

INDIANA  
INTERNATIONAL & COMPARATIVE  
LAW REVIEW

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VOLUME 5

1995

NUMBER 2

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# FINANCIAL LEASING UNDER THE UNIDROIT CONVENTION AND THE UNIFORM COMMERCIAL CODE: A COMPARATIVE ANALYSIS

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## I. INTRODUCTION

International equipment leasing has emerged as an important means of economic development in the global marketplace,<sup>1</sup> particularly where capital intensive acquisitions such as aircraft, ships, or machinery are involved.<sup>2</sup> Heretofore, financial developments have outpaced the evolution of sound legal theories<sup>3</sup> which are adapted to the *sui generis* form of the financial lease.<sup>4</sup>

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*Acknowledgements:* The author wishes to express special thanks to Professor Charles W. Mooney, Jr., of the University of Pennsylvania Law School, Professor Peter Winship of the Southern Methodist University School of Law, and Martin Stanford, Senior Research Adviser of the International Institute for the Unification of Private Law (UNIDROIT), without whose valuable assistance this paper would not have been possible. Any errors or omissions, however, are the sole responsibility of the author.

1. Lawrence M. Taylor, Jr., *International Leasing*, in 2 EQUIPMENT LEASING-LEVERAGED LEASING 1223, 1223 (Bruce E. Fritch et al. eds., 3d ed. 1988). See also Ian Shrank, *Cross-Border Leasing*, in HOT ISSUES IN EQUIPMENT LEASING 1, 1 (A.B.A. Section of Business Law ed., 1994). For an excellent discussion of the advantages and disadvantages of financial leasing in the context of economic development, see Jack L. Upper, *Asset Financing: Capital Equipment Leasing* (Economic Development Institute Seminar Paper 29, 1984). For a discussion of the impact of leasing in Europe, Latin America, and Asia, see Taylor, *supra*, at 1226-30. See also *Draft Convention on International Financial Leasing with Explanatory Report*, UNIDROIT Study LIX, at 20-22, Doc. 48 (1987) [hereinafter Secretariat Report].

2. Taylor, *supra* note 1, at 1225.

3. *Id.* at 1238. "[I]n many . . . jurisdictions around the world, leasing may have been introduced as a financial product by foreigners before local laws and regulations had been promulgated to deal with any of the[ ] conceptual issues." *Id.*

4. A financial leasing transaction involves three parties: (a) the lessee, who selects the equipment from the supplier and pays rent to the lessor for the right to use the equipment; (b) the supplier, who provides the equipment specified by the lessee and who is paid for the equipment by the lessor in the supply agreement; and (c) the lessor, whose basic function is that of a financier—to purchase the equipment specified by the lessee from the supplier under the supply agreement, and to enter into a leasing agreement with the lessee granting the lessee the right to use the equipment in exchange for payment. Peter Breslauer, *Finance Lease, Hell or High Water Clause, and Third Party Beneficiary Theory in Article 2A of the Uniform*

National laws vary considerably<sup>5</sup>—or are nonexistent—thus giving rise to commercial uncertainty and hindering the utilization of financial leasing as a vehicle for international economic development.<sup>6</sup>

Recognizing the need for certainty in international trade, the International Institute for the Unification of Private Law (UNIDROIT) began work in 1974 on a set of Draft Rules designed to govern "the civil and commercial aspects"<sup>7</sup> of international financial leasing. The effort culminated in a multilateral convention. Both the UNIDROIT Convention on International Financial Leasing and its companion instrument, the UNIDROIT Convention on International Factoring,<sup>8</sup> were the end result of a diplomatic conference of fifty-five participating States,<sup>9</sup> four observer States,<sup>10</sup> and seven intergovernmental

*Commercial Code*, 77 CORNELL L. REV. 318, 319-20 (1992). See also U.C.C. § 2A-103(1)(g) (1990); UNIDROIT Convention on International Financial Leasing, May 28, 1988, art. 1, 27 I.L.M. 931 (1988) [hereinafter Leasing Convention].

5. States that have statutes directly affecting financial leasing include Belgium, Brazil, Canada, France, Spain, and those jurisdictions in the United States that have enacted Article 2A of the U.C.C. Ronald Cuming, *Legal Regulation of International Financial Leasing: The 1988 Ottawa Convention*, 7 ARIZ. J. INT'L & COMP. L. 39, 41 n.5 (1989). Although the Convention is designed to govern international leases, many states which lack a modern leasing law may model their domestic laws upon the Convention. Martin Stanford, *Striking a Fair Balance*, ASSET FIN. & LEASING DIG., Nov. 1988, at 5. In the absence of a modern law governing leasing, such as U.C.C. Article 2A, many legal systems have been forced to conceptually view a single leasing transaction as being two separate contracts: a supply contract between the supplier and lessor, and a bailment contract between the lessor and lessee. Walter E. May, Note, *International Equipment Leasing: The UNIDROIT Draft Convention*, 22 COLUM. J. TRANSNAT'L L. 333, 338 (1984). Bifurcating the financial leasing transaction ignores the interrelationship of the dual contracts—the leasing agreement and the supply agreement—thereby creating commercial uncertainty between the respective parties. *Id.*

6. Financial leasing serves as a vehicle for international development by (1) providing access to foreign capital; (2) permitting the leased equipment to be acquired earlier than if purchased outright, thereby paying for itself through increased productivity; and (3) by expanding the market for both the supplier and lessor/financier. Taylor, *supra* note 1, at 1232-34.

7. The Convention is intended to govern only the "civil and commercial aspects of international leasing" while leaving accounting and taxation issues to applicable domestic law. Stanford, *supra* note 5, at 5; Leasing Convention, *supra* note 4, pmb1.

8. UNIDROIT Convention on International Factoring, May 28, 1988, 27 I.L.M. 943 (1988).

9. UNIDROIT listed the 55 states that participated in the Ottawa Diplomatic Conference as being:

"the People's Democratic Republic of Algeria; the People's Republic of Angola; Antigua and Barbuda; Australia; the Republic of Austria; the Kingdom of Belgium; the Federative Republic of Brazil; the People's Republic of Bulgaria; the Republic of Burundi; the Republic of Cameroon; Canada; the Republic of Chile; the People's Republic of China; the Republic of Colombia; the Republic of Cuba; the Czechoslovak Socialist Republic; the Kingdom of Denmark; the Dominican

organizations<sup>11</sup> hosted by the Canadian government in Ottawa in May, 1988.<sup>12</sup> The United States signed<sup>13</sup> the UNIDROIT Convention on International Financial Leasing on December 28, 1990.<sup>14</sup> The Convention requires ratification or accession by three States,<sup>15</sup> and, as of this writing, has yet to become effective.<sup>16</sup>

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Republic; the Arab Republic of Egypt; the Republic of El Salvador; the Republic of Finland; the Republic of France; the Federal Republic of Germany; the Republic of Ghana; the Hellenic Republic; the Republic of Guinea; the Hungarian People's Republic; the Republic of India; Ireland; the Italian Republic; Japan; the Republic of Korea; the Lebanese Republic; the United Mexican States; the Kingdom of Morocco; the Kingdom of the Netherlands; the Federal Republic of Nigeria; the Kingdom of Norway; the Republic of the Philippines; the Polish People's Republic; the Portuguese Republic; the Republic of Senegal; the Kingdom of Spain; the Democratic Republic of the Sudan; the Kingdom of Sweden; the Swiss Confederation; the Kingdom of Thailand; the Republic of Turkey; the Union of Soviet Socialist Republics; the United Kingdom of Great Britain and Northern Ireland; the United Republic of Tanzania; the United States of America; the Republic of Venezuela; the Socialist Federal Republic of Yugoslavia; and the Republic of Zaire."

UNIDROIT Final Act of the Diplomatic Conference for the Adoption of the Draft UNIDROIT Conventions on International Factoring and International Financial Leasing, May 28, 1988, at 1, 27 I.L.M. 927 (1988).

10. The four States which sent observers to the Conference were Malaysia, the Republic of Peru, the Republic of Uganda, and the Eastern Republic of Uruguay. *Id.*

11. The seven intergovernmental organizations represented by observers to the Conference were the Commission of the European Union, the Council of Europe, the Hague Conference on Private International Law, the Organization of American States, the United Nations Commission on International Trade Law (UNCITRAL), the United Nations Conference on Trade and Development (UNCTAD), and the World Bank. *Id.* at 2.

12. Peter H. Pfund, *International Unification of Private Law: A Report on U.S. Participation—1987-88*, 22 INT'L LAW. 1157, 1163 (1988).

13. Under United States treaty practice, the act of signing a treaty does not give that instrument the binding force of law; rather it is deemed to "represent political approval and at least a moral obligation to seek ratification." A signed treaty must then be submitted by the executive branch to the Senate for its advice and consent pursuant to Article 2, Section 2 of the United States Constitution. RESTATEMENT (THIRD) OF FOREIGN RELATIONS § 312 cmts. d, j (1986).

14. *Recent Actions Regarding Treaties to Which the United States is a Party*, 30 I.L.M. 573 (1991).

15. Leasing Convention, *supra* note 4, art. 16(1).

16. Letter from Valerie Hughes, Senior Counsel, Constitutional and International Law, Department of Justice, Canada, to David A. Levy, Legal Extern, State Department, Office of the Legal Adviser, Private International Law (Feb. 18, 1994) (on file with the State Department). The two countries which have ratified the Leasing Convention are France and Italy, with France having made the declaration permitted under Article 20. Letter from Valerie

First, this paper examines the UNIDROIT Convention on International Financial Leasing (Leasing Convention) from an American commercial law perspective by comparing it with Article 2A of the Uniform Commercial Code (U.C.C.),<sup>17</sup> which is a modern national law governing domestic commercial leasing.<sup>18</sup> The Convention embodies principles which are familiar to U.C.C.

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Hughes, Senior Counsel, Constitutional and International Law, Department of Justice, Canada, to David A. Levy (Sept. 1, 1994) (on file with the State Department) [hereinafter Letter from Hughes]. See discussion of Article 20, *infra* note 51.

17. For a useful overview of Article 2A, see generally Amelia H. Boss, *The History of Article 2A: A Lesson for Practitioner and Scholar Alike*, 39 ALA. L. REV. 575 (1988); Edwin E. Huddleson, III, *Old Wine in New Bottles: U.C.C. Article 2A—Leases*, 39 ALA. L. REV. 615 (1988). For an excellent discussion of issues concerning equipment leases generally, see Fritch et al., *supra* note 1.

18. As of this writing, Article 2A has been enacted in 42 American jurisdictions: Alabama, ALA. CODE §§ 7-2A-101 to -532 (1993); Alaska, ALASKA STAT. §§ 45.12.101 to .532 (1993); Arizona, ARIZ. REV. STAT. ANN. §§ 47-2A101 to -2A532 (Supp. 1994); Arkansas, ARK. CODE ANN. §§ 4-2A-101 to -532 (Michie Supp. 1993); California, CAL. COM. CODE §§ 10101 to 10532 (West Supp. 1994); Colorado, COLO. REV. STAT. §§ 4-2.5-101 to -533 (1992); Delaware, DEL. CODE ANN. tit. 6, §§ 2A-101 to -532 (1993); the District of Columbia, D.C. CODE ANN. §§ 28:2A-101 to -532 (Supp. 1994); Florida, FLA. STAT. ANN. ch. 680.1011 to .532 (Harrison Supp. 1992); Georgia, GA. CODE ANN. §§ 11-2A-101 to -532 (Michie Supp. 1994); Hawaii, HAW. REV. STAT. §§ 490:2A-101 to -532 (Supp. 1992); Idaho, IDAHO CODE §§ 28-12-101 to -532 (Supp. 1994); Illinois, ILL. ANN. STAT. ch. 810, paras. 5/2A-101 to -532 (Smith-Hurd 1993); Indiana, IND. CODE ANN. §§ 26-1-2.1-101 to -532 (Burns 1992); Kansas, KAN. STAT. ANN. §§ 84-2a-101 to -532 (Supp. 1993); Kentucky, KY. REV. STAT. ANN. §§ 355.2A-101 to -532 (Baldwin 1994); Maine, ME. REV. STAT. ANN. tit. 11, §§ 2-1101 to -1532 (West Supp. 1994); Maryland, MD. CODE ANN., COM. LAW I §§ 2A-101 to -532 (Supp. 1994); Michigan, MICH. COMP. LAWS ANN. §§ 440.2801 to .2982 (West 1994); Minnesota, MINN. STAT. ANN. §§ 336.2A-101 to -531 (West Supp. 1994); Missouri, MO. ANN. STAT. §§ 400.2A-101 to -532 (Vernon Supp. 1993); Montana, MONT. CODE ANN. §§ 30-2A-101 to -532 (1991); Nebraska, NEB. REV. STAT. §§ 2A-101 to -532 (1994); Nevada, NEV. REV. STAT. §§ 104A.2101 to .2532 (1993); New Hampshire, N.H. REV. STAT. ANN. §§ 382-A:2A-101 to -532 (1994); New Mexico, N.M. STAT. ANN. §§ 55-2A-101 to -532 (Michie Supp. 1993); New York, N.Y. U.C.C. LAW §§ 2-A-101 to -532 (McKinney Supp. 1995) (effective June 30, 1995); North Carolina, N.C. GEN. STAT. §§ 25-2A-101 to -532 (Supp. 1994); North Dakota, N.D. CENT. CODE §§ 41-02.1-01 to -80 (Supp. 1993); Ohio, OHIO REV. CODE ANN. §§ 1310.01 to .78 (Anderson 1993); Oklahoma, OKLA. STAT. ANN. tit. 12A, §§ 2A-101 to -532 (West Supp. 1995); Oregon, OR. REV. STAT. §§ 72A.1010 to .5310 (1993); Pennsylvania, 13 PA. CONS. STAT. ANN. §§ 2A101 to 532 (Supp. 1994); Rhode Island, R.I. GEN. LAWS §§ 6A-2.1-101 to -532 (1992); South Dakota, S.D. CODIFIED LAWS ANN. §§ 57A-2A-101 to -531 (Supp. 1994); Tennessee, TENN. CODE ANN. §§ 47-2A-101 to -532 (Supp. 1994); Texas, TEX. BUS. & COM. CODE ANN. §§ 2A.101 to .532 (West 1994); Utah, UTAH CODE ANN. §§ 70A-2a-101 to -532 (Supp. 1994); Virginia, VA. CODE ANN. §§ 8.2A-101 to -531 (Michie Supp. 1994); Washington, WASH. REV. CODE ANN. §§ 62A.2A-101 to -532 (West Supp. 1994); Wisconsin, WIS. STAT. ANN. §§ 411.101 to .532 (West Supp. 1993); and Wyoming, WYO. STAT. §§ 34.1-2.A-101 to -532 (1994).

practitioners, including the obligation of good faith,<sup>19</sup> "expectation-type" damages,<sup>20</sup> and the right of the parties to freely contract, subject to certain mandatory protections.<sup>21</sup> Second, this paper contends that the United States should ratify the Leasing Convention in order to protect the interests of American lessors who wish to enter into international leasing transactions secure in the enforceability of their contracts.<sup>22</sup>

### A. *The History of UNIDROIT*

The International Institute for the Unification of Private Law (UNIDROIT) was founded in 1926 by the League of Nations for the purpose of "exam[in]g ways of harmonizing and co-ordinating the private law of States and groups of States, and to prepare gradually for the adoption by the various States of uniform legislation in the field of private law."<sup>23</sup> UNIDROIT's offices are in Rome, and it is today an autonomous international organization.<sup>24</sup> The United States joined UNIDROIT in 1964<sup>25</sup> in recognition of the need to participate more actively in international law unification.<sup>26</sup>

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19. Compare Leasing Convention, *supra* note 4, art. 6 (setting forth the need to interpret the convention with regard to "observance of good faith in international trade") with U.C.C. § 1-203 ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.").

20. Leasing Convention, *supra* note 4, art. 13(2)(b); U.C.C. § 1-106.

21. Leasing Convention, *supra* note 4, art. 5. The comment to U.C.C. § 2A-101 emphasizes this point by stating that the codification of leases in Article 2A "was greatly influenced by the fundamental tenet of the common law as it developed with respect to leases of goods: freedom of the parties to contract. . . . to vary the effect of the provisions . . . subject to certain limitations . . ." U.C.C. § 2A-101 cmt. (1987). See also U.C.C. §§ 2A-103(4), 1-102(3).

22. The full text of the Leasing Convention has been provided as an appendix to this article for ease of reference.

23. Statute of the International Institute for the Unification of Private Law, done at Rome Mar. 15, 1940, art. 1, 15 U.S.T. 2494, 2504, T.I.A.S. 5743 (entered into force July 15, 1955; for the U.S., Mar. 13, 1964). Amendments: June 15-16, 1965, 19 U.S.T. 7802, T.I.A.S. No. 6611; Dec. 18, 1967, 20 U.S.T. 2529, T.I.A.S. No. 6716; Feb. 18, 1968, 30 U.S.T. 5663, T.I.A.S. No. 9519.

24. May, *supra* note 5, at 334 n.7.

25. Peter H. Pfund & George Taft, *Congress' Role in the International Unification of Private Law*, 16 GA. J. INT'L & COMP. L. 671, 673 (1986). See also 22 U.S.C. § 269(g) (1988) (authorizing membership and participation in Hague Conference and UNIDROIT).

26. Peter H. Pfund, *United States Participation in Transnational Lawmaking*, in LEX MERCATORIA AND ARBITRATION: A DISCUSSION OF THE NEW LAW MERCHANT 167, 177 (Thomas E. Carbonneau ed., 1990).

## B. *Financial Leasing Defined*

Financial leasing represents a "distinctive triangular relationship"<sup>27</sup> requiring three discrete parties:<sup>28</sup> (1) a lessor who advances funds for the purchase of the equipment which constitutes the subject of the leasing transaction, (2) a lessee who selects the equipment and pays a rental fee for the right to use it, and (3) a supplier who sells the equipment to the lessor.<sup>29</sup> Financial leasing also links two separate, albeit interrelated, contracts: a leasing agreement between the lessor and lessee, and a supply agreement between the supplier and lessor.<sup>30</sup>

Article 1 of the Leasing Convention sets forth the basic financial leasing transaction to which it applies and defines the relationship of the parties. Paragraph (1) states that the lessor is provided with equipment specifications by the lessee, and then, using those specifications, enters into a "supply agreement" to obtain the equipment from the supplier. The equipment may be "plant, capital goods, or other equipment," according to the lessee's specifications,<sup>31</sup> and the lessee has the right to approve the terms of the supply agreement entered into "so far as they concern its interests."<sup>32</sup> This

27. The Leasing Convention explicitly recognizes the "distinctive triangular relationship" created by the financial leasing transaction. Leasing Convention, *supra* note 4, pmb1. *See also* U.C.C. § 2A-103 cmt. g ("A finance lease is the product of a three party transaction.").

28. Note that the Leasing Convention by its terms is inapplicable to a simple bilateral lease, for example, where the supplier and the lessor are one and the same. Leasing Convention, *supra* note 4, art. 1(1)(a). The rationale for providing special protection for the lessor in a finance lease whose function is that of a financier does not exist where the lessor plays the more active role of the supplier. Secretariat Report, *supra* note 1, at 32. Consistently throughout the Convention, the more the lessor deviates from the role of financier, the greater is the assumed liability. *See, e.g.*, Leasing Convention, *supra* note 4, art. 8(1) (lessor's liability increased where "lessee has suffered loss as the result of its reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the equipment.").

29. "The reality of financial leasing is indeed that the technical specifications of the equipment, the terms of payment and delivery are worked out directly between the lessee and the supplier, with delivery being made directly by the supplier to the lessee." Secretariat Report, *supra* note 1, at 35.

30. Breslauer, *supra* note 4, at 319-20.

31. Leasing Convention, *supra* note 4, art. 1(1)(a). Moreover, the law of the Convention continues to apply between those parties even where the equipment "has become a fixture to or incorporated in land." *Id.* art. 4(1). Aircraft and other movables are expressly included. *Id.* art. 7(3).

32. *Id.* art. 1(1)(a). This right of approval becomes important as the Convention provides that the lessee effectively becomes the beneficiary of the supplier's warranties "as if it were a party to [the supply agreement] and as if the equipment were . . . supplied directly to the lessee." *Id.* art. 10(1). *Accord* U.C.C. § 2A-209(1).



definition of financial leasing under the Convention is consistent with the conception of a "finance lease" under U.C.C. Section 2A-103(g).<sup>33</sup>

Article 1, paragraph (2) of the Convention sets forth three criteria that must be met in order for the Convention to apply. First, the lessee must specify the equipment and select the supplier "without relying *primarily* on the skill and judgment of the lessor."<sup>34</sup> Second, the lessor must acquire the equipment in connection with the leasing agreement, and the supplier must know that the leasing agreement has been, or will be, entered into between the lessor and the lessee.<sup>35</sup> Third, rentals under the leasing agreement must "take into

33. Comment (g) to U.C.C. Section 2A-103 states:

A finance lease is the product of a three party transaction. The supplier manufactures or supplies the goods pursuant to the lessee's specification, perhaps even pursuant to a purchase order, sales agreement or lease agreement between the supplier and the lessee. After the prospective finance lease is negotiated, a purchase order, sales agreement, or lease agreement is entered into by the lessor (as buyer or prime lessee) or an existing order, agreement or lease is assigned by the lessee to the lessor, and the lessor and lessee then enter into a lease or sublease of the goods. Due to the limited function usually performed by the lessor, the lessee looks almost entirely to the supplier for representations, covenants and warranties.

*Id.* Note that under the U.C.C., in order to qualify as a finance lease, a transaction must first satisfy the definition of a "lease" under 2A-103(1)(j): "a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale and return, or retention or creation of a security interest is not a lease." U.C.C. § 2A-103(g) cmt. g.

34. Leasing Convention, *supra* note 4, art. 1(2)(a) (emphasis added). While the use of the term "primarily" suggests that the lessor may take steps to protect its investment by recommending a particular type of equipment or a dependable supplier, the lessor who does more than simply finance the transaction creates a greater potential for liability both to the lessee and to third parties. Secretariat Report, *supra* note 1, at 39. Article 8(1)(a) states that the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent that the lessee has suffered loss as the result of its reliance on the lessor's skill and judgment *and of the lessor's intervention in the selection of the supplier or the specifications of the equipment.*

Leasing Convention, *supra* note 4, art 8(1)(a) (emphasis added). The U.C.C. similarly states that in a finance lease in which the lessor does more than simply supply funds, "express warranties, covenants, and the common law will protect the lessee." U.C.C. § 2A-103 cmt. g. However, the Code explicitly provides that there is no implied warranty of fitness for a particular purpose in a finance lease. U.C.C. § 2A-213.

35. Leasing Convention, *supra* note 4, art. 1(2)(b). Prof. Ronald Cuming, the chief spokesperson for the Canadian delegation at the Ottawa Diplomatic Conference, points out that while the supplier must be aware that the equipment is being acquired in order to lease to the lessee, there is no requirement that the supplier be aware that the Convention will govern the leasing transaction. Because a primary goal of the Convention is to shift liability from the lessor to the supplier, suppliers who deal with foreign lessors risk facing additional potential

account in particular the amortisation of the whole or a substantial part of the equipment."<sup>36</sup> Paragraph (3) states that the Convention is applicable whether or not the lessee has the right to purchase the equipment or extend the lease period, and "whether or not for a nominal price or rental."<sup>37</sup>

### C. *International Commercial Leases*

The Leasing Convention was drafted to apply to international leases necessitating, at a minimum, that the parties to the leasing agreement,<sup>38</sup> the lessor and lessee, have their places of business in different Contracting States.<sup>39</sup> The supplier, the third essential party to the international financial lease, may have its place of business in the same Contracting State as the lessor or the lessee, or in a third-party State, provided that both the supply and leasing agreements are governed by the law of a Contracting State,<sup>40</sup> either through affirmative choice of law, or by virtue of conflicts rules.

If all three parties choose to do so, they may elect to exclude the Convention *in toto*.<sup>41</sup> However, the Convention permits the parties "in their relations with each other" to vary the effect of any of the Convention's

liability without being aware of the consequences. Cuming, *supra* note 5, at 54. *See also* Leasing Convention, *supra* note 4, art. 10.

36. Leasing Convention, *supra* note 4, art. 1(2)(c). Because under the Code, a finance lease must *a fortiori* qualify as a lease, U.C.C. § 2A-103(j), whether the obligations under the lease exceed the economic life of the leased goods is an important factor in U.C.C. Section 1-201(37) for determining whether a given transaction is a true lease or a "disguised" security interest governed by Article 9. This is a fact-specific determination that focuses on the economics of the transaction in question. U.C.C. § 1-201(37) & cmt. 37. This is not merely an exercise in semantics. If the transaction is determined to be a security interest disguised as a lease, the lessor will be required to file a financing statement to perfect its rights in the equipment as against the competing claims of third parties. U.C.C. § 2A-101 cmt. *See also* Edwin E. Huddleson III, *New Developments: Article 2A Leases of Goods*, in *COMMERCIAL LAW ANNUAL* 115, 117-23 (Louis F. & Patrick Del Duca eds., 1993) [hereinafter *New Developments*].

37. Leasing Convention, *supra* note 4, art. 1(3). Note that under U.C.C. Section 1-201(37), a purchase option of the leased equipment for nominal consideration is a factor which identifies a transaction as creating a security interest, rather than a true lease.

38. The drafters of the Leasing Convention focused on the leasing agreement to establish the international character of the lease because it represents the "fundamental legal relationship contained within the complex financial leasing transaction. . . ." Secretariat Report, *supra* note 1, at 42.

39. The Convention defines "place of business" as being that which has the "closest relationship to the relevant agreement and its performance." Leasing Convention, *supra* note 4, art. 3(2).

40. *Id.* art. 3(1).

41. *Id.* art. 5(1).

provisions.<sup>42</sup> The only exceptions to this permission are in Article 8(3) (lessor's warranty of quiet possession—intentional or grossly negligent acts of the lessor); Article 13(3)(b) (lessor's damages in the event of default by lessee); and Article 13(4) (acceleration of rentals due). The Leasing Convention thus follows the traditional principle of freedom of contract subject to limited mandatory provisions, which is generally consistent with Section 1-102(3) of the Uniform Commercial Code.<sup>43</sup>

Consumer leasing transactions are explicitly excluded from the Convention,<sup>44</sup> which also is inapplicable to leases purely of real estate.<sup>45</sup> Martin Stanford, Senior Research Adviser of UNIDROIT, observes that these limitations are a result of the different concerns underlying consumer and commercial laws, the limited instances of consumer leasing at the international level, and the impracticality of intertwining real and chattel property concepts into a single, uniform international law.<sup>46</sup>

42. *Id.* art. 5(2).

43. U.C.C. Section 1-102(3) states as a general principle that:

The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

*See also* U.C.C. § 2A-101 cmt., *supra* note 21.

44. The Convention does not apply to equipment which is leased "primarily for the lessee's personal, family, or household purposes." Leasing Convention, *supra* note 4, art. 1(4). By contrast, a financial lease under U.C.C. Section 2A-103(g)(iii) may be either a commercial or consumer transaction. The rationale for insulating a financial lessor against tort liability to third parties is weaker when consumer transactions are involved. The Code leaves consumer protection in leasing transactions primarily up to other law. U.C.C. § 2A-104(1)(c) & cmt. 4.

45. *See* Leasing Convention, *supra* note 4, art. 4(2):

Any question whether or not the equipment has become a fixture to or incorporated in land, and if so the effect of the rights *inter se* of the lessor and a person having real rights in the land, shall be determined by the law of the State where the land is situated.

The effect of this provision is that while the Convention was never intended to apply to real estate, it may potentially be applicable depending on the interpretation of the term "plant" in national courts. Secretariat Report, *supra* note 1, at 37. Section 2A-309(2) of the Code avoids this distinction by stating that "no lease exists under this Article of ordinary building materials incorporated into an improvement on land."

46. Stanford, *supra* note 5, at 5.

## II. LESSOR-LESSEE RELATIONSHIP

The leasing agreement, which gives rise to the lessor-lessee relationship, represents the core transaction in financial leasing. The treatment of the lessor and lessee under the Convention is substantially in accord with the rights and remedies of the respective parties set forth in the Uniform Commercial Code.

Financial leasing is a hybrid transaction; the concerns of the lessee parallel those of a buyer in a sales transaction, while the lessor's are those of a financier, rather than a seller of goods. The lessee wants to be able to use the equipment that it selects free from the competing claims of third parties, such as the seller's creditors, and with essentially the same warranty protection it would have if it had purchased the equipment from the supplier directly.

The lessor, on the other hand, wants to be guaranteed the right to receive payment from the lessee without the concern of liability (particularly products liability) exposure to third parties. This concern is due to the fact that the lessee selects the equipment regardless of its operational fitness.<sup>47</sup> Because of its limited involvement with the selection and acquisition of the equipment, the lessor seeks to maintain the supplier's warranty responsibility. Equally important, the lessor seeks assurance of the maintenance of its rights in the leased equipment in the event of the lessee's insolvency. The Convention addresses and clarifies each of these concerns.

### A. *Lessor's Warranty of Quiet Possession*

Both the Leasing Convention<sup>48</sup> and the Uniform Commercial Code<sup>49</sup> provide a lessor's warranty of quiet possession. Article 8(2) of the Leasing Convention states that "[t]he lessor warrants that the lessee's quiet possession will not be disturbed [unless such disturbance is] derived from an act or

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47. The drafters of the Convention, in recognition of this point, stated in the Secretariat Report:

[I]t would be morally indefensible for a lessee that has had ample opportunity to check on the technical suitability of the equipment required by it prior to delivery to be able to blame the lessor for its own bad choice when the equipment on delivery proves to be unsuited to its requirements.

Secretariat Report, *supra* note 1, at 38.

48. Leasing Convention, *supra* note 4, art. 8(2)-(4).

49. U.C.C. § 2A-211(1). "There is in a lease contract a warranty that for the lease term no person holds a claim to or interest in the goods that arose from an act or omission of the lessor . . . which will interfere with the lessee's enjoyment of the leasehold interest." Note that unlike the broader warranty stated in Article 8 of the Leasing Convention, the lessor under U.C.C. Section 2A-211(1) only warrants against conflicting claims that arise from the lessor's own acts or omissions.

omission of the lessee." Consequently, the lessor is deemed liable for any conflicting claims on the leased equipment brought by third parties, except those caused by the lessee.

The liability of the lessor for breaches of the warranty of quiet possession may, however, be contractually limited, subject to two exceptions: the mandatory provisions under paragraphs (3) and (4). Paragraph (3) states that the lessor cannot contract away responsibility for grossly negligent or intentional acts that give rise to superior claims in the equipment. Paragraph (4) provides that if a broader warranty of quiet possession is mandatory under the law governing the contract as determined by conflicts of law rules, attempts at disclaimer are ineffective.<sup>50</sup>

The rationale behind requiring a broad warranty of quiet possession, while perhaps understandable in domestic consumer transactions, makes little sense in the context of international commercial leasing. Effectively, the lessor is required to act as a title insurer, and presumably passes the cost of the risk to the lessee. This overlooks the fact that it is the lessee that selects both the leased equipment and the supplier, and arguably is in a better position to evaluate the reliability of title to the leased equipment. The well-advised lessor consequently will seek: (1) to narrow the scope of the warranty contractually, as is common practice in financial leasing, (2) to press the supplier and the lessee to exclude the Convention entirely,<sup>51</sup> or (3) to avoid the transaction altogether.<sup>52</sup>

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50. Leasing Convention, *supra* note 4, art. 8(2)-(4). In addition, the same concerns are addressed in Article 20 which states that "[a] Contracting State may . . . substitute its domestic law for Article 8(3) if its domestic law does not permit the lessor to exclude its liability for its default or negligence." This right to substitute domestic law was designed to accommodate French law, among others, which considers a warranty of quiet possession to be a fundamental feature of a leasing contract. Cuming, *supra* note 5, at 59. France, in fact, made the declaration under Article 20 in ratifying the convention. Letter from Hughes, *supra* note 16. Nevertheless, the domestic law declaration of Article 20 does defeat the purpose of "formulating certain *uniform* rules . . . of international financial leasing." Leasing Convention, *supra* note 4, pmb1. (emphasis added). The harmonization of commercial laws requires a degree of willingness to adapt domestic laws in order to achieve international commercial certainty. *See, e.g., The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 9 (1972) (noting that "[w]e cannot have trade and commerce in world markets . . . exclusively on our terms, governed by our laws . . .").

51. Leasing Convention, *supra* note 4, art. 5. *See also supra* text accompanying note 41.

52. For a through analysis of the lessor's warranty of quiet possession, see Charles W. Mooney, Jr., *Filing Requirements for Personal Property Leases: A Comment and Response to Professor Ziegel*, 16 CANADIAN BUS. L.J. 419, 432-36 (1990). Professor Mooney was a member of the U.S. delegation that participated in the drafting of the Leasing Convention.

### B. *Improper Tenders—Nonconformity or Delivery Problems*

Both the Leasing Convention and the Uniform Commercial Code outline the respective rights and duties of the lessor and the lessee when the leased equipment either fails to conform to the supply agreement or where the equipment is not delivered as agreed. Although fundamentally similar, their approaches differ in several important respects.

Article 12 of the Leasing Convention represents the sole set of remedies available to the lessee for claims against the lessor regarding the performance of the leased equipment<sup>53</sup> or its delivery under the Convention.<sup>54</sup> This is consistent with the theory of the finance lease that it is the *supplier* to which the lessee should look for claims arising out of the equipment.<sup>55</sup>

Article 12 of the Convention provides that when the equipment is not delivered, is delivered late, or otherwise fails to conform to the specifications contained in the supply agreement, the lessee has a right as against the lessor to reject the nonconforming tender<sup>56</sup> or to terminate the leasing agreement,<sup>57</sup> subject to a corresponding right of the lessor to cure the defective tender.<sup>58</sup> These rights must be exercised or lost, as if the lessee had bought the equipment directly from the lessor on the same terms as those whom the lessor bought the equipment from the supplier under the supply agreement.<sup>59</sup> When the

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53. This is distinguished from claims under Article 8 for breaches of the lessor's warranty of quiet possession or the lessor's interference with the selection of the equipment or the supplier. Leasing Convention, *supra* note 4, art. 8.

54. *Id.* art. 12(5). Note that where the defective tender or delivery is through the fault of the lessor—for example, by failure to pay the supplier—the lessee may potentially recover additional sums as damages. Secretariat Report, *supra* note 1, at 69.

55. Leasing Convention, *supra* note 4, arts. 10, 12(6). *Accord* U.C.C. § 2A-209(1). In fact, the U.C.C. places so much importance on this fundamental finance lease concept that comment (1) to Section 2A-209(1) states that "[a]s a matter of policy, the operation of this provision may not be excluded, modified or limited . . . ."

56. Leasing Convention, *supra* note 4, art. 12(1)(a). *Accord* U.C.C. § 2A-509(1) (restating "perfect tender" rule of U.C.C. § 2-601 in the context of a lease).

57. Leasing Convention, *supra* note 4, art. 12(1)(a). *Accord* U.C.C. §§ 2A-508(1)(a), 2A-501(1), 2A-505(1).

58. Leasing Convention, *supra* note 4, art. 12(1)(b). *Compare* U.C.C. § 2A-513 (limiting the lessor's right of cure under the U.C.C. to instances where time for performance has not expired, U.C.C. § 2A-513(1), or in the case of substituted deliveries, U.C.C. § 2A-513(2)).

59. Leasing Convention, *supra* note 4, art. 12(1). Article 12(2) of the Leasing Convention reiterates that "[a] right conferred by [art. 12(1)] shall be exercisable in the same manner and shall be lost in the same circumstances as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement." Thus, Article 12 effectively states a choice of law rule rather than an independent, substantive rule of law. *See* Cumings, *supra* note 5, at 57. By making specific rights and remedies of the lessee and lessor dependent on the domestic sales law of the supply contract, Article 12 fails to state the outcome where

lessee exercises the right to terminate the leasing agreement, it is entitled under the Convention to a restitution of rentals and other sums paid in advance, less an offset for beneficial use.<sup>60</sup>

For example, if the lessor purchases the equipment from the supplier under a supply agreement subject to U.S. sales law, Article 2 of the Uniform Commercial Code would govern, and the lessor as buyer can reject a less than perfect tender<sup>61</sup> or revoke its initial acceptance only in very limited circumstances.<sup>62</sup> The supplier as seller will have the right to cure only if the time for its performance has not yet passed,<sup>63</sup> or if it has tendered the nonconforming goods in the reasonable belief that they are acceptable.<sup>64</sup>

If the supply contract is governed by the Vienna Convention on the International Sale of Goods (CISG), following the contractual time for delivery, the lessor as buyer can reject the equipment and declare the contract avoided "if the failure by the seller to perform any of his obligations under the contract or [the CISG] amounts to a fundamental breach of contract."<sup>65</sup> If the contract

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there is no comparable right, such as the right to cure defective tenders provided under the applicable law. Given the generally recognized freedom of commercial parties to choose the substantive law applicable to their contract, this interperative anomaly will probably remain more of a theoretical, rather than a practical consideration. *Id.* at 57-58.

60. Leasing Convention, *supra* note 4, art. 12(4). *Accord* U.C.C. § 2A-508(1)(b) (allowing the lessee to rightfully reject or revoke acceptance of goods and recover amounts paid "as is just under the circumstances").

61. U.C.C. § 2-601 (allowing buyer to reject "if the goods or the tender of delivery fail in any respect to conform to the contract . . . .")

62. Revocation of acceptance under Section 2-608 of the U.C.C. requires a higher degree of nonconformity than the "perfect tender" rule of Section 2-601. For a buyer to be able to revoke its initial acceptance of goods, the nonconformity of the goods must "substantially impair[] its value" to the buyer, U.C.C. § 2-608(1), and where the initial acceptance was either based on the "reasonable assumption" that the nonconformity would be cured by the seller, U.C.C. § 2-608(1)(a); or that the defect was difficult to discover or that acceptance was based on the seller's assurances, U.C.C. § 2-608(1)(b). Even if the buyer has colorable grounds for revocation of acceptance, it must do so within a reasonable period of time and must notify the seller, U.C.C. § 2-608(2). *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 8-3 (2d ed. 1980).

63. U.C.C. § 2-508(1).

64. U.C.C. § 2-508(2).

65. United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, art. 49(1)(a), U.N. Doc. A/CONF.97/18, 19 I.L.M. 668 (1980) [hereinafter CISG] (entered into force Jan. 1, 1988; for the U.S., Jan. 1, 1988). Article 25 of the CISG defines a "fundamental" breach as that which "results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result." *See* Fritz Enderlein, *Rights and Obligations of the Seller Under the UN Convention on Contracts for the International Sale of Goods, in*

is not declared avoided, the supplier as seller has the right to cure "without unreasonable delay and without causing the buyer unreasonable inconvenience . . . ."66

Rather than invoking the law of sales to provide rights for the lessee against the lessor, as opposed to the supplier, for equipment or deliveries which are not in conformity with the contract (and thereby ignoring the limited role of the financial lessor), the Uniform Commercial Code takes a functional approach in restricting the remedies available to the lessee which reflects actual commercial practice in financial leasing. Section 2A-509(1) states a "perfect tender" rule, which permits the lessee to reject prior to acceptance equipment that fails to conform to the supply agreement in any way. Acceptance, which cuts off the right to reject the leased goods,<sup>67</sup> occurs after the lessee has inspected the goods and either indicates that they are conforming, accepts them despite non-conformity,<sup>68</sup> or otherwise fails to make an effective rejection.<sup>69</sup>

In a finance lease under the Code, once the lessee has accepted the goods, the right of revocation of acceptance is limited to instances where the lessee had no knowledge of the nonconformity and the lessor induced the lessee to take the nonconforming goods through additional promises or assurances. In addition, the nonconformity must be serious enough that it substantially impairs the value of the goods to the lessee.<sup>70</sup> This rather high standard for rejection is deemed equitable because in a financial lease, the lessee has a direct claim against the supplier for defects in the equipment.<sup>71</sup> Moreover,

INTERNATIONAL SALE OF GOODS: DUBROVNIK LECTURES 133, 187, 193-96 (Petar Šarčević & Paul Volken eds., 1986).

66. CISG, *supra* note 65, art. 48(1). Even if the seller cures, the buyer nevertheless retains the right to claim damages arising out of the breach. *Id.* Note that if the buyer declares the contract avoided under Article 49 of the CISG, the seller loses the right to cure under Article 48(1). Enderlein, *supra* note 65, at 193.

67. U.C.C. § 2A-516(2).

68. In fact, in a finance lease, if the lessee has accepted equipment with knowledge of the nonconformity, acceptance cannot be revoked because of it. *Id.*

69. U.C.C. § 2A-515.

70. U.C.C. § 2A-517(1)(b). *See also* U.C.C. § 2A-516 cmt. 1. As with the Convention, a financial lessor that chooses to do more than merely provide funds increases its potential for liability. *See, e.g.,* Leasing Convention, *supra* note 4, art. 8(1)(a), art. 12(5).

71. U.C.C. § 2A-516(2) cmt. 1. Comment 10 to Section 2A-508 states that: Absent supplemental principles of law and equity to the contrary, in the case of most finance leases, following the lessee's acceptance of the goods, the lessee will have no rights or remedies against the lessor, because the lessor's obligations to the lessee are minimal. Since the lessee will look to the supplier for performance, this is appropriate.

(Internal citations omitted.) *See also* U.C.C. § 2A-209(1); Leasing Convention, *supra* note 4, art. 10(1).



the right of the lessor to cure a defective tender arises only prior to the expiration of the time for the lessor's performance,<sup>72</sup> or if the lessor or supplier tenders nonconforming goods that they have reasonable grounds to believe are acceptable.<sup>73</sup>

A fundamental difference in the U.C.C. and the Leasing Convention concerns the right of the lessee to withhold payments until the lessor cures a nonconforming tender. Under the Convention, the lessee is permitted to withhold payments until the lessor cures the defective tender or the lessee has lost the right to reject the equipment.<sup>74</sup>

Unlike the Leasing Convention, the Code does not permit the lessee to withhold rental payments in the event of a nonconforming performance by the lessor or supplier. Section 2A-407 of the Code restates the traditional "hell or high water" leasing clause by providing that in a commercial finance lease, the lessee's obligation to pay under the terms of the rental contract "becomes irrevocable and independent" upon the lessee's acceptance of the goods.<sup>75</sup> The U.C.C. emphasizes that "due to the function of the lessor" in financial leasing, the lessee should be required to pay the lessor notwithstanding the nonconforming tender because the lessee looks to the supplier to honor the equipment warranties.<sup>76</sup> Moreover, the Code places such emphasis on this principle that if a lease qualifies as a finance lease under Section 2A-103(1)(g), then the "hell or high water" clause of Section 2A-407 becomes a self-executing statutory provision of the lease, without the need to consciously include it in the draft.<sup>77</sup> This obligation to pay "come hell or high water" is subject only to the obligation of good faith and the ability of the lessee to revoke acceptance.<sup>78</sup>

Article 12 of the Leasing Convention, while constituting a choice of law reference rather than a "uniform rule[ ] relating [to] international financial

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72. U.C.C. § 2A-513(1).

73. U.C.C. § 2A-513(2).

74. Leasing Convention, *supra* note 4, art. 12(3). Note that the drafting of Article 12 is somewhat less than ideal. Paragraphs (1) and (2) explicitly invoke domestic sales law in determining the right of the lessee to reject the equipment or terminate the leasing agreement and the right of the lessor to cure the nonconforming tender, while paragraphs (3) and (4) make no such reference. Query if this would permit the withholding of payment in circumstances where it would not be allowed under the applicable sales law.

75. See Breslauer, *supra* note 4, at 326-27.

76. U.C.C. § 2A-407 cmt. 1. Comment 3 to U.C.C. § 2A-209 makes clear that in a commercial financial lease, the "hell or high water" clause of U.C.C. § 2A-407 is the price that the lessee pays to gain the benefits of the supplier's promises to the lessor under the supply agreement.

77. U.C.C. § 2A-407 cmt. 1. Breslauer, *supra* note 4, at 327.

78. U.C.C. § 2A-407 cmt. 1.

leasing,<sup>79</sup> represents a non-mandatory provision which may be varied contractually<sup>80</sup> and therefore is unlikely to alter actual commercial leasing practices. The financial lessor does not want the lessee to raise claims against it arising out of the equipment after it has already paid the supplier. Consequently, as a matter of sound business practice, the lessor will require the lessee to verify in writing prior to the payment of the supplier that it received and accepted the equipment, that the equipment is conforming as specified, and that the lessee agrees to be bound by its normally absolute obligation to pay under the leasing agreement.<sup>81</sup>

### C. *Lessor's Remedies if Lessee is in Breach*

The rights and remedies available to the lessor upon default by the lessee under the Leasing Convention and the Uniform Commercial Code are largely in accord.<sup>82</sup>

#### 1. *"Expectation Damages"*

The theory of damages under both the Leasing Convention and the U.C.C. is that the party who is injured by the other party's failure to perform its obligations has the right to receive monetary compensation, effectively gaining the benefit of its bargain. Section 1-106 of the U.C.C. states that the purpose of damages is to put the aggrieved party in "as good a position as if the other party had fully performed . . . ."<sup>83</sup>

Article 13(1) of the Leasing Convention states the basic rule that where the lessee is in default, whether or not such default would be considered "substantial" under the terms of the contract,<sup>84</sup> the lessor is entitled to accrued

79. Leasing Convention, *supra* note 4, pmb1. *See also supra* note 59 and accompanying text.

80. Leasing Convention, *supra* note 4, art. 5(2).

81. Charles W. Mooney, Jr., Report on UNIDROIT Convention on International Financial Leasing 7 (1990) (manuscript on file with the State Department). *See also* Cuming, *supra* note 5, at 58.

82. Compare Leasing Convention, *supra* note 4, art. 13 (lessor's remedies under the Convention) with U.C.C. § 2A-523 (index of lessor's remedies under the Code).

83. U.C.C. § 1-106.

84. The drafters of the Leasing Convention felt that because the "essential factor" in determining what constitutes a "substantial default" in a given transaction is the creditworthiness of the lessee, establishing the threshold at which a default would be deemed "substantial" was best left to the parties in their agreement. *See* Secretariat Report, *supra* note 1, at 70.

unpaid rentals, together with interest and damages upon default by the lessee.<sup>85</sup> Similarly, Section 2A-523(3)(b) of the Code provides that where the lessee's default does not "substantially impair the value of the lease contract," the lessor may recover for its loss arising from the lessee's default "as determined in any reasonable manner."<sup>86</sup>

Unlike the U.C.C., Article 13 of the Leasing Convention requires the election of remedies by the lessor in the event of substantial default by the lessee.<sup>87</sup> If the lessee's fault is indeed "substantial," the lessee must first be given notice of the default and a reasonable opportunity to remedy it,<sup>88</sup> unless such notice would be futile.<sup>89</sup> Cure by the defaulting lessee returns the parties to *status quo ante*.

Where notice has been given and the lessee's default is not remedied, the lessor has the option to terminate the lease, repossess the equipment,<sup>90</sup> and recover "expectation-type" damages.<sup>91</sup> In the alternative, Article 13(2) of the Leasing Convention permits a lessor to elect to keep the leasing agreement in force, leave the lessee in possession of the equipment, and accelerate payments of future rentals if permitted under the leasing agreement.<sup>92</sup> However, as a practical matter, a lessee who is in substantial default because it cannot make rental payments as they come due in the ordinary course of business will not likely be able to pay accelerated future rentals in order to retain possession of the equipment for the original term of the leasing agreement.<sup>93</sup>

The comparable Code provision, Section 2A-529(1), permits the lessor to recover accelerated rentals, discounted to present value as of the date of judgment, plus incidental expenses, less expenses saved where a lessee is in substantial default and the goods are "not repossessed by or tendered to the

85. Leasing Convention, *supra* note 4, art. 13(1).

86. U.C.C. § 2A-523(2), (3)(b).

87. *Cf.* U.C.C. § 2A-523 cmt. 4 ("This Article rejects any general doctrine of election of remedy.")

88. Leasing Convention, *supra* note 4, art. 13(5). In contrast, U.C.C. Section 2A-502 states that a "lessee in default . . . is not entitled to notice of default or notice of enforcement . . . ."

89. For example, notice and an opportunity to remedy a substantial default would be futile where the lessee is bankrupt. Secretariat Report, *supra* note 1, at 71.

90. Leasing Convention, *supra* note 4, art. 13(2)(a). *Accord* U.C.C. §§ 2A-523, -525(2).

91. Article 13(2)(b) of the Leasing Convention provides that the lessor may "recover such damages as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms." Leasing Convention, *supra* note 4, art. 13(2)(b).

92. *Id.* art. 13(2).

93. Cuming, *supra* note 5, at 62.

lessor."<sup>94</sup> Under the Uniform Commercial Code, a clause permitting the lessor to accelerate payments "at will" is enforceable if the lessor has a good faith belief that the prospect of payment is "impaired."<sup>95</sup> Good faith is presumed, and the lessee has the burden of demonstrating that a commercial lessor is not acting in good faith.<sup>96</sup> Note that damages available to the lessor under the Convention, whether the default by the lessee is substantial or not, are subject to a duty of mitigation by the lessor.<sup>97</sup>

## 2. *Liquidated Damages Clauses Enforceable*

One of the key objectives of the Leasing Convention was to ensure the enforceability of liquidated damages clauses.<sup>98</sup> Article 13(3) of the Leasing Convention permits the parties to determine damages in advance through an enforceable liquidated damages clause subject to the mandatory rule that such damages cannot be substantially in excess of the amount that would have been due the lessor if the lease had been fully performed.<sup>99</sup> Similarly, Section 2A-504(1) of the Uniform Commercial Code provides that damages may be liquidated "only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default . . . ."

Article 13(5), one of the few mandatory provisions of the Convention, states that the lessor may not accelerate future rentals after termination of the leasing agreement; however, the same result may be achieved contractually by an enforceable liquidated damages clause that "take[s] into account" the value of future rentals.<sup>100</sup>

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94. U.C.C. § 2A-529(1). The other instances where a lessor has the statutory right to accelerate rentals under Section 2A-529(1) include where conforming goods have been lost or damaged within a commercially reasonable time after the risk of loss passed to the lessee, or where the goods were identified to the contract and the lessor is unable to dispose of them at a reasonable price after reasonable effort, or where circumstances reasonably indicate such effort will be unavailing. *See also New Developments, supra* note 36, at 134.

95. U.C.C. § 2A-109(1).

96. U.C.C. § 2A-109(2) & cmt.

97. Article 13(6) of the Leasing Convention states that "[t]he lessor shall not be entitled to recover damages to the extent that it failed to take all reasonable steps to mitigate its loss." Leasing Convention, *supra* note 4, art. 13(6).

98. R.M. Goode, *Conclusion of the Leasing and Factoring Conventions-I*, J. BUS. L. 347, 349 (1988) (U.K.). Professor Goode served as Deputy Chairperson of the United Kingdom's Committee to the Leasing Convention and was Chairperson of the Drafting Committee.

99. Leasing Convention, *supra* note 4, art. 13(3)(b).

100. *Id.* art. 13(4).

D. *Subleases—Rights of Assignment—Transfers of Interests*

Both the Leasing Convention and Section 2A of the U.C.C. provide for subleases, assignments, and transfers of interest. Article 2 of the Leasing Convention states that the Convention continues to apply to subleases and that the original supplier and supply agreement maintain the same relationship with the sublessee as they had *vis a vis* the original lessee. Similarly, the Code defines the term "lease" to include subleases.<sup>101</sup>

Article 14 of the Leasing Convention sets forth the rights of the parties to transfer or assign their interests under the leasing agreement. Paragraph (1) provides that the lessor may transfer "or otherwise deal with" its rights in the equipment or its rights under the leasing agreement. Significantly, paragraph (1) makes clear that such a transfer "shall not relieve the lessor of any of its duties" under the leasing agreement, nor will the transfer itself remove the leasing agreement from the application of the Leasing Convention. Therefore, a transferring lessor remains liable to the lessee for its promises under the leasing agreement, and if the lessor transfers its interest in the leasing agreement to a party whose principal place of business is not in a Contracting State,<sup>102</sup> the Convention continues to govern the leasing agreement as if the transferee's place of business was within a Contracting State.<sup>103</sup>

Under Section 2A-303(3) of the U.C.C., the lessor may transfer its duties under the lease to a transferee who effectively assumes a duty to perform the obligations of the lessor.<sup>104</sup> Consistent with the Leasing Convention, such a transfer of the lessor's interest does not relieve the lessor of its contractual obligations to the lessee absent agreement of the parties.<sup>105</sup>

Article 14(2) of the Leasing Convention states that the lessee may only transfer the right to use the equipment or any other rights under the leasing agreement with the consent of the lessor and subject to the rights of third parties. Similarly, lessor consent is required under the Code. Section 2A-303 of the U.C.C. provides that the transfer by the lessee of the right to possession or use of the equipment may be deemed contractually to constitute an event

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101. U.C.C. § 2A-103(1)(j).

102. Leasing Convention, *supra* note 4, art. 3(1). *See also supra* text accompanying note 39.

103. The second sentence in Article 12 was intended by the drafters to prevent the use of transfers by the lessor of its interests under the leasing agreement in order to either defeat the applicability of the Convention or to "internationalize" a purely domestic leasing transaction, thereby supplanting domestic law with the Convention. Secretariat Report, *supra* note 1, at 75.

104. U.C.C. § 2A-303(3) & cmt. 1.

105. U.C.C. § 2A-303(7).

of default<sup>106</sup> giving the lessor the range of rights and remedies set forth in Section 2A-501. Of course, the lessor may permit such assignment, provided that both it and any interested third parties have given prior consent.<sup>107</sup>

### E. Lessee's Standards for Use of the Leased Equipment

Article 9 of the Leasing Convention requires the lessee to take proper care of the leased equipment, "use it in a reasonable manner," and maintain the equipment in its original, as-delivered condition "subject to fair wear and tear."<sup>108</sup> Any modification must be agreed to by the parties.<sup>109</sup> Under Section 2A-219(1) of the U.C.C., the lessee in a finance lease bears the risk of loss arising out of the equipment.

## III. SUPPLIER—LESSEE RELATIONSHIP

Essential to the tripartite relationship in a financial leasing transaction is the concept that it is the supplier who provides the equipment. Therefore, the supplier is the proper party to whom the lessee should look for problems arising out of the equipment,<sup>110</sup> despite the absence of contractual privity. Both the Leasing Convention and the U.C.C. formalize this relationship.

Article 10(1) of the Leasing Convention provides that the supplier owes the same duty to the lessee as it does to the lessor under the supply agreement, "as if [the lessee] were a party to that agreement and as if the equipment were to be supplied directly to the lessee."<sup>111</sup> It also protects the supplier by providing that the supplier is not exposed to liability to both the lessor and

106. Note that if the leasing agreement does not specifically provide that a transfer of the lessee's interest constitutes an event of default—but only bars such transfer—the lessor must prove and is limited to the recovery of actual damages. U.C.C. § 2A-303(5)(b). In rare occasions where the transfer would materially increase risk, the court could issue an injunction. *Id.* & cmt. 9; *New Developments, supra* note 36, at 138.

107. Taylor, *supra* note 1, at 1260.

108. Leasing Convention, *supra* note 4, art. 9(1). Paragraph (2) states that the equipment is to be returned to the lessor by the lessee in the same condition described in paragraph (1). *Id.* art. 9(2). The drafters of the Convention elected to define a uniform obligation of the lessee to keep the leased equipment in good working order. Secretariat Report, *supra* note 1, at 61. While this is not an explicit risk of loss provision as stated in § 2A-219(1), it has much the same practical effect by creating a minimum standard for acceptable use of the equipment by the lessee. Note that the parties are free to include a more specific risk of loss provision in their leasing agreement.

109. Leasing Convention, *supra* note 4, art. 9(1).

110. Stanford, *supra* note 5, at 5.

111. Leasing Convention, *supra* note 4, art. 10(1).

the lessee "in respect of the same damage."<sup>112</sup> Paragraph (1) should promote legal predictability in leasing transactions involving jurisdictions that might otherwise be reluctant to enforce the assignment of rights arising under the supply agreement by the lessor to the lessee.<sup>113</sup> This is consistent with the policy stated in U.C.C. Section 2A-209 to treat the lessee in a finance lease as the beneficiary of the promises to the lessor in the supply agreement.<sup>114</sup> Article 10, paragraph (2) of the Leasing Convention further protects the lessor's interest by providing that the lessee may not "terminate or rescind the supply agreement without the consent of the lessor," notwithstanding the relationship of the lessee and supplier recognized by paragraph (1).<sup>115</sup>

Both the Leasing Convention and the U.C.C. provide comparable protection for the lessee. Article 11 of the Leasing Convention states that the consent of the lessee is required if any variation in the terms of the supply agreement previously approved by the lessee are to effect the lessee's rights. Under Section 2A-209(3) of the Code, modifications of the terms of the supply agreement are ineffective if the supplier has received notice prior to the attempted modification that the lessee has entered into a finance lease related to the supply agreement. However, if the supplier has not learned of the lease, the modification is nevertheless effective, and the lessor is deemed to have assumed any obligations of the supplier benefitting the lessee arising in the original supply agreement which were subsequently modified or rescinded.

#### IV. LESSOR—THIRD PARTY RELATIONSHIPS

##### A. *Lessee's Judgment Creditors and Trustees in Bankruptcy*

A major concern of a lessor in international commerce is the protection of its rights in the equipment in the event of the insolvency of the lessee.<sup>116</sup>

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112. *Id.*

113. Mooney, *supra* note 81, at 6-7.

114. Section 2A-209(1) of the U.C.C. states:

The benefits of a supplier's promises to the lessor under the supply contract and of all warranties, whether express or implied, including those of any third party provided in connection with or as part of the supply contract, extends to the lessee . . . under a finance lease related to the supply contract, but is subject to the terms of the warranty and of the supply contract and all the defenses or claims arising therefrom.

Further this concept is so central to the theory of the finance lease under the Code that "[a]s a matter of policy, the operation of [2A-209(1)] may not be excluded, modified or limited . . ." U.C.C. § 2A-209 cmt. 1.

115. Leasing Convention, *supra* note 4, art. 10(2). *Accord* U.C.C. § 2A-407(2).

116. Stanford, *supra* note 5, at 5-6.

Article 7 of the Leasing Convention therefore deals with the lessor's "real rights"<sup>117</sup> in the leased equipment as against the lessee's creditors and trustees in bankruptcy.<sup>118</sup>

Paragraph (1) provides that the lessor's "real rights" in the equipment are protected against the lessee's creditors and trustees in bankruptcy, providing for compliance with notice requirements, if any.<sup>119</sup> By negative implication, where there are no rules regarding public notice under the applicable law, the lessor's real rights are automatically protected against this class of claimants.<sup>120</sup> The Leasing Convention purposefully does not attempt to affect the priority of liens or security interests, excepting attachment or execution creditors;<sup>121</sup> nor does it affect the priority of any creditor having the "right of arrest, detention or disposition" of ships or aircraft under applicable international law.<sup>122</sup>

Protection for the lessor as owner is consistent with the general rule of Section 2A-307(1) of the U.C.C. that "except [for statutory liens], a creditor of the lessee takes subject to the lease contract." This provision of the Convention should be particularly beneficial to financial lessors where the equipment will be located in Contracting States that have not fully developed a system of laws for personal property security and where a determination of the lessor's property rights would be ambiguous at best.<sup>123</sup>

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117. The Convention uses the term "real rights" rather than "title" in reference to the leased equipment because the Convention also covers sub-leasing transactions (art. 2) under which the lessor will not necessarily be the owner of the equipment. *Id.*

118. The Secretariat Report, discussing an earlier, substantially similar version of the current Article 7, stated that the draft was only intended to address "those conflicts between the lessor and third party creditors of the lessee arising in the limited context of the [lessee's] bankruptcy. It does not attempt to deal with conflicts between the lessor and those third parties acquiring the leased asset in good faith from the lessee." Secretariat Report, *supra* note 1, at 51.

119. Generally, the applicable law which determines notice requirements will be the law where the equipment is situated (art. 7(3)(d)), although special rules are provided for registered ships (para. (3)(a)), aircraft (para. (3)(b)), and other mobile equipment including aircraft engines (para. (3)(c)). Leasing Convention, *supra* note 4, art. 7(3)(a)-(d). In addition, paragraph (4) subordinates the public notice rules of the Convention to "any other treaty under which the lessor's real rights in the equipment are required to be recognised." *Id.* art. 7(4).

120. Secretariat Report, *supra* note 1, at 49.

121. Leasing Convention, *supra* note 4, art. 7(5)(a). This choice reflects the difficulty of reconciling domestic laws concerning liens and security interests. Mooney, *supra* note 81, at 3. For example, U.C.C. § 1-201(12) defines a "creditor" broadly to include: "a general creditor, a secured creditor, a lien creditor, and any representative of creditors, including an assignee for the benefit of creditors, a trustee in bankruptcy, a receiver in equity and an executor or administrator of an insolvent debtor's or assignee's estate." U.C.C. § 1-201(12) (1990).

122. Leasing Convention, *supra* note 4, art. 7(5)(b).

123. Mooney, *supra* note 81, at 3.



### B. *Lessor/Persons having Interest in Land*

Although the Leasing Convention is not designed to govern real estate leasing, the definition of "equipment" may extend to situations where the equipment "has become a fixture to or incorporated in land."<sup>124</sup> Article 4 of the Convention states the general rule that the Convention continues to apply whether or not the equipment has become a fixture to the land as determined by the law of the State where the land is situated. It is state law that determines the rights of the lessor and a person having real rights in the land.<sup>125</sup>

Section 2A-309 of the U.C.C. provides that, as a general rule, the perfected interest of a lessor of fixtures has priority over the conflicting interests of the owner or encumbrancer of the real estate.<sup>126</sup> This interest is perfected by filing a fixture filing statement.<sup>127</sup> However, the lessor's interest is subordinate to a construction mortgage.<sup>128</sup> The Code leaves unenumerated examples to be determined according to priority rules established by real estate law.<sup>129</sup>

### C. *Lessor's Liability to Third Parties in Tort*

A major benefit to the international equipment lessor provided by the Leasing Convention is a general immunity from liability arising out of the equipment.<sup>130</sup> Article 8(1)(b) states the broad policy of the Convention to protect lessors *qua* lessors from tort liability to third parties. This policy reflects the fact that in a financial lease it is the *lessee*, not the *lessor*, that assumes responsibility for the selection, quality, or use of the equipment which is the subject of the lease.

American courts have reached similar holdings as a matter of public policy. For example, the Pennsylvania Supreme Court in *Nath v. National Equipment Leasing Corp.*<sup>131</sup> stated:

We agree . . . that the finance lease is *sui generis* and that the policy considerations justifying an extension of the concept of strict liability

124. Leasing Convention, *supra* note 4, art. 4. See also *supra* discussion accompanying note 45.

125. Leasing Convention, *supra* note 4, art. 4(2).

126. U.C.C. § 2A-309(4), (5).

127. *Id.* § 2A-309(9).

128. *Id.* § 2A-309(6).

129. *Id.* § 2A-309(7).

130. Stanford, *supra* note 5.

131. 497 Pa. 126, 439 A.2d 633 (1981).

to the true lease are not present when the lessor is not "marketing" or "supplying" the product, but is, in fact, merely a secured party, or financier, whose collateral is the "product."<sup>132</sup>

Similarly, the Seventh Circuit in *Abco Metals Corp. v. Equico Lessors, Inc.*<sup>133</sup> held that strict liability was inapplicable to a lessor that had no control over the production or use of a defective product.

Article 8, paragraph (1)(c) of the Leasing Convention states a limited exception to this policy, providing liability for the lessor acting in any other capacity, such as owner. This provision was included in order to avoid conflict with international conventions that base liability on ownership.<sup>134</sup>

## V. CONCLUSION

The UNIDROIT Convention on International Financial Leasing represents an important legal development for parties considering transborder leasing transactions. It has the potential to promote legal certainty by clarifying the positions of each party to the "distinctive triangular relationship" that is financial leasing. It shifts responsibility from the lessor to the supplier, restricts the lessor's liability to third parties, protects the rights of the lessor against the lessee's creditors, and provides for the enforceability of liquidated damages clauses. Moreover, it accomplishes these goals in a manner that is consonant with Article 2A of the Uniform Commercial Code and which will be familiar to American practitioners. The interests of American lessors and their legal counsel will be greatly advanced by United States ratification of the Leasing Convention, which should be facilitated as soon as possible.

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132. *Id.* at 130, 439 A.2d at 635.

133. 721 F.2d 583, 585 (7th Cir. 1983).

134. *See, e.g.*, International Convention on Civil Liability for Oil Pollution Damages, done at Brussels, Nov. 29, 1969, *as amended* by Protocol of 1984, May 25, 1984, 23 I.L.M. 177 (1984). *See also* Council Directive 85/374 of 25 July, 1985, on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products.

## APPENDIX I

UNIDROIT CONVENTION  
ON INTERNATIONAL FINANCIAL LEASING

THE STATES PARTIES TO THIS CONVENTION,

RECOGNISING the importance of removing certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction,

AWARE of the need to make international financial leasing more available,

CONSCIOUS of the fact that the rules of law governing the traditional contract of hire need to be adapted to the distinctive triangular relationship created by the financial leasing transaction,

RECOGNISING therefore the desirability of formulating certain uniform rules relating primarily to the civil and commercial law aspects of international financial leasing,

HAVE AGREED as follows:

CHAPTER I - SPHERE OF APPLICATION  
AND GENERAL PROVISIONS

## Article 1

1.- This Convention governs a financial leasing transaction as described in paragraph 2 in which one party (the lessor),

(a) on the specifications of another party (the lessee), enters into an agreement (the supply agreement) with a third party (the supplier) under which the lessor acquires plant, capital goods or other equipment (the equipment) on terms approved by the lessee so far as they concern its interests, and

(b) enters into an agreement (the leasing agreement) with the lessee, granting to the lessee the right to use the equipment in return for the payment of rentals.

2.- The financial leasing transaction referred to in the previous paragraph is a transaction which includes the following characteristics:

(a) the lessee specifies the equipment and selects the supplier without relying primarily on the skill and judgment of the lessor;

(b) the equipment is acquired by the lessor in connection with a leasing agreement which, to the knowledge of the supplier, either has been made or is to be made between the lessor and the lessee; and

(c) the rentals payable under the leasing agreement are calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment.

3.- This Convention applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental.

4.- This Convention applies to financial leasing transactions in relation to all equipment save that which is to be used primarily for the lessee's personal, family or household purposes.

## Article 2

In the case of one or more sub-leasing transactions involving the same equipment, this Convention applies to each transaction which is a financial leasing transaction and is otherwise subject to this Convention as if the person from whom the first lessor (as defined in paragraph 1 of the previous article) acquired the equipment were the supplier and as if the agreement under which the equipment was so acquired were the supply agreement.

## Article 3

1.- This Convention applies when the lessor and the lessee have their places of business in different States and:

(a) those States and the State in which the supplier has its place of business are Contracting States; or

(b) both the supply agreement and the leasing agreement are governed by the law of a Contracting State.

2.- A reference in this Convention to a party's place of business shall, if it has more than one place of business, mean the place of business which has the closest relationship to the relevant agreement and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that agreement.

#### Article 4

1.- The provisions of this Convention shall not cease to apply merely because the equipment has become a fixture to or incorporated in land.

2.- Any question whether or not the equipment has become a fixture to or incorporated in land, and if so the effect on the rights *inter se* of the lessor and a person having real rights in the land, shall be determined by the law of the State where the land is situated.

#### Article 5

1.- The application of this Convention may be excluded only if each of the parties to the supply agreement and each of the parties to the leasing agreement agree to exclude it.

2.- Where the application of this Convention has not been excluded in accordance with the previous paragraph, the parties may, in their relations with each other, derogate from or vary the effect of any of its provisions except as stated in Articles 8(3) and 13(3)(b) and (4).

#### Article 6

1.- In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

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

### CHAPTER II - RIGHTS AND DUTIES OF THE PARTIES

#### Article 7

1.- (a) The lessor's real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution.

(b) For the purposes of this paragraph "trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors.

2.- Where by the applicable law the lessor's real rights in the equipment are valid against a person referred to in the previous paragraph only on compliance with rules as to public notice, those rights shall be valid against that person only if there has been compliance with such rules.

3.- For the purposes of the previous paragraph the applicable law is the law of the State which, at the time when a person referred to in paragraph 1 becomes entitled to invoke the rules referred to in the previous paragraph, is:

(a) in the case of a registered ship, the State in which it is registered in the name of the owner (for the purposes of this sub-paragraph a bareboat charterer is deemed not to be the owner);

(b) in the case of an aircraft which is registered pursuant to the Convention on International Civil Aviation done at Chicago on 7 December 1944, the State in which it is so registered;

(c) in the case of other equipment of a kind normally moved from one State to another, including an aircraft engine, the State in which the lessee has its principal place of business;

(d) in the case of all other equipment, the State in which the equipment is situated.

4.- Paragraph 2 shall not affect the provisions of any other treaty under which the lessor's real rights in the equipment are required to be recognised.

5.- This article shall not affect the priority of any creditor having:

(a) a consensual or non-consensual lien or security interest in the equipment arising otherwise than by virtue of an attachment or execution, or

(b) any right of arrest, detention or disposition conferred specifically in relation to ships or aircraft under the law applicable by virtue of the rules of private international law.

## Article 8

1.- (a) Except as otherwise provided by this Convention or stated in the leasing agreement, the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent that the lessee has suffered loss as the result of its reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the equipment.

(b) The lessor shall not, in its capacity of lessor, be liable to third parties for death, personal injury or damage to property caused by the equipment.

(c) The above provisions of this paragraph shall not govern any liability of the lessor in any other capacity, for example as owner.

2.- The lessor warrants that the lessee's quiet possession will not be disturbed by a person who has a superior title or right, or who claims a superior title or right and acts under the authority of a court, where such title, right or claim is not derived from an act or omission of the lessee.

3.- The parties may not derogate from or vary the effect of the provisions of the previous paragraph in so far as the superior title, right or claim is derived from an intentional or grossly negligent act or omission of the lessor.

4.- The provisions of paragraphs 2 and 3 shall not affect any broader warranty of quiet possession by the lessor which is mandatory under the law applicable by virtue of the rules of private international law.

## Article 9

1.- The lessee shall take proper care of the equipment, use it in a reasonable manner and keep it in the condition in which it was delivered, subject to fair wear and tear and to any modification of the equipment agreed by the parties.

2.- When the leasing agreement comes to an end the lessee, unless exercising a right to buy the equipment or to hold the equipment on lease for a further period, shall return the equipment to the lessor in the condition specified in the previous paragraph.

## Article 10

1.- The duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment

were to be supplied directly to the lessee. However, the supplier shall not be liable to both the lessor and the lessee in respect of the same damage.

2.- Nothing in this article shall entitle the lessee to terminate or rescind the supply agreement without the consent of the lessor.

#### Article 11

The lessee's rights derived from the supply agreement under this Convention shall not be affected by a variation of any term of the supply agreement previously approved by the lessee unless it consented to that variation.

#### Article 12

1.- Where the equipment is not delivered or is delivered late or fails to conform to the supply agreement:

(a) the lessee has the right as against the lessor to reject the equipment or to terminate the leasing agreement; and

(b) the lessor has the right to remedy its failure to tender equipment in conformity with the supply agreement,

as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.

2.- A right conferred by the previous paragraph shall be exercisable in the same manner and shall be lost in the same circumstances as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.

3.- The lessee shall be entitled to withhold rentals payable under the leasing agreement until the lessor has remedied its failure to tender equipment in conformity with the supply agreement or the lessee has lost the right to reject the equipment.

4.- Where the lessee has exercised a right to terminate the leasing agreement, the lessee shall be entitled to recover any rentals and other sums payable in advance, less a reasonable sum for any benefit the lessee has derived from the equipment.

5.- The lessee shall have no other claim against the lessor for non-delivery, delay in delivery or delivery of non-conforming equipment except to the extent



to which this results from the act or omission of the lessor.

6.- Nothing in this article shall affect the lessee's rights against the supplier under Article 10.

### Article 13

1.- In the event of default by the lessee, the lessor may recover accrued unpaid rentals, together with interest and damages.

2.- Where the lessee's default is substantial, then subject to paragraph 5 the lessor may also require accelerated payment of the value of the future rentals, where the leasing agreement so provides, or may terminate the leasing agreement and after such termination:

(a) recover possession of the equipment; and

(b) recover such damages as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms.

3.- (a) The leasing agreement may provide for the manner in which the damages recoverable under paragraph 2 (b) are to be computed.

(b) Such provision shall be enforceable between the parties unless it would result in damages substantially in excess of those provided for under paragraph 2 (b). The parties may not derogate from or vary the effect of the provisions of the present sub-paragraph.

4.- Where the lessor has terminated the leasing agreement, it shall not be entitled to enforce a term of that agreement providing for acceleration of payment of future rentals, but the value of such rentals may be taken into account in computing damages under paragraphs 2(b) and 3. The parties may not derogate from or vary the effect of the provisions of the present paragraph.

5.- The lessor shall not be entitled to exercise its right of acceleration or its right of termination under paragraph 2 unless it has by notice given the lessee a reasonable opportunity of remedying the default so far as the same may be remedied.

6.- The lessor shall not be entitled to recover damages to the extent that it has failed to take all reasonable steps to mitigate its loss.

#### Article 14

1.- The lessor may transfer or otherwise deal with all or any of its rights in the equipment or under the leasing agreement. Such a transfer shall not relieve the lessor of any of its duties under the leasing agreement or alter either the nature of the leasing agreement or its legal treatment as provided in this Convention.

2.- The lessee may transfer the right to the use of the equipment or any other rights under the leasing agreement only with the consent of the lessor and subject to the rights of third parties.

### CHAPTER III - FINAL PROVISIONS

#### Article 15

1.- This Convention is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Unidroit Conventions on International Factoring and International Financial Leasing and will remain open for signature by all States at Ottawa until 31 December 1990.

2.- This Convention is subject to ratification, acceptance or approval by States which have signed it.

3.- This Convention is open for accession by all States which are not signatory States as from the date it is open for signature.

4.- Ratification, acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary.

#### Article 16

1.- This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the third instrument of ratification, acceptance, approval or accession.

2.- For each State that ratifies, accepts, approves, or accedes to this Convention after the deposit of the third instrument of ratification, acceptance, approval or accession, this Convention enters into force in respect of that State on the first day of the month following the expiration of six months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

### Article 17

This Convention does not prevail over any treaty which has already been or may be entered into; in particular it shall not affect any liability imposed on any person by existing or future treaties.

### Article 18

1.- If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may substitute its declaration by another declaration at any time.

2.- These declarations are to be notified to the depository and are to state expressly the territorial units to which this Convention extends.

3.- If, by virtue of a declaration under this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purposes of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.

4.- If a Contracting State makes no declaration under paragraph 1, the Convention is to extend to all territorial units of that State.

### Article 19

1.- Two or more Contracting States which have the same or closely related legal rules on matters governed by this Convention may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral decisions.

2.- A Contracting State which has the same or closely related legal rules on matters governed by this Convention as one or more non-Contracting States may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States.

3.- If a State which is the object of a declaration under the previous paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which the Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under

paragraph 1, provided that the new Contracting State joins in such declaration or makes a reciprocal unilateral declaration.

#### Article 20

A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession that it will substitute its domestic law for Article 8(3) if its domestic law does not permit the lessor to exclude its liability for its default or negligence.

#### Article 21

1.- Declarations made under this Convention at the time of signature are subject to confirmation upon ratification, acceptance or approval.

2.- Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.

3.- A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary. Reciprocal unilateral declarations under Article 19 take effect on the first day of the month following the expiration of six months after the receipt of the latest declaration by the depositary.

4.- Any State which makes a declaration under this Convention may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.

5.- A withdrawal of a declaration made under Article 19 renders inoperative in relation to the withdrawing State, as from the date on which the withdrawal takes effect, any joint or reciprocal unilateral declaration made by another State under that article.

#### Article 22

No reservations are permitted except those expressly authorised in this Convention.

### Article 23

This Convention applies to a financial leasing transaction when the leasing agreement and the supply agreement are both concluded on or after the date on which the Convention enters into force in respect of the Contracting States referred to in Article 3 (1)(a), or of the Contracting State or States referred to in paragraph 1 (b) of that article.

### Article 24

1.- This Convention may be denounced by any Contracting State at any time after the date on which it enters into force for that State.

2.- Denunciation is effected by the deposit of an instrument to that effect with the depositary.

3.- A denunciation takes effect on the first day of the month following the expiration of six months after the deposit of the instrument of denunciation with the depositary. Where a longer period for the denunciation to take effect is specified in the instrument of denunciation it takes effect upon the expiration of such longer period after its deposit with the depositary.

### Article 25

1.- This Convention shall be deposited with the Government of Canada.

2.- The Government of Canada shall:

(a) inform all States which have signed or acceded to this Convention and the President of the International Institute for the Unification of Private Law (Unidroit) of:

(i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;

(ii) each declaration made under Articles 18, 19 and 20;

(iii) the withdrawal of any declaration made under Article 21 (4);

(iv) the date of entry into force of this Convention;

(v) the deposit of an instrument of denunciation of this

Convention together with the date of its deposit and the date on which it takes effect;

(b) transmit certified true copies of this Convention to all signatory States, to all States acceding to the Convention and to the President of the International Institute for the Unification of Private Law (Unidroit).

IN WITNESS WHEREOF the undersigned plenipotentiaries being duly authorised by their respective Governments, have signed this Convention.

DONE at Ottawa, this twenty-eighth day of May, one thousand nine hundred and eighty-eight, in a single original, of which the English and French texts are equally authentic.

# SEEKING JUDICIAL LEGITIMATION IN THE COLD WAR: U.S. FOREIGN POLICY AND THE WORLD COURT, 1948-1962

*Michla Pomerance\**

## I. INTRODUCTION

In one of the twists of irony of which recent history has been replete, U.S. reassessment of its attitude to the International Court of Justice, sparked by the perceived unjustified judicial intrusion into the Cold War in the *Nicaragua* case, was launched just as the Cold War itself was winding down, to be replaced by a period of U.S. supremacy in a unipolar world. Reflecting the new global configuration of forces, the United Nations as a whole was becoming a forum more friendly to U.S. interests than at any time since the halcyon days of the Organization's infancy. The harmony of the U.S.-Court relationship in the early Cold War period now seemed to many a more relevant model for use in the ongoing reassessment than the state of acidity to which the relationship had fallen of late.

To critics of the official U.S. reaction to *Nicaragua*, the early U.S.-Court nexus had never lost relevance. Of particular importance was the succession of cases in which the United States had found judicial legitimation useful in Cold War-linked "organizational" skirmishes with the Soviet Union. However, the lessons to be derived from these cases varied, depending on the perspective of the critics. Some considered that the United States had attempted cynically to utilize the Court as yet another arena for pressuring the rival superpower and scoring propaganda points. They therefore faulted the Reagan Administration for continuing to adhere to this cynical tradition. Others, of the Moynihan persuasion, seeing in the earlier cases a significant measure of U.S. dedication to international law and the Court, berated the Administration for abandoning the earlier tradition because of unfounded fears that the cards in the Court were now stacked against U.S. interests and because of ignorance of the benefits of the rule of law for the long-term interests of the United States.<sup>1</sup> Both conclusions were oversimplified, in part perhaps because neither set of critics bothered to examine the early record closely. Yet, unless properly assessed, that record could surely yield little that was useful for the purposes of setting future policy toward the Court.

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*Acknowledgements:* The author wishes to thank the U.S. Institute of Peace and the National Endowment for the Humanities for generous grants that made possible the research for this article.

1. See, e.g., DANIEL PATRICK MOYNIHAN, *ON THE LAW OF NATIONS* (1990).

For obvious reasons, judicial legitimation in the Cold War could be furnished primarily by means of the Court's advisory, rather than contentious, jurisdiction. Straight-out adjudication required consent, and apart from the "fluke" of the *Corfu Channel* case,<sup>2</sup> this would not be forthcoming in those years, from either the Soviet Union or any of its satellites. U.S. attempts to have aerial incidents involving the Soviet bloc inscribed on the Court's agenda were made several times during the decade of the 1950s. These attempts were merely predictably futile gestures designed, as Jessup notes, "to reveal this country's devotion to the ideal of judicial settlement of international disputes and to expose the undeviating refusal by our adversaries to accept any third-party settlement of disputes to which they were parties."<sup>3</sup> However, the advisory competence was another matter. The absence of Soviet consent could still defeat a request for an advisory opinion in the Security Council,<sup>4</sup> but not

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2. Albania appeared before the Court without contesting jurisdiction, and the Court was therefore able to base its jurisdiction on that state's implied consent in the course of the proceedings. See 1948 I.C.J. REP. 15. See also the discussion of the *forum prorogatum* principle in 1 SHABTAI ROSENNE, *THE LAW AND PRACTICE OF THE INTERNATIONAL COURT* 344-63 (1965).

3. Philip C. Jessup, *The Development of a United States Approach Toward the International Court of Justice*, 5 VAND. J. TRANSNAT'L L. 6 (1971). For a description of the cases, see *id.* at 6-11.

In 1960, after the Soviet Union complained in the Security Council of U.S. violation of Soviet aerial space over the Barents Sea, Ambassador Lodge introduced a resolution, U.N. Doc. S/4409 (1960), to have the incident clarified by a fact-finding commission or the International Court of Justice, but the resolution was defeated by a Soviet veto. Jessup, *supra* this note, at 10; U.N. SCOR, 15th Yr., 881st-883rd mtgs. (July 25-26, 1960).

It may be noted that during several crises in the early years of the Cold War, the possibility of utilizing the Court by means of joint reference was considered by the State Department. On the Berlin blockade, see e.g., 2 FOREIGN RELATIONS OF THE U.S. 1948, at 954, 957. In the course of the Korean armistice talks at Panmunjom, the suggestion to refer to the International Court the issue of voluntary repatriation of prisoners of war—the main sticking point in the negotiations—was raised in high-level discussions at the State Department on January 31, 1952. Whether the Court's contentious or advisory jurisdiction was contemplated is not clear from the record. In any case, it was decided that "the action was not desirable on the grounds that public opinion value was doubtful and it would appear to build the issue up with decreased possibility of resolution." 15 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 33-34.

4. The matter of the vote required for Security Council requests is not explicitly governed by any Charter text. In the early years of the United Nations, there was some debate regarding the "substantive" or "procedural" nature of votes to request advisory opinions, but in practice the Security Council deemed the veto applicable.

In the *Namibia* case, South Africa contended that the requesting resolution (S.C. Res. 284) was invalid because, though it was "nonprocedural" in nature, two permanent members had abstained; and Article 27(3) required the "concurring votes" of all the permanent Council members on such questions. The Court did not find it necessary to pronounce itself on this



in the General Assembly, where recourse to the Court could be decided by a simple or two-thirds majority.<sup>5</sup> Thus, until 1960-1962, the Assembly could, at times, be a convenient forum both for providing political legitimation regarding Cold War issues and for summoning additional judicial legitimation. Thereafter, the picture was to change on both scores.

Even during the heyday of U.S. influence in the General Assembly and U.S. satisfaction with the Court, the United States exhibited no consistent pattern of seeking to involve the Court, whenever possible, in Cold War controversies. Its attitude was neither excessively cynical nor greatly idealistic, but, overall, pragmatic. Sometimes the United States initiated the march to the Court; at other times it unenthusiastically acquiesced; and, occasionally, it successfully resisted the initiatives of others. U.S. motives in the matter were varied, and hardly one-dimensional. Short-range calculations vied with longer-range considerations, not always very felicitously either from the standpoint of U.S. interests or from that of the prestige and status of the Court. This was demonstrated most sharply in the *Expenses* advisory opinion of 1962, where the United States, in the longer perspective, reaped a Pyrrhic victory. Its view of the powers of the General Assembly was endorsed by the Court at the very moment when the balance of forces within the Assembly was beginning to tilt against the United States. Before long, the United States, rather than the Soviet Union, would wish to default on payments decreed by "automatic majorities" in the Assembly.

In 1962, too, the signs of the changing times were felt in the Security Council, where a curious reversal of roles occurred. Recognizing that "two could play the same game," Cuba and its Soviet patron pressed for judicial clarification of the legality of a series of anti-Cuban decisions of the OAS—a suggestion strenuously objected to by the United States on the grounds that

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question since, in any case, it considered that the voluntary abstention of a permanent member did not prevent the adoption of non-procedural resolutions. 1971 I.C.J. REP. 22. However, compare the questions of Judges Jiménez de Aréchaga and Morozov to the U.S. representative, *Namibia* case, 1971 I.C.J. Pleadings 2, at 507-08, which were designed to elicit clarification on the applicability of the veto to requests for advisory opinions.

For the view within the State Department that requests for advisory opinions were subject to veto, see 2 FOREIGN RELATIONS OF THE U.S. 1951, at 353, 404. See also the statement of Representative Warren Austin 1 FOREIGN RELATIONS OF THE U.S. 1948, at 222, and the explanation of the U.S. Delegation's stand, offered by Eric Stein, *id.* at 252 ("[S]ince the Security Council would and should abide or act in accordance with a Court opinion the request for such opinion affects the substance of and the eventual action on the matter.").

5. There was no across-the-board ruling on the vote required for General Assembly requests. The issue has been decided *ad hoc* and has sometimes been dependent on the nature of the resolutions to which the proposed request for an advisory opinion was linked. For an early illustration of this trend, see MICHLA POMERANCE, *THE ADVISORY FUNCTION OF THE INTERNATIONAL COURT IN THE LEAGUE AND U.N.* ERAS 239 n.332 (1973).

the matter was entirely "political" and that the Court should not be dragged into the Cold War propaganda struggle. In essence, the Cuban episode was merely a preview of the drama to be played out more than two decades later in the *Nicaragua* case.

In the present article it is proposed to scrutinize more closely how U.S. foreign policy makers approached the idea of judicial legitimation in respect to Cold War matters during the critical period of 1948-1962. The four Cold War requests—in the *Admission*, *Competence*, *Peace Treaties*, and *Expenses* cases—necessarily form the primary focus.<sup>6</sup> In addition, abortive requests relating, respectively, to exit visas for Soviet wives, the aftermath of the *Competence* case, and the anti-Cuban OAS resolutions, furnish a complementary prism from which to gain a more accurate impression of the American tradition vis-à-vis the World Court.

## II. THE "COLD WAR" REQUESTS

### A. Admission *and* Competence

Of the four requests related to the Cold War, two arose in the context of the admissions deadlock that plagued the United Nations during its early years. Both of these requests involved interpretations of Article 4 of the Charter, specifically Article 4(1) in the *Admission* case and Article 4(2) in the *Competence* case.<sup>7</sup> The United States did not initiate or co-sponsor either request. But whereas it supported the first without expressing any reservation, its attitude to the second was highly ambivalent. U.S. consent was only reluctantly given against a background of internal divisions in the U.S. Delegation to the United Nations and the U.S. State Department.

By the end of 1947, the bipolar division of the world had led to an impasse over the admission of new members to the Organization. Each bloc, employing the weapon at its disposal, had excluded members of the other. Western-led majorities in the Assembly blocked the Soviet-sponsored applications of

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6. The cases involving spillover from the Cold War into the international secretariats—such as the *U.N. Administrative Tribunal* and *UNESCO* cases—will be considered in a separate article.

7. The text of Article 4 is as follows:

1. Membership in the United Nations is open to all other peace-loving states which accept the obligations contained in the present Charter and, in the judgment of the Organization, are able and willing to carry out these obligations.

2. The admission of any such state to membership in the United Nations will be effected by a decision of the General Assembly upon the recommendation of the Security Council.

Rumania, Bulgaria, Hungary, Albania, and Mongolia, while Soviet vetoes in the Security Council barred the admission of such non-communist states as Finland, Italy, Portugal, Ireland, Ceylon, Austria, and Transjordan. The reasons adduced for opposition to the several candidacies were varied.<sup>8</sup> Some were broadly related to the criteria set forth in Article 4(1) of the Charter ("peace-loving," "able and willing to carry out" Charter obligations), but others clearly were not. Among the latter was the stand finally taken by the Soviet Union regarding five former enemy states: Italy and Finland could be admitted only if Bulgaria, Hungary, and Rumania were admitted simultaneously. The suggestion for such *en bloc* admissions was strongly opposed by the United States and other Western states. True, in August 1946, the United States had itself proposed a "package" of admissions,<sup>9</sup> but after the proposal had encountered Soviet and Australian opposition, the United States had shifted its attitude and insisted that each candidacy be considered separately on its merits.

The idea of having the legality of the Soviet "package deal" approach judicially tested was not pushed by the United States. It was incorporated in a Belgian draft resolution of November 7, 1947,<sup>10</sup> and even many sympathetic states were skeptical of its utility.<sup>11</sup> Indeed, given the vigorous

8. See LELAND M. GOODRICH & EDVARD HAMBRO, *CHARTER OF THE UNITED NATIONS: COMMENTARY AND DOCUMENTS*, 128-30 (2d ed. 1949); U.N. SCOR, 1st Yr., 2d Ser., Supp. No. 4 (1946); *id.*, 2d Yr., Spec. Supp. No. 3 (1947). Grounds for opposition included a state's neutrality in the past war; the absence of diplomatic relations between the objecting and applicant states; and, in the case of former enemy states, the absence of peace treaties.

9. U.N. SCOR, 1st Yr., 54th mtg. (Aug. 28, 1946), at 42.

10. U.N. Doc. A/C.1/242 (1947). For the Belgian explanation of this draft resolution, see U.N. GAOR 1st Comm., 2d Sess., 98th mtg. (Nov. 7, 1947), at 342. The question asked was:

Is a Member of the United Nations which is called upon, in virtue of Article 4 of the Charter, to pronounce itself by its vote, either in the Security Council or in the General Assembly, on the admission of a State to membership in the United Nations, juridically entitled to make its consent to the admission dependent on conditions not expressly provided by paragraph 1 of the said Article? In particular, can such a Member, while it recognizes the conditions set forth in that provision to be fulfilled by the State concerned, subject its affirmative vote to the additional condition that other States be admitted to membership in the United Nations together with that State?

11. For example, the United Kingdom representative stated that, although the projected opinion would not solve the present difficulties, he would vote for requesting it because, under Article 96 of the Charter, the Court could be consulted in cases of conflicting interpretations of Charter provisions. U.N. GAOR 1st Comm., 2d Sess., 101st mtg. (Nov. 8, 1947), at 378. *And see* the statements of Australia, *id.*, 99th mtg. (Nov. 7, 1947), at 351; U.N. GAOR, 2d Sess., 117th plen. mtg. (Nov. 17, 1947) at 1053-55. The Greek representative cited as grounds for his support the desirability of more frequent use of the Court. U.N. GAOR 1st Comm.,

Soviet objections to recourse to the Court, the admission impasse was not likely to be affected by any Court pronouncement.<sup>12</sup> Even the propaganda value of the projected opinion could only be limited, at best. The conditions stated in Article 4(1) of the Charter are so broad that, even if deemed exhaustive—as, in fact, the Court majority subsequently deemed them to be—the Soviet Union would experience no great difficulty in confining itself to the stated criteria in order to bar the admission of any applicant state.<sup>13</sup> Moreover, no state is obliged to explain its vote, and the entire matter boiled down to a question of motives and good faith, which are not subject to judicial control.<sup>14</sup>

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2d Sess., 101st mtg. (Nov. 8, 1947), at 382. *See generally*, POMERANCE, *supra* note 5, at 91-92. The vote on the draft resolution in the First Committee (26 to 13, with 16 abstentions) reflected the widespread hesitation. In Plenary, the vote was more overwhelmingly in favor: 40 to 8, with 2 abstentions.

12. The Soviets objected, *inter alia*, to the "political" nature of the request and to giving the Court the task of interpreting the Charter in the abstract. The terms of Article 4 were said to be sufficiently clear; the grounds for refusing certain states' admission had been "political," and every state had an equal right to be guided by political motives. *See, e.g.*, U.N. GAOR, 2d Sess., 117th plen. mtg. (Nov. 17, 1947), at 1048, 1050-51; U.N. GAOR 1st Comm., 2d Sess., 99th mtg. (Nov. 7, 1947), at 360.

13. At least at one point in the pre-request debate, the Soviet delegate conceded the exhaustive nature of the requirements of Article 4(1) and stated that his government merely doubted the "peace-loving" nature of the states concerned. U.N. GAOR 2d Sess., 117th plen. mtg. (Nov. 17, 1947), at 1048.

14. OLIVER J. LISSITZYN, *THE INTERNATIONAL COURT OF JUSTICE: ITS ROLE IN THE MAINTENANCE OF INTERNATIONAL PEACE AND SECURITY* 91 (1951).

Both the majority and minority opinions were predicated on the exercise of good faith. In the majority opinion, the Court determined that the conditions in Article 4(1) were exhaustive. It held that a U.N. member "cannot, while it recognizes the conditions set forth in that provision to be fulfilled by the State concerned, subject its affirmative vote to the additional condition that other States be admitted to membership . . . together with that State." 1948 I.C.J. REP. 65. However, the Court interpreted the Assembly's request to relate only to "the statements made by a Member concerning the vote it proposes to give." It did not relate to a state's "actual vote," since "the reasons which, in the mind of a Member, may prompt its vote" were matters of "a mental process," which are "obviously subject to no control." *Id.* at 60. Moreover, the Court emphasized that "Article 4 does not forbid the taking into account of any factor which it is possible reasonably and in good faith to connect with the conditions laid down in that Article." And the Court added that "no relevant political factor—that is to say, none connected with the conditions of admission—is excluded." *Id.* at 63. On the other hand, the joint dissenting opinion held that the Assembly's question related not only to a U.N. member's statements, but also to the member's vote and the reasons underlying it, and that the conditions of Article 4(1) were necessary but not sufficient. *Id.* at 82-93. But, in their view, while a U.N. member is "legally entitled to make its consent to the admission dependent on any political considerations which seem to it to be relevant," in exercising this power the member "is legally bound to have regard to the principle of good faith, to give effect to the Purposes and Principles of the United Nations . . ." *Id.* at 92. "To act in good faith," they said, was "an overriding legal

Thus, the opinion, quite predictably, would be one which would "provide a cloak for any kind of action."<sup>15</sup> In the aftermath of the opinion, there was some appreciation of this fact in the State Department and the U.S. Delegation to the United Nations,<sup>16</sup> but the record indicates no comparable awareness on the part of U.S. decision-makers and representatives during the pre-request phase. The United States apparently voted for the Belgian draft resolution, and it made no qualifying explanatory statement.<sup>17</sup>

On the surface, the General Assembly request for an advisory opinion two years later, in the *Competence* case, was a natural sequel to the *Admission* opinion, a second sally in a concerted Western campaign against Soviet obstructionism in the United Nations. If salvation could not be provided by Article 4(1), *however interpreted*, the logical next step was to seek it in Article 4(2), *reinterpreted* so as to avoid the obstacle of the veto. In point of fact, no such grand design underlay the decision to consult the Court in this instance. From the pre-request history and the Pleadings in the case, it appears that the decision resulted from a one-man initiative, which was greeted by a notable lack of enthusiasm on the part of most Western states. Some of these States voted to oppose it, and the United States came very close to joining the opposing or abstaining camps.

The Argentine representative in the United Nations, Dr. Arce, had long espoused a rather controversial interpretation of Article 4(2), the crux (and better-known part) of which was that the word "recommendation" in that

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obligation resting upon every Member of the United Nations." *Id.* at 91. *See also* the dissenting opinions of Judges Zoričić and Krylov, *id.* at 94-115, and their emphasis on the good faith obligation, *id.* at 103, 115; and *see* the separate opinion of Judge Azevedo, *id.* at 73-81, in which he stated, *inter alia*, that "elements of expediency, manifest or hidden, can always be considered when reasonable use is made of the wide possibilities opened by Article 4." *Id.* at 81. Little wonder, then, that the French representative in the General Assembly later concluded that the difference between majority and minority opinions was merely semantic and was "largely based on a quibble." U.N. GAOR, 4th Sess., 251st plen. mtg. (Nov. 22, 1949), at 316; *see also* U.N. GAOR Ad Hoc Political Comm., 3d Sess., 1st Part, 11th mtg. (Nov. 24, 1948), at 117.

15. SIR HERSCH LAUTERPACHT, *THE DEVELOPMENT OF INTERNATIONAL LAW BY THE INTERNATIONAL COURT* 150 (1958).

16. *See, e.g.*, 2 FOREIGN RELATIONS OF THE U.S. 1951, at 347-50, 361, 363, 370, 380, 389, 392, 395, 403; 3 FOREIGN RELATIONS OF THE U.S. 1952-54, at 829-30, 833-34. *See also* the discussion of the aftermath of the *Competence* case, *infra* part III.B.

17. For discussions in the First Committee on the issue, *see* U.N. GAOR 1st Comm., 2d Sess., 98th-103d mtgs. (Nov. 7-10, 1947); U.N. GAOR, 2d Sess., 117th-118th plen. mtgs. (Nov. 17, 1947). For votes, *see* U.N. GAOR 1st Comm., 2d Sess., 103rd mtg. (Nov. 10, 1947), at 397; U.N. GAOR, 2d Sess., 118th plen. mtg. (Nov. 17, 1947), at 1078.

provision did not necessarily mean "favorable recommendation."<sup>18</sup> Just as the Assembly could proceed to deny a state admission after a *favorable* Security Council recommendation, it could reject an *unfavorable* Security Council recommendation and decide to admit a state. For this part of his thesis, Dr. Arce could find few buyers. But there was a second, alternative, part to the thesis, and it was gaining wider support, especially among some Latin American states. The veto, he argued, was inapplicable to admission questions, and the Assembly therefore was free to consider as *favorable* a recommendation which received the affirmative vote of any seven Council members.<sup>19</sup>

By the fourth General Assembly session, the Argentine representative had despaired of getting the Assembly to endorse the substance of his thesis.<sup>20</sup> The United States, the other permanent Security Council members, and a majority of the Assembly were arrayed together with the Soviet Union against it. But Dr. Arce could count on a large "sympathy vote" for his new initiative to have the thesis judicially tested.<sup>21</sup> Appreciation for Argentina's admirable motives and the desire to give Argentina its day in Court seemed to be the most compelling reasons prompting states to support the resolution requesting an advisory opinion.<sup>22</sup>

18. As he explained at one point, "recommendation" no more implies "favorable recommendation" than "woman" implies "pretty woman." *Id.* at 1072. The Argentine thesis was premised primarily on the *travaux préparatoires*, and especially one document of the Advisory Committee of Jurists at the San Francisco conference in 1945. *Id.*

19. These two alternative approaches are more fully set forth in the Argentine Written Statement submitted to the Court. 1950 I.C.J. Pleadings 123-48.

20. In the third session, for example, an Argentine draft resolution (U.N. Doc. A/AC.24/15 [1948]) was withdrawn after it became apparent that it would be defeated. U.N. GAOR Ad Hoc Political Comm., 3d Sess., 1st Part, 14th mtg. (Nov. 26, 1948), at 156.

21. U.N. Doc. A/AC.31/L.18 (1949). Earlier, Argentina had been among states expressing doubts concerning the Court's competence to interpret the Charter. *See, e.g.*, in the pre-request phase of the *Admission* case, U.N. GAOR 1st Comm., 2d Sess., 100th mtg. (Nov. 8, 1947), at 370; U.N. GAOR, 2d Sess., 118th plen. mtg. at 1071. (Nevertheless, Argentina voted for the request.) As late as the third Assembly session, the Argentine representative rejected a suggestion that the interpretation of Article 4(2) be referred to the Court, on the ground that the Court would probably consider itself incompetent to deal with it. U.N. GAOR Ad Hoc Political Comm., 3d Sess., 1st Part, 11th mtg. (Nov. 24, 1948), at 156.

22. POMERANCE, *supra* note 5, at 104-07. The resolution was reformulated, no longer focusing on one document in the *travaux préparatoires* of the U.N. Charter, as in the original Argentine draft resolution. A new text, formulated jointly by Argentina and Belgium, was substituted. U.N. Doc. A/AC.31/L.20 (1949). The question now was:

Can the admission of a State to membership in the United Nations, pursuant to Article 4, paragraph 2, of the Charter, be effected by a decision of the General Assembly when the Security Council has made no recommendation for admission by reason of the candidate failing to obtain the requisite majority or of the negative vote of a permanent member upon a resolution so to recommend?

The United States did not participate in the pre-request Assembly debate, presumably because the U.S. Delegation experienced considerable difficulty in determining its stance. Before the formal Argentine draft resolution was submitted, a U.S. Delegation position paper of October 22, 1949 had recommended firmly that "the United States should oppose any proposal embodying or giving application to the Arce view that the General Assembly can admit an applicant which has not received a favorable recommendation from the Security Council."<sup>23</sup> Notwithstanding its desire to break the admissions deadlock, the United States did not wish to weaken the veto in this manner. Furthermore, the Delegation was to "strongly discourage in its conversations" the idea of requesting an advisory opinion with respect to the Argentine thesis "on the ground that the question involves no serious legal difficulties." If the proposal nevertheless came to a vote, the Delegation "should preferably abstain or vote adversely."<sup>24</sup>

U.S. informal efforts at dissuasion having failed, the U.S. Delegation was convened on November 1, 1949 to consider how to vote on the Argentine draft resolution. Some members still insisted that abstention or opposition was the wiser course and that the draft resolution represented an improper

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Insofar as the Assembly desired a judicial answer to all parts of the Argentine thesis, the formulation of the question was defective. For while it required a reply as to the contention that an *unfavorable* Council recommendation might yet lead to admission by the Assembly, it allowed the Court to avoid answering directly the question—avowedly the more important—whether, despite the veto, a recommendation might be considered by either the Security Council or the General Assembly as *favorable*. As framed, the question assumed the absence of a Security Council recommendation. See 1950 I.C.J. REP. 7. The Court's interpretation of the question accorded with that urged by the United States. *Competence case*, 1950 I.C.J. Pleadings 110-22. On the other hand, the Argentine Written Statement revolved entirely around the question of the veto. *Id.* at 123-48. Indeed, certain states—most notably, Lebanon—recommended the inclusion of more specific questions related to the effect of the veto on the admission of new members. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 27th mtg. (Nov. 2, 1949), at 146. Most, however, appeared satisfied that the question, as framed, encompassed all the important elements of the problem.

Despite its narrow circumspection of the question, the Court did, in an oblique reference at the end of the opinion, indicate that the Assembly, at least, could not reverse to *favorable* a recommendation which the Security Council had deemed *unfavorable*. But the Court did not find it necessary to enter into the thicket of the applicability of Article 27(3) of the Charter to the admission of new states. Had the question of the veto been put unequivocally to the Court, it is conceivable that the Court would have considered itself incompetent to answer it. For it is by no means clear that the Assembly's authority to request advisory opinions extends to questions involving the voting procedure of a coordinate organ.

23. 2 FOREIGN RELATIONS OF THE U.S. 1949, at 303. See also 1 FOREIGN RELATIONS OF THE U.S. 1948, at 201.

24. 2 FOREIGN RELATIONS OF THE U.S. 1949, at 303. See also *id.* at 307; 5 FOREIGN RELATIONS OF THE U.S. 1949, at 240.

"passing of the buck" to the Court.<sup>25</sup> But Ambassador Austin was sympathetic to the Arce proposal, and the majority of the Delegation decided that, provided the draft resolution was appropriately reformulated, the United States should not oppose it.<sup>26</sup> In this way, the United States would remain true to its tradition of encouraging more frequent recourse to the Court.<sup>27</sup> Moreover, "the proposal presented an opportunity to take the Argentine proposition, which had been gaining favor over the years, 'out of the political forum' and on to a legal basis."<sup>28</sup>

In the end, the United States indeed voted for the proposal to request an advisory opinion.<sup>29</sup> But it opposed the Arce thesis in the Pleadings before the Court. It also presented an interpretation of the question that allowed the Court to evade the second and more crucial part of the Argentine thesis, which bore on the applicability of the veto to admissions.<sup>30</sup> That unresolved issue was to reemerge in later proposals and suggestions for requesting advisory opinions; and the United States helped ensure that all such suggestions would remain abortive.<sup>31</sup>

## B. Peace Treaties

A very different posture was assumed by the United States with respect to another Cold War case of the early U.N. period. Just one month prior to the adoption of the *Competence* request, the United States initiated and co-sponsored in the General Assembly a proposal to seek the Court's advice in interpreting provisions of the peace treaties with Bulgaria, Hungary, and Rumania. Although unlikely to improve the root problem of the observance

25. These included Paul Taylor, Sam Kopper and Jack Tate, the State Department's Deputy Legal Adviser. Jessup, *supra* note 3, at 35-36.

26. See *id.* at 36, for the views of James Hyde, Philip Jessup, and Harley Notter. The Delegation did not wish to have the request refer to specific documents at San Francisco, as in the original Argentine draft resolution. Argentina would be free, of course, to present those documents as evidence before the Court.

27. *Id.* This was the argument presented forcefully by Notter, in particular.

28. 2 FOREIGN RELATIONS OF THE U.S. 1949, at 308 n.1.

29. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 29th mtg. (Nov. 4, 1949), at 162; U.N. GAOR, 4th Sess., 252d plen. mtg. (Nov. 22, 1949), at 329. The vote in Committee was 37 to 9, with 8 abstentions; in Plenary, 42 to 9, with 6 abstentions.

30. *Competence* case, 1950 I.C.J. Pleadings 110-22. See *supra* note 22 and accompanying text. The first part of the Arce thesis was resoundingly rejected by the Court with a vote of 12 to 2, and the validity of past U.N. practice on admissions (requiring the Assembly to proceed only on the basis of a prior favorable Security Council recommendation) was thus confirmed. See 1950 I.C.J. REP. 4-10.

31. See the section on the aftermath of the *Competence* case, *infra* part III.B.



of human rights in the three satellite states, recourse to the Court was viewed as a relatively cost-free exercise which might at least yield benefits in the East-West battle for world public opinion. It also was deemed by the United States to be preferable to the alternative then being promoted by certain Western states: direct investigatory and condemnatory action by the United Nations. Not calculated, however, in the U.S. cost-benefit analysis was the potential harm of an ineffective opinion to the prestige and standing of the International Court. At most, some members of the U.S. Delegation who shared the misgivings of several U.S. allies questioned the wisdom of submitting to the Court the last two of the four questions posed, but their view did not prevail.

The chain of events leading to the decision to involve the Court began in early 1949, when news of the arrest and trial of church leaders in Bulgaria and Hungary—and most prominently, Cardinal Mindszenty of Hungary<sup>32</sup>—reached the West and aroused widespread consternation and indignation. Writing to Secretary of State Dean Acheson, the U.S. Minister in Hungary reported that "public opinion in Hungary—and presumably elsewhere behind [the] Curtain—looks with anxiety for vigorous countermeasures not only in defense of US prestige but also as evidence [of] official US cognizance [of] cynical violation [of] human rights and proof of continued US interest in [the] welfare [of] peoples behind [the] Curtain."<sup>33</sup> It seemed clear to him "that eventually the whole question of human rights in satellite countries must be forced into [the] UN Assembly and that Hungary, in light [of] recent developments . . . may well present [the] best point of attack."<sup>34</sup> Ineffective protests, he warned, made the United States "appear feeble and irresolute"; and he recommended concerted Anglo-American efforts leading to U.N. investigations, and, if necessary, economic sanctions. Such a course would probably "exert restraining pressure on Czechoslovakia and Poland" as well.<sup>35</sup>

In response, Secretary Acheson conceded the broader implications of the Mindszenty case. There had been, he wrote, a general "intensification [of] measures of oppression" in the satellite states "as [an] instrument [of] Soviet indirect aggression." A forceful U.S. counter-offensive, utilizing but not focusing exclusively on the Mindszenty trial, was therefore warranted.<sup>36</sup> At the outset, the United States merely issued diplomatic protests and public denunciations; but following the sentencing of Cardinal Mindszenty to life

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32. Cardinal Mindszenty was arrested on December 27, 1948, and tried in early February 1949 for treason, conspiracy, and other crimes against the Hungarian state. He was sentenced to life imprisonment.

33. Telegram from Chapin, U.S. Minister in Hungary, to Secretary of State Dean Acheson, (Jan. 26, 1949) 5 FOREIGN RELATIONS OF THE U.S. 1949, at 223-24.

34. *Id.* at 223.

35. *Id.* at 224.

36. Circular telegram from Secretary of State Dean Acheson to Certain Diplomatic Missions (Jan. 31, 1949), *id.* at 225.

imprisonment, the State Department concluded that further action was required.<sup>37</sup> After weighing two alternative approaches—invocation of the dispute-settlement provisions of the peace treaties with Bulgaria, Hungary, and Rumania<sup>38</sup> against submission of the problem to a U.N. organ—the State Department inclined toward use of the first procedure, followed, or, if necessary, supplemented, by "some form of UN action."<sup>39</sup> True, U.N. action had the advantage of providing "a forum for airing [the] entire subject of suppression of rights and Treaty violations with [the] opportunity for us [to] demonstrate [to] Eastern European peoples [the] cont[inue]d concern [of the] international community [with] their fate."<sup>40</sup> But if the prospect of effective U.N. measures was "dubious," this mode of procedure might "be injurious to UN

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37. Telegram from Secretary of State Dean Acheson to U.S. Embassy in U.K. (Feb. 12, 1949), *id.* at 227. Some U.S. embassies, in commenting on Acheson's circular telegram, had cautioned against measures which would merely accentuate Western ineffectiveness in Eastern Europe. *Id.* at 226. On the other hand, the U.S. Embassy in Moscow emphasized that any steps, including even sanctions, would probably be ineffective in the short term. They would not "deter the Soviet Union from consolidating its position in Eastern Europe" and "were not likely to cause any Communist regime to back down or reverse current policy." *Id.* Nevertheless, the prospects of victory in the long term militated against a policy of silence with respect to oppression by any Soviet bloc member. In words which ring truer today than when they were uttered, the U.S. Chargé in the Soviet Union (Kohler) wrote:

[O]ur best traditions and our present interests require US to be constantly on offensive in political and psychological warfare fields in east Europe, retaining initiative in every possible way and stimulating resistance to Sovietization countries this area now in process. We cannot agree that even from humanitarian point of view we do these peoples a favor by remaining silent and inactive. . . . Chances for these peoples to regain their freedom will in the long run depend largely on maintenance their love of liberty and fighting spirit. These will surely wither away unless kept exercised.

*Id.* at 231. The need for firmer U.S. action was spurred by the fact that on February 9, the House had adopted a concurrent resolution on the matter.

38. Under these provisions, disputes not otherwise settled by direct negotiations or by the three Allied Heads of Mission in the relevant capitals, were to be referred, at the request of either party, to a commission composed of one representative from each party and a third member selected by mutual agreement. Upon failure of the two parties to agree within a month on the appointment of the third member, either party might petition the U.N. Secretary-General to make the appointment. For the text of the provisions, *see* 1950 I.C.J. REP. 73.

39. Among the possible U.N. actions listed were "a reference to the Court, or a request for an advisory opinion from the Court." 5 FOREIGN RELATIONS OF THE U.S. 1949, at 229. Here, an advisory opinion on the merits of the issue of human rights observance was contemplated, *not* the questions eventually posed regarding the applicability of the dispute-settlement provisions of the peace treaties.

40. Telegram from U.S. Secretary of State Dean Acheson to Embassy in U.K. (Feb. 12, 1949), *id.* at 229.

organization."<sup>41</sup> Moreover, any steps taken in the United Nations would have to reconcile the U.N. Charter provisions on human rights with the domestic jurisdiction clause (Article 2, paragraph 7).<sup>42</sup> On the other hand, utilizing the treaty procedure would avoid this problem, though admittedly it "would preclude airing violations in Yugo[slavia], Czecho[slovakia] and Poland." It would place the case, "wherever brought," on "the soundest basis"; and even if it were necessary to involve the U.N. subsequently, it was better to first exhaust other methods, in line with Article 33 of the Charter. The peace-treaty procedure "might be protracted . . . which, however, could serve [to] keep issues before world public opinion for [a] considerable period [of] time." Hungarian obstructionism would not be fatal, since the Secretary-General might nevertheless appoint the "third member" of the dispute-settlement commission, resulting in a "definite and binding decision" (as opposed to a mere Assembly recommendation). If Hungary remained defiant, the matter could then be brought before the Assembly on a firm legal foundation, thus keeping the issue alive.

In view of all these considerations, the State Department instructed the U.S. Mission at the United Nations not to "either encourage or discourage any del[egation] considering raising [the] matter in [the] UN."<sup>43</sup>

U.S. strategy in this matter was challenged initially from two quarters. The British hesitated, at first, to join the United States in activating the peace treaty machinery. They feared that trade negotiations with the Eastern bloc might be jeopardized; that the protracted negotiations would merely parade Western impotence and further harm Western prestige and influence; and that economic and diplomatic sanctions would be the inevitable (and from the British standpoint, undesirable) result. The alternative of condemnatory pronouncements proclaimed to the world at large would, in their view, be equally effective in indicting the human rights violations of the Balkan states.<sup>44</sup> The State Department dismissed these arguments and contended, *inter alia*, that invocation of the treaty machinery was a "logical step" prior to U.N. involvement and would, more likely, forestall U.N. action in the interim; that "such course will usefully serve to continue pressure indirectly on the Soviet Union through the three satellites;" that "a definite binding decision," even if rejected by the satellites, would "be useful . . . as incontrovertible proof of treaty breach;" that the "mere fact that treaty machinery w[ou]ld consume [a] fairly extended period [of] time indicates [the] seriousness with which we view this matter"; that "our action would be heartening evidence of our

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41. *Id.* at 228.

42. *Id.*

43. *Id.* at 229 n.4. For the full text of Acheson's telegram, *see id.* at 227-29.

44. *Id.* at 230, 235-36 nn.4-6. Action against Hungary alone was deemed particularly objectionable. *Id.* at 230 n.1.

sustained interest in [the] fate of people of satellite countries and would serve to boost morale in cold war"; that public condemnatory pronouncements clearly would be ineffective, if only because of their past overuse; that the "principal British doubt" regarding future trade negotiations was unfounded because "the willingness of the satellites to trade" would be "more likely determined on a basis of strict economic advantage;" and that use of the treaty machinery, as opposed to an immediate appeal to the United Nations, would not lead inevitably to the imposition of economic or diplomatic sanctions. Rather, it would allow the maintenance of a "flexible position . . . as to what if anything should be done thereafter."<sup>45</sup>

This last argument was directed also at the second source of opposition to the U.S. approach: the Latin American states. Their fury at the satellites' abuse of the Catholic Church led them to desire immediate U.N. condemnatory action, preferably by the Security Council.<sup>46</sup> Cuba, in particular, was taking steps to move the issue to the Security Council, and, as Jessup attested, "the United States staff [at the U.N.] had difficulty in dissuading Cuba" from adopting this course.<sup>47</sup>

To bolster its case against immediate reference to the U.N., the State Department marshalled an array of additional arguments which included the following points.<sup>48</sup> As non-U.N. members, the three delinquent countries were not bound by the Charter and would certainly refuse to answer charges brought against them in the world organization.<sup>49</sup> However, they were bound by treaties,<sup>50</sup> and "broader support could be obtained for UN action if necessary, following utilization of Treaty procedure."<sup>51</sup> Furthermore, a "UN forum would offer satellites or their friends [the] opportunity to obscure charges of human rights suppression by irrelevant and false counter-charges against other Members which would not be possible in Treaty procedure where issues are confined to obligations of [the] three countries."<sup>52</sup>

As for the airing of the issues—presumably, the main beneficial result of U.N. proceedings—this "could perhaps be obtained through periodic release of documents relating to Treaty procedure which no doubt would extend over [a] long period of time and perhaps through governmental statements outside

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45. *Id.* at 230, 234-36. Invocation of the treaty machinery, according to Secretary of State Acheson, would *lessen* the possibility of "irresponsible actions" by the U.N. *Id.* at 236.

46. Within the United States, too, there was some demand for U.N. action. *Id.* at 233.

47. Jessup, *supra* note 3, at 23. On the Cuban moves, see 5 FOREIGN RELATIONS OF THE U.S. 1949, at 233, 235, 237, 239-40.

48. *Id.* at 236-40.

49. *Id.* at 237.

50. *Id.*

51. *Id.*

52. *Id.*

of [the] UN."<sup>53</sup> In any event, any "consideration of UN sanctions at this time [was] impracticable."<sup>54</sup> The most that could be expected was Security Council rejection, yet again, of the three satellite states' applications for U.N. membership. But that would hardly represent "effective or persuasive UN action." Moreover, if the Security Council adopted an *unfavorable* recommendation on admitting the three states, this "would raise important constitutional objections in that it might be interpreted as implied affirmation of [the] view championed by Argentina and opposed by almost all other members including [the] US that [the] Assembly can admit a member regardless [of] S[ecurity] C[ouncil] recommendation."<sup>55</sup>

The U.S. approach prevailed, but not completely. While British cooperation was enlisted for invoking the treaty procedures<sup>56</sup> and the issue was kept off the Security Council agenda, the General Assembly was seized of the matter in the spring of 1949, earlier than the United States would have wished.<sup>57</sup>

By then, efforts under the treaties were already underway. Though the United States conceded the Assembly's competence to discuss the matter,<sup>58</sup> it worked successfully to confine Assembly action at that stage primarily to endorsing the initiatives taken by the signatories of the peace treaties.<sup>59</sup>

53. *Id.*

54. *Id.* at 238.

55. *Id.* at 240. See *supra* discussion of the *Competence* case.

56. Telegram from Lewis Williams Douglas, U.S. Ambassador to the U.K., to Dean Acheson, U.S. Secretary of State, 5 FOREIGN RELATIONS OF THE U.S. 1949, at 240-41 (Mar. 25, 1949). For texts of U.S. and British notes, see *Peace Treaties* case, 1950 I.C.J. Pleadings 23-30, 72-77. For coordination of statements of denunciation, see 5 FOREIGN RELATIONS OF THE U.S. 1949, at 239. Earlier, the Secretary of State had decided that the United States would proceed unilaterally, if necessary. *Id.* at 235.

57. The issue was raised by Bolivia on March 16, 1949, U.N. Doc. A/820, with respect to the Mindszenty case, and by Australia, on March 21, 1949, U.N. Doc. A/821, in connection with the observance of fundamental freedoms and human rights in Bulgaria and Hungary, particularly in relation to the recent trials of Catholic Church officials. Before the Fourth Assembly Session, Australia requested that the question of the observance of human rights in Rumania be added to the original item. (U.N. Doc. A/948 [1949]). Australia was, at the time, acting in concert with a "Catholic bloc" in the United Nations on other issues as well—for example, the question of internationalization of Jerusalem. This may have been due to the felt need of the ruling Australian Labor party to woo the Catholic vote. See ABBA EBAN, AN AUTOBIOGRAPHY 145-56 (1977).

58. U.N. GAOR General Comm., 3d Sess., 2d Part, 58th mtg. (Apr. 6, 1949), at 8; *id.*, 59th mtg. (Apr. 7, 1949), at 34-35.

59. A Bolivian draft resolution was supported by the United States. It became G.A. Res. 272 (III) (Apr. 30, 1949). For the discussions, see U.N. GAOR Ad Hoc Political Comm., 3d Sess., 2d Part, 34th-41st mtgs. (Apr. 19-20, 1949), at 59-176; U.N. GAOR, 3d Sess., 2d Part, 201st-203rd plen. mtgs. (Apr. 29-30, 1949), at 225-73.

Alternative suggestions, envisaging the immediate establishment of a U.N. investigatory committee, were defeated with the help of the United States.<sup>60</sup>

All efforts at resolving the issue under the rubric of the Peace Treaties proved quickly and clearly abortive. The three communist governments (joined by the Soviet Union) denied the substantive allegations presented and rejected all diplomatic interventions as unwarranted intrusions in their domestic affairs and processes of justice. They also denied the existence of any dispute between them and the Allied Powers and refused to designate representatives to the treaty commissions provided for in the Peace Treaties.<sup>61</sup> In these circumstances, and with the Assembly due to resume debate on the issue at its Fall 1949 session, the United States began to map further strategy. Recourse to the Court featured prominently in the State Department planning, although the manner and contours of such recourse apparently engendered some internal debate.

The Department contemplated having the Assembly recommend to the parties, in the first instance, that *they* refer to the Court for decision either the question of the applicability of the dispute-settlement provisions *or* the merits of the disputes.<sup>62</sup> An Assembly request for an advisory opinion (limited to the procedural aspects) would be forwarded to the Court only in the event that the parties failed to refer either matter within six weeks.<sup>63</sup> Later, however, the first part of the plan was dropped. Since the satellites "will obviously not agree to go to [the] Court on this issue," it was recognized that such a recommendation, would be "a futile gesture."<sup>64</sup> And, as to submitting the substance of the dispute, the "G[eneral] A[ssembly] has already expressed [the] view that treaty proceedings are appropriate means of settlement and [the] G[eneral] A[ssembly] therefore sh[oul]d not at this stage recommend

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60. Such suggestions were raised by Cuba (U.N. Doc. A/AC.24/48/Rev.2) and Australia (U.N. Doc. A/AC.24/52). A joint Australian-Cuban draft resolution (U.N. Doc. A/AC.24/56) was defeated in committee. U.N. GAOR Ad Hoc Political Comm., 3d Sess., 2d Part, 41st mtg. (Apr. 22, 1949), at 171-72.

61. On the dispute-settlement procedure, *see supra* note 38. The Soviet Union argued, *inter alia*, that the dispute-settlement procedure applied only when all three Allied powers were in controversy with one of the satellite states. *See, e.g.*, U.N. GAOR Ad Hoc Political Comm., 4th Sess., 14th mtg. (Oct. 12, 1949), at 60. For relevant diplomatic exchanges, see *Peace Treaties* case, 1950 I.C.J. Pleadings 30-69, 77-104. *See also* 5 FOREIGN RELATIONS OF THE U.S. 1949, at 241-55, 260-61.

62. *See also supra* note 39, for a discussion of an earlier occasion when the State Department contemplated requesting the Court's opinion on the merits of the dispute.

63. Letter from Dean Acheson, U.S. Secretary of State, to the Embassy in U.K., 5 FOREIGN RELATIONS OF THE U.S. 1949, at 256-57 (July 8, 1949).

64. Letter from Dean Acheson, U.S. Secretary of State, to the Embassy in U.K., *id.* at 261 (Aug. 3, 1949).

another means of settlement. . . .<sup>65</sup> Rather, the suggested request for an advisory opinion should be adopted directly.<sup>66</sup>

But would not the lack of satellite cooperation make the contemplated resort to the Court's advisory function an equally "futile gesture"? What benefits would be derived from it, and what was the intended follow-up? State Department thinking on these matters was set forth by Secretary Acheson in a message conveyed to the British Foreign Office. "We believe," he stated, "that a judicial determination of the issue . . . is important not only as an additional pressure on the satellites but also as a basis for possible condemnation by the General Assembly of the satellite[s'] refusal to cooperate in the Treaty proceedings according to their international obligations and the recommendation by the General Assembly."<sup>67</sup> "We must . . . anticipate," Acheson admitted, "that the determination by the Court will not lead to the establishment of commissions under the Treaties."<sup>68</sup> In that event, he thought that there were several alternative ways by which the General Assembly subsequently might clarify the merits of the dispute, including fact-finding by an impartial jurist appointed by the Secretary-General (a procedure closely approximating the scheme of the treaties); a special committee to investigate the charges (an idea rejected by the General Assembly in its previous session); and inquiry by a subcommittee of the Interim Committee of the General Assembly.<sup>69</sup> At this stage, however, it was best for the Assembly to limit itself to a recommendation for judicial determination.<sup>70</sup>

Perhaps more important than what the United States hoped to *achieve* by judicial recourse in this case was what the United States expected to *avoid*: the precedent of direct Assembly inquiry into human rights violations, on the one hand, and judicial determination of the Assembly's competence in the human rights field, on the other. The following excerpts from Acheson's communication to the British Foreign Office are illuminating:

The above suggested resolution limited to the recommendation for judicial determination might not be enough for such states as Australia, New Zealand, Chile, Cuba and Colombia who were in favor of a more radical Assembly action already last spring. On the other hand, we recall twenty abstentions on the vote to place

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65. *Id.*

66. *Id.* But, for inconsistency in the Department position on referring the merits of the dispute to the Court, *cf.* statement by Secretary of State Dean Acheson, DEP'T ST. BULL., Oct. 31, 1949, at 495.

67. Letter from Dean Acheson, U.S. Secretary of State, to the Embassy in U.K., 5 FOREIGN RELATIONS OF THE U.S. 1949, at 257 (July 8, 1949).

68. *Id.*

69. *Id.* at 257-58.

70. *Id.*

this item on the agenda, the strong reluctance on the part of the Scandinavian countries, most Western Europeans, Arabs, and a number of Latin Americans to support General Assembly action beyond discussion and recommendation of procedural steps as well as the negative attitude of others toward *any* General Assembly action in this matter. . . . We ourselves are somewhat concerned that the General Assembly decision to inquire into the substance of the charges of human rights violations even though Treaty obligations are involved in this particular case might constitute a precedent starting perhaps a long line of cases of charges and counter-charges. As the United States Delegate stated last spring, we believe that the General Assembly's role in this field at this stage of United Nations development should be primarily to promote agreement on common standards and assist in composing differences rather than acting as a court of review on individual cases although the General Assembly in our view is not barred in appropriate circumstances from expressing opinion or making recommendations on this type of case. . . .

We would not favor a reference to the International Court of Justice of the question of General Assembly jurisdiction in this matter under Article 2(7) of the Charter. We believe that the General Assembly has jurisdiction to take the steps suggested above. . . . However, the Court should not be asked this jurisdictional question at this critical time in the development of international law in the human rights field when the Covenant on Human Rights and the problem of duties of a state towards its own citizens in the International Law Commission are in the process of final formulation.<sup>71</sup>

For its part, the British Foreign Office endorsed the idea of eliciting the Court's advice, but only as to whether the satellites breached their dispute-settlement obligations. On this question, the prospects of an affirmative Court response were deemed good. But to ask the additional question regarding the right of the Secretary-General to appoint the "third" members of the treaty commissions (even in the absence of the second members) would not "serve any useful purpose," since the Secretary-General clearly had no such right.<sup>72</sup>

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71. *Id.* at 258. On the delicacy of questions regarding the scope of Article 2(7), see also the comments of the Belgian representative in the General Committee, U.N. GAOR General Comm., 3d Sess., 2d Part, 58th mtg. (Apr. 6, 1949), at 20.

72. Telegram from U.S. Chargé in the U.K. (Holmes) to Secretary of State Acheson (Sept. 7, 1949), 5 FOREIGN RELATIONS OF THE U.S. 1949, at 263.



Nor was the additional question considered necessary. Default on the implementation provisions would be sufficiently incriminating, and the West could justly argue that it "was itself admission of satellites failure to give their people human rights."<sup>73</sup>

British advice on restricting the scope of the request was not heeded by the United States in the end, although similar advice was rendered by some members of the State Department and of the U.S. Mission to the United Nations.<sup>74</sup> The draft resolution introduced by the United States on October 4, 1949 (and co-sponsored by Canada and Bolivia) posed four questions to the Court: (1) whether disputes existed within the terms of the peace treaties; (2) whether the three satellite states were obligated to appoint their representatives to the peace treaty commissions; (3) whether, if the three states were so obligated and failed to appoint their representatives, the Secretary-General could appoint the third members of the commissions; and (4) whether such two-member commissions would be competent to make binding decisions.<sup>75</sup> An Australian amendment to the joint draft resolution would have deleted questions three and four and substituted for the contingent second phase of advisory proceedings the establishment of an *ad hoc* committee to investigate the substantive human rights issue, regardless of whether the Court's answer to question two would be affirmative or negative.<sup>76</sup> Other Western states, too, objected to the inclusion of questions three and four, mainly on the grounds that a negative judicial reply was certain, and the task of the Court would be transformed from interpreting to revising treaties.<sup>77</sup>

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73. Telegram from U.S. Ambassador to the U.K. (Douglas) to Secretary of State Acheson (Aug. 9, 1949), *id.* at 262. The Foreign Office also expressed skepticism about the advisability of some of the follow-up procedures suggested by the State Department since they "would drag matters out indefinitely." And without the submission of counterevidence by the satellites, the value of any inquiry would be lessened. *Id.*

74. In his message of August 25, 1949, Acheson reported to the Foreign Office that "our views on inclusion of this question not yet definite." *Id.* at 263. Jessup, for one, objected to incorporating the last two questions. Instead of "putting contingent questions to the Court in this fashion," he suggested having the Interim Committee interpret the Court's opinion for the Secretary-General after the first phase of the judicial proceedings. For formulation of the requesting resolution, the U.S. Delegation consulted Professor Manley O. Hudson, the last American judge of the Permanent Court of International Justice. Jessup, *supra* note 3, at 24.

75. U.N. Docs. A/AC.31/L.1 and A/AC.31/L.1/Rev.1 (1949).

76. U.N. Doc. A/AC.31/L.2 (1949). Australia thought an advisory opinion would prove to be of little assistance in the solution of the problem. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 7th mtg. (Oct. 4, 1949), at 26.

77. See the comments of the French delegate, *id.*, 14th mtg. (Oct. 12, 1949), at 58-59, and U.N. GAOR, 4th Sess., 234th plen. mtg. (Oct. 21, 1949), at 133. See also the statement of Peru that questions 3 and 4 "might be construed as interference in the internal affairs of States through the unilateral interpretation of the peace treaties." U.N. GAOR Ad Hoc Political Comm., 4th Sess., 15th mtg. (Oct. 13, 1949), at 66; U.N. GAOR, 4th Sess., 235th plen. mtg. (Oct. 22, 1949), at 150. Cf. the statement of the Dominican Republic, U.N. GAOR, 4th Sess.,

On the other hand, the U.S. delegate, Benjamin V. Cohen, vigorously defended the joint draft resolution and successfully opposed the Australian amendment.<sup>78</sup> The General Assembly, he said, was already on record as favoring the use of the treaty machinery, and this approach should be followed through to a "clear and definite conclusion."<sup>79</sup> It was "in the spirit of [A]rticle 33 of the Charter" that the peace treaty procedures should be exhausted "before the Assembly should attempt to set new or parallel procedures."<sup>80</sup> Furthermore, treaty procedures, unlike the Assembly, could yield "a definite decision binding upon the states concerned."<sup>81</sup> The Secretary-General needed to "be advised authoritatively by the Court concerning the scope of his authority,"<sup>82</sup> and it was important to know "whether one party, by refusing to appoint its arbitrator, might make a scrap of paper of its agreement to arbitrate."<sup>83</sup> This last question was one to which the United States, as signatory, was entitled to receive an authoritative judicial determination. Such a determination, in the U.S. view, was "equally necessary in the interest of the development of international law and of the community of nations under the Charter."<sup>84</sup> For its part, the United States pledged to accept the Court's opinion on all the questions as binding and expressed the hope that the three satellite states would do the same.<sup>85</sup>

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234th plen. mtg. (Oct. 21, 1949), at 139. The U.K. representative, though he now favored reference of questions 3 and 4 to the Court, deemed a negative judicial response probable. *Id.* at 144. In the Ad Hoc Political Committee, Britain abstained on the Australian amendment. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 15th mtg. (Oct. 13, 1949), at 66.

78. The vote to defeat the amendment was 29 to 5, with 22 abstentions. *Id.*

79. Benjamin V. Cohen, *Debate on Human Rights—Freedom Can Unite Us* (Statement of Oct. 4, 1949, in G.A. Ad Hoc Political Committee), DEP'T ST. BULL., Oct. 24, 1949, at 622 [hereinafter *Debate*].

80. *Id.* at 617.

81. *Id.*

82. *Id.* at 623.

83. U.N. GAOR, 4th Sess., 234th plen. mtg. (Oct. 21, 1949), at 131.

84. *Debate, supra* note 79, at 624. Regarding the hesitations of the Soviet and French representatives to have question four put to the Court, Cohen queried why, if they were so sure that the question would be answered in the negative, they "oppose, rather than welcome, an impartial and definite decision" on the matter. Benjamin V. Cohen, *Debate on Violation of Human Rights in Eastern Europe Continued* (Statement of Oct. 12, 1949, in G.A. Ad Hoc Political Committee), DEP'T ST. BULL., Oct. 31, 1949, at 660 [hereinafter *Debate Continued*]. *Cf.* the support of India in the Ad Hoc Political Committee for referring questions 3 and 4, too, because the Court's answer would have a bearing on the drafting of future treaties. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 10th mtg. (Oct. 7, 1949), at 40. However, India later abstained on the resolution to request the advisory opinion. U.N. GAOR, 4th Sess., 235th plen. mtg. (Oct. 22, 1949), at 150.

85. *Debate, supra* note 79, at 623; *Debate Continued, supra* note 84, at 660. *See also* Statement by Secretary Dean Acheson, Address of Secretary of State Dean Acheson at G.A. Plenary, Sept. 21, 1949, DEP'T ST. BULL., Oct. 3, 1949, at 150.

Realistically, the United States entertained no such hope, and its insistence on including questions three and four was itself testament to that fact. Soviet opposition to recourse to the Court was firm<sup>86</sup>—and predictably so, given the nature of the accusations which underlay the request. Even more than in the *Admission* case, the Western complaints exposed a raw nerve in the Communist world. Involved in this request were no "accidental phenomena, but the inevitable consequences of their [the satellites'] political and social structure."<sup>87</sup> In these circumstances, little could be gained from sucking the Court into the controversy,<sup>88</sup> but vital assets of the Court might be lost. However, only the Soviet bloc members professed any concern over the consequences of the request for the future authority of the Court. It was wrong, they protested, to make the Court a tool of the Cold War and transform it "into a mere branch of the State Department or the Foreign Office."<sup>89</sup> The majority of U.N. members proceeded to endorse the request,<sup>90</sup> though several expressed skepticism about its utility.<sup>91</sup>

From the U.S. perspective, involvement of the Court was simply a necessary last step in the course of exhausting the treaty procedures—a course

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86. For a summary of the legal arguments presented, see POMERANCE, *supra* note 5, at 100-02. The Soviets were especially opposed to questions 3 and 4. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 14th mtg. (Oct. 12, 1949), at 60 (comments of Vyshinsky).

87. Statement of The Netherlands, U.N. GAOR Ad Hoc Political Comm., 4th Sess., 11th mtg. (Oct. 10, 1949), at 44. See also the comment of Benjamin V. Cohen, that the human rights violations by the satellites were "the results . . . of the world-wide effort by the Soviet Union to use the world Communist movement as an instrument for carrying out by force and stealth its own imperialist objectives." Benjamin V. Cohen, *Problem of Human Rights in the Balkans* (Statement in G.A. Plenary, Oct. 21, 1949), DEP'T ST. BULL., Nov. 7, 1949, at 692.

88. An affirmative answer to the first two questions would presumably make clear to the world that the three governments, on top of their violations of obligations concerning human rights and fundamental freedoms, also violated their commitments regarding dispute settlement. If, in addition, the Court were to reply affirmatively to questions 3 and 4 (an unlikely prospect), the substantive accusations against the satellites might be upheld by treaty commissions, thus increasing, in some measure, the embarrassment of those governments.

89. See U.N. GAOR Ad Hoc Political Comm., 4th Sess., 12th mtg. (Oct. 11, 1949), at 48 (comments of Vyshinsky). See also U.N. GAOR, 4th Sess., 234th plen. mtg. (Oct. 21, 1949), at 134 (comments of Polish delegate).

90. After separate votes on each of the four questions, the joint draft resolution, as a whole, was adopted in the Ad Hoc Political Committee by a vote of 41 to 5, with 9 abstentions, and in Plenary by a vote of 47 to 5, with 7 abstentions. U.N. GAOR Ad Hoc Political Comm., 4th Sess., 15th mtg. (Oct. 13, 1949), at 66; U.N. GAOR, 4th Sess., 235th plen. mtg. (Oct. 22, 1949), at 150. There was less support for submitting questions 3 and 4, and there were a larger number of abstentions. *Id.*

91. See especially, U.N. GAOR Ad Hoc Political Comm., 4th Sess., 7th mtg. (Oct. 4, 1949), at 26 (statement of Australia); *id.*, 14th mtg. (Oct. 12, 1949), at 58-59 (statement of France).

to which the United States came to be obsessively committed.<sup>92</sup> This commitment, in turn, was probably prompted only to a small degree by a self-deluding assumption that a "binding" decision could make a difference, that it might induce change in satellite behavior. More importantly, the United States needed to appear to be doing the maximum for the embattled satellite populations, while eschewing more forceful actions, such as sanctions or U.N. actions preparatory to sanctions. It also clearly preferred judicial pronouncements on the competence of treaty commissions to judicial clarification of the competence of the General Assembly in the sphere of human rights. But in opting for what was, from its standpoint, the lesser evil, the United States omitted to appraise the "evil" of this preference from the standpoint of the Court and its still fragile standing in the world community.

### C. Expenses

A similar insensitivity to the Court's interests characterized the American attitude some twelve years later, when the United States was again actively engaged in the process of seeking the Court's advice on a matter sharply in contention between the two superpowers. Nor did the United States exhibit any particular perspicacity in weighing its stakes in procuring the judicial imprimatur for its stand.

As in the *Admission* case, the Court was called upon to select between alternative interpretations of Charter provisions bearing on the internal functioning of the Organization. But unlike the earlier case, the implications of the Court's ruling were potentially more far-reaching. In the background lurked the sanction provided for in Article 19 of the Charter,<sup>93</sup> which theoretically could be employed to pressure the Soviets to comply with a Court opinion. At the pre-request and early post-opinion phases, the United States appeared determined to resort to this sanction if necessary—unaware that most other U.N. members were disinclined to acquiesce in such a course, and unaware, too, that America's own long-range interests would not necessarily be served by a favorable Court opinion.

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92. The United States went as far as to anticipate the Court's opinion and to appoint, in advance, its commissioner to the treaty commissions. See 5 FOREIGN RELATIONS OF THE U.S. 1949, at 271-76 (1976).

93. Article 19 of the U.N. Charter provides:

A Member of the United Nations which is in arrears in the payment of its financial contributions to the Organization shall have no vote in the General Assembly if the amount of its arrears equals or exceeds the amount of the contributions due from it for the preceding two full years. The General Assembly may, nevertheless, permit such a Member to vote if it is satisfied that the failure to pay is due to conditions beyond the control of the Member.

The context in which the Court's opinion was sought was the threatened insolvency of the United Nations resulting from the failure of many states to share in the expenses of one or both of the costly peacekeeping operations then in progress—UNEF (the U.N. Emergency Force in Sinai) and ONUC (the U.N. Force in the Congo). Within the Assembly, no consensus had emerged on the proper method of financing the forces or on the question whether members were legally obligated to contribute. Most prominent among the non-contributors were the Soviet Union (which contributed to neither peacekeeping force)<sup>94</sup> and France (which demurred only on paying for ONUC). In 1961, as the financial crisis deepened, the Assembly established a Working Group of Fifteen (including the United States) to recommend solutions.<sup>95</sup> But the differences among the members proved unbridgeable,<sup>96</sup> and the Working Group could agree only to endorse a Canadian suggestion to seek the International Court's advice with respect to "the legal nature of financial obligations arising out of peace-keeping operations."<sup>97</sup> In the Fifth Committee, that suggestion was translated into a formal proposal co-sponsored by the United States.<sup>98</sup> As formulated, the request related no longer to expenditures for peacekeeping operations in the abstract, but rather to the particular expenditures already incurred for UNEF and ONUC.<sup>99</sup> Moreover, the question no longer specifically mentioned the

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94. The Soviet Union's nonpayment of UNEF expenses was based on the view that the Assembly had authority neither to establish the force nor to finance it. In the case of ONUC—which was set up by the Security Council and hence was unobjectionable on that score—Soviet opposition centered on the manner in which the Council's directives were implemented by the Secretary-General and on the fact that the expenses for the operation were again, as in UNEF, apportioned by the General Assembly.

95. G.A. Res. 1620 (Apr. 21, 1961). The full name of the unit was the Working Group of Fifteen on the Examination of the Administrative and Budgetary Procedures of the United Nations.

96. The extent of the differences is graphically revealed in the Report of the Working Group, U.N. Doc. A/4971 (in U.N. GAOR, 16th Sess., Annexes, Agenda Item 62), paras. 7-23 and Annex II (1961).

97. The formulation of the question was to be determined by the General Assembly. For U.S. endorsement of the Canadian suggestion, see U.N. Doc. A/AC.104/SR.11, at 7 (1961). The Soviet bloc objected, mainly because the issue was "political," and also because the matter was deemed too clear to warrant soliciting an advisory opinion. U.N. Doc. A/AC.104/SR.10, at 4 (1961); U.N. Doc. A/AC.104/SR.11, at 6 (1961); U.N. Doc. A/AC.104/SR.12, at 4 (1961). See also the objections of India, U.N. Doc. A/AC.104/SR.10, at 8 (1961).

98. U.N. Doc. A/C.5/L.702 & Add. 1-2 (1961). The other sponsors were Brazil, Cameroun, Canada, Denmark, Japan, the United Kingdom, Liberia, Pakistan, and Sweden.

99. Thus, the question now possessed a retrospective aspect which a general question on peacekeeping operations for future guidance might have avoided. On this ground, among others, Judge Basdevant considered that the Court should have declined to give the opinion requested. "Where," he said, "it would have been possible to obtain from an opinion requested of the Court collaboration in the present work of the United Nations, it has been sought to

financial obligations of member states. The Court was asked merely whether the expenditures incurred "constitute 'expenses of the Organization' within the meaning of Article 17, paragraph 2, of the Charter."<sup>100</sup> The proposal was adopted by the Fifth Committee and in Plenary,<sup>101</sup> but only after a lively debate both on the idea of soliciting the Court's advice and the terms of the question posed.

The United States, along with the other sponsors and supporters of the draft resolution, insisted that a Court opinion would help break the impasse. These nations believed a clearer definition of "the rights and obligations of each Member with respect to the United Nations" would be a necessary, if not sufficient, component of a solution. While "the question did have political implications . . . essentially it was a legal question."<sup>102</sup>

Soviet opposition to the request was predictably firm, in line with the traditional Soviet posture whenever recourse to the Court was at issue. In this case, the Soviets had additional cause to object, since the aim of the proposal was to pressure the Soviets to bear the costs of political actions to which they objected.<sup>103</sup> Arguing against requesting an advisory opinion, the Soviet representative contended, first, that the issue was clearly settled by the Charter and that the projected consultation of the Court would be equivalent to undermining the essential principles which member states had accepted upon signing the Charter. Second, the problem was essentially political and was not separable into legal, financial, and political elements. And finally, there was no need to seek judicial advice, since the requisite financing could and should be arranged in accordance with Article 43 of the Charter. The Soviet representative further served notice on the Assembly that his government would not consider itself bound by any Court decision because the question was not within the Court's competence.<sup>104</sup>

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obtain from the Court only a retrospective evaluation of what was done up to the end of 1961." *Certain Expenses of the United Nations (Art. 17, para. 2, of the Charter)*, 1962 I.C.J. REP. 151, at 237-38.

100. In the preamble, however, the Assembly recognized its need "for authoritative legal guidance as to obligations of Member States under the Charter of the United Nations in the matter of financing the United Nations operations in the Congo and in the Middle East." The Court discounted the importance of this preamble. *Id.* at 157-58. But compare the separate opinion of Judge Fitzmaurice. *Id.* at 198.

101. U.N. GAOR 5th Comm., 16th Sess., 899th mtg. (Dec. 11, 1961), at 299; U.N. GAOR, 16th Sess., 1086th plen. mtg. (Dec. 20, 1961), at 1153-54. The resolution was numbered 1731 (XVI).

102. U.N. GAOR 5th Comm., 16th Sess., 897th mtg. (Dec. 8, 1961), at 290.

103. The Congo operation, especially after the initial period of its existence, was viewed by the Soviet Union as directed against its influence in the region.

104. *Id.* at 289; *id.*, 898th mtg. (Dec. 8, 1961), at 295; U.N. GAOR, 16th Sess., 1086th plen. mtg. (Dec. 20, 1961), at 1151-52. See also U.N. GAOR 5th Comm., 16th Sess., 897th mtg. (Dec. 8, 1961), at 290 (Rumanian argument).

The French attitude was no more encouraging. Despite the fact that France had, in the Working Group, endorsed the recommendation to consult the Court,<sup>105</sup> the French representative now argued quite forcefully against such a course of action. For several reasons, he thought the product of the consultation could only be, at best, inconclusive, and at worst, positively harmful. The judges would find no guidance in the *travaux préparatoires*. U.N. debates and practice revealed that contributions to peacekeeping expenditures had become, in the opinion of many member states, purely optional. In addition, the national composition of the Court was not very different from that of the Working Group, and, although independent, the judges rarely adopt views contrary to those taken by their respective governments. As a result, a number of dissenting opinions would probably be involved, thus weakening the value of any opinion. Recourse to the Court would probably aggravate the situation by rigidifying the attitudes of governments, and would also cause a year's delay in the initiation of the necessary financial reforms.<sup>106</sup>

The terms of the question posed were also strongly criticized, especially by France, which proceeded in Plenary to offer an amendment designed to broaden the scope of the request. In answering the question as framed, France contended, the Court could not "elucidate the question of the Assembly's own powers or lack of powers in financial matters"; nor could it consider such other provisions as Articles 10, 11, 12, 14, and 19, all of which were highly relevant to the problem confronting the Assembly.<sup>107</sup> Under the terms of the French amendment, the Court would have been asked to determine whether the resolutions authorizing the UNEF and ONUC expenditures were "decided on in conformity with the Charter," and, only in the event of an affirmative answer, the further question of whether the expenditures constituted "expenses of the Organization."<sup>108</sup>

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105. France had merely insisted that the Sixth Committee be consulted with respect to the drafting of the question. U.N. Doc. A/4971, para. 25 (1961).

106. U.N. GAOR 5th Comm., 16th Sess., 897th mtg. (Dec. 8, 1961), at 291.

107. *Id.*, 899th mtg. (Dec. 11, 1961), at 300. Criticism was also voiced by the representatives of Peru and Mexico, both of whom felt that the applicability of Chapter VII should have been included in the request. *See id.*, 897th mtg. (Dec. 8, 1961), at 291-92; *id.*, 899th mtg. (Dec. 11, 1961), at 300-01 (statement of China). The Peruvian, French and Mexican representatives also criticized the failure of the Fifth Committee to consult the Sixth Committee on the precise formulation of the question, in accordance with the procedure outlined in G.A. Res. 684 (VII) (Nov. 6, 1952) and incorporated in Annex II of the Assembly's Rules of Procedure. *Id.*, 897th mtg., at 289-92; 899th mtg., at 300-01. *Cf.* U.N. GAOR, 16th Sess., 1086th plen. mtg. (Dec. 20, 1961), at 1153 (U.S. response that consultation of the Sixth Committee was only optional).

108. As the Court later noted, the French amendment would have had the Court consider the validity only of the resolutions authorizing the expenditures, not of the basic resolutions establishing UNEF and ONUC. *Certain Expenses of the United Nations*, 1962 I.C.J. REP. 156.

The U.S. representative deemed criticism of the formulation of the request to be unfounded. "It was not the view of the sponsors," he said, "that the Court should confine itself to an examination of Article 17 of the Charter." Rather, "it should consider the Charter as a whole" and handle the question "exhaustively and in all its aspects."<sup>109</sup> The motives of the French representative in pressing his amendment in plenary were viewed with a jaundiced eye by the U.S. representative:

It is illuminating to observe that in the debates in the Fifth Committee the proponent of the amendment opposed the whole idea [of recourse to the Court]. The purpose of an amendment urged in these circumstances requires extraordinary reasons to justify its acceptance. . . .

This amendment, in accordance with French opposition to the very idea of seeking the Court's opinion, does not clarify the questions at issue. Rather, it would tend to confuse it. At an hour when the United Nations is exerting its utmost efforts in the Congo, such confusion and elaboration of what is essentially a simple issue would be legally and psychologically most unfortunate.<sup>110</sup>

American suspicions were understandable. Though ostensibly designed to expand the scope of judicial inquiry and enhance the effectiveness of the consultation,<sup>111</sup> the French amendment represented, more plausibly, a maneuver aimed at defeating the draft resolution altogether. Many states, fearful of the expanded role to be assigned to the Court in assessing the legality of General Assembly actions, could be expected to withdraw their original support of submission of the problem to the Court.<sup>112</sup>

As urged by the United States, the Assembly Plenary proceeded to defeat the French amendment<sup>113</sup> and to adopt the Fifth Committee's draft resolution

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109. U.N. GAOR, 16th Sess., 1086th plen. mtg. (Dec. 20, 1961), at 1153.

110. *Id.* For the statements of Canada, U.K. and El Salvador, see *id.* at 1152-54.

111. *Id.* at 1151, 1154 (French explanation).

112. Significantly, the Soviet representative supported the amendment, and, for its part, France manifested an unsympathetic attitude to the entire idea of consulting the Court in this case, with or without the amendment. *Id.* at 1151-52, 1154.

113. It was defeated by a vote of 47 to 5, with 38 abstentions. *Id.* at 1153. The implications of the rejection of the French amendment later proved to be an issue of considerable contention, both in the pleadings before the Court and among the members of the Court themselves. See, e.g., *Certain Expenses at United Nations*, 1962 I.C.J. Pleadings 167-70, 203-04 (written statements of the United States and the Netherlands). For the oral statements of the U.K., Norway, Australia, Ireland, and the United States, see *id.* at 336, 352, 384, 387-89, 416. See also *Certain Expenses of United Nations*, 1962 I.C.J. REP. 157; *id.* at 182ff., 216ff. (separate opinions of Judges Spender



to request the Court's opinion.<sup>114</sup> American satisfaction with the outcome notwithstanding, it must be said that neither the decision to involve the Court in this case nor the formulation of the question bore the marks of much forethought. As even the sponsors of the draft resolution recognized, the basic problem was, after all, the empty coffers of the organization. In what way, then, could a Court opinion contribute to a solution of this problem? Surely not by virtue of the "moral force" or "authoritativeness" of such an opinion. Experience with earlier judicial pronouncements such as those in the *Admission and Peace Treaties* cases must have proved to all—if such proof was necessary—how unamenable the Soviet Union was to that particular form of influence. Nor, for that matter, was it realistic to expect the other major defaulter, France, to bow willingly to a Court opinion.

Undoubtedly, it was the theoretical availability of the Article 19 sanction which was expected to "persuade" the defaulters to mend their ways.<sup>115</sup> But could the sanction realistically be used against a major power? And if it could not, but was merely to be held in reserve as a threat, was it, then, a credible threat? Moreover, if the matter eventually had to be settled by negotiations—if it was to be settled at all—why involve the Court in such a controversial issue and risk impairing the Court's prestige? If, indeed, these questions engaged the minds of U.S. decision-makers, there is no indication of this on the record.

Some members of the nonaligned bloc took a more realistic view of the matter. The Ceylonese representative, especially, voiced far-sighted objection:

The present *de facto* situation could be altered only through the co-operation of Member States and particularly of the great Powers. An affirmative answer by the Court would only tend to complicate a situation which was already sufficiently complex. Such an answer would be of little value if a great Power still refused to pay its share of the present peace-keeping operations, and he doubted that much advantage would be gained by depriving that Power of membership in the United Nations on the basis of the Court's opinion. Legality could be of little value if it could not ensure compliance. Therefore, a practical approach involving a recognition of both reality and legality appeared preferable.

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and Morelli).

114. The vote was 52 to 11, with 32 abstentions. Only the Soviet bloc and France voted in opposition, while a majority of the non-aligned Afro-Asian states were among the abstainers.

115. Although Article 19 had not been mentioned by the United States or any of the draft resolution's sponsors, it was alluded to by other states and formed an unstated major premise of the decision to seek the Court's advice. See U.N. GAOR 5th comm., 16th Sess., 899th mtg. (Dec. 11, 1961), at 299-300 (statement of Australia).

Co-operation could not be achieved through compulsion. . . . [T]he attempt to refer the present issue to the International Court was futile and negative.<sup>116</sup>

The futility of the exercise apart, it is perhaps puzzling that U.S. decision-makers were so dedicated to procuring judicial endorsement of an expansive view of the General Assembly's budgetary and other powers at the very time the composition of the Assembly was changing so drastically. The new General Assembly could, quite predictably, be galvanized more readily against U.S. than against Soviet interests. Would the United States in the future be so anxious to enforce, against itself, any and all expenses decreed by a majority of the Assembly? It was only in 1965, with the enunciation of the "Goldberg Reservation,"<sup>117</sup> that the United States began to operate on a revised premise. In the pre-request period and in the immediate aftermath of the opinion, such foresight appeared notably absent.<sup>118</sup>

### III. SOME ABORTIVE "COLD WAR" REQUESTS

#### A. *Soviet Exit Visas*

Nearly a year before the Assembly turned to the Court for advice on preliminary procedural questions related to human rights observance in Soviet

116. U.N. GAOR 5th Comm., 16th Sess., 898th mtg. (Dec. 8, 1961), at 296. *Cf. id.*, 897th mtg. (Dec. 8, 1961), at 289 (statement of India); *id.*, 899th mtg. (Dec. 11, 1961), at 301 (statements of Afghanistan and Indonesia).

117. On August 16, 1965, U.S. Ambassador Arthur Goldberg, in a statement which brought the "Article 19 crisis" to an end, also enunciated a new U.S. policy with regard to the withholding of contributions to the United Nations. Speaking in the U.N. Special Committee on Peacekeeping Operations, Goldberg stated:

[W]ithout prejudice to the position that article 19 is applicable, the United States recognizes, as it simply must, that the General Assembly is not prepared to apply article 19 in the present situation and that the consensus of the membership is that the Assembly should proceed normally. We will not seek to frustrate that consensus, since it is not in the world interest to have the work of the General Assembly immobilized in these troubled days. At the same time, we must make it crystal clear that if any member can insist on making an exception to the principle of collective financial responsibility with respect to certain activities of the organization, the United States reserves the same option to make exceptions if, in our view, strong and compelling reasons exist for doing so. There can be no double standard among the members of the organization.

U.N. Doc. A/AC.121/PV.15, at 8-10 (1965); U.N. Doc. A/5916/Add.1, in U.N. GAOR, 9th Sess., Annex 21, at 86 (1965).

118. See POMERANCE, *supra* note 5, at 351-52, 361-64.

satellite states, the Assembly's Sixth Committee considered and rejected a proposal to involve the Court in a substantive question bearing on the observance of human rights by the Soviet Union itself. In this instance, the U.S. attitude was ambivalent, with members of the American mission to the United Nations sharing the skepticism of several other key Western U.N. delegations regarding the utility of a judicial consultation. Other courses of action were thought to entail less risk and more potential propaganda benefits.

The complaint which formed the basis of the Assembly's 1948 discussions of Soviet violations of "fundamental human rights, traditional diplomatic practices and other principles of the Charter" was the special problem of the former Chilean Ambassador to the Soviet Union. His Russian daughter-in-law had been refused permission to leave the Soviet Union with her husband. By this action, Chile contended, the Soviets had violated both general human rights norms governing family unity and free emigration and particular norms governing "diplomatic practices traditionally consecrated by international law."<sup>119</sup> Chile expressed willingness to have its controversy with the Soviet Union adjudicated by the Permanent Court of Arbitration or the International Court of Justice, but its offer for joint reference to either body was rebuffed by the Soviet Union.<sup>120</sup> In these circumstances, the idea of getting the matter to the Court by the advisory route appeared to some—including the U.S. State Department—as a logical alternative approach.<sup>121</sup> In its recommendations to the U.S. Delegation to the United Nations, the State Department urged U.S. support for a resolution to solicit a Court opinion on the legality of the Soviet action in the matter of the Chilean Ambassador's daughter-in-law.

Although the Department's recommendations were formally approved by the Delegation, internal debate revealed considerable reservations about their wisdom. It was recognized at the outset that only the specific Chilean-Soviet controversy entailed any legal issue at all. "As to the general problem of the detention of the Soviet wives of citizens of various countries," though the Soviet practice was undesirable and inhuman and though it also directly affected U.S. citizens,<sup>122</sup> there was "no legal obligation on the part of the Soviet Union to permit these persons to leave."<sup>123</sup> But even the Chilean case was thought by some to have a tenuous legal basis. Ernest Gross, in particular, pointed out that while "there were well established rules of international law . . . regarding the

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119. Letter from H. Santa Cruz, Chilean U.N. Ambassador, to the Secretary-General (May 27, 1948), U.N. Doc. A/560 (1948); U.N. Doc. A/C.6/296 (1948).

120. See U.N. GAOR 6th Comm., 3rd Sess., 1st Part, 135th mtg. (Dec. 3, 1948), at 728; *id.*, 139th mtg. (Dec. 7, 1948), at 779.

121. See 1 FOREIGN RELATIONS OF THE U.S. 1948, at 294; Jessup, *supra* note 3, at 22.

122. The number of U.S. citizens affected by the refusal of exit visas for their Soviet wives was variously estimated at 1,000 (Sandifer's figure in 1 FOREIGN RELATIONS OF THE U.S. 1948, at 293) and 350 (U.N. GAOR 6th Comm., 3d Sess., 1st Part, 135th mtg. (Dec. 3, 1948), at 735.

123. 1 FOREIGN RELATIONS OF THE U.S. 1948, at 294.

status of the retinue of a diplomatic envoy," the "question of the status of the members of their families was still an open one."<sup>124</sup> He considered it "unfortunate" that the item had been referred to the Sixth (Legal) Committee, "since it meant that it would be discussed by lawyers who might miss the broad questions of human rights which were involved."<sup>125</sup> For other members of the Delegation, too, it was clearly the broader question that needed emphasizing. As noted by one member (Eleanor Roosevelt concurring), the agenda item "afforded the United States a beautiful propaganda opportunity."<sup>126</sup>

The privately voiced skepticism of Gross regarding the legal-judicial approach to the problem was later publicly re-echoed by several Western delegations in the Sixth Committee's discussions in early December 1948. An Australian-sponsored draft resolution to request a Court opinion on the legality of Soviet violation of traditional diplomatic practices<sup>127</sup> met with a notable lack of enthusiasm. For example, the United Kingdom Delegate, Mr. (later Judge) Fitzmaurice, stated unequivocally that the matter was not strictly a legal one; rather, it involved the issues of human rights, "normal diplomatic usage" and "simple international courtesy."<sup>128</sup> Moreover, he asserted, a Court opinion was unnecessary and would not contribute to a solution of the basic problem. If the disputed actions were deemed illegal, "the principals in the case would still be in the Soviet Union"; and if those actions were upheld on legal grounds, the Soviet authorities "would still be in the position of having violated fundamental human rights."<sup>129</sup> The French delegate, M. Chaumont, also thought that the "human aspect . . . should over-ride any legal consideration."<sup>130</sup>

124. *Id.* at 294-95.

125. *Id.* at 295.

126. *See id.* (Mr. Thorp's remarks).

127. U.N. Doc. A/C.6/316 (1948). The questions to be referred to the Court were:

1. To what degree do the privileges and immunities granted to the head of a foreign mission in accordance with diplomatic practices traditionally established by international law extend to his family and to his establishment?
2. In particular, is the action of a State in preventing one of its nationals, who is the wife of a member of a foreign diplomatic mission or of a member of his family or of his establishment, from leaving its territory with her husband, or in order to join her husband, a breach of international law?

128. U.N. GAOR 6th Comm., 3d Sess., 1st Part, 135th mtg. (Dec. 3, 1948), at 733; *id.*, 137th mtg. (Dec. 6, 1948), at 751-52 (1948). *See also id.*, 139th mtg. (Dec. 7, 1948), at 781 (1948); and U.K. amendment, U.N. Doc. A/C.6/311 (1948), to the original Chilean proposal, U.N. Doc. A/C.6/296 (1948). The U.K. wished to replace "international law" with the expression "international usage and courtesy." *See also infra* text at notes 131 & 136 for the terms of the adopted resolution.

129. U.N. GAOR 6th Comm., 3d Sess., 137th mtg. (Dec. 6, 1948), at 752.

130. *Id.* at 751 (1948). The French delegate conceded that "[t]he question whether the person concerned was protected by diplomatic immunity was still a doubtful one." *Id.* at 750. *See also id.*, 138th mtg. (Dec. 7, 1948), at 766 (comments of the Greek delegate).

Besides being futile, M. Dupuy of France added, the proposed judicial recourse would be positively harmful. By turning to the Court, the Assembly would show indecisiveness and would "weaken the significance" of the resolution that it had already adopted, in which Soviet behavior had been pronounced, *inter alia*, "contrary to courtesy, to diplomatic practice, and to the principle of reciprocity."<sup>131</sup> Even Canada, one of the few states which supported the judicial consultation, took pains to stress that it should not be a means of disposing of the question, and that regardless of the outcome, the Assembly was justified in objecting to the Soviet actions and demanding rectification.<sup>132</sup>

Ambassador Gross, the U.S. delegate, "deplored" the refusal of the Soviet Union to submit its dispute with Chile to the Permanent Court of Arbitration or the International Court of Justice.<sup>133</sup> Nevertheless, he concurred with the United Kingdom view that "it was not for the Committee to deal with the questions raised by the Australian draft resolution" since "the whole problem was one of fundamental human rights."<sup>134</sup> Most of the U.S. statement was indeed devoted to the human rights aspects of the question, and the substantive legal issue was barely addressed.<sup>135</sup>

In the vote, the United States supported the draft resolution in which the Assembly objected to, and recommended the withdrawal of, Soviet measures denying exit visas to Soviet wives of foreign citizens, in general, and the application of those measures to "members of foreign diplomatic missions, their families or retinue," in particular.<sup>136</sup> How the United States voted on the Australian proposal is not indicated by the record.<sup>137</sup>

## B. *The Aftermath of the Competence Case*

From the records of the State Department, it is clear that there was extensive consideration of the possibility of involving the Court once more in the admission

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131. *Id.*, 139th mtg. (Dec. 7, 1948), at 780. The resolution adopted was based on a French-Uruguayan amendment, U.N. Doc. A/C.6/319 (1948). See Report of the 6th Comm., U.N. Doc. A/787 (1948).

132. U.N. GAOR 6th Comm., 3d Sess., 1st Part, 138th mtg. (Dec. 7, 1948), at 759-60.

133. *Id.*, 135th mtg. (Dec. 3, 1948), at 738.

134. *Id.*, 137th mtg. (Dec. 6, 1948), at 757.

135. See *id.*, 135th mtg. (Dec. 3, 1948), at 735-39; *id.* at 738 (the lone brief reference to diplomatic privileges and immunities).

136. See *id.*, 139th mtg. (Dec. 7, 1948), at 777; *id.*, 197th plen. mtg. (Apr. 25, 1949), at 162-63.

137. The proposal was defeated in Committee by a vote of 9 for, 13 against, and 12 abstentions. *Id.*, 6th Comm., 139th mtg. (Dec. 7, 1948), at 781.

imbroglio in the years 1951-1953.<sup>138</sup> On several occasions, the State Department evinced an inclination to acquiesce, albeit reluctantly, in further recourse to the Court, since other solutions for breaking the impasse that various Latin-American states, at the instigation of Italy, actively pressed were perceived as far more injurious to U.S. interests. In particular, the United States feared that the other alternatives "could lead to a gradual whittling away of the veto power."<sup>139</sup> Nevertheless, the State Department was fairly consistent in expressing reservations about the utility of the judicial option. It also strove to ensure a more felicitous drafting (from its standpoint) of any question which might be sent to the Court. In those years, too, the United States continued to withstand growing pressures for a package deal on admissions—an idea which ran counter to the thrust of the Court's opinion in the *Admission* case and also raised domestic and international political difficulties for the United States.

The strong desire of Italy to be admitted to the United Nations was the principal driving force behind persistent multifarious Latin-American efforts to devise a method that would circumvent the Soviet veto on membership questions. Like the Latin-American states, the United States sympathized with Italy's aspirations. In the Tripartite Declaration of September 26, 1951, it had pledged (along with France and the United Kingdom) to "make every effort" to secure Italy's admission.<sup>140</sup> And clearly, the United States was not impervious to Italy's repeated raising of the specter of Communist gains in Italy should the democratic government's foreign policy goals be frustrated.<sup>141</sup> But unlike the Latin American states, the United States was unwilling to countenance Italy's idea of "stretching the Charter" in this case—even as the General Assembly had done when it adopted the Uniting for Peace Resolution, and as the Security Council had acted when it evaded the "double veto" procedure via presidential rulings. From the long-range perspective, the United States deemed such initiatives nefarious.

In several of the Latin American initiatives, there was a judicial component—suggestions for further requests for advisory opinions or for bypassing previous opinions. Moreover, at various junctures (and primarily in order to avoid more serious denouements), members of the U.S. Delegation to the United Nations themselves (and even Secretary of State Acheson on two separate occasions) raised the possibility of soliciting a Court pronouncement

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138. See 2 FOREIGN RELATIONS OF THE U.S. 1951, at 347-454 *passim* (discussing admission of Italy to the U.N.); 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 826-37, 855, 868, 872-95 *passim*, 919-69 *passim*, 1031, 1049-51.

139. *Id.* at 829-30.

140. Removal of Certain Restrictions from Italian Treaty Favored, DEP'T ST. BULL., Oct. 1951, at 570.

141. See, e.g., 2 FOREIGN RELATIONS OF THE U.S. 1951, at 391, 393, 449, 453; 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 854.

regarding the effect of specific Soviet vetoes on admissions. The most pertinent suggestions, and the American reactions to them, may be summarized briefly.

1) According to a plan presented in 1951 by Mr. Belaunde of Peru, applicants for admission would bring proof to the Security Council of their qualifications under Article 4. In the event of a veto threat, the Assembly would request an advisory opinion on the value of the proof offered; and a favorable opinion on the matter would bind the Security Council and render the matter no longer subject to veto.<sup>142</sup> This initiative was strongly opposed by the State Department, which noted, *inter alia*, that Soviet vetoes, even when improperly used, were not void; that a State was not required to explain its vote on admissions; and that, in any event, the Soviet Union could easily invoke alleged Charter grounds—including, for example, Italy's membership in NATO as proof of its non-peace-loving nature. Furthermore, the Court might well consider itself incompetent to give an opinion, since in the *Admission* case, it had stated that "no relevant political factor . . . connected with conditions of admission is excluded."<sup>143</sup> The United States itself objected to submitting to the Court "an issue . . . so predominantly political in character."<sup>144</sup> In any case, the United States firmly opposed the elimination of the veto from admissions procedures, and it was unwilling to sanction Charter-stretching exercises (including the extension of the power of presidential rulings in the Security Council) lest dangerous precedents be thereby created.<sup>145</sup>

2) In internal discussions and memoranda in 1951 during the sixth General Assembly session, the idea of asking for judicial advice was put forward by, among others, Secretary of State Acheson and some members of the U.S. Delegation to the United Nations.<sup>146</sup> As noted earlier, the chief purpose in making these suggestions was to forestall *démarches* deemed objectionable by the United States, such as direct General Assembly action despite a veto in the Security Council, or the adoption of a procedure permitting the Security Council President to rule on the effect of a permanent member's negative vote, thereby greatly extending the evasion of the "double veto."<sup>147</sup> Although

142. See 2 FOREIGN RELATIONS OF THE U.S. 1951 at 361, 370, 372 n.4.

143. *Admission of a State to the United Nations* (Charter, Art. 4), Advisory Opinion, 1948 I.C.J. REP. 63.

144. 2 FOREIGN RELATIONS OF THE U.S. 1951, at 353.

145. Similar arguments were to be repeated whenever the issue of further advisory opinions on the admission problem was raised. See *id.* at 352-53, 355, 361, 363, 380, 389, 395, 397, 403-04, 406, 412-15; 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 827.

146. 2 FOREIGN RELATIONS OF THE U.S. 1951, at 390-91, 395-96, 403-04, 407-11, 414-15.

147. As explained in a later Departmental memorandum:

A Presidential ruling of this nature would establish a far-reaching precedent that the President has a right to rule on the effect of a Member's vote. To permit the President to make such a ruling subject only to rule 30 of the Council's Rules of Procedure would mean that the legality and effect of a Member's vote would

it was recognized that if the Court entertained the request at all, it was unlikely to give the response desired by the Assembly majority, turning to the Court was variously justified as a tactic which would "buy time," and provide a better legal basis for any eventual Security Council action.<sup>148</sup> Moreover, "it was better to litigate and lose than to lose only in a political arena"; and "even a negative decision by the Court would not do any particular harm."<sup>149</sup>

The formulation of the request was the subject of a detailed memorandum of December 11, 1951, by James N. Hyde, Adviser to the U.S. Delegation.<sup>150</sup> In it he set forth the advantages and disadvantages of an abstractly formulated request, related *generally* to the veto on admissions, as opposed to a request confined to the vote on *Italy's* application for admission. In addition, he presented two alternative drafts of Security Council resolutions to request a Court opinion. State Department instructions on the matter came shortly thereafter from Secretary of State Acheson. After firmly rejecting any "deal" tying Italian membership to simultaneous admission of Soviet satellites, and after stating his opposition to General Assembly action without a Security Council recommendation, Acheson turned his attention to the judicial option:

If [the] Sov[iet]s sh[ou]ld veto [Italy's membership] solely on non-Charter grounds, [the] Dep[artmen]t [is] prepared to support ref[er]ral of the question to [the] ICJ to determine [the] effect [of the] Sov[iets'] negative vote. If [the] Sov[iet]s sh[ou]ld veto referring [the] question [to the] ICJ, [the] Dep[artmen]t believes [the] effects [of the] original Sov[iet] veto on Italy's admission sh[ou]ld be left undetermined, i.e., [the] Chairman sh[ou]ld make no ruling and call for no vote on this question. This will make it easier for [the] G[eneral] A[ssembly] later to ask [the] ICJ [for an] opinion [on] what [the] effect [of the] Sov[iet] veto in [the] S[ecurity] C[ouncil] is. This procedure at least offers some hope and will keep [the] issue alive for [the] time being.<sup>151</sup>

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be left in the hands of the President and four other Members. The dangers of abuse of such a procedure cannot be minimized. For instance, on such a precedent the Soviet Chairman might rule that the vote of the Chinese National representative is illegal and it might not be possible to get seven votes to override him.

3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 828. *Cf. id.* at 665 (Ambassador Lodge's objections to an earlier suggestion by Acheson that the Court be asked to clarify the question of the applicability of the veto to the issue of Chinese credentials).

148. Telegram from U.S. Ambassador Warren R. Austin to Secretary of State Dean Acheson, 2 FOREIGN RELATIONS OF THE U.S. 1951, at 404 (Dec. 6, 1951).

149. *See id.* at 391, 395-96 (statements of Mr. Fisher and Congressman Vorys of U.S. Delegation).

150. *Id.* at 407-09.

151. *Id.* at 410.



On that occasion, a vote was not taken in the Security Council, and the contingency plan was therefore not put into effect.<sup>152</sup> Soon, however, the United States was faced with a new Italian-Peruvian initiative to evade the Security Council veto by having the Assembly characterize specific vetoes as illegal. Mr. Hyde was prompted to write a new memorandum, again suggesting possible recourse to the Court:

Any decision that the Dep[artmen]t takes on going along with action solely by the G[eneral] A[ssembly] to admit a state to membership must necessarily be based on an analysis of how important the US regards the veto from the point of view of its security. . . .

[I]t is clear that the Court has never passed on the question of when a negative vote is and when it is not a veto, and that question was left open in the 1950 opinion. Assuming there is strong sentiment in the G[eneral] A[ssembly] for the Belaunde theory, or in the S[ecurity] C[ouncil] for having a majority decide that a Soviet negative vote is illegal, it would clearly be better to try first of all to get the opinion of the Court in support of our position. Then, although we would be admitting members without the affirmative vote of the USSR in the S[ecurity] C[ouncil], we would have the support not only of the Assembly but also of the Court.

The State Dep[artmen]t would be willing to adopt this course, if we are faced with it. . . . This would involve a request for an advisory opinion, preferably by the G[eneral] A[ssembly], the President of the S[ecurity] C[ouncil] making no ruling on the question of whether the vote on the Italian application does or does not constitute a recommendation.<sup>153</sup>

The need for such a step did not eventuate. However, the United States was soon called upon to react to the first formal proposal to solicit the Court's advice on the applicability of the veto to questions of admission.

3) The proposal, presented to the First Committee by five Central American states on January 24, 1952, would have had the Assembly request an advisory opinion on the following questions:

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152. See *id.* at 411; U.N. SCOR, 6th Yr., 568th-569th mtgs. (Dec. 18-19, 1951).

153. Memorandum of December 20, 1951, 2 FOREIGN RELATIONS OF THE U.S. 1951, at 414-15.

a. What are the rules or criteria to be followed in interpreting the result of votes in the Security Council on recommendations for the admission of new members?

b. Can the negative vote of one of the permanent members nullify a recommendation for admission which has obtained seven or more votes?<sup>154</sup>

A lengthy preamble referred, *inter alia*, to the fact that some Assembly delegations doubted that Article 27 procedure on "decisions" should be applied to Article 4, which spoke of "recommendations" by the Security Council and "decisions" by the General Assembly.

Before asking for State Department instructions, the U.S. Delegation canvassed the opinion of the Italian observer, Guidotti, who endorsed the idea at the time.<sup>155</sup> The Delegation also consulted with the British and Belgian delegates, Vallat and Nisot, concerning the drafting of the proposal. As reported by Eleanor Roosevelt, Acting Chair of the U.S. Delegation, a "tactical question" was involved: Was it "better [to] take [the] language of sponsors or improve [the] language at [the] risk [of] associating ourselves with responsibility for [a] possible unfavorable answer from [the] court?" M. Nisot suggested narrowing the question to refer to the effect of a veto only in admission cases in which seven members of the Council voted for a state's admission and a permanent member voted against, "while recognizing that the state fulfills [the] conditions required" by Article 4, paragraph 1.<sup>156</sup>

The response of Secretary of State Acheson, though halting, clearly tilted against the idea of a judicial solution.<sup>157</sup> "While not enthusiastic re[garding] referral to ICJ," he stated, the State Department was "willing [to] support referral if [the] Ital[ian]s desire and if there is general sentiment in favor." However, he strongly criticized the formulation of the request.

If [the] matter [is] to be referred to [the] ICJ, [the] Dep[artmen]t believes [the] question submitted sh[ou]ld be calculated to assure [that the] ICJ will consider [the] question and increase [the] likelihood [of a] desirable decision. . . . [The] Preamble confuses [the] issues, and at least [the] first question calls for [a] general

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154. U.N. Doc. A/C.1/708 (1952).

155. 2 FOREIGN RELATIONS OF THE U.S. 1951, at 445. Subsequently, the Italians had second thoughts, for fear that judicial recourse might act as a boomerang, leading to a firm pronouncement on the vetoability of applications for admission. *Id.* at 449.

156. *Id.* at 445-46.

157. Telegram from U.S. Secretary of State Dean Acheson to Representative Austin, *id.* at 447-48 (Jan. 27, 1952).

exposition on S[ecurity] C[ouncil] voting which is difficult and unfruitful to give, and which [the] ICJ may well refuse [to] undertake.

[The] Dep[artmen]t believes [that] if [the] question [is] submitted, it sh[ou]ld be along [the] lines of Nisot[']s proposal. . . . [The] Dep[artmen]t [is] prepared [to] accept [the] question as there drafted, although we have some difficulty with [the] word "recognizing". It is not clear whether an explicit statement that [the] applicant is qualified is contemplated, or whether recognition of qualification can be inferred indirectly, e.g., from Sov[iet] willingness [to] include Italy in [the] omnibus Res[olution].

The proposed exercise was clearly viewed as superfluous, at best:

[The] Dep[artmen]t has taken [the] position [that a] membership application is subject to veto. We are reluctant to go to [the] ICJ on [a] question the answer to which in our opinion is clear. However, if L[atin] A[merican] states and others insist, we w[ou]ld support [a] Res[olution] which submits two questions to [the] ICJ: (1) [the q]uestion contained in final Para[graph] of the L[atin] A[merican] proposal . . . and (2) Nisot[']s question.

Further distancing himself from the suggestion, Mr. Acheson instructed the U.S. Delegation not to "take [the] lead" regarding "this aspect [of] membership question" and not to "cosponsor without prior consultation" with the Department.<sup>158</sup>

The sponsors of the draft resolution were persuaded to have consideration of their proposal deferred until the next (seventh) Assembly session.<sup>159</sup> At that session, the U.S. Delegation informally discussed with several Latin American delegations the possibility of linking the proposed question on the veto to the Court's earlier opinion in the *Admission* case. As explained in a State Department position paper:

If a question were to be submitted to the Court, it should at least be calculated to increase the likelihood that the Court would consider the question and give a desirable decision. A question which linked the veto problem to the Court's 1948 opinion would seem to be the most logical alternative. For instance, the Court might be asked whether the Assembly can admit a state when a permanent member

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158. *Id.*

159. U.N. Doc. A/C.1/716 (1952).

of the Security Council has proposed and voted for a proposal that the Council recommend the admission of the State as one of a group of states to be admitted simultaneously and yet voted against a proposal in the Security Council for a separate recommendation on the admission of the State, which proposal received seven or more affirmative votes and no negative vote from any other permanent member.<sup>160</sup>

Instead of pursuing this suggestion, the sponsors abandoned the idea of seeking a Court opinion and substituted a resolution urging the Assembly to attempt to resolve the admission problem.<sup>161</sup> The Assembly decided, at its seventh session, to set up a special committee to study the admission question.<sup>162</sup>

4) Within the State Department, skepticism as to the advantage of judicial recourse continued to be expressed, both because the Court was unlikely to consider itself competent to deal with the issue and because if it did, it could not readily endorse the view desired by those seeking the Court's advice.<sup>163</sup> Nevertheless, on occasion, State Department officials deemed the judicial option to be the one which, of all the other solutions under discussion, was the "least objectionable from our own standpoint." These officials thought that "we might have to resort to it in an effort to provide some new approach to the problem."<sup>164</sup>

The more objectionable solutions quickly became apparent during the deliberations of the Special Committee on Membership, where three different Latin American proposals were under consideration.

(a) Argentina resurrected the first part of its thesis,<sup>165</sup> arguing that the Assembly might decide to admit a state even if the Security Council recommendation was "unfavorable."<sup>166</sup> Although the thesis had been rejected by the Court in the *Competence* opinion, Argentina argued that the opinion was not binding and that the document of the *travaux préparatoires* upon which Argentina relied had not been dealt with by the Court.

160. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 952.

161. U.N. GAOR Ad Hoc Political Comm., 7th Sess., 42nd mtg. (Dec. 12, 1952), at 255. The new proposal was sponsored by four of the five co-sponsors of the earlier draft resolution to request the Court's opinion.

162. G.A. Res. 620A (VII) (Dec. 21, 1952). The study group idea accorded with the wishes of the U.S. Delegation, which sought a way of avoiding Assembly endorsement of either a Soviet package deal proposal or the Belaunde (Peru) plan. Acceptance of the latter would have allowed the Assembly to declare that certain applicants for membership had, in fact, received favorable recommendations from the Security Council. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 893-94. See also *infra* text accompanying note 168.

163. See, e.g., *id.* at 828, 833-34, 836, 868, 920, 947, 952-53.

164. *Id.* at 836.

165. See *supra* notes 18-22 and accompanying text.

166. U.N. Doc. A/AC.61/L.36 (1952).

(b) A Salvadoran or Central American proposal would have deemed questions of admission to be procedural in nature, thus making the veto inapplicable and enabling the Assembly to proceed to admit certain applicants.<sup>167</sup>

(c) A Peruvian proposal would have allowed the Assembly to determine that certain vetoes of applications for membership were illegitimate because they were contrary to the *Admission* opinion. The sponsor of the proposal, Mr. Belaunde, also implied that a "favorable" Security Council recommendation for admission might be deduced from multiple votes in the Council (e.g., a vote on another occasion for admission of an applicant as part of a package deal).<sup>168</sup>

In an internal legal memorandum, Mr. Leonard Meeker, Assistant Legal Adviser for U.N. Affairs, spelled out, in great detail, U.S. objections to each of these proposals.<sup>169</sup> The Argentine proposal had been rejected by the Court's 1950 opinion which, though not technically binding, could not be lightly ignored; nor, in the U.S. view, did the Argentine thesis accord with a proper interpretation of the legislative history of Article 4.<sup>170</sup> With respect to the Salvadoran proposal, it was not supported by the *travaux préparatoires*, despite their ambiguity; subsequent practice, including that of the General Assembly, contradicted it; and the Assembly was not free to interpret Article 27 in a manner "entirely repugnant to the interpretation which has consistently been given to that Article by the Council itself."<sup>171</sup> Finally, the Peruvian plan, which was certainly "ingenious," ran "counter to the usual practices of parliamentary bodies."<sup>172</sup> In sum, the State Department concluded: "none of the Latin-American 'juridical' plans for breaking the membership impasse rests on a good legal foundation."<sup>173</sup>

The U.S. representative on the Special Committee on Membership, therefore, was instructed to vote against all the Latin American initiatives, while expressing the "strong sympathy" of the United States with the motives of the sponsors.<sup>174</sup> On the judicial option, he was to adopt a passive and skeptical stance:

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167. U.N. Doc A/AC.61/L.31 (1952).

168. U.N. Doc. A/AC.61/L.30 (1952).

169. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 923-38.

170. *Id.* at 924-31. The United States had devoted a considerable part of its pleadings in the *Competence* case to a discussion of the *travaux préparatoires*. *Id.* at 924 (citing *Competence of the General Assembly For the Admission of a State to the United Nations*, 1950 I.C.J. Pleadings 110-22). But the Court did not find it necessary to deal with the legislative history of the provision in question, and based its conclusions on the "natural and ordinary meaning of the words in question" and on the structure of the Charter. 1950 I.C.J. REP. 7-10.

171. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 931-36.

172. *Id.* at 937-38.

173. *Id.* at 938.

174. *Id.* at 947.

If the Latin American countries wish to discuss the possibility of an advisory opinion from the International Court of Justice on the veto, a request for such an opinion should preferably be so framed as to link the question of the effect of a negative vote of a permanent member to the Court's opinion of 1948. However, the United States should not take the initiative in proposing this alternative or express optimism as to the results of recourse to the Court.<sup>175</sup>

None of the substantive proposals were endorsed, and the Court was not again embroiled in the controversy. Its previous 1948 pronouncement, however, seemed to present an obstacle to the emerging political solution to the impasse.

5) At the same time that Italy was urging innovative interpretations of the Charter, it also was attempting to persuade the United States to remove its firm opposition to Soviet proposals for a package deal, since such proposals seemed to offer the best, and perhaps only, hope for early Italian admission. Despite these pressures, the United States appeared to hold the line firmly against "omnibus resolutions" until mid-1952, insisting instead that each candidate be considered on its merits.<sup>176</sup>

Fidelity to the Charter and the spirit of the Court's opinion in the *Admission* case featured only tangentially in the reasons proffered by the United States for its adamant stand against compromise.<sup>177</sup> More important considerations were: (1) the difficulty of selling to the American public a departure from the traditional U.S. posture against package deals and against the admission of Soviet satellites (especially Hungary);<sup>178</sup> (2) the "serious effect in Korea" of admitting the "shadowy 'state'" of the Mongolian People's Republic while excluding South Korea, which was then "fighting together with [the] UN [to] repel aggression against it";<sup>179</sup> and (3) the fear that with the Soviet satellites inside, the United States would be deprived of "future bargaining power re[garding] Japan and others we favor."<sup>180</sup> Nor was the

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175. *Id.* at 947; *see also id.* at 952.

176. 2 FOREIGN RELATIONS OF THE U.S. 1951, at 351-52, 389, 410, 413-14, 417-19, 423, 431-32, 452-54.

177. For passing references, *see, e.g., id.* at 351, 414.

178. *See, especially, id.* at 431, 453. Apart from the still simmering dispute over human rights observance in Hungary, the American public was incensed over a recent aerial incident in which U.S. aviators had been detained by that state.

179. *Id.* at 431.

180. *Id.; see also id.* at 453. Later, in an internal State Department Memorandum of May 13, 1954, U.S. objections to package deals were linked "principally" to the Chinese representation issue. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 1004. "Our agreement to admit Soviet-sponsored applicants despite their conduct," it was explained, "would make it harder

United States persuaded by Italy that engaging in "benevolent abstention" on an omnibus resolution in the Security Council—on the assumption that only the Western candidates would proceed to muster the requisite two-thirds majority in the Assembly—would be a riskless endeavor. Given the strong sentiment for universality in the General Assembly, it was likely that some or all of the Soviet candidates would be admitted sooner or later.<sup>181</sup> Nevertheless, the United States agreed that if the Soviet omnibus resolution obtained seven votes in the Security Council, the United States would abstain rather than cast a veto.<sup>182</sup> However, since only six votes were cast in favor, the United States voted against and proceeded to attempt to assuage Italy's keen disappointment.<sup>183</sup>

By mid-1952, the State Department was clearly veering toward an abandonment of its previous policy on package deals—mainly in order to insure Italian and Japanese admission. It began concentrating on the new task of mobilizing the public opinion necessary to support this change in direction.<sup>184</sup> The ultimate result was the package deal of December 1955, which included Italy and the European satellites.<sup>185</sup> The words of Judge Krylov in his dissenting opinion in the 1948 *Admission* case proved to be prophetic:

In the present case, it may be asked whether the political organs of the United Nations, acting under conditions which cannot even be foreseen at the present time, might not one day depart from the precepts of the Court's opinion.<sup>186</sup>

In sum, it may be said that following the *Competence* opinion, State Department thinking on the role of judicial pronouncements as an aid in breaking the continuing admission deadlock was fairly realistic. With the veto and double veto under steady assault, especially by the Latin American states, the United States sometimes retreated briefly to contemplate the judicial option as a diversionary tactic. Even a "negative decision" by the Court—negative, presumably, from the standpoint of the Assembly majority rather than, necessarily, the United States—could do no harm and might even be

for us to keep out the Chinese Communists." *Id.*

181. See 2 FOREIGN RELATIONS OF THE U.S. 1951, at 389, 417-19, 423.

182. *Id.* at 431.

183. *Id.* at 452-54. For the proceedings of the Security Council, see U.N. SCOR, 7th Yr., 573rd mtg. (Feb. 6, 1952), at 3-39.

184. 3 FOREIGN RELATIONS OF THE U.S. 1952-1954, at 836-37, 918-23. *But see id.* at 1004 (cited *supra* note 180), regarding State Department objections to package deals.

185. G.A. Res. 995 (X) (Dec. 14, 1955). Japan was admitted a year later, and Mongolia only in 1961.

186. 1948 I.C.J. REP. 109.

advantageous and "buy time."<sup>187</sup> Ultimately, the time was used neither for more judicial recourse nor for operating within the perimeters set by previous judicial pronouncements, but for devising the requisite political compromises.

### C. *The Cuban Question*

During the 1962 Security Council debates on the Cuban question, observers were treated to an unusual spectacle, a harbinger of trends which would become more manifest over two decades later. The Soviet Union and its Latin American protégé, Cuba, assumed the mantle of proponents of greater recourse to the Court and successfully maneuvered the United States and its allies into the uncomfortable defensive position of spurning a U.N. member's urgent plea for judicial clarification of its grievances.

Cuba's grievances stemmed from the series of resolutions adopted by the Organization of American States ("OAS") at its 1962 Punta del Este meeting, resolutions which, *inter alia*, excluded Cuba from participation in the inter-American system, and suspended certain categories of trade with Cuba.<sup>188</sup> Thwarted, at first, in its attempt to get the matter inscribed in the Security Council agenda,<sup>189</sup> Cuba changed its tactics, imparting to its complaint a legal aspect.

The OAS measures, Cuba maintained, constituted illegal "enforcement action," since they had not been authorized by the Security Council, as required by Article 53 of the U.N. Charter. Furthermore, Article 52 obligated regional organizations to observe the "Purposes and Principles of the United Nations;" and according to Cuba, expulsion of a state on the basis of its social system conflicted with such central Charter principles as self-determination, non-intervention, and the tenet of universality embodied in Article 4. In addition, the OAS, it was charged, had acted contrary to its own Charter and to the Rio Treaty. Cuba translated its arguments into a draft resolution containing seven, decidedly loaded questions and requested that the Security Council convene for the purpose of referring these "specific legal questions" to the Court for an advisory opinion.<sup>190</sup> The Court would be urged to give the

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187. 2 FOREIGN RELATIONS OF THE U.S. 1951, at 395-96, 404.

188. See U.N. Doc. S/5075 (1962).

189. U.N. SCOR, 17th Yr., 991st mtg. (Feb. 27, 1962).

190. For the Cuban proposal, see U.N. Docs. S/5086 & S/5095 (1962). See also, for Cuba's elaboration of its case, U.N. SCOR, 17th Yr., 992nd mtg. (Mar. 14, 1962); *id.*, 994th mtg. (Mar. 16, 1962), at 1-5; *id.*, 997th mtg. (Mar. 22, 1962), at 7-16.

Questions 3 and 7 of the Cuban draft resolution were the most important. Question 3 asked:

Can the expression 'enforcement action' in Article 53 of the United Nations Charter



matter priority; and pending receipt of the opinion, the Security Council would adopt a "provisional measure" under Article 40 calling on the OAS to suspend its anti-Cuban resolutions.

For Cuba and its Soviet patron, the new tactic appeared to entail several benefits. Ideally, the Cuban proposal, if adopted, would grant Cuba a welcome temporary reprieve from the harsh OAS measures. At a minimum, the Security Council would be induced to at least *discuss* the Cuban complaints—since it could hardly deny a state a hearing on a "legal" request of this nature. Beyond that, the United States and the West would be compelled to concede, implicitly, that they feared an advisory opinion and perhaps doubted the legality of the OAS actions.

Cuba succeeded in obtaining the desired Security Council platform and proceeded to deliver the opening salvo in the long propaganda battle that ensued.<sup>191</sup> Interspersed with arguments on the legal issues were charges that the United States was planning renewed armed intervention against Cuba. The legal questions which Cuba wished to have referred to the Court were "very important for Cuba and for the independence of all Member States which want to defend their sovereignty through the rule of international law but which, should international law not provide them with sufficient protection, would . . . defend their independence and international legal principles, if necessary with the blood of their own sons."<sup>192</sup> "What organ of greater authority than the Court," the Cuban representative asked, "could be requested to give this verdict" regarding the legal issues raised?<sup>193</sup> "What argument can be used against requesting such an opinion, if not a lack of faith in the legality of the Punta del Este agreements?"<sup>194</sup> If an opinion "is prevented by the use of a mechanical majority in the Council," he asserted, "this will be solely because of a desire to prevent the verdict of the International Court of Justice

be considered to include the measures provided for in Article 41 of the United Nations Charter? Is the list of these measures in Article 41 exhaustive?

And the final question was:

In the light of the replies to the foregoing questions are, or are not, the resolutions adopted at Punta del Este . . . relating to the expulsion of a State member of the regional agency because of its social system and the taking of other enforcement action against it, without the authorization of the Security Council, consistent with the provisions of the United Nations Charter, the Charter of the Organization of American States and the Treaty of Rio?

191. The matter was discussed at Security Council meetings 992-998, March 14-23, 1962. This was the only instance in which the Security Council was specially convened for the purpose of deciding whether to request an advisory opinion. Normally, proposals for requesting opinions arise in connection with issues already under discussion.

192. U.N. SCOR, 17th Yr., 992nd mtg. (Mar. 14, 1962), at 26.

193. *Id.* at 28.

194. *Id.* at 26.

going against the unlawful activities of the regional agency."<sup>195</sup> "We, who know that international law is on our side," he continued, "do not fear decisions of the International Court."<sup>196</sup>

Mr. Morozov, the Soviet representative, repeated and supplemented the Cuban arguments.<sup>197</sup> The Court, he said, was considered by "most members of our Organization—though not, apparently, by the United States— . . . competent to give an impartial and objective reply on the legal points . . . ."<sup>198</sup> Such "an objective answer . . . will . . . make it impossible for the United States . . . and a number of other States which follow it, to continue to use the smoke-screen behind which they are now making political, economic and military preparations for a new attack on Cuba."<sup>199</sup> In the meantime, the Security Council had "a right and a duty to suspend implementation" of the Punta del Este resolutions.<sup>200</sup> But the period involved need not be long. "Unless some improper pressure is put on the Court, its opinion can and must be forthcoming in the shortest possible time."<sup>201</sup>

The United States was not alone in perceiving the Soviet-Cuban initiative as a thinly veiled attempt to render the OAS and other regional organizations impotent by subjecting them to the Soviet veto. There was no justification, U.S. representative Adlai Stevenson urged, for falling into the new trap, just because of its present "legal" disguise. The proposal remained "political," and the motives of its sponsors, clearly suspect and dangerous.

The representative of Cuba, has, regrettably, not presented his request for a judicial opinion in a very judicial manner. Rather, by the tone and substance of his speech . . . , it is clear that he is again arguing about a political dispute. . . . This time, the attack is against the Organization of American States. But it is clearly aimed at all regional organizations: it is an attempt to subject the activities of all regional organizations to the Soviet veto in the Security Council. . . . The Cuban letter is camouflaged with legalisms, but the issues it raises are 100 per cent political.<sup>202</sup>

The United States Government has repeatedly made clear that it favours increased recourse to the International Court of Justice. But it does not favour use of the Court for cold war political

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195. *Id.* at 28.

196. *Id.* at 26.

197. *Id.*, 993rd mtg. (Mar. 15, 1962), at 2-13.

198. *Id.* at 9.

199. *Id.* at 8.

200. *Id.* at 12.

201. *Id.* at 13.

202. *Id.* at 14.

purposes foreign to the Charter and the Statute of the Court. It is significant, in this connexion, that the Soviet representative, whose Government is consistently hostile to the use of the Court for the settlement of genuine legal disputes between States, and has deprecated the Court's advisory jurisdiction, should so enthusiastically favour submission to the Court of the rhetorical and self-serving questions which have been conjured up by the Cuban representative.<sup>203</sup>

[T]he Cuban complaint is politically, and not legally, motivated. The International Court of Justice should not be brought into the cold war or into the jungle of Communist propaganda.<sup>204</sup>

Apart from its political taint, the Cuban request should also "be dismissed for lack of substantiality, Stevenson argued."<sup>205</sup> The measures complained of were undoubtedly within the exclusive jurisdiction of the OAS. Clearly, a regional agency had the exclusive right to determine its own membership. Moreover, the economic measures adopted were not in the nature of "enforcement measures"—that term (as the Council had already determined in connection with the Dominican Republic question<sup>206</sup>) being reserved for action solely within the Security Council's competence (i.e., the use of force). It therefore was entirely "pointless" to refer to the Court decisions which were so noncontroversial.<sup>207</sup>

In response to the foregoing objections, the Cuban and Soviet representatives in effect raided the arsenal from which the United States and the Western states had traditionally drawn their arguments in favor of greater recourse to the Court's advisory function. Thus, Mr. Morozov, in the best

203. *Id.* at 24.

204. *Id.*, 994th mtg. (Mar. 16, 1962), at 7. For other arguments emphasizing the political nature of the Cuban request, see the statements of the United Kingdom, *id.*, 995th mtg. (Mar. 20, 1962), at 2-4; of France, *id.* at 10-12; and of Ireland, *id.*, 996th mtg. (Mar. 21, 1962), at 12-13. See also the Irish argument against "unwarrantably invading the autonomy which the Organization of American States is justifiably entitled to enjoy," *id.* at 11-12; and the comments of Chile, *id.*, 994th mtg. (Mar. 16, 1962), at 14-15.

205. *Id.*, 993rd mtg. (Mar. 15, 1962), at 24.

206. See *id.*, 15th Yr., 893rd-895th mtgs. (Sept. 8-9, 1960). *But cf.* Inis L. Claude, Jr., *The OAS, the UN, and the United States*, INT'L CONCILIATION, Mar. 1964, No. 547, at 48-53. (to the effect that the "Dominican precedent" was by no means as unequivocal as it was later construed to be).

207. U.N. SCOR, 17th Yr., 993rd mtg. (Mar. 15, 1962), at 15-24. See also the statements of the United Kingdom, *id.*, 995th mtg. (Mar. 20, 1962), at 4-6; China, *id.* at 6-9; Ireland, *id.*, 996th mtg. (Mar. 21, 1962), at 12-13; and Venezuela, *id.*, 997th mtg. (Mar. 22, 1962), at 1-7.

Western tradition, declared:

[I]f we were to agree at any juncture with the position of denying the importance of the principles of international law for the solution of political problems in the Security Council—which is the logical result of the stand taken by the United States representative and certain others in the Council—we would be denying that legal problems were of any significance in decisions on political questions in the Security Council. But we cannot break this organic link. It would be tantamount to admitting that anarchy, chaos and arbitrary action reigned in the United Nations.<sup>208</sup>

And the Cuban representative pleaded, in like vein:

In such a serious question as the scope of the Articles of the Charter that relate to the competence of this Council and are linked to such extraordinary measures as the expulsion of a Member State from a regional organization and the imposition of coercive measures on that State without the authorization of this Council, surely the least that can be granted is the right of that Member State, and of the international juridical community, to a clear and final ruling, made by those who are qualified and have the knowledge and mission to do so, on whether or not the international norm has been complied with? How can the effectiveness of treaties in so important and serious a matter be guaranteed?<sup>209</sup>

Addressing himself at great length to the "political question" objection, the Cuban representative launched a vigorous counter-attack. First, he argued, the Court itself should be allowed to rule on the "judicial" nature of the questions.<sup>210</sup> Second, acceptance of the argument that the Cuban questions were political "would render Article 96 of the . . . Charter virtually inoperative: a State concerned in a case would only have to assert that political questions were involved for the . . . Court . . . to be precluded from giving an opinion." In the present case, Cuba's legal questions were "being withheld from the Court by politicians, using political arguments, on the pretext that such questions have a concealed political purpose." In any event, however, the motivation behind the request was irrelevant.

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208. *Id.*, 998th mtg. (Mar. 23, 1962), at 8.

209. *Id.*, 994th mtg. (Mar. 16, 1962), at 4-5.

210. *Id.* at 4.

We seem to have heard some member of the Council object to the questions we raised on the ground that they are not 'purely legal' and are not prompted by a desire for 'legal knowledge,' as if the reasons motivating a State in requesting an advisory opinion also had to be legal and as if the International Court of Justice, that modern academy of international law, existed solely to dispel the scientific doubts of those who bring before it legal questions which are 'chemically pure'; as if every one of us, every time we came to this Council or engaged in any activity in this house, were not doing so in response to political necessity. If the questions put to the Court are framed in legal terms, objectively legal terms, that should be sufficient, and we should refrain from any consideration of their motivation.<sup>211</sup>

The true reason for opposition to the Cuban proposals, the Cuban representative repeatedly emphasized, was fear of an adverse verdict:

If the United States representative is so sure of the rightness of his position, why is he against requesting the . . . Court . . . for an opinion? And if not . . . of what value is his statement that his Government favours increased recourse to the Court?<sup>212</sup>

[W]hy should we not let the Court answer the legal issues we raise? Is it because we have doubts about the Court? Or do we not want an advisory opinion because the legal arguments are on the side of a small Member State in the war which another powerful Member State has launched against it?<sup>213</sup>

Clearly, Cuba was playing its propaganda advantage to the hilt.

Outside of the Soviet bloc, the Cuban proposal found its only real support in Ghana.<sup>214</sup> The Ghanaian representative conceded that some of the Cuban questions were either "political" or not relevant to the main juridical issue involved. The key issue, as far as he was concerned, was whether the Punta

211. *Id.*, 997th mtg. (Mar. 22, 1962), at 12.

212. *Id.*, 994th mtg. (Mar. 16, 1962), at 2.

213. *Id.*, 997th mtg. (Mar. 22, 1962), at 12.

214. The U.A.R., which might normally have been expected to lend more enthusiastic support to the Cuban proposal, was apparently caught up in a dilemma because of the implications of the Cuban request for regional organizations generally, including, therefore, the Arab League. Particularly objectionable to the U.A.R. was the Cuban theory that the regional agency should be a "microcosm" of the United Nations without the right to exclude members at will. *Id.*, 996th mtg. (Mar. 21, 1962), at 7-9. The U.A.R. voted for referring question 3 of the Cuban request to the Court, but it abstained on the other questions.

del Este resolutions did, in fact, constitute "enforcement action" within the meaning of Article 53 of the U.N. Charter (question 3 of the Cuban proposal). On this point, doctrine was divided, and, despite the so-called "Dominican precedent," reasonable doubt remained among Council members. The existence of these doubts constituted the strongest argument in favor of the Cuban request.

For, if juridical proprieties were to be abandoned in the formulation and execution of such important political decisions as those complained of, the very principles of international law and the basis of the Charter would be undermined; and those who would suffer most from such a development would be the small, weak States whose only recourse is the rule of international law.<sup>215</sup>

The Ghanaian representative therefore appealed to the Security Council to grant the request which Cuba, "as an aggrieved party," had presented. Although "bedeviled with political arguments," that request was—at least insofar as the interpretation of "enforcement action" was concerned—a "specific legal request" which merited the Council's endorsement.<sup>216</sup>

On Ghana's motion, and with Cuban consent, a separate vote was taken on question 3.<sup>217</sup> That paragraph was defeated by a vote of 7 to 4.<sup>218</sup> The remainder of the Cuban draft was defeated by an even wider margin.<sup>219</sup>

Whether or not Cuba and the Soviet Union reaped the expected propaganda dividend from the exercise in the Security Council, the United States and its allies were clearly placed in an embarrassing position. They now were denying to a Soviet bloc member what they had, on other occasions, standardly asserted to be a state's prerogative—namely, to have a judicial, and not merely a political, forum determine its rights. At least implicitly, they were conceding that they feared an adverse verdict—which, indeed, they did. They clearly were anxious to avoid judicial interpretation of Article 53 of the Charter. After all, it was precisely because of the Cold War that this provision had been evaded, even with respect to the use of armed force. The West had succeeded in having its interpretation prevail in the Security Council, but, as noted by Inis Claude, there could be "no assurance that the Court would similarly place general

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215. *Id.* at 18.

216. *Id.* at 19. For the entire Ghanaian argument, *see id.* at 13-19.

217. *Id.*, 998th mtg. (Mar. 23, 1962), at 16-17, 21.

218. *Id.* at 21. Voting in favor were Ghana, Rumania, the Soviet Union, and the U.A.R. *Id.*

219. The vote was 2 for, 7 against, with 1 abstention. The U.A.R. abstained, and Ghana did not participate in the vote. After the vote on question 3, the Soviet and Cuban representatives, for obvious reasons, did not wish to have the remainder of the proposal voted on. The President's ruling to put the rest of the draft to a vote was upheld by a vote of 7 to 2, with 2 abstentions (the U.A.R. and Ghana).

political considerations above textual analysis of the Charter."<sup>220</sup> Neither the United States nor any of its allies was prepared to allow the Soviet Union and Cuba to refoist upon the Western regional organizations the shackles of the veto from which they had effectively extricated themselves.

With the changing composition of the U.N. and the Court, U.S. distrust of the Court and, correspondingly, the confidence of the Soviet and Third World states, were to grow. What Cuba failed to do in 1962, Nicaragua succeeded in accomplishing in 1984-86. It obtained (amid loud U.S. protests) judicial clarification of a dispute between a Soviet-aligned Latin American state and the colossus of the North. Thus, the reversal of roles, adumbrated in 1962, became complete.

#### IV. CONCLUSIONS

In the early years of the Cold War, when the United Nations and the Court were arenas hospitable to U.S. interests, the solicitation of judicial assistance in East-West controversies appeared, on occasion, a tempting prospect. Like the Uniting for Peace Resolution, recourse to the Court's advisory function offered a way of overcoming Soviet "obstructionism," obtaining some action, or at least the appearance of action, and scoring propagandist points.

Contrary to widely held assumptions, the record reveals no consistent U.S. inclination to exploit the Court maximally and indiscriminately for these purposes. Most often, U.S. policymakers were guided by pragmatic calculations of costs and benefits, rather than a crusading spirit or reflexive, knee-jerk reactions. Thus, in determining their attitude regarding reference to the Court and the terms of that reference, they took into account such matters as: the potential exposure of the United States itself to direct Assembly investigation of human rights issues in the future (in the *Peace Treaties* case); the negative implications for long-term U.S. interests of weakening the veto power in the Security Council (in the *Competence* case and its aftermath); the undesirability of having a judicial straitjacket placed around General Assembly efforts to develop the emergent international law of human rights (in the *Peace Treaties* case); the possibility that an alternative procedure would yield a better propagandist dividend (as in the matter of exit visas for Soviet wives); and the need to avoid, at all costs, the risk of introducing a Soviet veto over the activities of regional organizations (in the Cuban case).

The pragmatic approach was not, however, much in evidence in relation to the *Expenses* request. Short-term pique and anti-Soviet fervor prevailed over long-term interest. The possible boomerang effect of securing the desired

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220. Claude, *supra* note 206, at 59.

Court opinion was not appreciated until several years later. By announcing the "Goldberg Reservation" in 1965,<sup>221</sup> the United States was implicitly conceding that its influence in the General Assembly was waning and might, indeed, be more greatly curtailed in the years to come. From the other side of the Iron Curtain, the Soviet Union, by backing the Cuban appeal for an advisory opinion three years earlier, was evincing a corresponding awareness that in the evolving U.N. system, the Court should no longer be seen as a hostile forum.

Clearly, the demise of the Cold War has not transformed the U.N. organs—including the Court—into fora either instinctively friendly or reflexively hostile to U.S. interests. Nor, even today, is a judicial solution to international problems automatically to be preferred in all instances. "Litigation," as Shabtai Rosenne aptly observed, "is but a phase in the unfolding of a political drama."<sup>222</sup> The likely effects of litigation (whether contentious or advisory) on the immediate problem at hand, the longer-term political interests at stake, the emergence of international norms, and the stature of the International Court—are still important in any realistic cost-benefit assessment. In this respect, the generally pragmatic American approach to judicial consultations, which underlay the U.S.-ICJ nexus during the Cold War, remains relevant today.

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221. *See supra* note 117.

222. ROSENNE, *supra* note 2, at 2.



# THE EMERGENCE OF UNITED STATES MUTUAL FUNDS IN DOMESTIC COMMERCIAL BANKS AND JAPAN

*Nicholas Panos\**

## I. INTRODUCTION

The United States' and Japan's mutual fund industry experienced incomparable growth during the last decade. While the much heralded industry continues to evolve in both countries, their markets now attract new competition. The new entrants into these respective markets are of different complexion. In the United States, commercial banks are the most discussed newcomers to the mutual fund industry. A series of administrative changes served as the catalyst for the entry of commercial banks into the domestic mutual fund industry. In Japan, somewhat like in the United States, a combination of administrative and legislative change will serve as the impetus for intensified competition in the investment trust, Japan's version of the mutual fund, industry. Unlike the United States, commercial bank competition in the Japanese investment trust industry is only a secondary development. In Japan, the gradual opening of markets to foreign competition headlines the investment trust management business.

The American mutual fund business enjoyed a euphoric year in 1993. Powered by low interest rates, total mutual fund assets increased to record levels while every fund-objective category showed gains.<sup>1</sup> Mutual funds that

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*Acknowledgements:* The author wishes to emphatically thank J. Robert Brown, Jr., for his encouragement, ideas, and time he took in editing this article. Additionally, the author is grateful for Professor Brown's ongoing fiscal support in the research of this paper. In researching the paper, S. Ariizumi at the Ministry of Finance was more than cordial and extremely helpful in supplying research at his own expense. Mr. Hiroshi Ozaki of the Japanese Embassy in Washington, D.C., was especially diligent in helping obtain research in a short period of time at his own expense, as was expert George Curuby of Curuby and Company. Without Angela Goelzer of the Investment Company Institute, contact with these individuals would not have been possible. Ms. Goelzer was also instrumental by helping establish contact with Treasury Department representatives. The collective effort of these individuals, who took time away from their daily rigors to help a struggling student, made researching this article a highly educational and personally rewarding experience. The author is sincerely grateful for the time and expense each incurred in helping his efforts.

1. Tom Siedell, *Which Mutual Funds to Buy Now*, YOUR MONEY, June 1994, at 38, 38.

have invested in Japanese stocks have also done well, returning over seventeen percent in the first quarter of 1994,<sup>2</sup> and finishing at 15.4% for the year.<sup>3</sup> New sales of domestic stock mutual funds hit a record \$128 billion in 1993.<sup>4</sup> Since 1980, assets in mutual funds have grown nearly twentyfold, to some \$1.8 trillion.<sup>5</sup> As of September 1993, the U.S. mutual fund market was the largest in the world, boasting 350 mutual fund management companies which controlled nearly \$2 trillion in assets.<sup>6</sup> The result: twenty-eight percent of all U.S. households today have mutual fund holdings, compared with six percent in 1980.<sup>7</sup> As a function of the depth and pace of this growth, domestic mutual fund assets exceeded commercial bank deposits in 1994.<sup>8</sup> Commercial banks have responded by entering the mutual fund business. American mutual fund products provide a product staple that will help keep commercial banks competitive into the next century.<sup>9</sup> The message is patently clear: domestic commercial banks must continue to enter the mutual fund industry, and the domestic mutual fund industry must continue to enter Japan.

Similarly in Japan, the volume of managed assets in stock investment trusts at the end of 1987 had grown 7.6 times from 1981.<sup>10</sup> In September 1993, Japan ranked third in the world for investment trust control with their management of over Y 47.5 trillion in assets, despite having only twenty

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2. *Id.* at 41.

3. John Waggoner, *Foreign funds may rebound; Japanese, Pacific funds may be the best*, USA TODAY, Jan. 5, 1995, at 5B. Last year, Japan's Nikkei stock index rose 13.5%, which helped account for the 15.4% return to investors. It is anticipated that Japanese stocks will continue to do well in 1995 because Japan's interest rates are low, the economy is recovering, and corporate profits are picking up. If the dollar continues to tumble, U.S. investors' foreign holdings will rise in value. For example, "[i]f the dollar falls to 99 yen, 1 million yen would be equal to \$10,101—a 16% rise." *Id.*

4. Jeffrey Marshall, *Rolling the Dice on Asset Management*, U.S. BANKER, Mar. 1994, at 33, 36.

5. Alyssa A. Lappen, *Fund Follies*, INSTITUTIONAL INVESTOR, Oct. 1993, at 39.

6. *Id.*

7. *The Bottom Line*, THE BANKER, Apr. 1994, at 88.

8. William R. McLucas et al., *SEC Enforcement Under Arthur Levitt*, 27 STANDARD & POOR'S THE REV. OF SEC. & COMMODITIES REG. 181 (1994). Consumers' mutual fund holdings are expected to grow at a rate of 15% through the 1990's, compared to four percent for bank deposits. Marshall, *supra* note 4, at 36 (quoting First Manhattan Consulting Group).

9. Borrowings by corporations and small businesses have been falling since the mid 1980's, and in 1991, debt repayments exceeded borrowings by \$11 billion. Commercial bank's share of the short and medium term credit financing of major corporations plummeted from 90% in 1970 to 60% in 1990. Marshall, *supra* note 4, at 38.

10. *The Sustained Rapid Growth of Japanese Investment Trusts*, INSTITUTIONAL INVESTOR, Apr. 1988, at S8.

investment trust management companies.<sup>11</sup> Regardless of this impressive growth, Japanese investors withdrew a net ¥ 2.8 trillion from stock investment trusts in the first nine months of 1993.<sup>12</sup> The trusts' lackluster performance has been a factor in its decreased popularity. All but a tiny fraction of the 2,000 Japanese managed investment trusts in Japan underperform similar Japan-orientated funds based in London.<sup>13</sup> Further, Japanese-based investment trusts generally do not clearly state their investment philosophies, do not provide breakdowns of specific securities owned, rarely identify fund managers, and do not permit prospective purchasers to compare past performances.<sup>14</sup> Any further introduction of American practice, expertise and performance in Japan would invariably make Japanese investment trusts more competitive while giving U.S. fund managers a world of opportunity with a \$1.5 billion pension industry that expects to grow at a rate of ten to fifteen percent in the next decade.<sup>15</sup>

Part One of this article will explore the legislative prohibitions against commercial bank sale of mutual funds and the resultant impact on the banking industry. The article then will chronicle the historic change, through administrative guidance and interpretation, away from the rigid legislative rules which isolated commercial banks from competing in the mutual fund industry. In addition, Part One accounts for the allowance of commercial bank entry into the mutual fund industry by highlighting the accompanying limitations.

Part Two of this article provides an overview of the Japanese Security Regulation System and Investment Trust management business. The section next describes the regulatory environment for foreign domiciled funds in Japan. Part Two emphasizes that just as the domestic commercial banks can become

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11. GEORGE CURUBY, *INVESTMENT TRUST MANAGEMENT BUSINESS IN JAPAN I* (Curuby & Co. 1993) [hereinafter *INVESTMENT TRUST MANAGEMENT*] (on file with IND. INT'L & COMP. L. REV.).

12. *Japanese Investment Trusts; Punting in the Dark*, *THE ECONOMIST*, Jan. 22, 1994, at 78, 78 [hereinafter *Punting*].

13. Eamonn Fingleton, *Mutual Frustrations*, *INSTITUTIONAL INVESTOR*, Mar. 1990, at 29, 30.

14. James Sterngold, *World Markets; A New Leaf for Japan's Mutual Funds?*, *N.Y. TIMES*, Jan. 2, 1994, § 3, at 13.

15. Mamoru Aoyama, *Is MPT Applicable to Japan?*, *J. PORTFOLIO MGMT.*, Oct. 1994, at 103.

The recent growth of Japanese pension funds is remarkable. Since the 1970's, growth has been steady at around 15% a year, and this growth is expected to continue in the future. Some researchers project that Japanese pension assets will reach 100 trillion yen by the year 2000, and 200 trillion yen by the year 2010.

competitors, against the odds, in an imposing and highly specialized American market, domestic fund companies can gain market share in a tersely regulated Japanese market. Most importantly, this section is not sympathetic to information access arguments as it provides the legal procedure necessary for U.S. mutual fund entry into the Japanese investment trust industry. It then studies the impact of these regulations on domestic attempts at entry, and details the unprecedented Ministry of Finance opening of the highly compartmentalized investment trust management industry to subsidiaries of Japanese city banks. Part Two concludes that the Japanese investment trust market and regulatory environment is ripe for entry by U.S. mutual fund managers.

## II. DEFINITION OF A MUTUAL FUND

An investment company is defined under the Investment Company Act of 1940 as "any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."<sup>16</sup> Investment companies allow small investors to aggregate their assets, access the securities markets, diversify their risk, and share in gains and losses.<sup>17</sup> A mutual fund is a type of investment company whose assets are invested in securities. Open-end mutual funds, the most common form of investment company, must redeem their shares on demand, at a value equal to the net asset value at the next calculation, and must mail the proceeds within seven days.<sup>18</sup> Conversely, the closed-end investment company does not redeem its shares and is more suitable for those who like less liquid securities.<sup>19</sup> Unlike open-end funds, whose issuers redeem shares at net asset value, the closed-end funds' chief disadvantage has been that its shares sell at a discount to net asset value.<sup>20</sup>

Mutual fund shares differ fundamentally from other types of securities. Investment companies use the security sale proceeds to engage in the business of investing in securities<sup>21</sup> as opposed to using the newly acquired funds received from their shareholders to finance existing or expanding operations. Unlike typical security shares that evidence an equity position or debt obligation in one company, a share or certificate in a mutual fund represents a pro rata interest in a pooled portfolio of financial assets.

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16. 15 U.S.C. § 80a-3(a)(1) (1988).

17. MELANIE L. FEIN ET AL., *MUTUAL FUND ACTIVITIES OF BANKS* § 1.03, at 1-7 (1993).

18. PHILLIP R. MACK, *Recent Trends in the Mutual Fund Industry*, 79 FED. RESERVE BULL. 1001, 1001-02 (1993).

19. *Id.* at 1002.

20. FEIN, *supra* note 17, § 4.03, at 4-16.

21. *Id.* § 1.03, at 1-7.

Under the Investment Advisers Act of 1940, mutual fund advisers must register with the Securities and Exchange Commission (SEC).<sup>22</sup> Commercial banks, and any bank holding company as defined in the Bank Holding Company Act of 1956, are specifically excluded from the definition of investment adviser and are subsequently exempt from registration under the Investment Advisers Act of 1940.<sup>23</sup> Commercial banks are therefore not subject to a number of substantive requirements such as the Advisers Act anti-fraud provisions,<sup>24</sup> the regulation of performance fees,<sup>25</sup> and to the requirement to establish procedures designed to prevent the misuse of non-public information.<sup>26</sup>

Mutual funds also are required by the Investment Advisers Act of 1940 to register with the SEC.<sup>27</sup> The mutual fund must be operated in the best interest of the fund's shareholders.<sup>28</sup> Fraudulent practices are expressly prohibited, and violations are subject to SEC enforcement. Shareholder approval is required for a change in investment policy and investment adviser compensation. Further, the use of financial leverage is limited, and transactions between the fund and its affiliates are prohibited.<sup>29</sup>

"Pursuant to the Securities Act of 1933, mutual funds must provide investors with accurate information about its investment objective, yield, and operating procedures through a prospectus."<sup>30</sup> Mutual fund shares must be registered with the SEC.<sup>31</sup>

To determine if the regulatory requirements are met, the SEC reviews disclosure statements and conducts on-site examinations. The SEC reviews fund disclosures about operating plans, management structure, and financial condition. On-site examinations typically probe the funds' valuation techniques, investment activities, management functions, and sales, and liquidation of shares.<sup>32</sup>

Because bank advisers are not required to register with the SEC as investment

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22. 15 U.S.C. § 80b-3(a) 1988.

23. 15 U.S.C. § 80b-2(11).

24. 15 U.S.C. § 80b-6.

25. 15 U.S.C. § 80b-5. Typically, the investment adviser's compensation is a fee based upon a percentage of the net asset value of the mutual fund. FEIN, *supra* note 17, § 1.04, at 1-11.

26. 15 U.S.C. § 80b-4a.

27. 15 U.S.C. § 80a-8. There are some exemptions to registration for certain specified investment companies. 15 U.S.C. § 80a-6.

28. 15 U.S.C. § 80a-1(b).

29. MACK, *supra* note 18, at 1003.

30. *Id.*

31. See *supra* note 27 and accompanying text.

32. MACK, *supra* note 18, at 1003.

advisers, SEC examiners may not have access to all the books and records normally available when an adviser is registered.<sup>33</sup>

### III. THE TRADITIONAL LAW GOVERNING BANK SALE OF MUTUAL FUNDS

Since a mutual fund share represents stock, and stock is a security, mutual funds are subject to considerable regulation by the SEC. The Glass-Steagall Act (GSA),<sup>34</sup> the oft-cited name for four provisions of the Banking Act of 1933,<sup>35</sup> is the federal banking law which severely restricts the securities activities of commercial banks. Where mutual funds have been effectively defined as securities, this act dictates what commercial banks can do with respect to mutual funds.

Before enactment of GSA, commercial banks were significant participants in the nation's capital markets. Indeed, by 1930, bank affiliates were sponsoring over fifty percent of all new securities issues, and forty-one percent of all commercial bank assets were invested in securities or securities-related loans.<sup>36</sup> The GSA was enacted to prevent commercial banks from engaging in the securities business, a business practice which ultimately led to fiduciary abuses.<sup>37</sup> By 1933, these abuses had helped lower the U.S. economy to unparalleled depths following the 1929 stock market crash. At the height of the depression, forty percent of the nation's banks had failed or were merged. President Roosevelt ordered the temporary close of banks to silence the panic.<sup>38</sup> Congress determined that commercial bank securities dealing and underwriting fueled the rampant stock speculation preceding the 1929 stock market crash, ultimately leading to commercial bank failures.<sup>39</sup> As a result of the new

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33. 15 U.S.C. § 80b-4.

34. Banking Act of 1933, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.A.)

35. *Id.*

36. See SUSAN E. KENNEDY, *THE BANKING CRISIS OF 1933*, 212 (1973); Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 694 (1987).

37. Abuses involving large commercial banks and their securities affiliates included banks making loans to securities purchasers to support artificially elevated securities prices and dumping of non-performing stocks in trust accounts managed by the bank. *Stock Exchange Practices: Report of the Comm. on Banking and Currency Pursuant to S. Res. 84, 72d Cong., and S. Res. 56 and S. Res. 97, 73d Cong., S. REP. NO. 1455, 73d Cong., 2d Sess. (1933).*

38. Don More, *The Virtues of Glass-Steagall: An Argument Against Legislative Repeal*, 1991 COLUM. BUS. L. REV. 433, 436 n.12 (1991).

39. *Id.* at 437 n.16. *But c.f.* William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281 (1981) (no link was ever shown between securities activities and collapse of banking system; Act responded to public outcry rather than hard evidence).

legislation, commercial banks would no longer be involved with securities underwriting and dealing.

Section 16 of the GSA prohibits national banks from underwriting securities, but allows them to purchase or sell securities "without recourse, solely upon the order, and for the account of customers."<sup>40</sup> Section 21 prohibits any firms engaged in the deposit-taking business, including banks, from engaging "in the business of issuing, underwriting, selling, or distributing . . . securities."<sup>41</sup> Section 20 prohibits member banks from being affiliated with any firms that are "engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of . . . securities."<sup>42</sup> Lastly, section 32 prohibits certain incestuous management relations between member banks and firms "primarily engaged in the issue, flotation, underwriting, public sale, or distribution . . . of . . . securities."<sup>43</sup> This formidable legislation has legally separated the investment banking and commercial banking segments of the financial sector.

As applied to commercial bank sale of mutual funds, the GSA has historically been interpreted to mean that a national bank may not operate a stock investment fund for its customers.<sup>44</sup> Although no provision of the National Banking Act expressly prevents the pooling of trust assets, management of assets, or purchase of stock by a bank for its customers, "the union of these powers gives birth to an investment fund whose activities are of a different character."<sup>45</sup> A collective investment fund of this type, offered by banks, would be similar to an open-end mutual fund and would be in direct competition with the mutual fund industry. As such, it "involves a bank in the underwriting, issuing, selling, and distribution of securities in violation of [Sections] 16 and 21 of the GSA."<sup>46</sup>

#### IV. IMPACT OF THE LAW ON THE BANKING INDUSTRY

Open-end and closed-end mutual funds dominate the modern financial products market. Instead of taking a risk on a "pick of the week" with a stockbroker, or accepting a marginal return in a bank certificate of deposit, individual and institutional investors are electing to capitalize on the collective expertise of

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40. 12 U.S.C. § 24 (1988 & Supp. V 1993).

41. 12 U.S.C. § 378.

42. 12 U.S.C. § 377 (1988 & Supp. V 1993).

43. 12 U.S.C. § 78.

44. *Investment Company Institute v. Camp*, 401 U.S. 617 (1971).

45. *Id.* at 625.

46. *Id.* at 617.

professionally trained fund managers.<sup>47</sup> Mutual funds are actively managed by money managers who are often able to generate returns greater than those produced by direct instruments.<sup>48</sup> This process saves investors the trouble of searching for individual securities.<sup>49</sup>

Because of their liquidity, returns, and diversity, mutual funds offer savings instruments that clearly threaten commercial banks' deposits. "Americans have withdrawn over \$500 billion from low yielding bank accounts from 1990 to 1992 in favor of higher paying investments, such as mutual funds."<sup>50</sup> In 1992, the public made net purchases of fund shares amounting to \$206 billion while making net withdrawals from their deposit accounts at banks.<sup>51</sup> Many illiquid bank products, such as certificates of deposit (CDs), have prompted this move. Mutual funds offer ease of investment, because of their liquidity, while yielding superior returns when compared to a bank certificate of deposit. Consequently, the mutual fund has supplanted the commercial deposit account as a limited risk sanctuary.

Where shrinking deposits have strained the commercial banks' working capital, and commercial banks must compete with many alternate sources of credit, the economics of the GSA's post-depression banking laws have deteriorated.<sup>52</sup> The share of financial assets held by banks and thrifts predictably has fallen from fifty-eight percent in 1974 to forty percent in 1991.<sup>53</sup> The share of financial assets held by banks is estimated to drop below thirty-five percent by 1995 and below thirty percent in the year 2000.<sup>54</sup> While banks once dominated business lending, today nearly eighty percent of all such loans came from non-bank lenders, such as life insurers, brokerage firms, and finance companies.<sup>55</sup> Now institutions and individuals can also write checks on their insurance company policies, get a loan from a pension fund, and deposit paychecks into a brokerage firm money market account.<sup>56</sup> "It is possible for banks to die and still have a vibrant economy."<sup>57</sup>

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47. Douglas E. Klinger, *A Banker's Guide to Mutual Funds*, BAKER'S MONTHLY, Dec. 1992, at 18, 18.

48. *Id.*

49. *Id.*

50. Bernard Baumohl, *Are Banks Obsolete? "Fat, Dumb, and Happy," Commercial Banks are Being Quickly Replaced as Financial Intermediaries*, TIME, June 28, 1993, at 49, 50.

51. MACK, *supra* note 18, at 1001.

52. Baumohl, *supra* note 50, at 50.

53. Richard L. Stern & Jason L. Zweig, *Bank Reform Wall Street Style*, FORBES, Mar. 30, 1992, at 62, 64. Pension funds have 30%, mutual funds and insurance companies have just over 10% each, and others have the rest. *Id.*

54. *Id.* (quoting Richard Crawford of Madison Financial Group, a Washington, D.C.-based consulting firm).

55. Baumohl, *supra* note 50, at 49.

56. *Id.*

57. *Id.* (quoting Edward Furash, a Washington bank consultant).



The historic regulation of commercial banks handicaps their ability to compete in this changing environment. Commercial banks must maintain reserves and pay deposit insurance premiums against their CDs and deposits, which limit their financial flexibility and lead to higher overhead cost.<sup>58</sup> As fund managers, they are required to do neither.<sup>59</sup> Commercial banks, therefore, must continue to enter the mutual fund industry to remain competitive for the same dollars that would otherwise be deposited in a savings account or CD.<sup>60</sup>

During the wave of change, commercial banks have evolved from pure credit organizations into astute marketers. As depositors have taken flight from the secure, insured, commercial deposit, commercial banks have responded by eluding the historic constraints of the Glass-Steagall Act. During this metamorphosis, commercial banks have turned to mutual funds to increase fee income, strengthen customer relationships, and expand their customer base.<sup>61</sup>

Because they are convenient and offer many consumer options, mutual funds have more appeal than the common trust funds traditionally offered by banks. By selling mutual funds or getting involved as fund managers, banks do not commit capital, yet still retain customers' business and invariably earn a fee.<sup>62</sup> Unfortunately, the one-time fee from mutual fund sales is hardly a substitute for loan returns, and money placed in mutual funds is unavailable for lending.<sup>63</sup> Nevertheless, the transition has been easy because mutual funds are a natural extension of the money management services that trust departments have been engaged in for years.

## V. LEGAL AUTHORITY THROUGH ADMINISTRATIVE GUIDANCE FOR THE CONTEMPORARY BANK SALE OF MUTUAL FUNDS

### A. *History of Bank Emergence into the Mutual Fund Industry*

The thirty years following the passage of the GSA saw little debate over its merits. In 1972, investment banks and other institutions began competing

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58. Jean A. Briggs & William Baldwin, *First National Bank and Fund Co.*, FORBES, Dec. 1, 1986, at 92, 94.

59. *Id.*

60. In 1993, the pressure on banks to enter the mutual funds business was intense. The \$1.8 trillion mutual fund industry was anticipated to quickly overtake the \$2.4 trillion on domestic deposit with U.S. banks. Much of that money used to be on deposit at banks. Lappen, *supra* note 5.

61. J. Christopher Svare, *Mutual Fund Rules and Options*, THE MAG. OF BANK MGMT., Sept. 1972, at 71, 71.

62. John Waggoner, *Giant Banks Step Into Funds; For Many, Attraction is Mutual*, USA TODAY, Sept. 30, 1993, at 1B.

63. Leslie Wayne, *Concern Over Bank Sales of Funds*, N.Y. TIMES, Dec. 31, 1992, at D1.

for commercial bank deposits by introducing money market funds. Although commercial banks already had begun to sell non-deposit investment products, the new competition for money that formerly had been dependable as deposits led those banks to petition federal regulators for permission to engage in non-traditional banking activities not explicitly proscribed by Glass-Steagall.<sup>64</sup> Extensive litigation resulted as representatives from commercial banks and securities firms appealed to the courts to protect their interests.<sup>65</sup>

The genesis of commercial bank entry into the mutual fund business can be traced to 1966. Citibank established a common trust fund for the purpose of managing agency accounts and registered it as an investment company with the SEC.<sup>66</sup> In 1971, the Supreme Court held that Citibank's management of the common trust fund/investment company violated the Glass-Steagall Act.<sup>67</sup> Also in 1971, the Board of Governors of the Federal Reserve (Board) ruled that a bank holding company's management of a mutual fund violated Section 20 of the GSA.<sup>68</sup>

Nonetheless, banks were not completely foreclosed from entering the mutual fund business. In 1972, the Board amended Section 225.4(a) of Regulation Y. Under amended Section 225.4(a)(5), bank holding companies<sup>69</sup> were permitted, in accordance with Section 225.4(b), to furnish investment advice to an open-end investment company.<sup>70</sup> This amended provision also

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64. See Edward J. Markey, *Why Congress Must Amend Glass-Steagall: Recent Trends in Breaching the Wall Separating Commercial and Investment Banking*, 25 NEW ENG. L. REV. 457, 467 (1990); THOMAS G. FISCHER ET AL., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 470-71 (1984).

65. See *Bd. of Governors v. Inv. Co. Inst.*, 450 U.S. 46 (1981) (upholding Federal Reserve Board's amendment of Regulation Y to permit affiliates of commercial banks to act as advisers to closed-end investment companies); *Sec. Indus. Ass'n v. Bd. of Governors*, 468 U.S. 207 (1984) (upholding Board approval of Bank of America's purchase of Charles Schwab on grounds the GSA was not violated because the bank's affiliate engaged in the purchase and sale of securities "for the account of customers" as permitted by Section 16 of GSA); *Sec. Indus. Ass'n v. Bd. of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (ruling that commercial paper could be placed by a commercial bank because a private placement is not the same as an underwriting, and is therefore not the same as an underwriting which is considered a public offering proscribed by Section 16 of GSA).

66. In the Matter of First Nat'l City Bank (Commingled Investment Account), Investment Company Act of 1940, Exchange Release No. IC-4538, 42 SEC 924 (Oct. 5, 1966).

67. *Inv. Co. Inst. v. Camp*, 401 U.S. 617 (1971). This decision came in the wake of 1970 amendments to the 1933 and 1934 Securities Acts, which provided express exemptions to registration for bank common trust funds.

68. *Board Rulings and Staff Opinions Interpreting Regulation Y: Acquisition of Bank Interests*, F.R.R.S. 4-270.3 (Mar. 1994).

69. The term includes both their bank and non-bank subsidiaries.

70. *Activities Closely Related to Banking—Investment Adviser Activities*, F.R.R.S. 4-177 (Feb. 1, 1972).

authorized bank holding companies to sponsor, organize, and advise closed-end investment companies.<sup>71</sup> In the Board's opinion, however, the GSA provisions, as interpreted by the Supreme Court, forbade a bank holding company to sponsor, organize, or control an open-end mutual fund. Conversely, the Board did not believe that such restrictions applied to the closed-end mutual funds, so long as such companies were not primarily or frequently engaged in the issuance, sale, and distribution of securities.<sup>72</sup> In 1972, Provident National Bank became the first bank to act as an investment advisor to a closed-end mutual fund named Independence Square Income Securities.<sup>73</sup> The introduction of investment advisor services to this fund marked the entrance of the banking industry into the mutual fund business.

Concurrently with this amendment, the Board adopted an interpretative rule outlining the types of relationships a bank holding company may have with a mutual fund and a closed-end investment company consistent with the Glass-Steagall Act.<sup>74</sup> This interpretative rule governs the manner in which a bank holding company that has obtained Board approval under Section 4(c)(8) of the Bank Holding Company Act may conduct its investment advisory activities. The Board's interpretative rule has been upheld by the U.S. Supreme Court.<sup>75</sup> Paragraph (h) of the Board's interpretative rule regarding investment advisory activities states that a bank holding company may not engage in the "sale or distribution" of shares of an investment company which is advised by the bank holding company or one of its non-bank subsidiaries.<sup>76</sup>

Despite the prohibition on outright distribution and underwriting of a mutual fund, the Supreme Court has agreed that Section 20 of the GSA does not prohibit a bank affiliate from sponsoring a closed-end investment company<sup>77</sup> or acting as a discount broker in the purchase and sale of securities for customers.<sup>78</sup> Such activities for bank affiliates are authorized under the Board's regulation Y pursuant to the Bank Holding Company Act.<sup>79</sup> Section 20 of the GSA prohibits a member bank from affiliating with a company that

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71. The language "serving as investment advisor [sic], as defined in Section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under the act" was added to the list of activities closely related to banking. *Id.*

72. *Id.*

73. Charles B. Landreth, *Bank Mutual Funds: Growth Vehicle of the 90's; Changes in the Industry*, TR. & EST., Sept. 1992, at 37, 37.

74. 12 C.F.R. § 225.125 (1972).

75. *See* Bd. of Governors, 450 U.S. at 56.

76. 12 C.F.R. § 225.125(h).

77. Bd. of Governors, 450 U.S. at 64.

78. *See* Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 207 (1984); *Sec. Indus. Ass'n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

79. 12 C.F.R. § 225.25(b)(4). *See also* 12 C.F.R. § 225.125 (the Board's interpretation of the regulation).

directly, or through a subsidiary, *engages principally* in the issue, flotation, underwriting, public sale, or distribution of securities. The Federal Reserve Board determined that Section 20 subsidiaries would not engage principally in an underwriting or dealing activity if gross revenues from such activities were limited to ten percent of their total gross revenue.<sup>80</sup> Based on this pronouncement, if a bank refrains from underwriting or purchasing shares of an investment company for its own account and acts only as an investment adviser, it does not violate the requirements of Section 16.<sup>81</sup> The Federal Reserve Board decided that a bank holding company may not organize and manage mutual funds, and that it is unnecessary for a bank holding company to perform all such functions in order to engage effectively in investment advising activity.<sup>82</sup> Acting in capacities such as registrar, transfer agent, or custodian for an investment company, however, is not a selling activity and is permitted under Section 225.4(a)(4) of Regulation Y.

In 1984, the FDIC continued to relax the legislative constraints on banks by permitting state non-member banks to underwrite mutual funds through "bona fide" securities subsidiaries.<sup>83</sup> By 1986, the brokering of mutual funds by bank holding companies was expressly authorized by the Federal Reserve Board.<sup>84</sup> In 1987, the FDIC rule that allows securities underwriting activities by "bona fide" subsidiaries of state nonmember banks was upheld.<sup>85</sup> Also in 1987, the Office of the Comptroller and Currency authorized national banks to recommend and broker mutual funds for which the bank acts as an investment

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80. See Statements to the Congress; Policy Statements by Members of Federal Reserve System, 76 FED. RESERVE BULL. 301, 313 (1990).

In January 1989, the [Federal Reserve] Board expanded the range of securities that could be underwritten in a section 20 subsidiary to include any debt or equity security except shares of mutual funds. . . . In September 1989, the Board raised from 5 to 10 percent the revenue limit on the amount of total revenues that a section 20 subsidiary could derive from underwriting and dealing in ineligible securities.

*Id.* at 313-14. *But c.f.* Alternate Revenue Test is About as Far as Fed Will Go on Section 20, 12 BANKING POLICY REPORT 10 (1993) (explaining a Section 20 company "can elect to use either the original 10 percent revenue standard or the alternative indexed revenue test for purposes of calculating compliance"). See also Robert M. Kurucz et al., *Securities and Investment Activities of Banks*, 48 BUS. LAW. 1105, 1110 (1993) (explaining that the FRB issued a final order approving the use by Section 20 subsidiaries of the indexed revenue-based test).

81. *Id.* at 62.

82. 12 C.F.R. § 225.125(e).

83. 12 C.F.R. § 337.4 (1988).

84. *Securities Activities-Discount Brokerage Services*, F.R.R.S. 4-655 (Mar. 1994).

85. *Inv. Co. Inst. v. FDIC*, 815 F.2d 1540 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 847 (1987).

adviser.<sup>86</sup> Perhaps the clearest and broadest administrative changes came in 1992. In July 1992, the Federal Reserve Board approved a revised interpretation authorizing bank holding companies to broker and recommend mutual funds for which an affiliate acts as an investment adviser.<sup>87</sup> In September of the same year, the Federal Reserve Board amended regulation Y and added to the list of permissible bank holding company activities full-service brokerage and expanded investment advisory.<sup>88</sup>

The role of banks with respect to mutual funds, in accordance with the above rules, has been limited to advisor, seller, custodian, transfer agent, shareholder servicing, and administrator. Under no condition may a bank underwrite or distribute mutual funds. Although the GSA does not explicitly define the term "distribution," it has been interpreted to be similar in scope to traditional "underwriting" of newly issued securities.<sup>89</sup> While an underwriter actually provides the initial capitalization, the distributor organizes the fund; registers with the SEC; prepares the prospectus, marketing materials, proxies, and shareholder reports; and arranges for credit lines. Banks need an underwriter or distributor independent of the bank itself to create the investment company.<sup>90</sup> GSA prohibits such activities due to concerns that they are too speculative for national banks and may subsequently expose them to other subtle hazards. The legislation prevents commercial banks from purchasing mutual fund shares from the issuer, in their own account, independently or in conjunction with other underwriters who also purchase and sell the particular issue of mutual funds as principals. Commercial banks may, however, take an active role in marketing, such as providing brokerage and investment advisory services to customers—and advertising related to those services. Commercial bank assets are therefore not exposed to the type of risks traditionally associated with underwriting and distribution.

### B. *The Law and Procedure for the Bank Sale of Mutual Funds*

In pursuing mutual fund opportunities in retail sectors, banks have three options. First, they can manage and advise proprietary mutual funds, which

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86. OCC Interpretative Letter No. 403, *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,627 (Dec. 9, 1987).

87. 57 Fed. Reg. 30,387 (1992).

88. 57 Fed. Reg. 41,381 (1992).

89. *See* Securities Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 207, 217 (1984) ("terms 'underwriting' and 'distribution' traditionally apply to functions different from that of a securities broker").

90. Malcolm P. Northam, *Mutual Funds . . . Beyond the Interagency Statement, Opportunities for Financial Institutions* (Federal Financial Institutions Examination Council, Arlington, Va., 1994) (on file with IND. INT'L & COMP. L. REV.).

are underwritten by an unaffiliated distributor.<sup>91</sup> Second, they can earn commission income by acting as a broker for mutual fund products offered by established mutual fund sponsors. This option requires minimal effort and capital investment.<sup>92</sup> Third, banks can make available "private-label" mutual funds which bear names designated by the bank, but actually are existing funds sponsored by an unaffiliated company.<sup>93</sup>

### 1. *Banks as Advisers and Proprietary Fund Managers*

Regulation Y specifically authorizes bank holding companies to act as investment advisers to registered investment companies.<sup>94</sup> When the Board of Governors amended Regulation Y to add "serving as an investment advisor," it felt the service should be added to the list of activities so closely related to banking as to be a proper incident thereto.<sup>95</sup> The principal activity of an investment adviser is to manage the investment portfolio of its advisee and to invest or reinvest the funds of its client.<sup>96</sup> Banks that act as investment advisers to mutual funds merely perform a traditional banking service in the form of giving investment advice to customers on a commingled basis. Banks are permitted to perform this function by organizing mutual funds in the form of common trust funds for their trust customers.<sup>97</sup> These trust funds are nothing more than mutual funds that are excluded from the definition of investment company.<sup>98</sup>

This interpretation withstood a challenge by the Investment Company Institute, which unsuccessfully argued that the regulation violated the GSA.<sup>99</sup> Although the interpretation says that the GSA precludes a bank holding company from sponsoring, organizing, or controlling an open-end investment company, the Board of Governors reasoned that the GSA does not prohibit a bank holding company from sponsoring, organizing, or controlling a closed-end investment company that does not engage primarily in the issuance, sale, or distribution of securities.<sup>100</sup> The bank or bank holding company, therefore, may exercise all functions of an investment adviser under the 1940 Act, except to the extent limited by the GSA.<sup>101</sup>

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91. Svare, *supra* note 61, at 71.

92. *Id.*

93. *Id.*

94. See 12 C.F.R. § 225.25(b)(4)(ii).

95. See Investment Adviser Activities, 12 C.F.R. § 225.125(a).

96. See *Inv. Co. Inst. v. Camp*, 401 U.S. 617.

97. 12 C.F.R. § 9.18 (1984).

98. FEIN, *supra* note 17, § 5.02, at 5-5.

99. See *Bd. of Governors*, 450 U.S. 46 (ICI II).

100. See 12 C.F.R. § 225.125(f).

101. *Id.* § 225.125(d).

The Office of the Comptroller of the Currency (OCC) also has interpreted the National Bank Act to permit national banks to act as investment advisers to mutual funds.<sup>102</sup> In an interpretative letter, the OCC explained that neither a bank nor its subsidiary could control any investment company.<sup>103</sup> The OCC added that any bank or subsidiary engaged in investment advisory activities was prohibited from distributing or underwriting mutual fund shares and that all of the fund's directors must be independent of the bank.<sup>104</sup> These restrictions are exemplified through commercial bank advisory and sale of proprietary funds. A proprietary fund is one for which the bank acts as an investment advisor and which is marketed primarily to the bank's customers.<sup>105</sup> Banks frequently have used proprietary funds as investment vehicles for trust assets held by them as a fiduciary. Because of Glass-Steagall restrictions on underwriting and distribution of securities, the proprietary funds of banking organizations must be organized and distributed by an independent distributor.<sup>106</sup> In the Federal Reserve Board's opinion, the GSA provisions, as interpreted by the U.S. Supreme Court, still forbid a bank holding company to sponsor, organize, or control a mutual fund.<sup>107</sup>

On April 21, 1993, the Federal Reserve Board gave Mellon Bank approval to provide administrative services to mutual funds.<sup>108</sup> In the order, the Board stipulated that control over the mutual funds must remain with the funds' boards of directors—*independent of The Boston Company and Mellon Bank.*<sup>109</sup> Despite overwhelming control over mutual funds, the Mellon Bank would not be considered in control on account of the board of director influence. As a result of this interpretation, Section 20 affiliates are free to sponsor,

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102. See 12 U.S.C. § 1831a. See also 12 C.F.R. § 337.4.

103. Letter of David L. Chew, Senior Deputy Comptroller, *reprinted in Fed. Banking L. Rep. (CCH) ¶ 85,468 (1984)*. See also Decision of the Comptroller of the Currency concerning an application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (Sept. 2, 1983), *reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,732*.

104. *Id.*

105. FEIN, *supra* note 17, § 4.06, at 4-26.

106. *Id.* at 4-27.

107. 12 C.F.R. § 225.125(f). In approving Mellon Bank's application to acquire The Boston Company, a mutual fund administrator, the Federal Reserve Board stated The Boston Company would not be allowed to sponsor or distribute new mutual funds following the acquisition because of GSA prohibitions. *Mellon Bank Corporation*, 79 Fed. Res. Bull. 626, 629 (1993).

108. These services would be provided due to the acquisition of The Boston Company, a mutual fund service provider. *Dingell, Markey Want Answers From Fed on Scope of Recent Mutual Fund Approval*, BNA Daily Rep. for Executives, May 7, 1993 (1993 DER 87 d11), available in WESTLAW, BNA-DER file.

109. *Id.*

underwrite, or distribute mutual funds "so long as they meet existing Fed tests for Section 20 activity."<sup>110</sup>

Commercial banks in 1995 engage in investment advisory activities that are comparable to, and competitive with, the services of registered securities firms and investment advisers. Unlike bank transfer agents and bank municipal and government securities activities, which are regulated under the federal securities laws, bank investment advisory services are administered outside the federal regulatory scheme. Without SEC oversight, 119 commercial banks in 1994 provided investment advice to over \$312 billion in mutual fund assets, representing approximately fifteen percent of total mutual fund assets.<sup>111</sup>

## 2. *Banks as Brokers*

The Federal Reserve Board has determined that securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory services, are not deemed to be the underwriting, public sale, or distribution of the securities prohibited by the Glass-Steagall Act. The U.S. Supreme Court has upheld that determination.<sup>112</sup> Congress gave a national bank the authority to purchase and sell a mutual fund share. This express authority was given in the language "upon the order, and for the account, of customers."<sup>113</sup>

On April 22, 1992, the Federal Reserve Board adopted final regulations, adding to the Regulation Y list of activities that are "closely related to banking."<sup>114</sup> Specifically, the Board allowed bank holding companies that receive or have received approval to engage in brokerage to sell, solely as an agent or broker for customers, to broker shares of proprietary mutual funds.<sup>115</sup> The rule requires that any bank holding company that provides securities brokerage in connection with the shares of a proprietary mutual fund must: (i) disclose its dual roles to customers; (ii) caution customers to read the prospectus of the fund before investing; and (iii) advise customers in writing that the fund's shares are not deposits, are not obligations of any bank, are not insured by the Federal Deposit Insurance Company (FDIC), and are not endorsed or guaranteed by the bank in any way.<sup>116</sup> The purpose

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110. *Id.*

111. *See* LIPPER ANALYTICAL SERVICES, INC., BANK-RELATED FUND ANALYSIS (Fourth Quarter 1994) (on file with IND. INT'L & COMP. L. REV.).

112. *See* Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 207.

113. 12 U.S.C.A. § 24 (1994).

114. 57 Fed. Reg. 41,381, 41,387 (1992) (to be codified at 12 C.F.R. § 225.25).

115. 57 Fed. Reg. 30,387.

116. 57 Fed. Reg. 30,391 (1992) (to be codified at 12 C.F.R. § 225.125).



of this regulation is to alert the public that bank-sold mutual funds are not insured or guaranteed by the bank itself.

Banks that engage directly in securities activities are excluded from the definitions of "broker" and "dealer" in the Exchange Act, and are therefore exempt from broker-dealer regulation under the federal securities laws with the exception of the antifraud provisions.<sup>117</sup> Banking regulations do not establish specific qualification and continuing education for securities salespersons, and do not provide for the statutory disqualification of bank securities salespersons with disciplinary histories. Despite the foregoing, in 1994, over 1800 banking firms sold mutual funds to their customers.<sup>118</sup>

### 3. *Bank Sales of Private Label Funds*

Specialized bank products, such as "private label" mutual funds, have also evolved. Private label mutual funds have an unaffiliated investment adviser, but are marketed and sold by the bank directly to bank customers. Typically, these funds will bear a name that is identified with the marketing bank. Banks and thrifts recommending or selling such products should ensure that customers are fully informed that the products are: (1) not FDIC insured; (2) not deposits or other obligations of the institution and are not guaranteed by the institution; and (3) involve investment risks, including possible loss of principal. These disclosures must be made in a clear and conspicuous manner.<sup>119</sup>

## VI. CONCLUSION OF PART ONE

As of March 31, 1992, banks managed ten percent of the \$1.428 trillion in U.S. mutual fund assets, up from less than five percent in 1987.<sup>120</sup> Assets of bank-related equity funds have grown nearly sevenfold since 1987, while assets of bank-managed fixed-income funds have increased tenfold.<sup>121</sup> The number of banks selling mutual funds climbed from 502 to 736 in the first six months of 1993, nearly triple the amount that existed in 1987,<sup>122</sup> and now accounts for fifteen percent of all the stock and bond mutual fund shares

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117. 15 U.S.C. § 78j (1988) (proscribing the use of manipulative and deceptive devices in connection with the purchase or sale of any security by "any person").

118. See Michelle Clark, *Call Reports Show Surprisingly Few Banks Selling Funds*, AMERICAN BANKER, Aug. 25, 1994, at 12.

119. FED. DEPOSIT INS. CORP., INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS (Feb. 15, 1994).

120. Landreth, *supra* note 73, at 37 (quoting Lipper Analytical Services).

121. *Id.*

122. *Id.*

sold in the United States.<sup>123</sup> Putnam reports that several hundred bank relationships produced thirty percent of its retail sales generating \$4 billion in 1992.<sup>124</sup> If those numbers do not entice banks to enter the business, then the fact that twenty-five million Americans were in the forty-five to fifty-five age group in 1990, and that there will be thirty-six million in that group by the year 2000, should provide the incentive.<sup>125</sup>

The mutual funds' reaction to banks' in-house brands is indifferent so far. Most fund companies seem to perceive little threat.<sup>126</sup> Nevertheless, banks have a strategic selling advantage in the unparalleled power of their distribution network.<sup>127</sup> Banks also have established relationships, objectivity, and a reputation for integrity.<sup>128</sup> There is little to support the argument that they cannot become major forces in the mutual fund industry.

## PART TWO

### VII. THE EMERGENCE OF U.S. MUTUAL FUNDS IN JAPAN

As in the United States, the size of Japan's mutual fund industry has grown exponentially during the last twenty years. Japan's investment trust market, the Japanese equivalent of the U.S. mutual fund industry, is one of the world's largest at \$465 billion. Unlike the United States, where each fund is an individual company, each investment trust management company in Japan may run many funds as separate investments—not companies. As a practical matter, the securities investment trust market has been exclusively dominated by Japan's four largest securities firms (the "Big Four": Daiwa, Nomura, Yamaichi, and Nikko) and twelve other securities firms, each of which is affiliated with the Big Four.

Unlike the United States, continued expansion of the investment trust business will not come as the result of bank entry into the business. Rather, the premier entrant into Japan's investment trust business will be foreign competition. Foreign investment trust funds have been allowed to offer shares to the Japanese public since the end of January 1973, and only then if they fulfilled the requirements of "Regulations Concerning the Trading in Foreign

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123. Lappen, *supra* note 5.

124. *Id.*

125. Lyn Perlmuth, *Banks Muscle into Mutual Funds*, INSTITUTIONAL INVESTOR, Mar. 1992, at 59, 63.

126. Suzanne Woolley, *Mutual-Fund Houses Start to Hear Footsteps*, BUS. WEEK, Feb. 3, 1992, at 68, 68.

127. Some fund groups and banks report that 20-30% of their sales are made through branches. *Id.*

128. *Id.* at 69.

Securities" stipulated by the Japan Securities Dealers Association.<sup>129</sup> After 1990, foreign firms were permitted to establish mutual fund activities in Japan.<sup>130</sup> Despite the entry of five foreign mutual fund companies in the last four years, U.S. mutual fund companies have been noticeably absent from the market. This absence is primarily due to high entry-cost barriers and the peculiar nature of the mutual fund industry in Japan. Regardless of these challenges and barriers, the investment trust market in Japan presents enormous opportunity for U.S. expertise.

In 1990, twelve percent of the Japanese population were aged sixty-five and over, making it younger than the United States or Western Europe. By 2010, twenty-one percent of the population will be in that bracket, thereby making Japan the greyest part of the industrial world.<sup>131</sup> Japan's pool of pension assets presently amounts to more than Y 65 trillion (\$500 billion).<sup>132</sup> Japan's investment trust industry manages a further Y 50 billion (\$430 billion).<sup>133</sup> Management of these assets can become a highly lucrative business for U.S. companies.<sup>134</sup> "By law and custom, participation in both of these markets is dominated by large Japanese financial institutions."<sup>135</sup> Despite this impressive market size and cartel-like concentration of firms, foreign firms have been marginalized in the participation of Japanese money management. "[F]oreign investment trust managers have only 1.1% of the Japanese mutual fund industry."<sup>136</sup> Further, foreign firms presently manage less than 0.2% of Japan's total pension assets.<sup>137</sup> "In contrast, foreign firms manage more than eight percent of U.S. pension assets."<sup>138</sup>

#### A. *Historical Overview of the Securities Regulatory System*

Japanese securities companies and the market structure of the securities industry historically have been the beneficiaries of protective legislation. Unlike the United

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129. THE INVESTMENT TRUSTS ASS'N, INVESTMENT TRUSTS IN JAPAN 5 (1993) (on file with IND. INT'L & COMP. L. REV.) [hereinafter INVESTMENT TRUSTS].

130. MINISTRY OF FINANCE, GUIDELINES FOR LICENSING INVESTMENT TRUST MANAGEMENT COMPANIES I (Dec. 14, 1989) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter GUIDELINES].

131. Aoyama, *supra* note 15.

132. U.S.-JAPAN BUSINESS COUNCIL, JAPAN'S FINANCIAL SERVICES MARKET: THE CASE FOR EXPANDED ACCESS 14 (June 3, 1993) (on file with IND. INT'L & COMP. L. REV.) [hereinafter U.S.-JAPAN BUSINESS COUNCIL].

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

States, which allows, to a great extent, market forces — and not government regulation — to determine the financial order of its markets, the number of securities firms and investment trusts in Japan is dependent upon existing legislation. This legislation permits screening and licensing by the Ministry of Finance (MoF) and greatly limits the number of entrants into the market. The regulation of securities firms differs from the regulation of investment trust management companies. Regulations in the securities industry were relaxed earlier and to a greater extent than regulations governing the investment trust management business.

Modeled specifically on the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934, Japan's Securities and Exchange Law (SEL) provides investor protection through mandatory disclosure and anti-fraud rules.<sup>139</sup> The SEL specifically regulates the securities industry and not the investment trust business. Thus, when a securities firm desires to issue "securities," it must file a registration statement with the MoF and comply with reporting requirements.<sup>140</sup> Certain rules, such as Article 65, also limit who is eligible to sell securities. Article 65 of the SEL is similar to the U.S. GSA because it essentially prohibits banks from entering the securities business.<sup>141</sup>

The Japanese economy was marked by a period of depression from 1961 to 1968.<sup>142</sup> In July 1961, Japan's credit markets tightened.<sup>143</sup> In an effort to procure new capital, corporations flooded the stock market with new issues and offerings of stock.<sup>144</sup> By the spring of 1963, the increase in stock supply, coupled with the cancellation of stock investment trusts, had serious repercussions on the stock market.<sup>145</sup> In 1965, the Japanese Securities Holding Association was organized by the securities companies, with the aid of the Bank of Japan, to acquire "excess stocks arising from the cancellations of investment trusts and stockholdings of securities companies."<sup>146</sup> After February of 1965, capital increases were suspended.<sup>147</sup> These events ultimately served as the impetus for change in Japanese securities regulation.

139. Megumi Suto, *The Securities Industry in Japan*, in JAPANESE CAPITAL MARKETS 164, 168 (Shinji Takagi ed., 1993).

140. *Id.* at 168-69.

141. *Id.* at 180. The history of Japan's adoption of Article 65 differs from the United States' adoption of the Glass-Steagall Act. Unlike the United States, which adopted the GSA to protect depositors' interests and prevent banks from making speculative investments, Article 65 was adopted in Japan at the insistence of the U.S. government during the occupation to protect a fledgling broker business from the competitive and established city banks. J. ROBERT BROWN, JR., OPENING OF JAPAN'S FINANCIAL MARKETS 29 (1994).

142. JAPAN SECURITIES RESEARCH INSTITUTE, SECURITIES MARKET IN JAPAN 17-18 (1992).

143. *Id.* at 17.

144. *Id.* at 17-18.

145. *Id.* at 18.

146. *Id.*

147. *Id.*

In 1965, the SEL was fundamentally revised.<sup>148</sup> Amendment of SEL was "aimed at substituting a licensing system for the prevailing registration system for securities companies . . ."<sup>149</sup> In addition to Article 65's limitations on who may actually sell securities, the licensing system regulated who could engage in the separate activities of underwriting, brokerage, distribution, and dealing.<sup>150</sup> A firm can be licensed in all four areas only if it has equity capital of one billion yen.<sup>151</sup> The MoF further restricts the expansion of the marketplace through administrative guidance on the behavior of securities companies, the position of balance sheets, the introduction of new financial products, and limitations on the number of member firms at the securities exchanges.<sup>152</sup> The objective of this regulation is to maintain the stability of the financial system and to protect investors from what authorities call "excess competition."<sup>153</sup>

After the introduction of the reforms in the wake of the securities panic of the early 1960's, the number of securities companies decreased drastically from a peak of 564 in 1962 to 255 at the end of 1968. This decrease can be attributed to the high standards that the MoF requires a company to meet before it can obtain a license.<sup>154</sup> The number of branch offices also declined from 2,853 to 1,825 during the same period.<sup>155</sup> Since 1968, the number of securities firms has continued to decrease, leaving only 210 in 1990. Among some 200 firms, full service securities operations has been highly concentrated in a small number of integrated companies, especially the Big Four.<sup>156</sup> In fact, the Big Four had 39.1% of stock transactions, 72.1% of bond transactions, 64.3% in stock underwriting, 74.1% in bond underwriting, and almost 66% of pre-tax profits in 1990. The securities companies can thus be classified into three major groups: the Big Four, a handful of integrated companies, and a large number of small firms that are highly specialized in stock brokerage.<sup>157</sup>

This cartel-like environment started to change in 1972 with the entry of major foreign securities firms into the securities market. Foreign firms were first allowed to obtain securities licenses in 1972.<sup>158</sup> By 1984, there

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148. Suto, *supra* note 139, at 168.

149. SECURITIES MARKET, *supra* note 142, at 18.

150. Suto, *supra* note 139, at 168.

151. *Id.*

152. *Id.* at 180.

153. *Id.* at 181.

154. Noboru Tanabe, *Japan's Investment Trust: A Vehicle of Savings for Tomorrow*, 2 *IND. INT'L & COMP. L. REV.* 385 (1992).

155. Suto, *supra* note 139, at 169.

156. *Id.* at 175.

157. *Id.*

158. *Id.* at 178.

were ten foreign firms operating in Japan. As of March 1991, there were fifty-two foreign firms operating in Japan, twenty-five of which were members of the Tokyo Stock Exchange.<sup>159</sup> Despite a few exceptions on direct sale transactions, only securities firms may market securities products in Japan.<sup>160</sup> Under Article 2(8) of the Securities and Exchange Law, a U.S. mutual fund is classified as a foreign security, and, as such, is subject to the provisions of the Securities and Exchange Law.<sup>161</sup> Since foreign securities firms generally lack retail networks in Japan, foreign investment trust management companies must market their products through Japanese security firms. These firms typically are the parent companies of Japanese investment trusts. As such, for all practical purposes, U.S. mutual fund companies must employ competitors if their products are to reach a broader investing public.<sup>162</sup>

### B. *The Japanese Investment Trust Management Business*

The Japanese investment trust management business, like the securities business, was traditionally shielded from foreign competition. As such, these funds initially experienced phenomenal growth, but recently have suffered the effects of not conforming to the western world of disclosure. Unlike their American counterparts, Japanese investment trusts have experienced a four-year decline in size and annual return.<sup>163</sup> This decline has been attributed to the Japanese investment trust industry's reluctance to construct a useful data

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159. *Id.*

160. Securities and Exchange Law (Law No. 25), ch. 5, art. 81 (Apr. 13, 1948, as amended to June 9, 1981) (Japan) [hereinafter Japanese Securities and Exchange Law]. Article 81 provides, in pertinent part, that "no securities exchange may be established by any person other than securities corporations." *Id.*

161. *Id.* at art. 2(8). The rule provides that securities or certificates issued by foreign countries or foreign juridical persons constitute securities referred to in the Securities and Exchange Law. *Id.*

162. Japanese Securities and Exchange Law, *supra* note 160, art. 2. The Japanese Securities and Exchange Law originally contained no provision that controlled distribution of foreign shares in Japan. Since 1971, however, the foreign securities or certificates have been defined as "securities" under Article 2, and, as such, may only be exchanged by licensed securities corporations pursuant to Article 81. Under the agreement reached between the United States and Japan on January 10, 1995, greater opportunities for the retailing of investment trust products were created. Specifically, Japan confirmed that "securities subsidiaries of commercial banks are permitted to sell investment trust products, and that investment trust management companies are permitted to sell such products directly . . ." JOINT STATEMENT ON THE UNITED STATES-JAPAN FRAMEWORK FOR A NEW ECONOMIC PARTNERSHIP, MEASURES BY THE GOVERNMENT OF THE UNITED STATES AND THE GOVERNMENT OF JAPAN REGARDING FINANCIAL SERVICES 12 (1995) [hereinafter JOINT STATEMENT] (on file with IND. INT'L & COMP. L. REV.).

163. Sterngold, *supra* note 14.

base for comparing the funds' present performance to their past performance.<sup>164</sup> Japanese investors have been expected to invest on faith and not knowledge. This situation of blind investment will reverse when Japanese nationals have access to the same type of information that American and other foreign investors have at their disposal. The top fifty Japanese-managed open-end funds investing in the Tokyo stock market underperformed foreign-managed funds of Japanese stocks by an average of four points a year from 1987 to 1992.<sup>165</sup> Despite today's gradual emergence of foreign competition into the marketplace, the status quo of limited competition has been preserved by regulatory licensing and brokerage requirements which in practice have frustrated U.S. attempts at entry.

Equity mutual funds, known in Japan as "stock investment trusts," began operation in Japan in 1951 with the passage of the Securities Investment Trust Law.<sup>166</sup> This law exclusively governs Japan's domestic investment trust business. American firms that acquire a license for brokering their investment trust products are also governed by this law. The investment trust products of U.S. firms without a license in Japan fall within the purview of the Securities and Exchange Law and are defined as FITS. As a result, licensed securities firms—oftimes a competitor—must be employed to market them under the SEL.

Originally, securities companies carried out the management operations of investment trusts jointly with other business. In order to maintain the independence of the management of entrusted assets, securities companies separated and assigned the management operations to securities investment trust management companies after 1960.<sup>167</sup>

Like its securities business, Japan's investment trust management business during modern history was resistant to competition. In contrast to the United States, where a foreign firm can enter the mutual fund business through straightforward registration with the SEC at modest cost, Japan has what amounts to significant regulatory barriers to entry. In guarding the industry, the MoF

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164. *Id.* Investment philosophies, investments owned, and past yields are not information disclosed by the investment trust management company. However, this situation will change pursuant to an agreement reached between the United States and Japan announced on January 10, 1995. JOINT STATEMENT, *supra* note 162. Pursuant to the agreement, the Japanese have made a commitment to move toward market value accounting for personal liability calculations and disclosure of fund manager performance on a market value basis. *Id.* at 12-13. Further, Japan will "require investment trust management companies to enhance disclosure of investment trust products by amplifying the contents of the prospectuses and regular reports on an annual basis . . . ." *Id.* at 13. The enhanced disclosure is intended to assist investors in making investment decisions by providing them with detailed information on such matters as investment policy, dividend distribution policy, risk profiles, asset allocation, and fees. *Id.*

165. Gale Eisenstodt, *Self-inflicted Wound*, FORBES, Oct. 26, 1992, at 226.

166. YOSHIO SUZUKI, THE JAPANESE FINANCIAL SYSTEM 88 (1992).

167. *Id.* at 239.

has imposed a discretionary licensing system. This system has led to the formation of only twenty foreign investment trusts management companies as of February 1992.<sup>168</sup>

In obtaining a license from MoF, investment trusts must demonstrate they have had average assets under management of no less than Y 300 billion over the most recent three year period, have marked a positive current balance for the latest period, be incorporated in Japan if an investment trust management company, and maintain net assets of no less than Y 50 million.<sup>169</sup> Because the SEL is inapplicable to investment trusts originating in Japan, the Securities Investment Trust Law stipulates that the management companies must prepare an explanatory statement in lieu of a registration statement.<sup>170</sup> This statement must be given to prospective subscribers. The companies must also prepare a financial report on the trust fund to be given to each certificate holder at the end of each fiscal year.<sup>171</sup> In terms of investment scope,

[t]he concrete criteria for holdings of securities are set forth in the trust deeds and self-regulatory rules of the Investment Trusts Association. . . . Domestic bonds and debentures . . . may be held in the portfolio. All domestic stocks listed on securities exchanges and traded on over-the-counter markets . . . can be held.<sup>172</sup>

Investment trusts of the open type may acquire no more than five to ten percent of the stock of any single issuing body.<sup>173</sup> In fact, the mainstay investment trust is designed as a financial product with low risk and strong savings orientation.<sup>174</sup> In many ways, the Japanese investment trust resembles a deposit because of its safety and expected rate of return.

"The total net assets of investment trusts reached a record high of Y 58.6 trillion at the end of December 1989."<sup>175</sup> Net assets have decreased considerably since the beginning of 1990, largely because the stock market has been depressed and stagnant, giving rise to capital outflows and the devaluation of portfolio stock.<sup>176</sup>

[N]et assets plunged to the recent [low] of Y 38.5 trillion at the end of April 1992. . . . Under the impact of falling stock prices, the performance of some stock investment trusts was [so poor]

168. Tanabe, *supra* note 154, at 397.

169. JOINT STATEMENT, *supra* note 162, at 11-12.

170. Tanabe, *supra* note 154, at 397.

171. NAT'L SEC. DEALERS' ASS'N, STANDARDS OF SELECTION OF FOREIGN INVESTMENT TRUST SECURITIES (Resolution of the Board, Nov. 20, 1972) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter STANDARDS].

172. INVESTMENT TRUSTS, *supra* note 129, at 22.

173. *Id.* at 24.

174. Tanabe, *supra* note 154, at 395.

175. INVESTMENT TRUSTS, *supra* note 129, at 4.

176. *Id.*



that their net asset values fell below the par value at the time of redemption. . . . On the contrary, the net assets of bond investment trusts increased steadily, because their characteristic of maintaining stable incomes appealed to investors. . . . All in all, the total net asset value of all Japanese investment trusts recovered to Y 43.5 trillion at the end of March 1993.<sup>177</sup>

### C. *Regulatory Environment for Foreign Domiciled Funds Sold in Japan*

Despite reforms in 1993 and recent confirmation by the government of Japan that subsidiaries of commercial banks are permitted to sell investment trust products,<sup>178</sup> Japanese banks have not matured to the point where they can be considered a viable retail distribution channel by U.S. Mutual Funds.<sup>179</sup> Modeled on the U.S. Glass-Steagall Act, Article 65 restrictions of the Securities and Exchange Law traditionally precluded banks from engaging in the securities business except for government and public securities.<sup>180</sup> Japanese banks are therefore not considered a distribution channel for American mutual funds. As such, U.S. mutual funds are forced to make an entry into the Japanese financial economy *de novo* by acquiring the proper licenses, or tolerate their products being sold by their competitors. To date, only five U.S. funds, among them Keystone and Dreyfus,<sup>181</sup> have been able to overcome the onerous regulations placed upon them. However, expansion in the investment trust market by foreign players could parallel foreign expansion into the securities market because of the MoF's current reform-orientated posture.

The Japanese investment trust market historically has been closed to foreign investment products by a Japanese monetary policy aimed at minimizing capital outflows. The MoF hesitated to lift restrictions on foreign investment trust securities because it felt a need to: "(1) harmonize the legal treatment of domestic trusts with that of foreign trusts established under a variety of legal regimes; and (2) consider measures for investor protection, given the differences between foreign trust securities and listed foreign securities . . . ." <sup>182</sup> The gradual opening of the Japanese market to foreign domiciled

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177. *Id.* at 4-5.

178. JOINT STATEMENT, *supra* note 162, at 12.

179. At a maximum, a bank has been able to sell securities for its own portfolio investment or underwrite government bonds, local government bonds, and government guaranteed bonds. The Banking Law, art. 10, § 2(2), (4) (1981) (Japan).

180. Japanese Securities and Exchange Law, *supra* note 160, art. 65.

181. The other three are Federated, Fidelity, and Allied. GEORGE CURUBY, SELLING OFFSHORE MUTUAL FUNDS IN JAPAN I-14, I-16 (Curuby & Co. 1993) [hereinafter OFFSHORE MUTUAL FUNDS] (on file with IND. INT'L & COMP. L. REV.).

182. *Id.* at 49.

investment trusts in 1973 was preceded by a period of liberalization of Japanese controls during the 1960's and early 1970's.<sup>183</sup> The first steps that set the stage for this process were taken in 1964 when Japan eased foreign exchange restrictions over current transactions and concurrently participated in the OECD Code of Liberalization of Capital Movements.<sup>184</sup>

The liberalization measures enabling investments in foreign domiciled trusts by Japanese Nationals included provisions for both open-end and closed-end trusts.<sup>185</sup> The measures aimed to loosen restrictions on Foreign Investment Trusts (FITS) "and to provide for their integration into Japan's Securities and Exchange Law."<sup>186</sup> As a result, FITS are defined as foreign securities by a Ministry Ordinance rather than the Japanese domestic Securities Investment Trust Law. As foreign investment trust securities, they must file a securities registration statement and a securities notice.<sup>187</sup> Further, because the only type of investment trusts that can be created and sold in Japan are *securities* investment trusts, the distribution and administration of investment trust beneficiary certificates can only be handled by securities companies licensed by the MoF.<sup>188</sup> The management companies themselves are not able to sell and redeem their funds/trusts directly or through affiliates unless they use an affiliate with a broker's license.

"The first foreign investment trust sold as a public offering was the U.S.-domiciled 'Dreyfus Fund,' distributed by Daiwa Securities in January 1973."<sup>189</sup> From 1974 to 1982, "only [twelve] additional foreign trusts were publicly offered due to a Japanese monetary policy aimed at minimizing capital outflows . . . ."<sup>190</sup> From 1983 to 1985, twenty-one new foreign trusts were publicly offered in Japan, thereby bringing the total to forty trusts.<sup>191</sup> By 1987, there were a total of eighty-two publicly offered foreign investment trusts in Japan with assets of \$6.4 billion.<sup>192</sup>

"At the end of September 1993, there were 5,943 total securities investment trusts in Japan accounting for Y 47.5 trillion (about \$430 billion) in assets."<sup>193</sup> As of June 1993, there were 247 publicly offered offshore funds/investment trusts

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183. *Id.*

184. *Id.*

185. *Id.* at 50.

186. *Id.*

187. OFFSHORE MUTUAL FUNDS, *supra* note 181, at 57 (citing MINISTRY OF FINANCE, Ordinance No. 78 (Nov. 18, 1972) (Japan)).

188. OFFSHORE MUTUAL FUNDS, *supra* note 181, at 61.

189. *Id.* at 45.

190. *Id.*

191. *Id.*

192. *Id.* at 46.

193. INVESTMENT TRUST MANAGEMENT, *supra* note 11.

in Japan with an outstanding \$6.4 billion in net assets held by Japanese investors.<sup>194</sup>

On an annual new fund sales basis, the public offering of offshore funds peaked in 1989 with 43 new funds totaling \$2.8 billion. This declined to 38 funds worth \$1.9 billion in 1990, 19 funds worth \$660 million in 1991, 14 funds worth \$540 million in 1992, and 6 funds worth \$330 million in the first half of 1993. On an aggregate outstanding NAV basis, offshore funds publicly offered reached their zenith at the end of March 1991 at \$9.2 billion. Since 1991, total assets invested in investment trusts has been decreasing.<sup>195</sup>

The decline resulted from:

- (1) an overall decrease in investments by Japanese residents and problems with financial institutions;
- (2) the appreciation of the yen which has outpaced . . . the performance of most funds during the period;
- (3) the establishment of foreign-affiliated mutual fund firms in Japan; and
- (4) the lackluster Japanese stock market, which has led both Japanese and onshore foreign mutual fund operators to create a large number of domestic trusts specializing in offshore investment.<sup>196</sup>

Foreign-owned investment trust management companies recently were allowed to compete directly with Japanese investment trust management companies by becoming eligible for licenses, rather than just have their products sold, in the Japanese market.<sup>197</sup> This quiet reform is probably the result of investor intolerance of what will become past investment trust practices. Further, Japanese investment trusts have performed poorly when compared to the risk-adjusted market return. The reasons for the poor performance include high transaction costs, government regulations on fund activities, and lack of competition.<sup>198</sup> Consequently, investors withdrew a net ¥ 2.8 trillion from stock-investment trusts in the first nine months of 1993.<sup>199</sup>

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194. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-1.

195. *Id.*

196. *Id.*

197. Tanabe, *supra* note 154, at 411 (Report by the Study Group on Investment Trusts, Securities Bureau of the Ministry of Finance (1988)). "As of January, 1992, four foreign-affiliated financial companies have been approved to get a license to establish investment trust management companies." *Id.* at n.42.

198. Junko Maru, *The Structure and Performance of Investment Trusts in Japan*, in JAPANESE CAPITAL MARKETS 489 (Shinji Takagi ed., 1993).

199. *Punting*, *supra* note 12.

#### D. U.S. Mutual Fund Procedure in Japanese Market Entry

The primary impediments to U.S. mutual fund entry into the Japanese investment trust business have been licensing, costs of entry, and distribution problems. Although the minimum capital requirements for license eligibility have been reduced, other costs associated with licensing and registration have raised questions about the commercial viability of foreign mutual fund management companies. Additionally, the application and approval process is highly subjective, which invariably makes U.S. competitors reluctant to expend the efforts abroad while business has been rewarding at home. In recent years, however, the MoF has made reforms designed to attract U.S. and other foreign fund companies.

Because beneficiary certificates of foreign mutual funds are defined as securities under the Japanese Securities and Exchange Law, they are subject to securities industry regulations.<sup>200</sup> When a company makes public offerings of mutual funds, those which are offered to fifty or more investors on equal terms and conditions for a specified period of time, a securities registration statement and a foreign registration statement with the MoF must be filed.<sup>201</sup> "The documentation and filing of a public offering entails costs ranging from \$50,000 to \$100,000, depending on the offshore domicile and whether the fund is already in operation. . . . From initial discussions to actual launch takes 2-3 months."<sup>202</sup> Private placements of FITS, those offered to between fifty and 500 institutional investors on equal terms, are required to file a less onerous Securities Notice instead of a registration statement.<sup>203</sup> A registration statement becomes necessary, however, if the fund is offered to more than 500 qualified institutional investors.<sup>204</sup> The notification process may require full explanation to the MoF regarding "funds with esoteric or high risk investment goals."<sup>205</sup> The funds also must appoint a designated broker as sales agent in Japan.<sup>206</sup> Since the paperwork is not as great as public offerings, the associated costs are lower, and the whole process may be completed in a six-week period.<sup>207</sup>

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200. Japanese Securities and Exchange Law, *supra* note 160, art. 2(1)(vii). In contrast, the Securities and Exchange Law does not, at present, apply to domestic investment trusts. Ichiro Kawamoto, *Investment Trusts*, in JAPANESE SECURITIES REGULATION 209, 221 (Lewis et al. eds., 1983).

201. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-3.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.* at I-4.

206. *Id.* at I-3.

207. *Id.* at I-4.

In addition to filing with the MoF, foreign investment trusts that sell to fifty or more persons, not necessarily Japanese nationals, within a six-month period also must file a registration statement with the National Securities Dealers Association (NSDA) for disclosure purposes.<sup>208</sup> In addition to the Securities and Exchange Law requirements, publicly offered FITS must conform with guidelines administered and enforced by the NSDA.<sup>209</sup> Ironically, the NSDA is *not* involved with private placements.<sup>210</sup>

All U.S. mutual fund companies, known as "Trust Managers," must be licensed before they can organize mutual funds in Japan.<sup>211</sup> Until recently, portfolio managers, known as "Discretionary Investment Advisers," also were required to acquire a separate license, despite being in a complementary business.<sup>212</sup> Licenses are granted on a discretionary basis, which gives broad powers to regulators by a subjective and wholly non-transparent registration process. Each license requires a separate capitalized local entity, with distinct office space and staff.<sup>213</sup> Further, while a local entity may accept advice

208. NAT'L SEC. DEALERS ASS'N, DISCLOSURE GUIDELINES FOR FOREIGN INVESTMENT TRUSTS, (Hideki Maedemari trans., Mar. 15, 1994) (Japan) (on file with IND. INT'L & COMP. L. REV.). Information furnished by Mikasa Law Office, Tokyo, Japan.

209. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-3. The principal regulatory provisions are: "(a) MoF Ordinance of 1972 regarding public offerings of FITS; (b) Standards of Selection of FITS of the JSDA; (c) Regulations concerning the trading of Foreign Securities; (d) certain provisions of the Securities Exchange Law and the Foreign Exchange Control Law." *Id.*

210. *Id.*

211. Securities Investment Trust Law, ch. 2, art. 6 (Law No. 198, June 4, 1951) (Japan) [hereinafter Trust Law].

212. Pursuant to an agreement reached between the government of the United States and Japan on January 10, 1995, Japan now will only "permit a discretionary investment management company to conduct, in one entity, investment trust business and discretionary investment management business," as well as investment trust management. JOINT STATEMENT, *supra* note 162, at 10-11. To be eligible to obtain a dual function license, a company must:

- 1) have had average assets under management of no less than 300 billion yen over most of the recent three year period; in case of a foreign discretionary investment management company in Japan, such assets will be the average assets under management by the parent company of such company; and
- 2) have marked a positive current balance for the latest period; in the case of a company that has a marked negative balance, under special circumstances, it is still eligible if it marked a positive balance under any of the three most recent periods.

*Id.* at 11. Further, an investment trust management company must be incorporated in Japan.

*Id.* at 12. Lastly, Japan will "remove the current minimum capital requirement . . . of 300 million yen . . . and replace it with the requirement that an adequate amount of capital be prepared to maintain net assets of no less than 50 million yen . . ." *Id.*

213. Any company desiring to obtain the license shall file an application for the license which shall include the following information: (1) the corporate name and the amount of capital; (2) the names and locations of the principal office, branch offices and other places of business;

from its U.S.-based parent, all portfolio transactions must be executed in Japan.<sup>214</sup> U.S. Funds without brokerage licenses must sell their products through licensed securities brokers.<sup>215</sup> Foreign firms must pay a "loyalty fee" of up to 0.6% to the brokerage house each year the trust remains operational.<sup>216</sup> "The brokers also take a two percent front-end commission from the investors."<sup>217</sup> Therefore, foreign fund operation costs could run three to four times higher than necessary.<sup>218</sup>

The biggest initial obstacle to opening up Japan's market to foreign participation is cost.<sup>219</sup> A centrally-located office, with one broker and one secretary, will cost about \$350,000 to \$400,000 per year to operate.<sup>220</sup> This amount of money will be required for a minimum of five years if the company is previously unknown in Japan.<sup>221</sup> The staffing requirements are also a problem.<sup>222</sup> The subsidiary of any foreign company should be run by a person from the head office.<sup>223</sup> Foreign companies have great difficulty in persuading their best executives to spend five years in Japan.<sup>224</sup>

Article 7 of the Securities Investment Trust Law contains the requirements for a Japanese investment trust management company license.<sup>225</sup> Prior to approval, each application for a license is reviewed by the MoF and judged in conformance with three basic criteria. The applicant must first be "sufficiently qualified to engage in the management of securities investment trusts, after being evaluated in the light of its personnel structure, experience in and ability to invest in valuable securities."<sup>226</sup> Secondly, the applicant's "prospects related to the income and expenditures of [its] business . . . [must be] sufficiently

and (3) the full names of the directors. *Id.* The actual requirement of separate office space and staff is derived from administrative, and not legislative, guidance. Currently, a total of about 30 people is considered standard. MINISTRY OF FINANCE, REVIEW OF THE STANDARDS FOR THE LICENSE FOR THE INVESTMENT TRUST MANAGEMENT BUSINESS 3 (Jan. 28, 1992) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter REVIEW].

214. U.S.-JAPAN BUSINESS COUNCIL, *supra* note 132, at 15.

215. Foreign investment trusts are banned from directly selling to Japanese nationals. Fingleton, *supra* note 13.

216. *Id.*

217. *Id.*

218. *Id.*

219. U.S. DEP'T OF THE TREASURY, Japan Office, EMBASSY OF THE U.S., INTERNAL MEMORANDUM ON INVESTMENT TRUST MANAGEMENT COMPANIES, (Mar. 22, 1991) (on file with IND. INT'L & COMP. L. REV.) [hereinafter INTERNAL MEMORANDUM].

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. Trust Law, *supra* note 211, art. 7.

226. *Id.* art. 7(1).

bright."<sup>227</sup> Lastly, the "applicant's business as a management company [must be] necessary and appropriate in light of the existing condition of the securities investment trust business and the securities market."<sup>228</sup> With the exception of these highly subjective legislative controls, the remainder of the licensing process relies largely upon administrative guidance.

The MoF issued guidelines on December 14, 1989, for the licensing of foreign investment trusts.<sup>229</sup> Pursuant to these guidelines, the granting of licenses to the first foreign-affiliated firms took place in 1990.<sup>230</sup> In response to the requests of other advanced nations, the MoF again reviewed its regulations in January 1992. "Amendments to these guidelines were subsequently announced on January 28, 1992."<sup>231</sup> While the MoF believed the current licensing standards should employ a more liberal standard and should approve more entities to promote fair competition, the MoF was adamant that a fire wall develop between the activities of the parent and the applicant firm in cases where the parent company engages in business other than the asset management business.<sup>232</sup> The purpose of such a wall was to prevent abuses after entry into the market.<sup>233</sup>

The 1989 guidelines provided that the applicant firms must have at least three consecutive years of investment trust experience and, among foreign firms, expressed preference for those with experience selling their offshore funds in Japan.<sup>234</sup> Licensing prerequisites, such as experience in the Japanese investment trust business, were dropped by the 1992 amendments, however, for parent bodies which had achieved a certain scale of results in their home country and which could be expected to attain the same results in Japan.<sup>235</sup> In 1989, a total of about thirty persons, including directors, was considered standard for setting up an investment trust company. Following the 1992 amendments, this requirement was dropped.<sup>236</sup> Similarly, applicant firms now can be jointly established by several companies instead of by a single parent company. The investment trust management company formerly was required to have a paid-in capital of Y 300 million and an ongoing net worth

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227. *Id.* art. 7(2).

228. *Id.* art. 7(3).

229. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

230. *Id.*

231. *Id.*

232. REVIEW, *supra* note 213, at 1.

233. *Id.*

234. GUIDELINES, *supra* note 130; *see also* INVESTMENT TRUST, *supra* note 11, at 15.

235. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

236. REVIEW, *supra* note 213.

of at least Y 50 million, and it must show a business profit after three years of operation (or after five years for foreign-affiliated firms).<sup>237</sup>

Sales forecasts sufficient to support business operations will be judged for foreign applicants based on their business record in their home country, concrete sales tie-ups with Japanese firms, and their prior success of selling offshore funds in Japan. In principal, directors must be full time employees, and the [investment trust management companies] must maintain separate offices. Personnel must have experience in the investment trust business, and the staff size must be considered adequate by [the Ministry of Finance].<sup>238</sup>

Following the adoption of measures by the governments of Japan and the United States regarding financial services, foreign investment trust management companies are no longer required to show paid-in capital of Y 300 million or an extended record of profit. It follows that Japanese Investment Trust will be less impervious to foreign competition as more foreign firms will likely be able to satisfy the entry requirements.

Other guidelines, until recently, have been equally restrictive. When the transactions are executed, they must conform with rigid asset allocation guidelines. Specifically, the NSDA guidelines provide that: the assets of the fund may not be used for underwriting or short sales of securities; that the fund may not borrow an amount beyond ten percent of its assets; may not invest more than ten percent of its assets in the stocks of one issuer or in other investment trust securities or in securities with low liquidity; and may not invest in commodities or real estate.<sup>239</sup> These legal guidelines on asset mix limited the free flow of capital and made it virtually impossible to construct truly efficient portfolios. Such guidelines also restrict the possibility of specialist management, an approach that is accepted in most other markets and is generally believed to yield better returns. Consequently, institutional Japanese funds were virtually assured suboptimal performance.<sup>240</sup>

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237. DEP'T OF THE TREASURY, EMBASSY OF THE U.S., UNCLASSIFIED INFORMATION RELEASE (1992) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter RELEASE].

238. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

239. STANDARDS, *supra* note 171.

240. However, under the new agreement reached between the United States and Japan, investment trust management companies will have more flexibility in choosing investments. JOINT STATEMENT, *supra* note 162. Specifically, "the government of Japan will permit investment trust management companies to invest up to but not including 50% of each fund in institutions other than those defined under Article 2 of the [SEL]." *Id.* at 13. Such companies may now invest in yen CD's, yen call money, and securitized real property. *Id.* Japan will "fundamentally deregulate current restrictions on the types of instruments in which funds will be allowed to



### E. *Impact of these Regulations on the Entry of U.S. Mutual Funds*

Although the January 1992 amended guidelines reduced the minimum capital requirement from Y 500 to Y 300 million (\$2.9 million), the minimum net worth requirement of Y 50 million (\$490,000) critically restrained entry into the Japanese market.<sup>241</sup> These guidelines created operational, as opposed to legal, constraints on effective competition. By contrast, the United States only requires \$100,000 of capital per individual mutual fund,<sup>242</sup> nearly a thirty to one ratio. The minimum capital requirement actually constrains U.S. company entry more than the minimum net worth requirement since foreign investment trust management companies (ITMC) must post a profit within five years of entry. Past new entrants in Japan could easily exhaust Y 300 million of capital from the time of start up to profitability, making it all the more difficult to maintain a minimum net worth of Y 50 million at all times. The MoF responds to criticism by saying that the U.S. mutual fund industry fundamentally differs from Japan's. In Japan, initial capital contributions support the ITMC, whereas in the United States, each individual fund represents a separately capitalized corporation.<sup>243</sup> Foreign investment adviser companies have no minimum capital requirement in the United States.<sup>244</sup> As such, either the adjusted minimum net worth requirements or the merger of the ITMCs and Investment Advisers' licensing process should inspire new, lower-cost entry into the Japanese market.<sup>245</sup>

The requirement that only qualified securities companies can serve as distribution agents for offshore mutual funds has created a marketing problem, which in turn may dissuade entrance by U.S. mutual fund companies. The broker class is limited to Japanese brokers and foreign brokers who have a branch license and who have applied to the Japan Securities Dealers Association for authorization to sell FITS. Distributors place their greatest effort on selling

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invest in . . ." *Id.* Accordingly, the requirement that futures and options trading be used only for hedging is abolished, and the permissible range of margin transactions in which stock may be borrowed and sold will be expanded. *Id.* at 13-14. Additionally, investment trust management companies are allowed to invest in foreign and domestic privately placed bonds, other investment trust products, and securitized investment backed by real property. *Id.* at 14.

241. U.S. DEP'T OF TREASURY, ASSET MANAGEMENT (INVESTMENT TRUSTS) (May 1994) (on file with IND. INT'L & COMP. L. REV.) [hereinafter ASSET MANAGEMENT].

242. 15 U.S.C. § 80a-12(a)(1). This section provides that no registered investment company shall make a public offering of securities of which such company is the issuer, unless: such company has a net worth of at least \$100,000.

243. ASSET MANAGEMENT, *supra* note 241.

244. 15 U.S.C. 80b-1 to 80b-21. The Investment Advisers Act of 1940 has no minimum capital requirements for the application of an investment adviser license.

245. ASSET MANAGEMENT, *supra* note 241.

domestically-created trusts and only sell foreign-domiciled trusts as an occasional means of "rounding out" their product line. There are fewer distributors than funds, so securities brokers generally form relationships with those foreign funds that pay the highest commissions and share their investment expertise. Most foreign management firms only have relations with the international departments of Japanese brokers, while it is the domestic investment trust sales departments that actually sell these foreign trusts in Japan. There is also a disruptive MoF guideline which applies to publicly-offered foreign funds in Japan. The guideline requires that an amount equal to twenty percent of the value of the Japanese offering must be placed outside Japan.<sup>246</sup> This guideline is burdensome because many brokers cannot place this amount with certainty and the investment objectives of funds specifically designed for Japanese investors are often not suited for other foreign investors.<sup>247</sup>

Brokers are further hindered by the prohibition on implementation of special sales charge systems, such as special discount, "no-load," or "front-end load."<sup>248</sup> The brokerage commission is strictly regulated to a maximum of 180 basis points. "The MoF [also] does not permit the management company and the broker to agree on a commission between them."<sup>249</sup> Additionally, "the upper limit is too low to permit commission splitting arrangements where more than one [agent] may be involved."<sup>250</sup>

In addition to the legal barriers to market entry, exclusionary structural impediments confront U.S. money managers who seek to enter the Japanese market. Historical practices and institutional structure have resulted in a concentrated, Japanese-exclusive financial market, according to a 1993 report by the U.S.-Japan Business Council. That report stated:

For example, in Japan there is no well-defined concept of fiduciary responsibility. In addition, there are no generally accepted standards for measurement of performance for investment managers. Finally, rigid asset allocation guidelines make it difficult, if not impossible, for investment managers to construct efficient portfolios. Consequently, fund managers are restricted in competing on the basis of performance. The effect of this system is to restrict competition from new entrants, domestic or foreign, and thus preserve the lucrative status quo for the small number of dominant firms. While the regulations and business

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246. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-5.

247. *Id.*

248. STANDARDS, *supra* note 171.

249. INTERNAL MEMORANDUM, *supra* note 219.

250. *Id.*

practices are not targeted specifically at foreign firms, they have the effect of limiting the participation of foreign firms in this market.<sup>251</sup>

The U.S. Treasury has negotiated on the topic of ITMC's for a number of years, and recently reached an agreement with Japan. In the course of negotiations, the Treasury proposed a number of changes that would help both foreign and domestic investment trusts operate more competitively in Japan. In particular, the life of funds is usually limited to five years with an upper limit of seven years. The result is investor perception that the trust is a stable, "savings-type" product and not an investment with a degree of risk — and reward. Eliminating the duration period would encourage more investors to invest. A burdensome cash reserve rule also requires sixty percent of any surplus above initial issue price to be set aside at each half and full year. Eliminating this rule would increase investor exposure to the equity market through more equity investments by the investment trust. Investment trusts also should be placed on equal footing with direct equity investment. Currently, investment trust profits are taxed at twenty percent when investors may choose to pay a one percent tax on private investment disposals instead.<sup>252</sup> Also, the investment trust management rules are absurdly complicated. "For example, the rules allow for up to [fifty percent investment] in "second section" stocks . . . and separately, [fifty percent] in over-the-counter . . . stocks. The rules do not say that together, these two categories may not exceed [fifty percent]. But this is the unwritten guidance."<sup>253</sup>

On January 10, 1995, the governments of the United States and Japan adopted Measures Regarding Financial Services under the Joint Statement on the Japan-United States Framework for a New Economic Partnership. The measures established under the agreement with respect to investment trusts are expected to increase sales and access of competitive foreign financial goods and services. This goal will be achieved through less burdensome licensing requirements, expansion of distribution channels for investment trust products, and a host of newly permitted investments. Further, the Japanese have agreed to enhance the disclosure of investment trust management performance data.<sup>254</sup> This decision should intensify, at a minimum, the competition between Japanese Investment Trusts and ultimately lead to better returns. In the final analysis,

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251. U.S.-JAPAN BUSINESS COUNCIL, *supra* note 132.

252. INTERNAL MEMORANDUM, *supra* note 219.

253. *Id.*

254. Investment Trust Management Companies must now enhance disclosure of investment trust products by amplifying the contents of prospectuses and regular reports on an annual basis in order that investors may make investment decisions based on more detailed information such as investment policy, dividend distribution policy, and risk. JOINT STATEMENT, *supra* note 162, at 13.

effectiveness of these measures should be easy to gauge by examining whether there is an increase of foreign ITMC presence as compared to pre-1995.

F. *Japanese Bank Entry into the Investment Trust Management Business*

On April 15, 1992, the MoF formally "announced that it would relax licensing and operational requirements for investment trust management companies."<sup>255</sup> The MoF is now injecting competition into the investment trust business and has allowed five banks to manage funds.<sup>256</sup> Prior to their entry in October 1993, all Japanese ITMCs were affiliated with a securities company and, in some cases, a major banking group through minority shareholding. The recently established bank-affiliated ITMCs have been created as subsidiaries of the investment advisory subsidiaries of the bank's group. These ITMCs carry the name of their parent company and are considered direct representatives of their group.<sup>257</sup> Banks are still prohibited from acting as distributors of investment trusts. Due to the opposition of securities companies to banks selling investment trusts, Japanese Investment Trust expert George Curuby estimates "this restriction is likely to continue for at least the next three years."<sup>258</sup>

Many major investment trust management companies are hopeful that banks eventually will be allowed to distribute mutual funds in Japan because they expect this to broaden the mutual fund ownership by Japanese households. In the United States, about twenty-five percent of the population owns mutual funds, which account for about ten percent of household assets. In Japan, only ten percent of households own funds which account for about four percent of household assets. "Banks becoming distributors will be a positive factor for the industry."<sup>259</sup>

Despite years of pushing the MoF for deregulation, some banks are concerned that the investment trust management business will not be initially profitable. Furthermore, some Japanese bank institutions were unhappy with Ministry restrictions on the sale of investment trusts through their own large bank networks. As it stands now, non-securities firms which enter the market must manage the funds in a separate affiliate and enlist the help of Japanese securities houses, which hold exclusive rights on the direct sale of investment

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255. RELEASE, *supra* note 237.

256. *Id.* The banks are not allowed to sell the funds through their branches, but must instead use brokers. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 3.

257. The five banks are Fuji Bank, Sanwa Bank, Sakura Bank, Sumitomo Bank, and Norinchukin Bank. *Id.*

258. *Id.*

259. *Id.*

trusts, to move the product.<sup>260</sup> City Banks fear, however, that if they delay entry this time they may alienate the MoF, which is anxious for further financial industry deregulation, and will not get the "OK" when they feel they are ready. It is understood that the Ministry can cite any reason for refusing a license, such as "inadequate corporate performance" or "poor timing."<sup>261</sup>

The entrance of the banks invariably comes in response to calls for reform. Of the 2,918 stock investment trust funds in Japan at the end of September 1993, 1,551 were below their initial value.<sup>262</sup> One cause for this decline has been the lack of an independent rating system. Although investors do receive performance information twice a year, they have difficulty obtaining information which compares the funds.<sup>263</sup> Although the investment trust skills of banks are open to question, their entry heralds the start of competition between bankers and securities brokers. Where the investment trust subsidiaries of banks have three years to become profitable under the terms of their license approval, this intensified competition likely will produce a better performing investment trust product.

## VI. CONCLUSION

"In 1992 . . . the Diet took a major step [in] bringing the Japanese financial system into closer alignment with other industrial countries."<sup>264</sup> Although legislation has permitted carefully defined crossing over by most classes of financial institutions into each other's business, the reforms have amounted to less distinctions between financial institutions on paper than in actual practice.<sup>265</sup> Article 65-3 now makes companies owned by banks eligible for a MoF securities license.<sup>266</sup> Where the financial climate in Japan is maturing, an opportunity is present for U.S. mutual fund companies to penetrate the market and seize market share. The opening of the investment trust management business to banks reflects Japan's relaxing regulatory position.

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260. Yas Idei, *City Banks Split on Investment Trusts*, Apr. 12, 1993, available at Embassy of the United States in Japan, Office of the Financial Attache (on file with IND. INT'L & COMP. L. REV.).

261. Tomohiro Akamatsu, *Four City Banks Reluctantly Move into Investment Trusts*, TOKYO BUS. TODAY, Dec. 1993, at 56.

262. Hiroyuki Nishomura, *Investment Trusts Probing for Reforms*, Oct. 25, 1993 (quoting the Investment Trust Association) (on file with IND. INT'L & COMP. L. REV.).

263. *Id.*

264. J. Robert Brown, Jr., *Japanese Banking Reform and the Occupational Legacy: Decentralization, Deregulation, and Decentralization*, 21 DENV. J. INT'L L. & POL. 361, 362 (1993).

265. *Id.*

266. *Id.* at n.6.

It follows that where the MoF has been responsive to foreign requests for change, and has responded accordingly with amended guidelines, the U.S. mutual fund industry immediately can impact the investment trust market. The U.S. funds should capitalize on their popularity and worldwide reputation while they have it—and domestic banks do not—to penetrate and capture the anticipated growth in the Japanese asset management business.

Internationalization of the investment trust market is a concomitant of internationalization of the Japanese economy. As the Japanese economy continues to expand internationally, so too will the securities industry—and invariably the investment trust business. The MoF has facilitated this internationalization through simplifying foreign investment trust access to its financial markets. Public offering of closed-end investment trusts are treated the same as foreign stocks in general and are not subject to the provisions of the ministerial ordinance. Conversely, foreign open-end investment trust funds in Japan are regulated by the "Ministerial Ordinance Concerning Disclosure of Issuers of Foreign Investment Fund Shares." If the open-ended investment trust meets the "Standard Rules for the Selection of Foreign Investment Trust Funds to be Sold in Japan,"<sup>267</sup> the foreign approval to sell to Japanese nationals soon will follow.

Since the turn of the decade, investment trusts have faltered and suffered from the fall in stock markets.<sup>268</sup> As a consequence, the value of their net assets has decreased precipitously.<sup>269</sup> Japanese stock funds have performed badly, due in part to affiliates of the four largest brokers controlling about seventy percent of the fund market.<sup>270</sup> In response to the trusts' poor performance, the Japanese Finance Ministry has tried to compensate investors by extending the investment trusts' redemptive period.

When compared with American mutual funds that invest in Japanese companies, the Japanese Investment Trust would be hard-pressed to compete. A preliminary analysis of these funds tracked for the first quarter of 1994 revealed gains of 17.3%.<sup>271</sup> This statistic alone should encourage, at a minimum, the managers of those Japanese Equity and OTC funds to pursue opportunities with Japanese nationals. Mutual funds and mutual fund managers must consider the Japanese as a source of revenue because it has become increasingly difficult to compete for domestic dollars. Where American funds do very well investing in Japanese companies, they could probably charge a load in Japan and still be competitive. With the U.S. Treasury's recent agreement easing the regulatory framework, the investment trust management

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267. INVESTMENT TRUSTS, *supra* note 129, at 47.

268. *Id.* at foreword.

269. *Id.*

270. Eisenstodt, *supra* note 165.

271. Eric J. Savitz, *Losing Ground, Keeping Calm*, BARRON'S, Apr. 4, 1994, at 25.

industry in Japan has advanced to the point where it makes commercial sense for foreign mutual funds to compete there.

If the evolution of the investment trust selling activity of the Japanese bank subsidiaries in any way parallels the success U.S. banks have enjoyed with their involvement in mutual funds, U.S. Mutual Funds will enjoy immediate success. First Union Bank "forecasts that it will grow a current \$3 billion in mutual fund assets under management into \$25 billion within five years."<sup>272</sup>

Overall, the banks' mutual fund assets have risen sixfold since 1987, to \$180 billion. In 1993, banks accounted for sixteen percent of all mutual fund sales.<sup>273</sup> On present trends, the U.S. mutual fund industry will become the principal repository for U.S. money. At the end of 1993, mutual funds comprised eighty-one percent of commercial bank deposits, compared with about ten percent in the early 1980's.<sup>274</sup> Total assets in mutual funds has doubled in just three years through the capturing of domestic dollars. This expansion could easily continue into Japan, where investors are starved for a premium investment trust. It can no longer be said that the incentive for entry has been lost in the translation.

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272. *Id.*

273. *The Bottom Line, supra note 7.*

274. *Id.*





# DITHERING OVER DIGITIZATION: INTERNATIONAL COPYRIGHT AND LICENSING AGREEMENTS BETWEEN MUSEUMS, ARTISTS, AND NEW MEDIA PUBLISHERS

*"There has never been a doubt in my mind that law is an art. Now I find myself more well-equipped to appreciate the creativity involved in a contract. The relationship to painting is much closer than I ever imagined."*<sup>1</sup>

## I. INTRODUCTION AND SCOPE

Museums around the world are besieged with requests to include their holdings in new media<sup>2</sup> art compilations published on CD-ROM (compact disk - read only memory) by a variety of software firms and electronic publishers.<sup>3</sup> CD-ROM is fast becoming the staple of personal and library computing, but museums are hesitant to join this artery on the information superhighway for fear of losing control: control over the lucrative licensing system in place and control over the integrity of the artwork.<sup>4</sup> These disks, the physical twin of compact disks in the music industry, can bring the Russian National Museum, the Louvre, or the National Gallery into your home. The acquisition of such images by new media publishers raises complex questions for museums and artists regarding licensing agreements and copyright protection, questions which may require creative new solutions.

The scope of a new media project is better understood if imagined as a continuum, a vector linking preproduction contractual arrangements through the production process to the use of the product in homes and offices. Preceding the vector would be a museum's acquisition of a physical object for its collection. This acquisition may or may not include some or all of the elements of copyright's bundle.<sup>5</sup> At the beginning of the vector, a CD-ROM publisher negotiates with a museum to acquire the necessary "rights" to include a

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1. J.S.G. Boggs, *Who Owns This?*, 68 CHI.-KENT L. REV. 889, 910 (1993).

2. New media refers to the combination of video, audio, and text in a computerized setting. For a fuller discussion of technology and terms, see *infra* text accompanying notes 50-60.

3. See Suzanne Muchnic, *Technoarts; In Cyberspace, Can Anyone Really Appreciate Art? CD-ROMs Are Giving Home Computer Users Access to Museum and Private Collections. But Some Institutions are Holding Back From the Digital Age For Fear of Losing Control—And Dollars*, L.A. TIMES, Apr. 3, 1994, at Calendar 4 [hereinafter Muchnic, *Cyberspace*]; Suzanne Muchnic, *Art World Meets the Techno World; The Arts: An International Group of Museum Directors is Gathering in Seattle to Ponder the Technological New Age and the Impact on Institutions*, L.A. TIMES, June 1, 1994, at F 1 [hereinafter Muchnic, *Art World*]; and Phil Patton, *The Pixel and Perils of Getting Art on Line*, N.Y. TIMES, Aug. 7, 1994, at § 2, 1.

4. Muchnic, *Cyberspace*, *supra* note 3.

5. 17 U.S.C. § 106 (1976) (specifying reproduction, derivative works, distribution, performance, and display as divisible elements of copyright's bundle).

museum's collection in its database. The result of this negotiation is a licensing agreement. Further along the continuum, the database becomes a separate entity, perhaps entitled to copyright protection.<sup>6</sup> Toward the end of the continuum, the artwork may become subject to the perils of unauthorized reproduction and alteration in homes, offices, libraries, or even local museums.<sup>7</sup>

This paper will examine the implications of new media technology for the relationship between publishers, artists, and museums. The production of a CD-ROM database hinges on the acquisition of materials,<sup>8</sup> and that acquisition depends on the availability of those materials under international copyright through licensing agreements. First, the old system of acquisition of rights, a one-time use license, will be shown to have problems and limitations in the context of new media technology. Second, new media technology tends to emphasize the role of museums in licensing negotiations, highlighting their fiduciary duties to the public and to the artists they represent, duties which will be examined in detail. A primer on new media technology and its uses for museums will provide additional context for an analysis of the legal problems considered here. Third, the limitations of copyright protection for artists and museums in dealing with new media publishers will be examined. U.S. and

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6. For an analysis of copyright protection for computer databases, see Dennis J. Karjala, *Copyright Protection for Computer Databases, CD-ROMS and Factual Compilations: Copyright and Misappropriation*, 17 U. DAYTON L. REV. 885 (1992); Priscilla A. Walter, *Databases: Protecting an Asset; Avoiding a Liability*, THE COMPUTER LAW., Mar. 1991, at 10.

7. It is beyond the scope of this paper to discuss artists' moral rights in the protection of their artwork against unauthorized alterations once it is part of the database. See Note, *Visual Artists' Rights in a Digital Age*, 107 HARV. L. REV. 1977 (1994); Carl H. Settlemeyer, Note, *Between Thought and Possession: Artists' "Moral Rights" and Public Access to Creative Works*, 81 GEO. L. J. 2291 (1993); Don E. Tomlinson & Christopher R. Harris, *Free-Lance Photojournalism in a Digital World: Copyright, Lanham Act and Droit Moral Considerations Plus a Sui Generis Solution*, 45 FED. COM. L.J. 1 (1992); Russ VerSteeg, *Federal Moral Rights for Visual Artists: Contract Theory and Analysis*, 67 WASH. L. REV. 827 (1992); and John Gastineau, Note, *Bent Fish: Issues of Ownership and Infringement in Digitally Processed Images*, 67 IND. L.J. 95 (1991). It is also beyond the scope of this paper to discuss artists' rights in the resale of their work. See Marilyn J. Kretsinger, *Droit de Suite: The Artist's Right to a Resale Royalty*, 15 HASTINGS COMM. & ENT. L.J. 967 (1993); William A. Carleton, III, Note, *Copyright Royalties for Visual Artists: A Display-Based Alternative to the Droit de Suite*, 76 CORNELL L. REV. 510 (1991).

8. New media publishers can also acquire content by commissioning its creation, but reliance on such works for hire unnecessarily limits the range of material that could be made available through new technologies. This paper focuses on the acquisition of extant material as content for new media compilations, and it is beyond the scope of this paper to address the range of questions associated with creating content for new media products. See William A. Tanenbaum, *Current Multimedia Patent, Copyright, Work Made for Hire, and Rights Acquisition Issues*, in MULTIMEDIA AND THE LAW 1994, at 95 (PLI Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series No. G4-3918, 1994).

international copyright protections vary, raising questions of conflicts of law and jurisdiction which must be considered in reshaping licensing relationships. Finally, this paper will examine new systems for revising the international licensing process for the acquisition of rights, suggest ways in which liability may be avoided, and propose a new method of regulating the relationship between publishers, museums, and artists. Regulating the relationship involves striking a balance between protecting the rights of creators and meeting the needs of new media producers without compromising museums' fiduciary duties to control and protect the artwork in their possession.

## II. LICENSING AGREEMENTS FOR ACQUISITION OF RIGHTS TO USE ARTWORK

The traditional method for publishers to acquire rights to merchandise products using images of artwork is through a one-time use license for a set fee payable to the holder of the copyright. The holders of copyright are either museums or the individual artists or their estates, and under the one-time use system, publishers could deal easily with individual artists to obtain permission to reproduce an image on a poster, note card, or tee-shirt. New media publishers, faced with acquiring massive numbers of images as content for one compilation, realize the limitations of this one-time use license. New media publishers, therefore, favor dealing with museums because they are single entities holding the reproduction rights to thousands of items. Otherwise, the publisher must not only determine what rights are needed but who owns those rights, necessitating extended negotiations with many people or organizations.<sup>9</sup> Museums, furthermore, are also sources of public domain works, and this may provide a publisher with less expensive material for new media products. The need to acquire large quantities of material to fill the huge capacity of new media products reveals the limitations of the old system of licensing for one-time use.

### A. *The Old System of Acquisition of Rights: One-Time Use*

Museums hold copyrights to photographic images of many, but not all, works of art in their collections; works with expired copyrights (i.e. in the public domain) and pieces whose copyrights are held by artists or their estates are the two major exceptions.<sup>10</sup> Ownership of the object must be conceived

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9. Richard Raysman & Peter Brown, *Multimedia Licensing*, N.Y. L. J., July 13, 1993, at 3.

10. Muchnic, *Cyberspace*, *supra* note 3.

of as separate from ownership of copyright: "[e]ven if the museum owns a painting, bought at great expense, it does not hold the copyright on the painting unless it is specifically transferred by the artist."<sup>11</sup> When the financial stakes were smaller—the occasional postcard or tee-shirt—artists were less reluctant to convey copyright with the canvas, but with the burgeoning market for new media products, artists are becoming more sensitive to copyright as a separate item for negotiation in the sale of a piece of art.<sup>12</sup>

Publishers who wish to reproduce artists' or museums' copyrighted images—or the museums' photographs of works in the public domain—must request and receive permission from the copyright holder and pay for one-time publication rights, at an average cost of \$200 to \$500 per image.<sup>13</sup> This traditional system generates income for museums and allows them to maintain quality control over the use of the images through a limited license to manipulate the image of the artwork.<sup>14</sup> Museums need to exercise control in order to protect their reputation and that of the artist, and to fulfill their recognized fiduciary duty to the public regarding suitable display of the image or the object itself.

The license, "a right amounting to a less-than-complete ownership interest in a work," may be exclusive or non-exclusive.<sup>15</sup> That is, if the grantor agrees to convey that right to no one else, it is exclusive, but if the grantor retains the right to convey it to another party, then it is non-exclusive.<sup>16</sup> Under United States Copyright law, an exclusive license, as a transfer of copyright interest, must be in writing; a non-exclusive transfer need not be, but a written instrument is strongly indicated.<sup>17</sup>

## B. *Problems and Limitations*

The one-time license method of acquiring rights to reproduce images is outmoded in an age of rapidly advancing technology. Two major problems adversely affect the parties to such a licensing agreement: negotiating with numerous artists is expensive for publishers, and the resulting license usually

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11. Rhoda L. Berkowitz & Marshall A. Leaffer, *Copyright and the Art Museum*, 8 COLUM. J. ART & L. 249, 258 (1984). The same consideration holds for photographs, sculptures, and other artwork whose image is reproducible.

12. *Id.* at 258.

13. Muchnic, *Cyberspace*, *supra* note 3.

14. *Id.*

15. RALPH E. LERNER & JUDITH BRESLER, *ART LAW: THE GUIDE FOR COLLECTORS, INVESTORS, DEALERS, AND ARTISTS* 368 (1989).

16. *Id.*

17. *Id.* (referring to 17 U.S.C. §204(a)). See also Sherri L. Burr, *Introducing Art Law*, COPYRIGHT WORLD, Feb. 1994, at 25.

fails to protect a copyright holder's rights adequately in the context of new technology due to the lack of standardized definitions for "electronic rights," new media, and multimedia.

First, one-time licensing is an expensive and cumbersome system of acquiring image reproduction rights for publishers, which adds to the complexity and expense of obtaining content for new media products.<sup>18</sup> Creating a new media product requires negotiations with many individual owners possessing proprietary rights to the desired components.<sup>19</sup> As one example of the costs associated with producing a new media product, Microsoft recently paid approximately \$500,000 in licensing fees to obtain the rights to use photographic images in its Encarta Multimedia Encyclopedia, reportedly ten percent of Microsoft's entire budget for the project.<sup>20</sup> The costs of such a project are so high in part because the new media industry and copyright holders have not yet established a standard payment scale, and fees "can range from free to hundreds of thousands of dollars—if permission can even be obtained."<sup>21</sup> The new technological context is what shapes new media publishers' preference for negotiating with museums rather than individuals.

Museums are potential sources, not only of the copyrighted images they hold, but of the public domain artwork that may be less expensive to license. The use of public domain works, however, will not guarantee publishers' freedom from liability. An object that is in the public domain could be there for one of two reasons. The copyright could have expired; or, under the 1909 U.S. copyright statute,<sup>22</sup> the artist could have failed to copyright the object and with first publication it entered the public domain. In either case, the image of the object may not be available to the publisher either because the museum holds copyright to an image of the object, or because the title is protected by trademark law.<sup>23</sup> Liability can be avoided or at least minimized by "distinguishing clearly the multimedia product and its source, either by indicating that the product is produced by a source other than the original

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18. Allen R. Grogen, *Acquiring Content for New Media Works*, THE COMPUTER LAW., Jan. 1991, at 2.

19. *Id.*

20. Raysman & Brown, *supra* note 9, at 3.

21. John Eckhouse, *Rigors of Trying to Obtain Rights*, S.F. CHRON., Aug. 30, 1993, at D5.

22. Act of March 4, 1909, 35 Stat. 1075 (1909) (requiring registration or the work entered the public domain upon first publication), *repealed by* Copyright Act of 1976, 17 U.S.C. § 104.

23. Thomas F. Smegal, Jr. & Caroline Mead, *By Taking Precautions, Sellers of CD-ROMs and Multimedia Products Can Minimize the Liability Risks Involved in Using Public-Domain Works*, THE NAT'L L. J., July 4, 1994, at B5. A trademark "is a word, phrase, symbol or device that identifies the source of the product for which it is used." *Id.* See also *infra* text accompanying note 49.

creator of the public-domain work or by using an express disclaimer."<sup>24</sup> If these problems are identified and precautions taken, public domain works can be a cost-efficient source of content for new media companies.<sup>25</sup>

The second problem with one-time licensing agreements for copyrighted or public domain artwork is that contracts under the old system were probably negotiated and signed without considering electronic exploitation. Many such agreements do not adequately define the rights of each party with respect to new technologies emerging today,<sup>26</sup> much less those barely imagined for tomorrow.<sup>27</sup> The courts may ultimately be final interpreters of "electronic rights" as distinguished from more traditional forms of display, including television, motion picture, and video cassette.

Thus, a bare bones agreement for one-time use cannot adequately protect museums or artists as the rights' holders against unauthorized use of digital images of artwork that can be downloaded, reproduced, or even altered without permission. The language in a typical license specifies that the artwork is furnished "for the purpose of one-time reproduction but must not be loaned, syndicated or used for advertising or other purpose without prior written permission from Artist."<sup>28</sup> Once a piece of art becomes part of a new media compilation, however, neither the grantor nor the licensee can guarantee that unauthorized duplication or alteration will not occur in the hands of home, library, or museum users.

Technology could provide several forms of protection: a watermark could be encoded on the image to provide copyright information during home printing;<sup>29</sup> printing of a particular image could be prevented if a grantor agreed only to inclusion in the compilation but wanted an absolute guard against further reproduction;<sup>30</sup> and new media products could be interactive on the screen, allowing for a temporary alteration but preventing printing if the image has been distorted.<sup>31</sup> Technological protections, however, are unreliable and subject to counter-technological end runs.<sup>32</sup> A more reliable protection today would be promulgation of industry wide standard contracts for licensing the

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24. *Id.*

25. *Id.*

26. Allen R. Grogen, *Licensing for Next Generation New Media Technology*, THE COMPUTER LAW., Nov. 1993, at 4 [hereinafter *Licensing*].

27. Janet Ibbotson & Nainan Shah, *Interactive Multimedia and Electronic Publishing*, COPYRIGHT WORLD, Oct. 1993, at 29.

28. WILLIAM R. GIGNILLIAT, III, CONTRACTS FOR ARTISTS 67 (1983).

29. Jennifer D. Choe, Note, *Interactive Multimedia: A New Technology Tests the Limits of Copyright Law*, 46 RUTGERS L. REV. 929, 986.

30. Patton, *supra* note 3, at 31.

31. Ibbotson & Shah, *supra* note 27, at 30.

32. Choe, *supra* note 29, at 987.

use of artistic images in new media products.<sup>33</sup> Artists and museums must play an active role in the process of defining the relationship between rights holders and publishers in the world of changing technology. Understanding the role of the museum and the potential for new technology is therefore essential for analyzing the limitations of the current system and proposing better solutions.

### III. THE SETTING: MUSEUMS AND TECHNOLOGY

#### A. *The Museum's Role and Fiduciary Duty*

An examination of the definition and role of museums, in the United States and internationally, raises the question of whether a museum can fulfill its fiduciary duties while participating in the mass marketing of artwork through CD-ROM and other new media products. A museum, according to U.S. and international standards, is responsible for the appropriate use of the images of the artwork it controls. A distinction between ownership of the object and an image of that object, either of which may or may not be copyrighted, will clarify the duty of a museum to its artists. Finally, a survey of the use of new technology by museums will illustrate the explosive growth in the application of new media technology and the importance of clarifying these issues.

##### 1. *Definition*

Museums around the world can be categorized as either private or public (authorized by statute), but both types operate with a common mission: to preserve and display the artwork they hold. While museums internationally have varying degrees of success carrying out this mission, U.S. museums are representative of the organization and goals of such institutions worldwide. A museum in the United States is defined by statute as a "public or private nonprofit agency or institution organized on a permanent basis for essentially educational or esthetic purposes, which, utilizing a professional staff, owns or utilizes tangible objects, cares for them, and exhibits them to the public on a regular basis."<sup>34</sup> Most museums in the United States are classified as charitable corporations that hold artwork in trust.<sup>35</sup>

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33. Ibbotson & Shah, *supra* note 27, at 28.

34. 20 U.S.C. § 968 (1978) (Museum Services Act of 1976).

35. MARIE C. MALARO, A LEGAL PRIMER ON MANAGING MUSEUM COLLECTIONS 4-5 (1985). A museum is a corporation pursuing a charitable purpose, acting in trust as a fiduciary by holding property and administering it for the benefit of others. *Id.*

The beneficiaries of this trust are the public, but the museum has a duty to the artists to assure that the artwork held in trust is used and displayed in accordance with the museum's mission.<sup>36</sup> Museums have a responsibility to protect the artwork, to supervise how licensed pieces are used, and must be wary of selling exclusive rights that prevent their exercise of control over quality.<sup>37</sup>

Museums face a double challenge as a result of their status as charitable corporations. If CD-ROM and similar technology will allow the display of the fine arts to a greater number of people in a more educationally rewarding manner, then museums have a duty to explore this new technology. But if the technology that will allow for greater exposure to artwork will put the integrity of the artwork in jeopardy, then the duty becomes less clear. What is clear is that if museums do not participate in the evolution of the licensing framework for the acquisition of the rights to reproduce artwork, then they will be less able to fulfill their fiduciary duty to the public and the artists who produce the work.

## 2. *Acquisition of Materials*

Museums acquire materials for their collections through gift, bequest, purchase, exchange,<sup>38</sup> or loan.<sup>39</sup> The completeness of title must be considered with any transfer of an object. Title to the object may be obtained, but this transaction may be separate from the acquisition of copyright, trademark rights, and specific interests reserved by the creator or seller.<sup>40</sup> Each right desired by a museum should be specifically negotiated and included in the licensing agreements. With the increased profitability of merchandising the fine arts, courts should not interpret a contract's silence on electronic rights as an intentional and knowing relinquishment of those rights.<sup>41</sup> The quality of title transferred must be considered also, as it determines the freedom of a museum to resell or license an object's image by assuring that the object acquired is as represented.<sup>42</sup>

The details of a standard contract for the sale of an art object can be rather limited. A piece of art initially sold for less than two hundred dollars (\$200.00) can be transferred with a simple bill of sale. At most, an artist may delineate the reservation of reproduction, derivative rights, merchandising

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36. *Id.*

37. Muchnic, *Cyberspace*, *supra* note 3.

38. MALARO, *supra* note 35, at 46.

39. *Id.* at 49.

40. *Id.* at 57.

41. *See infra* notes 125-36 and accompanying text.

42. MALARO, *supra* note 35, at 57.



rights, publication rights, and the use of the title.<sup>43</sup> A simple bill of sale may include further protection against "intentional destruction, damage or modification."<sup>44</sup> Perhaps more importantly, a bill of sale for works sold for more than two hundred dollars (\$200.00) is not much more detailed. In addition to the delineated rights in the simple bill of sale, this slightly more complex contract may contain a guarantee that the work is in full compliance with the United States Copyright Act as codified at 17 U.S.C. section 101 et. seq., and that the artist reserves the following rights:

all right, title and interest in and to the copyright, the common law copyright, the right to apply for copyright registration, and any extensions and renewals, common law and statutory copyright in all publication, reproduction or other derivative rights of the work, including merchandising rights, use of title rights, publication rights, foreign edition rights, reproduction rights, derivative work rights. This sale is not intended to transfer any rights of copyright to the Purchaser. . . . Purchaser will not permit any intentional destruction, damage or modification of the Work of Art, including any removal of the copyright notice.<sup>45</sup>

This contractual language is clearer on the traditional uses of a work of art after purchase: the artist retains his or her financial and, in effect, moral interest<sup>46</sup> in the display, reproduction, and merchandising of the artwork. The question remains: what protection does the artist retain when a museum enters a licensing agreement with an electronic publisher for the effective display, reproduction, and merchandising of the image of his or her artwork through digital technology?

### 3. *Ownership of the Copyrighted Object Versus the Copyrighted Image*

Most copyright systems in the world distinguish between ownership of the object and ownership of the copyright to that object, with the corollary that "alienation of the chattel that constitutes the material form of a copyrighted

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43. GIGNILLIAT, *supra* note 28, at 13

44. *Id.*

45. *Id.* at 15.

46. Moral rights protect a creator from unauthorized alterations of his or her creation that would devalue the original or harm the reputation of the artist. Moral rights are common in Europe, but only a few jurisdictions in the U.S. offer such protections through state law. *See infra* note 108.

work does not carry the copyright with it.<sup>47</sup> Sale of a painting, therefore, does not constitute an automatic transfer of copyright, even though it is the only copy available. Variation in national copyright laws, and in international conflicts of law, clouds the determination of who, between artist and purchaser, owns the copyright.<sup>48</sup>

Three distinct situations may arise in the discussion of ownership of an object versus ownership of the copyrighted image. First, a museum may hold a piece of art in its collection while the artist or his or her estate retains ownership of the creation and the accompanying copyright. Second, a museum may hold or own a physical piece of art with or without the accompanying copyright. Third, a museum may hold or own an art object that has entered the public domain due to expired copyright. Even the use of a title to a piece of artwork in the public domain may cause difficulties. If it is covered by trademark, publishers may have to pay a fee for the use of that alone.<sup>49</sup> Assuming the museum is located in a different country from the CD-ROM publisher, or the museum and the artist are domiciliaries of different countries, each of the above situations presents a different set of considerations when negotiating a licensing agreement. Alleged copyright infringements must be judged under the international rules of copyright, contracts, and conflicts of law.

## B. *CD-ROM Technology and Uses in an Art Museum*

### 1. *Essential Terms and a Primer on Process*

New media refers to technology that combines sound, video, and text,<sup>50</sup> with CD-ROM as a popular example. CD-ROM "[c]ombines different media to produce educational, entertainment and productivity programs."<sup>51</sup> An

47. Jane C. Ginsburg, *Conflicts of Copyright Ownership Between Authors and Owners of Original Artworks: An Essay in Comparative and International Private Law*, 17 COLUM.-VLA J.L. & ARTS 395 (1993) (explaining that under 17 U.S.C. § 202 (1988), ownership of copyright is distinct from ownership of "any material object in which the work is embodied," and that under the Code de la Propriete Intellectuelle (Fr.), art. L. 111-3, "[t]he incorporeal property right is independent of the property right in the material object").

48. *Id.* at 395.

49. Smegal & Mead, *supra* note 23.

50. New media is a more accurate term than multimedia because multimedia can refer to low-tech combinations of media as well. For example, a painter could use oil paint and coffee grounds or mud for color and apply it to cardboard and canvas for a multimedia creation. See *supra* text accompanying note 2.

51. MAXWELL L. ANDERSON ET AL., ART MUSEUMS ON THE INFORMATION SUPERHIGHWAY: INFORMATION TECHNOLOGY PRIMER, Association of Art Museum Directors 1994 Annual Meeting, June 1-4, 1994, Seattle, glossary 24.

inexpensive option for the early phases of building an imagebase is photo-CD, a digital system for storing up to 150 color slides.<sup>52</sup> CD-i, Compact Disk-Interactive, differs from the above technologies in that it combines multimedia applications on a single CD and can be plugged into a television and controlled by a joystick or trackball.<sup>53</sup>

Getting a piece of artwork onto a CD-ROM database is a multi-step project. The object is photographed, and this image is then passed through a computer scanner for digitization; the digital signal is then reassembled into a precise reproduction.<sup>54</sup> Transforming a museum's holdings into marketable new media products is not as simple as dumping a catalog onto CD-ROM.<sup>55</sup> The technology may not be adequate yet, as fine details may not be picked up, objects may flatten out, and images may "dither" or begin to "pixelate" into a gridlike pattern "not unlike what one would expect if a snapshot were taken through a screen door."<sup>56</sup>

For example, Rogier van der Weyden's "St. George and the Dragon" has been one of the most difficult images for the National Gallery to scan.<sup>57</sup> Behind the knight and the monster is a walled city, and so finely detailed is the background that it pixelates.<sup>58</sup> Better scanning techniques will soon be available, but museums will continue to dither over the use of new technologies such as CD-ROM databases.<sup>59</sup> Some consider them the St. George of the modern world, slaying the dragon of ignorance by bringing art to more people, and some consider them the beast itself, "inherently hostile to the uniqueness and power of art."<sup>60</sup>

## 2. *Uses of New Technologies by Museums*

Museums may make use of new media technologies in several ways: free-standing computer work stations where visitors can find out more about collections, photo-CDs of their collections made available on networks, and CD-ROM databases sold to off-site users. Each of these present their own perils for the holders of copyright, and a brief overview of the first two will aid in an understanding of the third.

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52. *Id.* at 26.

53. *Id.* at 25.

54. Muchnic, *Cyberspace*, *supra* note 3. Digitization is the conversion of an image into electronic signals in a series of ones and zeros, i.e. digits. *Id.*

55. Patton, *supra* note 3, at 1.

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

Many museums<sup>61</sup> have computerization projects planned or near completion that include the introduction of networked<sup>62</sup> or non-networked<sup>63</sup> computer stations where visitors will be able to call up, for example, an image, a biography of the artist, and an explanation of the techniques used. The Scholar's Workstation at the *Centre Canadien d'Architecture* in Montreal will go further, allowing researchers to move from one medium to another to retrieve even more information about objects and books more easily and seamlessly:

Vendor-provided systems will be combined with tools to locate and explore ancillary material in an attempt to make the scholar's task one of scholarly examination of material instead of one focused upon the laborious search for relevant material. We expect that this system will serve as a model of what commonplace access to cultural information will look like by the middle of the next decade.<sup>64</sup>

More dramatically, the Michael C. Carlos Museum at Emory University in Atlanta will use interactive multimedia at seven kiosks linked to a hypermedia authoring station,<sup>65</sup> allowing the average visitor "to make cross-cultural links and comparisons usually impaired by gallery walls."<sup>66</sup>

The Indianapolis Museum of Art is searching for an image-based collections management system which has a public interface. A photo-CD has been developed, and the Museum plans to try new "writable" disks<sup>67</sup> soon which will allow library users to search computer managed photo-CDs and make prepackaged collections available to teachers for use in the classroom.<sup>68</sup> The use of stand alone computer stations, photo-CD cataloging, hypertext, and interactive new media are just some of the possibilities for museums willing to hop on the information superhighway.

61. ANDERSON, *supra* note 51, at tab 6 (outlining technology goals of museums in the United States, Canada, Central America, South America, and Europe).

62. Networked computers are linked to each other through a central server (a computer dedicated to managing a local area network of computers) and allow sharing of information between stations. Networks can be linked to other networks, as in the Internet.

63. Non-networked computers are freestanding, unlinked units. A personal computer without a modem is an example of a non-networked computer.

64. ANDERSON, *supra* note 51, at tab 6 (*Centre Canadien d'Architecture* statement).

65. Hypertext consists of "randomly connected pieces of information through machine-supported links that allow you to touch a screen or indicate a highlighted word with a mouse for a definition or connection to other avenues of information." *Id.* at glossary 25.

66. *Id.* at tab 6 (Michael C. Carlos Museum statement).

67. A writable disk is a laserdisc whose data not only can be read but altered, added to, or deleted by the user, like standard memory disks.

68. ANDERSON, *supra* note 51, at tab 6 (Indianapolis Museum of Art statement).

The production of CD-ROM databases is a more troubling possibility, given the potential for loss of control over the image. The image is no longer on site, and the possibility of piracy of images increases because even home laser printers can produce copies, albeit of low quality, from the data on the CD. Due to this potential loss of control and the conflict with their fiduciary duty, museums today hesitate to allow more than a printout of an image from Mosaic, "the client based multimedia avenue *du jour*, which permits you *free* access to the World Wide Web<sup>69</sup> and [*sic*] retrieve text, images, sound, and quick-time video<sup>70</sup> from the Internet<sup>71</sup>."<sup>72</sup> Such printouts are low quality and do not pose a reproduction threat to copyright holders. With rapidly improving technology, however, museums are more reluctant to grant a publisher a license to use copyrighted images in its collections because the possibility of easily produced reproductions, with and without alterations, conflicts with their fiduciary duty to the artwork itself and/or the artists or their estates. Yet the educational potential of such new technology is equally undeniable, forcing a museum to balance educational and proprietary interests. Museums should not ignore this new technology simply because it is hard to control; rather, museums should actively participate in its development and use in order to fulfill their fiduciary duty to the public to display artwork.

#### IV. LIMITATIONS OF COPYRIGHT PROTECTION FOR ARTISTS

The problems for museums and artists inherent in the old system of licensing arise, in part, out of the limitations of international copyright protections for artists and their works. The acquisition of new media content from museums can occur in a number of ways, raising issues relating to the doctrines of international copyright, conflicts of law, and contracts. Because new media technology is dominated by a few corporations located in the United States, while the sources of artwork are global, a copyright infringement problem may occur under the law of the situs of the publisher, artist, or museum. The use of international copyright conventions may facilitate a publisher's

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69. The World Wide Web is the "cyberspace home of huge volumes of technical data, electronic dailies, scientific and educational programs, available at present through Mosaic." *Id.* at glossary 28.

70. Quick time video can display moving images digitized from sources such as video tape.

71. The Internet is a "free, self-governing, global web of computer networks. Begun in the [19]60s as a Department of Defense network for its research projects, it was set up for academic institutions doing work for them. Non-DOD academics found it easy to get on the system once their institutions were signed on. Permits file-sharing, electronic mail, and access to news groups for an estimated 20 million users. See SHARON FISHER, RIDING THE INTERNET HIGHWAY (1994); Anderson, *supra* note 51, at glossary 25-6.

72. *Id.* at glossary 26 and tab 2 at 4.

return to U.S. courts if no law is designated as controlling in the pertinent contracts. Designation of controlling law is vitally important, as many European countries provide greater protections for their artists, especially regarding moral rights and resale rights.<sup>73</sup>

An examination of U.S. copyright law, including the 1909 and 1976 Codes, and the influence of the Berne Convention for the Protection of Literary and Artistic Works<sup>74</sup> on the 1976 Code is necessary to set the stage for a discussion of international infringement and the choice of law and contracts questions so tied to transactions in the digital age. The date of creation and/or purchase of the art object determines which version of the U.S. Copyright Code controls if the museum is located in the United States. If the artist or museum is a foreign national, the date of creation and/or purchase will determine whether protection under United States copyright law can be claimed.

The conclusion that emerges from an overview of international and U.S. law is that artists and museums have limited protections. Foreign artists may not have as much protection under U.S. law as under their own, and U.S. software companies may find it difficult to return to U.S. courts in a diversity suit with a foreign domiciliary. Museums could face similar problems in defending their rights and the artwork they are bound to protect. Reliance on statutory protections in litigation should be a last resort, as evidenced by the inherent difficulties of protecting artists' rights under international copyright standards. Furthermore, U.S. copyright law needs to be revised to reflect the rapidly changing technological context of copyright disputes, revisions which are unlikely in the near future.<sup>75</sup> By recognizing these limitations, artists and museums may be quicker to take an active role in shaping the future forms of licensing agreements with new media publishers.

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73. Burr, *supra* note 17, at 24.

Moral rights derive from the codes of civil law countries, where they are recognised [*sic*] as, for example, *droit d'auteur* in France and as *derecho de autor* in Spain and Mexico. According to Professor Marshall Leaffer, 'the civil law tradition views the author's work as an extension of his personality which springs into existence by a personal act of creation.' 'In the civil law world,' he continues, 'an author is deemed to have a moral entitlement to control and exploit the product of his intellect. Under a principle of natural justice, the author . . . is given the right to publish his work as he sees fit, and to prevent its injury or mutilation.'

*Id.*

74. The Berne Convention for the Protection of Literary and Artistic Works of September 9, 1886 [hereinafter The Berne Convention]. The Berne Convention was completed at Paris on May 4, 1896, revised at Berlin on November 13, 1908, completed at Berne on March 20, 1914, and revised at Rome on June 2, 1928, at Brussels on June 26, 1948, at Stockholm on July 14, 1967, and at Paris on July 24, 1971; it was amended on October 2, 1979. See *infra* text accompanying notes 88-89.

75. See Choe, *supra* note 29, at 993.

### A. *Protection Provided Under United States Copyright Law*

Copyright is the “legal recognition of special property rights which a creator may have in his work,”<sup>76</sup> and the U.S. Copyright Code specifically distinguishes ownership of copyright from the right to ownership of the object.<sup>77</sup> Copyright is a bundle of rights, including the rights to reproduction, derivative works, distribution, performance, and display.<sup>78</sup> A museum may acquire an object with some or all or even none of the rights in the bundle, as these exclusive rights are divisible. Therefore, for objects acquired after January 1, 1978, the copyright law presumes that copyright is not automatically acquired along with the object.<sup>79</sup> For an object acquired before January 1, 1978 without mention of copyright interests, the copyright law presumes that the museum obtained the available copyright along with the object.<sup>80</sup>

In the acquisition of content from museums for new media works, it is disputable which of the five rights in copyright’s bundle should be considered. One theory is that all five rights are involved “since such an application may involve the copying of images, the distribution to the public of such images, the derivation of images through animation, detailing, and other forms of manipulation, the broadcast of images as both “performance’ and ‘display’”;<sup>81</sup> but it is disputable whether the digital manipulation of images constitutes performance as contemplated by the U.S. Copyright Code.

### B. *Copyright Protection Through International Treaties*

To determine the rights of foreigners in a particular country during a copyright dispute, two questions must be asked: first, whether the foreigner can claim protection under one of the international conventions to which the country is a party; second, if not, whether the foreigner can claim protection under the section of the national law of the country delineating the rights of foreigners.<sup>82</sup> An examination of the general copyright principles adhered to in the major conventions, and their relation to conflicts of law, is necessary

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76. MALARO, *supra* note 35, at 113.

77. 17 U.S.C. § 102 (1976).

78. 17 U.S.C. § 106 (1976).

79. MALARO, *supra* note 35, at 114-15.

80. Burr, *supra* note 17, at 22.

81. Anderson, *supra* note 51, at tab 2, page 5.

82. STEPHEN M. STEWART, *INTERNATIONAL COPYRIGHT AND NEIGHBOURING RIGHTS* 35 (2d ed. 1989).

for a later examination of the copyright implications of licensing artwork from museums around the world for inclusion in new media compilations.<sup>83</sup>

### 1. *Principles and Conflicts of Law*

The phrase "international copyright protection" is a bit misleading, as no single international rule, law, or principle protects a holder's rights abroad.<sup>84</sup> Protection, if offered at all, is through individual countries, and while most countries do offer some protection, it varies as to object covered and protection provided.<sup>85</sup> Increases in the international trade of copyrighted works has stimulated a growing consensus on certain fundamental principles, forged through the adoption of international copyright treaties guaranteeing a core group of rights to which signatory nations must conform their domestic laws.<sup>86</sup> Therefore, individuals do not have extensive private rights under international copyright treaties,<sup>87</sup> such as the Berne Convention for the Protection of Literary and Artistic Works (the Revised Berne Convention)<sup>88</sup> or the Universal Copyright Convention. These treaties mandate that nations conform their laws to international standards, but if a member fails to do so, most treaties have no effective enforcement mechanism to compel compliance.<sup>89</sup> Nonfulfillment of an obligation under such a treaty would be an infringement on that agreement, and other member states could take a claim to the

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83. Copyright can attach under the theory of *lex loci* (or *lex originis*) where the work is treated like a person, with its nationality determined by that of its creator at the time of its birth if unpublished or at the time of its first publication. *Id.* at 37-38. *Lex loci contractus* may denote "the law of the place where the contract was made, and at other times . . . denote[s] the law by which the contract is to be governed (i.e. place of performance), which may or may not be the same as that of the place where it was made." BLACK'S LAW DICTIONARY 911 (6th ed. 1990). Alternatively, under *lex fori*, copyright attaches when the person protected by the convention claims the same protection in another country as that country's nationals would receive. STEWART, *supra* note 82, at 37-38. *Lex fori* is the "law of the forum, or court; that is, the positive law of the state, country, or jurisdiction of whose judicial system the court where the suit is brought or remedy sought is an integral part. Substantive rights are determined by the law of the place where the action arose, 'lex loci,' while the procedural rights are governed by the law of the place of the form [*sic*], 'lex fori.'" BLACK'S LAW DICTIONARY, at 910.

84. Beryl R. Jones, *Legal Framework for the International Protection of Copyrights*, in GLOBAL INTELLECTUAL PROPERTY SERIES 1993: PROTECTING TRADEMARKS AND COPYRIGHTS; SUCCESSFUL STRATEGIES, at 169-196 (PLI Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series No. G4-3906, 1993).

85. *Id.* at 169.

86. *Id.* at 170.

87. *Id.*

88. *See supra* note 74.

89. *Id.* at 174.



International Court of Justice.<sup>90</sup> At the same time, however, the Revised Berne Convention includes provisions that “create immediate rights for all or certain nationals of the contracting states” which are designated as *ius conventionis* or convention law.<sup>91</sup>

Conflicts of law between the convention and a country’s domestic regulations are avoided because it is necessary for a contracting country to adopt specific domestic law which will determine the scope and content of legal protection actually afforded.<sup>92</sup> If a contracting country adopts a convention’s minimum rights, for example, then an individual would have standing to invoke those rights as binding law.<sup>93</sup>

The question of precedence of international law over domestic law confuses

90. WILHELM NORDEMANN ET AL., INTERNATIONAL COPYRIGHT AND NEIGHBORING RIGHTS LAW: COMMENTARY WITH SPECIAL EMPHASIS ON THE EUROPEAN COMMUNITY 16 (Gerald Meyer ed. & R. Livingston trans., 1990) [hereinafter NORDEMANN].

91. *Id.* at 16 (referring to the Berne Convention; arts. 10, 13, and 14 of the Rome Convention). The term “convention law,” in its narrow sense, refers to certain principles embodied in the treaty, such as national treatment and assimilation under the Universal Copyright Convention and the Berne Convention; minimum rights as well are guaranteed under the Berne Convention. *Id.* Reservations may be made to avoid the grant through minimum rights of greater protection to aliens than nationals. *Id.* For example, the comparison term of protection, also called substantive reciprocity, provides that “no contracting state is obligated to grant longer terms of protection to nationals of another contracting state (or to a copyright owner assimilated to such national of the other contracting state) than such other contracting state grants to nationals of the first contracting state.” *Id.* at 18. Reservations and the application of the principle of reciprocity weaken convention law even while facilitating accession for countries with domestic law standards below those set by the convention. *Id.* at 17.

92. *Id.* at 20.

93. *Id.* at 21. This is a separate issue from whether *ius conventionis* derogates from other domestic law or has equal standing with it, and the question whether *ius conventionis* derogates from other domestic law or has equal standing is of particular importance in three conceivable situations. *Id.* First, if prior domestic law differs from subsequent convention law, under the principle “*lex posterior derogat legi anteriori*,” (“[a] later statute takes away the effect of the prior one. But the later statute must either expressly repeal, or be manifestly repugnant to, the earlier one.” BLACK’S LAW DICTIONARY, *supra* note 83, at 912.) convention law would prevail over domestic law even if they are judged of equal standing. NORDEMANN, *supra* note 90, at 21. Second, if more recent domestic law diverges from prior convention law, then one of three options exist: (1) the more recent domestic law would be interpreted in light of the convention law; (2) if wording and legislative history makes this reconciliation impossible, then it may be held that different law applies to domestic nationals and to nationals of contracting countries; or (3) convention law could be interpreted in light of domestic law. *Id.* at 21-22. Third, if more recent domestic law expressly repeals prior convention law, then one of two situations could occur: convention law would prevail only if treaty law is specifically accepted, constitutionally, as taking precedence over domestic law; or a foreign judge, called upon to apply the domestic law of another country, could not do so if it would violate convention law, for doing so would violate the principle of *ordre public* (public policy) as recognized by all countries. *Id.* at 22-23. See Ginsburg, *supra* note 47, at 4B for a discussion of *ordre public*.

the major tenet espoused by such treaties: after a convention is integrated into domestic law, the treaty formally becomes part of domestic law, but substantively it takes precedence over that law, with interpretation of domestic law in light of convention law and that interpretation sanctioned by the even higher ranking international law.<sup>94</sup>

Article 234 of the European Economic Community Treaty anticipates possible conflicts of European and convention law by establishing a rule of interpretation to prevent an incompatibility of convention law with European Community law:

The rights and obligations resulting from conventions concluded prior to the entry into force of this Treaty between one or more Member States, on the one hand, and one or more third countries, on the other hand, shall not be affected by the provisions of this Treaty.

In so far as such conventions are not compatible with this Treaty, the Member State or States concerned shall take all appropriate steps to eliminate any incompatibility found to exist. Member States shall, if necessary, assist each other in order to achieve this purpose and shall, where appropriate, adopt a common attitude.

Member States shall, in the application of the conventions referred to in the first paragraph, take due account of the fact that the advantages granted under this Treaty by each Member State form an integral part of the establishment of the Community and are therefore inseparably linked with the creation of common institutions, the conferring of competences upon such institutions and the granting of the same advantages by all other Member States.<sup>95</sup>

European Community law serves a special function in the creation of the Community, and *subsidiarity* (the principle that no state relinquishes more sovereignty than necessary) does not apply to its interpretation.<sup>96</sup> Member states of the European Community signed revised convention agreements with knowledge of Community law and must consider them in harmony.<sup>97</sup> Therefore, copyright interpretation should not be at the expense of Community law, but as a result of careful balancing; if doubt remains, Community law

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94. NORDEMANN, *supra* note 90, at 23.

95. *Id.* at 24-25.

96. *Id.* at 26.

97. *Id.*

should prevail.<sup>98</sup> This line of reasoning has been followed in the copyright cases decided so far by the European Court of Justice, leaving author's rights untouched in principle but subjecting them to Community law principles.<sup>99</sup>

## 2. *Under the Berne Convention*

The purpose of the Berne Convention is to establish international relations in the field of copyright by dealing with situations in which the laws of more than one country could apply and by furthering the uniformity of copyright protection.<sup>100</sup> For example, copyright protection under the Berne Convention extends over the life of the author plus fifty years.<sup>101</sup> This conflicted with U.S. copyright protection of fifty-six years until the 1976 U.S. Copyright Code revision; this harmonization of terms allowed the U.S. to sign the Berne Convention in 1989.<sup>102</sup> The goals of the Berne Convention are achieved through the use of national treatment, minimum rights, reciprocity, automatic protection, and reservations.<sup>103</sup> The history of the Berne Convention includes a number of additions between 1886 and 1971,<sup>104</sup> further confusing conflicts of law questions. Such specifics must be analyzed in the context of a particular infringement, and as a result, only general principles from the 1971 Paris Revision, the most recent version of the convention,<sup>105</sup> are outlined below.

The Berne Convention provides a number of minimum rights, commonly known as moral rights, which includes the exclusive right to authorize reproductions<sup>106</sup> and protection from unauthorized "distortion, mutilation or other modification of, or other derogatory action in relation to" the creative work.<sup>107</sup> These minimum rights exceed those available to artists under federal law in the United States. State copyright laws providing for moral and resale rights are available in a small number of jurisdictions in the United States.<sup>108</sup> Limited exceptions to moral and resale rights, including fair use, are available

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98. *Id.*

99. *Id.*

100. STEWART, *supra* note 82, at 99.

101. The Berne Convention, *supra* note 74, art. 7, sec. 2.

102. 17 U.S.C. 101-1010 (1976).

103. STEWART, *supra* note 82, at 99-100.

104. *See supra* note 74.

105. STEWART, *supra* note 82, at 101.

106. The Berne Convention, *supra* note 74, art. 9.

107. *Id.* art. 6bis.

108. Burr, *supra* note 17, at 24 (specifying California, Connecticut, Louisiana, Maine, Massachusetts, Nevada, New Jersey, New Mexico, New York, Pennsylvania, and Rhode Island as states with rights of paternity and integrity guaranteed by state statute; furthermore, Utah, Montana, and Georgia have enacted legislation for limited moral rights protection). *See supra* text accompanying note 46.

under the Berne Convention.<sup>109</sup> Each Berne country, however, may legislate the nature of fair use agreements, the extent of fair use protection, and limits of permissible fair use purposes.<sup>110</sup>

Protection under the Berne Convention applies both to nationals of Berne Convention signatory countries and to authors who either first publish their works in a Berne country or who simultaneously publish their works in a non-Berne and a Berne country.<sup>111</sup> Each member state must provide national treatment to the owners of foreign copyrights.<sup>112</sup> National treatment means that a country extends the same protection to a foreigner that it extends to its own citizens. For example, in a copyright dispute between a French national and a U.S. national in a French court, the U.S. national would be able to claim the protections of moral and resale rights under France's copyright law protection.

National treatment does not mandate the incorporation of all Berne Convention provisions into a signatory's domestic law. If a signatory country qualifies as "developing," it may reject or modify certain provisions by declaring in its instrument of ratification or accession to which article or articles it objects.<sup>113</sup> Without such a declaration, ratification or accession "shall automatically entail acceptance of all the provisions and admission to all the advantages of this Convention."<sup>114</sup>

### C. *Territorial Reach of United States Courts in International Copyright Disputes*

In many instances, U.S. citizens or corporations involved in an international copyright dispute may wish to use U.S. laws and courts, but the following factors, in addition to substantive law, must be considered: personal jurisdiction, venue, *forum non conveniens*, subject matter jurisdiction, choice of laws questions, and comity.<sup>115</sup> Publishers incorporated in the United States especially would

109. The Berne Convention, *supra* note 74, arts. 10, 10bis. "It shall be permissible to make quotations from a work which has already been lawfully made available to the public, provided that their making is compatible with fair practice, and their extent does not exceed that justified by the purpose. . . ." *Id.* art. 10.

110. *Id.* arts. 10(2), 10bis.

111. *Id.* art. 3(1)(a)-(b).

112. *Id.* arts. 5-6.

113. *Id.* art. 28. *See also* The Berne Convention, art. VI(1) of the Appendix.

114. *Id.* art. 30(1).

115. JONES, *supra* note 84, at 185-89. First, personal jurisdiction in copyright claims litigated in federal court is not specifically provided for by Congress and must be determined by reference to the statutes or rules where the court sits. *See* Fed. R. Civ. P. 4(e) and *Stabilisierungsfonds Fur Wein v. Kaiser Stuhl Wine Distributors Pty. Ltd.*, 647 F.2d 200 (D.C.

want to remain in U.S. courts for convenience, familiarity, limited expense, and, most importantly, the less stringent protections afforded to artists and other rights holders. Foreign artists and museums, conversely, may wish to avoid U.S. courts for that very lack of protection. Some developing countries, such as the former Soviet republics, may have even less protection<sup>116</sup> for artists and museums in a copyright dispute with U.S. publishers, and therefore all parties may wish the foreign parties to gain access to U.S. courts. The

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Cir. 1981). State court jurisdiction is limited by the due process clauses of the Fifth and Fourteenth Amendments. See *Ashai Metal Indus. Co., Inc., v. Super. Ct.* 480 U.S. 102 (1987) and *GBM Marketing USA, Inc. v. Gerost*, 832 F.2d 763 (2d Cir. 1991). Second, venue must be established under the specialized statute for venue in copyright cases arising under United States law. See 28 U.S.C. §1400. The general venue provisions under 28 U.S.C. §1391 will apply where the plaintiff does not try to enforce a right under U.S. law but rather under the law of a foreign jurisdiction. Section 1391(a) dictates venue where all plaintiffs or all defendants reside or where the claim arose. Third, the analysis for *forum non conveniens* in intellectual property cases follows the traditional factors, such as whether the defendant is present in the forum, whether other forums are available, and whether relevant acts occurred in the forum. See *London Film Productions, Inc. v. Intercontinental Communications*, 580 F. Supp. 47 (S.D.N.Y. 1984); see also *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501 (1947); *Piper Aircraft v. Reyno Co.*, 454 U.S. 235 (1981); and *Update Art v. Maarin Israel Newspaper, Inc.*, 635 F. Supp. 228 (S.D.N.Y. 1986). Fourth, subject matter jurisdiction in copyright cases is determined by the statutory grant of subject matter jurisdiction and the extent of the Constitutional grant of power to Congress. Under 28 U.S.C. §1338, subject matter jurisdiction over copyright claims arising under federal law is granted to the federal courts, but the reach of this provision depends on whether Congress intended to cover the conduct in question and whether Congress' intended territorial reach is permissible under art. I, sec. 8, cl. 8 of the Constitution. Courts have interpreted the territorial reach of copyright statutes narrowly. If the copyright claim does not arise under U.S. law, then general diversity jurisdiction under 28 U.S.C. §1332(a) may provide for subject matter jurisdiction through the complete diversity of parties in cases involving foreign citizens. Fifth, the determination of whether U.S. or foreign law will control determines which statute provides the court with jurisdiction: Section 1338, if United States law is applied and Section 1332, if foreign law is applied. Sixth, even if the court can hear the claim, the availability of remedies must be considered. *Id.*

116. *U.S., Russia Meet on Copyright Protection Issue*, REUTER TEXTLINE, Feb. 24, 1994. Russia is a "huge potential market, 'but to freely engage U.S. business, there must be better enforcement of copyright protection'." *Id.* Russia has a copyright law, but it is not a member of the Berne convention that ensures protection of foreign copyrights. *Id.* Russia's law on Copyright and Related Rights was adopted by the Parliament on April 29, 1993. S. Viktorov & Ye. Medvedev, *Russia: New Copyright Law Adopted*, REUTER TEXTLINE, May 5, 1993. The law guarantees to protect the rights of citizens of any country who publish or show their works in Russia; to protect the rights of Russians who publish or show their works abroad; and to protect against unauthorized duplication. *Id.* The law protects "all literary works, works of art, scientific works, including those not yet revealed to the public, computer programs, data bases, audio recordings, and TV shows." *Id.* The term of protection is life of the author plus fifty years, and the law provides for confiscation of illegal copies and profits in case of infringement. *Id.*

limitations and restrictions in conflicts of law and jurisdiction must be considered carefully before a forum is selected.

Foreign authors can be protected under United States Copyright Code if certain conditions are met. Protection will be afforded to any unpublished work<sup>117</sup> and published works if they fall under one of the following categories: if the author is a domiciliary of the United States at the time of publication;<sup>118</sup> if the work is first published in the United States;<sup>119</sup> if the author of the work is a national or domiciliary of a nation that has signed a treaty to which the United States is a party;<sup>120</sup> if the works were published in a country for which the President has issued a proclamation extending protection;<sup>121</sup> if the works were published by the Organization of American States or the United Nations;<sup>122</sup> or if the works were produced by nationals of countries that have signed the Berne Convention or were first published in a Berne country.<sup>123</sup> Protection is available under U.S. copyright law to foreign authors even if such protection is unavailable under the law of his or her domicile, even though the traditional rule in copyright cases is that the applicable U.S. law reaches activity involving foreign conduct only if the infringing act occurred in the United States.<sup>124</sup>

All of these questions, whether of choice of law or of jurisdiction, must be considered carefully during the drafting phase of the licensing process so that parties can predict which court may have the power to adjudicate a copyright dispute, especially as the selection of the better forum may differ for each party. Litigation of copyright claims will be difficult and expensive even if a forum or dispute mechanism is specified in the contract. The best advice may be to avoid such disputes with a clear delineation and limitation of rights made available to publishers. The old system of one-time-use licenses clearly cannot keep pace with advancing technology, and international copyright law is limited in its protection of artists, even if they take advantage of it. The best protection for artists and museums is to take a pro-active role in the development of new licensing systems for artwork.

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117. 17 U.S.C. § 104(a) (1988).

118. 17 U.S.C. § 104(b)(1).

119. 17 U.S.C. § 104(b)(2).

120. 17 U.S.C. § 104(b)(1), (2), (4).

121. 17 U.S.C. § 104(b)(5).

122. 17 U.S.C. § 104(b)(3).

123. 17 U.S.C. § 104(b)(4).

124. JONES, *supra* note 84, at 190 (referring to Robert Stigwood Group Ltd. v. O'Reilly, 530 F.2d 1096 (2d Cir. 1976), where "the court refused to extend the 1909 Copyright Act to Canadian performances of a work protected under United States copyright law").

## V. PROPOSED NEW SYSTEMS

It is not a widely accepted proposition that the current licensing system needs to be overhauled. One theory holds that a complete overhaul is not necessary because technological advances are evolutionary and can be controlled with continuing small adjustments to contract language. An opposing theory provides that the technological leap involved in new media products is such that a more stringent licensing system, perhaps controlled by licensing organizations akin to those long used in the music industry, is the more complete safeguard for the creators and trustees of artwork. Finally, as an alternative to these sorts of licensing agreements, museums may proactively work with software companies in joint ventures, thereby sidestepping most of the pitfalls of licensing away rights to reproduction, especially loss of control over the images.

A. *Licensing Systems and the Acquisition of Rights Through Contracts: Is an Update Necessary?*

If the advent of new media technology is viewed as more evolutionary than revolutionary, then a full scale updating of the current licensing system may be unnecessary.<sup>125</sup> Technological advances in the past have forced earlier courts to interpret contractual grants of rights entered into before the invention of later media and technologies. The leading cases have examined grants of rights requiring a distinction between motion pictures and television,<sup>126</sup> transcriptions and video cassettes,<sup>127</sup> an examination of the meaning of exhibition,<sup>128</sup> and a determination of which phrase modifies which grant of rights.<sup>129</sup>

This line of cases<sup>130</sup> leads to two identifiable approaches.<sup>131</sup> Under

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125. *Licensing, supra* note 26, at 2.

126. *Id.* (citing *Bartsch v. Metro-Golywyn-Mayer, Inc.*, 391 F.2d 150 (2d Cir. 1968)).

127. *Id.* (referring to *Peggy Lee v. Walt Disney, No. S029681*, 1992 Cal. LEXIS 6172 (Dec. 16, 1992)).

128. *Id.* (citing *Platinum Record Co., Inc. v. Lucasfilm, Ltd.*, 566 F. Supp. 226 (D.N.J. 1983)).

129. *Id.* (citing *Cohen v. Paramount Pictures Corp.*, 845 F.2d 851 (9th Cir. 1988) for the proposition that a protective phrase such as "by any means or method now known or hereafter devised" or "in any manner, medium, form, or language" must modify all relevant grants or a contrary interpretation may be reached by the courts.)

130. *See also* *Ettore v. Philco Television Broadcasting Corp.*, 229 F.2d 481 (3rd Cir. 1956); *Rey v. Lafferty*, 990 F.2d 1379 (1st Cir. 1993); *Bourne Co. v. The Walt Disney Co.*, 1992 CCH Copyright Law Decisions P26, 933 (S.D.N.Y. 1992); *Murphy v. Warner Bros. Pictures, Inc.*, 112 F.2d 746 (9th Cir. 1940); *Filmvideo Corp. v. Hastings*, 448 F. Supp. 725 (S.D.N.Y. 1978); *Rooney v. Columbia Pictures, Ind., Inc.*, 538 F. Supp. 211 (S.D.N.Y. 1982). *Licensing, supra* note 26, at 8-10.

131. *Licensing, supra* note 26, at 4.

an approach favored by the Second Circuit, the court will presume that "a grant of rights covers new uses or new media if the words are reasonably susceptible to that interpretation."<sup>132</sup> The licensee is free to pursue any use which "may reasonably be said to fall within the medium as described in the license."<sup>133</sup> A distinction is possible "if the disputed use was not even intended at the time of contract."<sup>134</sup> Another approach, favored by the First, Third, and Ninth Circuits, presumes that "new uses or new media not contemplated at the time of contract are not included in the grant of rights."<sup>135</sup> A license would include only those uses that "fall within the unambiguous core meaning of the term . . . and excludes any uses which lie within the ambiguous penumbra," leaving reserved any rights not expressly and unambiguously granted.<sup>136</sup> Under either analytic approach, a clear intent evidenced by the contractual language of the parties regarding the new uses and the new media will overcome either of these presumptions.

This line of cases and the resulting analysis indicate that U.S. courts may be fully equipped to interpret vague language in licensing contracts signed before the advent of new media technology such as CD-ROM. Two questions remain: first, does the ability to alter and reproduce easily and without authorization remove CD-ROM, CD-i, and interactive new media from the range of technological transitions the courts envisioned in the past? Second, even if this kind of technological leap is permissible under the analysis U.S. courts have used in the past for less invasive types of technologies, is it equitable to force this leap on artists, a class of people perhaps nescient about such technology?

Copyright law is designed to promote creativity by rewarding it with protections against unauthorized duplication and alteration.<sup>137</sup> New media technologies seem more threatening to the fundamental premise of copyright than a transition from film to television or film to video cassette. The transition

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132. *Id.* at 11.

133. *Id.* at 4 (quoting 3 NIMMER ON COPYRIGHT at 10-86).

134. *Id.* at 11.

135. *Id.*

136. *Id.* at 4 (quoting 3 NIMMER ON COPYRIGHT at 10-85).

137. "The Congress shall have power . . . [t]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." U.S. CONST. art. I, § 8, cl. 8. Visual artist J.S.G. Boggs questions the practicality of copyright law:

It strikes me that the areas of law devoted to protecting intellectual property confront a strange dilemma. On the one hand, protection stimulates individual creative productivity. On the other hand, it can stifle the advances of a collective effort in a specific arena of human interest, or the "additive" refinements of an individual breaking new ground on an existing body of work.

Boggs, *supra* note 1, at 889.



from film to television broadcasts seems to fit squarely within the analytical constructs of earlier courts. They are both display technologies which provide no opportunity for alteration or reproduction by the viewer without authorization, and both can be efficiently policed. The advent of video cassette technology provided the opportunity to copy easily from television, but licensing contracts took that into account and provided for compensation.<sup>138</sup> The development of interactive technologies such as CD-ROM and CD-i presents the possibility of high quality reproductions of altered or unaltered artwork found on such databases. It is this difference in ease of alteration and duplication and the quality of the product that can then be circulated that distinguishes new media technologies from previous advances in electronics. This qualitative difference requires a more formal review and updating of contractual language for the licensing of artwork for new media products.

B. *The Intersection of International Copyright and Contract in Multimedia Licensing Agreements: Suggestions for Avoiding Liability*

A revision of the standard language used in licensing agreements will have several desirable effects. First, requiring clearer language will allow the grantor to consider the ramifications of granting rights to all specified and unspecified technologies and provide for a measured response to the issues presented by such a grant. Second, clearer language is produced by clearer thoughts and more resolute intent. Third, if parties do litigate a conflict, the court will have a better opportunity to divine intent and provide an equitable solution if pertinent issues have been negotiated or at least considered. The challenge for lawyers is to deal not only with "new industry" but to take into account future developments through fair and sensible licensing and royalty agreements.<sup>139</sup>

The question then becomes whether the new language in the contracts should be precise, which would protect the artist, or broad, as publishers would desire. One attempt to address the complexities of new media is a broad definition of "electronic rights":

As used herein, 'electronic rights' shall mean the sole and exclusive right to adapt, and to authorize others to use or adapt, the Work or any portion thereof, for one or more electronic versions. As used herein, 'electronic versions' shall mean any and all methods of copying, recording, storage, retrieval, broadcast or transmission of all or any portion of the Work, alone or in combination with

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138. Ibbotson & Shah, *supra* note 27, at 32.

139. *Id.* at 28.

other works, including any multimedia work or electronic book, by any electronic or electromagnetic means now known or hereafter devised including, without limitation, by analog or digital signal, whether in sequential or non-sequential order, or any and all physical media, now known or hereafter devised including without limitation, magnetic tape, floppy disk, CD-1 [*sic*], CD-ROM, laser disk, optical disk, integrated circuit card or chip and any other human or machine readable medium, whether or not permanently affixed in such media, and the broadcast or transmissions thereof by any and all means now known or hereafter devised, but excluding audio recording rights, video recording rights and all uses encompassed in motion picture rights and television rights (provided that the exercise of such rights shall not preclude the exercise of the electronic rights).

If publisher exercises the electronic rights under one of its own or its affiliated imprints, the royalty rate paid by publisher on electronic versions shall be the prevailing rate paid for similar uses. The parties shall negotiate in good faith to establish such rate. If publisher sublicenses a third party to publish an electronic version, publisher shall pay author 50 percent of the gross receipts from such sublicenses.<sup>140</sup>

Publishers want a complete grant of rights, as indicated in the expansive sample language above, to preclude the risk that the grantor will be able to license the reserved rights to others. In addition to the language above, licensees can further reduce this risk by including a "right of first negotiation and a right of last refusal" clause in the contract.<sup>141</sup>

Additional concerns should be addressed in license agreements that are not unique to new media applications. The grantor should guarantee that it is the rightful holder of the rights purported to be transferred, that it has the authority to transfer said rights, and that the work does not infringe on another's copyright.<sup>142</sup> An indemnification clause should be included in the contract to protect the licensee from any claim brought by third parties for breach of the right holder's warranty.<sup>143</sup>

Rights holders have a different set of concerns, centered on the general unwillingness to agree to broad transfers of rights for fear of losing control over the work and access to revenues on future technologies.<sup>144</sup> Museums

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140. Alan J. Hartnick, *Checklist for Lawyers for Multimedia Matters*, N.Y. L.J., Oct. 8, 1993, at 5. See also *supra* note 129.

141. Raysman & Brown, *supra* note 9, at 3.

142. *Id.*

143. *Id.*

144. *Id.*

will want to limit the scope of the grant by restricting the range of devices or formats the grant will apply to and by reserving certain key rights by using a narrower definition of product forms than the one quoted above.<sup>145</sup> Another tactic would be to limit the term of the license and to include a reversion clause for the return of the rights to the grantor if the licensee does not produce the new media product within a certain amount of time.<sup>146</sup> It was the broad and general grants of rights that survived judicial scrutiny in the line of cases analyzing contractual language to determine whether the original grant included future technologies.<sup>147</sup>

Whether original creators receive any of the profits when electronic publishers purchase the rights to put major art collections into computer databases depends on the nature of the contract the artist has with the museum. Even if the original contract for the sale or loan of the work did not mention electronic rights, museums will usually give the artist or his or her estate a share of the proceeds.<sup>148</sup> When the original contract for the sale or loan includes electronic rights, an analysis of the scope of the grant will still be necessary. Museums are under no obligation to share profits, but when the work is on public display as part of the museum's holdings in the public domain, the museum will control and receive royalty on such artwork included in new media products—as a safety measure for software companies to avoid liability because of the trust responsibility a museum continues to have over the artwork.<sup>149</sup> It is vital to remember that museums hold works of art in trust and have the responsibility to protect the art by knowing how the material they license will be used. Problems arise when museums (or artists) sell exclusive rights<sup>150</sup> without adequate guarantees.

In short, there is no standard contractual language for the sale or transfer of digital rights, forcing the parties to negotiate each deal separately. Publishers work with curators to select images and scan photographs provided by the museum, and museums generally receive a cash advance against royalties and a promise of future royalties if the product produces sufficient income.<sup>151</sup> Museums, as rights' grantors, should strive to limit the scope of the agreement to certain specific tasks; to restrict the license to specific technologies and hardware and software platforms; to provide for quality control; to allocate ownership of the proprietary rights in the product; to provide for the use of proprietary markings; to provide for the reversion of rights for failure to market

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145. *Id.*

146. *Id.*

147. *Id.* See also *supra* text accompanying notes 130-36.

148. See Ibbotson & Shah, *supra* note 27.

149. Muchnic, *Cyberspace*, *supra* note 3.

150. *Id.*

151. *Id.*

the product within a specified period of time; and to secure distribution details, including royalties.<sup>152</sup> Compliance with licensing agreements comes through contract theory backed by international copyright protections.<sup>153</sup>

Visual artists and museums have an option beyond one-on-one contractual negotiations: the use of blanket licensing through licensing organizations patterned on those used by composers and lyricists.<sup>154</sup> New technology has brought the visual arts to the "same watershed in licensing and rights administration which the creators of musical works faced with the advent of recording and broadcasting some 60 to 90 years ago."<sup>155</sup> Forms of collective administration of licenses could help ensure that artists receive the full benefit of new media technologies.<sup>156</sup> Blanket licensing through the establishment of such collecting societies would allow public display, downloading, use on networks, rentals, and home copying.<sup>157</sup> Collecting societies and rights owners could investigate methods of marking and tracking works to ensure payment for actual use for works transmitted through telecommunications networks.<sup>158</sup>

This form of protection is not universally favored. A working group of representatives from visual artists collecting societies located in Europe, working on behalf of such organizations worldwide, advocates instead the licensing of works on the basis of key reproducing acts necessary to new media products.<sup>159</sup> Five key rights could be licensed: initialization, multiplication, public display, printout, and on-line access.<sup>160</sup> The initialization/fixation right would require a nominal charge per work to input a single visual work onto a master copy by digitization.<sup>161</sup> This process would remind publishers and users that digitization is reproduction. Multiplication rights would require a fee for the reproduction of a visual work from the master copy onto a commercially produced CD-ROM, CD-i, Laserdisc, or similar new media product, with the fee structure tied to the number of discs produced and works included on those discs.<sup>162</sup> The public display and consultation on screen rights would generate a fee for use based on the appearance of the image on

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152. Raysman & Brown, *supra* note 9, at 3.

153. *Id.*

154. Ibbotson & Shah, *supra* note 27, at 31. See also Maralee Buttery, Note, *Blanket Licensing: A Proposal For the Protection and Encouragement of Artistic Endeavor*, 83 COLUM. L. REV. 1245 (1983).

155. Ibbotson & Shah, *supra* note 27, at 31.

156. *Id.* at 32.

157. *Id.*

158. *Id.*

159. *Id.* at 33.

160. *Id.* at 33-34.

161. *Id.* at 33.

162. *Id.*

screen being interpreted as a reproduction.<sup>163</sup> If an artist had the right to a fee for each printout, this could cover the cost of production of high quality printouts; with "audit trailing devices within their systems providing exact data on the number of copies of each individual work used."<sup>164</sup> The on-line access/communication networks right would require licensors to consider each request in order to meet the concerns for controlling on-line systems.<sup>165</sup>

Jean Francois Verstryngne of the European Commission cautions against rushing toward collective licensing for the visual arts:

'If every time we can no longer enforce the exclusive nature of a right . . . if every time we react by creating a remuneration right only, we are gradually pushing copyright away from its nature as a fundamental right into a type of taxation system . . . . If this continues without a reaction, copyright will be dead in 30 years.'<sup>166</sup>

The obvious reaction to the impending death of copyright is a revision of the codes to accommodate new media products.<sup>167</sup> Such revisions, however, will be slow in coming because of the nature of the political process through which copyright laws pass and the complexity of the issues. In the meantime, therefore, a balance must be found through licensing contracts between protecting the rights of creators and meeting the needs of new media producers and users. Such a balance would help create an efficient and cost effective licensing system that does not compromise the trust responsibilities of museums around the world.

While blanket licensing systems, collecting agencies, and newly created rights requiring fees may seem excessive, there is no denying the pressure artists face to give up their rights: "Fine artists and those whose work is held in libraries and collections are expected to make it available for the new media for little fee and even fewer safeguards."<sup>168</sup> Creators are best situated to protect their interests against the greed of publishers desperately searching for the rights to acquire content for new media productions, and strengthened copyright laws may be the best way to protect the interests of artists.<sup>169</sup> Artists have traditionally been at a disadvantage in their negotiations with publishers, "but the speed, and ease of storage, transmission and manipulation

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163. *Id.* at 34.

164. *Id.*

165. *Id.*

166. *Id.* at 32.

167. See Choe, *supra* note 29, and the text accompanying note 73.

168. Ibbotson & Shah, *supra* note 27, at 34.

169. *Id.* at 34-35.

that the new technologies offer make it exceptionally unfair” for publishers to control the evolution of the licensing agreements.<sup>170</sup> Museums, to fully carry out their fiduciary duties as charitable corporations, must include the artist as they negotiate licensing agreements for the use of artworks in their collections or holdings in new media products.

### C. *Joint Ventures*

If museums around the world wish to avoid the “cultural disaster” of artworks becoming “mere chattels (to be endlessly recycled and regurgitated) . . . choking the very life force from a community whose endeavors drive so much of our industry and commerce as well as our culture,”<sup>171</sup> they could license only production and distribution rights. United States software companies are the major buyers of the rights to a digitize foreign museum’s collections and holdings. A creative solution is the joint partnership of a U.S. software firm with a foreign firm for distribution rights only. Roundbook Publishing, a fledgling operation in Scott’s Valley, California with only eleven employees, is a partner with the Russian firm that controls the rights to 90,000 slides of Russian artwork previously managed by the state of Russia.<sup>172</sup> Roundbook negotiated an exclusive marketing and distribution agreement with a Russian group, the Laboratory of Optical Telemetry (LOT), seeking help with CD-ROM development.<sup>173</sup> These former military scientists declined an offer of greater money from software giant Microsoft to keep the slides in country and to avoid losing control over the use of the images.<sup>174</sup>

Such an arrangement has multiple advantages. First, it keeps the artwork in the country of origin, and this provides an extra layer of protection against cultural expropriation by U.S. software firms of pieces of a country’s cultural identity. Second, copyright protections for artists are stronger in Europe, and in the case of an international copyright dispute, the artist whose works are part of a European based joint venture with a U.S. software publisher has a better chance of staying in his or her home court and benefiting from those greater protections. Third, partnerships spread the wealth: new media products are selling vigorously and a partnership between a foreign firm that has the artwork or the rights thereto and smaller software companies in the United States decentralizes the power over artwork that could be possible if giants like Microsoft developed a monopoly.

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170. *Id.* at 35.

171. *Id.*

172. Sandy Reed, *Digitizing the Masters*, POPULAR SCIENCE, Aug. 1994, at 18.

173. *Id.*

174. *Id.* and interview with Dean Quarnstrom, President, Roundbook Publishing (Oct. 1994).

## VI. CONCLUSION

Clearly, technology will continue to outpace law making. Despite the lack of clarity and certainty associated with fledgling regulation of a new industry, contract theory can protect the respective interests of artists, museums, and electronic publishers. This is not to say regulation should be left to the market, with individual contracts for each transaction reinventing the basic protections possible for each party. The key is drafting appropriate contracts that reflect the technological advances made and that could possibly be made in the future.

The internationalization of U.S. law due to the adoption of international copyright treaties provides some safeguards for foreign artists and museums in their contractual dealings with U.S. software companies, provided they can get into federal court over the jurisdictional and conflicts of law hurdles. A museum's trust relationship with the artwork in its control requires it to maintain control over the use of the artwork. The museum should not license artwork for use unless it is reasonably protected against unauthorized use. CD-ROM technology makes that guarantee nearly impossible, but the educational uses of putting artwork into easily accessible databases may force a compromise on this issue. Museums must now decide what risks are worth taking.

Joint partnerships between U.S. and foreign firms have advantages in allowing the artwork's country of origin to maintain cultural integrity by controlling the images and avoiding the buyout of their culture. Creativity in contracting for multimedia content is necessary because international copyright in its current form may not be capable of safeguarding national artworks, even though remedies are available through litigation.

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# EUROPEAN CULTURAL PROTECTIONISM AND THE SOCIOECONOMIC FORCES THAT WILL DEFEAT IT

## I. INTRODUCTION

The last minute concession was forced upon President Clinton in the early morning hours of December 14, 1993. The European trade delegation would not compromise on the issue of audiovisual trade. The debate over the "cultural exclusion" for trade protections of entertainment products would have to be tabled, so that negotiations on the Uruguay Round Trade Accord<sup>1</sup> to the General Agreement on Tariffs and Trade (GATT)<sup>2</sup> could proceed. Some U.S. officials continued to assert that the "cultural exclusion" was superseded by the GATT agreement.<sup>3</sup> But in March of 1994, the U.S. ambassador to the European Union (EU), Stuart Eizenstat, said that the United States would not pursue sanctions in the dispute.<sup>4</sup> And so, with an oddly appropriate

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1. On December 15, 1993, participants from 117 countries concluded the Uruguay Round of international trade negotiations to expand and revise the 45 year old GATT treaty regulating worldwide trade. The Uruguay Round Trade Accord, a document over 400 pages in length, is the result of seven years of negotiations that began in Punta del Este, Uruguay, in Sept. 1986. The Accord must be ratified by each participating nation before taking effect. If ratification proceeds as expected, the Accord should become effective July 1, 1995. Lisa B. Martin and Susan L. Amster, *International Intellectual Property Protections in the New GATT Accord*, 6 J. PROPRIETARY RTS. 9 (Feb. 1994). See also Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, *opened for signature* Dec. 15, 1993, Doc. No. MTN/FA II-AIC [hereinafter Uruguay Round Accord].

2. The General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187 [hereinafter GATT] creates international obligations among its members concerning the trade of goods. The primary goal of GATT is to ensure national treatment of imported goods by the importing country, and to ensure common levels of tariffs for all signatory members of GATT for intra-GATT trade. See Stacie I. Strong, *Banning the Cultural Exclusion: Free Trade and Copyright Goods*, 4 DUKE J. COMP. & INT'L L. 93, 103 (1993). Common levels of tariffs are based on the most favored nation principle, which requires a member state to apply the lowest tariff rate set by it to all other member states. *Id.*

3. One argument put forth was that, because the GATT General Agreement on Trade in Services (GATS) text contains no explicit provision for excluding broadcasting services, they are still covered by the GATS agreement. *GATT Deal Is Signed but Row Continues*, SCREEN FIN., Apr. 20, 1994, available in WESTLAW, INT-NEWS-C Database. See also General Agreement on Trade in Services, Dec. 15, 1993, 33 I.L.M. 44. Note that broadcasting has been held to be a service rather than "goods" within the meaning of the GATT treaty, and is therefore not eligible for basic GATT protections. Michael Braun & Leigh Parker, *Trade in Culture: Consumable Product or Cherished Articulation of a Nation's Soul?*, 22 DENV. J. INT'L L. & POL'Y 155, 179 (1993). See also GATT, *supra* note 2, Introduction.

4. *GATT Deal Is Signed but Row Continues*, *supra* note 3. The U.S. could retaliate through "Super 301" sanctions, which include trade tariffs and quotas. Omnibus Trade and Competitiveness Act of 1988 § 301, 19 U.S.C. § 2411(a) (1994). See also Lisa L. Garrett, Comment, *Commerce Versus Culture: The Battle Between the United States and the European Union over Audiovisual*

air of drama, the fiction of "cultural" versus "commercial" products was temporarily sustained.<sup>5</sup>

The refusal to deal on "cultural exemptions" has succeeded in preserving the existing system of audiovisual quotas and subsidies from GATT anti-protectionist measures.<sup>6</sup> This gives the European audiovisual industry a brief respite in which to reverse its downward slide. According to the European Commission (EC), the EU's audiovisual market is worth 257 billion Ecus (325 billion U.S. dollars).<sup>7</sup> In the past ten years, European films have lost fifty percent of the European cinema screens and two thirds of the audience.<sup>8</sup> Only twenty percent of European films get distribution outside their country of origin, and almost none achieve the box office success of their Hollywood counterparts.<sup>9</sup> Although EC officials have disclaimed any anti-U.S. motivation behind audiovisual protectionist measures, it is clear that American domination of the audiovisual market is the primary target.<sup>10</sup> Europe accounts for sixty percent of the United States' audiovisual exports, and the total has increased

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*Trade Policies*, 19 N.C. J. INT'L L. & COM. REG. 553, 574 (1994).

5. Article 36 of the Treaty of Rome allows materials of cultural significance to be exempted from Treaty provisions regulating trade. Treaty Establishing the European Economic Community EEC Treaty, Mar. 25, 1957, art. 36, 298 U.N.T.S. 11. Although copyrighted goods and services now fall within GATT protections, GATT permits states to exclude certain items from GATT because of their "artistic value" to a state's culture. GATT, *supra* note 2, art. XX(f). GATT also contains provisions to allow cinema quota restrictions on foreign films. *Id.* art. IV. These quota restrictions were included in the original 1947 treaty to aid the flagging European post-war film industry. See Braun & Parker, *supra* note 3, at 182 (discussing this and other GATT provisions which may be relied upon to support audiovisual quotas). The Article IV quota provision may be the clearest proof of an intended difference in GATT of treatment between commercial and cultural trade. *Id.* at 183.

6. 'Vague' Green Paper Must Be Reworked, SATELLITE TV FIN., Mar. 30, 1994, available on LEXIS, News Library, CURNWS File.

7. Brussel's TV on the Blink, ECONOMIST, Nov. 12, 1994, available in WESTLAW, INT-NEWS-C Database.

8. Sarah Lambert, *Europe Wants Action to Save its Film Industry*, THE INDEPENDENT, Apr. 8, 1994, at 10.

9. *Audiovisual Production: A Strategy to Create Jobs and European Culture*, MULTINATIONAL SERVICE, Apr. 12, 1994, available on LEXIS, News Library, CURNWS File.

10. "We are definitely not engaged in a crusade against the United States," EU audiovisual minister Joao de Deus Pinheiro has stated emphatically. *Euros Reassures U.S.; A/V Minister Says Cooperation is the Answer*, DAILY VARIETY, June 21, 1994, NEWS section, at 1. However, a European speaker at the Apr. 1994 "Media in Europe Toward the Millennium" conference in Brussels sums it up differently: "Let there be no mistake. We mean American films and American programming." Joe Cappo, *Europeans See U.S. as Threat to Their 'Highway' - Conference*, ADVERTISING AGE, Apr. 11, 1994, available in LEXIS, News Library, CURNWS File.

from 330 million Ecus in 1984 to 3.6 billion Ecus in 1992.<sup>11</sup> That leaves the EU with an audiovisual deficit of around 3.5 billion Ecus a year.<sup>12</sup> In cinema alone, the U.S. share of European screens has risen over the past fifteen years from thirty-five to eighty percent. In contrast, Europe's film industry claims only one percent of the American market.<sup>13</sup> The United States also has significant leverage in broadcast programming. MTV Music Television is the number one station among young European viewers.<sup>14</sup> Ted Turner's Cable News Network is the leading news operation.<sup>15</sup>

Beyond the economic concern lies the fear that American Culture will inundate and destroy the indigenous cultures of Europe. "Europeans must avoid Europe's becoming an advance outpost of American civilization," warned Leon Schwartenberg, president of the Intergroupe Cinema of the European Parliament.<sup>16</sup> Lobbying French filmmakers adopted the epithet, "transforming the grandchildren of Moliere into the grandchildren of Coca-Cola," to dramatize this issue.<sup>17</sup> Many in the American industry hold the French responsible as the driving force behind protectionism in the European film industry.<sup>18</sup> The French alone, however, did not preserve the EU subsidy and quota system that December in Geneva.

Collateral questions have been raised as to the effect of violent American programs on European society. The relentless brutality in American entertainment is generally perceived to be a reflection of the American lifestyle.<sup>19</sup> The inevitable question is whether, by receiving such violent programming, Europeans will be indoctrinated with a greater indifference to suffering, or worse, a penchant for violence.<sup>20</sup> A shocking killing spree in October 1994 by a young French couple, apparently inspired by the movie "Natural Born Killers," punctuates the reasonableness of such concern.<sup>21</sup> At least one European country has postponed the release of the 1994 Oliver

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11. *Brussel's TV on the Blink*, *supra* note 7.

12. *Id.*

13. *Id.*

14. Cappo, *supra* note 10.

15. *Id.*

16. Fred Hift, *Europe's New Tactic in Media War*, CHRISTIAN SCIENCE MONITOR, Aug. 16, 1994, at 13.

17. Cappo, *supra* note 10.

18. Ian Griffiths, *Starring Role Awaits British Film Moguls*, EVENING STANDARD, Sept. 26, 1994, at 40.

19. Sharon Waxman, *Paris Reels from Cinema Verite*, WASH. POST, Oct. 8, 1994, at C4.

20. *Id.*

21. *Id.*

Stone film because of apprehension over copycat murders in France and the United States.<sup>22</sup>

This note does not attempt to grapple with the moral and ethical questions posed by the merging and evolution of cultures. Rather, it makes an in-depth examination of the future direction of European audiovisual legislation, and the socioeconomic forces which will be encountered. The analysis begins in Part II with an overview of present laws regarding broadcast content quotas and production subsidies. Part III is devoted to recent proposals for changes in European audiovisual legislation. The focus then turns in Part IV to the economic and social environment which the industry is likely to encounter, and how proposed legislation will function in that environment. Part V suggests a course of action that would allow the European audiovisual industry to meet short-term programming needs while growing into a world-class entertainment production entity.

## II. EUROPE'S PRESENT AUDIOVISUAL QUOTA AND SUBSIDY SYSTEM

### A. *Broadcast Quotas*

EU broadcast quotas are derived primarily from the 1989 "Television Without Frontiers" Directive (TWFD).<sup>23</sup> The TWFD was implemented in response to European production weakness and American dominance of the broadcast market. Article 4 contains the language of the cultural quota, requiring that European broadcasters devote a preponderance of their broadcast time to "European Works," as defined by Article 6 of the TWFD.<sup>24</sup>

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22. Dan Conaghan, *Film Blamed for Murders Held Up by Censors*, DAILY TELEGRAPH, Oct. 28, 1994, at 4.

23. Council Directive of 89/552 of 3 Oct. 1989 on the Coordination of Certain Provisions Laid Down By Law, Regulation, or Administrative Action in Member States Concerning the Pursuit of Television Broadcast Activities, 1989 O.J. (L 298) 28 (hereinafter TWFD). The provisions of the TWFD are almost identical to those included in the Council of Europe Convention on Transfrontier Broadcasting, drafted six months before the TWFD. See European Convention on Transfrontier Broadcasting, Mar. 15, 1989, Europ.T.S. No. 132, art. 10. The Council of Europe has 32 members, including the 12 EC Member States and 20 other European countries. COOPERS & LYBRAND, E.C. COMMENTARIES, AUDIOVISUAL COMMUNICATIONS, § 4 (Sept. 22, 1994) [hereinafter COOPERS & LYBRAND].

24. TWFD, *supra* note 23, art. 4 provides that:

Member States shall ensure where practicable and by appropriate means, that broadcasters reserve for European works, within the meaning of Article 6(a), a majority proportion of their transmission time, excluding the time appointed to news, sports events, games, advertising and teletext services. This proportion, having regard to the broadcaster's informational, educational, cultural and entertainment responsibilities to its viewing

The Article 4 language contains several relative terms that allow diverse EU Member State interpretations, and, in some cases, even avoidance. Some flexibility was intentional to allow Member States to incorporate the policies of the TWFD into their own national laws, as per Article 3 of the directive.<sup>25</sup> Most Member States have legislation implementing the TWFD quotas.<sup>26</sup> However, charges from European audiovisual lobbies of systematic evasion of the quota restrictions in some Member States have made the flexible language of Article 4 a major point of contention.<sup>27</sup>

The EC has informed Member States that in 1994 it intends to begin utilizing the review and enforcement provisions of the Maastricht Treaty to insure compliance with EC rules.<sup>28</sup> Article 169 creates a three-step review process of potential infractions.<sup>29</sup> In the first stage, the EC corresponds with the Member State about the issue in question. The EC may then drop the inquiry, or move to the second stage and deliver a "Reasoned Opinion" to the Member State.<sup>30</sup> The Reasoned Opinion sets out a course of action for compliance with EU legislation, and gives the Member State a deadline to act.<sup>31</sup> The third step is to initiate proceedings in the European Court of Justice.<sup>32</sup> In 1994, the EC resolved to instigate court proceedings against the United Kingdom (U.K.) for licensing foreign satellite stations to broadcast without obligating them to meet TWFD quotas.<sup>33</sup>

In the interest of preserving lucrative satellite movie channels, the British Department of National Heritage (DNH) has opposed the legality of mandatory

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public, should be achieved progressively, on the basis of suitable criteria.

*Id.*

25. Laurence G. C. Kaplan, *The European Community's "Television Without Frontiers" Directive: Stimulating Europe to Regulate Culture*, 8 EMORY INT'L L. REV. 255, 289 (1994). Critics point to several specific TWFD phrases as being overly broad. "[W]here practicable" has allowed an unlimited number of excuses to implementation of the TWFD quotas. "[A]ppropriate means" permits a wide range of legislative strategies, without entailing any specific mode or prohibiting any specific course of action. Similarly, the admonition to "progressively" achieve a majority proportion "on the basis of suitable criteria" provides no clear working guidelines. *See id.* at 288. *See also* *Brussel's TV on the Blink*, *supra* note 7.

26. *See* Kaplan, *supra* note 25, at 295 - 301, for a thorough discussion of individual EC Member State legislation implementing the TWFD broadcast quotas.

27. *See* *Brussel's TV on the Blink*, *supra* note 7.

28. *New Weapon in European Community Compliance Battle*, BUS. EUR., Aug. 15, 1994, available in LEXIS, News Library, CURNWS File.

29. *See* Maastricht Treaty on Political Union, Feb. 7 1992, 31 I.L.M. 247, art. 169 [hereinafter Maastricht Treaty].

30. *New Weapon in European Community Compliance Battle*, *supra* note 28.

31. *Id.*

32. *Italy Taken to Court Over TV Directive*, TECH EUROPE, Sept. 6, 1994, available in LEXIS, NEWS Library, CURNWS File.

33. *Id.*

broadcast quotas.<sup>34</sup> The U.K. and the EC audiovisual commission Directorate General X (DG-X) disagree about how countries gain jurisdiction over satellite broadcasts for quota purposes. DG-X officials suggest that the DNH has been "deliberately misleading" over the TWFD's meaning of jurisdiction.<sup>35</sup> The commission claims that laws such as those regarding the place of establishment of fishing boats would control.<sup>36</sup> Article 171 of the Maastricht Treaty will allow the EC to fine the U.K. if it refuses to comply with the pending ruling of the Court of Justice.<sup>37</sup>

An audit of the efficacy of TWFD quotas shows that most land-based European stations have met or exceeded the fifty-one percent standard.<sup>38</sup> The highest levels remain with publicly owned channels (which constituted almost all networks until the late 1980's).<sup>39</sup> Commercial channels, which usually relied on low-priced American fare when starting out, are also falling into line.<sup>40</sup> However, there's still some question whether TWFD quotas can be credited with creating these levels, as the survey was held during the years of 1991 and 1992, before most national legislation became fully binding.<sup>41</sup>

## B. *Cinema Quotas*

The 1947 GATT treaty allows nations to set legislative limitations on the number of foreign films shown in domestic cinemas.<sup>42</sup> There are currently no EC-wide quotas on the number of domestic films shown in European cinemas.<sup>43</sup> However, individual Member States may create national quotas and quota-like restrictions.

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34. Lambert, *supra* note 8, at 10.

35. *Brussels Considers Quota Deal as UK Row Looms*, SCREEN FIN., June 1, 1994, available in WESTLAW, INT-NEWS-C Database. The DG-X argues that the TWFD defines the licensing country as the one where a television channel is "established." *Id.* UK officials contend that it is licensed where it maintains the satellite uplinks or transponder frequencies. *Id.* The DG-X rejects the UK's position because of the extreme mobility of satellite uplinks, which may be mounted on trucks. *Id.*

36. *Id.*

37. *New Weapon in European Community Compliance Battle*, *supra* note 28.

38. Peter Goodwin, *Air Traffic Controls—European Programming*, BROADCAST, May 13, 1994, at 16.

39. *Id.*

40. *Id.*

41. *Id.*

42. GATT, *supra* note 2, art. IV.

43. Diana Quintero, *American Television and Cinema in France and Europe*, 18 FLETCHER F. WORLD AFF. 115 (Summer/Fall 1994), available in WESTLAW, TP-ALL Database.

In some Member States, cinema restrictions are financial in nature. A 1994 change in Italian law replaces the previous obligatory cinema quota regime with a program of tax breaks for movie houses screening indigenous product.<sup>44</sup> France implements a levy system, requiring film producers to pay an average of eleven percent of cinema box office receipts into a fund to finance and publicize French films.<sup>45</sup> The system effectively functions as a discriminatory tariff, because French legislation and government regulations make it almost impossible for non-EC producers to qualify for funding from the levy.<sup>46</sup>

Spain has a more traditional cinema quota system. In towns of 125,000 residents or more, Spanish law demands that every two days dedicated to American films must be followed by one day of European movies.<sup>47</sup> In smaller towns, theaters must show one day of European movies for every three days of American films.<sup>48</sup>

Additionally, Spain requires distributors to first release an EU or Spanish film before allowing domestic access to the distributor's foreign film.<sup>49</sup> The Spanish government controls market access through "dubbing licenses."<sup>50</sup> Without a dubbing license, the distributor must release the film without dubbing, which renders a foreign movie practically unmarketable in Spain.<sup>51</sup> The number of dubbing licenses granted depends on the success of the Spanish or EU films previously released by the distributor.<sup>52</sup> U.S. officials claim that the dubbing laws allow only fifty American films to be screened each year, given the numbers of Spanish and EU films normally released in Spain.<sup>53</sup>

The United States has already raised the issue with the Organization for Economic Co-operation and Development (OECD), and intends to continue pushing for the elimination of the system.<sup>54</sup> Spanish distributors recently won a ruling from the Directorate-General IV (DG-IV) (which is responsible

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44. *GATT Deal is Signed but Row Continues*, *supra* note 3.

45. Margaret Moore, *International Film Co-production Tax and Subsidy Mechanisms*, 16 HASTINGS COMM/ENT. L.J. 287, 296 (1994), available in WESTLAW, TP-ALL Database.

46. *See id.* *See also* Anne Moebes, *Structuring Media Joint Ventures in the European Community*, 14 HASTINGS COMM/ENT. L.J. 1, 10 (1991).

47. Kaplan, *supra* note 25, at 302.

48. *Id.*

49. *Id.* *See also* Rick Setlowe, *U.S. Pic Makers Seek Ways, Coin to Go Int'l*, DAILY VARIETY, July 20, 1994, available in LEXIS, News Library, CURNWS File.

50. *Id.*

51. *Id.*

52. *Id.* Mark Damon, president of the distribution company MDP Worldwide, explains that "[i]f a Spanish or European Common Market film does, say, 20 million pesetas [about \$143,000 U.S. dollars], it gets one license for the distributor; 40 million gets two . . . ." *Id.*

53. *GATT Deal Is Signed but Row Continues*, *supra* note 3.

54. *Id.*

for EC competition issues), holding that part of the dubbing license system violates the Treaty of Rome.<sup>55</sup>

### C. *Audiovisual Subsidies*

Subsidies are a fundamental part of the European audiovisual system. Large government-controlled support programs for the audiovisual sector have been established at both the EC and Member State levels. Money is generally available for all areas of production, including scripting and development, production, editing, prints, distribution and promotion of films.

#### 1. *National Subsidies*

Sixty-five percent of European films in production during the summer of 1994 received some kind of Member State subsidy.<sup>56</sup> In some cases, the subsidy is relatively small, but may still act to stimulate additional investment.<sup>57</sup> The percentage subsidy breakdown by nation during the summer of 1994 is:

<u>NATION</u>	<u>FILMS</u>	<u>SUBSIDIZED</u>
Denmark	10	90%
Belgium	8	88%
Switzerland	12	83%
Germany	60	83%
Netherlands	20	80%
Sweden	9	78%
France	91	59%
United Kingdom	55	40%
Italy	56	39% <sup>58</sup>

Additionally, fifty-one percent of European films received television backing during the summer of 1994.<sup>59</sup> This is often regarded as a quasi-subsidy, because of government ownership or control of broadcaster production

55. *Id.* See also Treaty of Rome, *supra* note 5. Article 36 regulates anti-competitive Member State laws.

56. *European Features: 510 in Production, Another 2,271 in Development*, SCREEN FIN., July 27, 1994, available in LEXIS, News Library, CURNWS File [hereinafter *European Features*]. Subsidy awards in most countries favor culture over commercial appeal, but a counter trend is appearing. *Id.* Several countries are merging co-controlling agencies to create a standardized national criteria for awards. *Id.*

57. *Id.*

58. *Id.*

59. *Id.* Smaller countries like Belgium and Switzerland may have nearly one hundred percent television backing of domestic film production. *Id.*



investments.<sup>60</sup> France had television backing for seventy-four percent of its films, Germany had sixty-three percent, and the U.K. had forty-four percent television backing.<sup>61</sup>

In France, nearly one percent of the national budget is allocated to culture, amounting to 13.5 billion francs in 1994 (about 2.5 billion U.S. dollars).<sup>62</sup> There are at least six sources of grants for the French movie industry, all of which receive money from the government.<sup>63</sup> Money is channeled into film subsidies from levies on cassette rentals, cinema tickets, and privately owned television programmers.<sup>64</sup> About half the money collected from levies goes to buying new films, usually on the strength of the script.<sup>65</sup> The rest goes to the government's general filmmaking fund, script-writing fund, pre-production fund, production fund, cinema owners' fund, and film distributors' fund.<sup>66</sup>

In 1994, the French Television producers' organization, USPA, formed a collective body to promote French television production internationally.<sup>67</sup> The confederation is likened to support systems already in place for French cinema production.<sup>68</sup> The French government will sponsor USPA with a budget in 1995 of 25 million francs (approximately 3.1 million U.S. dollars).

The U.K. eliminated its largest subsidy program, the Eady Levy, in the 1985 Films Act.<sup>69</sup> The French-style revenue-derived subsidy funded approximately 900 films.<sup>70</sup> The U.K. now has among the lowest percentage of subsidized films within the EC.<sup>71</sup> Financing is still available from British Screen Finance, which distributes about 2 million pounds for feature production

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60. *Id.*

61. *Id.*

62. Sharon Waxman, *Arts of the State: France Tries to Subsidize a Culture*, WASH. POST, Oct. 23, 1994, at G1. France is one-fifth the size of the United States but spends more than five times as much to support the arts. *Id.*

63. *Id.*

64. *Id.* The pay-TV service Canal Plus is required to pay a minimum of 18.5% of its pre-tax revenues to subsidize the movie industry. In exchange, Canal Plus can air French films a year after their release. *Id.*

65. *Id.*

66. *Id.*

67. *French TV Producers Launch Promo Drive*, BROADCAST, Oct. 21, 1994, at 12.

68. *Id.*

69. *Government "Gutted" Film Industry*, SCREEN FIN., July 27, 1994, available in WESTLAW, INT-NEWS-C Database.

70. *Id.* Film producer David Puttnam contends that cutting the Eady Levy, together with increased tax and licensing costs to independent British television, "gutted" the national production industry. *Id.* Lower levels of film subsidy in the U.K. have caused a corresponding dropoff in film production. Moore, *supra* note 45, at 307.

71. Only 40% of the 55 UK films in production in the summer of 1994 received a government subsidy. See *European Features*, *supra* note 56.

and development.<sup>72</sup> British Screen also has a European Co-Production Fund that provides financing.<sup>73</sup>

Germany was one of the top ten EC nations for ratio of subsidized and television-backed films in 1994.<sup>74</sup> Germany provides subsidies through the Federal Interior Ministry, which dispenses direct grants for film productions.<sup>75</sup> German state and regional funding is also available.<sup>76</sup> Additionally, new films may receive interest-free loans from the government.<sup>77</sup> Every EC Member State maintains some type of government subsidy system. Smaller European nations usually have a higher percentage of subsidized films, but on average produce only about ten films a year.<sup>78</sup> Italy has the lowest percentage of government subsidy, with only thirty-nine percent of the fifty-six films in production in the summer of 1994 receiving government funds.<sup>79</sup>

## 2. *EC Subsidies*

At the EC level film financing support is administered primarily by the "Measures to Encourage the Development of Industry of Audiovisual Production" (MEDIA 95) program.<sup>80</sup> MEDIA 95 is a five-year "action program" intended to support production and distribution of European audiovisual material through seed money, loan guarantees, financial investment stimulus, and industry cooperation.<sup>81</sup>

72. Moore, *supra* note 45, at 306.

73. *Id.*

74. See *European Features*, *supra* note 56.

75. Moore, *supra* note 45. Additionally, Filmforderungsanstalt gives grants for scripts, short films, children's films, and documentaries. *Id.*

76. *Id.*

77. *Id.* Most of these subsidies are given in relation to participation by German citizens, but regional awards may be made on purely economic criteria. *Id.*

78. The top European countries (both in and out of the European Community) by ratio of subsidized films in production during the summer of 1994 include Austria - 12 of 12 films, Bulgaria - 5 of 5 films, Greece - 13 of 13 films, Portugal - 9 of 9 films, Finland - 6 of 6 films, Poland - 8 of 8 films, Denmark - 9 of 10 films, Belgium - 7 of 8 films, and Switzerland - 12 of 12 films. *European Features*, *supra* note 56.

79. *Id.*

80. Eurimages, the Council of Europe's (CE) co-production support fund, also offers limited distribution aid to CE member states who are not part of the EC. *Media Fosters Euro-distribution Groups*, SCREEN FIN., Sept. 9, 1994, available in WESTLAW, INT-NEWS-C Database. In 1992 the budget of Eurimages was approximately 21 million Ecus. *Id.*

81. COOPERS & LYBRAND, *supra* note 23, § 6. Media 95, which covers the years 1991-95, is the third phase of an initiative to make the European film and television industries competitive on the world market. See Garrett, *supra* note 4, at 558. The first two phases, encompassing industry consultation and development of a pilot program, were inaugurated under MEDIA 92. *Id.* See also Council Decision 90/685/EEC of December 21, 1990 concerning the

Much of MEDIA 95's work is handled by sub-agencies known as action-lines. Currently MEDIA 95 has nineteen action-lines, covering initiatives as diverse as script development, animation, film dubbing, documentaries, and media business education.<sup>82</sup> A pending reorganization of the program will reduce and consolidate the number of action-lines to nine.<sup>83</sup> Three action-lines, the European Film Distribution Office (EFDO), Support for Creative Independent Production Talent (SCRIPT), and the Media Business School,<sup>84</sup> have been singled out as "senior" initiatives, and would each administer two "junior" action-lines in the planned reorganization.<sup>85</sup>

EFDO offers matching funds for film distribution costs in any three EU countries to a cap of 100,000 Ecus (121,140 U.S. dollars) per country.<sup>86</sup> The maximum distribution subsidy from the EFDO is 300,000 Ecus for prints and advertising.<sup>87</sup> EFDO has recently been allocated additional funds to foster creation of regional distribution consortia.<sup>88</sup>

Previous efforts to create European distributor joint ventures have met with limited success.<sup>89</sup> Political difficulties obstruct the building of cross-nation distribution ventures, as local marketers are reluctant to surrender control of their individual fiefdoms.<sup>90</sup>

implementation of an action program to promote the development of the European audiovisual industry, 1990 O.J. (L 380) 37 [hereinafter MEDIA 95].

82. See COOPERS & LYBRAND, *supra* note 23, § 6 (discussing the various MEDIA 95 action-lines in detail).

83. *Media's Nine-Line Plan Gives Star Roles to SCRIPT, EFDO, and MBS*, SCREEN FIN., Mar. 23, 1994, available in WESTLAW, PTS-NEWS Database [hereinafter *Media's Nine-Line Plan*].

84. The Media Business School in Madrid, Spain, coordinates and co-finances training, workshops, seminars, and research to improve the economic environment of the European audiovisual sector. See COOPERS & LYBRAND, *supra* note 23, at § 6.10.

85. *Media's Nine-Line Plan*, *supra* note 83.

86. *U.S. Pic Makers Seek Ways, Coin to Go Int'l*, *supra* note 49.

87. *Id.* The Disney subsidiary Miramax has previously received EFDO funds for the distribution of "Enchanted April" and "The Crying Game." *Id.*

88. The EFDO in conjunction with two other MEDIA 95 action-lines, Espace Video Europeene and Europa Cinemas, is administering the "Distribution Plus" plan, initiated in Sept. 1994. *Media Fosters Euro-distribution Groups*, SCREEN FIN., Sept. 9, 1994, available in WESTLAW, INT-NEWS-C Database. The plan provides funds to promote creation of regional distributor collaborations for film distribution across Europe. *Id.* At least five European countries are involved. The "Distribution Plus" plan is intended to challenge American distributors, which now hold an eighty percent share of the European market. *Id.* Restricted funds (about 200 million Ecus), and the pending expiration of the MEDIA 95 program makes the prospective impact of the "Distribution Plus" plan questionable. *Id.*

89. *Id.*

90. *CIC Opts for Localized Strategy*, MARKETING, Nov. 3, 1994, available in WESTLAW, INT-NEWS-C Database.

SCRIPT is a fund dedicated to improving the quality of screen and musical writing in the EC by providing loans to cover the cost of screenplays and pre-production for dramatic films.<sup>91</sup> SCRIPT supports projects likely to attract audiences in at least two separate EC countries, and preference is given to projects co-developed by nationals from at least two different Member States.<sup>92</sup>

Audiovisual Eureka was created in October 1989, to stem the flow of program purchasing funds out of Europe.<sup>93</sup> Twenty-six European governments and the EC participated in the creation of Audiovisual Eureka, with the objective "to invigorate the European market by favoring the establishment of a network of partners around concrete projects, from their creation up to the distribution of audiovisual and cinematographical works."<sup>94</sup> It is not a direct funding subsidy, but distributes information and coordinates meetings to improve access to other public and private financing mechanisms.<sup>95</sup> Audiovisual Eureka offers support for producers, broadcasters, and distributors to find partners for co-productions, and help in collecting funds for budget completion.<sup>96</sup>

EC and Member State subsidies have spent billions of dollars to support the production and distribution of European films and television programs. However, there has not been a resulting improvement in quality or market reach.<sup>97</sup> Even persons within the European industry are beginning to acknowledge the failure of the subsidy system, but the general consensus is that the present weakness of the audiovisual sector demands increased financial support.<sup>98</sup>

### III. PROPOSED CHANGES TO EC AUDIOVISUAL QUOTA AND SUBSIDY LEGISLATION

European audiovisual officials are acutely aware of the need to find solutions to the industry's poor performance. In April 1994, the Directorate General X (DG-X), responsible for European cultural issues, published a set

91. COOPERS & LYBRAND, *supra* note 23, § 6.7. SCRIPT offers loans to writers and writer/producer teams. *Id.*

92. *Id.*

93. *Audiovisual Eureka Supports European Audio Visual Industry*, HDTV REPORT, Apr. 27, 1994, available in WESTLAW, INT-NEWS-C Database.

94. *Id.* Audiovisual Eureka has a permanent secretariat in Brussels. *Id.* Its role is to inform the audiovisual professionals and the general public on multi-state initiatives, provide information on projects in EU countries, and help European producers proposing projects to assemble a marketing presentation, find possible partners, and get financial support. *Id.*

95. *Id.*

96. *Id.*

97. See discussion *infra* part IV(C).

98. See *European Features*, *supra* note 56.

of audiovisual industry concerns known as the "Green Paper."<sup>99</sup> In putting the paper together, the DG-X solicited input from independent sources.<sup>100</sup> The predominant problems cited by these sources included the lack of a coherent EC policy and the absence of an efficient Europe-wide film distribution network.<sup>101</sup> Increased protectionism and EC monetary support was almost exclusively the suggested response.<sup>102</sup>

Notably the DG-X declined to endorse proposals for greater protectionism submitted by independent sources.<sup>103</sup> Rather than recommending new barriers to non-EU productions, the Green Paper poses questions about future policy alternatives.<sup>104</sup> The Green Paper bases its discussion on an analysis of the thirty-year decline in the European audiovisual sector, new technologies which are revolutionizing the industry, and the importance of supporting the industry in terms of economics and culture.<sup>105</sup> The Green Paper recommends building upon the TWFD and the MEDIA 95 program to pursue these policy interests.<sup>106</sup>

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99. See Strategy options to strengthen the European Program Industry in the context of the Audiovisual Policy of the European Union—Green Paper, COM(94)96 final [hereinafter Green Paper].

100. *'Vague' Green Paper Must Be Reworked*, *supra* note 6. Independent sources submitting information included the European Federation of Audiovisual Filmmakers (FERA), a Brussels based directors lobby, and the "Committee of the Wise," a group of seven prominent European audiovisual industry experts. *Id.*

101. *Audiovisual Production: A Strategy to Create Jobs and European Culture*, *supra* note 9.

102. The "Committee of the Wise" report recommended tighter entertainment import barriers in the next 10 years, coupled with 2 billion Ecus (about \$2.25 billion American) in increased industry subsidies. Tom Buerkle, *Hollywood to the Rescue as Culture War Abates*, INT'L HERALD TRIB., Apr. 8, 1994, available in LEXIS, News Library, CURNWS File. Development of a Europe-wide audiovisual distribution entity was also proposed. *Vague Green Paper Must Be Reworked*, *supra* note 6. In the interim, they suggested subsidies to encourage joint ventures between regional distributors, and to lower cinema print rental costs. *Audiovisual Production: A Strategy to Create Jobs and European Culture*, *supra* note 9. Additionally, the committee wants development of a network of European cinemas, with subsidies and loans for those agreeing to dedicate 35% of their screens to European films. *Id.* Money for this broad initiative is to come from an EU-wide levy on cinema tickets, video rentals, and broadcasting receipts. *Vague Green Paper Must Be Reworked*, *supra* note 6. FERA published a 15-point plan aimed at coordinating film policies across Europe. *Id.* The plan includes the introduction of a number of pan-European tax incentives to encourage the promotion and distribution of European productions. *Id.* FERA also urges measures to force all European pay-television channels to invest in European feature production as a prerequisite to licensing. *Id.*

103. Buerkle, *supra* note 102.

104. *Id.*

105. *ECOSOC Opinion on Green Paper on Audiovisual Policy*, REITERS EC REP., Sept. 28, 1994, available in LEXIS, News Library, CURNWS File.

106. *Id.*

Release of the Green Paper was followed by a round of proposals from European audiovisual regulatory groups and lobbyists. Like the pre-Green Paper submissions, most of these proposals centered around strengthening protectionist legislation and expanding EC audiovisual support funds. Although recommendations came from many diverse entities, they generally involved one or more of the following propositions; 1) maintaining the division between cultural and commercial trade; 2) tightening and extending the TWFD quota system; 3) organizing, consolidating, and increasing funding for government support programs; 4) improving European controlled cinema distribution; and 5) development of better voice dubbing technology for film.

#### A. *Individual Recommendations by Regulatory Bodies and Interest Groups*

Five European audiovisual regulatory groups met at a conference convened by the DG-X in Brussels to discuss the Green Paper and propose future policies for the industry.<sup>107</sup> The so-called Brussels coalition proposed doing away with Eurimages and the MEDIA program in favor of a single EC audiovisual fund, with a budget of 1.5 billion Ecus over five years.<sup>108</sup> The money would be dedicated to a three-prong program to promote television broadcasting, cinema distribution, and creation of new film production and producers.<sup>109</sup> The fund would provide both "soft loans" with easy repayment terms, and guarantees for loans from financial institutions.<sup>110</sup>

The Brussels coalition also recommended changes to the TWFD language to expand the Article 6 definition of "European works" and make broadcast quotas mandatory.<sup>111</sup> They seek more specific quotas on prime-time European

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107. *Five Audiovisual Groups Seek More EU Funds and Changes to the TV Directive*, TECH EUR., July 11, 1994, available in LEXIS, News Library, CURNWS File. The attendants at the July 1994 meeting included the Cinematographic Industries Committee of the European Community (CICCE), the European Broadcasting Union (EBU), the producers association Eurocinema, the Federation of European Sound and Vision Industries (FEITIS), and the European Federation of Audiovisual Filmmakers (FERA). *Id.*

108. *Id.* The group suggests that the EU provide up to 750 million Ecus of the fund, approximately one percent of the EU's entire budget. *Euro-Group Calls for Tougher Quota Rules*, SATELLITE TV FIN., July 7, 1994, available in LEXIS, News Library, CURNWS File. The balance would be raised through audiovisual levies. *Id.* See discussion of the Eurimages initiative, *supra* note 80.

109. *Euro-Group Calls for Tougher Quota Rules*, *supra* note 108.

110. *Id.* Director of DG-X Joao de Deus Pinheiro noted that he would be against any direct subsidy fund, and favors loan assistance. *Id.*

111. *Five Audiovisual Groups Seek More EU Funds and Changes to the TV Directive*, *supra* note 107. The group wants the TWFD Article 6 definition of "European works" to be expanded to include documentaries and animated films. *Id.* See discussion of Article 6 *infra*

broadcasting.<sup>112</sup> Non-dramatic programming services such as sports and news should not apply toward meeting the TWFD quota, according to the group.<sup>113</sup> Finally the Brussels coalition seeks expansion of the TWFD quotas and levies to include new services like pay-per-view.<sup>114</sup> It was agreed that quotas would not be feasible for services such as video-on-demand and tele-shopping, and therefore the group proposed additional taxes on these services.<sup>115</sup>

On September 15, 1994, the Economic and Social Committee on the Strategy Options to strengthen the European audiovisual industry (ECOSOC) released an opinion paper on the issues raised by the Green Paper.<sup>116</sup> ECOSOC recommended maintaining the division between economic and cultural imports, reasoning that European cultural identity would be lost in "unbounded competition."<sup>117</sup> In this regard ECOSOC stressed the need for more comprehensive regulation for existing and new audiovisual services.<sup>118</sup> The ECOSOC suggested stepped-up promotional efforts for European productions, concentrating on the best programs produced, with the collateral development of better dubbing technology.<sup>119</sup>

France's powerful industry lobby, Authors/Directors/Producers (ARP), sponsored the Beaune Film Forum in October 1994, to draft recommendations for increased protectionism.<sup>120</sup> Forum participants proposed making the TWFD broadcast quota system mandatory by removing all flexible language.<sup>121</sup> ARP further suggested extending quotas to "the new services carried by the

part II(A). The group also calls for the "where practicable" phrase to be removed from Article 4 to make quotas mandatory. *Id.*

112. *Euro-Group Calls for Tougher Quota Rules*, *supra* note 108.

113. *Five Audiovisual Groups Seek More EU Funds and Changes to the TV Directive*, *supra* note 107.

114. *Id.*

115. *Euro-Group Calls for Tougher Quota Rules*, *supra* note 108. The Co-ordination of European Independent Producers (CEPI) suggested an alternative plan, in which all broadcasters could choose to meet the TWFD 51% quota or to invest 20% of annual income in European originated film production. *European Producers to Propose Alternative System of Quotas*, BROADCAST, July 1, 1994, at 3.

116. *ECOSOC Opinion on Green Paper on Audiovisual Policy*, *supra* note 105.

117. *Id.*

118. *Id.*

119. *Id.* To finance these efforts the ECOSOC supports a Pan-European levy system. *Id.*

120. *Finding Cure for Euro Woes Sets Tone at Beaune*, HOLLYWOOD REP., Oct. 28, 1994, available in LEXIS, News Library, CURNWS File.

121. *Beaune Film Forum Calls for Revision of Cross-Border TV Rules*, EUR. COMMISSION PRESS RELEASES, Oct. 31, 1994, available in WESTLAW, INT-NEWS-C Database.

information highways."<sup>122</sup> They called for levies to be extended to developing audiovisual services, with funds dedicated to supporting film production.<sup>123</sup>

Parties at the Beaune Forum also encouraged doing away with Article 85(3) of the EEC Treaty, which contains exemptions to anti-competition rules allowing European film distribution to be concentrated in non-European countries.<sup>124</sup> The Article 85 exemption permitted the formation of American distribution organizations such as United International Pictures (UIP), a joint European distribution network representing MGM, Paramount, and MCA/Universal.<sup>125</sup> The EC exemption given to UIP expired on July 16, 1994.<sup>126</sup>

Most European audiovisual policy-makers, including culture commissioner Joao de Dues Pinheiro, oppose the UIP application for renewal of the exemption.<sup>127</sup> European industry officials contend that the UIP application should be denied because overall American control of European distribution violates anti-trust laws.<sup>128</sup> UIP argues that its market share has dropped from twenty-nine percent, considered acceptable by the EC in 1989, to twenty percent in 1994.<sup>129</sup> Analysts say the final ruling on the application has been delayed because DG-IV can find no sound legal reason to reject it.<sup>130</sup>

UIP and two European co-producers have filed suit against the EC for allegedly requesting the EFDO to delay a decision on a 1994 UIP distribution funding request for two European films, pending the EC ruling on UIP's

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122. *Id.*

123. *French Film Industry Wants Guarantees Information Superhighway Will Not Benefit US Films*, LES ECHOS, Oct. 31, 1994, at 39.

124. *Beaune Film Forum Calls for Revision of Cross-Border TV Rules*, *supra* note 121. See also Treaty of Rome, *supra* note 55, art. 85(3).

125. *UIP Pleads in Favour of Retaining Distribution Rights*, REUTER AGENCE EUR., Sept. 20, 1994, available in LEXIS, News Library, CURNWS File.

126. *UIP Asks for Distribution Aid as EC Says Bid is too Hot to Handle*, SCREEN FIN., Sept. 9, 1994, available in WESTLAW, INT-NEWS-C Database. Although UIP filed for an extension of its exempt status in June 1992, politically motivated delays have pushed a final ruling back to mid-1995. *Id.* "This is too much of a political hot potato even to consider a timetable, let alone the application itself" said Norbert Menges, a senior official at the competition Directorate General IV (DG-IV). *Id.*

127. *Id.*

128. *Id.*

129. *UIP Pleads in Favour of Retaining Distribution Rights*, *supra* note 125. UIP further points out that it has been found by officials of the EC, the UK, Germany, and Denmark, to meet their separate competition regulations. *Id.* UIP asks the EC to take into account the approximately 150 European films UIP has distributed since 1989, and denies charges of manipulative cinema booking practices. *Id.*

130. *UIP Asks for Distribution Aid as EC Says Bid is too Hot to Handle*, *supra* note 126.



exemption status.<sup>131</sup> As noted, the EFDO has previously granted funds to other American distributors promoting European films in Europe.<sup>132</sup>

### B. *Implementation of the TWFD Changes*

Legislative changes for the TWFD are to be finalized by the end of 1995.<sup>133</sup> In March 1995, a draft of proposed TWFD changes sponsored by incoming DG-X commissioner Marcelino Oreja was passed by a majority of European Commissioners.<sup>134</sup> It proceeds to the European Council of Ministers, where intense debate is expected.<sup>135</sup>

The Oreja draft largely follows the changes proposed by predecessor Joao de Deus Pinheiro.<sup>136</sup> The most significant of these changes is the removal of the flexible "where practicable" language, making the Article 4 broadcasting quota mandatory.<sup>137</sup> In an effort at compromise, the Oreja draft would put a ten-year time limit on the TWFD quota regime.<sup>138</sup> It also provides that "thematic channels" devoting more than eighty percent of their broadcast time to one particular type of programming would be given the option of an

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131. *Filmmakers Take Commission to Court over Funding*, REUTER ECON. NEWS, Nov. 16, 1994, available in WESTLAW, INT-NEWS-C Database. Co-producer Allied Vision Limited said in a released statement, "Our international distribution plans for 'Nostradamus' have been based on the availability of EFDO support, for which we, the film, and UIP clearly qualify." *Id.* Producers of the Italian film "Maniaci Sentimentali" are the third party in the suit, which asks the European Court of First Instance in Luxembourg to reverse the EFDO decision. *Id.* UIP representatives said the petitioning parties needed to file suit in November 1994 to meet a two-month deadline for appealing EC decisions. *Id.*

132. See discussion *supra* note 87 and accompanying text.

133. Michael W. Stern, *EC Backs French Proposal, Sets Up Heated Debate*, VARIETY, Mar. 27, 1995, at 39.

134. *Commission Opts for Stiffer TV Quotas: 10 Years Non-Renewable*, EUR. REP., Mar. 24, 1995, available in LEXIS, News Library, CURNWS File. The TWFD draft changes passed by vote of 15 to 5. *Id.* Commissioners voting against it included Sir Leon Brittan, Hans van der Broek, Martin Bangemann, Monika Wulf-Mathies, and Anita Gradin. *Id.*

135. Stern, *supra* note 133, at 39.

136. Commissioner Pinheiro stated he wanted to remove the "ambiguity" from the TWFD. *Brussel's TV on the Blink*, *supra* note 7.

137. *Id.*

138. *Id.* Initially, the 10-year limitation has not found support from either side. Parties against the TWFD quota point out that, given the rapid changes in broadcast and related media, ten years will be about the useful period of any rule. Stern, *supra* note 133. Those in favor of protectionism decry the time limitation as a misguided commitment to abandon the cultural exception. *Commission Opts for Stiffer TV Quotas: 10 years Non-renewable*, *supra* note 134.

"investment quota" rather than a content quota.<sup>139</sup> The Oreja draft would allow thematic channels the alternative of committing twenty-five percent of the channel's production budget to "European" productions.<sup>140</sup> All broadcasters are given a three-year grace period to comply with the new mandatory quota rules once they are adopted.<sup>141</sup>

Instead of broadening the scope of the TWFD quotas to include newer services such as interactive and pay-per-view channels, additional research and planning toward a separate regulatory framework has been suggested.<sup>142</sup> The concern is that premature or ill-conceived legislation could have a negative impact on the development of these so-called "information society" services.<sup>143</sup> However, at present, individual member states remain free to regulate developing communication services.<sup>144</sup>

The incorporation of strengthened financial subsidies and support mechanisms for European productions is also expected. A levy on telecommunications services is being considered.<sup>145</sup> The restructuring of the MEDIA program is also seen as a possible avenue for increased film production subsidies.<sup>146</sup>

In the foreseeable future, it appears that proponents of increased protectionism will prevail. The Oreja draft of proposed changes would remove all flexibility from the TWFD regime of broadcast quotas. Although it has a long journey to final ratification, the Oreja draft has found broad initial support

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139. *Id.* Examples of "Thematic channels" include movie services such as Filmnet, ARTE, and Canal Plus. *Id.*

140. *Id.* Presumably, this means European Works, as defined by TWFD Article 6. See discussion *supra* part V(A)(2).

141. *Id.*

142. *Information Society: Martin Bangemann Argues Against Premature or Excessive Regulation*, MONTHLY REP. ON EUR., Apr. 26, 1995, available in LEXIS, News Library, CURNWS file. This plan was proposed by DG-X Commissioner Oreja, Internal Market Commissioner Mario Monte, and European Telecommunications Commissioner Martin Bangemann. *Id.* The research would involve the generation of four Green Papers in the areas intellectual property rights, legal protection of coded transmissions, commercial communications, and the development of new services. *Id.*

143. *Id.*

144. *EU may tighten TV Quota Rules*, DAILY VARIETY, Oct. 27, 1994, at 31.

145. *Commission Opts for Stiffer Quotas: 10 Years Non-Renewable*, *supra* note 134.

146. *France Postpones Debate on Broadcasting Quotas until June*, MONTHLY REP. ON EUR., Apr. 25, 1995, available in LEXIS, News Library, CURNWS File.

within the EC.<sup>147</sup> In fact, the most adamant opposition in Europe has come from those who see the Oreja draft as too lenient.<sup>148</sup>

#### IV. THE ECONOMIC AND TECHNICAL REALITIES THAT WILL DEFEAT PROTECTIONISM

Quotas and subsidies clearly do not provide a long-term solution to Europe's weak audiovisual industry. Even the drafters of the Green Paper recognize "an urgent need to restructure an industry [able to] survive without protectionism and without subsidies."<sup>149</sup> But, as discussed, the direction of most current legislative proposals is toward increased protectionism, rather than progressive restructuring. By preserving and reinforcing the status quo, the EU is missing a rare opportunity to direct expansion by a controlled opening of its market. Social and economic forces are already severely straining the present protectionist system. The only question which remains is when the system will collapse and what will be left afterwards.

##### A. *Europe's Inability to Meet Programming Demands of New Technology*

Europe currently does not produce enough audiovisual product to meet its market needs. During July of 1994, European producers had 510 films in some stage of production.<sup>150</sup> This included films currently being filmed, in post-production, and awaiting release.<sup>151</sup> An average of 500 films are produced in Europe each year, whereas over 1,000 film distributors service the European market.<sup>152</sup>

147. *Commission Opts for Stiffer TV Quotas: 10 Years Non-Renewable*, *supra* note 134.

148. *Id.* French audiovisual lobbying groups have asserted that the 10-year limit will "systematically dismantle idea of the cultural exception." *Id.* Representatives of Eurocinema took issue with the "investment quota" alternative for thematic channels. *Id.* Eurocinema also supports broadening the scope of the TWFD quota regime to include newer services such as pay-per-view. *Id.*

149. *Vague Green Paper Must Be Reworked*, *supra* note 6. *See also* Green Paper, *supra* note 99.

150. *European Features: 510 in Production, Another 2,271 in Development*, *supra* note 56.

151. *Id.* The top four producer nations represented approximately 51% of total production including France with 91 films, Germany with 60 films, Italy with 56 films, and the UK with 55. *Id.*

152. Lambert, *supra* note 8, at 10.

Further, European broadcasters need 16,000 hours of dramatic and comedic programming each year, but current production levels are barely at 2,500 hours.<sup>153</sup> Ira Goldman, Trade Representative to the Governor of California, points out that if technological changes proceed, there will never be enough audiovisual product to fill the demand.<sup>154</sup> "Unfortunately, there are some who do not seem to want a solution, and it is up to us to persuade them otherwise."<sup>155</sup> It is not realistic to expect European producers to meet the immediate market need, let alone the inevitable increase in demand created by new audiovisual services.<sup>156</sup>

The lower prices of American programming are pushing open the European market. To meet TWFD standards, European broadcasters need a great deal of European product.<sup>157</sup> Therefore, demand is higher for "European works," and broadcasters must pay more for quality European productions than for American films that are as good or better.<sup>158</sup> Hollywood has a huge stock of films, and it is much less expensive to buy American imports than to produce new material.<sup>159</sup> Prices are also lower because of competition between American distributors for the European market.<sup>160</sup> Former chairman of Britain's GMTV, Greg Dyke, claims, "The British audience much prefers British drama," but new channels playing mainly American entertainment will make it "more advantageous for commercial television to get a smaller audience but pay far less for [American programs]."<sup>161</sup> With the continued growth of audiovisual media and major investments at stake, economics will force media services to break with the TWFD quota regime.<sup>162</sup>

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153. Quintero, *supra* note 43.

154. Griffiths, *supra* note 18, at 40.

155. *Id.*

156. Beatrice Le Fraper Du Hellen, French Cultural Attache to the United States has noted that if French television stations were forced to meet that country's quota of airing 60% European works, the broadcasters would go bankrupt. Vernon Scott, *French Attache Seeks U.S. Market*, UPI, Oct. 24, 1994, available in LEXIS, NEWS Library, CURNWS File.

157. Setlowe, *supra* note 49.

158. *Id.*

159. Scott, *supra* note 156.

160. *Id.*

161. Martina Devlin, *Limits on American TV Imports Urged*, PRESS ASS'N NEWSFILE, July 13, 1994, available in LEXIS, News Library, CURNWS File.

162. Lowell Forte, *Film Industry Left Out of Landmark Trade Pact*, CORP. LEGAL TIMES, June 1994, at 14. American Film Marketing Association (AFMA) counsel Edward S. Labowitz, asserts broadcasters "will say, 'get out of our way with these stupid quotas.' The future will write its own history, with the European television broadcasters telling the governments to go to hell." *Id.*

## B. *The Expansion of Media Services in Europe*

Quite a few audiovisual advancements are on the horizon for Europe. France is currently considering a 40 billion dollar "autoroute d'information," wiring every French household with fiber optic cable by 2015.<sup>163</sup> British Telecom will begin testing an experimental "information highway" style interactive system in 1995 on 2,500 homes in East Anglia, U.K.<sup>164</sup> In addition to television programs and films, the system will offer customers the chance to schedule vacations, do shopping, and buy books without leaving home.<sup>165</sup> In Europe, the conversion to digital terrestrial television is in the final stages of development. Digital television is expected to offer viewers a wide assortment of channels to choose from, including crime, sports, "thematic channels," and movie channels.<sup>166</sup>

The challenge to broadcast quotas by new technology is already evident in the area of satellite services. Existing communication satellites can beam a single signal to most of Europe. Existing licensing procedures limit licensing satellite services to a territory-by-territory basis.<sup>167</sup> However, "in a Europe committed to free trade, decoders will become readily available," says Edward Labowitz, council for the American Film Marketing Association (AMFA).<sup>168</sup> Importantly, home dishes will not be under TWFD quota controls in the foreseeable future.<sup>169</sup>

The alien invader beaming down from space to menace European culture is Ted Turner. His satellite stations, Turner Network Television (TNT) and the Cartoon Channel, together with Rupert Murdoch's Sky One, have flouted European content quotas since their inception.<sup>170</sup> Turner has lobbied for greater access, meeting with French President Francois Mitterrand to argue for TNT distribution in France and Europe.<sup>171</sup> Currently, the channel is

163. Fred Brenchley, *Crash Ahead on Superhighway - Multi Media*, AUSTL. FIN. REV., Oct. 31, 1994, at 12.

164. Ross Tieman, *BT Offers Families the Chance to Dial M for Movies*, LONDON TIMES, Nov. 16, 1994, available in WESTLAW, INT-NEWS-C Database.

165. *Id.* Users will be able to choose services from a menu on their television screens. *Id.* The system functions without interfering with normal telephone lines. *Id.*

166. Mike Jones, *Allen Foresees Channel Boom in Wake of Digital*, BROADCAST, Nov. 4, 1994, at 1.

167. Forte, *supra* note 162, at 14.

168. *Id.*

169. Quintero, *supra* note 43.

170. Devlin, *supra* note 161.

171. *Brussels Considers Quota Deal as UK Row Looms*, *supra* note 35. Turner has also met with Alain Carignon, French communications minister, and Jacques Boutet, president of the French regulatory body, Conseil Supérieur de l'Audiovisuel (CSA). *Id.*

banned from France's cable networks because of its all-American content.<sup>172</sup> Turner is also pursuing audiovisual production and cinema distribution expansions in Europe.<sup>173</sup>

The U.K. government has been at odds with the EC over licensing of satellite channels, such as Sky Movies, TNT, and the Cartoon Network.<sup>174</sup> Department of National Heritage Secretary Peter Brooke said in April 1994 that "the U.K. would seek a clarification of the wording in its favor [sic] if the commission did not agree that the present directive allows for the flexibility which the U.K. perceives to exist."<sup>175</sup> The U.K. wants to preserve the linguistic accommodations of the TWFD, allowing quotas to be imposed "where practicable and by appropriate means" and "progressively, on the basis of suitable criteria."<sup>176</sup> The November 1994 draft of changes to the TWFD proposes removal of this language, but would give satellite channels five years to comply with the fifty-one percent quota.<sup>177</sup>

The DG-X has excluded interactive services such as video-on-demand and pay-per-view from its 1995 changes in the TWFD quota regime. But the draft changes left an ominous loophole; individual governments would have the right "where they consider it necessary for purposes of language policy" to "lay down more detailed or stricter rules."<sup>178</sup> Before the "information superhighway" can go forward, comprehensive pan-European laws must be developed. Experts believe that without a solid legal framework, regional rules will surface that fragment the market and make it unworkable.<sup>179</sup>

European audiovisual experts see evolving technologies as a route to circumvent broadcasting quotas.<sup>180</sup> Thus, those concerned with American "cultural imperialism" have a vested interest in maintaining and increasing

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172. *Id.*

173. In 1994, Turner established Turner Productions SA, a Paris-based film production company. *New Film Distribution Networks in Offing*, SCREEN DIG., June 1994, available in LEXIS, NEWS Library, CURNWS File. Turner Broadcasting is also organizing a global distribution network through its Castle Rock Entertainment subsidiary. *Id.*

174. Marlene Edmunds, *EC Plans Quota Respite - Satellite and Cable Channels*, BROADCAST, Nov. 4, 1994, at 10.

175. *Brussels Considers Quota Deal as UK Row Looms*, *supra* note 35.

176. *Id.* See also discussion of controversy between EC and UK, *supra* notes 28-37 and accompanying text.

177. Edmunds, *supra* note 174, at 10. See also discussion of proposed TWFD changes *supra* part III(B). The draft changes also suggests that individual EU Member State governments could impose budget levies instead of quotas. Edmunds, *supra* note 174, at 10.

178. *Brussels' TV on the Blink*, *supra* note 7.

179. *Intellectual Property: 'Information Society' Leads EU to Begin Intellectual Property Study*, BNA INT'L TRADE REP., Aug. 31, 1994.

180. *Notebook*, TELEVISION DIG., July 18, 1994, at 3.

regulatory roadblocks to expanding audiovisual services.<sup>181</sup> The very success of American entertainment creates fear of the freedom of choice technology may bring. Access to many components of existing telecommunications media are priced out of reach by regulatory tariffs.<sup>182</sup> Moreover, material distributed over government controlled communications networks may lend itself to increased control.<sup>183</sup> The dream of technological freedom could give way to a reality of technological bondage.<sup>184</sup> Generally, the lack of stable legislation for new technologies will discourage high-tech firms from investing in the necessary infrastructure and equipment.<sup>185</sup>

In France, the effect of protectionist legislation on developing audiovisual services is already apparent. Over-regulation has significantly impaired the development of French cable television. Whereas 13.5 million German homes have cable, including some 800,000 in former East Germany, just under 1.3 million French households were connected to cable networks at the end of 1993, out of a total of nearly 5.3 million homes where cable is available.<sup>186</sup> The largest cable network in France, Lyonnaise Communications' Parisian network, is not expected to break even until the end of 1995, almost a decade after its commercial launch.<sup>187</sup>

Currently, French satellite, cable, and terrestrial television channels cannot show most feature films on Saturdays, or before 10:30 on Wednesday and Friday nights.<sup>188</sup> This measure is intended to shore up weak movie theater

181. Jube Shiver, Jr., *Wiring the World/The New Age of Global Telecommunications...*, LOS ANGELES TIMES, July 26, 1994, at 7.

182. *Id.*

183. *Id.*

184. *Id.*

185. Copyright holding authors are also concerned about proposals to grant broadcasters proprietary rights to programming. *Intellectual Property: 'Information Society' Leads EU to Begin Intellectual Property Study*, *supra* note 179. Broadcaster rights in transmitted programming are part of the doctrine of "neighboring rights," and are provided for in the Uruguay Round Accord. See Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement on Trade-Related Aspects of Intellectual Property Rights, including Trade in Counterfeit Goods (TRIPS), *opened for signature* Dec. 15, 1993, Doc. No. MTN/FA II-A1C. Until the longterm effects are proven, any dramatic change in European intellectual property laws will likely chill market interest in copyright holders. *Intellectual Property: 'Information Society' Leads EU to Begin Intellectual Property Study*, *supra* note 179.

186. Kenneth S. Hart, *Duel to the Death? Cable Television Industry in France*, COMM. INT'L, May 1994, at 7.

187. *Id.* Lyonnaise Communications' Paris has only 150,000 subscribers in a city of over 2 million residents. *Id.*

188. *Id.* French satellite, cable, and terrestrial channels include TF1, M6, France Television 2/3, and Canal Plus. *Id.* The pay-television service Canal Plus has seen widespread success, in large part because of more flexible broadcast rules, provided in return for payment of 18.5% of Canal Plus' pre-tax revenues to subsidize the French film industries. Waxman, *supra* note

attendance. Combined with national content quotas, the result is that cable channels cannot distinguish themselves from broadcast TV by offering more films or thematic programming.<sup>189</sup> Unless some broadcast restrictions and quotas are dropped, French cable television companies may be pushed out of the market.<sup>190</sup> In the age of digital satellite and cable services, says French Senator Jean Cluzel, French regulatory efforts to maintain a balance between cultural identity and technological innovation are becoming "more and more illusory."<sup>191</sup>

Preliminary industry surveys indicate that development of interactive shopping and video-on-demand services in Europe will lag ten years behind the United States.<sup>192</sup> The lag is attributed primarily to lower interest in the new services, rather than technological hurdles.<sup>193</sup> Given the general lack of quality viewing options in programming now broadcast in many European nations, audience cultivation also seems to be an issue.<sup>194</sup> By American standards, the quality of programming shown on European broadcast television approaches the unwatchable.<sup>195</sup> Cable TV and pay-per-view are making the first inroads to broadening viewer taste.<sup>196</sup>

### C. *The Comparatively Low Quality of European Audiovisual Product*

Myron Karlin, president and CEO of Motion Picture Export Association of America (MPEAA), caused an uproar at the international panel discussion of the 1994 World Film Festival when he stated bluntly:

Withdraw from your markets? Like hell! We're not going to do it. Throw up barriers? We'll jump them. Protectionism is not the answer. Make films people want to see. [There isn't any]

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62, at G1.

189. Hart, *supra* note 186, at 7.

190. *Id.* Negotiations were initiated in 1994 between the Ministry of Communications, the CSA, cable companies and French film producers to loosen broadcast regulations for both analog and upcoming digital cable services. *Id.*

191. *Id.*

192. *Interactive Shopping, Video-On-Demand in Europe to Lag U.S. by a Decade*, EUROMARKETING, Nov. 1, 1994, available in WESTLAW, INT-NEWS-Database.

193. Brenchley, *supra* note 163.

194. See Matt Baker, *Pic 'N' Mix Viewing—Pay-TV*, BROADCAST, Oct. 21, 1994, at 18. Baker feels that in the U.K. viewers will need to be educated about the advantages of expanded media services. *Id.*

195. See Greg Farrell, *Culture Schlock; Television Programs in Europe*, MEDIAWEEK, July 18, 1994, at 14.

196. Baker, *supra* note 194, at 18.



European-American film problem . . . . There is a European film problem. People in those countries don't want to see their own product.<sup>197</sup>

European filmmakers attempting to penetrate the American market have had a notorious lack of success.<sup>198</sup> European officials attribute this to American provincialism and indifference to foreign cultures.<sup>199</sup> Some believe it is poor response to dubbed and subtitled films.<sup>200</sup> European Director Roman Polanski has stated that "[i]f we made better films in Europe, there would be no problem."<sup>201</sup> EC's audiovisual commissioner, Juao Pinheiro, has also criticized the European cinema industry's failures "to produce films that meet public expectation and to implement a real commercial strategy able to boost film production."<sup>202</sup>

From the perspective of the American audiovisual industry, Europeans stress creative interests at the expense of pursuing business interests.<sup>203</sup> Europeans, especially the French, view cinema as an art form.<sup>204</sup> Conversely, Hollywood operates at a more commercial level, best described by the Hollywood axiom, "[i]f making movies were art, it would be called 'show art' rather than 'show business'."<sup>205</sup> The divergent attitudes of the U.S. and Europe regarding audiovisual commodities form the crux of the commercial versus cultural trade controversy.<sup>206</sup>

The European subsidy system is actually detrimental to product quality, according to AMFA counsel, Edward Labowitz. "I've seen the projects developed by these subsidy-seeking producers," asserts Labowitz. "What they create are projects and scripts that will appeal to the intellectuals within the subsidy bureaucracies of their respective countries."<sup>207</sup>

The current situation in the highly subsidized French audiovisual industry supports this assertion. The Centre National de la Cinematographie (CNC)

197. Kirk Honeycutt, *MPEAA Pulls No Punches in Fest "Free-for-All,"* HOLLYWOOD REP., Aug. 31, 1994, available in LEXIS, News Library, CURNWS File.

198. Scott, *supra* note 156.

199. *Id.*

200. *Id.*

201. Hift, *supra* note 16, at 13.

202. Forte, *supra* note 162, at 14.

203. Pia Farrell, *Finding Cure for Euro Woes Sets Tone at Beaune,* HOLLYWOOD REP., Oct. 28, 1994, available on LEXIS, News Library, CURNWS File (quoting AFMA president Jonas Rosenfield).

204. Scott, *supra* note 156 (quoting French Attache Beatrice Le Fraper Du Hellen's assertion that film is part of the art and culture which forms French national identity).

205. Forte, *supra* note 162, at 14.

206. See Braun & Parker, *supra* note 3, at 171.

207. Forte, *supra* note 162, at 14.

expects to receive over 1.92 billion Francs in 1994 from direct state aid, as well as taxes levied on movie tickets, television stations, and video cassettes.<sup>208</sup> CNC bureaucrats channel the money to French movie and television producers.<sup>209</sup> In October 1994, a special report by the Cour des Comptes blasted the CNC for "management without any rigor" and for subsidizing "projects that were not marketable" and others that "clearly should not have benefited" from public funds.<sup>210</sup> Further, French officials have criticized the intimate association the CNC maintains with French audiovisual producers, represented by the Bureau des Liaisons de l'Industrie Cinematographique (BLIC).<sup>211</sup> The cozy alliance between BLIC and the CNC has created a stale, anti-competitive environment in the French audiovisual industry.<sup>212</sup>

Moreover, the French subsidy system has tended to create dependency, as the industry becomes unable to function without government support. Recent small cuts in audiovisual funding have met with bewilderment and disbelief on the part of French filmmakers.<sup>213</sup> And despite the overall high level of subsidies, the number of French moviegoers has fallen by almost thirty-seven percent, from 175 million in 1984 to 110 million in 1994.<sup>214</sup> A government-ordered investigation of the film industry concluded that fully half of the 100-plus French films produced each year are made because there is government money to be spent, not because they ought to be made.<sup>215</sup> "Forget, forget, forget, the French example," says commercial station TF1 executive Etienne Mourgeotte. "French regulation is counterproductive."<sup>216</sup>

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208. Hart, *supra* note 186, at 7.

209. *Id.*

210. *Id.*

211. *Id.* Phillippe-Olivier Rousseau, an official at the Conseil Superieur de l'Audiovisual (CSA), decries the tightly knit clan of French audiovisual producers represented by BLIC as an "inbred, state-run lobbying group" that wields enormous influence over the French mass media. *Id.* Another analyst describes the tight BLIC-CNC relationship as a nationalized "quasi-Mafia" that prevents new talent from entering the market. *Id.*

212. *Id.* American investigative journalist Marc Hunter says the French system "creates interlocking circles in which everybody owes something to everybody else. There's no criticism and not much movement, and the public becomes really irrelevant to what's produced. Except they pay the taxes." Waxman, *supra* note 62, at G1.

213. Waxman, *supra* note 62, at G1. When Jacques Toubon became France's Minister of Culture in 1993, he eliminated a \$2.5 million movie fund established by his predecessor, Jack Lang. *Id.* However filmmakers kept coming to his office, looking for \$10,000 to finish a script treatment, \$50,000 to get through production, a quarter-million to get a project going. *Id.* "They had gotten used to this, and they didn't understand that there was no more money," says Hubert Astier, Toubon's cabinet director. *Id.*

214. *Id.*

215. *Id.*

216. Tom Buerkle, *Can a Divided Industry Conquer?; European Filmmakers Find Little Common Ground*, INT'L HERALD TRIB., July 2, 1994, Finance Section.

European product is often limited to a regional appeal because of cultural diversity and language barriers. EC Commissioner Pinheiro claims, "The situation in Europe is different and will remain so if only because nine official languages are spoken. Thus, the European film industry faces serious difficulties to define its public."<sup>217</sup> The United States has succeeded by using a one-market approach to the entire European continent. "Do the American's make better films?" international filmmaker Dino De Laurentiis posed.<sup>218</sup> "Absolutely not, they simply have the merit of believing in a single European market."<sup>219</sup> Besides European familiarity with American culture, the single market approach works because of the widespread use of English. Throughout the world, English has become the international method of expression.<sup>220</sup> In science, in business, in diplomacy, on television, radio, and movies, English is a transcultural medium, allowing diverse peoples brought together by modern technology to interact.<sup>221</sup> Thus, a film produced in English has a much broader potential audience than a French or German language film.

#### V. A WORKABLE PLAN TO RESUSCITATE THE EU AUDIOVISUAL INDUSTRY

American audiovisual production continues to be the standard by which European work is measured. European producers seek to co-opt the American pedigree that establishes "hit" status. For example, U.K. backed filmmaker British Screen releases many of its movies in the United States before they are shown in Britain, because of the lack of initial interest in British audiences.<sup>222</sup> Chief executive Simon Perry points to British Screen's "The Crying Game," as an example of how films flounder in the U.K. before they take off in America.<sup>223</sup> Only when a film's reputation had been made in the United States does the film fare better in Britain.<sup>224</sup>

To become a true contender in the audiovisual market, Europe must follow a two-step course of action. First, Europe needs to increase production

217. Forte, *supra* note 162, at 14.

218. Buerkle, *supra* note 216.

219. *Id.*

220. Michael Rezendez, *English as the Global Language from Poles to Poles, It's Now on the Tip of a Billion People's Tongues*, BOSTON GLOBE, Nov. 6, 1994, at 82.

221. *Id.*

222. Richard Brooks, *UK Filmgoers Regarded as Box-Office Flop*, OBSERVER, Oct. 30, 1994, at 13.

223. *Id.*

224. *Id.* "Four Weddings and a Funeral" is another recent film that flopped in the UK before it did so well in America that the British media took notice. *Id.* It is now the most profitable British film ever, with receipts so far of 25 million pounds. *Id.*

of commercial-quality films that can gain access to the American audience. The fastest way to achieve this goal is co-production with American financial partners. The subsequent supply of quality product will rejuvenate Member State audience interest, allow for audiovisual communications technology expansion, and build the infrastructure of an international production center.<sup>225</sup> It is not necessary for European producers to surrender creative control to their American financial partners; such cultural concerns can be protected through carefully drafted co-production regulations.

Once the structures are in place to create and market profitable productions, the major European finance centers will be ready to take the next step and assume control of the funding aspect.<sup>226</sup> Daniel Marquet, president of the France's Studio Canal Plus, agrees with the need to collaborate with American studios:

We cannot avoid becoming an industry to survive in Europe. Ride on the strength of what [Americans] do best. Build strong product and cooperate with the majors, using their strength and knowledge of distribution.<sup>227</sup>

In contrast, the United Kingdom already has the film talent and production facilities to succeed in the American market.<sup>228</sup> Veteran British film producer Barry Spikings, now working in Hollywood, sums up the situation, "The U.K. has talented people who make films. It does not, however, have a regular supply of finance to fund film production."<sup>229</sup> The reason is that worldwide distribution, which generates a majority of film revenue, is controlled by major Hollywood studios.<sup>230</sup> U.K. film production is thus dependent on investment by American distributors.<sup>231</sup> The problem is that as long as U.S. producers

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225. To grow and gain wider distribution, American independent filmmakers have found it necessary to form alliances with major studios analogous to those suggested here for European filmmakers. See Rick Setlowe, *Allied Forces Invade H'Wood; Studios, Indies Mutually Dependent in Ever-Changing Field*, DAILY VARIETY, July 20, 1994, available in LEXIS, News Library, CURNWS file (describing the modern amalgamation of major studios and independent filmmakers).

226. Movie marketing and finance consultant Seth Willenson similarly asserts, "As foreign entertainment-information conglomerates reach the size where they really want to become competitors in the international market, foreign financing [will] become even greater." Setlowe, *supra* note 49.

227. Honeycutt, *supra* note 197.

228. Recent successful UK productions include "Damage," "Four Weddings and a Funeral," and "The Crying Game." See Brooks, *supra* note 222, at 13.

229. Griffiths, *supra* note 18, at 40.

230. *Id.*

231. *Id.*

put up the production money, no profits return to the British film industry.<sup>232</sup> Spikings contends that it is time for London financiers to take the second step and

[i]nvest in movies at home and abroad on terms which reflect the needs of the U.S. studios to put in place long-term strategic alliances. [ ] The U.K. [can then] take advantage of the worldwide distribution systems [already] created.<sup>233</sup>

Before European backers take on large-scale financing of film production, the European film industry must demonstrate the ability to sustain a competitive level of quality production. So far the huge sums of money infused by the EC and Member State governments have failed to create any consistence of quality. Consequently, the task must fall to private sector entities that have the money and experience to compete. The American film industry is uniquely suited to meet these needs. However, the confusion of regulations governing EC co-productions is proving to be a serious impediment to cooperative efforts between the United States and Europe.

#### A. *Legislative Hurdles to Co-Production*

American producers are eager to get EC co-production status for their films, because it greatly increases access to the EU market.<sup>234</sup> Co-production also provides an avenue to European subsidies, quota incentives, and tax deals.<sup>235</sup> But international co-productions tend to be extremely complex deals that are difficult to execute, and European co-production regulations only exacerbate the problem.<sup>236</sup>

During the summer of 1994 only thirty-one percent of all European films were international co-productions.<sup>237</sup> Almost half of these are intra-European ventures, where different co-production definitions can lead to double and triple counting.<sup>238</sup> For instance, excluding over-counting from 1993 film production figures revealed only twenty-seven percent of films were co-

232. *Id.*

233. *Id.* To this end, UK government officials are contemplating abolishing the withholding tax on motion picture artists and allowing a 100% capital allowance for the year of investment. *Id.*

234. *U.S. Pic Makers Seek Ways, Coin to Go Int'l*, *supra* note 49.

235. *Id.*

236. *Id.* "Co-productions are a wonderful, wonderful premise that, in fact, are very difficult to execute historically," notes Steven Bickel, President of Samuel Goldwyn International. *Id.*

237. *European Features*, *supra* note 56.

238. *Co-Production in Europe*, SCREEN DIG., July 1994, available in WESTLAW, INT-NEWS-C Database.

productions, as opposed the original estimate of thirty-six percent.<sup>239</sup> Of the 1993 European co-productions, 59.5% had non-EU partners, a little more than sixteen percent of the total number of productions.<sup>240</sup>

### 1. Member State Standards for National Treatment of Co-Productions

In general, the complexity of international co-productions can have a chilling effect on investors.<sup>241</sup> Unfortunately, regulatory initiatives to simplify co-production are almost non-existent. Co-productions with European partners must qualify as "national works" to get national treatment on Member State subsidies, quotas, and taxes, and "European Works" to apply toward the TWFD quota and receive EC subsidies. Widespread discrepancies exist between EU Member States as to standards for "national works" qualification.<sup>242</sup> A survey of intra-European co-productions found only two cases where EU states agreed on the number of co-productions between their respective countries.<sup>243</sup>

The U.K., Italy, France, Germany, and Norway all have various co-production treaties effecting "national treatment" of film, but none directly involve the United States.<sup>244</sup> Some Member States only accord national treatment to co-productions within the context of specific government made treaties, or when there is actual production involvement by their country.<sup>245</sup> Other Member States regard forms of co-financing, pre-sales, or even the use of post-production facilities as factors qualifying a "national work."<sup>246</sup> American producers seeking to avail themselves of EU Member State benefits do not have uniform standards from which to work. Furthermore, even if a co-production qualifies for national treatment, it may still not meet the "European Works" standard.

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239. *Id.*

240. *Id.* This represents a 3.7% rise from the 1992 level of European co-productions with non-EU partners. *See id.*

241. Greg Coote, president of Australia's Village Roadshow Pictures, explains the complexity of one such deal: "We're looking at a picture about Greenpeace, written by a Canadian who lives in Santa Monica. So this Australian-Canadian co-production meets on Montana Avenue [in Santa Monica]." *U.S. Pic Makers Seek Ways, Coin to Go Int'l*, *supra* note 49. Before the production can go ahead, Coote must get French involvement and meet that country's co-production regulations to get access to French funds and tax incentives. *Id.*

242. *Co-Production in Europe*, *supra* note 238.

243. *Id.* The number of Portugal/Belgium and U.K./France co-productions was agreed to by both participating nations. *Id.*

244. *See* Margaret Moore, *supra* note 45 (delineating typical threshold criteria and Member State agencies administering co-production treaties).

245. *Co-Production in Europe*, *supra* note 238.

246. *Id.*

## 2. Member State Standards for EC "European Works"

Co-productions must meet the TWFD Article 6 definition for "European works" to be considered "European" for TWFD quota purposes and eligible for EC subsidies. Essentially an American co-production may be considered a "European work" if it meets two requirements:

- (1)(a) It is "made by one or more producers *established* in" Member States,<sup>247</sup> or
- (b) It is "*supervised and actually controlled* by one or more producers *established*" in Member States,<sup>248</sup> or
- (c) "[T]he contribution of co-producers" from Member States "to the total co-production costs is preponderant and the co-production is not *controlled*" by producer(s) *established* outside Member States;<sup>249</sup> and
- (2) It is "made *mainly* with *authors* and *workers residing* in one or more [Member States]"<sup>250</sup> (emphasis added).

This broad definition has left a great deal of room for Member States to develop divergent interpretations.<sup>251</sup> In France, the leeway in Article 6 has been used to develop a strict regulatory interpretation of "European work" based on a point system.<sup>252</sup> Other Member States have created informal discretionary interpretations of qualifying "European works," dependent on a case-by-case evaluation.<sup>253</sup>

If a co-production fails to fully meet the amorphous "European work" standard, it will be relegated to the status of a "partially qualified" work under

247. TWFD, *supra* note 23, art. 6.2(a).

248. *Id.* art. 6.2(b).

249. *Id.* art. 6.2(c)

250. *Id.* art. 6.1.

251. See Moebes, *supra* note 46, at 8 - 9. For example, "established" could relate to a period of time, the size of the operation, the intent of the parties, or some combination thereof. *Id.* Similar questions arise for the term "residing." *Id.* "Supervised and actually controlled" could refer to creative control or ultimate monetary control. *Id.* "Mainly" made by resident workers could mean the preponderant number of people or the preponderance of actual creative input. *Id.* Finally, it is not clear how much creative input makes one an "author," or what jobs qualify as "worker." *Id.*

252. *Id.* at 8. See also Decree No. 90-66 of Jan. 17, 1990, Journal Officiel de la Republique Francaise, [J.O.] Jan. 18, 1990 at 757 (codifying France's "European works" legislation).

253. Letter from Manuel Kohnstamm, Representing Time Warner Europe, to Melanie Moen, Director of Legal Affairs, American Film Marketing Association (June 14, 1994) (on file with the IND. INT'L & COMP. L. REV.).

Article 6.4.<sup>254</sup> It counts as a "European Work" only to the pro rata extent that the EU Member State co-producers contributed to the cost of the production.<sup>255</sup> Thus a ninety-minute film in which the EC partners contributed one-third of the budget will qualify as a thirty-minute "European work" for quota and subsidy purposes.

The Council of Europe's Convention on Cinematographic Co-Production (CCC) was developed to clear the thicket of co-production treaties and regulations existing between the EC and Member States.<sup>256</sup> Films qualifying under the CCC regime would be considered both "European works" and "national" productions of the signatory states whose co-producers participated in the production.<sup>257</sup>

The CCC applies only to productions involving three co-producers in three separate signatory states.<sup>258</sup> Co-producers from outside states may be involved to a limit of thirty percent of total production costs.<sup>259</sup> The CCC provides that a European film be in a language "culturally suited to the work."<sup>260</sup> Further, the CCC sets up a point system to evaluate co-productions. A film must have fifteen of a total nineteen points to qualify as "European."<sup>261</sup>

Although the CCC may represent a move in the direction of clarifying co-production regulations, its limitations on non-EU member investment and trilateral structure make it questionable as a means for American producers to work with Member State producers. A comprehensive regulatory program must be developed that encourages the dominant U.S. audiovisual industry to form production partnerships with creative control vested in the EU partners.

#### B. *How U.S. Companies are Dealing with Co-production Difficulties*

American film industry leaders are looking for innovative ways to enter into cooperative enterprises with their European counterparts.<sup>262</sup> The seven

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254. TWFD, *supra* note 23, art. 6.4. *See also* Moebes, *supra* note 46, at 10.

255. *Id.*

256. Council of Europe's European Convention on Cinematographic Co-Production, Oct. 2, 1992, Europ. T.S. No. 147 [hereinafter CCC].

257. *Id.* As of 1994, the CCC needs to be signed by five more nations to take effect. *Id.*

258. Moore, *supra* note 45.

259. CCC, *supra* note 256.

260. *Id.*

261. *See* Moore, *supra* note 45. Directors, screenwriters, and lead actors from signatory states each rate three points. *Id.* "Second lead" actors are worth two points, and "third lead" actors are worth one point. *Id.* A point is given for the music composer, the editor, the post-production facility, and the location or studio. *Id.*

262. Michael Williams, *DEJA VU VALENTI VIEW; Pushes Free Market Pix Message in Paris*, DAILY VARIETY, Sept. 29, 1994, at 18.



major Hollywood studios began quietly talking with EU producers about joint ventures in film, television production, and distribution soon after the close of the Uruguay Round.<sup>263</sup> The EU-U.S. Audiovisual Roundtable, hosted by European Parliament deputies on November 3, 1994, provided a forum for MPAA president Jack Valenti to pledge Hollywood assistance in boosting the European film industry.<sup>264</sup> Filmmakers and distributors from both sides of the Atlantic participated in the forum.<sup>265</sup> Roundtable administrator David Reinfeld promised the pending announcement of a broad joint campaign.<sup>266</sup>

American audiovisual industries have begun investing in development of European television shows and TV movies directly with European broadcasters.<sup>267</sup> Inroads to co-production have also come through "format" deals, in which popular programs are franchised to European television producers.<sup>268</sup> The system has been particularly successful with "local formats" - programming that lends itself to regionalization, such as talk shows, game shows, daily/weekly serial dramas, and to a lesser extent sitcoms.<sup>269</sup>

Conversely, Hollywood producers, faced with a lack of original material, have turned to remakes of successful European films.<sup>270</sup> The trend has positive and negative consequences for European producers. In addition to infusing money from licensing rights for remakes, studios may hire key European

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263. Buerkle, *supra* note 102.

264. Suzann Perry, *Hollywood Set to Help European Filmmakers*, REUTERS NEWSWIRE, Nov. 3, 1994, available in WESTLAW, INT-NEWS-C Database. This includes cooperation on developing digital dubbing techniques, and a \$40,000 grant to Media 95 sponsored Media Business School. *Id.*

265. John Carvel, *Europe and Hollywood Close to Peace Deal*, GUARDIAN, Nov. 2, 1994, at 16.

266. *EU, U.S. Film Producers Agree to Cooperate*, REUTERS NEWSWIRE, Nov. 3, 1994, available in WESTLAW, INT-NEWS-C Database.

267. Twentieth-Century Fox recently began co-production on a television game show slated to air in Britain, Spain, Germany, and Scandinavia, investing \$2.5 million in the "science-fiction" set where it will be produced. *Hollywood to the Rescue as Culture War Abates*, *supra* note 102. Hearst Enterprises and state-owned German television broadcaster ZDF announced a joint fund to develop TV movies and mini-series for global distribution. *Hearst and ZDF to Develop TV Movies and Documentaries*, EUROMARKETING, Nov. 3, 1994, available in WESTLAW, INT-NEWS-C Database.

268. Robert Marich, *MIPCOM Heat: The Format Deal; Foreign Broadcasters See Wisdom in Growing Their Own -- With Help*, HOLLYWOOD REPORTER, Oct. 14 1994, at 5.

269. *Id.* These types of programs are high volume, filling a great deal of airtime for a relatively low price. *Id.* The system also provides the unique advantage of allowing local producers to develop and incorporate regional sponsorships. *Id.*

270. Recent remakes include "La Femme Nikita," "Breathless," and "Three Fugitives." Vernon Scott, *supra* note 156.

personnel from the original.<sup>271</sup> However, remakes do not increase U.S. distribution of these original European works. In fact, they may actually have a negative impact.<sup>272</sup> Hollywood producers buy the U.S. rights to the best European productions, and shelve the original to concentrate on the remake.<sup>273</sup> There is no financial impetus for major studios to nurture a dubbed or subtitled film through a limited release when a big-budget remake can garner higher box office receipts in a single day.<sup>274</sup>

Disney Studios has taken a lead in remedying the situation by creating a subsidiary to market French films in the U.S. and co-produce with France.<sup>275</sup> Disney is at the forefront of European remakes, having previously sired big-budget reproductions, including "Three Men and a Baby," "Three Fugitives," "Paradise," and "My Father the Hero." The subsidiary, launched in 1994, plans to distribute at least three new French pictures a year, and has set aside \$3 million to \$4 million for redubbing.<sup>276</sup>

## VI. CONCLUSION

The American initiative to enter into cooperative ventures with European producers, notwithstanding the regressive EU co-production regulatory scheme, is indicative that the false economies generated by legislated protectionism cannot be sustained against the pressures of the free market. If the recent fall of communism around the world has taught any lesson, it is that government subsidies and regulation cannot indefinitely withstand economic forces. No trade barrier can prevent people from going to see a good film, and no subsidy can persuade them to see a bad one.<sup>277</sup>

The current legislative course contemplated by the European Commission will work to the long-term detriment of the audiovisual sector. Taken to the extreme, the protectionist stance could render Europe a non-entity in the burgeoning information age. The underdevelopment of the European audiovisual market represents a tremendous economic loss to both Europe and the U.S.

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271. Josh Young, *Hollywood's Love of Remakes Means Rejection of French Originals*, N.Y. TIMES, Oct. 30, 1994, at 1C.

272. *Id.*

273. *Id.*

274. *Id.*

275. Pia Farrell, *Miramax Cook Up New Unit for French Fare; Goal: 'Greater Exposure on American Screens'*, HOLLYWOOD REPORTER, Oct. 10, 1994.

276. *Id.* Miramax has also promised investments of \$20 to \$30 million in future French co-productions. *Id.* The cash investment is relatively small by Hollywood standards. French filmmakers view the move as an appeasement for continuing efforts to infiltrate the French entertainment market. *Id.*

277. Griffiths, *supra* note 18.

It is therefore in the interest of all parties to work toward creating a healthy, thriving European audiovisual industry.

Europe must resist the cultural bureaucrats who value self-preservation over the good of the European Community. Rather than pursuing novel regulatory schemes, the EC should be seeking ways to deregulate in a controlled fashion, so as to best benefit from the resulting economic shift. By simplifying and clarifying co-production regulations, the EC could generate a cash influx on its own terms, retaining cultural and creative control. The two-step program outlined here offers an efficient method to rehabilitate the European audiovisual industry.

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# THE DOCTRINE OF EQUIVALENTS IN PATENT LITIGATION: AN ANALYSIS OF THE EPILADY CONTROVERSY

## I. INTRODUCTION

Today the primary element in the growth of modern economies is the development and use of new ideas and new technologies.<sup>1</sup> “[T]he ability to create and make use of new ideas and new technologies is increasingly becoming a factor which distinguishes the successful from the unsuccessful, be it in nation-to-nation or firm-to-firm competition.”<sup>2</sup> Because of the economic importance new ideas and technologies play in the marketplace, most industrial nations afford inventors of new products or processes protection within their borders.<sup>3</sup>

This protection is provided by what is called a patent. A patent is an instrument granted by a government or sovereign of a country which gives the patentee an exclusive right to use the new product or process for a period of time. However, the exclusive use is only applicable in the territory of the country granting the patent. In the United States, a patent confers the right to exclude others from making, using or selling the patented invention for seventeen years.<sup>4</sup> Today, even though most industrial nations grant patent protection, the methods used to determine the scope of a claim and whether the claim encompasses the accused product or process vary from one industrial nation to another.

Direct infringement of a patent occurs in one of two ways: literal or by equivalence. Literal infringement is essentially outright duplication of the patented device and is rarely litigated.<sup>5</sup> Therefore, the vast majority of infringement disputes involve the doctrine of equivalents. Patent attorneys know from experience that a patent system not recognizing infringement by equivalence would provide little protection for patented products or processes. Recognizing the important role the doctrine of equivalents plays in patent protection, it is equally important that the doctrine is applied uniformly wherever patent protection is afforded. Because patent protection is based on the patent laws of the country granting the patent and the political agendas of each country differ, global uniformity in regard to equivalency has yet to be achieved. Without a worldwide uniform equivalents doctrine, the degree of patent protection will vary from one nation to the next. The global inconsistencies of claim interpretation force industries holding foreign patent rights to allocate additional capital for legal counsel interpretation of these inconsistencies, which

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1. R. MICHAEL GADBAW & TIMOTHY J. RICHARDS, *INTELLECTUAL PROPERTY RIGHTS* 1 (1988).

2. *Id.*

3. *Id.*

4. 35 U.S.C. §§ 154 & 271 (1988).

5. *Graver Tank & Mfg. Co. v. Linde Air Products Co.*, 339 U.S. 605, 607 (1950).

effectively reduces the capital available for activities vital to the long run financial success of these industries, such as research and development and purchases of machines and equipment.

The purpose of this note is to illustrate the lack of harmony in determining infringement by equivalency between the United States and the Member States of the European Community (E.C.). In order to familiarize the lay reader with the doctrine of equivalents, Part II of this note briefly describes the doctrine as it is applied in the United States. Part III then focuses on international patent protection and the role the doctrine of equivalents plays in the E.C. Part IV discusses the contradictions among the national courts of the E.C. in applying the doctrine of equivalents, and illustrates these contradictions by analyzing the Epilady controversy. Briefly, the Epilady controversy involved an infringement dispute between a European Patent holding Panamanian company and an American-based company. The patented device, the Epilady, is a depilatory device used to remove hair from the arms and legs of women. What is particularly interesting about the Epilady dispute is that when the Panamanian company sought to enforce its European Patent in various E.C. national courts, some national courts found infringement and others did not. This inconsistency occurred even though each national court considered the same patent, the same infringing device, a similar set of facts, and applied the same uniform standard of interpretation. The Epilady controversy serves as a dramatic illustration of the contradictions among the national courts of the E.C. in applying the doctrine of equivalents. Lastly, as a possible solution to the inconsistent applications of the doctrine of equivalents, Part V discusses how the current draft of the Patent Harmonization Treaty will facilitate harmonization of the doctrine of equivalents worldwide.

## II. PATENT INFRINGEMENT AND THE DOCTRINE OF EQUIVALENTS IN THE UNITED STATES

With respect to a utility patent, the United States Government grants, for the term of seventeen years, the right to exclude others from making, using, or selling the patented invention in the United States.<sup>6</sup> Violation of this right is a tort<sup>7</sup> analogous to trespass<sup>8</sup> for which the patent holder may bring a civil action<sup>9</sup> in Federal Court. Violation of this right to exclude others from making, using, or selling the patented invention in the United States is called direct

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6. 35 U.S.C. § 154 (1988).

7. *Carbice Corp. of America v. American Patents Development Corp.*, 283 U.S. 27, 33 (1931).

8. *Thompson-Houston Elec. Co. v. Ohio Brass Co.*, 80 Fed. 712, 721 (6th Cir. 1897).

9. 35 U.S.C. § 281 (1988).

infringement. The statutory definition of direct infringement, on its face, appears to be quite simple. Section 271(a) provides: “[e]xcept as otherwise provided in this title, whoever without authority makes, uses or sells any patented invention, within the United States during the term of the patent thereof, infringes the patent.”<sup>10</sup> Although the statutory definition of direct infringement appears to be straight forward, the definition requires the courts to conduct two difficult inquiries: the determination of the scope of the claims, as a matter of law, and the factual finding of whether the properly construed claims encompass the accused structure.<sup>11</sup>

Direct infringement can be found in one of two ways: literal or by equivalence. To establish infringement of a patent every limitation set forth in a claim must be found in the accused product or process exactly or by a substantial equivalent.<sup>12</sup> In determining both literalism and equivalence, the focus must be on the elements of the individual claim rather than the invention as a whole.<sup>13</sup>

#### A. *Literal Infringement*

Literal infringement is found when the words of the claim literally read on the accused subject matter and such subject matter embodies the essential characteristics of the invention defined by the claim. The United States Supreme Court in *Graver Tank & Mfg. Co. v. Linde Air Products Co.*, summarized the process of determining literal infringement of a patent as: “[i]n determining whether an accused device or composition infringes a valid patent, resort must be had in the first instance to the words of the claim. If the accused matter falls clearly within the claim, infringement is made out and that is the end of it.”<sup>14</sup>

As most patent attorneys know though, literal infringement is basically outright duplication of the patented device and is rarely litigated.<sup>15</sup> Most infringement disputes involve an accused device which has not copied every literal essential characteristic of the patented device. More often the accused device embodies elemental substitutions and minor changes that take the accused device outside the scope of the literal meaning of the patent’s claims.

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10. 35 U.S.C. § 271(a) (1988).

11. *McGill Inc. v. John Zink Co.*, 736 F.2d 666, 671 (Fed. Cir. 1984) (citing *SSIH Equip. S.A. v. USITC*, 718 F.2d 365, 376 (Fed. Cir. 1983)), *cert. denied*, 469 U.S. 1037 (1984).

12. *Johnston v. IVAC Corp.*, 885 F.2d 1574, 1581 (Fed. Cir. 1989).

13. *Pennwalt Corp. v. Durand-Wayland, Inc.*, 833 F.2d 931, 935 (Fed. Cir. 1987), *cert. denied*, 485 U.S. 961, 1009 (1988).

14. *Graver Tank*, 339 U.S. at 607.

15. *Id.*

## B. *Equivalency (Doctrine of Equivalents)*

If the requirements of literal infringement are not met, infringement may still be found by applying the doctrine of equivalents. According to the doctrine of equivalents, if the words of the claim do not literally read on the accused subject matter, but the accused device performs substantially the same function in substantially the same way to obtain substantially the same result, there is infringement unless the patent holder is estopped from broadening the scope of the claim beyond the literal meaning of its words.<sup>16</sup> The patentee has the burden of proving the accused device infringes the patent's claims, and to do so under the doctrine of equivalents requires a showing that all three components of the equivalency test—function, way, and result—are met.<sup>17</sup> Therefore, to find infringement under the doctrine of equivalents, a patentee must prove by a preponderance of the evidence<sup>18</sup> the substantial identity as to each of the function, way, and result prongs of the doctrine of equivalents.<sup>19</sup>

### 1. *Interchangeability Factor of Equivalency*

An important factor in the determination of equivalence is whether persons reasonably skilled in the art would have known of the interchangeability of an ingredient not contained in the patent with one that was.<sup>20</sup> The patent specification need not disclose the equivalent element and the fact that it is a proper substitute in order for the doctrine to apply.<sup>21</sup> The Federal Circuit

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16. *E.g.*, *Pennwalt Corp.*, 833 F.2d at 934 (citing *Perkin-Elmer Corp. v. Computervision Corp.*, 732 F.2d 888, 901-02 (Fed. Cir. 1984), *cert. denied*, 469 U.S. 857 (1984) and *Graver Tank*, 339 U.S. at 608); *Stewart-Warner Corp. v. City of Pontiac*, 767 F.2d 1563, 1570-72 (Fed. Cir. 1985) (citing *Graver Tank*, 339 U.S. at 609 (quoting *Sanitary Refrigerator Co. v. Winters*, 280 U.S. 30, 42 (1929))).

17. *Universal Gym Equip., Inc. v. ERWA Exercise Equip. Ltd.*, 827 F.2d 1542, 1548 (Fed. Cir. 1987).

18. *Smithkline Diagnostics, Inc. v. Helena Labs. Corp.*, 859 F.2d 878, 889 (Fed. Cir. 1988).

19. *Malta v. Schulmerich Carillons, Inc.*, 952 F.2d 1320, 1325 (Fed. Cir. 1991), *cert. denied*, 112 S. Ct. 2942 (1992).

20. *Perkin-Elmer Corp.*, 822 F.2d at 1535 (citing *Graver Tank*, 339 U.S. at 609); *Palumbo v. Don-Joy Co.*, 762 F.2d 969, 975 (Fed. Cir. 1985) (citing *Graver Tank*, 339 U.S. at 609). Substitution of an ingredient known to be an equivalent to that required by the claim presents a classic example for finding infringement under the doctrine of equivalents. *Corning Glass Works v. Sumitomo Elec. U.S.A., Inc.*, 868 F.2d 1251, 1260 (Fed. Cir. 1989) (citing *Graver Tank*, 339 U.S. at 609). Interchangeability is a useful consideration when determining whether two specific structures are equivalents. *Rite-Hite Corp. v. Kelley Co.*, 819 F.2d 1120, 1125 (Fed. Cir. 1987) (citing *Graver Tank*, 339 U.S. at 609).

21. *Thomas & Betts Corp. v. Litton Sys.*, 720 F.2d 1572, 1579 (Fed. Cir. 1983).



in *C.R. Bard Inc. v. Kendall Co.*, put the “interchangeability” factor in to perspective when it held that “interchangeability” is but one factor to be considered in an equivalents analysis, and does not by itself establish equivalence under the *Graver Tank* standard.<sup>22</sup>

## 2. *Timing of Equivalency Review*

In regard to timing, infringement by equivalents is determined at the time of infringement, and not by what the inventor (or others skilled in the art) knew when the patent was filed or issued.<sup>23</sup> In other words, it is not required that those skilled in the art knew of the asserted equivalent means of performing the claimed function at the time the patent application was filed, but that those skilled in the art know of the asserted equivalent means of performing the claimed function at the time infringement takes place.<sup>24</sup> Therefore, a partial variation in technique or an embellishment made possible by post-patent technology, does not always allow the accused method or product to escape the ‘web of infringement.’<sup>25</sup>

## 3. *The Additional Functions Defense*

A common defense to the doctrine of equivalents is that the accused device performs additional functions not found in the patented device. The Federal Circuit has held that infringement under the doctrine of equivalents is not precluded merely because the accused device performs functions in addition to those performed by the claimed device.<sup>26</sup> It is the limitations and functions of the invention described in the claims, not the elements or functions of the accused device, that establish the reference point for the doctrine of equivalents.<sup>27</sup>

## 4. *Limitations on the Doctrine of Equivalents*

As mentioned earlier, the patent holder may be estopped from broadening the scope of the claim beyond the literal meaning of its words.<sup>28</sup> Three

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22. *C.R. Bard Inc. v. Kendall Co.*, 935 F.2d 280, 280 (Fed. Cir. 1991).

23. *Atlas Powder Co. v. E.I. duPont de Nemours & Co.*, 750 F.2d 1569, 1581 (Fed. Cir. 1984); *Texas Instruments, Inc. v. United States Int'l Trade Comm'n*, 805 F.2d 1558, 1563 (Fed. Cir. 1986).

24. *Texas Instruments*, 805 F.2d at 1563 (citing *Atlas Powder Co.*, 750 F.2d at 1581). See also *American Hosp. Supply Corp. v. Travenol Labs., Inc.*, 745 F.2d 1, 8 (Fed. Cir. 1984).

25. *Moleculon Research Corp. v. CBS, Inc.*, 872 F.2d 407, 409-10 (Fed. Cir. 1989) (citing *Hughes Aircraft Co. v. United States*, 717 F.2d 1351, 1365 (Fed. Cir. 1983)).

26. *Insta-Foam Prods., Inc. v. Universal Foam Sys.*, 906 F.2d 698, 702 (Fed. Cir. 1990).

27. *Id.*

28. See cases cited *supra* note 16.

frequently cited limitations of the doctrine of equivalents include: prosecution history estoppel, prior art, and technological advances.

a. *Prosecution History Estoppel*

Prosecution history estoppel is an equitable tool for determining the permissible scope of patent claims.<sup>29</sup> Normally, in order to obtain the patent grant, the patent applicant will make material representations to the Patent and Trademark Office (PTO), in response to references cited by the PTO, that in effect alter the scope of the patent claims. Typically these representations reduce the scope of the patent in order to avoid the prior art. These material representations are pertinent to the subsequent determination of the permissible scope of the patent claim.<sup>30</sup> Prosecution history estoppel will not allow the patentee to recapture through equivalence certain coverage given up during prosecution.<sup>31</sup>

b. *Prior Art*

There can be no infringement under the doctrine of equivalents if the asserted scope of equivalency would encompass the prior art.<sup>32</sup> The limitation posed by the prior art is simply that the asserted range of equivalents may not encompass the prior art at the very point at which the claims distinguish

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29. *Mannesmann Demag Corp. v. Engineered Metal Prods. Co.*, 793 F.2d 1279, 1284 (Fed. Cir. 1986).

30. *Builders Concrete, Inc. v. Bremerton Concrete Prods. Co.*, 757 F.2d 255, 258 (Fed. Cir. 1985).

31. *Loctite Corp. v. Ultraseal Ltd.*, 781 F.2d 861, 870 (Fed. Cir. 1985); *Jonsson v. Stanley Works*, 903 F.2d 812, 821 (Fed. Cir. 1990) (quoting *Thomas & Betts Corp.*, 720 F.2d at 1579); *Mannesmann Demag Corp.*, 793 F.2d at 1284 (citing *Thomas & Betts Corp.*, 720 F.2d at 1579 and *Stewart-Warner Corp.*, 767 F.2d at 1572). For example, "[w]hen an accused device is the same as a disclosed embodiment, and claims covering the disclosed embodiment are rejected and canceled, the yielded claim scope cannot be recovered in order to encompass the accused device through the doctrine of equivalents." *Diversitech Corp. v. Century Steps, Inc.*, 850 F.2d 675, 681 (Fed. Cir. 1988). In *Diversitech*, the rejected claim was to a device with a coating on all sides; the final claims recited a coating on top and sides only. The defendant put a coating on the bottom and the patentee argued equivalency. Inasmuch as equivalence was demonstrated in the specification, the Federal Circuit's refusal to accept this argument is clearly grounded on estoppel. Although the claim was not amended, the broader claim from which it depended was canceled. See also *E.I. duPont de Nemours Co. v. Phillips Petroleum Co.*, 849 F.2d 1430, 1438 (Fed. Cir. 1988), *cert. denied*, 488 U.S. 986 (1988); *Hi-Life Products Inc. v. American Nat'l Water-Mattress Corp.*, 842 F.2d 323, 325 (Fed. Cir. 1988).

32. *Pennwalt Corp.*, 833 F.2d at 934 n.1 (citing *Loctite Corp.*, 781 F.2d at 870).

from the art.<sup>33</sup> Discerning the range of equivalents “involves consideration of what the prior art would have anticipated, 35 U.S.C. § 102, and what the prior art would have made obvious, 35 U.S.C. § 103, when the patentee filed the original application.”<sup>34</sup> Whether an asserted range of equivalents would cover what is already in the public domain, is a question of law.<sup>35</sup>

The Federal Circuit has established a method for determining the limits of claim coverage in view of prior art which in essence involves writing a hypothetical claim covering the accused device and deciding whether it is patentable over the prior art.<sup>36</sup>

[I]t may be helpful to conceptualize the limitation on the scope of equivalents by visualizing a hypothetical patent claim, sufficient in scope to literally cover the accused product. The pertinent question then becomes whether that hypothetical patent claim could have been allowed by the PTO over the prior art. If not, then it would be improper to permit the patentee to obtain that coverage in an infringement suit under the doctrine of equivalents. If the hypothetical claim could have been allowed, then the prior art is not a bar to infringement under the doctrine of equivalents.<sup>37</sup>

Thus, *Wilson Sporting Goods* teaches that the patentee bears the burden of showing that the range of equivalents it seeks will not encompass the prior art.<sup>38</sup>

### c. *Technological Advances*

It has always been thought that an “embellishment” made possible by technological advances may not permit the accused device to escape the ‘web

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33. *Stewart-Warner Corp.*, 767 F.2d at 1572 (citing *Thomas & Betts Corp.*, 720 F.2d at 1580 and *Hughes Aircraft Co.*, 717 F.2d at 1362). It is well established that limitations in a claim cannot be given a range of equivalents so wide as to cause the claim to encompass anything in the prior art. *Senmed, Inc. v. Richard-Allen Med. Indus., Inc.*, 888 F.2d 815, 821 (Fed. Cir. 1989) (citing *Perkin-Elmer Corp.*, 732 F.2d at 900). Claims may not be enlarged by equivalents to encompass the teachings of the prior art. *Tandon Corp. v. United States ITC*, 831 F.2d 1017, 1026 (Fed. Cir. 1987) (citing *Perkin-Elmer Corp.*, 732 F.2d at 900).

34. *We Care, Inc. v. Ultra-Mark Int'l Corp.*, 930 F.2d 1567, 1571 (Fed. Cir. 1991) (vacating the district court's preliminary injunction based on the likelihood of success in proving infringement under the doctrine of equivalents because the district court failed to determine whether the prior art would have made the range of equivalents given to the patent).

35. *Wilson Sporting Goods Co. v. David Geoffrey & Assoc.*, 904 F.2d 677, 684 (Fed. Cir. 1990), *cert. denied*, 498 U.S. 992 (1990).

36. *Id.*

37. *Id.* See also, *Insta-Foam Prods.*, 906 F.2d at 703-4.

38. *Wilson Sporting Goods*, 904 F.2d at 685.

of infringement."<sup>39</sup> Indeed, that has been suggested as one of the purposes underlying the doctrine—to protect inventors from unanticipated equivalents.<sup>40</sup> But in *Texas Instruments Inc. v. United States ITC*, the court held that where extensive technological advances in all claimed functions result in multiple departures from literal readability, the totality of change in the accused device may be too much to support a holding of infringement.<sup>41</sup>

### C. *Purpose of the Doctrine of Equivalents*

The doctrine of equivalents originated almost a century ago in the case of *Winans v. Denmead*, 56 U.S. (15 How.) 330.<sup>42</sup> Since that time, the doctrine has been consistently applied by the Supreme Court and lower federal courts, and continues today ready and available for utilization when the proper circumstances for its application arise. The doctrine of equivalents was judicially devised to provide equity<sup>43</sup> and is intended to be used "in situations where there is no literal infringement but liability is nevertheless appropriate[,] to prevent what is in essence a pirating of the patentee's invention."<sup>44</sup> The Supreme Court in *Graver Tank* recognized the necessary role the doctrine of equivalents plays in patent protection when it stated:

[C]ourts have also recognized that to permit imitation of a patented invention which does not copy every literal detail would be to convert the protection of the patent grant into a hollow and useless thing. Such a limitation would leave room for—indeed encourage—the unscrupulous copyist to make unimportant and insubstantial changes and substitutions in the patent which, though adding nothing, would be enough to take the copied matter outside the claim, and hence outside the reach of the law. . . . Outright and forthright duplication is a dull and very rare type of infringement. To prohibit no other would place the inventor at the mercy of verbalism and would be subordinating substance to form. It would deprive him of the benefit of his invention and

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39. *Datascope Corp. v. SMEC, Inc.*, 776 F.2d 320, 326 (Fed. Cir. 1985) (quoting *Hughes Aircraft Co.*, 717 F.2d at 1365).

40. *See Kinzenbaw v. Deere & Co.*, 741 F.2d 383, 389 (Fed. Cir. 1984), *cert. denied*, 470 U.S. 1004 (1985).

41. *Texas Instruments*, 805 F.2d at 1571.

42. *Graver Tank*, 339 U.S. at 608.

43. *Hughes Aircraft Co.*, 717 F.2d at 1361.

44. *Hormone Research Found., Inc. v. Genentech, Inc.*, 904 F.2d 1558, 1564 (Fed. Cir. 1989) (quoting *Loctite Corp.*, 781 F.2d at 870).

would foster concealment rather than disclosure of inventions, which is one of the primary purposes of the patent system.<sup>45</sup>

To achieve this purpose, equivalency is judicially determined by reviewing the content of the patent, the prior art, and the accused device, and essentially redefining (broadening) the literal scope of the claims. Broadening the literal scope of a claim, in essence, "constitutes a deviation from the need of the public to know the precise legal limits of patent protection without recourse to judicial ruling."<sup>46</sup> "To the extent that the doctrine of equivalents represents an exception to the requirement that the claims define the metes and bounds of patent protection," the doctrine is admissible only to serve its real purpose, which is "to temper unsparing logic and serve the greater interest of justice."<sup>47</sup>

The doctrine of equivalents essentially presents the courts with a difficult dichotomy. On the one hand, claims must be particular and distinct so that the public has fair notice of what the patentee and the PTO have agreed constitute the metes and bounds of the claimed invention. Notice permits other parties to avoid actions that infringe the patent and to design around the patent. On the other hand, the patentee should not be deprived of the benefits of his or her patent by competitors who appropriate the sense of the invention while barely avoiding the literal language of the claims. Thus, although designing around a particular patent is encouraged, piracy is not. The doctrine of equivalents emerged to deal with this problem.<sup>48</sup>

Some courts have doubted whether the doctrine of equivalents automatically should be considered in every case where literal infringement is not present:

Application of the doctrine of equivalents is the exception, however, not the rule, for if the public comes to believe (or fear) that the language of patent claims can never be relied on, and that the doctrine of equivalents is simply the second prong of every infringement charge, regularly available to extend protection beyond the scope of the claims, then claims will cease to serve their intended purpose. Competitors will never know whether their actions infringe a granted patent.<sup>49</sup>

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45. *Graver Tank*, 339 U.S. at 607.

46. *Texas Instruments*, 805 F.2d. at 1572. The court had previously cautioned against expansion of the doctrine too far, to the point where patent counsel cannot rely at all on what the claims recite when advising a client as to infringement. *Great Northern Corp. v. Davis Core & Pad Co.*, 782 F.2d 159, 166 (Fed. Cir. 1986).

47. *Texas Instruments*, 805 F.2d. at 1572 (foreshadowing a less expansive application of the doctrine of equivalents in future cases).

48. *London v. Carson Pirie Scott & Co.*, 946 F.2d 1534, 1538 (Fed. Cir. 1991).

49. *Id.*

"Each case in which infringement by equivalents is asserted turns on its facts, . . . and requires the trier of fact to balance the competing public policies of avoiding a 'fraud on the patent'" with the public's need for reasonable certainty as to the scope of the patent grant.<sup>50</sup>

In summary, application of the doctrine expands the right to exclude "equivalents" of what is claimed. The doctrine of equivalents does not change the scope of the patent protection as defined by the claims. The doctrine, "by definition, involves going beyond any permissible interpretation of the claim language; i.e., it involves determining whether the accused product is 'equivalent' to what is described by the claim language."<sup>51</sup>

### III. INTERNATIONAL PATENT PROTECTION AND THE ROLE OF THE DOCTRINE OF EQUIVALENTS

The laws of a country relating to patent protection are generally concerned with acts accomplished or committed in the country itself.<sup>52</sup> Consequently, a patent is effective only in the country that effected the grant.<sup>53</sup> Therefore, a patent owner desiring protection in several countries, must obtain a patent grant in each country separately.<sup>54</sup> Today, many American industries conduct their business in the global marketplace. In order to protect their unique products worldwide, these international companies pursue patent rights in the foreign countries where they conduct business. Just as the doctrine of equivalents is crucial in protecting patent rights in the United States, it is equally important in international forums. Although the doctrine of equivalents is applied in many international forums, it is not applied or interpreted harmoniously. This lack of harmony in patent protection is just one of the risks incurred by companies doing business internationally.

#### A. *The European Community*

One exception to the general rule that a patent is only effective in the country issuing the grant is in the E.C., where the European Patent is recognized by all

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50. Sun Studs, Inc. v. ATA Equip. Leasing, Inc., 872 F.2d 978, 987-8 (Fed. Cir. 1989) (quoting *Graver Tank*, 339 U.S. at 608).

51. *Wilson Sporting Goods*, 904 F.2d at 684.

52. NEW YORK COUNTY LAWYERS ASS'N. COMM. ON PATENTS TRADEMARKS & COPYRIGHTS, HANDBOOK ON PATENTS TRADEMARKS & COPYRIGHTS 89 (1982).

53. *Id.* at 89-90.

54. *Id.* at 90.

the E.C. Member States. Since the Treaty of Rome (E.E.C. Treaty)<sup>55</sup> came into effect on January 1, 1958, the Member States of the E.C. have been striving to establish a common market and coordinating their economic policies to promote harmonious economic development throughout the Community. The establishment of a common market has dramatically increased the economic opportunities available to both Member States and foreign businesses. Along with the increase in economic opportunities within the E.C. has come an increase in businesses competing for the financial rewards of a growing E.C. market. As competition within the E.C. continues to heighten between businesses actively involved in the E.C. market, the patent protection afforded by each Member State becomes vitally important.

Recognizing the importance of harmonization of national patent laws in the E.C., the Member States committed themselves to patent law harmonization via the European Patent Convention (EPC).<sup>56</sup> The EPC provides that an inventor may apply for a European Patent at the European Patent Office (EPO) in Munich, or at its branch in The Hague.<sup>57</sup> After the EPO has conducted a priority search and examined the application for originality and capability of industrial use, the EPO may grant a European Patent.<sup>58</sup> In the event a European Patent is granted, the inventor is deemed to have acquired a patent in each of the ratifying states<sup>59</sup> for twenty years from the date of application.<sup>60</sup> The EPC reconciles a number of key substantive patent law concepts in the ratifying states<sup>61</sup> and provides for a central system to review challenges to the application or patent.<sup>62</sup> However, many aspects of the European Patent continue to be governed by different national laws.<sup>63</sup> A key aspect of the EPC is that any infringement of a European Patent is handled by special national courts set up in each Member State to settle patent infringement issues.<sup>64</sup>

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55. Treaty establishing the European Economic Community, Mar. 25, 1957, TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES (Office for Official Publications of the European Communities abr. ed., 1979).

56. Convention on the Grant of European Patents (European Patent Convention), Oct. 5, 1973, 13 I.L.M. 270 [hereinafter EPC]. The EPC came into force on March 1, 1979, and strongly promotes the harmonization of patent rules. The Convention was signed by the then nine Member States, as well as the five non-EC states. Most of the Member States and several non-EC states have ratified it, so the EPC is effective throughout most of Western Europe.

57. *Id.* art. 75(1)(a).

58. *Id.* art. 52(1).

59. *Id.* art. 64(1).

60. *Id.* art. 63(1).

61. *Id.* art. 52-74.

62. *Id.* art. 15-22.

63. *Id.* art. 74.

64. *Patent Litigation Before European National Courts; Today And Tomorrow*, Patent, Trademark & Copyright Law Daily (BNA) ¶ 6 (July 7, 1992).

In order to help the national courts determine infringement disputes uniformly, Article 69 of the EPC provides a guideline for interpreting the scope of protection conferred by a European Patent.<sup>65</sup> The Protocol on the Interpretation of Article 69 of the EPC (Protocol) calls for an intermediate standard that "combines a fair protection for the patentee with a reasonable degree of certainty for third parties."<sup>66</sup> The purpose of the Protocol is to strike a balance between two fundamental extremes: strict literal interpretation and broad guidelines. The Protocol, having been officially adopted by all members of the EPC,<sup>67</sup> should have pulled followers of the extremes to a common, harmonized, middle ground of "fair protection" and "reasonable certainty." Article 69 of the EPC and the Protocol, in theory, should allow for the use of the doctrine of equivalents in EPC patent interpretation. The freedom from strict literal interpretation, which the equivalents doctrine provides, should inhibit a tumbling into open-ended guidelines that might chill third parties fearing extensive infringement liability.

A good example of how the Protocol has not fulfilled its objective of pulling the Member States to a common, harmonized, middle ground of "fair protection" and "reasonable certainty" is clearly demonstrated in the Epilady litigation conducted in the United Kingdom and West German national courts.

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65. EPC, *supra* note 56, art. 69(1). Article 69(1) states: "The extent of the protection conferred by a European patent or a European patent application shall be determined by the terms of the claims. Nevertheless, the description and drawings shall be used to interpret the claims." *Id.*

66. Protocol on the Interpretation of Article 69 of the Convention, Oct. 5, 1973, 13 I.L.M. 270 [hereinafter Protocol]. The Protocol reads as follows:

Article 69 should not be interpreted in the sense that the extent of the protection conferred by a European patent is to be understood as that defined by the strict, literal meaning of the wording used in the claims, the description and drawings being employed only for the purpose of resolving an ambiguity found in the claims. Neither should it be interpreted in the sense that the claims serve only as a guideline and that the actual protection conferred may extend to what, from a consideration of the description and drawings by a person skilled in the art, the patentee has contemplated. On the contrary, it is to be interpreted as defining a position between these extremes which combines a fair protection for the patentee with a reasonable degree of certainty for the third parties.

*Id.* at 348.

67. David Perkins, *Foreign Principles Of Intellectual Property/Antitrust: The EEC*, in INTELLECTUAL PROPERTY/ANTITRUST 279, 317 (Practicing Law Institute, 1992). All EC countries, except Ireland, and all EFTA countries except Finland and Iceland have ratified the EPC. EC Member States have also amended their national laws to harmonize them with the EPC, the exception again being Ireland. *Id.*



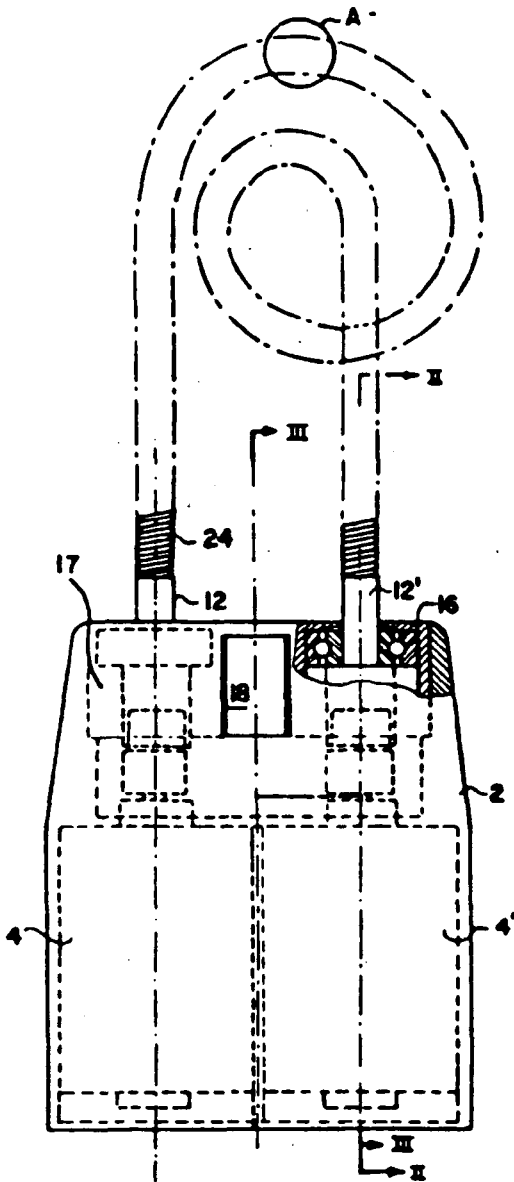


FIG. 1

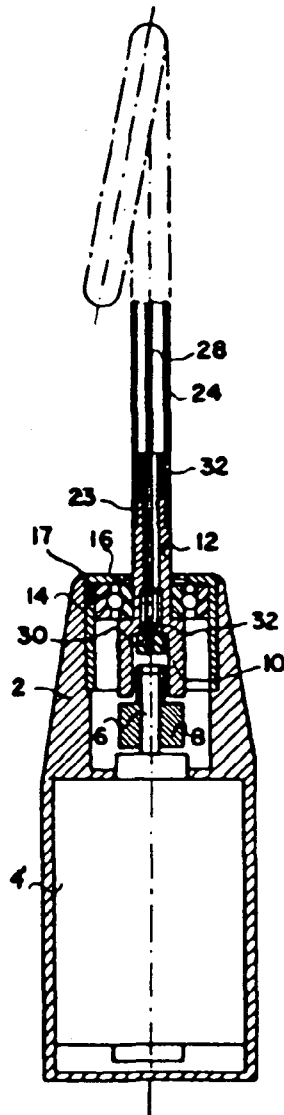


FIG. 2

\* Diagram reprinted as found in *Improver Corp. & Others v. Remington Consumer Products Ltd. & Others*, [1990] F.S.R. 181, 185-186 (Eng. Ch. 1989) (reprinted in 21 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 680, 681 (1990)).



## IV. THE EPILADY CONTROVERSY

A. *Epilady Story*

In July of 1983 two Israeli men filed a patent application with the EPO.<sup>68</sup> They were seeking a patent for their invention of a device that removes body hair from the arms and legs of women for cosmetic purposes. The European patent, Number 0101656,<sup>69</sup> was granted in November 1986<sup>70</sup> for the depilatory device. The European Patent was valid in a considerable number of Contracting States, including the United Kingdom and West Germany.<sup>71</sup> Improver Corporation [hereinafter Improver], the owner of the patent by assignment, marketed the depilatory device under the name "Epilady".<sup>72</sup>

The Epilady, illustrated in Figures 1 and 2, consisted of an electric motor (4,4') in a hand-held housing (2) to which was attached a helical steel spring (24) held by its end and stiffened by a guide wire to form a loop.<sup>73</sup> The arcuate form of the spring caused gaps between the windings to open on the convex side and close on the concave side.<sup>74</sup> When the spring was rotated at high speed and held close to the skin, hairs entered the gaps on the convex side and were gripped between the windings as the rotational movement brought them around to the concave side.<sup>75</sup> The effect was to pluck the hair from the skin.<sup>76</sup>

Marketing of the Epilady began in 1986 and was an enormous commercial success.<sup>77</sup> In the first two years over 5.8 million devices were made, generating sales in excess of \$340 million dollars.<sup>78</sup> Based on the quick success of the Epilady, Improver and licensed manufacturers and distributors soon found themselves facing a variety of imitators.<sup>79</sup> "The most notorious alleged infringement involved a competing product manufactured for and sold by

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68. Sanford T. Colb, *The Epilady Hair Remover Litigation*, in GLOBAL INTELLECTUAL PROPERTY SERIES 1993, at 107, 109 (PLI Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series No. G4-3907, 1993).

69. Improver Corp. & Others v. Remington Consumer Products Ltd. & Others, [1990] F.S.R. 181, 184 (Eng. Ch. 1989).

70. Improver Corp. v. Remington Consumer Products Ltd., [1989] R.P.C. 69, 71 (Eng. C.A. 1988).

71. *Id.*

72. *Id.* at 72.

73. *Improver Corp. & Others*, [1990] F.S.R. at 184.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. Colb, *supra* note 68, at 110.

Remington Consumer Products [hereinafter Remington], an American-based company known for its line of electric shaving products."<sup>80</sup>

Remington produced a rival device known as the "Smooth and Silky".<sup>81</sup> This device also comprised of an electrical motor and a hand held housing.<sup>82</sup> But instead of using a metal helical spring, the element attached to the motor and used to extract the hair was a cylindrical rod of elastic synthetic rubber held by its ends to form an arc subtending about 60 degrees.<sup>83</sup> A number of parallel radial slits were cut into the rubber.<sup>84</sup> The arcuate form of the rod caused the slits to open on the convex side and to be pressed together on the concave side. When the rod was rotated at high speed and held close to the skin, hairs entered the gaps on its convex side and were gripped between the walls of the slits as the rotational movement brought them around to the concave side.<sup>85</sup> The effect was to pluck the hair from the skin.<sup>86</sup>

When the "Smooth and Silky" entered the U.K. and German markets, Improver sought a preliminary injunction in both the U.K. and Germany.<sup>87</sup> The application before the English Patents Court was dismissed on the basis of no arguable case on infringement.<sup>88</sup> In contrast, a preliminary injunction was granted by the German District Court (Landgericht of Dusseldorf).<sup>89</sup> When the decision of the English Patents Court was appealed, the Court of Appeals—having regard for the findings of the German District Court—held there was an arguable case for infringement and granted the preliminary injunction ordering the English Patents Court to reconsider the claim.<sup>90</sup> In the meantime, the German Court of Appeals (Oberlandesgericht), having regard for the initial decision of the English Patent Court, discharged the preliminary injunction granted by the German District Court.<sup>91</sup> When the Epilady dispute was decided on the merits in the German District Court, it found that the

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80. *Id.*

81. *Improver Corp. & Others*, [1990] F.S.R. at 181.

82. *Id.* at 186.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

87. *Improver Corp.*, [1989] R.P.C. at 71; *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, Case No. 2 U 181/88 (OLG 1988), translated in 21 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 572, 573 (1990).

88. *Improver Corp.*, [1989] R.P.C. at 73.

89. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, 21 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 572, 573.

90. *Improver Corp.*, [1989] R.P.C. at 81.

91. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, 21 INT'L. REV. OF INDUS. PROP. & COPTRIGHT LAW 572, 579.

“Smooth and Silky” infringed on the Epilady patent.<sup>92</sup> In contrast, at trial before the English Patents Court, the “Smooth and Silky” was held not to have infringed on the Epilady patent.<sup>93</sup>

The Epilady dispute serves to illustrate the substantive contradictions among the national approaches in regard to patent claim interpretation. The most disconcerting aspect of the Epilady litigation is that both the German and English courts interpreted the same patent, operated under an approximately identical set of facts, utilized a uniform standard of interpretation—Protocol on the Interpretation of Article 69 of the EPC—and still managed to come up with two polar decisions.

The remainder of this note will closely analyze the final decisions of the Epilady dispute in both the German and English courts. A comparison will be conducted to distinguish the reasons causing the inconsistent decisions and a hypothetical U.S. decision will be proposed applying U.S. patent law to the facts of the Epilady dispute. Lastly, the current draft of the Patent Harmonization Treaty—intended to harmonize some of the patent laws throughout the world—will be analyzed to see whether it might have helped prevent the inconsistent decisions that the Epilady dispute generated.

#### B. *U.K. Epilady Decision*

When the English Patents Court considered the merits of the Epilady dispute, Justice Hoffmann decided the question of infringement turned upon a short but undoubtedly difficult point of construction.<sup>94</sup> This difficult point of construction was whether the rubber rod is a “helical spring” as that expressed in the claims of the Improver European Patent.<sup>95</sup> Justice Hoffmann said that the proper approach to the interpretation of patents registered under the Patents Act 1977<sup>96</sup> was explained by Lord Diplock in *Catnic Components*

92. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, Case No. 2 U 27/89 (OLG 1991) translated in 24 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 838, 839 (1993).

93. *Improver Corp. & Others*, [1990] F.S.R. at 195.

94. *Id.* at 187.

95. *Id.*

96. Section 130(7) of the 1977 Patents Act declares that certain provisions of the Act, including section 125, “are so framed as to have, as nearly as practicable, the same effects in the United Kingdom as the corresponding provisions of the European Patent Convention . . . .” Patents Act, 1977, ch. 37 § 130(7).

Subject 1 of Section 125 of the 1977 Patents Act, which corresponds to Article 69 of the EPC provides:

(1) For the purposes of this Act an invention for a patent for which an application has been made or for which a patent has been granted shall, unless the context otherwise requires, be taken to be that specified in a claim of the specification

*Ltd. v. Hill & Smith Ltd.*, [1982] R.P.C. 183, 242 (H.L. 1980).<sup>97</sup> Justice Hoffmann summarized Lord Diplock's interpretation approach saying that the language of the claim should be given a "purposive" and not necessarily a literal construction.<sup>98</sup> Justice Hoffmann in applying the "purposive" construction technique said that when the issue is whether a variant<sup>99</sup> embodied in an alleged infringing product is within the claim's language as properly interpreted, the court should ask itself three questions: (1) does the variant have a material effect upon the way the invention works; (2) would the fact that the variant has no material effect upon the way the invention works have been obvious at the date of publication of the patent to a reader skilled in the art; and (3) would the reader skilled in the art nevertheless have understood from the language of the claim that the patentee intended that strict compliance with the primary meaning was an essential requirement of the invention.<sup>100</sup>

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of the application or patent, as the case may be, as interpreted by the description and any drawings contained in that specification, and the extent of the protection conferred by a patent or application for a patent shall be determined accordingly.

*Id.* § 125(1).

Subject (3) of Section 125 declares:

The Protocol on the Interpretation of Article 69 of the European Patent Convention (which Article contains a provision corresponding to subsection (1) above) shall, as for the time being in force, apply for the purposes of subsection (1) above as it applies for the purposes of that Article.

*Id.* § 125(3).

97. *Improver Corp. & Others*, [1990] F.S.R. at 187. Lord Diplock's description in *Catnic Components* of how a patent specification should be construed, particularly with regard to what is and what is not to be regarded as an essential integer (element), as follows:

A patent specification should be given a purposive construction rather than a purely literal one derived from applying to it the kind of meticulous verbal analysis in which lawyers are too often tempted by their training to indulge. The question in each case is: whether persons with practical knowledge and experience of the kind of work in which the invention was intended to be used, would understand that strict compliance with a particular descriptive word or phrase appearing in a claim was intended by the patentee to be an essential requirement of the invention so that any variant would fall outside the monopoly claimed, even though it could have no material effect on the way the invention worked.

*Catnic Components Ltd. v. Hill & Smith Ltd.*, [1982] R.P.C. 183, 242 (H.L. 1980).

98. *Improver Corp. & Others*, [1990] F.S.R. at 187.

99. It can be inferred that since Justice Hoffmann applies the three question analysis in his opinion that he agrees with Justice Falconer that the rubber rod is not a "helical spring" but a variant ("mechanical equivalent") of the "helical spring" described in the *Improver* European Patent.

100. *Improver Corp. & Others*, [1990] F.S.R. at 187.

1. *Justice Hoffmann's Three Question Analysis*

- a. *Question (1): Does the variant have a material effect upon the way the invention works?*

If the variant has a material effect upon the way the invention works, the variant is outside the claim and there is no infringement.<sup>101</sup> If the variant does not have a material effect upon the way the invention works, then the second question of Justice Hoffmann's three prong test must be addressed. Justice Hoffmann discussed two important guidelines to consider in answering question one. First, a variant is a feature embodied in the alleged infringing product which is not within the literal or contextual meaning of a descriptive word or phrase in the claim.<sup>102</sup> Second, whether the variant would make a material difference to the way the invention worked is a question of fact and not a question of construction; although it cannot be sensibly answered without reference to the patent.<sup>103</sup>

Justice Hoffmann stated the answer to the first question "depends upon the level of generality at which one describes the way the invention works"<sup>104</sup> and "that the right approach is to describe the working of the invention at the level of generality with which it is described in the claim of the patent."<sup>105</sup> Remington's expert witness attempted to show the following four ways in which the rubber rod used in the "Smooth and Silky" materially effected the way the "Smooth and Silky" worked: (1) the gripping pressure of the rubber rod is one-third of Epilady (i.e. less broken hairs); (2) the rubber rod has one-fourth the number of slits and the slits themselves are discontinuous (i.e. pulls less hair therefore less painful); (3) the slits in the rubber rod close at earlier point and therefore grip shorter hairs better; and (4) the rubber rod doesn't have a hollow core to trap hairs as does the "Epilady."<sup>106</sup> Justice Hoffmann after considering the expert witness's testimony decided that the rubber rod works in the same way as the helical spring and the differences Remington's expert described were not material (i.e., the rubber rod is an equivalent to the helical spring).<sup>107</sup>

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101. *Id.*

102. *Id.*

103. *Id.* at 188.

104. *Id.* at 189.

105. *Id.* at 190.

106. *Id.* at 189-90.

107. *Id.* at 190.

- b. *Question (2): Would the fact that the variant has no material effect upon the way the invention works have been obvious at the date of publication of the patent to a reader skilled in the art?*

If it would *not* have been obvious at the date of publication of the patent to a reader skilled in the art that the variant has no material effect upon the way the invention works, the variant is outside the claim and there is no infringement.<sup>108</sup> But, if at the date of patent publication it *would have been* obvious to a reader skilled in the art that the variant has no material effect upon the way the invention works, the third question must be considered.<sup>109</sup> Justice Hoffmann describes two essential guidelines with respect to the second question: first, he says that question two is a question of fact;<sup>110</sup> and second, question two supposes that the person skilled in the art is told of both the invention and the variant and asked whether the variant would obviously work in the same way.<sup>111</sup>

In considering this question, both Improver and Remington presented expert testimony. Experts for both sides agreed that it would have been obvious that *any* rod which had the qualities of the "helical spring" in sufficient degree and did not have other defects, would in principle work in the same way as the "helical spring," and that the rubber rod embodied in the "Smooth and Silky" plainly belonged to that class.<sup>112</sup> Accordingly, Justice Hoffmann held that since the experts agreed that a person skilled in the art would have obviously understood that the rubber rod would work in the same way as the "helical spring," the third question must be considered in order to determine infringement.<sup>113</sup>

- c. *Question (3): Would the reader skilled in the art nevertheless have understood from the language of the claim that the patentee intended that strict compliance with the primary meaning was an essential requirement of the invention?*

Rephrasing this question as it applies to the Epilady dispute, the question asks: would a reader, skilled in the art, have understood the patentee to have intended to confine his claim to the literal meaning of "helical spring." If so, the rubber rod (the variant) is outside the claim and there is no

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108. *Id.* at 187.

109. *Id.*

110. *Id.* at 188.

111. *Id.* at 190.

112. *Id.*

113. *Id.* at 190-1.



infringement.<sup>114</sup> A negative answer to this question would lead to the conclusion that the patentee was intending the phrase, "helical spring," to have not a literal but a figurative meaning denoting a class of things which included variants (such as Remington's rubber rod) and the literal meaning (helical springs), the latter being perhaps the most perfect, best known or striking example of the class.<sup>115</sup>

Justice Hoffmann stated that question three raises the question of construction and Lord Diplock's formulation makes it clear that on this question the answers to the first two questions are not conclusive. "Even a purposive construction of the language of the patent may lead to the conclusion that although the variant made no material difference and this would have been obvious at the time [to a person skilled in the art], the patentee for some reason was confining his claim to the [literal] meaning and excluding the variant."<sup>116</sup>

Justice Hoffmann in answering the third question considered the views of two expert witnesses.<sup>117</sup> Dr. Sharp, Improver's expert witness skilled in the art, stated:

[I]t would have been obvious to me that all the inventor wanted a helical spring for was as a convenient rotating bent beam in which slits formed by the adjacent windings would open and close as it rotated. It would then have been equally obvious to me that he could have not intended to exclude equivalents like the [rubber] rod. . . . [I]n thinking of equivalents I feel driven by the last paragraph of the specification before the claims [the equivalents clause] to think that the inventor was trying to make me think of equivalents for the helical spring . . . .<sup>118</sup>

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114. *Id.* at 187.

115. *Id.* at 187-88.

116. *Id.* at 188.

117. *Id.* at 190-93.

118. *Id.* at 191. The description of the Improver European Patent ends with the following general statement, which the court refers to as the "equivalents clause":

It will be evident to those skilled in the art that the invention is not limited to the details of the foregoing illustrative embodiments, and that the present invention may be embodied in the other specific forms without departing from the essential attributes thereof, and it is therefore desired that the present embodiments be considered in all respects as illustrative and not restrictive, reference being made to the appended claims, rather than to the foregoing description, and all variations which come within the meaning and range of equivalency of the claims are therefore intended to be embraced therein.

*Id.* at 185.

Dr. Laming, Remington's expert witness skilled in the art, stated:

My opinion is that there is no way of interpreting . . . [Improver's] specification such that anything other than a helical spring is intended. . . .

I have now read the European Patent several times and it is clear that nothing other than a helical spring is referred to. If there were alternatives to a helical spring which the inventor or draftsman had in mind he did not indicate anywhere that such alternative might be used. . . .

. . . .

If . . . [Improver's] specification contained anywhere such words as "or any other configuration of an elastic member or members whereby rotation of the member or members causes a spread apart orientation at one position and a pressed together orientation at another position or point in the cycle" then at least one might be led to think about alternatives to the helical spring.<sup>119</sup>

In regard to the equivalence clause contained in the Improver patent, Dr. Laming said:

It is true that [in the equivalents clause] reference is made to embodiment 'in other specific forms' and it asks there for reference to be made 'to the appended claims rather than the foregoing description.' But what follows is a series of claims in which the variations are all on such matters as the angle subtended by the arcuate portion, the degree of opening of the windings, various mechanical drive options, and different surface speeds. A constant feature of all the claims is the specification of a helical spring which itself is the only type of element mentioned in the text of the specification and shown in the figures.<sup>120</sup>

Justice Hoffmann's opinion of the expert testimony was that the difference between the experts depends on how one construes the equivalents clause contained in the Improver patent.<sup>121</sup> Justice Hoffmann believed the first part of the clause, which is not at issue in this case, meant that the description should not be construed to restrict the meaning of the language used in the

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119. *Id.* at 192-93.

120. *Id.* at 193.

121. *Id.*

claim.<sup>122</sup> Justice Hoffmann went on to say that the words “and all variations which come within the meaning and range of equivalency of the claims are therefore intended to be embraced therein” meant no more than to construe the claims in accordance with *Catnic Components Ltd.* and the Protocol.<sup>123</sup>

Justice Hoffmann after considering the testimony of the expert witnesses, answered question three saying: “I do not think that the ‘helical spring’ can reasonably be given a wide generic construction and I accept Dr. Laming’s reasons for thinking that a skilled man would not understand it in this sense.”<sup>124</sup> In summary, Justice Hoffmann held that even though the differences between the rubber rod and the helical spring are not material (i.e., the rubber rod and helical spring work in the same way), and that a person skilled in the art would obviously understand the rubber rod works in the same way as the helical spring, there is nevertheless *no* infringement since a reader, skilled in the art, would interpret the patentee as confining his claim to the literal meaning of helical spring.

### C. *German Epilady Decision*

The German District Court in deciding the Epilady controversy applied a two question test.<sup>125</sup> The first question was whether the rubber rod had the identical effect of the helical spring (i.e., was the rubber rod an equivalent of the helical spring), and the second question was whether the rubber rod would have been an obvious equivalent to a person skilled in the art, looking at the descriptions prospectively from the time the patent was issued.<sup>126</sup>

#### 1. *The German District Court’s Two Question Analysis*

- a. *Question (1): Does the rubber rod have the identical effect of the helical spring?*

The German District Court in determining whether the Remington depilatory device infringed on Improver’s European patent began its inquiry by using claim one of the patent to determine the patent’s “teaching.”<sup>127</sup>

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122. *Id.*

123. *Id.*

124. *Id.*

125. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, 24 INT’L. REV. OF INDUS. PROP. & COPYRIGHT LAW 838, 842.

126. *Id.*

127. *Id.* at 839. Claim one reads as follows:

An electrically powered depilatory device comprising: a hand held portable housing (2); motor means (4,4<sup>1</sup>) disposed in said housing; and a helical spring (24)

The German court identified seven features that it believed were the essential characteristics of the Epilady depilatory device defined in claim one.<sup>128</sup> Similar to the method used to determine infringement in the United States,<sup>129</sup> the German court required that in order to find infringement, each of the seven features must be embodied by the Remington depilatory device either literally or by equivalence.<sup>130</sup>

The German court subsequently held that the Remington depilatory device fulfilled features one and two literally, but said that features three through seven were not fulfilled literally since Remington's depilatory device did not

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comprising a plurality of adjacent windings arranged to be driven by said motor means in a rotational sliding motion relative to skin bearing hair to be removed, said helical spring (24) including an arcuate hair engaging portion arranged to define a convex side whereat the windings are spread apart, and a concave side corresponding thereto whereat the windings are pressed together, the rotational motion of the helical spring (24) producing continuous motion of the windings from a spread apart orientation at the convex side to a pressed together orientation at the concave side and for engagement and plucking of hair from the skin of the subject, whereby the surface velocities of the windings relative to the skin greatly exceeds the surface velocity of the housing relative thereto.

*Id.* at 838.

128. *Id.* at 840. The seven features comprising the teaching of claim one according to the Court are as follows:

The electrically powered depilatory device comprises

1. a hand held portable housing,
2. motor means positioned in said housing,
3. a helical spring comprising a plurality of adjacent windings,
4. the windings are arranged to be driven by said motor means in rotational sliding motion relative to skin bearing hair to be removed,
5. said spring includes a hair engaging portion which
  - a) is arcuate,
  - b) defines a convex side whereat the windings are spread apart and
  - c) defines a concave side corresponding to said convex side whereat the windings are pressed together,
6. the rotational motion of the spring produces a continuous motion of the windings from a spread apart orientation at the convex side to a pressed together orientation at the concave side and for engagement with the hair and for plucking of hair from the skin of the subject,
7. the surface velocity of the windings relative to the skin greatly exceeds the surface velocity of the housing relative thereto.

*Id.*

129. To establish infringement of a patent every limitation set forth in a claim must be found in the accused product or process exactly or by a substantial equivalent. *Johnston v. IVAC Corp.*, 885 F.2d 1574, 1581 (Fed. Cir. 1989).

130. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, 24 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 838, 841 (1993).

feature a helical spring per se.<sup>131</sup> However, the German court explained that the “motor-driven rubber roll is . . . a replacement means equivalent to the coil spring of the patent,” and that features three through seven were given in equivalent form.<sup>132</sup> The German court concluded its inquiry into the first question when it stated that it had no doubt the rubber rod was an equivalent based on the fact that the rubber rod “is identical in effect to a device making use of the wording of claim 1 of the patent in suit.”<sup>133</sup> Since the German court did not find that the Remington depilatory device literally embodied features three through seven, it noted that a second inquiry, in regard to the obviousness of equivalency, must be conducted since infringement would ultimately be based on equivalency.<sup>134</sup>

- b. *Question (2): Whether the rubber rod would have been an obvious equivalent to a person skilled in the art, looking at the descriptions prospectively from the time the patent was issued?*

According to the German court, in order to find infringement by equivalents, not only does the accused embodiment have to be an equivalent (i.e., have identical effect), but a person skilled in the art—applying the professional knowledge at his disposal at the time the patent was issued and based on the consideration progressing from the meaning of the patent claims—must be able to detect the modified means used in the disputed embodiment as being identical in effect as a solution to the problem underlying the invention.<sup>135</sup> The German court stated that this inquiry into the determination of infringement by equivalency is intended to align German patent law with Article 69(1) of the EPC and the Protocol.<sup>136</sup>

In answering the second question, the German court was convinced that a person skilled in the art—owing to the content of the claims of the Improver patent—was capable of arriving at the disputed embodiment.<sup>137</sup> The German court’s starting point for this conclusion was that a person skilled in the art would recognize by virtue of his professional knowledge that the helical spring described in the Improver patent is used contrary to its common application (as an mechanical energy buffer).<sup>138</sup>

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131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* at 842.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.* at 843.

[A] person skilled in the art . . . will easily recognize that the coil spring is only proposed for the reason that it is an elastic cylindrical body which may be quickly rotated in the arcuate state and, above all, for the reasons that it features . . . means that stretch the surface of the body to form gaps at the convex side, while at the concave side they result in clamping areas with the help of which the hairs that entered the gaps may be clamped and plucked.<sup>139</sup>

The court concluded that a person skilled in the art—looking at the descriptions prospectively at the time the patent was issued—would interpret the words “helical spring” not as a spring per se, but as a cylinder-shaped elastic element with gaps, and therefore if the patent conveyed this knowledge, it would be obvious to a person skilled in the art to use an elastic cylindrical rod with slits, as used in the Remington depilatory device, as a hair plucking element.<sup>140</sup> Such an atypical use of the spring (as opposed to its conventional use as a mechanical energy buffer) seemingly justified the broad interpretation of the words “helical spring” used in claim one of the Improver patent.

In conclusion, the German court held that the rubber rod is identical in effect to a “helical spring” disclosed in the Improver patent, and would also be considered as an obvious equivalent to the “helical spring” by a person skilled in the art orientating himself to the meaning of the patent claims, with the help of findings available to him due to his professional knowledge. Since the Remington depilatory device fulfilled features one and two literally and features three through seven by equivalents, the German court found there was infringement of the Improver European Patent by Remington’s depilatory device.<sup>141</sup>

#### D. *Implications Of The Variances Between The U.K. And German Decisions*

While there is agreement between the English and German courts as to the continued existence of the doctrine of equivalents, the application of the doctrine differs. The principle difference between the German and English approaches to claim interpretation is embodied in the third question of the English Patent Court’s equivalency analysis which is, in effect, an exception to the doctrine of equivalents.<sup>142</sup> The third question can in certain circumstances limit the court’s interpretation of the claim to the strict literal meaning of the claim’s words. Justice Hoffmann believed that the third question is

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139. *Id.*

140. *Id.*

141. *Id.* at 844.

142. *Id.* at 867-68.

a question to be asked in all cases of infringement by equivalence.<sup>143</sup> He also emphasized the importance of the third question when he stated that the first two questions were merely questions of fact which served to provide the background against which the third question should be asked.<sup>144</sup>

The third question asked by Justice Hoffmann is the reason the Epilady dispute was decided differently in the U.K. than in Germany. For after having answered variations of Justice Hoffmann's first two questions in favor of Improver, the German court treated these answers as concluding the matter. In direct contrast, while answering the first two questions in favor of Improver, Justice Hoffmann found it necessary to ask the third question, on which basis he found for Remington.

The principle difference in claim interpretation between the German court and the English Patents Court—posed by Justice Hoffmann's third question—raises two points. First, this difference suggests that the scope of protection offered by a patent in the U.K. will be less than in Germany.<sup>145</sup> The reduction in scope of protection is brought about when the third question forces the court to limit the scope of the claim to the strict literal meaning of the claim's words. Second, since both the English and German decisions were based upon Article 69 of the EPC and the Protocol on Interpretation, these decisions reflect not only a different approach to patent infringement, but also a different understanding of the nature of the Protocol itself.<sup>146</sup> Given the importance of claim interpretation in patent law, these differences suggest a potential barrier to the harmonization of patent laws of the Member States of the EPC.<sup>147</sup>

The World Intellectual Property Organization (WIPO) recognized the problems associated with inconsistent claim interpretation and the application of the Protocol. In an effort to resolve these problems, the Committee of Experts on the Harmonization of Certain Provisions in Laws for the Protection of Inventions (Committee of Experts), drafted Article 21 of the Patent Harmonization Treaty to harmonize the doctrine of equivalents worldwide during the second part of the eighth session in Geneva, from October 29 to November 9, 1990.<sup>148</sup>

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143. *Improver Corp. & Others v. Remington Consumer Products Ltd. & Others*, [1990] F.S.R. 181, 188 (Eng. Ch. 1989).

144. *Id.*

145. *Improver Corp. v. Remington Consumer Products Ltd.*, 21 INT'L. REV. OF INDUS. PROP. & COPYRIGHT LAW 860, 868 (1990).

146. *Id.*

147. *Id.*

148. The Patent Harmonization Treaty is currently only in draft form. Article 21 is based on the EPC's Protocol but goes on to give definitions of equivalence. Article 21 is reprinted in 30 INDUS. PROP. 118, 127 (1991). The Patent Harmonization Treaty is discussed in Part V of this note.

E. *Hypothetical Epilady Decision: Applying the U.S. Doctrine of Equivalents*

In the United States, the doctrine of equivalents permits a finding of direct infringement if the accused device performs substantially the same function in substantially the same way to obtain substantially the same result.<sup>149</sup> In applying the doctrine of equivalents it is important to remember that the doctrine does not focus on the invention as a whole but on each element of the claim.<sup>150</sup> Therefore, a finding of infringement requires the patentee to show the presence of every essential element or its substantial equivalent in the accused device.

In the Epilady controversy the determination of infringement was contingent upon whether the elastic rubber rod used in the Remington depilatory device is a substantial equivalent of the "helical spring" described in claim one of the Improver patent. According to U.S. patent law, for the rubber rod to be an equivalent of the helical spring all three prongs of the equivalency test—function, way, and result—must be met.<sup>151</sup> In the Epilady dispute the function and result prongs of the equivalents test are easily met. First, the rubber rod performs substantially the same function as that of the helical spring, that is, the trapping of hairs for depilatory removal. Likewise, the result of the helical spring and the rubber rod are substantially the same, that is, the clamping and plucking of the hairs. The way component of the equivalency test is not so easily determined.

The way in which the helical spring performs is best described as follows: the arcuate form of the spring causes the gaps between the windings to open on its convex side but to be pressed together on the concave side and when the spring is held closely to the skin and rotated, the hairs enter the gaps on its convex side and are gripped between the windings as the rotational movement brings the hairs around to the concave side. In all likelihood, a federal district court would hold that the elastic rubber rod performs in substantially the same way as the helical spring described in the Improver patent. The rubber rod, like the helical spring, when held in an arcuate position, deforms, causing gaps between the parallel slits in the rubber rod to open on its convex side but to be pressed together on the concave side. Also, in virtually the same manner as the helical spring, when the rubber rod is held closely to the skin and rotated, the hairs enter the gaps on its convex side and are gripped between the parallel slits as the rotational movement brings the hairs around to the concave side. Based on this analysis, the rubber rod performs substantially the same way as the helical spring.

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149. See *supra* part II.B.

150. *Pennwalt Corp. v. Durand-Wayland, Inc.*, 833 F.2d 931, 935 (Fed. Cir. 1987), *cert. denied*, 485 U.S. 961, 1009 (1988).

151. *Universal Gym Equip., Inc. v. ERWA Exercise Equip. Ltd.*, 827 F.2d 1542, 1548 (Fed. Cir. 1987).



Even though it appears that all three components of the equivalency test are met, the patent holder may be estopped from broadening the scope of the claim beyond the literal meaning of the words.<sup>152</sup> The two most likely barriers preventing a finding of equivalence in the Epilady dispute are the limitations posed by prior art and prosecution history estoppel. There can be no infringement under the doctrine of equivalents if the asserted scope of equivalency would encompass the prior art.<sup>153</sup> Nor can the coverage given up during patent prosecution with the PTO be recaptured through equivalence.<sup>154</sup>

Determining the coverage of protection given up during prosecution of the Improver patent is beyond the scope of this note,<sup>155</sup> but an analysis of the prior art limitation is possible because the prior art is disclosed in the Improver patent.<sup>156</sup> The Improver patent cites six other patents as comprising the prior art.<sup>157</sup> Each of these patents concerns depilatory devices.<sup>158</sup> Four involve manually operated helical springs.<sup>159</sup> Three of the four manually operated devices capture the hair by compressing the spring in a tweezer like fashion and jerking the hairs out of the skin.<sup>160</sup> The other manually operated device engages and grips the hairs in the same manner as does the Improver device, but the specification is unclear if the same rotational motion removes the hairs or if the hairs must be removed by moving the device away from the skin.<sup>161</sup> The remaining two patents describe power-operated depilatory devices that are quite different in comparison to the Epilady.<sup>162</sup> One of the power-operated depilatory devices uses a pair of rotating discs instead of a rotating helical spring.<sup>163</sup> The other uses a helical spring, but the spring is reciprocatingly compressed (in contrast to being held in an arcuate form and rotated), extended, and intermittently rotated by an electrically driven

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152. See *supra* part II.B.

153. *Pennwalt Corp.*, 833 F.2d at 934 n.1 (citing *Loctite Corp. v. Ultraseal Ltd.*, 781 F.2d 861, 870 (Fed. Cir. 1985)).

154. Prosecution history estoppel will not allow the patentee to recapture through equivalence certain coverage given up during prosecution. *Loctite Corp.*, 781 F.2d at 870.

155. A record of the Epilady European Patent prosecution history was not available to the author.

156. *Improver Corp. & Others v. Remington Consumer Products Ltd. & Others*, [1990] F.S.R. 181, 184 (Eng. Ch. 1989).

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

cam.<sup>164</sup> Note that none of the six devices embodies an elastic rubber rod which could prevent the scope of the Improver patent from encompassing rubber rods as an alternative to helical springs.<sup>165</sup> Assuming these six patents comprise the prior art, it is unlikely that broadening the scope of the Improver patent to encompass elastic rubber rods will intrude upon the prior art.

In conclusion, if the Epilady dispute had been litigated in the United States under approximately the same set of facts presented to the English and German courts, a federal district court in the United States, applying the United States version of the doctrine of equivalents, would probably find that the Remington depilatory device infringed upon the Improver patent.

## V. THE PATENT HARMONIZATION TREATY

### A. *General Overview*

The aim of the Patent Harmonization Treaty (draft treaty), if it ever becomes a reality, is the worldwide harmonization of patent laws.<sup>166</sup>

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164. *Id.*

165. The limitation posed by the prior art is simply that the asserted range of equivalents may not encompass the prior art at the very point at which the claims distinguish from the art. *Stewart-Warner Corp. v. City of Pontiac*, 767 F.2d 1563, 1572 (Fed. Cir. 1985) (citing *Thomas & Betts Corp. v. Litton Sys.*, 720 F.2d 1572, 1580 (Fed. Cir. 1983) and *Hughes Aircraft Co. v. United States*, 717 F.2d 1351, 1362 (Fed. Cir. 1983)). It is well established that limitations in a claim cannot be given a range of equivalents so wide as to cause the claim to encompass anything in the prior art. *Senmed, Inc. v. Richard-Allen Med. Indus.*, 888 F.2d 815, 821 (Fed. Cir. 1989) (citing *Perkin-Elmer Corp. v. Computervision Corp.*, 732 F.2d 888, 900 (Fed. Cir. 1984)). Claims may not be enlarged by equivalents to encompass the teachings of the prior art. *Tandon Corp. v. United States ITC*, 831 F.2d 1017, 1026 (Fed. Cir. 1987) (citing *Perkin-Elmer Corp.*, 732 F.2d at 900).

166. While attention has been focused on the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) and its intellectual property provisions known as The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), the WIPO negotiations have been, to a large extent, on hold. Jacques J. Gorlin, *Update on International Negotiations on Intellectual Property Rights*, in *GLOBAL DIMENSIONS OF INTELLECTUAL PROPERTY RIGHTS OF SCIENCE AND TECHNOLOGY* 175, 176 (National Academy Press, 1992).

The GATT negotiations on TRIPs and discussions of the WIPO share similar objectives: the strengthened protection and improved enforcement of intellectual property rights via multilateral instruments. However, the overwhelming interest of the principal developed countries in a trade-based multilateral regime for intellectual property as part of the current GATT Uruguay Round . . . [has] pushed the TRIPs negotiations to the fore.

*Id.* at 175.

In contrast to the Patent Harmonization Treaty though, the GATT TRIPs agreement contains

Worldwide harmonization of patent laws is of particular importance to all applicants, especially to those who file outside their national borders. Negotiations concerning the draft treaty have taken place before the WIPO since 1983<sup>167</sup> and are currently in draft form.<sup>168</sup>

Wide in scope, the draft treaty addresses, at least in broad terms, virtually the entire field of patent law. Twenty-four of the draft treaty's thirty-nine articles address substantive aspects of patent law. Included in these twenty-four substantive articles are detailed provisions relating to issues such as statutory subject matter,<sup>169</sup> novelty,<sup>170</sup> obviousness,<sup>171</sup> and the rights conferred by patenting.<sup>172</sup> The draft treaty also addresses the proper legal definition of the doctrine of equivalents and the role of the specification in construing claim scope.<sup>173</sup>

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only *minimum* standards of patent protection and enforcement. *Id.* at 179. The WIPO negotiators delayed their patent harmonization discussions until the GATT resolved the rules for minimum standards of patent protection and enforcement. *Id.* at 180. There is optimism in some circles that ratification of the GATT TRIPs agreement will be followed by the WIPO concluding the Patent Harmonization Treaty. *Id.*

167. R. Carl Moy, *The History of the Patent Harmonization Treaty: Economic Self-Interest as an Influence*, 26 J. MARSHALL L. REV. 457, 459 (1993). The draft treaty has been negotiated in a series of sessions before the WIPO of the Committee of Experts on the Harmonization of Certain Provisions of Law for the Protection of Inventions. To date, eleven preparatory sessions have been held.

168. *Draft Treaty Supplementing the Paris Convention for the Protection of Industrial Property As Far As Patents Are Concerned*, WIPO Doc. No. PLT/DC/3 (Dec. 21, 1990) reprinted in *Records of the Diplomatic Conference for the Conclusion of a Treaty Supplementing the Paris Convention as Far as Patents are Concerned*, 30 INDUS. PROP. 118 (1991) [hereinafter PHT].

169. *Id.* art. 10.

170. *Id.* arts. 11(2), 12-13.

171. *Id.* art. 11(3).

172. *Id.* art. 19-20.

173. *Id.* art. 21. The relevant portions of Article 21 state:

(1) [Determination of the Extent of Protection] (a) The extent of protection conferred by the patent shall be determined by the claims, which are to be interpreted in the light of the description and drawings.

(b) For the purposes of subparagraph (a), the claims shall be so interpreted as to combine fair protection for the owner of the patent with a reasonable degree of certainty for third parties. In particular, the claims shall not be interpreted as being confined to their strict literal wording. Neither shall the claims be considered as mere guidelines allowing that the protection conferred by the patent extends to what, from a consideration of the description and drawings by a person skilled in the art, the owner has contemplated, but has not claimed.

(2) [Equivalents] (a) Notwithstanding paragraph (1)(b), a claim shall be considered to cover not only all the elements as expressed in the claim but also

B. *Article 21 of the Draft Treaty: The Definition of Equivalency*

Article 21 of the draft treaty states that “[t]he extent of protection conferred by the patent shall be determined by the claims, which are to be interpreted in the light of the description and drawings.”<sup>174</sup> In order to avoid a restrictive interpretation of the claim language, Paragraph (1)(b) of Article 21 asserts that the claims shall not be limited to the literal meaning of the wording, yet neither should they be considered as mere guidelines that would allow an extension to what the inventor may have contemplated but has not expressly claimed.<sup>175</sup> The doctrine of equivalents is empowered by Paragraph (2)(a) which describes the general rule that patent protection not only extends to elements literally expressed in the claim, but also to equivalent elements as well.<sup>176</sup>

Paragraph (2)(b) defines equivalent elements.<sup>177</sup> Interestingly, the draft treaty contains two definitions of equivalency.<sup>178</sup> The multiple definitions are due to the fact that the members of the Committee of Experts could not agree on one particular definition of equivalency, and in order to keep the doctrine of equivalents in the draft treaty, it was necessary to place both definitions adjacent to each other and leave it to the future Contracting States to apply one or the

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equivalents.

(b) An element (“the equivalent element”) shall generally be considered as being equivalent to an element as expressed in a claim if, at the time of any alleged infringement, either of the following conditions is fulfilled in regard to the invention as claimed:

(i) the equivalent element performs substantially the same function in substantially the same way and produces substantially the same result as the element as expressed in the claim, or

(ii) it is obvious to a person skilled in the art that the same result as that achieved by means of the element as expressed in the claim can be achieved by means of the equivalent element.

(c) Any Contracting Party shall be free to determine whether an element is equivalent to an element as expressed in a claim by reference to only the condition referred to in subparagraph (b)(i) or to only the condition referred to in subparagraph (b)(ii), provided that, at the time of depositing its instrument of ratification of or accession to this Treaty, it so notifies the Director General.

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*Id.*

174. *Id.* art. 21(1)(a).

175. *Id.* art. 21(1)(b).

176. *Id.* art. 21(2)(a).

177. *Id.* art. 21(2)(b).

178. *Id.* art. 21(2)(b)(i)-(ii).

other.<sup>179</sup> The first definition coincides with the United States standard.<sup>180</sup> According to the first definition, an element is an equivalent if it “performs substantially the same function in substantially the same way and produces substantially the same result as the element as expressed in the claim.”<sup>181</sup> The second definition resembles the German standard and defines an equivalent element as one in which “it is obvious to a person skilled in the art that the same result as that achieved by means of the element as expressed in the claim can be achieved by means of the equivalent element.”<sup>182</sup> In essence, the first definition requires three conditions to be met: function, way, and result; the second requires only one, the same result. However, the second definition also requires that the “way” be obvious to a person skilled in the art.

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### C. *The Treaty's Hypothetical Impact On The Epilady Controversy*

If the draft treaty had been in effect in its current text when the Epilady dispute was litigated, it would have eliminated the inconsistent decisions of the English and German courts. The German court, finding infringement, followed the second definition of the draft treaty. The German court, in accordance with the requirements of the second definition, first concluded the rubber rod was “identical in effect to a device making use of the wording of claim 1 of the [Improver] patent . . . .”<sup>183</sup> This satisfies the “same result” criteria of the second definition. The German court concluded its finding of infringement by equivalency by deciding that it would be obvious to a person skilled in the art that the same result achieved by the helical spring could be achieved by the rubber rod.<sup>184</sup>

The English Patents Court, on the other hand, did not explicitly follow the draft treaty, but added an exception to the determination of infringement by equivalency not found within the four corners of the draft treaty. The English Patents Court, like the German District Court, held that the rubber rod was an equivalent in accordance with the second definition, but Justice Hoffmann asked one additional question that is more or less an exception to the doctrine of equivalents.<sup>185</sup> Justice Hoffmann’s exception, his third question, said that if a reader skilled in the art understood from the language of the claim that the patentee intended

179. *Id.* art. 21(2)(c). According to Article 21(2)(c) of the draft treaty, the Contracting Parties will adopt one of the two definitions during ratification of or accession to the treaty.

180. *See supra* part II.B.

181. PHT, *supra* note 168, art. 21(2)(b)(i).

182. *Id.* art. 21 (2)(b)(ii).

183. *Improver Corp. & Sicommerce AG v. Remington Products Inc.*, 24 INT’L. REV. OF INDUS. PROP. & COPYRIGHT LAW 838, 841.

184. *Id.* at 843.

185. *Improver Corp. & Others v. Remington Consumer Products Ltd. & Others*, [1990] F.S.R. 181, 190-1 (Eng. Ch. 1989).

to confine his claim to the literal meaning of a word or phrase (in this case "helical spring"), there could be no finding of infringement by equivalency.<sup>186</sup> Justice Hoffmann held that a person skilled in the art would interpret the patentee as confining his claim to the literal meaning of helical spring, and as a result, ruled the Remington device did not infringe on the Improver patent.<sup>187</sup> Had the draft treaty been in effect and Justice Hoffmann followed it in its current text, he would not have asked the third question, and as a result, just as the German court did, he would have held that the Remington depilatory device infringed upon the Improver European patent.

## VI. CONCLUSION

Patent attorneys dealing with patent litigation know from experience that a patent system without equivalents is worthless for inventors and industry. Because of the important role the doctrine of equivalents plays in patent protection, patent attorneys around the world would like the WIPO to develop a uniform equivalency doctrine that can be consistently applied in the forums around the world. With economic success dependent on the ability to compete in the global marketplace, an industry must be able to rely upon patent protection in the foreign countries where they conduct business.

The Epilady dispute clearly did not provide a clear set of guidelines for future patent infringement cases in the E.C. What the Epilady dispute has done is show that patent protection based on equivalency is by no means applied on a consistent basis in the E.C. national courts despite having a uniform standard. For the time being, advocates for the holders of European Patents must accept the reality of diversity. Codification and harmonization of the doctrine of equivalents in the Patent Harmonization Treaty would facilitate the preparation and prosecution of patent infringement suits. For this reason, the WIPO's initiative on protection, scope, and claim interpretation deserves full support. Worldwide recognition of the doctrine of equivalents, and consistent application thereof, would be a monumental step toward increased enforceability of patents on an international scale.

*John P. Hatter Jr.\**

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186. *Id.* at 187.

187. *Id.* at 193.

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# DEATH ROW INMATES OR ORGAN DONORS: CHINA'S SOURCE OF BODY ORGANS FOR MEDICAL TRANSPLANTATION

## I. INTRODUCTION

China is using condemned prisoners as the principal source of body organs for medical transplantation purposes.<sup>1</sup> The body parts of executed prisoners are removed immediately after execution by a waiting medical staff without the prisoner's consent. In some cases, executions are deliberately mishandled to ensure that the prisoners are not yet dead when their organs are removed.<sup>2</sup> Executions appear to be scheduled according to transplant needs.<sup>3</sup> "The procedure is coordinated by the relevant health officials 'in accordance with the degree and urgency of need'."<sup>4</sup> Organs are given to government authorities or sold to patients awaiting transplant surgery from other countries, particularly Hong Kong. It is believed that as many as twelve hospitals in Guangdong alone provide organs to meet emergent transplant requirements in Hong Kong.<sup>5</sup> Most of these organs sent to Hong Kong are removed from executed prisoners. One of Hong Kong's top renal specialists, Dr. George Chan Man-Kam, refers patients to China to receive the kidneys of executed prisoners.<sup>6</sup> Dr. Chan declined to reveal the number of kidney patients he sends to China for transplants, but said it was more than the fifty-three who underwent transplant operations in Hong Kong last year.<sup>7</sup>

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1. *China: Organ Procurement and Judicial Execution in China*, HUMAN RIGHTS WATCH/ASIA (Human Rights Watch/Asia, New York, N.Y.), Vol. 6, No. 9, Aug. 1994, at 2 [hereinafter HUMAN RIGHTS WATCH/ASIA]. Human Rights Watch/Asia is a non-governmental organization established in 1978 to monitor and promote the observance of internationally recognized human rights.

2. *Id.* at 3. According to HUMAN RIGHTS WATCH/ASIA, *id.*, sometimes executions are intentionally botched so that a victim can be kept alive longer, thereby increasing the viability of organ transplantation. Plus, vivisection (experimentation) may occur. *Id.* at 28. See also *Allegations of Organs Trade in China Spark off Furore*, THE STRAITS TIMES (SINGAPORE), Nov. 18, 1994, at 20 (A Chinese doctor now living in the West related his experience with a transplant operation in which he was given the task of removing both kidneys from a prisoner who was still alive.).

3. *Id.* at 28.

4. Lena H. Sun, *China's Executed Convicts Donate Organs Unwittingly*, WASH. POST, March 27, 1994, at A22.

5. Mariana Wan, *Transplant Patients in AIDS Peril*, SOUTH CHINA MORNING POST, July 18, 1993, at 14.

6. Queenie Wang, *Medic Linked to Prison Kidney Transplants; Hong Kong Medic in Mainland Referrals; "Anyway their organs will be thrown away after they die."*, SOUTH CHINA MORNING POST, Oct. 30, 1994, at 1. See also *Allegations of Organs Trade in China Spark Off Furore*, THE STRAITS TIMES (SINGAPORE), Nov. 18, 1994. Dr. Chan is informed of execution dates by a network of his former students who now work on the mainland. "They find out from the notices posted by the courts, and they call me." *Id.*

7. *Id.*

Despite campaigns to increase organ donations, donors are still in short supply in Hong Kong.<sup>8</sup> This shortage forces patients to visit the mainland for transplants, although many Hong Kong residents who have undergone kidney transplants in China are known to have experienced serious medical problems after their operations.<sup>9</sup> Desperate patients will not stop going to China to buy organs of executed prisoners until there are enough organs donations in Hong Kong to meet the demand.<sup>10</sup> While visiting Guangdong, Professor Arthur Li, dean of the medical facility at the Chinese University of Hong Kong, was offered kidneys by the Chinese hospital staff.<sup>11</sup> Professor Li was willing to take the organs back to Hong Kong for transplant purposes provided they were free and he received proof of consent from the prisoners. After stating these conditions, he heard nothing further about the offer.

Reports of organ harvesting of condemned prisoners have been confirmed by doctors and judges who were present at the executions, and most compelling, by members of the Communist Party in China.<sup>12</sup> Restricted circulation documents acknowledge that these practices occur, even to the point of conceding that in some cases, organs were removed from living prisoners.<sup>13</sup> The United Nations Committee Against Torture summarized official comments made in April 1993 by China's delegation to the United Nations, led by Ambassador Jin Yongjian as follows: "Removal of organs without the permission of either the person or his family was not standard practice. There were, however, cases in which permission had been given to remove organs from the bodies of the persons executed."<sup>14</sup>

It is estimated that 2,000 to 3,000 organs (mostly kidneys and corneas) are removed from prisoners each year and used in transplant procedures.<sup>15</sup> One Chinese government document describes chilling details of how the harvesting of the organs should be carried out.

The use of the corpses or organs of executed criminals must be kept strictly secret, and attention must be paid to avoiding negative repercussions. [The removal of organs] should normally

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8. Alison Wiseman, *Prisoners' Organ Trade 'Will Go On,'* SOUTH CHINA MORNING POST, Aug. 30, 1994, at 6.

9. *Id.*

10. *Id.*

11. Mariana Wan & Simon Beck, *Organs of Prisoners Used in Operations,* SOUTH CHINA MORNING POST, July 25, 1993, at 1.

12. See HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 7-8.

13. ALL THINGS CONSIDERED, (National Public Radio, Aug. 29, 1994), available in LEXIS, NEXIS Library, Scripts File).

14. U.N. GAOR Comm. Against Torture, 48th Sess., Supp. No. 44A, U.N. Doc. A/48/44/Add.1 (1993).

15. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 2.



be carried out within the utilizing unit. Where it is genuinely necessary, then with the permission of the people's court that is carrying out the death sentence, a surgical vehicle from the health department may be permitted to drive onto the execution grounds to remove the organs, but it is not permitted to use a vehicle bearing health department insignia or to wear white clothing. Guards must remain posted around the execution grounds while the operation for organ removal is going on.<sup>16</sup>

This Comment primarily focuses on the violations of Chinese and international law committed by the government of the People's Republic of China in the sanctioning of organ removal from executed prisoners without their consent. In addition, this Comment focuses on possible ways in which the government of the People's Republic of China can increase voluntary participation by its citizens in an organ donor program, and ways in which other countries, international companies, and the medical society can apply pressure on the Chinese government to stop the human rights violations occurring in China's prisons with regard to the procurement of organs.

## II. FACTORS CONTRIBUTING TO THE EXPANSION AND SUCCESS OF ORGAN TRANSPLANTATION IN CHINA

China's organ transplantation program began during the 1960's, when a number of kidney transplant operations were conducted with the help of foreign medical advisors.<sup>17</sup> Although there were a number of kidney, liver, heart, and lung transplants across the country in the late 1970's, the success rate remained low and by the early 1980's, the country's organ program appeared to be faltering.<sup>18</sup> In 1983, two unrelated factors combined to give the program a major boost, and provide a foundation for the new expansion and success of organ transplantation in China. One was the introduction of Cyclosporine A (CsA), a drug which inhibits the body's natural tendency to reject foreign body tissue. The other was the commencement of a series of "crackdown on crime" campaigns which greatly increased the number of criminals sentenced to death.<sup>19</sup>

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16. Temporary Rules Concerning the Utilization of Corpses or Organs from the Corpses of Executed Criminals, Oct. 9, 1984, *reprinted in* HUMAN RIGHTS WATCH/ASIA, *supra* note 1, app. at 36.

17. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 4. The organ transplantation program was not publicly announced until 1974. *Id.*

18. *Id.*

19. *Id.* at 4.

### A. Cyclosporine A "*The Wonder Drug*"

Cyclosporine A, an immunosuppressive agent which inhibits the body's natural tendency to reject foreign body tissue, was introduced into China in the mid-1980's by the Swiss company Sandoz.<sup>20</sup> The drug raised the first year survival rate for recipients of kidney transplants from fifty to eighty percent. By 1991, the survival rate rose to more than ninety percent.<sup>21</sup> In addition to raising the transplantation program's success rate, Cyclosporine A also introduced a major financial element into the organ transplantation process. The drug's high price created, not only a need to cut costs, but also, an incentive to provide organ transplants for high-paying foreign customers as a way of subsidizing wider domestic availability.<sup>22</sup>

Advances in medical science in China went hand-in-hand with a series of anti-crime campaigns that produced a steadily growing supply of body organs for transplant surgery. "In absence of proper legal safeguards for prisoners' rights, this caused the evolving relationship between China's surgical capacity, patient demand and organ supply to develop in a particularly abusive direction."<sup>23</sup>

### B. *Anti-Crime Campaigns*

Beginning in 1983, the government of the People's Republic of China, began a "crackdown on crime" campaign. Since this time the prison population has doubled.<sup>24</sup> In addition, far more people are now being condemned to death and judicially executed each year in China than at any time since the early 1950's.<sup>25</sup> According to official reports<sup>26</sup> the number of people actually

20. *Id.* at 5.

21. *Id.*

22. *Id.* at 5, 6.

23. *Id.* at 6.

24. *Id.* at 18.

25. *Id.* at 5. Statistics on the number of death sentences and executions carried out in China are regarded as "state secrets" by the government and are never made public. According to most outside estimates, however, approximately 10,000 people were executed in 1983, the year of the first "crackdown" campaign, and annual totals remained high for the rest of the decade. According to Amnesty International, which monitors use of the death penalty worldwide, the numbers of death sentences and executions reported publicly by the authorities this decade are as follows: in 1990 there were at least 980 death sentences and 750 completed executions; the numbers were 1,650 and 1,050 respectively in 1991; and 1,891 and 1,079 in 1992. During 1993, at least 2,564 persons were sentenced to death, of whom at least 1,419 actually were executed. *Id.* at 5, n.8 (citing Amnesty International, China: The Death Penalty: Unprecedented Rise in Death Sentences and Executions Since September 1993, ASA 17/09/93, London, July

executed in Henan Province alone between January and July 1989 increased 47.28 percent over the same period the previous year, while the number of those sentenced to death with a two-year suspension increased by 107.8 percent.<sup>27</sup> As a result of legislative changes promulgated by the government since 1982, there are two and a half times as many criminal offenses punishable by the death penalty and almost three times as many articles of law stipulating capital punishment as there were prior to the introduction of the criminal law in 1979.<sup>28</sup>

The President of the Supreme People's Court, Ren Jianxin has vowed to sentence to death anyone guilty of crimes that have harmed the country's image or jeopardized economic reforms.<sup>29</sup> "Major corruption and bribery cases that have seriously infringed in the interest of the country and destroyed the reputation of the Communist party and the Government" are among those crimes punishable by death.<sup>30</sup> Other crimes mentioned by Ren Jianxin are murder, rape, smuggling, fraud, production of false goods and tax fraud. Amnesty International reports that at least 1,890 death sentences were handed down in 1992. This is the highest figure since 1983 when an estimated 10,000 people were executed at the start of the "crack-down on crime" campaign.<sup>31</sup>

### III. VIOLATIONS OF CHINESE LAW

#### A. *Temporary Rules Concerning the Utilization of Corpses or Organs from the Corpses of Executed Criminals*<sup>32</sup>

A directive issued jointly on October 9, 1984, by the Supreme People's Court, Supreme People's Procuracy, Ministry of Public Security, Ministry of Justice, Ministry of Health and Ministry of Civil Affairs, provides three ways in which organs may be removed from prisoners.<sup>33</sup> First, if a prisoner's

1994, and China: Death Penalty in 1992, ASA 17/09/93, London, July 1993).

26. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 18 (citing "Criminal Trial Work Report of the Henan Provincial High People's Court" (*Henan Sheng Gaoji Renmin Fayuan Guanyu Xingshi Shenpan Gongzuo de Baogao*), Aug. 25, 1989, in *Renmin Fayuan Nianjian 1989* (1989 People's Court Yearbook), People's Court Press (Beijing: 1992), at 462).

27. *Id.*

28. *Id.* at 19.

29. Chris Yeung, *Top Judge in Execution Vow*, SOUTH CHINA MORNING POST, July 30, 1993, at 10.

30. *Id.*

31. *Id.* See also AMNESTY INTERNATIONAL REPORTS 1993.

32. Temporary Rules Concerning the Utilization of Corpses of Executed Criminals, October 9, 1984, *reprinted in* Human Rights Watch/ Asia, *supra* note 1, app. at 36.

33. *Id.*

body is unclaimed by their family, the government may then take the organs. Second, the prisoner has volunteered his organs to be removed after his death. Third, the prisoner's family may consent to the donation of the organs.

### 1. *Unclaimed Corpse*

Following the execution of a prisoner, if the body is not claimed by his family, the government may then use the prisoner's organs for transplantation. However, often a family is not informed of the date of execution and has little or no contact with the condemned prisoner. "[Prisoners] are denied access not only to their families but to a defense lawyer, from the moment they are first detained and until a matter of days before trial. Since pre-trial detention often lasts from several months to more than a year, . . ." <sup>34</sup> By the time a family learns of the execution, it may be too late for them to claim the remains, thus making it easier for the Chinese government to justify the use of organs by claiming that the body was not taken by the family. In addition, once the organs have been removed, the bodies are then cremated, so that a family claiming the body would not be able to determine whether the cremation occurred with the organs intact or not. <sup>35</sup>

### 2. *Voluntary Consent*

Second, where the executed criminal has volunteered to have his corpse provided to a medical treatment or health unit for use, the organs may then be removed. <sup>36</sup> Voluntary consent by the prisoners is often not sought. <sup>37</sup> According to Chinese law, a corpse cannot be used for dissection or organ transplantation purposes unless the consent of the person whose body is to be used or the consent of their family is first obtained. <sup>38</sup> Even in the minority of cases where the consent is sought as required by law, it is likely that it is not genuine free consent. Based on the abusive circumstances of detention in China, from the time a person is first accused of a capital offense until the moment of his or her execution, any notion of "free and voluntary consent" is absurd. <sup>39</sup> A captured capital offender is kept in leg irons until trial. If the prisoner is sentenced to death, he will remain in leg irons and often in handcuffs continuously until he is executed. Prisoners are held in small dark

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34. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 23.

35. *Id.* at 15 n. 42.

36. HUMAN RIGHTS WATCH/ASIA, *supra* note 16, app. at 37.

37. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 11.

38. *Id.* at 10.

39. *Id.* at 12.

cells where they are tortured by "severe beatings, the use of electric batons and shackles, deprivation of sleep and food, and exposure to extremes of cold or heat."<sup>40</sup> The following account of conditions on "death row" was written by a retired prison guard in the Tianjin Municipal Jail:

There is a special place inside the jail for holding condemned prisoners—a long chamber comprising several "solitary quarters" (*du ju*), one cell for each evil felon. The door to the chamber is lined with black rubber, very heavy, like an "entrance to hell" designed by some devil. The corridor is dark and deathly quiet. No sounds at all can be heard apart from the footsteps of guards and the clinking of ankle-fetters. Each criminal is kept all alone in a tiny, narrow cell. The four walls are lined with thick, springy sheets of leather, and it is as dark as a coffin. If they wish to talk to the guards, prisoners must stand and speak through a surveillance hole in the door. All of the prisoners are in handcuffs and leg irons, which will not be removed before the time of their execution. In order to eat, drink or go to the toilet, they have to be helped by "general duties" staff (*zayi*, prisoners serving light sentences). Once transferred there, condemned prisoners are denied access to the [communal] latrine and are barred from reading newspapers or listening to the prison's educational broadcasts. The only recreation left to them is to doze lethargically or just sit there in blank contemplation. In effect, criminals sent to the "solitary quarters" have lost even their souls, for what awaits them is death.<sup>41</sup>

According to a former judge familiar with pre-execution procedures in China, prisoners still in shackles would be taken into interrogation rooms the night before their execution and they would be bound by a rope around their arms, wrists, and waist to a chair. A judge would then enter and announce the final rejection of appeal, read the final death warrant aloud, and request that the prisoner sign the document. If the prisoner refused, the judge would forcibly press his finger to an ink pad and stamp a fingerprint onto the sentencing document. The prisoner remained tied to the chair for the rest of the night.<sup>42</sup> At no time are the prisoners asked if they are willing to have their organs removed after execution. In the rare cases they are asked, what would prevent the judge from forcibly pressing the prisoner's finger to an ink pad and stamp a fingerprint onto the consent form? Under these conditions, there is no meaningful possibility of "free consent" being given.

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40. AMNESTY INTERNATIONAL USA, 1994 REPORT.

41. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 13.

42. *Id.* at 14.

Moreover, if a prisoner expressly states that he does not want his organs to be removed after he is executed, the likelihood of his declaration not to donate his organs reaching his family is highly doubtful. According to confidential regulations issued by the Supreme People's Court in 1984,<sup>43</sup>

[T]he people's court responsible for handling a condemned criminal over for execution should promptly examine any last will or statements made by the condemned criminal. . . . Those parts which are slanderous in nature or which make reactionary statements are not to be handed over to the person's family. . . . sections complaining about grievances or alleged injustices are not to be passed on to the person's family.<sup>44</sup>

Since officials are directed to edit prisoners' wills and last statements for slanderous statements and grievances there is nothing to prevent them from omitting any expression by the prisoner of his intention to keep his organs. Officials have carte blanche with regard to manipulating any documents written by the prisoners. Unauthorized dissections and organ removal can be carried out by the authorities with impunity.<sup>45</sup>

### 3. *Family Consent*

Thirdly, the organs of executed criminals may be provided for use if the family consents to the use of the corpse. Often families are either not informed about the organ donation or they are offered cash payments in advance as an incentive to consent.<sup>46</sup> It appears that families are given the choice to consent or to refuse but refusal to grant permission may result in the families being presented with large bills for the prisoner's food, other expenses, and even the cost of the bullet used for execution.<sup>47</sup>

## IV. VIOLATIONS OF INTERNATIONAL LAW

The United Nations Charter [Charter], to which China is a signatory, begins with the following language:

With a view to the creation of conditions of stability and well-

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43. *Id.* at 12, n.33 (citing *Circular Concerning the Correct Handling of Last Wills and Various Objects Left Behind by Criminals Condemned to Death*, January 11, 1984).

44. *Id.*

45. *Id.* at 15.

46. *Id.* at 14.

47. *Id.*

being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations shall promote:

- (a) higher standards of living, full employment, and conditions of economic and social progress and development;
- (b) solutions of international economic, social, health, and related problems; and international cultural and educational cooperation; and
- (c) universal respect for, and observance of human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion.<sup>48</sup>

#### A. *Charter of the United Nations*

China has voluntarily accepted obligations under the Charter which requires it to ensure its citizens basic human rights. Upon admittance to the United Nations, China assumed an obligation under the Charter of the United Nations to take joint and separate action to "promote . . . universal respect for, and observance of, human rights and fundamental freedoms for all . . ." <sup>49</sup> As a country, it is bound by established human rights standards, which are part of international law and have been accepted by the international community as interpreting the human rights provisions of the Charter.

The act of taking organs from prisoners without their consent is not consistent with the purposes and principles of the Charter. The Charter's purpose, *inter alia*, is to promote and encourage respect for human rights and fundamental freedoms for all.<sup>50</sup> As one of the eleven members of the United Nations Security Council, China is to discharge its duties in accordance with the purposes and principles of the Charter.<sup>51</sup> China is obligated to uphold fundamental human rights as a member of the United Nations, as well as a member of the Security Council. China's current behavior with respect to upholding the rights of its citizens raises serious doubt as to its ability to uphold its obligations as a member of both the United Nations and the United Nations Security Council.

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48. U.N. CHARTER art. 55. See GOODRICH & HAMBRO, *Charter of the United Nations Commentary and Documents* 319 (1949). China was an original signatory to the United Nations Charter on June 26, 1945 at the United Nations Conference in San Francisco, California. China then ratified the United Nations Charter on August 28, 1945, and the ratification was deposited on September 28, 1945. *Id.* at 545, 570.

49. *Id.* U.N. CHARTER arts. 55, 56.

50. *Id.* U.N. CHARTER art. 1, § 3.

51. *Id.* U.N. CHARTER art. 24, § 2.

## B. *International Covenant on Civil and Political Rights*

Article 7 of the International Covenant on Civil and Political Rights (ICCPR)<sup>52</sup> states that "[no] one shall be subjected to torture or to cruel, inhuman or degrading treatment or punishment. In particular, no one shall be subjected without his free consent to medical or scientific experimentation."<sup>53</sup>

Although China is not a signatory to the ICCPR, the rights of criminal defendants under the ICCPR are fully embodied in China's criminal and procedural law.<sup>54</sup> The provisions in the ICCPR reflect norms of customary international law and are therefore binding on states on that basis.<sup>55</sup> Customary international law results from a general and consistent practice of states which is followed by them from a sense of legal obligation.<sup>56</sup> In the highly codified humanitarian law context, the primary and most obvious significance of a norm's customary character is that it binds states not party to the instrument on which that norm is restated.<sup>57</sup> Since Article 7 of the ICCPR is considered to be a customary norm of international law, then China is bound by it. Hence, China's taking of prisoners' organs without their consent, an action similar to subjecting one to non-volitional medical experimentation, violates Article 7. This article plainly states that consent must first be obtained before medical experimentation can take place.

The provisions of the ICCPR are declaratory of the law laid down in the Charter and therefore bind the members of the United Nations on that basis.<sup>58</sup> A further argument that the ICCPR binds non-state parties is based on the foundation that certain of its provisions reflect "the general principles of law recognized by civilized nations."<sup>59</sup> In other words, because Article 7 is recognized by most civilized nations and China considers herself a civilized nation, China is obligated to recognize it.

52. HUMAN RIGHTS: A COMPILATION OF INTERNATIONAL INSTRUMENTS, at 8, U.N. Doc. ST/HR/Rev.2, U.N. Sales No. E83. XIV.1 (1983). The ICCPR was adopted and opened for signature, ratification, and accession by General Assembly Resolution 2200A (XXI) of Dec. 16, 1966. ICCPR was entered into force on March 23, 1976. *Id.*

53. *Id.* at 9.

54. *Report by the special Rapporteur, Mr. S. Amos Wako, pursuant to Commission on Human Rights resolution 1990/51*, U.N. Commission on Human Rights, 47th Sess., Agenda Item 12, at 22, U.N. Doc. E/CN.4/1991/36 (1991).

55. DOMINIC MCGOLDRICK, *THE HUMAN RIGHTS COMMITTEE: ITS RULE IN THE DEVELOPMENT OF THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS* 21 (1991).

56. THEODOR MERON, *HUMAN RIGHTS AND HUMANITARIAN NORMS AS CUSTOMARY LAW* 3 (1989).

57. *Id.*

58. McGoldrick, *supra* note 55, at 21.

59. *Id.*



### C. *Standard Minimum Rules for the Treatment of Prisoners*

China is in violation of a number of provisions set out in the Standard Minimum Rules for the Treatment of Prisoners (Standard Minimum Rules).<sup>60</sup> Based on the account relayed by a retired prison guard,<sup>61</sup> prisoners are kept in leg irons until trial and if sentenced to death, remain in leg irons until execution.<sup>62</sup> According to the Standard Minimum Rules, "leg irons shall never be applied as punishment, or used as restraints."<sup>63</sup> Furthermore, "the patterns and manner of use of instruments of restraints shall be decided by the central prison administration. Such instruments must not be applied for any longer time than is strictly necessary." Occasionally, prisoners may have to be restrained for long periods of time, an act contrary to the Standard Minimum Rules. Therefore, China's standard practice of constraining convicted criminals in leg irons until execution violates this provision.<sup>64</sup>

Section 36 (3) states ". . . that every prisoner shall be allowed to make a request or complaint, without censorship . . .",<sup>65</sup> but a directive issued by the Chinese government expressly directs officials to censor a condemned criminal's last will or statement.<sup>66</sup> The directive is in direct violation of the Standard Minimum Rules. Prisoners are also regularly allowed under necessary supervision to visit or correspond with their family and reputable friends.<sup>67</sup> However, families are often not even informed of their relatives incarceration so the opportunity to communicate and visit is controlled by the government, and if it so chooses, there is no visitation at all.<sup>68</sup>

Last, the conditions on "death row" as described by a retired prison guard directly contradicts the provision in section 39.<sup>69</sup> The guard stated that once a prisoner is transferred to death row, he is barred from reading newspapers or listening to the prison's educational broadcasts.<sup>70</sup> Section 39 of the Standard Minimum Rules is as follows: "Prisoners shall be kept informed regularly

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60. Standard Minimum Rules for the Treatment of Prisoners [hereinafter Standard Minimum Rules], *reprinted in* UNITED NATIONS, HUMAN RIGHTS A COMPILATION OF INTERNATIONAL INSTRUMENTS 75 (1983). The Rules should serve to stimulate a constant endeavor to overcome practical difficulties in the way of their application, in the knowledge that they represent, as a whole, the minimum conditions which are accepted as suitable by the United Nations. *Id.*

61. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 13.

62. *Id.*

63. Standard Minimum Rules, *supra* note 60, at 77.

64. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 13.

65. Standard Minimum Rules, *supra* note 60, at 78.

66. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 11.

67. Standard Minimum Rules, *supra* note 60, at 78.

68. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 23.

69. Standard Minimum Rules, *supra* note 60, at 78.

70. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 13.

of the more important items of news by the reading of newspapers, periodicals, or special institutional publications, by hearing wireless transmissions, by lecture or similar means as authorized or controlled by the administration."<sup>71</sup>

#### D. *Code of Conduct for Law Enforcement Officials*

Article 1 of the Code of Conduct of Law Enforcement Officials<sup>72</sup> (Code of Conduct) provides that "law enforcement officials shall at all times fulfill the duty imposed on them by law, by serving the community and by protecting all persons against illegal acts, consistent with the high degree of responsibility required by their profession."<sup>73</sup> It is a law enforcement official's duty to protect all persons against illegal acts. Since non-volitional removal of prisoners' organs is illegal under Chinese law,<sup>74</sup> the law enforcement officials are in violation of the Code of Conduct because they are not protecting the prisoners against illegal acts. Also, in performance of their duty, "law enforcement officials shall respect and protect human dignity and maintain and uphold the human rights of all persons."<sup>75</sup> If a law enforcement official has reason to believe that a violation of the Code of Conduct has occurred, he shall report the matter to his superior and where necessary, to other appropriate authorities or organs vested with reviewing or remedial power.<sup>76</sup> This provision clearly requires all law enforcement officials to report the illegal act of organ procurement from condemned prisoners to the proper authorities. By failing to report the illegal acts, they violate the Code of Conduct. This failure, especially since it occurs under color of law, puts China in clear violation of international law, and the international community must force China to cease its current practices.

#### E. *Principles of Medical Ethics*

The involvement of Chinese doctors and other medical personnel in the process of removing executed prisoners' organs is necessarily extensive. Blood

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71. Standard Minimum Rules, *supra* note 60, at 78.

72. *Code of Conduct of Law Enforcement Officials*, reprinted in UNITED NATIONS, HUMAN RIGHTS: A COMPILATION OF INTERNATIONAL INSTRUMENTS 84, U.N. Doc. ST/HR/1/Rev. 2, U.N. Sales No. E. 83 XIV.1 (1983) [hereinafter *Code of Conduct*].

73. *Id.* The term "law enforcement officials" includes all officers of the law, whether appointed or elected, who exercise police powers, especially the powers of arrest or detention. *Id.*

74. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 39.

75. *Code of Conduct*, *supra* note 72, at 84.

76. *Id.* at 86.

tests are performed prior to execution to determine the prisoner's health and suitability as an organ donor. Medical personnel are also present at the execution, awaiting the moment of death so that they can immediately remove the organs and rush them back to the hospital to perform the operation.<sup>77</sup>

The involvement of medical professionals in the judicial execution and transplantation process represents a grave violation of internationally accepted standards of medical behavior.<sup>78</sup> According to the United Nations' "Principles of Medical Ethics Relevant to the Role of Health Personnel, Particularly Physicians, in the Protection of Prisoners and Detainees Against Torture and Other Cruel and Inhuman or Degrading Treatment or Punishment," health personnel have a duty to provide prisoners with protection of their physical and mental health and treatment of disease of the same quality and standard as afforded to those who are not imprisoned or detained.<sup>79</sup> Healthcare providers do not take organs from non-imprisoned Chinese citizens without consent; likewise, under the Principles of Medical Ethics, they should not remove prisoners' organs without consent.

The third tenet of the Principles of Medical Ethics mandates that: "[i]t is a contravention of medical ethics for health personnel, particularly physicians, to be involved in any professional relationship with prisoners or detainees the purpose of which is not solely to evaluate, protect or improve their physical and mental health."<sup>80</sup> Organ removal does not fall into the category of evaluation, protection, or improvement of physical health and, therefore, health personnel who harvest prisoners' organs violate the Principles of Medical Ethics.

The last principle states that "it is a contravention of medical ethics for physicians to certify the fitness of prisoners for any form of treatment or punishment that may adversely affect their physical or mental health or to participate in any way in the infliction of any such treatment or punishment which is not in accordance with the relevant international instruments."<sup>81</sup> The role played by medical personnel in the execution and organ transplantation process in no way furthers the health of the prisoners involved.<sup>82</sup> "Instead, it converts state-sponsored killing into a grotesque, quasi-medical operation."<sup>83</sup> The physician's primary duty to safeguard life and health as set out in the principles of Medical Ethics is fundamentally corrupted by the practice of using executed prisoners as a source of organs.

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77. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 31. In addition, hospitals are notified ahead of time when the execution is to be held so they may arrange a donor patient match and prepare to make the transplant. *Id.*

78. *Id.*

79. *Principles of Medical Ethics*, reprinted in UNITED NATIONS, HUMAN RIGHTS: A COMPILATION OF INTERNATIONAL INSTRUMENTS 87, U.N. Doc. ST/HR/1/Rev. 2, U.N. Sales No. E. 83 XIV.1 (1983).

80. *Id.*

81. *Id.* at 87. See also *id.* Principle 4(b).

82. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 32.

83. *Id.*

## V. PROPOSED SOLUTIONS

### A. *Legally Effective Methods of Organ Procurement*

In place of the current reliance on executed prisoners as a source for organ procurement, the Chinese government should take vigorous steps and commit adequate resources toward establishing a comprehensive national program to encourage voluntary organ donation by the general public.

#### 1. *Cadaveric Organ Donor Act*

The Cadaveric Organ Donor Act (CODA) is a proposed bill which is designed to alleviate the organ shortage in the United States. "CODA proposes a new, comprehensive, national approach to the donation of human organs for transplantation purposes with its National Organ Donor Registry and broad acceptance of the concept of mandated choice."<sup>84</sup>

If CODA, or a similar act is established in China, it could significantly increase the supply of available organs for transplantation. "Under CODA, every individual under the age of sixteen is provided an opportunity to file a National Organ Donor Registration Form (Donor Form) on which he can elect to be a donor of all organs, a donor of only some organs, or not to be a donor at all."<sup>85</sup> The Donor Form will accompany the individual's application for any form of identification (driver's license, passport, etc.). All elections are then filed on a National Organ Donor Registry.<sup>86</sup> The National Registry would provide a single uniform database recording the decisions that citizens have made regarding their donative status. The database is made accessible to all health care institutions.

The status of an individual as a donor, restricted donor or non-donor can be changed at any time by the donor prior to death. The status of an individual over the age of sixteen may not be changed by anyone after the individual dies, including members of his or her family.<sup>87</sup> Parents of a minor under the age of sixteen may elect to donate or refuse to donate their child's organs regardless of how the minor is listed in the National Registry.<sup>88</sup> Upon the death of an individual whose organ donation decision was not officially recorded in the National Registry, medical authorities may presume that the individual or an appropriate decision maker has consented to the donation

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84. Proposed Federal Statute, *Cadaveric Organ Donor Act-Report*, 18 J. CORP. L. 543, 544 (1993).

85. *Id.*

86. *Id.*

87. *Id.* at 545.

88. *Id.*

of all needed organs.<sup>89</sup> If however, the decedent's family objects to the removal, then the organs will remain intact.

By implementing a system of mandated choice, China would raise the level of consciousness among its citizens by forcing them to make a choice of whether or not to donate their organs. Informing and educating the citizens of a country as large as China about voluntary organ donation will substantially increase donations. Several states in the United States have begun to experiment with a form of mandated choice through their driver registration system.<sup>90</sup> In Colorado, for example, drivers are asked to state directly on their license whether they wish to be a donor. The reverse side of the license acts as an organ donor card. With this system, approximately sixty percent of all Colorado drivers are registered as organ donors.<sup>91</sup> If China implements an act similar to CODA, the purpose of which is to close the gap between the number of potential donors and the number of actual organ donors and thereby increase the supply of needed organs for transplantation, she would have no need to violate the human rights of executed prisoners.

## 2. *The Brain Death Criterion*

"China's current legal standard for determining the time of death is the moment at which the heart stops beating."<sup>92</sup> Most other countries recognize the "brain-stem death" criterion as being a more accurate and scientific standard of clinical death.<sup>93</sup> Non-living organ donors must have had irreversible brain injury such that two neurospecialists with no professional conflict of interest in organ donation or treatment recipient benefit, can unambiguously state that there is no possibility of higher level brain function recovery.<sup>94</sup> These prospective donors are typically located in hospitals, are on mechanical ventilation, and are of a neurological status such that if the respirator is disconnected, inability to breathe leads to cardiac arrest.<sup>95</sup> Recognition of the brain death standard would clearly be beneficial to China's supply situation, since it would allow broader access to non-prisoner sources of organs, for example, respirator-sustained accident victims. Because time is of the essence in organ transplantation, many organs are not suitable for transplantation unless taken from the donor immediately after death. By observing the brain-death criterion, the availability of usable organs will increase because the organs

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89. *Id.*

90. *Id.* at 545, 546.

91. *Id.*

92. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 29.

93. *Id.*

94. Ronald D. Guttman, M.D., *The Meaning of "The Economics and Ethics of Alternative Cadaveric Organ Procurement Policies,"* 8 YALE J. on Reg. 453, 454 (1991).

95. *Id.*

will not deteriorate while the donor is respirator sustained, thus allowing for more time to notify the recipient and coordinate the transplantation. Brain-death criterion coupled with a system of mandated choice would greatly improve China's organ deficiency. However, without an outright ban on the procurement of organs from prisoners, the new standard could well result in further serious human rights violations.<sup>96</sup>

### 3. *Presumed Consent*

One common suggestion for increasing the supply of organs and tissues is to utilize presumed consent law. There are at least sixteen countries with some version of presumed consent: Austria, Belgium, Czech Republic, Denmark, Finland, France, Greece, Israel, Italy, Japan, Norway, Poland, Singapore, Spain, Sweden, and Switzerland.<sup>97</sup> In Finland, Greece, Italy, Japan, Norway, and Spain, presumed consent is weak because doctors first ascertain if the next of kin have any objections before proceeding. The results obtained in these countries have been disappointing. The disappointment has not resulted from widespread exercise of the "opt out"<sup>98</sup> choice. The problem instead seems to be that despite having the legal right to harvest the organs of a deceased person who has not "opted out" without obtaining the consent of his relatives, hospital personnel are unwilling to proceed without family consent, and are understandably reluctant to approach grieving survivors about the subject.<sup>99</sup>

"Strong presumed consent laws however, exist in Austria, Czechoslovakia, Denmark, France, Israel, Poland, Singapore, and Switzerland, where organ or tissue recovery proceeds unless there is knowledge that the next of kin objects or that the decedent had objections prior to death."<sup>100</sup> "Under presumed consent, physicians and organ procurement personnel are presumed to have the individual's and surviving family members' consent to remove needed organs at death unless these potential suppliers expressly make their preferences to the contrary known beforehand."<sup>101</sup> If a person dies with harvestable organs, and he has not given express indications of being unwilling to donate

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96. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 31.

97. Daphne D. Sipes, *Does It Matter Whether There Is Public Policy Or Presumed Consent In Organ Transplantation?*, 12 WHITTIER L. REV. 505, 515 (1991).

98. "Opt out" is the term used to describe what a person does when the person expressly states that they do not wish to have their organs removed after death.

99. Gregory S. Crespi, *Overcoming the Legal Obstacles To The Creation Of A Futures Market In Bodily Organs*, 55 OHIO ST. L. J. 53 (1994).

100. Sipes, *supra* note 97, at 515.

101. Roger D. Blair & David L. Kaserman, *The Economics And Ethics Of Alternative Cadaveric Organ Procurement Policies*, 8 YALE J. ON REG. 403, 434 (1991).

those organs, then he is presumed to have consented to their harvestation.<sup>102</sup> (This presumption overrides any objections to donation asserted by the surviving kin of the decedent)

There are currently two types of presumed consent removal statutes in the United States: "quasi," which requires a search for the next of kin to obtain consent, if the search is successful; and "pure," which requires no search and no consent of the family.<sup>103</sup> Both types of presumed consent statutes are typically limited to the removal of corneas and pituitary glands in the United States. The basic difference between the "quasi-" and "pure-types" is the former's requirement of a reasonable search for the next of kin. The pure-type requires no search for next of kin and allows removal without the family's consent so long as there is no known objection.<sup>104</sup>

Although a presumed consent law would likely increase the number of organs available for transplant, it is not free from criticism. First, it is exploitative in the sense that many people are reluctant to expressly revoke consent, which is necessary if one does not want the organs harvested.<sup>105</sup> This policy has an unsound foundation, as it suggests that presumed consent works because people hesitate to object to something that they do not want done.<sup>106</sup> Second, presumed consent may also exploit ignorance or temporary confusion. Most organs are harvested from accident victims. Their families may not take the affirmative step of objecting to organ removal at that critical point when a loved one dies either because they are unaware of the imminent removal of the organs or because they do not think about it in their time of grief.<sup>107</sup>

#### 4. *Market Based System of Kidney Procurement*

Advocating a market solution to the existence of excess demand is commonplace among economists and non-economists alike when the commodity in question is a standard product normally traded in the market.<sup>108</sup> When the scarce resource in question is a human organ however, this suggestion is much less readily received.<sup>109</sup> An organ market does not propose "barkers

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102. Crespi, *supra* note 99, at 53.

103. Sipes, *supra* note 97, at 524.

104. *Id.*

105. Blair & Kaserman, *supra* note 101, at 434. *See also* Sipes, *supra* note 97. Singapore enacted a strong presumed consent law in 1987. The Singapore law penalizes a person who opts out by giving him a lower waiting-list priority if he should ever need an organ transplant.

106. *See* Blair & Kaserman, *supra* note 101, at 434.

107. *Id.*

108. *Id.* at 420.

109. *Id.*

hawking human organs on the street corners," or "an auction in which desperate recipients bid against each other for life sustaining organs."<sup>110</sup> Nor do advocates of the market system envision transplant patients, or their agents, dickering for a heart or liver with families of the recently deceased.<sup>111</sup> Finally, they do not advocate a market for organs from living donors.<sup>112</sup>

Advocates of the market system suggest adopting the following scenario as an arrangement to equilibrate demand and supply of cadaveric organs. Potential organ suppliers could be offered some fixed payment in exchange for entering into a binding contract that authorizes removal of one or more of their organs at death.<sup>113</sup> This is known as a forward market for organs, in that payment would occur well in advance of expected delivery.<sup>114</sup> It is important to note that a fundamental prerequisite for the functioning of the market-based system is the legal clarification of property rights in this area. Physicians must be entering confident that they have the legal right, or even obligation, to remove needed organs from the cadaver of a person who has executed a supply contract.<sup>115</sup> The contract should not be subject to renegotiation or unilateral cancellation by the family of the deceased, but at the same time, it need not be irreversible.<sup>116</sup> People should be allowed to buy back their agreement at any point for an appropriate price.

In addition to the forward market, a spot market for kidneys and other organs could be instituted as well.<sup>117</sup> Under a spot market, the organ procurement firm would approach the surviving family members of potential donors. The representative would appeal to altruism and the opportunity to salvage something good (saving someone else's life) out of an otherwise tragic experience (the loss of the relative who is to be the donor) in exchange for payment.<sup>118</sup>

The additional kidneys that would become available under a market system would provide obvious direct benefits to recipients. Patients receiving these kidneys would experience improved health and be relieved of the tiring process of dialysis.<sup>119</sup> There are several indirect benefits of a market system. First,

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110. *Id.*

111. *Id.*

112. *Id.* In fact, an institutional market for cadaveric organs would, in all likelihood, drive out a market for organs from living donors, because for the majority of the population the opportunity cost of organs obtained from cadavers is substantially less than the cost of organs obtained from living donors. *Id.*

113. *Id.* at 421.

114. *Id.*

115. *Id.* at 431.

116. *Id.*

117. *Id.*

118. *Id.* at 427.

119. *Id.* at 429.



an increase in the quantity of cadaveric kidneys supplied should lead to improvements in tissue matching between the transplanted organs and their recipients.<sup>120</sup> In addition, the increase in supply would allow surgeons to be more selective about the overall condition of the organs transplanted.<sup>121</sup> The enhanced supply of organs expected under a market system would make greater selectivity possible, thereby improving cadaveric organ transplant success rate.<sup>122</sup>

Second, an increase in the number of cadaveric kidneys made available for transplantation would permit a reduced reliance upon living donors.<sup>123</sup> This would alleviate cost to living donors in terms of lost time from work, pain of major surgery, and risks that result from loss of kidneys.<sup>124</sup> Third, people who donate kidneys also constitute the principal source of hearts and livers for transplantation.<sup>125</sup> An increased number of kidneys harvested under a market regime will therefore be accompanied by an increased number of hearts, livers, and other organs.<sup>126</sup> Thus, patients in need of these other organs will also benefit from adopting a market system of kidney procurement.

Fourth, an increase in the quantity of organs supplied is likely to lead to reductions in the cost of performing transplant operations, especially hearts and livers.<sup>127</sup> For example, the cost of a kidney transplant has fallen from about \$100,000 to about \$25,000 over the 1962-1988 period.<sup>128</sup> Heart, liver, lung, pancreas, and other organ transplantations are now at a relatively early stage of development. A substantial increase in the number of such transplants performed annually could have a dramatic effect on the costs of these types of surgeries.<sup>129</sup> As these costs fall, the treatment would become available to an increasing number of individuals in need of such operations.

While there is general agreement that potential recipients are dying while utilizable organs are being wasted, the commentators disagree sharply on whether allowing the commercial sale of organs would be an effective and acceptable means of dealing with the problem.<sup>130</sup> Proponents argue that society cannot

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120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 430.

124. *Id.* These costs are no longer warranted by differential success rates between cadaveric and living donors. The continued reliance on the living donor is more likely due to the prolonged waiting period. An increase in the quantity of organs supplied would largely alleviate these problems. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. Crespi, *supra* note 99, at 55.

rely upon the altruistic feelings of people to provide society with organs. Instead, society must capture people by appealing to their economic self-interest to ensure that the unpleasant tasks that need to be done are carried out.<sup>131</sup>

B. *Pressure From Outside Sources as a Method to Halting Organ Harvesting in China's Prisons*

1. *United Nations*

The United Nations Special Rapporteur on extrajudicial, summary or arbitrary executions should take a more aggressive role in the investigation of the alleged human rights violations occurring in China's prisons. The Special Rapporteur receives communications from non-governmental organizations, individuals and sometimes governments, containing information concerning alleged human rights violations. Once a year the Special Rapporteur makes reports to the United Nations Committee on Human Rights.<sup>132</sup> It is the responsibility of the Special Rapporteur to send different types of communications to various governments defined by the nature of the human rights violations occurring in that country. In most cases, it is the Special Rapporteur's primary concern to establish whether the state has complied with its obligation under international law to prevent violations of the right to life, or where extrajudicial, summary or arbitrary executions have already occurred, to investigate the case circumstances of the death, identify the perpetrators and impose appropriate sanctions.<sup>133</sup>

Concerning the reports and allegations received by the Special Rapporteur, there are two principal difficulties he is continuously confronted with. First, he is only mandated to act upon information about human rights violations which come before him.<sup>134</sup> Therefore, if he finds himself in a situation where there are serious grounds to believe that extrajudicial, summary or arbitrary executions are being committed in certain countries, even if they are covered by extensive reports in the media, and he has not received any allegations, he cannot act. Second, the Special Rapporteur has to decide on the credibility of the allegation being made, or whether it is politically or otherwise motivated. The more information that the allegation contains

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131. *Id.* at 56. "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, bur from their regard to their own interest, we address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." *Id.*, quoting ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 14 (Modern Library 1937) (1776).

132. U.N. ESCOR, 49th Sess., Agenda Item 12, at 2, U.N. Doc. E/CN.4/1993/46 (1992).

133. *Id.*

134. *Id.* at 4.

concerning the particulars of the purported victim (full name, age, place of residence or origin, profession, marital status etc.) and the precise circumstances of the incident (date, place, description of how the event occurred, etc.) the more likely it is that the allegation will be considered credible and forwarded to the state concerned.<sup>135</sup> In principle though, the Special Rapporteur transmits all allegations he receives unless he has serious grounds to believe that the information provided is not credible.<sup>136</sup>

If the Special Rapporteur receives an allegation and determines its validity, he then sends urgent appeals and follow-up letters to the government of the country in which the alleged violations are taking place. It is hoped that the governments concerned will support him in the matter by providing him with updated information on cases under investigation. The Special Rapporteur often receives replies which are incomplete. In some instances, replies are general in character and do not refer to the particular cases transmitted; sometimes governments address special issues related with the mandate, without going into details with regard to the cases, and some governments inform the Special Rapporteur that the cases are being investigated.<sup>137</sup> Examples of complete replies would include assurances from the government that the offenders have been identified and brought to justice, and that measures have been undertaken to effectively prevent reoccurrence.

However, such assurances are not always an indication that the violations have ceased. It is the Special Rapporteur's primary concern to establish whether the state complied with its obligation under international law to prevent violations of the rights to life, or where extrajudicial, summary or arbitrary executions have already occurred, to investigate the cause and circumstances of the death, identify the perpetrator and impose necessary sanctions. Thus, it may be necessary to visit The People's Republic of China in order to evaluate the allegations by human rights groups and the media, that China is executing prisoners for the purpose of harvesting organs. On-site visits are the only means by which the Special Rapporteur can familiarize himself with the facts and report to the United Nations Commission on Human Rights so that the United Nations can act to halt the harvestation of prisoners' organs in China.

## 2. *Foreign Governments*

With advances in medical technology and the desire to prolong life comes an increase in the responsibilities of the international communities to ensure that proper measures are enacted to guard against the violation of basic human rights. Foreign governments, especially in the Asia region, should take steps

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135. *Id.* at 5.

136. *Id.*

137. *Id.*

to discourage or bar their citizens from obtaining organ transplants in China until such time as rigorous regulations and procedures are enacted by the Chinese government to ensure that prisoners' organs are not involved and that any organs for such use have been obtained with full prior consent of the donors or their families.<sup>138</sup>

In order to discourage its citizens from traveling to China for organ transplantation, each country should implement an organ procurement program of its own to increase the availability of organs for its citizens. In addition, citizens of other countries should be made aware of the risks involved in the transplantation operation. Many people are not educated about the risks involved in transplantation surgery. The risks involved in traveling to China to receive an organ taken from a prisoner are substantially greater than in many countries. Due to the widespread disease in prisons and the lack of any pre surgical testing of organs, the risks of obtaining an organ infected with hepatitis or AIDS is far greater than if the transplant were to be performed in a country that had a system regulating such operations.

Not only should other nations discourage or bar its citizens from obtaining transplants in China, other nations should apply direct pressure on the Chinese government by refraining from entering into or continuing any current trade agreements until the government puts an end to its current activities. Only after the Chinese government stops killing prisoners to obtain organs should any country resume trade negotiations or agreements with China.

### 3. *Medical Establishments*

Foreign funding agencies, medical establishments and individual health practitioners should adopt a strict policy of non-participation in all People's Republic Of China government sponsored organ transplantation related research programs or academic gatherings.<sup>139</sup> Foreign medical and pharmaceutical companies, such as Switzerland's Sandoz, which currently supply goods or services to China's organ transplant establishment should cease all such commercial activities until the Chinese authorities have demonstrated that executed prisoners' organs are no longer being used for transplant purposes.<sup>140</sup>

## VI. CONCLUSION

Organ transplantation is a relatively new procedure in the medical world and, although the procedure is becoming quite routine and the success rate

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138. HUMAN RIGHTS WATCH/ASIA, *supra* note 1, at 33.

139. *Id.*

140. *Id.*

continues to rise, one major problem still remains: the demand for organs far exceeds the available supply. As a result, China has been taking organs to be used for transplantation purposes from executed prisoners. The Chinese Government may rationalize this practice by a philosophy that, "it happens only in rare instances and it's what the prisoner owes to society." However, the fact that it occurs even in the first instance clearly violates both Chinese and international law. Yet directives issued by the Chinese government create ways for law enforcement officials to circumvent existing laws requiring consent prior to organ removal.

China should ban all further use of prisoners' organs for transplant operations, and should comply with the United Nations Charter, the International Covenant on Civil and Political Rights, the Standard Minimum Rules of the Treatment of Prisoners, the Code of Conduct for Law Enforcement Officials, and the Principles of Medical Ethics Relevant to the Role of Health Personnel, Particularly Physicians, in the Protection of Prisoners and Detainees Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment. By implementing one of the proposed solutions suggested in this Comment, China would be able to solve the current shortage of organs available for transplant, and simultaneously comply with both its own laws and those of the international community. A comprehensive system of voluntary organ donation may seem to be far off in China's future, but every step in that direction is a step towards preserving the human rights of prisoners in China.

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