vessel's conditions, the cost-effectiveness of the same technology varies. Generally, compliance by bigger vessels is less expensive than smaller vessels.<sup>181</sup> Compared with fuel switching, NO<sub>x</sub> abatement technologies take longer to introduce because they usually take about ten years to be amortized, and hence, more risk-taking is involved in investment.<sup>182</sup> Vessels that approach the end of their service life<sup>183</sup> or those that spend a small portion of service time inside ECAs are likely to struggle the most under the current Annex VI enforcement scheme.<sup>184</sup> It has been reported that some shipping carriers have started passing the increased compliance cost on to customers.<sup>185</sup> The increased shipping price, an unintended effect of Annex VI, calls for the well-recognized flexibilities that MBMs could offer.<sup>186</sup>

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[http://www05.abb.com/global/scot/scot267.nsf/veritydisplay/1abd7848c7849981852578110051bee0/\\$file/IMO%20III%20Emission%20Regulation.pdf](http://www05.abb.com/global/scot/scot267.nsf/veritydisplay/1abd7848c7849981852578110051bee0/$file/IMO%20III%20Emission%20Regulation.pdf).

<sup>181</sup> KÄGESON, *supra* note 62, at 13.

<sup>182</sup> *Id.*

<sup>183</sup> See KÄGESON, *supra* note 62, at 26 (it is better for infrequent visitors or ships with few remaining years in operation to just pay for the costs of pollution); PER KÄGESON, ECONOMIC INSTRUMENTS FOR REDUCING SHIPPING EMISSIONS: A PILOT PROJECT FOR THE BALTIC SEA 10 (2006) (abatement of SO<sub>x</sub> differs from that of NO<sub>x</sub> because a shift to low sulfur fuel might still be cost effective even for ships that are approaching the end of their operation life), available at [www.airclim.org/sites/default/files/documents/apc24\\_0.pdf](http://www.airclim.org/sites/default/files/documents/apc24_0.pdf).

<sup>184</sup> See Mel Davies, *Emissions Trading for Ships – A European Perspective*, 118(3) NAVAL ENG'G J. 131, 136 (2006).

<sup>185</sup> See Jim Romeo, *New IMO Low-Sulfur Fuel Regulations Creating Challenges for Vessel Operator*, PROF'L MARINER (Nov. 8, 2012, 11:29 AM), <http://www.professional-mariner.com/December-January-2013/New-IMO-low-sulfur-fuel-regs-creating-challenges-for-vessel-operators/> (ZIM Integrated Shipping Services Ltd. said that it will implement a low-sulfur fuel charge of \$20 (USD) per 20-foot equivalent unit for trade between North Europe/Mediterranean and all North American coasts in both directions); see also Michiel Vervloet, *Emission Trading in the Shipping Industry: Where Goes/Is the Money?* (Dec. 5, 2010) (unpublished Masters' thesis, Ghent University) (on file with University Library, Ghent University), at 11.

<sup>186</sup> See generally T.H. Tietenberg, *Economic Instruments for Environmental Regulation*, 6(1) OXFORD REV. ECON. POL'Y 17, 18, 30 (1990) (because emissions trading allows the issue of who will pay for the pollution from who will install pollution control measures, it introduces additional flexibility).

## B. Possible Market-Based Mechanisms (MBMs)

MBMs could be categorized broadly as emission charges or emission trading regimes.<sup>187</sup> Based on the “polluters pay” principal, emission charges could take the form of a tax, an abatement subsidy, or differentiated service fees.<sup>188</sup> Sweden pioneered differentiated fairway dues at ports to encourage reductions in NO<sub>x</sub> and SO<sub>2</sub> emissions at ports since 1998.<sup>189</sup> Because all major ports participated in this program, adverse economic impacts, if any, on port businesses have not been evident.<sup>190</sup> Norway launched a NO<sub>x</sub> tax, forming a funding pool, which provides grants to fund vessels to apply emission reduction technologies.<sup>191</sup> Without getting into details, two main concerns arise if a MBM is designed that voluntarily imposes additional dues based on the environmental performance of vessels. First, the program would risk diluting the force of Annex VI enforcement regime by shifting the focus on vessels to ports, weakening the regime’s deterrence effects. Adequate levels of regulative pressure on foreign vessel owners should be maintained since they have to invest in emission control measures eventually. Second, viewed from ship owners’ standpoint, the purpose of the environmental charges duplicates that of the civil penalties under APPS.

Therefore, this comment focuses on the other two main types of emission trading schemes: cap-and-trade and emission credit trading. This comment argues in favor of an emission credit trading mechanism based on a consumption-emission formula. This MBM

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<sup>187</sup> See DAVID HARRISON ET AL., ECONOMIC INSTRUMENTS FOR REDUCING SHIPS EMISSIONS IN THE EUROPEAN UNION 1, 9, 29, 45, 66 (2005), available at [http://ec.europa.eu/environment/air/pdf/task3\\_final.pdf](http://ec.europa.eu/environment/air/pdf/task3_final.pdf); Tietenberg, *supra* note 186, at 18-21.

<sup>188</sup> See JINHUA ZHAO, IRREVERSIBLE ABATEMENT INVESTMENT UNDER COST UNCERTAINTIES: TRADABLE EMISSION PERMITS AND EMISSIONS CHARGES 18 (2000), available at <http://www.card.iastate.edu/publications/dbs/pdffiles/00wp252.pdf>; see also Tietenberg, *supra* note 186, at 20-21.

<sup>189</sup> HARRISON ET AL., *supra* note 187, at 45-46 (Germany, Finland, and the State of Alaska also have such environmental programs at their ports).

<sup>190</sup> KÄGESON, *supra* note 62, at 16.

<sup>191</sup> *Id.* at 34-35.

could be offered to the violator as a final leniency before the prosecutor brings a criminal proceeding.

1. *Cap-and-Trade (Allowance Trading)*. - Under a cap-and-trade scheme, the regulatory body sets a figurative cap for total emission on the industry, and allocates emission allowances to participating companies, which are the existing pollution sources.<sup>192</sup> Companies may continue to emit pollution as permitted by the pollution amount prescribed by the allowances until the allowances expire. When the initial allowances run out, the companies are supposed to purchase un-used allowance from other companies, which manage to reduce emissions through improved technologies.<sup>193</sup> The government might auction off the allowances to the highest bidders or, in a corresponding amount to the polluter's historical emission data, free of charge.<sup>194</sup>

Studies on cap-and-trade programs indicate that vessels could potentially decrease a considerable amount of the cost on emission control technologies through participation in such programs.<sup>195</sup> For SO<sub>2</sub> emission reduction, a market-based approach that allows vessels in ECAs to either undertake fuel switching, install exhaust cleaning systems, or purchase SO<sub>2</sub> emission allowances from other vessels could save each vessel up to \$63 million (USD), annually.<sup>196</sup>

One option is to create an emission cap based on geographical area. Under this scenario, a macro-level design issue is

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<sup>192</sup> See generally EPA CLEAN AIR MARKETS DIVISION, AN OVERVIEW OF THE REGIONAL CLEAN AIR INCENTIVES MARKET (RECLAIM) 1-6 (2006); Tietenberg, *supra* note 186, at 18-20.

<sup>193</sup> *Id.*

<sup>194</sup> See generally Sergey Paltsev et al., ASSESSMENT OF U.S. CAP-AND-TRADE PROPOSALS 4-5 (2007) (the free distribution of allowances to upstream entities may create an inequitable outcome whereby the emission costs are passed on to downstream fuel users. Meanwhile, the revenue from auctioning permits could be directed to those who ultimately bear the cost of abatement), *available at* [http://dspace.mit.edu/bitstream/handle/1721.1/38460/MITJPSPGC\\_Rpt146.pdf?sequence=1](http://dspace.mit.edu/bitstream/handle/1721.1/38460/MITJPSPGC_Rpt146.pdf?sequence=1).

<sup>195</sup> See Nikopoulou et al., *supra* note 9, at 151.

<sup>196</sup> Wang et al., *supra* note 42, at 8233, 8235 (the estimation is based on analysis of U.S. foreign commerce ships traveling in European or U.S. West Coast ECAs).

whether emission trading between different sectors should be permitted. Some researchers' answer is an ambitious "yes."<sup>197</sup> As an initial matter, a sufficient number of participating entities are required to keep the allowance trading market active.<sup>198</sup> Permitting vessels to trade with land-based emission sources not only ensures the scale of the market, but also benefits the shipping industry substantially since abatement costs for shipping are lower than that for land-based installations in general.<sup>199</sup> However, an over-inclusive trading scheme might give more room for companies to buy allowances or use basic cost-saving measures rather than being induced to invest in green technologies.<sup>200</sup> To determine whether the participating vessels would become "lazy" under such a program, an in-depth analysis of the emission reduction capacities of different sectors, which operate under quite different environmental and technical standards, would be required.

Another option is to impose a cap on the shipping industry itself. A major concern about the cap-and-trade mechanism is its economic impact on the shipping industry as a whole.<sup>201</sup> Reliance on ocean shipping to transport goods internationally is expected to rise, because ocean shipping is already one of the most economically and environmentally efficient modes of long-distance transportation.<sup>202</sup>

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<sup>197</sup> See KRISTINA HOLMGREN ET AL., GREENHOUSE GAS EMISSIONS TRADING FOR THE TRANSPORT SECTOR 69 (2006), available at <http://www3.ivl.se/rapporter/pdf/B1703.pdf>.

<sup>198</sup> See EPA Clean Air Markets Division, AN OVERVIEW OF THE REGIONAL CLEAN AIR INCENTIVES MARKET (RECLAIM) 17-18 (2006) (RECLAIM is criticized for not being an actually active market with few entities participating in its trading actions).

<sup>199</sup> HOLMGREN ET AL., *supra* note 197, at 69.

<sup>200</sup> Richard Toshiyuki Drury et al., *Pollution Trading and Environmental Injustice: Los Angeles' Failed Experiment in Air Quality Policy*, 9 DUKE ENVTL. L. & POL'Y F. 231, 275-85 (1999).

<sup>201</sup> WORLD SHIPPING COUNCIL, THE LINER SHIPPING INDUSTRY AND CARBON EMISSIONS POLICY, 9-10 (2009), available at [http://www.worldshipping.org/pdf/liner\\_shipping\\_carbon\\_emissions\\_policy\\_presentation.pdf](http://www.worldshipping.org/pdf/liner_shipping_carbon_emissions_policy_presentation.pdf).

<sup>202</sup> WORLD SHIPPING COUNCIL, THE LINER SHIPPING INDUSTRY AND CARBON EMISSIONS POLICY, 9, (2009), available at [http://www.worldshipping.org/pdf/liner\\_shipping\\_carbon\\_emissions\\_policy\\_presentation.pdf](http://www.worldshipping.org/pdf/liner_shipping_carbon_emissions_policy_presentation.pdf); see also KHEE-JIN TAN, *supra* note 117, at 7 (the biggest contributor to marine pollution is land-based sources and pollutions from ships contributes a relative small fraction of the overall marine pollution (12%)).

Posing emission caps on the shipping industry is likely to force the industry to eventually purchase allowance from other sectors where similar cap-and-trade mechanisms apply.<sup>203</sup> As such, a large amount of money would flow into other sectors that are not subject to the same air emission standards as the shipping industry.<sup>204</sup> The emission reduction in other sectors would be a proxy to verify the effectiveness of emission control measures in the shipping industry. The result would probably be an “open-ended” regime where the actual emission reduction becomes difficult to track.

Further, a cap-and-trade mechanism might not be effective in terms of engaging new polluters. Experience of the Acid Rain Program of SO<sub>2</sub> trading shows that most of the trading under the Program has been internal, namely, acquiring excess allowances from within the company, rather than inter-regional or inter-company.<sup>205</sup> If a cap-and-trade mechanism were applied to the shipping industry, large international shipping companies, which are already leading the industry’s emission reduction endeavors, would possibly prefer obtaining extra allowances internally to avoid delays and transaction costs. As a result, there might not be enough active allowances for trade with new ships.

2. *Emission credit trading.* - A more straightforward model is to focus on the difference in emissions between vessels, targeting the non-compliant vessels.<sup>206</sup> The emission credit trading mechanism would require the establishment of a baseline of different ship models in terms of the correlation between the power output and the amount of pollutant emission.<sup>207</sup> Alternatively, correlation could be

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<sup>203</sup> WORLD SHIPPING COUNCIL, THE LINER SHIPPING INDUSTRY AND CARBON EMISSIONS POLICY 9 (2009).

<sup>204</sup> See also IMO, *Review of MBMs: Consolidated Proposal of Efficiency Incentive Scheme (EIS) Based on the Leveraged Incentive Scheme (LIS) and the Vessel Efficiency Systems (VES)*, Submitted by Japan and the World Shipping Council, GHG-WG 3/3/2 (Feb. 24, 2011), available at [http://www.worldshipping.org/industry-issues/environment/air-emissions/Japan\\_-\\_WSC\\_Consolidated\\_Proposal\\_GHG-WG\\_3-3-2.pdf](http://www.worldshipping.org/industry-issues/environment/air-emissions/Japan_-_WSC_Consolidated_Proposal_GHG-WG_3-3-2.pdf).

<sup>205</sup> Jonathan Remy Nash, *Too Much Market? Conflict between Tradable Pollution Allowances and the “Polluter Pays” Principals*, 24 HARV. ENVTL. L. REV. 465, 488-92 (2000).

<sup>206</sup> See Vervloet, *supra* note 185, at 33.

<sup>207</sup> See KAGESON, *supra* note 62, at 24.

established between the energy efficiency index of a ship<sup>208</sup> or a modification of the index,<sup>209</sup> and the amount of pollutant emission for the determination of the baseline. Trading entities should be primarily vessels. The participation by ship manufacturers should be limited or even prohibited, because the estimation of emission amount would be too speculative before the vessel is put into operation.<sup>210</sup>

The amount of credits that a vessel obtains would be determined on the amount of deviation of the vessel's performance from this baseline. The most powerful credit generators are large vessels that operate in ECAs for their entire service time. The purchasers who would benefit most from this scheme would be vessels that spend a small portion of their time inside ECAs.<sup>211</sup> Non-compliant vessels could be offered to opt-in to this trading mechanism; or else criminal proceedings would likely be brought. This offer could also be made during the plea bargaining stage.<sup>212</sup> Such offer should be conditioned on the facts that render the immediate implementation of compliant measures not cost-effective, such as the fact that the vessel is approaching its service life. Although, such program design requires a large volume of record keeping, it is nevertheless necessary for conveying a clear message to the polluters: this offer in lieu of criminal proceeding is not a way

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<sup>208</sup> See IMO, *Amendments to the Protocol of 1997 to Amend the International Convention for the Prevention of Pollution from Ships, 1973, as Modified by the Protocol of 1978 Relating Thereto (Inclusion of Regulations on Energy Efficiency for Ships in MARPOL Annex VI)*, Resolution MEPC.203(62) (July 15, 2011). The regulation requires ships to be certified based on an assessment of Energy Efficiency Design Index (EEDI) and all ships shall have Ship Energy Efficiency Management Plans. The EEDI is a non-prescriptive, performance-based mechanism that leaves the choice of technologies to the industry, as long as the required energy efficiency level provide in Regulations 20 and 21 is attained. The amendment came into force on January 1, 2013. *Id.*

<sup>209</sup> See Vervloet, *supra* note 185 at 33-34.

<sup>210</sup> *Id.*

<sup>211</sup> See Mel Davies, *Emissions Trading for Ships – A European Perspective*, 118(3) *NAVAL ENG'G J.* 131, 136 (2006).

<sup>212</sup> See also James B. Nelson, *Alternative Sentencing under the MARPOL Protocol: Using Polluters' Fines to Fund Environmental Restoration*, 10 *HASTINGS W.-N. W.J. ENV. L. & POL'Y* 1, 23-26 (2003) (advocating the use of alternative sentencing provisions to MARPOL prosecutions to provide funding for clean-up projects to correct the harm caused by the defendant's actions).



through which vessels could pay to pollute, but only a regulative mercy considering the violator's economic hardship.

Additionally, participating foreign-flagged vessels should be required to designate local agents for service of process.<sup>213</sup> An independent trans-governmental authority could be established to monitor and verify the quality of credits.<sup>214</sup> This entity could be financed through the civil penalties collected from the non-compliant ships.

### C. General Considerations on MBMs

Ideally, the MBM should be built under a bilateral agreement between the United States and its major waterborne trade partners that have not enforced Annex VI in full, such as China. Although treaties and executive agreements are treated alike under international law, an executive agreement would be preferable from a U.S. point of view, because no advice and consent of the Senate would be required as long as the executive agreement does not contradict statutory provisions.<sup>215</sup> The EPA would have the authority to run this trading program under the 1990 Amendments of the Clean Air Act, which added Title IV, relating to controlling acid deposition including SO<sub>x</sub> and NO<sub>x</sub>.<sup>216</sup>

Manifestly, the influence of a governmental agency, acting on its own, is rather limited when its ultimate purpose is to induce domestic legislation in a foreign country. Therefore, the overall structure of a bilateral agreement would lay a stronger foundation for the subsequent agreements on the technical parameters of the MBM;

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<sup>213</sup> See SOUTH COAST AIR QUALITY MGMT. DIST., OVER A DOZEN YEARS OF RECLAIM IMPLEMENTATION: KEY LESSONS LEARNED IN CALIFORNIA'S FIRST AIR POLLUTION CAP-AND-TRADE PROGRAM, Chapter 1, 8 (2007).

<sup>214</sup> See also Richard E. Ayres, *Expanding the Use of Environmental Trading Programs into New Areas of Environmental Regulation*, 18 PACE ENVTL. L. REV. 87, 117 (2000).

<sup>215</sup> See Kathryn C. Wilson, *The International Air Quality Management District: Is Emissions Trading the Innovative Solution to the Transboundary Pollution Problem?*, 30 TEX. INT'L L.J. 369, 384-85 (1995).

<sup>216</sup> 1990 Amendments to the Clean Air Act of 1970, Pub. L. No. 101-549, 104 Stat. 2399.

the discussion of which could be led by agencies in the respective countries. Further, high-level official negotiation is more likely to identify and define the necessary flexibilities to connect the priorities of the United States and targeted foreign countries in controlling air pollutions. Given the facilitation by national governments, as opposed to administrative agencies delegated with the authority to enforce Annex VI under national laws, companies are more likely to agree upon the qualifying emission reduction measures to meet the same emission standards under Annex VI.

Finally, two important technical components need to be agreed upon under the bilateral agreement. The first component to be established is the eligible equivalents.<sup>217</sup> A clear mutual understanding of equivalents would not only help keep the trading market active,<sup>218</sup> but also benefit the later monitoring and verification of emission credits during implementation. The second component to be clarified is the monitoring and reporting procedures. Safeguards need to be established to prevent fraud and missed reporting, and furthermore, to ensure information transparency.<sup>219</sup> When necessary, penalties should be imposed on repetitive violation of reporting rules.<sup>220</sup>

#### CONCLUSIONS

The current U.S. regulatory scheme to enforce Annex VI leaves an administrative vacuum in terms of ensuring foreign-flagged vessels' compliance when operating in U.S. waters. The conventional combination of civil penalties and criminal charges is challenged when the enforcement of international environmental law is achieved through an uneven worldwide regulatory landscape and depends

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<sup>217</sup> See KÄGESON, *supra* note 62, at 18.

<sup>218</sup> See Nikopoulou et al., *supra* note 9, at 149 (switching to 1% sulfur residuals, without other alternative compliance measures, has the major disadvantage in that it does not create cost efficient credits for trading in the emissions' markets).

<sup>219</sup> See SOUTH COAST AIR QUALITY MGMT. DIST., OVER A DOZEN YEARS OF RECLAIM IMPLEMENTATION: KEY LESSONS LEARNED IN CALIFORNIA'S FIRST AIR POLLUTION CAP-AND-TRADE PROGRAM, Chapter 5, 1-3 (2007).

<sup>220</sup> *Id.* at 9-10.

heavily on the technological developments in the private sector. This comment recommends an emission credit trading mechanism as a supplement to the current Annex VI enforcement regime. The credit trading mechanism would encourage firms, based on their superior knowledge about the market and effectiveness of various technological options, to find the best solution in response to the regulative requirements without compromising their valued commercial interests. If the establishment of a credit trading mechanism is initiated through high-level official dialogues, as recommended by this comment, the U.S. enforcement agencies would be afforded a proper platform to work with foreign agencies to establish compliance equivalents under Annex VI. MBMs, therefore, would serve an important role in making the current rigid enforcement regime more adaptive during the transition period where firms are yet to phase out substandard vessels and plan for investments in vessel designs that are far more environmentally friendly.