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The Importance of the Principles of Equality of the EU Member States and Economic Actors in EU law

I The Consequences of the Eastern Enlargement of the European Union: Economic Effects and the Conundrum of 'Loss' of Sovereignty

The Europe Agreements of 1997 and, subsequently, the EU accessions by the Czech Republic, Hungary and Poland in 2004 are viewed today as an inevitable and logical consequence of the fall of the Berlin Wall and the dissolution of the Soviet Union. However, even at the time of concluding the Europe Agreements, membership of our countries in the Community was by no means a foregone conclusion. Whilst participating in the Europe Agreements negotiations, I vividly remember that the joint Czech, Hungarian and Polish efforts to obtain assurances that our three countries would achieve fully-fledged membership of the European Union failed. The identical preambles of the first three Eastern Europe Agreements did not contain any promise of membership.The accession process constituted a challenge to post-socialist countries, but a voluminous *acquis communantaire* was implemented rapidly and rather successfully. Delays and difficulties in its adoption have been overcome thanks to the efforts of the political and economic actors in the new Member States and the assistance of the EU administration.

On balance, the results of the European enlargement, the tenth anniversary of which we are celebrating today, are greatly beneficial for both the old and new Member States. The implementation of the *acquis* and the obligations of the new members undertaken in the Europe and the Accession Agreements was by no means easy and cost-free but it was generally successful. From the new Member State's perspective, the main gains include both economic and political benefits. Joining the common market has enabled our economies to benefit from the freedoms of movement of goods, services, capital, and labour, which are enforced at less than equal speed. Of course, the freedom of labour has been delayed and not fully implemented, even today. However, on balance, the new Member States have undoubtedly gained a lot from their

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accession. Economic advantages also include significant direct financial assistance from Brussels. By way of example, the current 7-year EU budget provides for Poland an equivalent of about EUR 100 million. Sceptics indicate that about 70 per cent of this sum will be paid directly or indirectly to foreign EU firms. However, it is worth noting that the projects financed by Brussels will improve our road and railway infrastructure and other critically important projects aimed at modernising our economy.

Indeed, the costs of implementation of the *acquis,* which is aimed at implementing the four freedoms, involved financial and social costs but, as a rule, they constituted the necessary costs of transformation from a centrally planned economy into a free market economy.

The benefits of accession are not limited to the aforementioned economic gains. The new Member States may 'pick and choose', substantially free of charge (i.e. without a license fee), from among numerous, sometimes contradictory, legislative and organisational blueprints developed in the old Member States. Whilst some of them are similar or complementary, there are important areas where leading EU countries developed and practise diverging, if not contradictory, solutions. For instance, in the area of labour relations (in particular in the field of employee participation in the management of firms), we observe opposing policies and legal standards epitomised by the British and German governance models of labour relations. It remains to be seen if Eastern enlargement will tip the scales in favour of the UK or the German model of employee participation or whether the issue will be left to market forces.

The overall balance sheet of the EU accession by Hungary and Poland a decade ago is best illustrated by comparing the main economic indicators of our economies with those of our neighbours to the east of our countries. Moreover, the earlier tensions in Georgia and the current Ukrainian conflict demonstrate the significance of EU membership, which functions not only as a model in designing our basic economic and social policies but as an anchor of our political stability.

And yet, an overall positive evaluation of the decision to join the EU and the fact that its effects are unquestionably beneficial does not mean that we do not face difficult issues. At the outset, I should mention the 'sovereignty conundrum' upon joining the European Union and after the adoption of the Lisbon Treaty. Taking into account the positive effects of EU membership, one could expect that ethnic and nationalistic attitudes would gradually diminish and finally disappear. However, we observe that such attitudes seem to be on the rise in the majority of the new Member States. Apart from this, ethnic and nationalistic attitudes are visible also in old Member States, for instance in France, the UK, Finland and the Netherlands. The sovereignty conundrum is explained by several factors. First, many citizens of the former socialist countries feel uneasy about giving up or accepting any limitation of their newly regained independence. As explained by a Hungarian professor, 'Past communist states cannot escape becoming nation-states because the community and homogeneity necessary for the functioning of a state will be based on ethnic community'.[1] The mobilisation function is an important aspect of nationalist

1 A. Sajo, *Protecting Nation States and National Minorities: A Modest Case for Nationalism in Eastern Europe,* (University of Chicago Law School Roundtable 1993) v. 53, 53.

ideologies. J. Breully identifies three functions of such ideologies which render nationalism an effective instrument of political action in the modern State: coordination and mobilisation of civic activities and legitimacy.[2] W. Sandurski, a prominent Polish constitutionalist, makes an interesting observation, namely that the appeal to cultural identity is often a substitute for the failure of political parties to connect their programmes with significant social interests.[3] While describing the robustness of nationalism in our region, the author draws attention to the fact that nationalism has found fertile ground in those new EU members in particular which 'are literally speaking "new" states (all three Baltic states, the Czech Republic, Slovakia and Slovenia).'[4] In his opinion, 'these new states strongly appeal to their national identity, both as a way of asserting their legitimacy in the international order and of matching a new territorial polity to an ideology which provides the necessary degree of coherence and mobilization to make a new political elite sufficiently comfortable.'[5] While agreeing that the nationalistic movements in these countries are on the rise and push the dominant elites towards more nationalistic policies than preferred thereby, I do not see any difference between the robustness of the ethnic feelings in the 'new' and 'old' states of our region. Moreover, despite the divorce between Slovakia and the Czech Republic, the latter polity has a somewhat longer state tradition than Poland. Furthermore, Lithuania has a much longer state lineage than that of Slovakia and Slovenia.

The transfer of a part of sovereign power to the supranational authority is not easy to some segments, if not to the majority, of the electorates in Poland and even more so in Hungary, the 'old' countries of the region. However, it is by no means clear that the strong identification that ethnic feelings provide (especially a strong endorsement of one's nation's independence) is hostile to a voluntary transfer of some sovereignty in exchange for a fair bundle of rights and duties at the supranational level. The 'realists' among many Poles, who see the transfer of sovereignty conundrum as a real problem, endorse the Lisbon Treaty and are even willing to accept granting further powers to Brussels institutions, providing certain conditions are met.

As long as the EU remains a community of national states, their governments play a decisive role in the Council. Hence, the question arises as to what extent, if at all, the EU constitution provides for the equal status of Member States.

Traditionally, sovereignty and equality of states have been viewed as two interrelated concepts incorporated in Art. 2.1 of the Charter of the United Nations. The principle of Sovereign Equality has been long recognised in customary international law and formally reaffirmed by the League of Nations. Because of its incorporation in the United Nations Charter, all members have to follow the principle.[6] The concept of sovereign equality of states implies, inter alia, that each

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2 J. Breuilly, *Nationalism and the State* (Manchester University Press 1982, Manchester) 349-350.

3 W. Sandurski, 'The Role of the EU Charter of Rights in the Process of Enlargement' in G.A. Bermann, K. Pistor, (eds), *Law and Governance in an Enlarged European Union* (Oxford and Portland 2004, Oregon) 74. The author argues that Breuilly's remarks regarding the role of ethnic policies in post-colonial states apply equally to post-communist countries of Central and Eastern Europe.

4 Ibid, 74.

5 Ibid.

6 Sbugdha Nahar, Sovereign Equality Principle in International Law, <http://www.globalpolitican.com/print.asp?id=4351> accessed 24 March 2014.

state has the legal competence to participate in the UN and other international organisations on an equal footing with other states, conclude treaties, govern its internal affairs, and protect its territory.[7] Moreover, the principle endorses comity and respect *vis-à-vis* all states.

The Principle of Sovereign Equality is sometimes characterised as ius cogens. However, the UN Charter's rules on the powers of the Security Council conclusively prove that the member states are competent to derogate from it. Moreover, even in the General Assembly the principles of 'one state one vote' and unanimity hardly exist. In practice, important matters are decided on a two-thirds' majority and others on a simple majority. As such, there is no doubt that the EU constitution (i.e. the Lisbon Treaty) and its other governance rules is either a multilateral delegation of sovereign powers to the supranational organs or a limitation of the sovereign equality of the EU member states.

Polish scholars stress that each international agreement assumes a surrender of some sovereign rights, but that such practice constitutes an exercise of sovereignty.[8] Of course, there is no doubt that there are quantitive and qualitative differences between standard international covenants and the consequences of EU accession. In particular, limitations of sovereignty are material and visible when a member state is bound by regulations or directives adopted by the competent EU organs (the Council and the Commission). In all fairness, the principle of the sovereign equality of EU member states is also deeply limited by the rule of primacy of community law over our domestic laws. The latter proposition evokes a still unresolved conundrum of potential conflicts between EU law and the constitutions of the Member States.

Theories of the joint exercise of sovereign powers of EU Member States by the Community organs and the transfer of partial state powers to Brussels as an international organisation offer interesting solutions aimed at reconciling the principle of sovereign equality with EU membership. However, in all fairness, the traditional concept of sovereignty of states has been substantially eroded and redefined. Several experts in constitutional law in old and new EU Member States advocate the abandonment of the traditional principle and the development of a modern concept of the sovereign equality of states.[9]

The limitations of the traditional principle, enshrined in the UN Charter as a consequence of EU accession, seem to be justified in the light of globalisation and geopolitical realities. Recent events in Ukraine illustrate the contrast between the real value and effects of the unrestricted but formal sovereignty of our Eastern neighbour, whose independence and its borders were guaranteed by major powers a few years ago in Budapest, and the practical consequences of the limited sovereignty enjoyed by its former Comecon partners that have joined the EU.

However, in all fairness, I am not advocating a radical abandonment of the critically analysed concept of sovereign equality of states as a basis for orderly intra-community state relations. Tensions and conflicts between national interests and the policy goals of the EU should be

7 R.H. Steinberg, 'Who is Sovereign' (2004) 40 Stanford Journal of International Law 1.

8 See, for instance, A. Raczyńska, 'Reinterpretacja pojęcia suwerenności wobec członkostwa w Unii Europejskiej' (2001) 1 Przegląd Europejski, 113-114.

9 W. Sadurski (n 3) 78-80.

resolved whilst taking into account that all Member States are equal despite obvious inequalities in other respects: inequality of size, cultural tradition, population, GNP per capita, etc.

Whilst constitutional covenants granting new powers to the EU Commission, the Council and the Court of Justice should be fully respected as necessary requirements of fostering cooperation and effective governance of the Community, the *residual aspects of the principle of sovereign equality* shall be taken seriously. Furthermore, limitations of this traditional principle, granted in accordance with the constitutions of Member States to the supranational organs, should be *strictly interpreted* with the aim of avoiding conflicts between the Lisbon Treaty and the constitutions of the Member States.

The temptation to think mainly in terms of national interests rather that in the interest of the common market is not alien to policy makers from large and small EU members. However, the latter countries are usually afraid to use their veto power, which is viewed as a political weapon of mass destruction and, sometimes, self-destruction.

Past intra-EU conflicts show that major member states, such as Germany, France and the UK, have resorted to open or veiled threats to use their veto powers more frequently and successfully than the other members. Examples include the UK claw-back of special tax privileges and current threats to block the Tobin tax on financial transactions.[10] In addition, Germany successfully derailed the adoption of the takeover directive in 2001 and the European Private Company project in 2012. Small and medium size EU members are frequently irritated when the Council and the Commission interpret the principle of equality along the lines that 'all states are equal but some of them are more equal than others'. Such special treatment was visible when both France and Germany violated Euro disciplines regarding permissible levels of budgetary deficits. Also, the European Commission has approved generous state aid packages for German and French-Belgian banks, while insolvent Greek and Cypriot financial institutions had to apply tough restructuring procedures, including the participation of bank creditors and large deposit-holders in covering bank losses.[11]

The EU Commission's interventions regarding 'golden shares' in partially or newly privatised companies, where states established privileged corporate rights, also reflect the principle that some states are more equal than others. For several years, it challenged 'golden shares' almost exclusively established in Southern Europe (e.g. in Portugal, Spain and Italy); then it charged similar practices in France, Britain and Benelux countries before it directed its otherwise legitimate legal crusade in Germany, although the Volkswagen special corporate rights existed earlier than those successfully defeated in other countries.[12]

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[10] The Tobin tax constitutes a taxation of transnational financial transactions (FTT), Financial Times 22 May, 2013.

[11] By way of example, in the case of *H.RE*, a German bank, the Commission, which rightly advocates the concept of 'bail in' by creditors of insolvent financial institutions, approved a state aid package which covered 95% of all the losses of the bank. See further J.P. Krahnen, *Why Bail In is not a Fata Morgana* (Goethe University, House of Finance 2013, Frankfurt) <http://screm.com/aphp?sid=5hm2t.1dsaa48>.

[12] See generally S. Sołtysiński, 'Golden Shares: Recent Developments in E.C.J. Jurisprudence and Member States Legislation' in: S. Grundmann, B. Haar, M. Merkt, P. Mülbert, M. Wallenhoter et al. (eds) *Festschrift für Klaus J. Hopt* (W. de Gruyter 2010, Berlin, New York) v.2, 2571ff.

Although the principle of sovereign equality is limited by the EU governance rules and powers granted to Community institutions, its remaining residual components permit new Member States to argue in favour of a more harmonious and balanced implementation of all four freedoms. The history of EU policy conflicts shows that the most developed economies pay more attention to the freedoms of movement of capital and goods than to the freedom of labour. Naturally, many new Member States are more concerned with the freedoms of movement of workers and, to some extent, the freedom of provision of services. These natural conflicts of policies are also reflected in the process of implementing measures promoted by the EU Commission and even in the case law of the Court of Justice.

It is also worth mentioning that whilst the principle of equality of states is not mentioned in the Lisbon Treaty but 'exists' in the residual form based on international law, the doctrine of equal treatment and non-discrimination of economic actors (i.e. companies sensu largo) is well established in articles 49 and 54 of TFEU. A recent judgement of the Court (Grand Chamber) of 5th February 2014, dealing with the Hungarian progressive turnover tax, illustrates the scope of applying the concept of indirect discrimination.[13] The Court ruled that

> Articles 49 TFEU and 54 TFEU must be interpreted as precluding legislation of a Member State relating to tax on the turnover of store retail trade which obliges taxable legal persons constituting, within a group, 'linked undertakings' within the meaning of that legislation, to aggregate their turnover for the purpose of the application of a steeply progressive rate, and then to divide the resulting amount to tax among them in proportion to their actual turnover, if – and it is for the referring court to determine whether this is the case – the taxable persons covered by the highest band of the special tax are 'linked', in the majority of cases, to companies which have their registered office in another Member State.

The foregoing decision is in line with earlier precedents of the ECJ; these explain that neither the protection of the economy of the country nor the restoration of budgetary balance justify such indirect discrimination.[14]

A deeper analysis of this and other cases implementing the four basic freedoms and initiatives of the EU Commission and the Council demonstrates that they frequently foster the interests of the companies with headquarters in the most developed economies and are organised in the form of groups. Freedoms of movement of labour and provision of less sophisticated services, that require a significant component of manual work, enjoy less interest in Brussels, and are subject to long transition periods. Of course, freedom of movement of capital is less visible and, paradoxically, entails fewer social tensions than the freedom of movement of workers. Admittedly, the reaction of the population in the old and new member states is basically similar in this respect. Foreigners are more visible than foreign capital or financial services.

Several authors argue that the risk of a new financial 'bubble' is real, because unequal treatment of economic actors is coupled with the legal rules which treat the governments and

[13] Case C-385/12 *Hervis Sport- és Divatkereskedelmi Kft. v Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága* (5 Februar 2014).

[14] See ECJ Case C-35/98, *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071, paras 47 and 48.

central banks of each Member State of the European Economic Area surprisingly equally.[15] Even German regulations aimed at assuring adequate capital requirements for credit institutions treat the obligations of all Member States and their central banks as high quality liquid assets which are completely risk-free.[16] Such an over-optimistic assessment of credit risk exists in the regulations of the majority of EU countries, despite the notorious crises of Argentina, Greece and Cyprus and the near insolvencies of Ireland and Spain. As a result, financial institutions are more than willing to invest in government bonds and extend credit to the zero risk states. Recently, a German professor put forward a provocative comment: 'The banks feed the sovereigns' ever-growing hunger for more money and sovereigns repay with the guarantee that the investment does not share the fate of a loan. But a closer look at the history of defaulting states […] reveals that such a guarantee is based on a mere fiction.'[17] Paradoxically, the equality of states and their central banks is respected only for the purpose of limiting the financial risks of the banks feeding spendthrift governments, which deserve to be treated equally but with other commercial debtors rather than benefit from their sovereign status in this field.

So far, the countries of the Visegrad Group have failed to develop a common platform advocating a harmonious and more balanced implementation of the four freedoms. Despite their overall good political relations, Budapest, Prague, Bratislava and Warsaw rarely conduct joint in-depth economic or legal studies of controversial policy issues, such as the EU Patent Package or the consequences of the close-out netting privileges proposed by the European Commission in the context of the EU Insolvency Regulation.[18] I will revisit these two issues in the next sections of this paper.

II The Demise of the Principle of Equality of Economic Actors

1 The Problem

In the preceding section, I contrasted the importance of the tenets of equality and non-discrimination of companies in TFUE against the background of limitations of the principle of equality of sovereignty of the EU member states. Now, I would like to draw the reader's attention to a new phenomenon of departures from the traditional principle of equality of economic actors by way of granting privileged status to firms of systemically important sectors ('SIFIS'). This trend is visible not only in the EU but also in many other OECD countries. I will illustrate this

15 C.G. Paulus, 'Some Thoughts of an European about the Interrelationship of Sovereign Debt and Distressed Banks' [2014] Texas International Law Journal<http://www.tilj.org/forthcoming>; S. Merler, J. Pisany-Ferry, 'Hazardous Tango. Sovereign-Bank Interdependence and Financial Stability in the Euro Area' (2012, April) 16 Bank de France Financial Stability Review.

16 *German Solvabilitätsverordnung* of 20 December 2012, BGB L1, 2926.

17 Ibid.

18 Proposal for a Regulation of the European Parliament and of the Council Regulation No. 1346.2000 on insolvency proceedings, Brussels 25 February 2014, 5983/1/14, DGZ ZA.

process, its actors and consequences by describing the lobbying successes of financial institutions, intellectual property owners and foreign investors.

Whilst new EU Members may sometime complain about the unequal attention paid by the EU organs to the balanced implementation of the four freedoms, their companies have a chance to benefit from the common market and 'catch up', provided, inter alia, that the antitrust policy of the Commission and the national antimonopoly offices keep the market reasonably open for small and medium size companies (SMEs), and in particular for new firms. However, free competition may be seriously limited if the EU and local legislators continue to grant legal privileges to firms in the most lucrative sectors of the economy dominated by firms from leading OECD countries. Apart from in the United States, there is little discussion on the consequences of this new trend. Again, the new EU member states should be vitally interested in analysing the economic and social implications of these developments.

2 The Close-out Netting Super-priorities

During the last 25 years, financial institutions have developed new legal instruments aimed at reducing their risk exposure when trading in derivatives, swaps, repurchase contracts ('repos') and other new financial instruments, in particular in the event of insolvency of a counter-party. Various types of netting transactions employ mechanisms similar to the traditional set-off or novation but they are functionally and conceptually different from the latter concepts. Close-out netting is usually described as an umbrella agreement covering a bundle of financial instruments and other transactions ('Eligible Contracts') between two parties, who have agreed that, upon the occurrence of a predefined event (default), the party 'in the money' (i.e. the non-defaulting party) may terminate all contracts covered by the netting agreement, which shall become immediately due and the party which is 'out of the money' shall pay a net amount to the counter-party. Depending upon the terms and conditions of the umbrella agreement, often described as the 'master agreement', close-out netting occurs automatically or upon the wish of the non-defaulting party. As a rule, the calculation of the net amount of all unperformed obligations is performed by the party which is 'in the money' in accordance with a contractually agreed formula. The single net payment obligation constitutes the only obligation in lieu of all terminated contracts covered by the master agreement.[19]

The close-out netting master agreement frequently covers dozens or sometimes hundreds of contracts. Netting is mainly a product of banks and other financial institutions that offer such agreements to other financial institutions or large firms of the 'real' economy. During the last two decades the denomination of 'close-out netting' has become widely used in the standard agreements drawn up by market associations, such as the International Swaps and Derivatives

[19] P. Paech, *Preliminary Draft Principles regarding the Enforceability of Close-out Netting Provisions,* UNIDROIT 2012, Study LXXVIII L-Doc. 11, January 2012, at 3.

Association (ISDA) and the International Capital Market Association (ICMA). This paper analyses the consequences of the special status of close-out netting and its underlying transactions in the event of insolvency of a party to the umbrella (master) agreement.

The prevailing model of bankruptcy law in the US and EU countries favours restructuring a failing firm's business and repayment of its debts, partially or wholly, upon the firm's reorganisation. Upon declaration of insolvency, creditors may not collect and set off their debts, even if they are due. The estate's administrator has broad powers. He may assume or reject outstanding obligations, recover pre-bankruptcy fraudulent conveyances when the debtor made payments or granted other benefits to its creditors for less than fair value, etc. The most fundamental principles of bankruptcy law are equal treatment of creditors and a directive of reorganisation of the insolvent firm rather than its liquidation by selling separate assets of the estate.

Banks and other financial institutions have long tried to receive special treatment in bankruptcy laws. In the United States, for instance, some financial transactions were insulated from the rigours of bankruptcy law in the Bankruptcy Code of 1978. Despite a gradual expansion of the scope of the special status of financial transactions in the 1980s and 1990s, until the Bankruptcy Abuse Prevention and Consumer Protection Act 2005,[20] substantial uncertainty surrounded the range of transactions and parties eligible for a statutory recognition of enforcement of close-out-netting in insolvency proceedings and close-out netting was granted almost complete immunity from the disciplines of bankruptcy laws.

The US Bankruptcy Reform Act (2005) radically expanded the definition of protected financial transactions. Companies eligible for close-out netting have been 'liberated' from bankruptcy disciplines. The privileged transactions cover, inter alia, swaps, forwards, commodity contracts, repurchase agreements (repos) and securities contracts.

The reform of 2005 granted the above privileges not only to banks and other regulated financial institutions (such as commodity brokers, forward contract merchants and stockbrokers) but to all 'financial participants, defined as a clearing organization or an entity that entered protected financial transactions worth at least USD 1 billion in national value (or USD 100 million in mark-to-market value) anytime during the preceding 15 months'.[21] This was just one example of the new principle that the big creditors should be treated with a bit more respect than lower class creditors.

The 'safe harbours' for financial products advocated by ISDA and other propagators of netting have been justified as necessary instruments for the protection of financial markets, including over the counter ('OTC') markets. Without these protections, parties to derivatives transactions, swaps and close-out netting agreements would be subject to automatic stays for extended periods. While the bankruptcy administrator (trustee of a bankrupt entity) would be allowed to assume 'in-the-money' contracts and reject 'out-of-the-money' contracts in an effort to perform a successful restructuring of the debtor. These characteristic powers of the bankruptcy

[20] Pub. L. No 109-8, §§, codified at 11 U.S.C. § 362(a) of 2000, here-and-after US Bankruptcy Reform Act 2005.

[21] § 907(b) (i) (3), as codified at 11 U.S.C § 01 (22A).

administrator are pejoratively described by financial industry lobbyists as 'cherry picking'. According to this view, losses from exposure to 'cherry picking' and other bankruptcy rigours could undermine the stability of the financial markets.

The second rationale for special treatment of parties to financial transactions is that repos, derivatives and, in particular, the netting agreements that may cover a dozen or more underlying contracts are too complex and too interconnected to be treated in the same way as other contracts. The complexity rationale is sometimes merged with the argument that many financial institutions function merely as middlemen. The whole clearing chain would become paralysed if a broker were to be exposed to bankruptcy law disciplines.[22]

The third justification in favour of special treatment of parties to financial transactions has been that the application of the bankruptcy rules to financial transactions would create a risk of market 'grid-lock' and interfere with the handling of monetary supply. US industry representatives and the Federal Reserve argued that, without special treatment, the netting and swaps markets would be destabilised.[23]

The fourth rationale aimed at justifying close-out netting stresses the fact that netting reduces the risk arising under a cluster of transactions to the net amount, thus reducing the equity amount required by banks and other regulated financial institutions by up to 85-97%.

Following its success in the US, financial institutions soon persuaded market regulators and policy makers in other jurisdictions to adopt similar 'netting friendly' laws. The crusade orchestrated by the ISDA has resulted in a proliferation of 'netting friendly' reforms of bankruptcy laws.[24] By the middle of 2011, netting agreements and the underlying financial transactions had been 'liberated' from the impact of bankruptcy laws in more than 40 countries. The EU Directive Amending the Settlement Finality Directive and the Financial Collateral Arrangements Directive provides that credit claims constitute an eligible type of collateral to financial collateral arrangements.

A prominent executive of the ISDA explains that close-out netting is an essential component of the hedging activities of financial institutions and other users of derivatives.[25] He rightly stresses that swap dealers and other traders try to limit their exposure by maintaining a matched

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[22] Arguments presented in favour and against of special treatment of financial transactions are discussed by D. Skeel and T. Jackson, 'Transaction Consistency and the New Finance in Bankruptcy' (2012) Col.L.Rev., v. 112, 152-202. See also E.R. Morrison, J. Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Market from Bankrupt Debtors and Bankruptcy Judges,* (Columbia Law School, The Center for Law and Economic Studies 2006) <http//ssrn.com.abstract=8783289> 1-5.

[23] S. J. Lubben, 'Derivatives, Netting, Insolvency, and Users' (1995) 112 Banking Law Journal, 638, 640M. Krimminger: *Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts* (October 11, 2005) available at www.f.dic.gov. The debate in Congress in the 1980s and 1990s is summarized by D. Skeel and T. Jackson (n 22) 8-11.

[24] ISDA has over 830 members from 60 countries. They include the majority of dealer's associations that are in the business of privately negotiated derivatives and financial transactions, including cross-border deals. The ISDA publishes standard contracts for users of close-out netting agreements and templates for transactions in OTC derivatives. See P.M. Werner, 'Close-Out Netting and the World of Derivatives in Central and Eastern Europe and Beyond-ISDA's Perspective' [2012] Law in Transition, at 49.

[25] Peter M. Werner (n 24) 51.

(balanced) book of offsetting transactions: 'The result of this hedging activity is that, [...] the aggregate of derivatives activity includes a large number of inter-dealer and other hedge transactions that function largely to adjust risk positions and limit exposure to market movements'.[26] The author points out that dealers do not wish to retain their exposures to unanticipated market movements. Legislative recognition of close-out netting that provides for the insulation of such agreements from the intervention of an insolvency administrator's 'cherry picking', 'claw-back' claims with regard to payments made by the insolvent entity on the eve of bankruptcy and other bankruptcy law rigours, radically limits the risk of the eligible parties (i.e. non-defaulting counterparties to financial transactions that obtained privileged status by 'netting-friendly' laws).

According to the Bank for International Settlements, close-out netting reduces the risk exposure of the non-defaulting party by up to 85%.[27] According to the British Bankers' Association, enforceable netting agreements would reduce the risk and capital requirements of their members for such transactions by 95-97%.[28] The objectives of the crusade aimed at assuring legal certainty for close-out netting master agreements drawn up by the ISDA are thus clear. Their main goals are twofold: (1) to minimise the risk of financial intermediators and (2) reduce the capital requirements of banks and other regulated financial institutions doing business in the form of close-out netting (e.g. bank capital requirements under the Basel rules).

The adverse macro-economic consequences associated with the growing privileges granted to eligible financial parties by Congress since 1978 were identified by a few legal scholars, who expressed scepticism about the soundness of the policy of granting bankruptcy priorities. Several early studies alerted legislators that if the risk of one class of creditors is lowered by Congress, it would be transferred to passive and less sophisticated creditors, such as consumers, tort claimants and employees.[29] The evidence from the crisis analysed in several legal and economic studies, published during the last five years, demonstrates that the decisions to leave the market of derivatives largely unsupervised, coupled with the special treatment of financial transactions in bankruptcy law, did not contribute to keeping systemic risk under control. On the contrary, solid data have been compiled which indicate that these legislative decisions constituted factors that had accelerated the financial crisis. Several scholars in the field of bankruptcy law presented evidence that the privileges granted to the 'eligible parties' by the US bankruptcy law reform in 2005, which had been justified as keeping systemic risks in check, actually exacerbated them. They triggered 'fire sales' of collateral of such defaulting parties as Bear Stearns, Lehman Brothers and A.I.G. by the parties 'in the money' (e.g. J.P. Morgan and

[26] Ibid.

[27] P. Paech, *Preliminary draft Report on the Need for an International Instrument on the Enforceability of Close-Out Netting*, UNIDROIT 2011, Study LXXVIII C-Doc. 2, March 2011, 17.

[28] British Bankers' Association, Special Resolution Regime – Response to HM Treasury Consultation Document (2009) 4.

[29] See A. Schwarz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 Journal of Legal Studies 1-3, 7-8, 11-13; L.A. Bebchuk & Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale Law Journal, 857ff.

Goldman). Studies of the collapse of Bear Stearns and Lehman Brothers demonstrate how the statutory exclusions of the automatic stays first encouraged the non-defaulting parties to terminate their contracts and then to sell vast volumes of collateral.[30] J.P. Morgan's actions on the eve of Lehman Brothers' bankruptcy are the best example of the effects of the statutory immunities from the automatic stay rule. The 'party-in-the money' terminated the contract with Lehman, froze billions in securities and cash, and demanded an additional USD 5 billion payment. Due to the special treatment of derivatives, the party-out-of-money (Lehman) could not stop its privileged creditor from selling the assets by filing for bankruptcy. While the bankruptcy administrator could not 'claw back' those assets, even if a transaction was made a few hours before Lehman's bankruptcy, except for cases of actual fraud, which is almost impossible to prove.

The argument that the special treatment of the eligible financial transactions constitutes an effective mechanism reducing the contagion risk in the event of insolvency of systemically important financial firms (the so-called SIFIS), is also refuted by economic studies. A recent analysis of AIG's debacle concludes that the 'safe harbours' replaced systemic risk in one segment of the market 'by another form of systemic risk involving "fire" sales of qualified financial contracts and liquidity funding spirals'.[31] The authors of these studies revealed that creditors of Lehman, AIG, Bear Stearns and other failed financial institutions displayed surprisingly low risk-awareness, if not negligence. This explains the surprisingly insufficient attention to the creditworthiness of their clients by such preeminent Wall Street investment banks as Goldman and JP Morgan. The bankruptcy privileges dampened their incentive to screen and monitor the risks associated with their transactions.[32] Mark J. Roe demonstrated that the *super-priorities function as disincentives for market discipline and indirectly subsidise high risk derivatives and repurchase markets.* He and other authors conclude that the US Bankruptcy Code privileges decrease the derivatives and repo players ex ante market discipline.[33]

There is ample evidence that the privileges granted to the eligible financial parties have neither increased the systemic stability of the financial markets nor reduced contagion effects. On the contrary, bankruptcy super-priorities contributed to the financial crisis, encouraged simultaneous liquidation of collateral during the crisis, and exacerbated the information gap because the aforementioned special rights discourage financial counterparties from conducting solid audits. The disincentives to market discipline caused by these privileges encouraged knife-edge, systematically dangerous financing. This is illustrated, for instance, by Goldman's financing of

30 M. Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' Stanford Law Review, v. 63 C, 539-590, at D. Skeel, T. Jackson (n 22*)* 12-13.

31 V. Acharya, B. Adler, M. Richardson & N. Roubini in Acharya, T. Coleym, M. Richardson, J. Walter, *Regulating Wall Street. The Dodd Frank Act and the New Architecture of Global Finance* (Wiley 2011) 298. An eminent German expert of transnational insolvency law recently mentioned an ostensible banality that banks need a special treatment at the expense of other firms deserve closer scrutiny 'by slow thinking.' C.G. Paulus, Some Thoughts (n 15) 2.

32 Ibid, 16.

33 Mark J. Roe (n 30) 5ff.; D. Skeel, T. Jackson (n 22) 16ff; V. Acharya, Alberto Bisin, *Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets,* (2011); <http://ssrn.com/abstract=1788187> 37.

AIG's and JP Morgan's overnight crediting of Bear Stearn. Bear's counterparties were willing to finance it for several years by way of overnight repos, until the debtor collapsed. Indeed, the alleged risk of reducing the advantages of netting and the justification of reduction of regulatory capital by credit default swaps, repos and other financial instruments covered by netting agreements has been characterised as 'trading sleight of hand' by the New York Times. The Basel Committee on Banking Supervision has proposed limiting the ways in which capital requirements can be reduced by such transactions.[34]

The privileges offered to netting contracts creditors consist of exempting them from bankruptcy law discipline. They are not subject to such insolvency law rules as prohibitions of set-offs; they do not need to return payment received from the insolvent party within a statutory period (e.g. 90 days prior to bankruptcy under U.S. Bankruptcy Code); they are not subject to the administrator's 'cherry picking' (i.e. a decision to perform or avoid a given contract), etc. As a result, such special treatment of netting disrupts the reorganisation-based nature of bankruptcy rules. The scope of those privileges is illustrated by Principle 7 (c) of the UNIDROIT Principles and Rules on the Netting of Financial Instruments, which contains a non-exhaustive list of exemptions to be granted to close-out netting parties.[35] Whilst treatment of a cluster of contracts covered by a netting agreement as a unity seems to be justified, it is worth mentioning that the proposals advocated by ISDA amount to *'mega-cherry picking'* or 'the whole cake is mine' privilege, to be assured ex ante by law and soft-law principles in favour of the beneficiaries of the close-out netting contracts.

Critics argue that the privileges granted to the netting eligible parties not only amount to an unequal treatment of other creditors but also offer special status to short-term and high risk financing arrangements at the expense of parties to less risky and longer term transactions.[36] Legislators should carefully consider extending their support to the apparent departure from the principle of equal treatment of parties to commercial transactions and substituting it with the principle of special treatment of mainly financial institutions that are 'too big to fail'. If they deserve to be granted such 'superpriorities' due to the systemic risk, this proposition should be supported by solid economic and public policy arguments. We should not close our eyes and disregard arguments to the contrary. Recent economic studies criticise the 'safe harbours' granted to qualified financial contracts (QFCs) in bankruptcy laws and, to some extent, also in the Dodd-Frank Act. They stress that the reduction of a systemic risk in one segment of the market 'is replaced by another form of systemic risk involving fire sales of QFCs and liquidity funding spirals.'[37] According to the same study, an equally strong argument against the safe harbours offered to money markets and derivatives markets is that it creates regulatory arbitrage, pushing parties

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[34] Federal Reserve, Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy, SR 11-1 (January 2011).

[35] UNIDROIT 2012, CD (91) 5(a) Add., 20-22.

[36] M. Roe, 'Derivatives Markets in American Bankruptcy' [2012] Revue d' Economie Financiere, 231ff.

[37] V. Acharya, B. Adler, M. Richardson and N. Roubini in V. Acharja, T. Cooleym M. Richardson, J. Walter, *Regulating Wall Street. The Dodd Frank Act and the New Architecture of Global Finance* (Wiley 2011) 229.

> […] toward designing complex products that can help shift assets from the banking to the trading book, which are then financed using short-term repos in the shadow banking system away from the monitoring of regulators and at substantially lower capital requirements. The effective outcome is tremendous liquidity in repo markets in good times, with systemic stress and fragility when products are anticipated to experience losses.[38]

Critics also maintain that the safe harbours offered by legislators to derivatives and repo players transfer their risks to the remaining creditors. This criticism is based upon an economic theory elaborated by Modigliani and Miller, who have developed an argument that public policies aimed at mitigating financial risks should take into account their effects on an *economy as a whole* and avoid shifting risks from shoulder to shoulder. Furthermore, several economists argue that the safe harbours offered to derivatives and repos substantially contributed to the debacle of Lehman, Bear Stearns and A.J.G.[39] Another recent economic study on derivative markets and netting demonstrates that 'Netting merely redistributes wealth among a defaulter's creditors, and this redistribution does not necessarily enhance welfare'.[40] We should also not overlook the fact that several economists argue that welfare benefits of derivatives markets are speculative because of their high costs and systemic tail risk: 'The social costs of future financial crises will continue to be correlated with the high rents in the market'.[41]

So far, the EU legal framework[42] making references to netting does not provide for substantive and conflict of laws rules in the field of bankruptcy law.

In 2013 the European Commission submitted proposals on amending Council Regulation (EC) No. 1346/2000 on insolvency proceedings, which include[43] several new provisions aimed at introducing netting privileges into the framework of the Regulation. So far Directive 2002/47 restricts the benefits of the close-out netting mechanism where both parties are financial or public institutions, but several Member States, among them Germany, France, Czech Republic, Slovenia and Belgium, have exercised an opt-out option fully or partially. The two main changes advocated by the financial institutions and adopted in the Commissions' proposals involve extending netting privileges to all companies and, more importantly, introducing conflict of law rules, according to which netting agreements shall be governed by lex contractus instead of lex

38 Ibid, 230-231.

39 J. Taylor, 'The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong, National Bureau of Economic Research' (2009) Working Paper, No. w 14 631, <www.nber.org/papers/w.14631>. Skeel D.A. (2009) 4 Bankruptcy Boundary Games, Brooklyn Journal of Corporate Finance and Commercial Law, 1-22; Stulz R.M., 'Credit Default Swaps and the Credit Crisis' (2010) 1 (24) Journal of Economic Perspectives 73-92. Similar arguments against superpriorities in bankruptcy law were made much earlier by T. Bebchuk and J. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' 4 (105) Yale Law Journal, 857-934.

40 C. Pirrong, *University of Houston* (2009), http://ssrn.com/abstract=1340660.

41 M. Singh, 'Making OTC Derivatives Safe – A Fresh Look' 2011, IMF Paper, WP//11/6617.

42 Directives on Settlement Finality 98/26/EC, Financial Collateral Arrangements 2002/37/EC and Insolvency Regulation 1246/2000.

43 Council of the European Union, Brussels 25th February 2014, 5983/1/14 REV 1, Art. 6a.

concursus. The latter proposal would mean that close-out netting provisions 'shall be governed solely by the law of the contract governing such provisions.'[44]

The above-mentioned proposals have met with strong criticism from the Belgian and French delegations. They rightly observed that the proposal to submit netting agreements to lex contractus will encourage *forum shopping* and 'give the opportunity to some creditors to escape from the collective discipline of the [insolvency] proceedings and hence, to become contractual privileged creditors (…), or to acquire a status equivalent of super privileged entities (…), which is not acceptable.'[45] The comments of the two delegations also stress that the superpriorities do not reduce global risk and constitute a factor contributing to the last financial crisis. The French-Belgian criticism echoes the warnings of the U.S. critics of netting. Countries of the Visegrad Group should therefore also analyse the problem in depth as soon as possible.

3 Special Treatment of IP Rights

Over the last 40 years, we have witnessed a significant strengthening of intellectual property rights. It was in the mid-1980s, particularly as a result of US pressure and subsequently due to the standards established under TRIPS, that the majority of its signatories had to incorporate laws ensuring effective protection of patent and other intellectual property rights. It soon turned out that the net beneficiaries of the new rules were firms from the US and a few other developed countries, whilst their markets have remained closed or difficult to penetrate by exporters of agricultural products and so-called sensitive industrial goods (e.g. textiles, steel and chemicals) from developing economies.[46] In the course of the last two decades, the Intellectual Property Alliance has continued its lobbying efforts aimed at extending the scope and duration of IP rights and sanctions for their violations. Recently, however, these repeated blanket extensions of patent and copyright terms have met with growing criticism in the US and EU. The phenomena of 'patent thickets' and 'patent trolls', coupled with a rapid increase in litigation, prompted even the Supreme Court of the United States to limit to some extent the traditional 'patent friendly' interpretation of patent laws.[47] Below, I will briefly discuss two interrelated questions: Do the newest initiatives by advocates of strengthening IP rights treat large firms and SMEs equally? Is the process of lobbying sufficiently transparent?

The Anti-Counterfeiting Trade Agreement ('ACTA') is a multilateral agreement. It was secretly negotiated and signed almost exclusively by developed countries.[48] Although ACTA is aimed at beefing up TRIPS, it was negotiated outside the WTO forum because the signatories

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[44] Ibid.

[45] Note from the Belgian and French delegations, Brussels, 6 March 2014, DFD 2A, 7377/14.

[46] Compare: Integrating Intellectual Property Rights and Development Policy Report of the Commission and Intellectual Property Rights, London 2002, 22ff.

[47] See further S. Sołtysiński, *The Patent Reform Act and Recent US Supreme Court Decisions – A Correction of the Intellectual Property Policies? Patents and Technological Progress in a Globalized World* (Liber Amicorum Joseph Straus 2009, Berlin, Heidelberg) 856ff.

[48] They are: Australia, Canada, Korea, the US, Japan, Morocco, New Zealand, Singapore and the EU.

were afraid that developing countries would this time demand trade concessions. Whilst the obligatory provisions of ACTA largely overlap with those of the EU directives, some of the ACTA provisions on criminal sanctions are not clear and conflict with freedom of information and privacy rights guaranteed by several EU Member States.[49] Numerous academics deplored the fact that the ACTA initiative was a 'club approach of like-minded countries which excluded other globally important partners (e.g. Brazil, India, China and Russia) in the effort to impose agreed rules via bilateral agreements'.[50]

ACTA unexpectedly triggered massive street protests of young people, first in Poland and the Baltic States, and later on in 'old' EU Member States. Soon afterwards, these protests were supported by hundreds of intellectual property and privacy experts, leading to a rejection of the agreement by an overwhelming majority of the European Parliament in 2012. These massive and successful protests were prompted not so much by the substance of ACTA but by the lack of safeguards protecting privacy rights and, foremost, by the secret negotiations during which stakeholders (i.e. internet users), critics of strengthening IP rights and emerging market countries were not represented.

The phenomena of secrecy, lack of transparency and proper representation of all interested parties during negotiations aimed at bestowing new economic privileges have nevertheless continued apace. The recently accomplished negotiations of agreements for the unitary EU patent, and for the Unified Patent Court provide another illustration of this trend.[51] Basically, the long discussed idea of a unitary patent covering the entire EU market is sound, despite the fact that it will create new imbalances and strengthen the competitive positions of a few of the most developed EU economies, as well as innovative firms from the US and Japan.[52] New Member States ought to be prepared to make reasonable sacrifices in the interests of a long-term development of the single market. However, they should not be expected to support a new patent project which is deeply flawed and unduly favours large patent owners.[53] First, inevitable imbalances will increase because the project provides that the new unitary European patents, covering 25 EU Member States, will be granted in English, French and German. In this way, the hitherto universally followed patent law requirement that a monopoly right should be granted in exchange for the disclosure of the best method of practicing the invention and that, in principle, its specification should be published in the official language of the jurisdiction where protection is sought will be abandoned in the interests of the most advanced EU Member States and third countries where the official language is English, French or German (e.g. the US, Canada and Australia).

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49 See Ch. Geiger, in *Workshop on the Anti-Counterfeiting Trade Agreement (ACTA)*, Expo/B/Inta, FWC/2009-01/Lot 7/25, March/2012, 55-60.

50 Ibid 53-55.

51 See European Commission, Proposal for a Regulation of the European Parliament and of the Council implementing enhanced cooperation in the area of the creation of unitary patent protection COM (2011) 215 final.

52 The European Patent Office in Munich grants roughly half of its patents to US and German firms, and about 2% to applicants. Italian firms obtain about 3% of these grants. Polish firms received about 0.03% of such patents in 2011.

53 Italy and Spain, whose R&D potentials are much stronger than those of Poland and other new Member States, refused to join the new patent project and challenged it before the Court of Justice.

Second, in principle, the same language requirements will apply during judicial proceedings before a new European Patent Court located in London, Paris and Munich. Hence, the owner of a medium-sized firm in Poland or Hungary will have to study patent specifications in three foreign languages, hire a foreign law firm and defend a patent infringement case in a foreign language.

The third important principle respected in the EU conventions to date (namely, that a defendant shall be sued in a local court and may have to defend his/her case in the local language) will also be abandoned. The importance of the official language is illustrated by the fact that a compromise Spanish and Polish proposal suggesting the use of one official language (i.e. English) was rejected by those countries whose official languages are German and French.[54] For those for whom English, French and German are foreign languages, the patent system's information function will not be fully satisfied. It will also cause a lack of legal transparency, which favours 'foreign' patentees, not only by giving them the said substantive legal procedural and language privileges but also by forcing other market actors to operate at the risk of patent infringement. This is not only because the UK, Belgium, France and Germany, the main beneficiaries of the new language regime, will be exempt from the traditional requirements of publication and conducting legal proceedings in the official language of the territory where the exclusive right is sought or enforced. The consequences of the new uniform patent package are best characterised by H. Ullrich:

> [T]he language regime produces direct and indirect costs over the lifetime of a patent for those who are not at full ease with its language, and it favours those who are familiar with it. [I]t distributes advantages and disadvantages […] it enables the linguistic beneficiaries […] to cover the entire EU market, including the language territories of the non-beneficiaries by an exclusivity at no extra cost, extra effort of care and risk avoidance, while the non-beneficiaries seeking EU-wide act exclusion are asked to cover extra costs, which other members of the majority are not willing to make themselves.[55]

As with bankruptcy superpriorities, the new language regime not only bestows legal privileges on the strongest business actors but also shifts the costs of the reform onto their weaker competitors.

The relevance of the equal treatment of official languages of EU Member States was stressed by the ECJ in the past. In case C-42/97, the Court emphasised that EU citizens and firms, especially small and medium sized enterprises, experience difficulties 'in overcoming language barriers'.[56] It explained that 'marginalization of the language may be understood as the loss of an element of cultural heritage but also as the cause of difference of treatment between economic

[54] H. Ullrich, *Harmonizing Patent Law: The Untameable Union Patent, Max Planck Institute,* Research Paper No. 12-03, 13-15, <http://ssrn.com/abstract=2027920>.

[55] Ibid, 21–22.

[56] *Parliament v. Council,* Judgement of 23.02.1999, 1, 882-903.

operators in the Community, who enjoy greater or lesser advantages depending on whether or not the language they use is widespread'.[57]

Equal treatment of the official languages of all Members State involves costs. The joint Polish-Spanish proposal to agree on the application of only the English language was a rational compromise, especially if it were to be combined with genuine concessions for SMEs. Unfortunately, such a proposal was not contemplated by the EU Commission and not even discussed by the members of the Visegrad Group. Paradoxically, my own government pushed for an early closing of the patent package negotiations to achieve a success at the end of the Polish Presidency when many issues were still open. It changed its attitude following strong criticism by Polish business organisations and intellectual property professors.

Fourth, several prominent patent law experts demonstrated that the reduction in translation costs, advocated by the proponents of the uniform project, will mainly benefit a relatively small number of large firms which file hundreds of patent applications per annum. These imbalances will be exacerbated on the level of EU Members whose official language is English, French or German.[58] The EU patent package was adopted in 2013 when France, Germany and UK agreed that the Unitary Patent Court ('UPC') would be split into three central divisions, located in Paris, Munich and London. Bulgaria, Poland and Spain have not joined the project.

Recent research published by a London IP monthly revealed that out of €200 million to be earned by the UK economy per annum as a result of the adoption of the EU Patent Package, according to the British Government study, about 150-200 million is expected to be reaped by English law firms located mainly in London where one of the three branches of the new Patent Court has been situated.[59] By contrast, UK firms in which the inventions are developed may count to benefit from up to £40 million.

Not surprisingly, the negotiations of the European patent package were conducted largely in secrecy. Opinions of the industry, especially SMEs, university circles and judges, were largely disregarded. Dr. J. Pagenberg, a member of the EU Commission's Committee of Experts, withdrew from this body at the end of 2011. He protested against negotiations behind 'closed doors', the refusal to disclose drafts of the negotiated documents and to address the questions and proposals made by future users of the system.[60] Pagenberg also concludes that, apart from

[57] Ibid, 899.

[58] Ibid, 13-14. The criticism that the largest firms will be the main beneficiaries of the project while advantages for SMEs are illusive was also expressed in the House of Commons of European Scrutiny Committee document: *The Unified Patent Court: Help or Hindrance,* HC 1799 (3 May 2012) 26-29, 39-41.

[59] J. Norton, *Unitary Patent Figures Don't Add Up,* Managing Intellectual Property of 16 May 2013, 2. The author writes that the government report describing benefits of the unitary patent and hosting one division of the new Patent Court (UPC) in London is misleading and government propaganda because it implied that the €200 million figure referred to the gains to the British industry.

[60] J. Pagenberg, (2012), The EU Patent Package – Politics vs. Quality and the New Practice of Secret Legislation in Brussels. *EPPLAW Patent Blog,* at 3, http://hdl.handle.net/11858/001M-0000-000E-7C60-B, 2 and 17-19. Professor Nowicka, who teaches intellectual property at A. Mickiewicz University (Poznań), showed me a reply from the EU Commission. The enclosed text of the uniform patent package contained only the Preamble and titles of all chapters, with the remaining contents deleted. Her criticism of the secrecy of the negotiation process echoes reservations made by Pagenberg and Ullrich.

numerous imperfections, the EU patent package takes into account the interest of the multinational corporations only, and disregards those of SMEs and individual inventors. The latter users of the new system should be able to apply for uniform protection in a few countries of their choice, 'combined with an efficient and affordable court system close to home and in their local language'.[61] The final negotiations about the location of the three divisions of the new Patent Court focused on the right of 'cherry picking' by law firms rather than on concessions for SMEs.

4 Bilateral Investment Protection Treaties and Arbitration (BITs)

I subscribe to the view that sees investor-protection institutions to be very important for industrial development. Judicial and administrative institutions that protect property rights and investments effectively are prerequisites of sustainable development. However, granting special privileges to foreign investors undermines the fundamental principle of equality of business actors and discriminates against local business. Moreover, it encourages the most efficient domestic firms to 'emigrate' abroad, at least by way of investing shares acquired in their domestic companies in foreign-held parent companies, thus obtaining a privileged status under the protective umbrella of BITs. It also transfers wealth from emerging markets to capital exporting countries.

In 1905, the US Secretary of State, E. Root, a Peace Prize Winner, argued that foreign investors cannot demand more rights than their local competitors:

> When a man goes into a foreign country to reside or to trade he submits himself, his rights, and interests to the jurisdiction of the courts of that country […]. It is very desirable that people who go into other countries shall realize that they are not entitled to have the laws and police regulations and methods of judicial procedure and customs of business made over to suit them, or to have any other or different treatment than that which is accorded to the citizens of the country into which they have gone; so long as the government of that country maintains, according to its own ideas and for the benefit of its own citizens […].[62]

The Calvo Doctrine provided that foreign investors may not seek protection abroad. A resolution of the General Assembly of United Nations of December 12, 1974 incorporated essential aspects of that doctrine in the Charter of Economic Rights and Obligations of States. But the BITs have completely reversed these legal standards. They have established preferential legal standards aimed at granting special status to foreign investors. Their privileges involve, inter alia:

– access to 'friendly' arbitration fora after a short period of negotiations with the host State (usually six months). This privilege is described by arbitrators as 'the best guarantee that the investment will be protected against undue infringement by the host state'.[63]

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[61] Ibid 22.

[62] E. Root, 'The Basis of Protection of Citizens Abroad' (1910) 4 American Journal of International Law 526-527. The author argued that host states are liable only if they violate 'the common standards of justice'. Ibid.

[63] *Eastern Sugar v. Czech Republic,* SCC No. 088/2004, <http://ita.law,uvic.cg>.

– protection by a plethora of capacious and sweeping clauses such as 'fair and equitable treatment, 'the MFN treatment', 'full protection and security' and assurances of 'justified expectations of the investor'. As admitted by the arbitral tribunal in EURECO v. Slovakia,[64] these concepts do not mirror protection available under EU Law. Several arbitral tribunals have held that the host country may not introduce legislative or other measures against the investor's 'justified expectations'. Some courts of capital-exporting countries have issued decisions which have contributed to a deepening discrimination against host countries in arbitration fora. For instance, the Paris Court of Appeal gave a very broad meaning to the term of 'foreign investment' as 'any kind of asset invested in connection with economic activities'.[65] Moreover, the court ruled that a legal action taken by the Czech Republic against an investor who concluded a lease contract in violation of Czech mandatory law amounts to a breach of a fundamental right of the foreign investor, 'such as the right to legal security that the state must provide under fair and equitable treatment and under which investors' legitimate trust and expectations must be protected'.[66] This shocking decision amounts to a proclamation of a new investor's right, consisting of dispensing him from respecting the host country's laws and imposing a duty on the host country to abstain from taking legal action against the investor.[67] The Paris Court of Appeal explained that filing a legal action violated the investor's *'legitimate trust and expectations'* protectable under the BIT, regardless of its legitimacy under Czech law.[68]

As a rule, BITs are incompatible with the host country's constitutional principles of equality of business actors. Intra-EU BITs are difficult to reconcile with Art. 18 of the Treaty on the Functioning of the European Union, because they discriminate against firms from those Member States which do not benefit from such treatment in a given EU country. The Czech Republic brought a case before the EU Tribunal arguing that BITs are inconsistent with the Lisbon Treaty. Several authors and NGOs criticize the substantive law and procedural privileges granted to foreign investors.[69] Several World Bank and UNCTAD studies demonstrate that there is no evidence that the BITs materially increase foreign investment.[70] Critics of BITs point, inter alia, to the contrast in the economic performance of Argentina, a country that was persuaded to execute more than 40 BITs and was exposed to dozens of foreign investment suits, and that of Brazil, which has refused to sign such agreements.

[64] As reported by L. Peterson, Investment Arbitration Reporter, Vol. 3, No. 17, 7.

[65] *Czech Republic v. Pren Nreka,* as reported by P. Duprey in Journal of International Arbitration (2009), vol. 26(4) 591.

[66] As quoted by P. Duprey, 603.

[67] A commentator rightly stressed that enforcement of one's right is recognised by French courts as a fundamental constitutional right but it was refused to the host country.

[68] Ibid.

[69] S. Frank: *The Legitimacy Crisis in Investment Arbitration: Privatizing Public International Law through Inconsistent Decisions,* [2005] Fordham Law Review.

[70] Hollward-Dreimaier, *Do Bilateral Investment Treaties Attract FDI? Only a BIT but they Can Bite,* The World Bank 2003, 3121ff. ; UNCTAD, Bilateral Investment Treaties in the mid-1990s, United Nations, New York 1998, 6.

Evidence has been presented by researchers who allege that investment arbitration tribunals display pro-investor bias. In particular, a recent study by Gus van Harten gives rise to concern.[71] The study verified the attitude of arbitral tribunals related to several topics that are usually not regulated in investment treaties. The expansive interpretation was adopted in more than 76% of cases. For instance, parallel claims were allowed in 82% of the disputes; minority shareholders were granted the right of standing in nine out of each ten cases (92%), and a broad concept of 'investment' was adopted in almost three out of four cases (72.27%).[72] A somewhat more restrictive attitude was demonstrated with regard to the scope of Most Favoured Nations ('MFN') treatment, where respondents frequently argue that the principle covers only substantive, and not procedural, rights. It is even more disquieting that the probability of an expansive interpretation was statistically much higher than average in arbitration cases involving claimants from those leading capital exporting countries with the highest number of elite arbitrators and top law firms. In cases initiated by investors from the US, the UK and France, the probability of an expansive interpretation of treaty claims regarding ambiguous jurisdictional and substantive matters was 98.95% and 86%, respectively.[73]

The van Harten study supports the assumption that the asymmetrical claims structure and the absence of criteria of neutrality and independence of arbitrators in the relevant treaties may have an impact on their attitudes and decisions. The fact remains that BITs provide for the investor's right to sue the host country but not vice versa. This asymmetry is frequently overlooked, even by courts that decide disputes initiated by host countries in actions challenging arbitration awards. For instance, in the *Czech Republic v. Pren Nreka,*[74] the Paris Court of Appeal held that the host country's claim brought before a Czech court against a Croatian investor amounted to a violation of the principles of legal security, fair and equal treatment, 'under which investors' legitimate trust and expectations must […] be protected.'[75] In justifying its decision, the Paris Court of Appeal observed that 'the right for the host country to file a counterclaim in a proceeding may always be exercised before an arbitral tribunal […]'.[76] As rightly stressed by a commentator, the right for the host State to file a counterclaim is not provided by BITs and the ICSID Convention. Moreover, it is highly doubtful whether such a right is compatible with those conventions, which establish unilateral commitments of States towards investors.[77]

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71 Gus Van Harten, *Pro-Investor or Pro-State Bias in Investment-Treaty Arbitration? Forthcoming Study Gives Cause for Concern*, Investment Treaty News, Apr. 13, 2012, available at <http://www.iisd.org/itn/2012/04/13/pro-investor-or-pro-state-bias-in-investment-treaty-arbitration-forthcoming-study-gives-cause-for-concern/>. The study was based on an analysis of 140 publicly available awards (decisions).

72 Ibid at 2.

73 Ibid at 3.

74 Cour d'Appel de Paris (CA) (Regional Court of Appeals) Paris, 1e ch., Sept. 25, 2008, 3ff, No. 2007/4675.

75 Ibid at 28.

76 Ibid at 8.

77 Pierre Duprey, *Comments on the Paris Court of Appeal Decision in Czech Republic v. Pren Nreka*, 26 J. International Arbitration 591, 606 (2009). In any event, the Paris Court's argument that the host state could file a counter-claim in the arbitration proceedings is difficult to reconcile with its equally unpersuasive finding that an action for an annulment of the lease contract constituted a violation of fundamental rights of the investor.

To sum up, the asymmetry of claims structure and investors' powers to initiate arbitral proceedings in investment arbitration disputes, the lenient interpretation of conflict of interests by courts, and the lack of convincing arguments that there is a correlation between BITs and the flow of foreign investment have led to growing criticism of the legitimacy of the current regime of foreign investment arbitration.[78]

The bad experience of new EU Member States with BITs have led the Czech Republic and Slovakia to argue, albeit unsuccessfully so far, that pertinent intra-EU bilateral investment treaties are inconsistent with the EU Treaty. For instance, in the *Eastern Sugar BV (Netherlands) v. Czech Republic,*[79] the Czech Republic challenged the jurisdiction of the arbitral tribunal, arguing that the BIT executed between the Netherlands and the Czech Republic should not be applicable after the accession of the Czech Republic to the European Union because the protection of business actors in the single market belongs to the domain of the EU Treaty. In a nutshell, the arbitration tribunal rejected the respondent's argument and held that the Netherlands-Czech-BIT remains in force until it is repealed or terminated.[80] A similar objection was raised by Slovakia in *Eureko BV v. The Slovak Republic.*[81] The tribunal rejected the challenge and held that it had jurisdiction for similar reasons as those advanced by the arbitrators in the Czech Sugar case.[82]

The discussions about the legitimacy of the current regime of investor-State arbitration rarely focus on the issues of inequality and discrimination of entrepreneurs and their pernicious effects. In *Eureko v. the Slovak Republic,*[83] the tribunal mentioned the problem *en passant*, but summarily held that the argument of discrimination against some foreign business actors does not undermine its broad powers of jurisdiction under an intra-EU BIT between the two Member States.

The consequence is that in any particular case investors protected by the BIT may have wider rights than those given to investors of (other) EU Member States under the substantive provisions of EU law. The Tribunal held that granting wider protection to those investors while not affording it to investors of other EU States may violate EU law prohibitions on discrimination. But that is not a reason for cancelling a Claimant's wider rights under the BIT. More significantly, the Tribunal explained that it is even less of a reason for treating the Parties' consent to these arbitration proceedings as invalid or otherwise ineffective, particularly where the first stage of

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78 See, e.g. Susan D. Frank, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions' (2005) 73 Fordham L. Rev. 1521; 'The Backlash Against Investment Arbitration: Perceptions and Reality' [Michael Waibel, Asha Kaushal, Kwo-Hwa Chung & Claire Balchin (eds) 2010]; Sornarajah (n 20), 631ff.; Luke R. Nottage & Kate Miles, 'Back to the Future' for Investor-State Arbitrations: Revising Rules in Australia and Japan to Meet Public Interests (2009) 26 J. Int'l. Arb. 25-58

79 *Eastern Sugar B.V. (Netherlands) v. The Czech Republic*, SCC Case No. 088/2004, Partial Award, March 27, 2007, available at http://italaw.com/cases/documents/369.

80 See further Markus Burgstaller, 'European Law and Investment Treaties' (2009) 26 J. Int'l. Arb. 181-216.

81 *Achmea B.V. (formerly known as 'Eureko B.V.') v. The Slovak Republic*, PCA Case No. 2008-13, Award on Jurisdiction, Admissibility and Suspension, Oct. 26, 2010 *('Eureko v. Slovakia Case').*

82 Ibid. See the text accompanying notes 38-43.

83 See *Eureko v. Slovakia Case* (n 36).

such consent pre-dated the relevant EU Treaties, the second stage pre-dated the Lisbon Treaty, and Claimant is an EU investor.[84]

III Concluding Remarks

How can one explain the fact that policy decision-makers are so easily 'captured' by vested interests groups, despite the lesson of the recent financial crisis and evidence presented in studies that demonstrate the adverse consequences of departures from the principle of equal treatment of business actors? Firstly, the power of lobbying organisations representing financial institutions, top intellectual property firms, and capital exporting countries stems from their financial resources and political leverage. The invisible hand of the market has thus been gradually replaced by the visible hand of the lobbyist. By way of example, it is reported that the number of lobbyists representing financial institutions at the US Senate is four times larger than the number of senators.

Secondly, general creditors, SMEs, and other economic actors from emerging markets are not only weaker financially but usually badly organised. Paradoxically, the experience of recent patent negotiations in Brussels shows that the political leverage of young users of the Internet, who protested against ACTA, was much stronger than SMEs in old and new EU Member States.

Thirdly, policy makers and executives of international organisations where economic reforms are prepared, and even market regulators, are usually inclined to approve proposals submitted by leading and well-organised industries. My own hindsight teaches that the 'gatekeepers' are usually recruited from the ranks of the supervised industries. Frequently, those officials dream of being hired by the industry they regulate. Moreover, officials of central banks and other market regulation authorities are often persuaded that granting privileges to firms in the sectors of economy subject to their control will assure a smooth functioning of the relevant industry.[85]

International organisations equipped with the task of preparing reform proposals and new conventions should try to avoid the trap or even steer clear of creating the impression that their fora are used to promote vested interests. When certain initiatives are financed by organisations representing vested interests and their recommended experts are paid from such sources, the host organisation should at least assure the presence of reputable critics of the industry proposals. At a minimum, the opposing views should be considered and given thorough explanations in a final report. Unfortunately, with both the recent EU patent package negotiations and works on UNIDROIT Principles on Netting, these standards have not been observed. For instance, *the preparatory studies and the final explanatory memorandum accompanying the UNIDROIT Draft Principles on the Netting of Financial Instruments submitted to Member*

[84] Ibid.

[85] During my chairmanship of the UNIDROIT Study Group on Netting, I was surprised that the majority of market regulators from the OECD countries and delegates of IMF, EIB and the European Commission usually approved ISDA proposals without asking difficult questions.

States did not contain a single reference to critical legal and economic studies of netting super-priorities, despite specific requests made during the works of the Study Group.[86] Organizations such as UNCITRAL and UNIDROIT are underfinanced and their executives are in a difficult situation. During the recent Uniform European Patent negotiations, the EU Commission explained that the opinions of hundreds of law professors, judges and SMEs were dismissed as the voice of alleged lobbyists or 'interest parties'.[87]

To date, meaningful reforms have stopped half-way and the elimination of the privileges constitutes the most difficult issue. Paradoxically, the UNIDROIT Close-Out Netting Project and the EU Uniform Patent rules demonstrate that industries having vested interests in the status quo try to 'capture' the policy decision-makers and obtain new privileges or 'dilute' reforms. They defend the privileges gained with the vigour of the French aristocracy that resisted reforms before the French Revolution and the Polish nobility that fought for their privileges with the elected kings before Poland's partition at the end of the XVIII century. Both groups were very much attached to their privileges and deeply convinced that they were 'too powerful to fail' and 'systemically important.

There are signals that some executives of the financial industry see the need to implement reforms that require sacrifices. Sandy Weill, the founder of the modern Citi Corporation, the largest global universal bank, publicly supports the Volcker rule that requires separation of investment banking from traditional core banking. Support has been growing for similar 'ring-fencing' proposals in Europe (e.g. Vicker and Likkanen twin initiatives). Mr. Weill's successors have been restructuring this universal bank with the aim of strengthening the role of the traditional banking and reducing the risky derivatives-trading.[88]

P. Singer, the Chairman of Elliot Associates (a lead US hedge fund) and a top contributor to Mr. Romney's election fund, has recently outlined proposals for a deep reform of the banking system that goes beyond the Volcker rule.[89] He concluded that 'conservatives who believe in free markets should also believe in sound fair markets'.[90] N. Lawson, the UK's Chancellor of the Exchequer in the 1980s, also sees that the twin doctrines of 'too big to fail' and 'systemic importance' undermined market discipline, and fostered greed and incompetence in the financial sector. Industry leaders should realise that reforms imposed from outside are usually more painful and frequently implemented too late.

The new privileges constitute examples of sectional egoism aimed at assuring leading sectors of the economy short-term benefits but they pose a serious risk to the global economy as a whole. The unprecedented success of capitalism was built on the principles of formal equality of economic actors and fair competition. Academics, business and political leaders of the Visegrad Group should be vitally interested in critically analysing the consequences of departures from

[86] However, the UNIDROIT Governing Council recommended that the Chairman's critical observations be included in the materials submitted to UNIDROIT Member States.

[87] Pagenberg (n 60) 2.

[88] Financial Times of 20 August 2012.

[89] Financial Times of 16 August 2012.

[90] Ibid. 'Capitalism in Crisis' Financial Times of 6 February 2012.

the principle of equal treatment of economic actors, because a sustainable growth of our economies and the common market cannot be achieved in a legal framework which discriminates against SMEs and grants privileges to industries and firms viewed as 'too big to fail' or 'systemically important'. Departures from the principle of equal treatment of economic actors are justified in exceptional situations and almost exclusively in favour of SMEs. Privileges bestowed to leading sectors of the economy and multinationals undermine for foundations of a free-market economy and a fair system of competition upon which the EU Single Market was established. Proliferation of quasi feudal sectorial privileges which benefit mainly economies of old Member States strengthen passions of nationalism and loss of sovereignty, especially but not only, in new Member States.