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by
Donna M. Gitter*

INTRODUCTION

"'You Did It!': The European Biotechnology Directive At Last."[1] "Biotech Patents, At Last."[2] So exulted articles in scholarly and trade journals which heralded the enactment in the European Union (E.U.) of Directive 98/44/EC of the European Parliament and of the Council of 6 July 1998 on the Legal Protection of Biotechnological Inventions (Directive),[3] after nearly ten years of raucous debate among various E.U. government institutions[4] and segments of

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1. Robin Nott, *'You Did It!': The European Biotechnology Directive at Last*, 20 EUR. INTELL. PROP. REV. 347, 347 (1998).

2. Ian Judge & Matthew Frankel, *IP Watch*, IP WORLDWIDE, July-Aug. 1998, LEXIS, General News Library, Magazines & Journals File.

3. 1998 O.J. (L 213) 13 [hereinafter Directive]. A directive is a type of E.U. legislation that targets one or more specific Member States, *see infra* note 4, and binds them with respect to the end to be achieved, while allowing each Member State some choice as to the method, and, sometimes, the extent, of implementation. It is distinguishable from a regulation, which is binding upon all Member States and mandates a particular means of attaining the stated goal. Thus, directives are more flexible and accommodating to national law, making them particularly useful in order to harmonize the laws within a certain area. *See* W. R. CORNISH, INTELLECTUAL PROPERTY: PATENTS, COPYRIGHT, TRADE MARKS AND ALLIED RIGHTS 20-21 (3d ed. 1996).

4. In light of the coming into force of the Treaty on European Union, 1992 O.J. (C224) 1 [hereinafter Maastricht Treaty], on November 1, 1993, the term E.U. will be employed throughout this article, even where certain entities would have been called European Community (E.C.) institutions at the time in question. The fifteen Member States of the E.U. are: Belgium, Germany, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Portugal, Spain, Sweden, Austria and Finland. *See* RICHARD SCHAFFER ET AL., INTERNATIONAL BUSINESS LAW AND ITS ENVIRONMENT 88 (4th ed. 1999). The principal E.U. institutions involved in the legislative process are the European Commission (Commission), the European Parliament (Parliament) and the Council of Ministers (Council). The Commission, the executive and bureaucratic arm of the E.U., has the sole authority to propose new legislation. Thomas C. Vinje, *Harmonising Intellectual Property Laws in the European Union: Past, Present and Future*, 8 EUR. INTELL. PROP. REV. 361, 361 n.2 (1995). The Commission's twenty members, who are appointed, function as members of a supranational body, rather than as national representatives. The Council, which coordinates economic policies of the Member States and approves legislation and international agreements, is a

the citizenry. The Directive, which came into force on July 30, 1998,[5] has two major objectives. First, it is designed to foster effective and harmonized patent protection for biotechnological inventions[6] throughout all of the E.U. Member States.[7] By doing so, the E.U. intends to stimulate investment in the European biotechnology industry, which seeks to enhance its competitiveness vis-à-vis the United States (U.S.) and Japan.[8] The Directive's second objective is to preserve a unique feature of European patent law which has no analogue in U.S. patent practice,[9] namely the ability of E.U. Member States to consider the ethical dimension of biotechnological inventions when determining whether to grant a patent.[10]

However, not all the parties concerned with the European biotechnology industry have greeted the Directive with enthusiasm. Indeed, the Directive is arguably one of the most heavily lobbied pieces of legislation that the European Parliament has ever considered.[11] In particular, Articles 5[12], 6[13] and

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body of delegates, one from each Member State. SCHAFFER, *supra*, at 88. The Parliament is a body of 626 elected representatives from the various Member States. The approval of the Parliament is required for all international agreements, and it has co-decision powers with the Council on measures dealing with the single market and other important matters, including consumer protection, the environment and health. *See* SCHAFFER, *supra*, at 91. For a description of the legislative process culminating in the enactment of the Directive, *see infra* Part II.A.

5. *See* Nott, *supra* note 1, at 347.

6. For the purposes of the Directive:

> [b]iotechnology is understood to comprise all the techniques that use or cause organic changes in any biological material (such as animal and plant cells or cell lines, enzymes, plasmids and viruses), microorganisms, plants and animals; or that cause changes in inorganic material by biological means. In its modern appearance, biotechnology includes the techniques of recombinant DNA . . ., gene transfer, embryo manipulation and transfer, plant regeneration, cell culture, monoclonal antibodies, and bioprocess engineering.

Proposal for a Council Directive on the Legal Protection of Biotechnological Inventions, EUR. PARL. DOC. (COM 88 496 final—SYN 159) 7-8 (1988) [hereinafter Commission Proposal of 1988].

7. *See* Directive, *supra* note 3, ¶¶ 1 to 7, at 13. Although the Recitals in the Directive are not operative, they serve to elucidate the intent of the drafters. *See* Nott, *supra* note 1, at 347.

8. According to a 1998 report, approximately 65% of all biotech patents originate from the U.S., and only about 15% from European nations. *See* Sean Milmo, *EU Biotech Industry Wins Major Battle*, CHEMICAL MARKET REP., May 18, 1998, at 5. Moreover, in 1997, the biotechnology sector employed some 140,000 people in the U.S., compared with only 39,000 in the E.U. U.S. biotech companies had revenues of $17.4 billion in 1997, and invested $9 billion in research and development, while European biotechnology sector revenues were only $2.9 billion and research and development expenditures totaled less than $2.1 billion. *See* ERNST & YOUNG, EUROPEAN LIFE SCIENCES 98, at 11, tbl. 3 (1998) [hereinafter EUROPEAN LIFE SCIENCES].

9. *See* Kevin J. Dunleavy & Milan M. Vinnola, *E.U. Biotech Directive Departs From U.S. Practices*, NAT'L L.J., May 24, 1999, at C11, C12 (stating that the "most significant difference" between the patentability of biological materials in the U.S. and the E.U. is the assessment of the morality of the invention when determining whether to grant a patent). *But cf.* Thomas A. Magnani, *The Patentability of Human-Animal Chimeras*, 14 BERKELEY TECH. L.J. 443, 451-54 (1999) (citing an infrequently invoked and possibly moribund doctrine in U.S. patent law which bars a patent grant on the grounds of utility to inventions deemed to contravene morality).

10. *See* Directive, *supra* note 3, ¶¶ 37 to 45, at 16.

11. Dr. Nick Scott Ram, *Biotechnology Patenting in Europe: The Directive on the Legal Protection of Biotechnological Inventions: Is This the Beginning or the End?*, 2 BIO-SCIENCE L. REV. 43, 43 (1998).

12. *See infra* notes 113-15 and accompanying text.

13. *See infra* notes 18-19, 116-21 and accompanying text.

7[14], which relate to ethical and moral standards, are the most controversial provisions in the Directive. Many opposed to patents on plants and animals, so-called "life patents,"[15] contend that these provisions do not protect sufficiently against violations of ethical and moral standards, depredations of the environment and the exploitation of small farmers.[16] Conversely, many supporters of the biotech industry have accepted the Directive as a necessary political compromise, while simultaneously lamenting what they perceive as its shortcomings. They oppose the use of patent law to protect what is broadly termed morality and ethics, contending that legislative regulations are a better vehicle for attaining compliance with standards for ethical research, public health and safety, animal welfare, environmental protection, and the preservation of genetic diversity.[17]

Regardless of one's view regarding the propriety of the E.U. biotechnology patent law provisions aimed at preserving ethics and morality, the fact remains that the Directive does incorporate such language, principally via Article 6, which declares that "[i]nventions shall be considered unpatentable where their commercial exploitation would be contrary to *ordre public*[18] or morality."[19] The question then arises how this language is likely to affect the Directive's goals of achieving harmonization of patent laws throughout all of the E.U. Member States while preserving the ability of Member States to consider morality when determining whether to grant a patent. The complete answer to this query remains to be seen, as the majority of the Member States have not yet enacted the legislation and regulations necessary to implement the Directive, including the Article 6 morality provision,[20] and national courts have yet to

14. *See infra* notes 122-23 and accompanying text.

15. Patents on life forms such as micro-organisms have long been accepted in Europe, and are not the source of the controversy regarding the Directive. For example, the German Federal Supreme Court permitted patent protection for yeast in 1975. *See Baker's Yeast (Backerhefe)*, Federal Supreme Court, 1975 GRUR 430 (BGH 1975), *reprinted in* 6 INT'L REV. INDUS. PROP. & COPYRIGHT L. 207-19 (1975).

16. *See infra* Part II.A.

17. *See infra* note 272.

18. The nearest English translation of *ordre public* is "public interest" or "public policy." *See* CORNISH, *supra* note 3, at 195 n.86.

19. Directive, *supra* note 3, art. 6.1, at 18. Article 6 then enumerates a non-exhaustive list of inventions that "shall be considered unpatentable," including:

> (a) processes for cloning human beings; (b) processes for modifying the germ line genetic identity of human beings; (c) uses of human embryos for industrial or commercial purposes; [and] (d) processes for modifying the genetic identity of animals which are likely to cause them suffering without any substantial medical benefit to man or animal, and also animals resulting from such processes.

Id. art. 6.2, at 18-19. Other provisions in the Directive designed to preserve morality are Articles 5 and 7. *See infra* notes 113-15, 122-23 and accompanying text.

20. Pursuant to the Directive, Member States were required to "bring into force the laws, regulations and administrative provisions necessary to comply with this Directive not later than 30 July 2000." Directive, *supra* note 3, art. 15, at 20. As of September 2, 2000, only Denmark, the United Kingdom and Austria had amended their national laws in accordance with the Directive. *See MEPs Clamour for Ad-Hoc Bioethics Committee*, EUR. REP., Sept. 2, 2000, LEXIS, World News Library, European News Sources File. Conversely, the Netherlands and Italy are pursuing an action before the European Court of Justice opposing the Directive. *See infra* notes 129, 275-80, and accompanying text. Moreover, German and French lawmakers have demanded an immediate rene-

interpret such laws. Analysis of the Directive reveals, however, that the morality provision is likely to impede the Directive's dual goals. First, with respect to harmonization, although the Directive does mandate a minimum level of patent protection that all Member States must attain with respect to biotech inventions,[21] Article 6 is exceedingly vague as to the legal standard that will be applied in order to determine whether an invention ought to be denied patent protection on the grounds of immorality. Consequently, Article 6 will be subject to conflicting interpretations, thereby precluding harmonization.[22] With respect to its second stated goal, preservation of the right of patent offices and courts in each Member State to deny patent protection to any invention deemed contrary to morality or public policy, the Directive is likely to prove inadequate, a point on which, ironically, both its advocates and detractors agree.[23]

Part I of this Article examines the emergent biotechnological inventions that are currently stirring controversy in the E.U. on moral and ethical grounds, and addresses the importance of patent protection to their inventors. Part II summarizes both the legislative debate surrounding the enactment of the Directive, and the provisions of the Directive governing patentability of biotechnological inventions. Part III focuses on the prospective effect of these provisions, especially the Article 6 morality provision, on the Directive's stated goal of harmonizing European patent law. Specifically, Part III examines the inconsistent legal tests applied in the judicial decisions rendered pursuant to the morality provision of the European Patent Convention (EPC),[24] upon which the Directive's Article 6 was modeled essentially verbatim, and to which all E.U. Member States are signatories. Part IV addresses the inability of the Directive's Article 6 morality provision to foster compliance with standards for ethical research, public health and safety, animal welfare, environmental protection, and the preservation of genetic diversity. Finally, Part V proposes revisions to the Directive that would enhance its ability to meet the challenges facing the E.U. biotechnology industry.

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gotiation of the Directive. They contend that the Directive's Article 5, which permits patenting of a gene that has been isolated from the human body, *see infra* notes 100-03, 113-15 and accompanying text, is not only counter to human dignity, but also threatens to impede scientific research. *See, e.g.*, Alison Abbott & Ulrike Hellerer, *Politicians Seek to Block Human-Gene Patents in Europe*, 404 NATURE 802, 802 (2000); Ralph Atkins & Timm Kragenow, *Germany Imposes Extra Gene Patent Limits*, FIN. TIMES (London), Aug. 11, 2000, at 6; *Community Law Takes Precedence Over National Law*, EUR. REP., June 21, 2000, LEXIS, World News Library, European News Sources File; *Council of Europe Calls for Revision of Biotechnology Directive*, EUR. REP., July 15, 2000, LEXIS, World News Library, European News Sources File; Quirin Schiermeier, *German Agencies Sound Alarm on Risks of Broad Gene Patents*, 406 NATURE 111, 111 (2000).

21. The Directive provides that "Member States shall protect biotechnological inventions under national patent law. They shall, if necessary, adjust their national patent law to take account of the provisions of this Directive." Directive, *supra* note 3, art. 1.1, at 18.

22. *See infra* Part III.

23. *See infra* Part IV.

24. This instrument, known as the European Patent Convention, was signed into existence in Munich as the Convention on the Grant of European Patents, Oct. 5, 1973, art. 53, 1065 U.N.T.S. 255, 272, 13 I.L.M. 270, 286 [hereinafter EPC]. *See infra* text accompanying notes 132-37.

I.
BIOTECHNOLOGICAL INNOVATION IN THE E.U. AND THE NEED FOR PATENT PROTECTION

A. *Current Innovations in the European Biotechnology Industry*

In 1997, Scottish researchers from the Roslin Institute and PPL Therapeutics PLC of Edinburgh sought a patent for one of the most renowned and controversial biotech inventions in recent years, Dolly, the cloned sheep. Although among the most famous biotech inventions on any continent, Dolly is but one development of the European biotech industry. From the early 1980s through the beginning of 1998, the European Patent Office (EPO) received a total of 15,000 patent applications for biotechnological inventions.[25] Of these, roughly 4,000 concern genetic engineering,[26] approximately 1,000 are for transgenic plants,[27] about 500 are for transgenic animals, and over 2,000 relate to DNA sequences isolated from the human genome[28] that are used to develop therapies and medicines.[29]

With respect to plants, inventors use transgenesis to pursue four major goals. First, scientists wish to raise the consumer value of plants or the foods derived therefrom, leading to the creation of firmer tomatoes, potatoes with a longer shelf life and higher-protein soya. Second, researchers seek increasing yields through the creation of genetically altered hybrid grains that produce more under the same cultivation conditions. Third, some inventions help plants develop resistance to the pests afflicting specific species. Fourth, certain inven-

25. Ulrich Schatz, *Patentability of Genetic Engineering Inventions in European Patent Office Practice*, 29 INT'L REV. INDUS. PROP. & COPYRIGHT L. 2, 2-3 (1998). For a discussion of patent application procedure in the European Patent Office (EPO) in Munich, *see infra* note 139 and accompanying text.

26. Genetic engineering refers to various techniques, developed during the last thirty years, which "permit the controlled transfer of specific genes or groups of genes from one cell or organism to another, thereby creating cells or organisms that would not likely occur in nature or through conventional breeding practices." Reid G. Adler, *Controlling the Applications of Biotechnology: A Critical Analysis of the Proposed Moratorium on Animal Patenting*, 1 HARV. J.L. & TECH. 1, 1 n.3 (1988).

27. A transgenic plant or animal is one whose DNA, or hereditary material, has been added to DNA from different animals or plants at early stages of development. U.S. CONGRESS, OFFICE OF TECH. ASSESSMENT, NEW DEVELOPMENTS IN BIOTECHNOLOGY: PATENTING LIFE, at 93-94 (1989). *See infra* Part III.B.2 for a discussion of *Harvard/Onco-mouse*, which concerns a transgenic animal, and *Greenpeace Ltd. v. Plant Genetic Systems N.V.*, which involves a transgenic plant.

28. A genome is all the genetic material contained in any one cell of a particular organism. The human genome is comprised of roughly three billion pieces of information, contained on individual genes, and is responsible for determining everything from an individual's appearance to his chance of contracting certain diseases. *See* Nicholas Wade, *Human Life Is Cracked by Scientists: A Shared Success*, N.Y. TIMES, June 27, 2000, at A1.

29. Schatz, *supra* note 25, at 2-3. With respect to human DNA sequences, researchers seek to isolate all such sequences that form a human being's genetic makeup and to match them to gene functions, with the ultimate goal of developing products and technologies that will identify and correct the genetic defects that cause illnesses. *See generally* Michael J. Malinowski & Maureen A. O'Rourke, *A False Start? The Impact of Federal Policy on the Genotechnology Industry*, 13 YALE J. ON REG. 163, 164-77 (1996) (examining the medical applications of the genotechnology industry).

tions aid in the development of plants resistant to particular herbicides,[30] which can then be used selectively.[31]

Similarly, with respect to animals, inventors employ transgenesis to raise yields and improve quality. For example, the "Beltsville pig," an animal containing a human gene, was developed to grow quicker and leaner than the usual varieties.[32] Scientists also use mammals, which are genetically similar to human beings, for pharmacological research.[33] For example, researchers at Harvard University created the Harvard Onco-mouse, which has been given a genetic defect to make it more susceptible to breast cancer, and therefore particularly suitable for testing cancer drugs.[34] Many other patent applications are for animals that function as bioreactors to produce human metabolic products in their blood or milk. The most famous example is Tracy, a sheep whose germ line contains a genetic construction comprising a human gene plus "promoter," which causes Tracy's milk glands to produce proteins identical to human ones.[35] These transgenically created proteins are then removed from the milk and used in the medical treatment of human beings. Examples of such proteins enumerated in the patent application for Tracy are human insulin, tissue plasminogen activators, and alpha-1-anti-trypsin, a drug used to treat severe lung inflammation and emphysema.[36]

Scientists have also isolated human genes, allowing them to produce pharmacological products in microbiological reactors. One very controversial application of such technology involves relaxin, a human hormone naturally produced in a woman's ovaries which serves to relax the muscles used in giving birth. Although the gene that produces relaxin is activated only at the onset of labor, inventors have been awarded a patent that claims the isolation of this gene from the ovarian cells, and its insertion into the genome of a bacterium from which artificial relaxin can then be produced commercially and used to prevent complications in labor.[37] A second example of such technology involves another human protein, tissue plasminogen activator, which is necessary for the body to break down blood clots. Recently, researchers have isolated the gene that encodes this protein, and have transmitted it to various micro-organisms, thereby facilitating the production of this protein in pure form and the desired quantity, for use by those who lack it.[38]

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30. *See infra* Part III.B.2.b for a discussion of such a plant in *Greenpeace Ltd. v. Plant Genetic Systems N.V.*

31. Schatz, *supra* note 25, at 3.

32. *See infra* note 81 and accompanying text.

33. Schatz, *supra* note 25, at 3.

34. *See infra* Part III.B.2.a for a discussion of the *Harvard/Onco-mouse* case.

35. The creators of the cloned sheep Dolly, PPL Therapeutics PLC of Edinburgh, Scotland, also created Tracy. *In Sheep's Clothing, A Balm for Lung Disease*, Bus. Wk., Sept. 20, 1999, at 82.

36. Schatz, *supra* note 25, at 3; *In Sheep's Clothing, A Balm for Lung Disease*, *supra* note 35, at 82.

37. *See infra* Part III.B.1.b for a discussion of the *Hormone Relaxin* case.

38. Schatz, *supra* note 25, at 3-4.

B. The Need for Biotechnology Patents

Supporters of the E.U. biotech industry are well aware that the creation of the aforementioned inventions, which are vitally important to the E.U. economy, requires substantial investment of time and money. Indeed, the Directive recognizes that "biotechnology and genetic engineering are playing an increasingly important role in a broad range of industries and the protection of biotechnological inventions will certainly be of fundamental importance for the Community's industrial development,"[39] and, further, that such inventions require "a considerable amount of high-risk investment and therefore only adequate legal protection can make them profitable."[40] The protection referred to in the Directive is patent protection, which stimulates invention, whether in the biotech industry or any other, in the E.U. or abroad, in several ways.[41]

First, patent law awards and enforces a limited monopoly,[42] so that an inventor can recoup the costs of investment in research and development.[43] Absent this state-enforced monopoly, the inventor would likely soon face competition from others who would copy the new invention. Liberated from the need to invest heavily in research and development, these free riders could undercut the inventing firm's price and deny it a fair return. Thus, in the absence of adequate patent protection, an inventor has little incentive to invest in the development of new products and processes.[44] This is particularly true for the small start-up companies that presently perform most biotech research in Europe

39. Directive, *supra* note 3, ¶ 1, at 13.

40. *Id.* ¶ 2, at 13.

41. Notably, the idea for patent protection is believed to have originated in Europe, when the Council of Venice enacted the first patent statute in 1474, offering a ten-year monopoly to the inventor of any machine or process that improved or expedited silk-making. David G. Scalise & Daniel Nugent, *Patenting Living Matter in the European Community: Diriment of the Draft Directive*, 16 FORDHAM INT'L L.J. 990, 996 (1993).

42. A patent does not grant the right to exploit an invention, but merely permits the holder to preclude others from reproducing the invention for a limited period of time. *See* Directive, *supra* note 3, ¶ 14, at 14 ("[A] patent for invention does not authorise the holder to implement that invention, but merely entitles him to prohibit third parties from exploiting it for industrial and commercial purposes . . . ."). *See also* Schatz, *supra* note 25, at 12 (stating that a patent grant "does not mean its proprietor can actually use his invention, let alone exploit it industrially," but merely that he can prevent others from doing so). This is referred to as the "negative character" of a patent right. Currently, under the Agreement on Trade-Related Aspects of Intellectual Property Rights, to which both the U.S. and the E.U. are parties, a patent grants an inventor a monopoly that can last up to twenty years. *See* Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, LEGAL INSTRUMENTS - RESULTS OF THE URUGUAY ROUND vol. 31; 33 I.L.M. 81, 96 (1994).

43. Bringing a technology-based pharmaceutical product to market requires an average of $300,000,000 and over twelve years. *EuropaBio*, *at* http://www.europa-bio.be/publications/patent04.htm (visited March 13, 2000). Moreover, an estimated 90% of biotech companies have drugs that fail or are delayed, incurring research costs for projects that may never produce a profit. Lisa Buckingham, *Shock for Shares as Treatments Fail to Yield Hoped-For Dividends*, GUARDIAN (London), Apr. 28, 1998, at 3.

44. *See* Scalise & Nugent, *supra* note 41, at 997. *See also* Commission Proposal of 1988, *supra* note 6, at 6 ("The primary purpose of the modern patent system is to promote technical innovation as the major factor of economic growth by encouraging inventive activity through rewarding inventors for their creative efforts. The patent system thus secures costly investment in research and development and industrial exploitation of research results.").

and depend especially heavily upon patent protection in order to recoup their considerable research and development costs.[45]

Second, patents stimulate the biotech industry by requiring full disclosure of the patented subject matter to the public. Without such protections, inventors would invoke the trade secrets doctrine, thereby engendering duplicative and superfluous research.[46] Indeed, as noted by one scholar, the cloned sheep, Dolly, was first announced publicly in the February 27, 1997 issue of *Nature*, just a few days before the publication of the European patent application. Thus, without patent protection for biotech inventions, firms might be reluctant to invest in research and development at all, or, at a minimum, would shield such inventions in absolute secrecy.[47]

Finally, the patent system encourages competitors to "invent around" or improve upon a patented invention.[48] According to a former U.S. Assistant Commissioner for Patents:

> [t]here are only rare instances of any situations where somebody obtains a patent on something that gives them a real monopoly in a field. What it really does when a patent is granted is stimulate others to invent around it, to improve upon it, to find a different way to do the same thing, and it spurs competition rather than restricts competition.[49]

Thus, although a patent is considered to accord a "limited monopoly" to an inventor, it actually advances technology by stimulating innovation.

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45. *See* EUROPEAN LIFE SCIENCES, *supra* note 8, at 11 (stating that almost 75% of European biotech firms have fewer than 50 employees, the industry average is less than 40 employees, and 20% of such companies have fewer than 10 employees). *See also* Third Report of the Committee on Legal Affairs and Citizens' Rights on the Commission Proposal for a Council Directive on the Legal Protection of Biotechnological Inventions, EUR. PARL. DOC. (COM 88 0496 final—C3-0036/89—SYN 159) 27 (1992) [hereinafter 1992 Committee Report] (stating that the vast majority of firms in the European biotech sector are small or medium-sized enterprises).

46. *See* Scalise & Nugent, *supra* note 41, at 997. *See also* Commission Proposal of 1988, *supra* note 6, at 6 (explaining that "the patent system encourages an early and beneficial dissemination of knowledge in the field of activity involved which, without such protection, might be kept secret.").

47. *See* Schatz, *supra* note 25, at 2 n.1.

48. *See* Report of the Committee on Legal Affairs and Citizens' Rights on the Proposal for a European Parliament and Council Directive on the Legal Protection of Biotechnological Inventions, EUR PARL. DOC. (COM 95 0661 final—C4-0063/96-95/0350(COD)) 31 (1997) [hereinafter 1997 Committee Report] (noting that patents stimulate the biotech industry by providing a "quid pro quo" whereby "[t]he inventor publishes his invention, which can thus provide a basis for further research," in return for an exclusive right to the invention). *See also* Adler, *supra* note 26, at 11 (stating that the patent system "encourages competition to 'invent around' or improve upon a patented invention").

49. *Patents and the Constitution: Transgenic Animals: Hearings Before the Subcomm. on Courts, Civil Liberties and the Administration of Justice of the House Comm. on the Judiciary*, 100th Cong., 1st Sess. 27 (1987) (testimony of Rene D. Tegtmeyer, Assistant Commissioner for Patents).

II.
THE E.U. DIRECTIVE ON THE LEGAL PROTECTION OF BIOTECHNOLOGICAL INVENTIONS

A. *The Political Debate Surrounding Enactment of the E.U. Biotechnology Directive*

In October 1988, the European Commission,[50] recognizing the importance of patent protection for biotech inventions,[51] which were governed by a patchwork of national legislation and regulations and international conventions,[52] issued its Proposal for a Council Directive on the Legal Protection of Biotechnological Inventions (the Commission Proposal of 1988).[53] The Commission, impelled to act by what it viewed as an impending crisis facing the European biotech industry, declared that:

> [w]hereas the two leading nations in biotechnology, the United States of America and Japan, have been able continuously to adapt their patent protection according to the latest needs of the industry, science and consumers, the Member States, representing comparable potential of intellectual manpower and capital, are immobilized by a not yet completed and . . . in part outdated legal framework.[54]

In proposing the Directive, the Commission hoped to stimulate the European biotechnology industry in several ways. First, the establishment of a harmonized system of patent law for biotech inventions would eliminate barriers to the exchange of information and technology among Member States.[55] In addition, the Proposed Directive would foster vigorous trade, which would otherwise be "hampered by the fact that export of self-reproducible biotechnological products into areas with uncertain, weak or even non-existent protection is less than attractive for obvious reasons."[56] Moreover, harmonization and legal certainty with respect to patent protection throughout the E.U. would enhance investment opportunities in the biotech industry. This would, in turn, stimulate E.U. firms to repatriate their funds, previously invested overseas, and attract foreign investors.[57]

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50. *See supra* note 4.

51. *See supra* Part I.B.

52. The international agreements regulating E.U. biotech patents at the time of the Commission Proposal of 1988, which are still in force, include: (1) the EPC, *see supra* note 24 and *infra* Part III.A, pursuant to which the original eleven member nations adopted; (2) the Convention on the Unification of Certain Points of Substantive Law on Patents for Invention, Nov. 27, 1963, Eur. T.S. No. 47 [hereinafter The Strasbourg Convention]; and (3) the International Convention for the Protection of New Varieties of Plants, Dec. 2, 1961, 33 U.S.T. 2703, 815 U.N.T.S. 89, T.I.A.S. No. 10199 [hereinafter UPOV]. The Strasbourg Convention of 1963 established the principles governing the EPC, and UPOV is an international convention among forty-four nations that is aimed at protecting new plant varieties and ensuring plant breeders a fair return on their investments. *See* Scalise & Nugent, *supra* note 41, at 1012 & nn. 107-08; *The International Union for the Protection of New Varieties of Plants, at* http://www.upov.int/eng/ratif/pdf/ratifmem.pdf (last modified Sept. 24, 2000).

53. Commission Proposal of 1988, *supra* note 6.

54. *Id.* at 22.

55. *See id.*

56. *Id.*

57. *See id.*

With its 1988 proposal for a biotech directive, the Commission set in motion a debate that raged throughout the E.U. for nearly ten years. This protracted deliberative process, lengthy even by E.U. standards,[58] resulted in part from the highly controversial nature of the subject matter, as well as the fact that the legislature used for the first time a new co-decision procedure, which gave more power to the Parliament.[59] Once the Commission sent the Proposed Directive to the European Parliament,[60] which has the role of suggesting amendments to the Commission's proposals,[61] the legislation faced opposition from a huge segment of European society, led by Parliament's Green Party,[62] who were supported in their efforts by advocates for small farmers.[63] Due to vociferous opposition and lobbying by these citizens, the 1988 Proposed Directive did not get a formal reading before the Parliament until October 1992.[64] Parliament then called for major reforms of the Proposed Directive, including forty-six amendments, a number of which the Commission incorporated into a modified text issued on December 16, 1992.[65] After more than two years of wrangling between the Parliament and the Council of Ministers regarding the Amended Directive,[66] with the latter generally supporting it, the Parliament rejected the Amended Directive in March 1995, primarily on ethical grounds.[67] The Commission then presented a new draft in January 1996,[68] which, after further debate and amendment,[69] Parliament finally approved on July 6, 1998.[70]

During this ten-year period, the most passionate arguments against the Directive by the Greens and others were based upon moral, ethical and philosophi-

58. Because the E.U. accepts input from all sources when considering legislation that will supersede the national law of the Member States, change occurs only at an incremental pace.

59. Sven J. R. Bostyn, *The Patentability of Genetic Information Carriers*, 1 INTELL. PROP. Q. 1, 1 (1999). For a detailed description of the co-decision procedure under Article 189(b) of the Maastricht Treaty, *supra* note 4, pursuant to which the E.U. Parliament and the Council jointly adopt E.U. legislation, *see* Vinje, *supra* note 4, at 362, Fig. 1.

60. *See supra* note 4.

61. Thomas C. Vinje, *Recent Developments in European Intellectual Property Law*, 13 J.L. & COM. 301, 301 n.3 (1994).

62. The term "Greens," when used in the context of the E.U. debate regarding patenting biotechnological inventions, refers to all persons harboring moral, ethical and/or environmental objections to patenting living matter, and includes, among others, animal rights activists and environmentalists. Scalise & Nugent, *supra* note 41, at 1024.

63. *Biotechnology: Ethics, Patents and the Human Body*, EUR. REP., Jan. 25, 1992, at 5, LEXIS, World News Library, European News Sources File.

64. Vinje, *supra* note 4, at 367.

65. Amended Proposal for a Council Directive on the Legal Protection of Biotechnological Inventions, 1993 O.J. (C 44) 36; *see also* Vinje, *supra* note 4, at 367.

66. *See supra* note 4.

67. *See* Vinje, *supra* note 4, at 367. *See also* Andy Coghlan, *Europe Kills Off Patents on Life*, NEW SCIENTIST, March 11, 1995, at 7.

68. Proposal for a European Parliament and Council Directive on the Legal Protection of Biotechnological Inventions, EUR. PARL. DOC. (COM(95) 661 final—95/0350 (COD)) (1995). *See also* Gert-Jan van de Kamp, *The New Directive on the Legal Protection of Biotechnological Inventions*, 7 EUR. ENVTL. L. REV. 234, 235 (1998).

69. *See MEPs Resume Debate on Protecting Biotechnology Inventions*, EUR. REP., Feb. 5, 1997, LEXIS, World News Library, European News Sources File.

70. Directive, *supra* note 3. *See also* Ian Judge & Matthew Frankel, *European Parliament Approves Biotech Directive*, IP WORLDWIDE, Sept.-Oct. 1998, LEXIS, General News Library, Magazines & Journals File.

cal grounds, and proved particularly difficult to resolve through legislative and judicial pronouncements.[71] First, many opposed to patents on plants and animals, including some Green Party members, were concerned about the monopoly over genetic resources that life patents would foster.[72] Further, they contended that biotechnological advances ought to be shared for the benefit of all humankind, and that living matter is part of the "'heritage of Humanity and Nature in general'" and should not be classified as "'private property.'"[73] In turn, Parliament acknowledged the problems of access to biotechnological inventions and monopolistic powers of patent holders in its Third Report of the Committee on Legal Affairs and Citizens Rights (1992 Committee Report).[74] Parliament concluded that facilitating patentability of biotechnological inventions is but one consideration in the restructuring of the biotech industry,[75] and that legal policy in the E.U. "must be more than a set of arrangements aimed at bringing about favorable conditions of competition."[76] This decidedly continental European perspective on the preferred goals of patent law is not widely shared in the U.S., as demonstrated by the protests from Europe when a U.S. research institute participating in the Human Genome Project[77] sought to patent human gene sequences.[78]

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71. *See generally* Michael E. Sellers, *Patenting Nonnaturally Occurring, Man-Made Life: A Practical Look at the Economic, Environmental, and Ethical Challenges Facing Animal Patents*, 47 ARK. L. REV. 269, 290-91 n.144 (1994) (explaining that it is "unlikely that legislative or judicial line-drawing on [animal patenting] will substantially affect a particular person's beliefs").

72. Darrell G. Dotson, Comment, *The European Controversy Over Genetic-Engineering Patents*, 19 HOUS. J. INT'L L. 919, 943 (1997).

73. *Id.* at 943-44 (quoting *EP Greens Launch a Campaign Against the Draft EEC Directive on Patenting Biotechnological Inventions*, REUTERS, Jan. 25, 1992).

74. *See* 1992 Committee Report, *supra* note 45, at 35-36.

75. *Id.* at 35.

76. *Id.* at 27.

77. The Human Genome Project, which was initiated by the U.S. Congress in 1988-89 and commenced in 1990, is an international effort to map and sequence the genes on all twenty-three pairs of chromosomes and decipher their contribution to the composition of the human being. *See* Malinowski & O'Rourke, *supra* note 29, at 166, 190.

78. In 1991 and 1992, an international debate arose when the U.S. National Institutes of Health (NIH), a governmental biomedical research institute, filed patent applications for thousands of human gene fragments sequenced in NIH laboratories. Malcolm Gladwell, *NIH Seeks Patent Protection for Human Genes*, WASH. POST, Feb. 13, 1992, at A16; Leslie Roberts, *Genome Patent Fight Erupts*, 254 SCIENCE 184 (1991); Leslie Roberts, *NIH Gene Patents, Round Two*, 255 SCIENCE 912 (1992). The international scientific community protested these applications, contending that the information contained therein should be part of the public domain. Robin Herman, *The Great Gene Gold Rush*, WASH. POST, June 16, 1992, at Z11 (describing reactions of experts to gene patenting). These scientists lamented that the award of such patents would foster secrecy among scientists, hamper international collaboration among researchers, and hobble the biotech industry. In protest, leading French human genome researchers handed over French research results on the Human Genome Project to the United Nations Educational, Scientific and Cultural Organization (UNESCO) in Paris. Declan Butler, *Who Owns the Building Blocks of Life?*, INDEP. (London), Nov. 2, 1992, at 14; Christine Gorman, *The Race to Map Our Genes*, TIME, Feb. 8, 1993, at 57. More than two hundred genome scientists from around the world also signed a declaration calling for the results of the Human Genome Project to be freely accessible to all. Butler, *supra*. Ultimately, NIH abandoned its patent application in early 1994, not on ethical grounds, but because the sequences lacked proven utility, one of the requirements for patentability. Michael Waldholz, *NIH Gives Up Effort to Patent Pieces of Genes*, WALL ST. J., Feb. 11, 1994, at B1.

Second, animal rights activists and others opposed to patenting life forms wished to prevent the pain suffered by animals subject to biotech experimentation, particularly transgenic animals created by genetic manipulation to be prone to disease.[79] Notable in this regard is the Harvard Onco-mouse, a transgenic animal that was created to be susceptible to cancer and continues to stir intense controversy in the E.U.[80] Another example is the "Beltsville pig," which was inserted at the embryonic stage with a gene originating from human genetic material that is responsible for producing a growth hormone. Although these pigs did indeed grow faster, carry less fat and pass these traits on to their offspring, as intended, they also suffered from arthritis and were more susceptible to infections.[81] Moreover, European Parliament officials expressed ethical concerns that a patent right in an animal "leads to the presumption that animals are merely production machines or research tools to be redesigned and used for the convenience of humankind."[82]

In addition to harboring moral and ethical reservations about patenting plants and animals, many Greens and other environmentalists contended that such patents present great environmental risks. First, they argued that genetic engineering increased the likelihood of inadvertently releasing a pathogen into the environment.[83] Furthermore, they warned that even the release of putatively "safe" genetically engineered organisms could threaten the delicate ecological balance of the natural environment. For example, the overuse of specially bred plants and animals could threaten the diversity of the natural gene pools of various species.[84]

Forming an alliance with the Greens were European farmers, especially small family farmers, who challenged biotech patents on economic grounds. They contended that their costs of operation would rise significantly if they were forced to pay licensing fees and royalties to obtain and reproduce patented plants and animals. The expense of obtaining costly biotech inventions impacts small family farmers especially severely vis–à-vis their corporate counterparts, as small farmers can neither afford the high start-up costs nor achieve the economies of scale necessary to reap the rewards of biotechnological advances. Thus, small farmers feared that large farming corporations would eventually dominate

79. *See* 1992 Committee Report, *supra* note 45, at 31-33.

80. *See infra* Part III.B.2.a.

81. *See* 1992 Committee Report, *supra* note 45, at 33.

82. 1997 Committee Report, *supra* note 48, at 44.

83. *See* Scalise & Nugent, *supra* note 41, at 1024.

84. 1992 Committee Report, *supra* note 45, at 37-38 (noting that German farmers were reported to be using as few as six winter wheat varieties on 75% of their arable land, and over 90% of the beet harvest in the Netherlands was from only three varieties, leading to concerns that this trend would grow more prevalent with the spread of varieties developed via genetic engineering); 1997 Committee Report, *supra* note 48, at 43 ("The patenting of living material will be a further incentive to develop only *new high-performance varieties and races* adapted to the increased industrial trends in agriculture. Their use will place further curbs on regional and ecologically appropriate crop varieties and will further reduce genetic diversity.").

the market with patented plants and animals, thereby driving small farming operations out of business.[85]

B. *Provisions of the Directive*

The version of the Directive ultimately enacted in 1998[86] represents a compromise between the biotech industry and its supporters, on the one hand, and the various factions opposing the Directive on moral, ethical, environmental and economic grounds, on the other.[87] As stated in the Recitals of the Directive's Preamble, the Directive is designed to ensure the "effective and harmonised protection throughout the Member States" so ardently desired by the biotech industry "in order to maintain and encourage investment in the field of biotechnology."[88] Indeed, some scholars have noted that, although the Recitals indicate that E.U. institutions are merely pursuing the goal of harmonization,[89] without creating a separate body of patent law that offers rights beyond those available under national laws,[90] the unstated goal of the Directive is actually to strengthen patent protection throughout the E.U.[91] With regard to accommodating the Greens and other opponents of patents on plants and animals, the Preamble emphasizes that "inventions must be excluded from patentability where their commercial exploitation offends against ordre public or morality."[92] An examination of the operative provisions of the Directive demonstrates the intent of its drafters to protect biotechnological inventions under national patent law,[93] while preserving the ability of Member States to consider the ethical dimensions of biotechnological inventions when determining whether to grant patents.[94]

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85. *See* 1992 Committee Report, *supra* note 45, at 65-66; 1997 Committee Report, *supra* note 48, at 42-43. *See also* Scalise & Nugent, *supra* note 41, at 1025.

86. Directive, *supra* note 3.

87. *See* Ram, *supra* note 11, at 45 (stating that the Directive was developed through compromise and that the various interested parties made concessions).

88. Directive, *supra* note 3, ¶ 3, at 13.

89. *See id.* ¶¶ 3, 5, 6 and 7, at 13.

90. *See id.* ¶ 8, at 13.

91. *See* Vinje, *supra* note 4, at 361 ("Generally speaking, EU institutions are pursuing the goal not only of harmonising intellectual property legislation, but also, and at least as vigorously, of strengthening it at the same time."). Indeed, this view is supported by language in the Directive, which, despite asserting that "legal protection of biotechnological inventions does not necessitate the creation of a separate body of law in place of the rules of national patent law," nonetheless provides that those national rules "must be *adapted or added to* in certain specific respects in order to take adequate account of technological developments involving biological material which also fulfill the requirements for patentability." Directive, *supra* note 3, ¶ 8, at 13 (emphasis added).

92. Directive, *supra* note 3, ¶ 37, at 16. *See also id.* ¶¶ 38-42, at 16 (further discussing the concepts of *ordre public* and morality embodied in the Directive).

93. Article 1.1 of the Directive provides that "Member States shall protect biotechnological inventions under national patent law. They shall, if necessary, adjust their national patent law to take account of the provisions of this Directive." *Id.* art. 1.1, at 18.

94. Article 6.1 of the Directive provides that "[i]nventions shall be considered unpatentable where their commercial exploitation would be contrary to *ordre public* or morality." *Id.* art. 6.1, at 18.

1. What Is Patentable Under the Directive

The Directive is divided into five chapters, the first of which sets forth the extent of plant and animal patentability.[95] Within Chapter I, Article 3.1 confirms that it is possible to patent "biological material,"[96] provided that the usual patent criteria are satisfied, meaning that the invention is new, involves an inventive step and has an industrial application.[97]

Article 3.2 of the Directive provides that "[b]iological material which is isolated from its natural environment or produced by means of a technical process may be the subject of an invention even if it previously occurred in nature."[98] This provision confirms that the novelty requirement for a patent has been met where biological material that occurs naturally has instead been isolated or produced by a technical process. Patent protection does indeed exist in such cases because the technical processes used to identify, purify and classify the material and to reproduce it are man-made and cannot be accomplished by nature alone, rendering the material a patentable invention rather than a mere discovery.[99] A particular application of this principle is illustrated in Article 5, which provides patent protection for certain elements isolated from the human body.[100] Pursuant to Article 5.1, "[t]he human body, at the various stages of its formation and development, and the simple discovery of one of its elements, including the sequence or partial sequence of a gene" is unpatentable.[101] However, isolated elements, including human genes, are patentable under Article 5.2, which provides that "[a]n element isolated from the human body or otherwise produced by means of a technical process, including the sequence or partial sequence of a gene, may constitute a patentable invention, even if the structure of that element is identical to that of a natural element."[102] Thus, Article 5.2 confirms that the results of research on the human genome can be patented, so long as the industrial usefulness of such research can be demonstrated.[103]

95. *Id.* Chap. 1, at 18-19.

96. "Biological material" is defined in Article 2 of the Directive as "any material containing genetic information and capable of reproducing itself or being reproduced in a biological system." *Id.* art. 2.1, at 18.

97. *Id.* art. 3.1, at 18. The criteria set forth in Article 3.1 of the Directive, also known as novelty, nonobviousness and usefulness, derive from the EPC and the Strasbourg Convention, two European patent treaties upon which the Directive is modeled. EPC, *supra* note 24, art. 52(1), 1065 U.N.T.S. at 271, 13 I.L.M. at 285, and the Strasbourg Convention, *supra* note 52, art. 1.

98. Directive, *supra* note 3, art. 3.2, at 18.

99. *Id.* ¶ 21, at 15.

100. Such patent protection was strongly opposed by the Greens and their allies. *See* Scalise & Nugent, *supra* note 41, at 1026-27. *See also Biotechnology: Ethics, Patents and the Human Body*, EUR. REP., *supra* note 63; Claire O'Brien, *European Parliament Axes Patent Policy*, 267 SCIENCE 1417 (1995); Rory Watson, *European Parliament Tackles Biotechnology*, 313 BRIT. MED. J. 964 (1996).

101. Directive, *supra* note 3, art. 5.1, at 18.

102. *Id.* art. 5.2, at 18.

103. Specifically, Article 5.3 of the Directive provides that "[t]he industrial application of a sequence or a partial sequence of a gene must be disclosed in the patent application." *Id.* art. 5.3, at 18.

2. *What Is Not Patentable Under the Directive*

Articles 4, 5, and 6 of the Directive identify creations that are not patentable. First, Article 4 of the Directive precludes patent protection for plant and animal varieties,[104] although plants and animals are not per se unpatentable,[105] and for "essentially biological processes for the production of plants and animals."[106] A process for the production of plants and animals is "essentially biological" if it "consists entirely of natural phenomena such as crossing or selection."[107]

The exclusion of essentially biological processes and plant and animal varieties from patent protection in part indicates ethical objections to human intervention in the generation of animals and plants, objections that may be raised on moral and public policy grounds.[108] For the most part, however, these provisions derive from earlier treaties that date from a time when new varieties of plants and animals could be achieved only through cross-selection and breeding,[109] and the law sought to protect farmers from paying royalties when they bred plants and animals on their farms. Although Article 4.1 of the Directive may seem to bar unnecessarily patents on transgenic[110] plants and animals, its language is qualified by Article 4.2, which provides patent protection to inventions concerning plants or animals "if the technical feasibility of the invention is not confined to a particular plant or animal variety."[111] Article 4.2 inevitably will engender debates about the extent to which a particular invention is applicable to different plant and animal varieties if the research has focused on a single variety.[112]

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104. *Id.* art. 4.1(a), at 18. The concept of plant varieties is defined in Article 2.3 of the Directive, which refers to Article 5 of the Council Regulation (EC) 2100/94 of 27 July 1994 on Community Plant Variety Rights, 1994 O.J. (L 227) 1 [hereinafter Plant Variety Regulation].

105. *See supra* notes 96-97 and accompanying text.

106. Directive, *supra* note 3, art. 4.1(b), at 18. Article 4.3 allows an exception to Article 4.1(b), however, expressly providing patent protection for microbiological processes, along with products obtained by means of such processes. *Id.* art. 4.3, at 18. As noted by one scholar, the exception in Article 4.3 acknowledges that microbiological production techniques have been patentable for so long that, even when used for plant and animal production, they must be treated as patentable. CORNISH, *supra* note 3, at 194. For example, as stated at note 15, *supra*, the German Federal Supreme Court permitted patent protection for yeast as early as 1975. Cornish contends, however, that there is no scientific line between micro- and macro-biology, which renders this distinction increasingly ambiguous. *See* CORNISH, *supra* note 3, at 194.

107. Directive, *supra* note 3, art. 2.2, at 18.

108. *See supra* Part II.A for a discussion of the arguments raised in the E.U. by opponents of patents on plants and animals.

109. The Directive's Article 4 bar on patents for animals varieties, except for microbiological inventions, Directive, *supra* note 3, art. 4, at 18, tracks almost exactly the language from Article 53(b) of the EPC, *supra* note 24, which precludes patents on "plant or animal varieties or essentially biological processes for the production of plants or animals; this provision does not apply to microbiological processes or the products thereof." EPC, *supra* note 24, art. 53(b), 1065 U.N.T.S. at 272, 13 I.L.M. at 286.

110. *See supra* note 27 for a definition of transgenic plants and animals.

111. Directive, *supra* note 3, art. 4.2, at 18.

112. The Directive's ban on patent protection for plant varieties is premised in part on the fact that inventors of a particular *plant* variety can avail themselves of alternative methods of plant variety protection, such as the Plant Variety Regulation, *see supra* note 104, and also the UPOV, *see supra* note 52, which was revised in 1991 to admit intergovernmental organizations, including the

Article 5 of the Directive, which deals with the patentability of humans,[113] prohibits a patent on "[t]he human body, at the various stages of its formation and development, and the simple discovery of one of its elements."[114] Nonetheless, as stated previously, elements isolated from the human body are patentable so long as their usefulness can be demonstrated.[115]

Limitations on patentability are also embodied in the Article 6 morality provision, which provides that "[i]nventions shall be considered unpatentable where their commercial exploitation would be contrary to ordre public[116] or morality; however exploitation shall not be deemed to be so contrary merely because it is prohibited by law or regulation."[117] Article 6.2[118] then provides an illustrative, rather than comprehensive, list of processes and products that contravene this requirement and are therefore unpatentable, including processes for cloning human beings; processes for modifying the germ line genetic identity of human beings;[119] processes for using human embryos for industrial or commercial purposes; and "processes for modifying the genetic identity of animals which are likely to cause them suffering without any substantial medical benefit to man or animal, and also animals resulting from such processes."[120] The Directive makes clear that this list is not exhaustive.[121]

E.U. CORNISH, *supra* note 3, at 683. This presents an obstacle to inventors of *animal* varieties, however, in that no analogous system of protection exists for them. *Cf.* van de Kamp, *supra* note 68, at 236 & n.21 (noting that the EPO, in determining whether to grant a patent in cases regarding transgenic plants and animals under the EPC, has proved itself more likely to grant a patent for an animal invention in light of the fact that alternative legislation exists to protect inventors of plant varieties but not animal varieties).

113. Directive, *supra* note 3, art. 5, at 18.

114. *Id.* art. 5.1, at 18.

115. *See id.* arts. 5.2 and 5.3, at 18. *See also supra* notes 100-03 and accompanying text.

116. *See supra* note 18 for a definition of *ordre public.*

117. Directive, *supra* note 3, art. 6.1, at 18.

118. *Id.* art. 6.2, at 18-19.

119. Germ line gene therapy alters a person's reproductive cells so as to transmit genetic changes to a person's descendants. It is distinguishable from somatic cell gene therapy, which applies to differentiated cells such as the cells of the liver, blood or other organs, and which is patentable under the Directive. Bostyn, *supra* note 59, at 8 & nn.36-37. Many commentators have criticized the Directive's exclusion of germ line gene therapy processes from patent protection, in light of the fact that numerous inheritable diseases could potentially be cured by such therapy. In particular, one scholar noted that "[i]t seems retrograde and short-sighted to exclude from patentability a process which might have such a substantial benefit to humankind," particularly in light of the fact that the Directive was enacted, at least in part, in order to improve human health. Nonetheless, this scholar noted that, given the complex ethical issues raised by such research, this exclusion "was probably inevitable in order to get the Directive approved." Nott, *supra* note 1, at 349.

120. Directive, *supra* note 3, art. 6.2, at 19. Transgenic animals such as the Harvard Oncomouse, discussed *infra* in Part III.B.2.a, could well be subject to this provision.

121. Indeed, Recital 38 confirms that the list of immoral inventions set forth in the operative part of the Directive is not comprehensive, and gives as an additional example that "processes to produce chimeras from germ cells or totipotent cells of humans and animals, are obviously also excluded from patentability." Directive, *supra* note 3, ¶ 38, at 16. A chimera is a living creature created by combining the genetic material of animals of two different species in such a way that their genetic material does not mix in each cell throughout the animal, as it would for a hybrid animal. Instead, a chimera is made up of some cells that come entirely from one species and some cells that derive entirely from the other. *See* Magnani, *supra* note 9, at 445. Molecular biologists have possessed the ability to create animal-animal chimeras for more than a decade. In the mid-1980s, scientists in the United Kingdom announced the creation of a "geep," an animal that was part goat and

Article 7 of the Directive provides that the Commission's European Group on Ethics in Science and New Technologies (EGEST) will evaluate all ethical aspects of biotechnology.[122] This twelve-member group, which is completely independent of the Commission and is intended to be free from political and national interests as well, has a broad mandate. The opinions it delivers will concern not only biotechnology, but also other fields, such as information technology. In addition to delivering opinions at the Commission's request, this group will have the option of examining matters and rendering opinions on its own initiative.[123]

3. *Implementation of the Directive*

Chapter V of the Directive provides for its implementation and ongoing refinement. Pursuant to Article 15, "Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive not later than 30 July 2000."[124] Moreover, under Article 16 of the Directive, the Commission is required to report to Parliament and the Council every five years on problems relating to human rights that arise from the Directive, and to report annually on the development of patent law in the field of biotechnology and genetic engineering.[125]

III.
WILL THE DIRECTIVE FOSTER HARMONIZATION AMONG THE MEMBER STATES?

As of September 2, 2000, only three E.U. Member States had amended their national legislation, regulations and administrative provisions relating to biotechnology in compliance with the Directive.[126] Until all of the national legislatures have enacted and the national courts interpreted such legislation, it is impossible to determine to what extent the Directive will harmonize the patent laws of the Member States. One factor making harmonization particularly difficult is the Directive's Article 6, inserted as a concession to the Greens in Parliament, which precludes patents for inventions contrary to morality or public

part sheep. *See* Carole B. Fehilly et al., *Interspecific Chimaerism Between Sheep and Goat*, 307 NATURE 634 (1984); Sabine Meinecke-Tillmann & B. Meinecke, *Experimental Chimaeras – Removal of Reproductive Barrier Between Sheep and Goat*, 307 NATURE 637 (1984). In the United States, a patent application was filed on December 18, 1997 for a method of making creatures that are part human and part animal by combining the embryos of both and implanting these chimeric embryos into surrogate mothers. *See* David Dickson, *Legal Fight Looms Over Patent Bid on Human/Animal Chimeras*, 392 NATURE 423 (1998); Rick Weiss, *Patent Sought on Making of Part-Human Creatures: Scientist Seeks to Touch Off Ethics Debate*, WASH. POST, Apr. 2, 1998, at A12.

122. Directive, *supra* note 3, art. 7, at 19.

123. van de Kamp, *supra* note 68, at 237.

124. Directive, *supra* note 3, art. 15, at 20. Thus, although the Directive is not intended to displace national patent laws in the Member States, *id.* ¶ 8, at 13, the Commission is empowered to impose sanctions upon Member States that fail to alter their national laws in conformance with the Directive, *id.* arts. 1 and 15, at 13 and 20-21.

125. *Id.* art. 16, at 21.

126. For a discussion of the resistance of some E.U. Member States to implementing the Directive, *see supra* note 20 and accompanying text, and *see infra* notes 129, 275-80 and accompanying text.

policy.[127] Article 6 will be subject to widely varying interpretations throughout the Member States, which differ greatly in their acceptance of emergent biotechnological inventions. The United Kingdom and Germany, for instance, are quite willing to grant patents on life forms,[128] while the Netherlands generally opposes the patenting of life forms per se.[129]

Some scholars have dismissed the notion that patent officers and judges from nations opposed to plant and animal patents will interpret Article 6 so broadly as to preclude most biotechnology patents, given that European judges have already begun to communicate with one another in an effort to harmonize E.U. patent law.[130] Even if these scholars are correct, harmonization will nonetheless remain elusive under the Directive. As it is drafted, the ambiguity of the Directive's Article 6 invites inconsistent interpretations, even from judges committed to achieving uniformity. An examination of cases decided by the EPO under the EPC's morality provision, upon which the Directive's morality provision is modeled nearly verbatim, demonstrates that the morality provision has been subject to inconsistent interpretations even by a *single* adjudicatory body.[131]

A. *The European Patent Convention Morality Provision*

Article 53(a) of the European Patent Convention (EPC),[132] an international agreement currently in force among nineteen nations, including all of the E.U. Member States,[133] provides that European patents shall not be granted for "inventions the publication or exploitation of which would be contrary to 'ordre public'[134] or morality,[135] provided that the exploitation shall not be deemed to be so contrary merely because it is prohibited by law or regulation in some or all

127. *See supra* notes 116-21 and accompanying text.

128. Since the mid 1970s, Germany and the United Kingdom have been especially willing to grant patents on life forms. *See, e.g., American Cyanamid v. Berk Pharm.*, 1976 R.P.C. 231 (1976) (approving patents on life forms in the United Kingdom); *Red Dove*, 1969 GRUR 672 (BGH 1969) (allowing patents on higher animals in Germany); *Baker's Yeast Decision, supra* note 15. The seminal *Red Dove* decision in 1969, in which the German Federal Supreme Court approved patents on higher animals, preceded by over 10 years the U.S. Supreme Court's decision in *Diamond v. Chakrabarty*, 447 U.S. 303 (1980), in which the U.S. Supreme Court concluded that patentable subject matter was to "include anything under the sun that is made by man." *Id.* at 309.

129. In 1998, the Netherlands brought an action before the European Court of Justice opposing the Directive. *See* Case C-377/98, *Netherlands v. Parliament*, 1998 O.J. (C 378) 13. Italy has since joined the case as well. *See infra* notes 275-80 and accompanying text.

130. Nott, *supra* note 1, at 350-51.

131. *See infra* Part III.B.

132. EPC, *supra* note 24, art. 53(a), 1065 U.N.T.S. at 273, 13 I.L.M at 286.

133. Signatories to the EPC include all fifteen of the E.U. Member States, *see supra* note 4, as well as Switzerland, Liechtenstein, Monaco and Cyprus. *See* Helen Gavaghan, *EU Ends 10-Year Battle Over Biopatents*, 280 SCIENCE 1188, 1188 (1998). *See also European Patent Office, at* http://www.european-patent-office.org/epo/members.htm (visited October 13, 2000).

134. According to the decision of the Technical Board of Appeal of the EPO in *Greenpeace Ltd. v. Plant Genetic Systems N.V.*, *see infra* Part III.B.2.b:

> the concept of '**ordre public**' covers the protection of public security and the physical integrity of individuals as part of society. This concept encompasses also the protection of the environment. Accordingly, under Article 53(a) EPC, inventions the exploitation of which is likely to breach public peace or social order . . . or to seri-

of the contracting states."[136] As is readily apparent, the language of Article 6 of the Directive is not only modeled upon, but is indeed nearly identical to that of EPC Article 53(a).[137]

The EPC, which is completely independent of the E.U,[138] was created in order to enable a patent applicant seeking patent rights in more than one contracting nation to file a single European Patent Application, which, if granted, becomes a national patent in each of the nations designated in the application.[139]

> ously prejudice the environment are to be excluded from patentability as being contrary to 'ordre public.'

Greenpeace Ltd. v. Plant Genetic Systems N.V., T 356/93 - 3.3.4, 1995 O.J. E.P.O. 545 (Technical Bd. of App.), ¶ 5 [hereinafter *PGS*]. Thus, as mentioned previously "*ordre public*" is the equivalent of "public policy." *See supra* note 18.

135. In *PGS*, the EPO Technical Board of Appeal declared that:

> [t]he concept of **morality** is related to the belief that some behaviour is right and acceptable whereas other behaviour is wrong, this belief being founded on the totality of the accepted norms which are deeply rooted in a particular culture. For the purposes of the EPC, the culture in question is the culture inherent in European society and civilisation. Accordingly, under Article 53(a) EPC, inventions the exploitation of which is **not** in conformity with the conventionally-accepted standards of conduct pertaining to this culture are to be excluded from patentability as being contrary to morality.

PGS, *supra* note 134, ¶ 6. It should be noted that the EPO recognized that "there was no European definition of morality," and that the "interpretation of the concept of morality should be a matter for European institutions." *Id.* ¶ 4 (*citing* EPC WORKING PARTY DOCUMENT IV/2767/61-E, at 7).

136. EPC, *supra* note 24, art. 53(a), 1065 U.N.T.S. at 273, 13 I.L.M at 286. Regarding the qualification in Article 53(a) of the EPC "that the exploitation shall not be deemed to be so contrary merely because it is prohibited by law or regulation in some or all of the Contracting States," the EPO Technical Board of Appeal explained in *PGS* that:

> [t]his qualification makes clear that the assessment of whether or not a particular subject-matter is to be considered contrary to either 'ordre public' or morality is not dependent upon any national laws or regulations. Conversely and by the same token, . . . a particular subject-matter shall not automatically be regarded as complying with the requirements of Article 53(a) EPC merely because its exploitation is permitted in some or all of the contracting states. Thus, approval or disapproval of the exploitation by national law(s) or regulation(s) does not constitute per se a sufficient criterion for the purposes of examination under Article 53(a) EPC.

PGS, *supra* note 134, ¶ 7. One reason for this is that "a product could still be manufactured under a European patent for export to States in which its use is not prohibited." GUIDELINES FOR EXAMINATION IN THE EPO, at C-IV, § 3.2, *reprinted in* 2 EUROPEAN PATENTS HANDBOOK 56/215 (2d ed. 1995) [hereinafter GUIDELINES FOR EXAMINATION].

137. *See supra* text accompanying notes 116-17. The only significant difference between the language of Article 6 of the Directive and Article 53(a) of the EPC is that the Directive omits the word "publication." This omission precludes the body assessing the morality of a patent application under the Directive from denying a patent based upon the morality of the methods used to create the invention. In contrast, under Article 53 of the EPC, the EPO has discretion to reject a patent application based upon the morality of the methods used to create the invention, as well as upon the subsequent use of the invention after the patent had been awarded. *See* Richard Ford, *The Morality of Biotech Patents: Differing Legal Obligations in Europe?*, 19 EUR. INTELL. PROP. REV. 315, 316 (1997).

138. The governing bodies of the E.U. do not exercise any control over the EPC, and the EPO is not legally bound to follow the Directive. *See* Gavaghan, *supra* note 133, at 1188; Judge & Frankel, *supra* note 70. Experts believe that the Directive will influence the EPO's decisions, however, since fifteen of the nineteen signatories to the EPC are E.U. Member States. Gavaghan, *supra* note 133, at 1188.

139. A European Patent Application can be filed at the EPO in Munich, at The Hague, or with the national patent office of the individual nation. The EPO then conducts an examination of the

Thus, the EPC does not grant a supranational patent, but provides a centralized system for obtaining a bundle of national patent rights[140] which are governed by the independent laws of the various contracting states, rather than the EPO.[141]

The EPC is therefore a patent registration system, not a legislative body, and as such, cannot foster harmonization of European patent law. While the EPC reduces the time and cost necessary to obtain patent rights in certain of the signatory nations, a governing precept of the EPC is that it may not replace or supersede the various national patent laws already in effect in the signatory nations. Consequently, under the EPC schema, the individual contracting countries may interpret and modify a single European patent, thus affording the patentee varying degrees of patent protection.[142] In contrast, the Directive is intended to harmonize[143] intellectual property rights throughout the E.U. and requires Member States to amend their laws in compliance with it.[144] Further, the Directive is backed by the enforcement powers of the European Community, which can coerce legislative action in any Member State by threat of sanctions.[145]

As signatories to the EPC, the E.U. Member States have already included in their national laws provisions that are based on the EPC Article 53(a) morality provision.[146] For example, the British Patents Act of 1977 provides, in relevant part, that "[a] patent shall not be granted for an invention the publication or exploitation of which would be generally expected to encourage offensive, immoral or anti-social behaviour."[147] Moreover, "behaviour shall not be regarded

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patent application. The applicant must designate at the time of filing the countries of the EPC to which he wishes protection of his invention to extend. Examination of a patent application is divided into: (1) an examination of whether the application has met all formal requirements followed by (2) a substantive examination. During the formalities examination, the EPO also scrutinizes the application for compliance with the Article 53(a) morality provision. The substantive examination of each application is conducted by the Examining Division, the first level of such review, which consists of three technically qualified examiners of different nationalities. Within nine months from the date the Examining Division has granted a patent, any person may file a notice of opposition, which must contain a statement of the extent to which the European patent is opposed and the grounds upon which the opposition is based. Oppositions are conducted by the Opposition Division, which consists of three technical examiners, at least two of whom must not have taken part in the proceedings for the grant of the patent to which the opposition relates. An appeal to the Technical Board of Appeal lies from a decision of the Opposition Division. *See* PETER D. ROSENBERG, 3 PATENT LAW FUNDAMENTALS 19-102 to 19-106 (2d ed. 1999). Alternatively, a patent granted under the EPC can be challenged before the national patent offices or courts, in which case the decisions have only a national effect. *See* van de Kamp, *supra* note 68, at 235.

140. *See* Janice McCoy, *Patenting Life in the European Community: The Proposed Directive on the Legal Protection for Biotechnological Inventions*, 4 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 501, 509 n. 45 (1993).

141. *See* Scalise & Nugent, *supra* note 41, at 1013.

142. *Id.* at 1012-13.

143. *See supra* notes 6-8 and accompanying text.

144. Directive, *supra* note 3, art. 15, at 20-21. Moreover, although the Directive provides that Member States' national patent laws "remain the essential basis" for protection of biotech inventions, it emphasizes that such laws "must be adapted or added to" so as to "take adequate account of technological developments involving biological material." *Id.* ¶ 8, at 13.

145. *See supra* note 124.

146. Rainer Moufang, *Patenting of Human Genes, Cells and Parts of the Body? The Ethical Dimensions of Patent Law*, 25 INT'L REV. INDUS. PROP. & COPYRIGHT L. 487, 503 (1994).

147. British Patents Act of 1977, ch. 37, Sec. 1(3)(a).

as offensive, immoral or anti-social only because it is prohibited by any law in force in the United Kingdom or any part of it."[148] Other EPC signatory nations have similar provisions in their patent law.[149] Thus, the legal interpretations of Article 53(a) of the EPC will serve as a model for E.U. Member States, all of which are members of the EPC, as their legislatures and judiciaries grapple with the Directive's morality provision.

B. *Two Conflicting Morality Tests Under the European Patent Convention*

Morality is an exceedingly complex standard to implement as a criterion of patentability. Already, in the four biotechnology cases in which the morality criterion has formed the basis for challenging a patent under the EPC, two distinct tests have emerged. First, the "public abhorrence" test denies a patent grant to any invention where public consensus determines that such a grant would be abhorrent.[150] Second, the "unacceptability" test denies a patent grant where the disadvantages of the patent to society would outweigh the advantages,[151] or where, put somewhat differently, the grant of a patent would be unacceptable in light of the "conventionally accepted standards of conduct of European culture."[152] The "unacceptability" test is more stringent, since an invention that is not "abhorrent" may still be deemed so "unacceptable" as to preclude patent protection. Thus, variation in which of the two tests is applied results in inconsistent standards of patentability.

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148. British Patents Act of 1977, ch. 37, Sec. 1(4).

149. Moufang cites as examples Sec. 4(2) of the Belgian Patent Act; Sec. 1(4)(i) of the Danish Patent Act; Sec. 2(1) of the German Patent Act; Art. L. 611-17 of the French Intellectual Property Code; Sec. 5(8)(a) of the Greek Patent Act; Sec. 13(1) of the Italian Patent Act; Sec. 1(3)(a) of the Luxembourg Patent Act; Sec. 5 of the Dutch Patent Act; Art. 2(1) of the Austrian Patent Act; Sec. 1(4)(1) of the Swedish Patent Act; Sec. 2(a) of the Swiss Patent Act; and Sec. 5(1)(a) of the Spanish Patent Act. He notes that there "may be slight differences in the precise wording" of these acts. Moufang, *supra* note 146, at 503 n.76.

150. The "public abhorrence" test was adopted in *In re Lubrizol Genetics, Inc.*, (*Lubrizol II*), EP-B1-122 791, 1990 O.J. E.P.O. 71 (Opp. Div.), *reprinted in* 21 INT'L REV. INDUS. PROP. & COPYRIGHT L. 487 (1990) [hereinafter *Lubrizol*], and in *Hormone Relaxin*, 1995 O.J. E.P.O. 388 (Opp. Div.) [hereinafter *Relaxin*]. *See infra* Part III.B.1. This test derives from the GUIDELINES FOR EXAMINATION, *supra* note 136, at C-IV, § 3.1, *reprinted in* EUROPEAN PATENTS HANDBOOK 56/214 to 56/215, which provides that, in order to determine whether an invention is contrary to *ordre public* or morality, "[a] fair test to apply is to consider whether it is probable that the public in general would regard the invention as so abhorrent that the grant of a patent right would be inconceivable." The GUIDELINES FOR EXAMINATION then explain that Article 53(a) "is likely to be invoked only in rare and extreme cases," giving the example of a letter bomb. *Id. See also* EDWARD ARMITAGE & IVOR DAVIS, PATENTS AND MORALITY IN PERSPECTIVE (1994) (two former Comptrollers of the U.K. Patent Office, who were involved in the creation of the EPC, state that the morality exception ought to be invoked only where it is virtually "inconceivable" that the invention could be put to a moral use and the invention is clearly "abhorrent").

151. This test was applied in *Harvard/Onco-mouse*, 1992 O.J. E.P.O. 588 (Examining Div.), *reprinted in* 1991 EUR. PAT. OFF. REP. 525, 527-28 [hereinafter *Harvard/Onco-mouse Decision of 3 April 1992*].

152. This test was adopted in *PGS*, *supra* note 134, ¶ 17.3. *See also infra* notes 242-46 and accompanying text. As noted previously, however, *supra* note 135, the *PGS* Board noted that "there was no European definition of morality," and that the "interpretation of the concept of morality should be a matter for European institutions." *PGS*, *supra* note 134, ¶ 4.

1. *The "Public Abhorrence" Standard*

a. *In re Lubrizol Genetics, Inc.*

The EPO first espoused the "public abhorrence" test in the 1992 decision *In re Lubrizol Genetics Inc. (Lubrizol)*,[153] in which the EPO Opposition Division[154] approved the patent granted for a hybrid transgenic plant as well as the method of rapidly producing such plants.[155] In March 1989, after mention of a patent grant to Lubrizol was published, eleven parties, including several political and environmental organizations, filed notices of opposition. These opposition groups demanded that the Opposition Division revoke the European patent, basing their arguments in part on the premise that such a plant patent contravened morality.[156]

First, opponents of the Lubrizol patent contended that Article 53(a) of the EPC[157] precluded patenting of plant genetic resources, which should be freely available to all. Second, they argued that patenting plant inventions would engender a decrease in the number of plant varieties and ultimately lead to a loss of genes. Finally, those opposed to the Lubrizol patent argued that patent protection on plant inventions would offend religious sensibilities in Europe.[158] While these arguments opposing the Lubrizol patent actually deny the patentability of plants per se, the EPO disregarded such objections in principle to patents on plants and animals in the *Harvard/Onco-Mouse* case,[159] decided in the same year as *Lubrizol*. Nonetheless, the Opposition Division's deliberations in the *Lubrizol* case regarding the patentability of life forms illuminate the devel-

153. *See supra* note 150.

154. *See supra* note 139 regarding the role of the EPO Opposition Division.

155. More specifically, the patent contained claims relating to a DNA shuttle vector comprising T-DNA having inserted therein a plant gene comprising a plant promoter and a plant structural gene, a method for genetically modifying a plant cell and a plant produced according to the method contained in the patent application. *See* Hans-Rainer Jaenichen & Andreas Schrell, *The European Patent Office's Recent Decisions on Patenting Plants*, 12 EUR. INTELL. PROP. REV. 466, 466 (1993).

156. *Id. See also supra* note 139 regarding the procedure for filing an opposition to the grant of a patent in the European Patent Office.

157. *See supra* notes 132-37 and accompanying text.

158. *See* Jaenichen & Schrell, *supra* note 155, at 467.

159. *See infra* Part III.B.2.a. In all likelihood, such contentions will no longer be tenable under the Directive, which expressly provides patent protection for plants. *See supra* text accompanying notes 96-97, 105. As least as early as 1988, the Commission emphasized that "[w]here the principle is not completely accepted, . . . the argument can no longer be raised that all living matter must be excluded from patent protection on the ground that the mere fact of being alive disqualifies such inventions from being regarded as patentable." Commission Proposal of 1988, *supra* note 6, at 32. The Commission noted that the EPC contracting states incorporated principles regarding patentability of life forms which derived from earlier conventions, dating as far back as 1961, *see supra* notes 108-09 and accompanying text, "without seriously reconsidering developments which in the meantime had taken place in various areas of biotechnology." Commission Proposal of 1988, *supra* note 6, at 10. The belief inhered in the EPC that biological inventions were patentable only in rare cases. *See id.* at 10-12. The Directive expressly departs from this view, however, providing that "Member States shall protect biotechnological inventions under national patent law," Directive, *supra* note 3, art. 1.1, at 18, and "inventions which are new, which involve an inventive step and which are susceptible of industrial application shall be patentable even if they concern a product consisting of or containing biological material or a process by means of which biological material is produced, processed or used." *Id.* art. 3.1, at 18.

opment of the "public abhorrence" test under Article 53(a) of the EPC. This test remains viable,[160] and is likely to be applied in some of the cases brought under Article 6 of the Directive.

The EPO's Opposition Division rejected any contention that the Lubrizol patent contravened morality. First, they held that because known subject matter is not patentable under the EPC,[161] and only known plant genetic resources can be considered a part of a common heritage, the patented invention at issue must contain unknown genetic resources and therefore could not be part of a common heritage. Second, with respect to genetic diversity, the Opposition Division concluded that biotechnology inventions involving plants normally give rise to a new combination of genes and that the patent system therefore facilitated an increase in the amount of available genetic material. Furthermore, biotechnology did not pose the only potential threat to biodiversity, since a decrease in the number of plant varieties could arise simply from traditional breeding techniques. Finally, the Opposition Division rejected the argument that plant patents conflicted with European religious sensibilities, because many European nations already provided patent protection for plants, as did the U.S., which is similarly influenced by Christian ethical thought.[162]

The *Lubrizol* case is significant in that, in 1992, at the same time that the European Parliament was debating the inclusion of a morality provision in the Directive, the EPO held that "patent law is not an appropriate instrument for regulating the development of new technologies and that the legislature should determine whether a certain technology is so dangerous and unacceptable to the public that it should be suppressed."[163] Furthermore, the Opposition Division emphasized that exclusions from patentability generally are to be interpreted narrowly,[164] relying on past decisions of the Technical Boards of Appeal.[165]

Most importantly, the Opposition Division in Lubrizol adopted the "public abhorrence" test to determine whether an invention violated Article 53(a) of the EPC. According to this test, an invention will be excluded from patent protection only where the public in general would regard the invention as so abhorrent that the grant of a patent would be inconceivable.[166]

b. Hormone Relaxin

In 1994, two years after its decision in *Lubrizol*, the Opposition Division of the EPO again applied the "public abhorrence" test, this time in the case of

160. Indeed, the "public abhorrence" test was again employed by the EPO in the 1994 *Hormone Relaxin* action. *See infra* Part III.B.1.b.

161. *See supra* notes 96-97 and accompanying text regarding the novelty requirement under European patent law.

162. *See* Jaenichen & Schrell, *supra* note 155, at 467.

163. *Id.*

164. *See id.*

165. *See supra* note 139 for a discussion of EPO procedure, including the role of the Technical Board of Appeal.

166. *See* Jaenichen & Schrell, *supra* note 155, at 467.

Hormone Relaxin (Relaxin).[167] In the *Relaxin* case, the Opposition Division approved the grant of a patent for a DNA fragment encoding a human protein, produced by pregnant women, that had useful applications during the childbirth process.[168]

The patent at issue in *Relaxin* had originally been granted in 1991,[169] and the Green Party[170] filed an opposition in 1992 on the grounds that, *inter alia*, the invention offended against *ordre public* and morality.[171] Opponents of the relaxin patent invoked powerful language in calling for its revocation. First, they claimed that the patent instructs that tissue be taken from pregnant women in order to replicate the invention. The Greens' argument, as paraphrased by the EPO, was that "[t]he isolation of the DNA relaxin gene from tissue taken from a pregnant woman is immoral, in that it constitutes an offence against human dignity to make use of a particular female condition (pregnancy) for a technical process oriented towards profit."[172] Second, opponents of the patent asserted that patenting human genes amounted to "a form of modern slavery since it involves the dismemberment of women and their piecemeal sale to commercial enterprises throughout the world."[173] Third, they contended that the patenting of human genes is equivalent to the patenting of human life, which is inherently immoral.[174]

In evaluating these arguments against the relaxin patent, the Opposition Division noted that the provisions of Article 53(a) of the EPC, which "have only very seldom been invoked," must "be seen as a measure to ensure that patents would not be granted for inventions that would universally be regarded as outrageous."[175] In light of this standard, the Opposition Division rejected the arguments of the patent opponents on several grounds.[176]

First, regarding the isolation of tissue taken from pregnant women, the patent holder stated that the women who donated the tissue consented to do so during the course of necessary gynecological procedures. The Opposition Division noted that human tissue and other materials such as blood and bone had served for years as a source for products such as proteins, RNA and DNA. Numerous life-saving substances, such as blood clotting factors, had been isolated

167. *See supra* note 150.

168. *See Relaxin*, *supra* note 150. *See also* Stephen Crespi, *Biotechnology Patenting: The Wicked Animal Must Defend Itself*, 17 EUR. INTELL. PROP. REV. 431, 434 (1995).

169. *See Relaxin*, *supra* note 150, Facts and Submissions, ¶ I.

170. *See supra* note 62.

171. *See Relaxin*, *supra* note 150, Facts and Submissions, ¶ II.1.

172. *Id.* ¶ 6.1(a).

173. *Id.* ¶ 6.1(b).

174. *Id.* ¶ 6.1(c). Similarly, the Directive provides that human life generally cannot be patented. *See supra* notes 100-03, 113-15 and accompanying text.

175. *Relaxin*, *supra* note 150, ¶ 6.2.1. The Opposition Division referred to the EPO GUIDELINES FOR EXAMINATION, *supra* note 136, in stating that Article 53(a) of the EPC "is likely to be invoked only in rare and extreme cases, for example that of a letter bomb." *Id.* ¶ 6.2.1. The Opposition Division further noted that "[t]he boards of appeal have repeatedly found that such exceptions [under Article 53(a)] are to be narrowly construed." *Id.* ¶ 6.2.2 (citations omitted).

176. *Id.* ¶ 6.3.

in this way and many had been patented.[177] According to the Opposition Division, "[e]very evidence indicates that this practice is perfectly acceptable to and even welcomed by the vast majority of the public."[178] Moreover, the Opposition Division observed that, contrary to the opponents' assertions concerning the repeatability of the invention, the isolation procedure need not be repeated in order to carry out the invention since a DNA fragment encoding relaxin can be chemically synthesized.[179]

Second, as for the opponents' assertions concerning slavery and the dismemberment of women, the Opposition Division admonished that such arguments "betray a fundamental misunderstanding of the effects of a patent."[180] A patent does not confer on its holder any rights whatsoever in individual human beings, but merely allows the holder to preclude third parties from commercially exploiting the patented invention for a designated period of time.[181] Thus, "[n]o woman is affected in any way by the present patent – she is free to live her life as she wishes and has exactly the same right to self-determination as she had before the patent was granted."[182] Nor does the exploitation of the invention involve dismemberment and the piecemeal sale of women, according to the Opposition Division. Indeed, the very aim of the patent, as with other types of gene cloning, is that the protein encoded by the cloned gene – in this case human H2-relaxin – is produced in unicellular organisms containing the corresponding DNA, thereby obviating the need to use human beings as a source of the protein. The only stage at which a women was involved was at the beginning, as a voluntary source for the relaxin mRNA.[183]

Third, the Opposition Division rejected the allegation that human life was being patented, since DNA is not itself "life," but rather a chemical substance that carries genetic information and can be used to produce proteins with medical applications. According to the Opposition Division, the patent opponents "apparently do not object to the patenting and exploitation for medical purposes of other human substances such as proteins (even the H2-relaxin protein)." The Opposition Division found "no moral distinction . . . in principle between the patenting of genes on the one hand and other human substances on the other, especially in view of the fact that only through gene cloning have many important human proteins . . . become available in sufficient amounts to be medically applied."[184]

In addition to addressing the specific arguments made by the opponents of the relaxin patent, the Opposition Division also responded to the opponents' general arguments that patenting human genes is inherently immoral. The Opposition Division alluded to the contemporaneous debate regarding whether the

177. *Id.* ¶ 6.3.1.
178. *Id.*
179. *Id.* ¶ 6.3.2.
180. *Id.* ¶ 6.3.3.
181. *Id. See also supra* note 42 and accompanying text.
182. *Relaxin, supra* note 150, ¶ 6.3.3.
183. *Id.* ¶ 6.3.3.
184. *Id.* ¶ 6.3.4.

Directive would permit patenting of human genes (ultimately, it did[185]) to prove that there was no consensus among the contracting states that the patenting of human genes is abhorrent and hence prohibited under Article 53(a).[186]

Thus, the *Relaxin* case established that the EPO would apply the "abhorrent" standard even to patents involving human gene sequences. The Opposition Division held that:

> there is no provision in the EPC that only those inventions actively approved of by the public should be patented. If such a provision existed, it is arguable that the number of patents granted would be decimated since there are plenty of fields other than biotechnology (which the opposition division, unlike the opponents, does not see as a special case) in which patents may well be objectionable to parts of the public. Only in those very limited cases in which there appears to be an **overwhelming consensus** that the exploitation or publication of an invention would be immoral may an invention be excluded from patentability under Article 53(a).[187]

In *Relaxin*, the Opposition Division, which had applied the "public abhorrence" test to transgenic plants in the *Lubrizol* action two years earlier, employed that same standard in a case dealing with genetic data derived from human beings.

2. *The Unacceptability Test*

a. *Harvard/Onco-mouse*

In 1992, the EPO Examining Division[188] departed from the "public abhorrence" test articulated in the EPO Guidelines for Examination[189] and applied the more stringent "unacceptability" test in approving the first patent granted to a transgenic animal, the Harvard Onco-mouse. Scientists at Harvard University created the Harvard Onco-mouse in the 1980s by inserting into a mouse a human gene that renders the mouse highly susceptible to breast cancer.[190] The inventors applied for an U.S. patent on January 22, 1984, for the process of producing genetically-manipulated animals, as well as for the transgenic animal

185. *See supra* notes 100-03, 113-15 and accompanying text.

186. *See Relaxin*, *supra* note 150, ¶¶ 6.4.1 to 6.4.4.

187. *Id.* ¶ 6.5.

188. *See supra* note 139 for a discussion of EPO procedure, including the role of the Examining Division.

189. *See supra* note 150.

190. Carrie F. Walter, *Beyond the Harvard Mouse: Current Patent Practice and the Necessity of Clear Guidelines in Biotechnology Patent Law*, 73 IND. L.J. 1025, 1029 (1998). The Harvard researchers isolated a gene that causes cancer in many mammals, including humans. They then injected this gene into a fertilized mouse egg that developed into the Harvard mouse. *See id.;* Keith Schneider, *Harvard Gets Mouse Patent, a World First*, N.Y. TIMES, Apr. 13, 1988, at A1. The scientists developed the animal, which eventually became the property of the pharmaceutical company Du Pont, to serve as a more effective model for studying how genes contribute to various forms of cancer, particularly breast cancer, as well as for testing drugs for breast cancer. *See* Alun Anderson, *Oncomouse Released*, 336 NATURE 300, 300 (1988).

itself.[191] The patent, granted on April 12, 1988, was the first patent the U.S. Patent and Trademark Office awarded for a new variety of animal.[192]

In 1985, less than two years after they applied for a patent in the U.S., the inventors of the Harvard mouse sought a patent in Europe from the EPO.[193] In 1989, the Examining Division of the EPO denied the Harvard Onco-mouse patent application. This rejection was based largely upon EPC Article 53(b), which provides that European patents shall not be granted for "plant or animal varieties or essentially biological processes for the production of plants or animals."[194] The EPO interpreted the term "animal variety" in Article 53(b) of the EPC in a manner that excluded patent protection for all animals per se.[195] The Examining Division did not address the moral considerations implicit in the patent application, concluding that patent law was not the appropriate tool for regulating conflicts that arise from genetic engineering technology.[196]

The inventors of the Harvard mouse appealed the decision of the Examining Division to the EPO Technical Board of Appeal.[197] In this proceeding, the Technical Board of Appeal held that the EPC does not exclude the patenting of

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191. *See* 6 EUROPEAN PATENTS HANDBOOK 106:E-35 (2d ed. 1995). In distinguishing among patents upon processes used to make products, patents on the resultant products themselves, and patents on useful applications of such products, the Commission Proposal of 1988 explained as follows:

> Inventions resulting from modern biotechnological techniques can be grouped according to the usual patent law distinction made between product, process and use or application inventions.
>
> Inventions relating to products concern living entities of natural or artificial origin, such as plants, animals and microorganisms, biological material, such as plasmids, viruses and replicons, and parts thereof (e.g., organs, tissues, cells and organelles). They may also relate to naturally occurring substances from living entities, biological materials and parts thereof. The invention itself may be the plant, animal, microorganism or a specific biological material (e.g., a plasmid) per se or the plant, animal, etc. produced by a particular process.
>
> The second category (process inventions) concerns processes for the creation of plants, animals, microorganisms or any biological material and parts thereof. It includes also such processes as cultivation, isolation, and purification, and also of bioconversion.
>
> The third category of biotechnological inventions (application inventions) comprises specific uses of plants, animals, microorganisms or biological material.

Commission Proposal of 1988, *supra* note 6, at 9-10.

192. *See* Walter, *supra* note 190, at 1029. *See also* U.S. Patent No. 4,736,866 (1988).

193. European patent application 85 304 490.7 was filed on June 24, 1985. *See Harvard/Onco-mouse*, 1989 O.J. E.P.O. 451 (Examining Div.), *reprinted in* 1990 EUR. PAT. OFF. REP. 4, 5 [hereinafter *Harvard/Onco-mouse Decision of 14 July 1989*].

194. *See supra* note 109.

195. *See Harvard/Onco-mouse Decision of 14 July 1989, supra* note 193, at 8. Although Article 53(b) of the EPC, *see supra* note 109, was formerly interpreted to preclude patents on plants and animals per se, *see supra* notes 104-12 and accompanying text, this provision is now understood to mean that, at least with respect to plants, an invention is patentable provided that it is not confined to a particular variety. *See infra* note 222.

196. *See Harvard/Onco-mouse Decision of 14 July 1989, supra* note 193, at 11.

197. *See Harvard/Onco-mouse*, 1990 O.J. E.P.O. 476, *reprinted in* 1990 EUR. PAT. OFF. REP. 501 [hereinafter *Harvard/Onco-mouse Decision of 3 October 1990*].

animals as a per se category.[198] The EPO Board interpreted Article 53(b),[199] which purports to exclude plant and animal varieties from patentability, to bar only existing varieties, not new and distinct plants or animals engineered by biotechnology.[200] With this decision, the EPO Technical Board of Appeal expanded the scope of patentable subject matter, moving in the direction of the U.S., which first recognized the right to patent living organisms in the 1980 case of *Diamond v. Chakrabarty*.[201]

The Technical Board of Appeal stopped short of granting a patent for the Harvard mouse, however. It remanded the case to the Examining Division for further inquiry on the issue of whether the exploitation of the invention would be contrary to morality and *ordre public* as those terms are used in Article 53(a).[202] The Board's concern was two-fold. First, the genetic manipulation described in the claim caused the animal to be inordinately sensitive to carcinogenic substances and predisposed to develop tumors, which caused suffering. Moreover, the release of genetically-manipulated animals into the environment could have unintended and irremediable adverse effects.[203] The Technical Board of Appeal also disagreed with the Examining Division's conclusion that patent law was not an appropriate means of dealing with moral concerns.[204] In remanding the question of whether the patent should be barred by Article 53(a), the EPO Board articulated a test for "unacceptability" that involved "a careful weighing up of the suffering of animals and possible risks to the environment on the one hand, and the invention's usefulness to mankind on the other."[205]

On remand, in determining whether a patent grant for the *Harvard/Onco-mouse* would violate Article 53(a) of the EPC, the Examining Division invoked this "unacceptability" test, weighing the interest of humankind in treating diseases against the need to protect the environment against the uncontrolled dissemination of unwanted genes and the need to avoid cruelty to animals.[206] In

198. *Id.* at 510-11. The Board stressed that "the Examining Division was wrong in refusing the present application on the ground that Article 53(b) EPC excludes the patenting of animals as such." *Id.* at 511.

199. *See supra* note 109.

200. *See Harvard/Onco-mouse Decision of 3 October 1990, supra* note 197, at 510-11. The patent actually covered any non-human mammal with an inserted oncogene. *See* Tom Wilkie, *'Onco-Mouse' Spreads Confusion in Patent Office*, INDEP. (London), Nov. 25, 1995, at 8.

201. *Diamond v. Chakrabarty*, 447 U.S. 303 (1980). At issue in *Chakrabarty* was whether a human-made, genetically engineered multicellular organism capable of breaking down crude oil qualified as patentable subject matter under U.S. law. *Id.* at 309. The organism, which was useful for controlling oil spills, was a bacterium developed by a microbiologist through cross-breeding of four different strains of oil-eating bacteria into one microorganism. *Id.* at 305 n.1. No naturally-occurring bacteria was capable of breaking down the components of crude oil. *Id.* at 305. The U.S. Supreme Court concluded that patentable subject matter was to "include anything under the sun that is made by man." *Id.* at 309 (quoting S. Rep. No. 1979, 82nd Cong., 2d Sess. at 5 (1952); H.R. Rep. No. 1923, 82nd Cong., 2d Sess. at 6 (1952)).

202. *Harvard/Onco-mouse Decision of 3 October 1990, supra* note 197, at 513.

203. *Id.*

204. *Id.*

205. *Id.* Although this balancing test appears to be incorporated into Article 6.2(d) of the Directive, *see supra* note 19, it is not evident that the Directive actually employs this same standard, *see infra* notes 267-70 and accompanying text.

206. *See Harvard/Onco-mouse Decision of 3 April 1992, supra* note 151, at 527-28.

1992, the Examining Division finally granted Harvard a patent on the Onco-mouse, holding that the transgenic mouse was not immoral or contrary to public policy, since the invention's usefulness in cancer research outweighed the actual harm suffered by animal research subjects and the potential harm to the environment.[207] The Examining Division gave clear priority to curing the disease, stating that "[a]ny contribution to the development of new and improved human anti-cancer treatments is . . . a benefit to mankind and must be regarded as valuable and highly welcome by everybody."[208] Moreover, the use of patented animals for conducting cancer research was likely to necessitate a smaller number of animals being needed for testing overall.[209] With respect to possible risks to the environment, the Examining Division concluded that, since no release of the animals was planned, the only possible risk was that a malevolent scientist would bring about such a release intentionally or an inept scientist would do so inadvertently.[210] According to the Examining Division, "[t]he mere fact that such uncontrollable acts are conceivable cannot be a major determinant for deciding whether a patent should be granted or not."[211] Thus, "in the overall balance," the Examining Division determined that the patented invention could not be considered immoral or contrary to *ordre public*.[212]

Legal challenges to the Harvard mouse patent continue to the present day in the E.U. When the EPO announced in 1992 that it intended to approve the Onco-mouse patent application, protests arose throughout Europe. More than two hundred organizations, whose members include animal welfare activists, environmentalists and religious adherents, combined to support seventeen oppositions. Most of these oppositions rely on the argument that the patent is inconsistent with Article 53(a) of the EPC.[213] In February 1993, under pressure from these groups, the European Parliament revoked the patent and banned further animal patenting until a formal policy could be researched and established.[214] In deference to national law, this revocation was non-binding, resulting in diverging national laws.[215] At this writing, the outcome of the opposition pro-

207. *See id.* at 528. Notably, in *Harvard/Onco-mouse Decision of 3 April 1992, see id.*, the Examining Division declined to consider the general objection made by opponents to the patent that transgenic animals represent per se an unethical interference with evolution. The refusal of the Examining Division to examine this question presaged the enactment of the Directive, which expressly provides for patenting of transgenic animals in Article 3.2, *see supra* notes 98-99, 159 and accompanying text. The fact that the Directive does not permit per se objections to patenting plants and animals represents a significant limitation of the Directive, in the view of those opposed to such patents. *See infra* notes 273-80 and accompanying text.

208. *Harvard/Onco-mouse Decision of 3 April 1992, supra* note 151, at 527. The Examining Division also pointed out that legislation was in place in the contracting states to regulate animal testing. *See id.*

209. *Id.*

210. *Id.* at 528.

211. *Id.* The Technical Board of Appeal stated that such issues should be regulated by specialized government authorities, not the European Patent Office. *See id.*

212. *Id.*

213. *See* van de Kamp, *supra* note 68, at 236; Charles Arthur & Tom Wilkie, *Is This the Work of Man or Nature?*, INDEP. (London), Nov. 20, 1995, at 2.

214. Estelle J. Tsevdos et al., *Law and Nature Collide*, NAT'L L.J., June 16, 1998, at C1, C27.

215. *Id.*

ceedings has not yet been decided, and it is expected to be affected by the recent Directive.[216]

b. Greenpeace Ltd. v. Plant Genetic Systems N.V.

In *Greenpeace Ltd. v. Plant Genetic Systems N.V.* ("*PGS*"),[217] the Technical Board of Appeal of the EPO clearly established that the "unacceptability" standard employed in the *Harvard/Onco-mouse* action could also apply to plant patents. The case arose from the EPO's 1990 grant of a patent to Plant Genetic Systems N.V. for a method of developing plants and seeds resistant to a particular class of herbicides. The method involved inserting into the cell genome a gene coding for an enzyme that protects the cells when they come into contact with the herbicide.[218] The patent was granted for genetically engineered plant cells and for all subsequent seeds and plants derived from the genetically altered cells. Greenpeace, an international nongovernmental organization concerned with environmental issues, filed an opposition to the patent in 1992 on the grounds that, *inter alia*, it violated Article 53(a) of the EPC.[219] The Opposition Division heard the action in 1992, and upheld the patent.[220] Greenpeace immediately lodged an appeal, which the Technical Board of Appeal decided in February 1995.[221] After applying the "unacceptability" test, the Technical Board of Appeal held that none of the claims in the patent violated Article 53(a) of the EPC.[222] The "unacceptability" test in *PGS* is particularly significant because the Technical Board of Appeal used it to reverse the Opposition Division's 1993 decision, which had employed the "public abhorrence" test.[223]

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216. Gavaghan, *supra* note 133, at 1188. According to Gavaghan, although "not officially acknowledged, it is widely believed" that the *Harvard/Onco-mouse* decision has been "on hold until the directive was passed." *Id.*

217. T 356/93 - 3.3.3, 1995 O.J. E.P.O. 545 (Technical Bd. of App.) [hereinafter *PGS*].

218. *See* Ingeborg Voelker, *Europe Won't Reverse Controversial EPO Ruling*, IP WORLDWIDE, July-Aug. 1997, LEXIS, General News Library, Magazines & Journals File.

219. *See supra* notes 132-37 and accompanying text.

220. *See Greenpeace Ltd. v. Plant Genetic Systems N.V.* (Opp. Div. 1992), reprinted in 24 INT'L REV. INDUS. PROP. & COPYRIGHT L. 618 (1993).

221. *See* Margaret Llewelyn, *Article 53 Revisited: Greenpeace v. Plant Genetic Systems NV*, 17 EUR. INTELL. PROP. REV. 506, 506 (1995); Voelker, *supra* note 218.

222. *See PGS*, *supra* note 217, ¶ 19. The Technical Board of Appeal did, however, reject two of the patent claims, those directed to the transgenic plants obtained by regenerating mature plants from the genetically modified plant cells, and the seeds derived from the plants, on the grounds that these claims embraced new plant varieties, which, along with animal varieties, were explicitly excluded from plant protection by Article 53(b) of the EPC. *See* Voelker, *supra* note 218. However, in light of a December 1999 EPO decision, an invention that is not confined to a particular plant variety is patentable under the EPC. *See European Patent Office, at* http://www.european-patent-office.org/news/pressrel/991220_e.htm (last modified October 13, 2000). With this decision, the EPO has tracked the language of the Directive with respect to plant varieties. *See supra* notes 104-12 and accompanying text.

223. *See Greenpeace Ltd. v. Plant Genetic Systems N.V.* (Opp. Div. 1992), *supra* note 220, ¶ 3.16. The Opposition Division in *PGS* had invoked the EPO GUIDELINES FOR EXAMINATION, *see supra* notes 136 and 150, stating in 1992 that, in most cases, it was not necessary to consider the question of morality, and that morality should be considered only where there was an application that would "universally be regarded as outrageous" that is, "only in rare and extreme cases." *See Greenpeace Ltd. v. Plant Genetic Systems N.V., supra* note 220, ¶ 3.5.

In *PGS*, Greenpeace contended that the patent at issue violated the Article 53(a) morality provision of the EPC in several ways. First, because plant material is the common heritage of mankind, it would be immoral to allow any entity a monopoly over such material.[224] Second, as paraphrased by the EPO, Greenpeace contended that the patent was immoral in that it sought to exercise "dominion . . . over the natural world."[225] Third, patenting of plant material could have disastrous environmental effects.[226] Greenpeace based these arguments in part upon opinion polls in which a significant majority of those surveyed opposed the patenting of genetically engineered, herbicide-resistant plants as technical inventions.[227] Fourth, Greenpeace argued that the Examining and Opposition Divisions that had considered *PGS* had failed to follow the "unacceptability" standard established in the *Harvard/Onco-mouse* case.[228] In light of that case, Greenpeace demanded that, in deciding whether a patent grant violated Article 53(a) of the EPC, the Technical Board of Appeal must weigh the benefits to be gained from herbicide-resistant plant material against any environmental harm that might result from such an invention.[229]

In response to Greenpeace, PGS contended that the patent grant was proper for several reasons. First, although Greenpeace feared that the patent at issue would foster a monopoly, the negative character of the patent right[230] meant that the patentee did not have an unfettered right to exploit the claimed invention, and was subject to all applicable government regulation.[231] Second, since no governmental regulation proscribed the invention, it followed that the patent was not universally disfavored, survey evidence notwithstanding. As noted by the patentee, many scientists believe that biotechnology is a useful tool for ensuring sufficient food supplies for the growing world population.[232] Third, with respect to environmental harm, appellants had not furnished sufficient evidence regarding alleged potential risks, such as the spreading of the herbicide-resistant gene to other plants or the transformation of crops into weeds.[233] PGS asserted that, rather than reducing biological diversity, the patent grant would instead foster greater genetic variability by furnishing new genetic material.[234] Finally,

224. *See PGS, supra* note 217, Summary of Facts and Submissions, ¶ IX(a). As set forth previously, such an argument would likely fail under the Directive. *See supra* note 159.

225. *PGS, supra* note 217, Summary of Facts and Submissions, ¶ IX(a).

226. Specifically, Greenpeace asserted that the invention at issue in *PGS* posed the following environmental risks: (1) the plants could themselves become weeds or pests and pass their genes on to other plants which, in turn, might become herbicide-resistant; (2) the release of the plants could disrupt the ecostructure and lead to a reduction in biodiversity; and (3) the patent could increase the use of herbicides, and lead to the creation of more genetically engineered plants. *See PGS, supra* note 217, Summary of Facts and Submissions, ¶ IX(c).

227. *Id.* ¶ 15.

228. The Examining and Opposition Divisions in *PGS* had applied the "public abhorrence" standard. *See id.* ¶ III(b). *See also* note 223 *supra*.

229. *See PGS, supra* note 217, ¶ IX(c) (stating that Greenpeace called for the application of a "balancing exercise" pursuant to "the guidance given" in the *Harvard/Onco-mouse* case).

230. *See supra* note 42.

231. Llewelyn, *supra* note 221, at 507.

232. *PGS, supra* note 217, Summary of Facts and Submissions, ¶ X(a).

233. *Id.* ¶ X(b).

234. Llewelyn, *supra* note 221, at 507.

with respect to the test to be applied in deciding whether the invention contravened morality, PGS referred to the EPO's Guidelines for Examination,[235] which state that only inventions that can be regarded as "abhorrent" would be excluded under Article 53(a). PGS contended that the *Harvard/Onco-mouse* case had not established the "unacceptability" test as precedent to be applied in every biotechnology patent case, and in no way mandated the weighing of benefits and detriments for every invention. Rather, the result of such a balancing test was merely one factor to be considered with respect to a patent application. Furthermore, according to PGS, even under the "unacceptability" test, any risks posed by their invention would be handily outweighed by the potential benefits.[236] As for the governmental organization that should conduct such a balancing test, PGS asserted that the regulatory institutions that determine whether genetically modified material can be exploited commercially were better suited than the EPO to weigh the risks of an invention against its advantages.[237]

In its February 1995 decision in the *PGS* case, the EPO Technical Board of Appeal implicitly denied PGS's assertion that the EPO was not well-situated to interpret terms such as morality and *ordre public*, by agreeing with Greenpeace's assertion that "patent offices are placed at the crossroads between science and public policy"[238] and by proceeding to consider the morality of the *PGS* invention. The EPO stated that, since there was no pan-European definition of morality or *ordre public*,[239] it would examine each particular invention on its own merits in order to assess whether it constituted an exception to patentability under Article 53(a) of the EPC.[240] The Technical Board of Appeal also criticized the survey evidence submitted by Greenpeace, stating that it was not representative of attitudes prevalent in society. Indeed, the results of the survey undertaken in Sweden were skewed, because the only participating group, farmers, was the one most likely to be harmed by the patent grant.[241]

After declaring itself competent to evaluate the morality of an invention, the Technical Board of Appeal then considered the transgenic plant at issue, treating separately the questions of morality and *ordre public*.[242] With respect to the morality of the invention, the Technical Board of Appeal held that "plant biotechnology per se cannot be regarded as being more contrary to morality than traditional selective breeding" since "both traditional breeders and molecular biologists are guided by the same motivation, namely to change the property of a plant by introducing novel genetic material into it in order to obtain a new and,

235. *See supra* note 150.

236. *PGS*, *supra* note 217, ¶ X(b); Llewelyn, *supra* note 221, at 507-08. Although PGS also asserted that a regulatory government organization, rather than the EPO, ought to engage in such a weighing process, the EPO implicitly recognized its own authority to consider morality and *ordre public* when evaluating a patent grant. *See PGS*, *supra* note 217, ¶ 13.

237. *PGS*, *supra* note 217, ¶ X(b); Llewelyn, *supra* note 221, at 507-08.

238. *PGS*, *supra* note 217, ¶ 18.3. The EPO recognized that it shared this authority with "an increasing number of other authorities and bodies." *Id.*

239. *Id.* ¶ 4.

240. *Id.* ¶ 13.

241. *Id.* ¶ 15.

242. *Id.* ¶ 16.

possibly, improved plant."[243] The main difference between genetic engineering techniques and traditional breeding is that the former allows "a more powerful and accurate control of genetic modifications."[244] The Board then held that the patented invention would violate Article 53(a) only if used for destructive purposes.[245] In the view of the Technical Board of Appeal, none of the claims of the patent, which related to the process of producing plants and seeds that are protected from weeds or fungal diseases, as well as products such as plant cells, plants, and seeds themselves, was tantamount to an actual misuse or destructive use of plant biotechnology, in light of "conventionally accepted standards of conduct of European culture."[246] Thus, the invention at issue in *PGS* was not barred by the morality prong of the EPC's Article 53(a).

The Technical Board of Appeal next considered the question of public policy, stating that the patent at issue would indeed be contrary to *ordre public* if its exploitation would be likely to "seriously prejudice the environment."[247] According to the Board, evidence that the exploitation of the invention would seriously prejudice the environment must be "sufficiently substantiated at the time the decision to revoke the patent is taken,"[248] and that "[i]t would be unjustified to deny a patent under Article 53(a) [of the] EPC merely on the basis of **possible, not yet conclusively-documented hazards**."[249] The Board then held that since Greenpeace had not proved conclusively[250] that any harm would result from exploitation of the subject matter at issue, the *ordre public* prong of Article 53(a) of the EPC did not preclude the Board from granting PGS a patent for its invention.[251] Thus, Article 53(a) of the EPC did not bar patentability, since none of the claims of the patent at issue contravened *ordre public* or morality.[252]

While the Board in *PGS* applied the more stringent "unacceptability" test as opposed to the "public abhorrence" standard set forth in *Lubrizol* and *Relaxin*, in *PGS* the Board deviated somewhat from the balancing test applied in *Harvard/Onco-mouse*. In *PGS*, the Board decided that "since no sufficient evidence of actual disadvantages has been adduced, the assessment of patentability with regard to Article 53(a) EPC may not be based on the so-called 'balancing exercise' of benefits and disadvantages," as had been done in the *Harvard/Onco-mouse* action.[253] The Board emphasized that the "balancing exercise" performed in that decision was "not the only way of assessing patentability with

243. *Id.* ¶ 17.1.
244. *Id.*
245. *Id.*
246. *Id.* ¶ 17.3. *See supra* note 191 regarding the distinction among patents on processes, products and the useful application of such products.
247. *PGS, supra* note 217, ¶ 18.
248. *Id.* ¶ 18.5. The Board stated that "[t]his view is consistent with the requirement that the exceptions to patentability under Article 53(a) [of the] EPC have to be narrowly construed." *Id. See supra* note 150.
249. *Id.* ¶ 18.7.
250. The Board made it evident that Greenpeace bore the burden of proof as to environmental harm. *See* Llewelyn, *supra* note 221, at 509.
251. *See PGS, supra* note 217, ¶ 18.7.
252. *See id.* ¶ 18.8.
253. *Id.*

regard to Article 53(a) EPC, but just one possible way, perhaps useful in situations in which an actual damage and/or disadvantage (eg [sic] suffering of animals as in [the *Harvard/Onco-mouse* case]) exists."[254] Thus, in the most recent case decided under Article 53(a) of the EPC, the Technical Board of Appeal applied the "unacceptability" test, while proclaiming that this test was just one possible, but by no means exclusive, vehicle for assessing patentability.

c. Analysis of the Case Law Under Article 53(a) of the EPC Highlights the Difficulty of Harmonization Under the Directive

As the foregoing review of EPO decisions under Article 53(a) of the EPC demonstrates, the analogous Article 6 morality provision will hamper harmonization, the Directive's primary goal. Strikingly, harmonization will remain elusive even though the Member States will have nearly identical morality provisions in their respective patent laws, as a result of their membership in the EPC. As mentioned previously, all of the E.U. Member States, as signatories to the EPC, have already enacted legislation modeled after Article 53(a) of that convention.[255] Because Article 6 of the Directive derives nearly verbatim from Article 53(a) of the EPC,[256] most Member States will not need to change the morality provisions in their national laws in order to comply with the Directive's requirement[257] that their patent laws be in accordance with the Directive.[258] Thus, the conflicting interpretations under Article 53(a) of the EPC are likely to hound the Directive as well.

The major barrier to harmonization under Article 6 of the Directive is that the conflicting case law leaves in doubt whether the "public abhorrence" or the "unacceptability" test will apply.[259] In two cases decided by the EPO in 1992, the Opposition Division applied the more lenient "public abhorrence" test for plants in *Lubrizol*,[260] while the Technical Board of Appeal employed the stricter "unacceptability" standard for mice that had been bred to be susceptible to cancer in *Harvard/Onco-mouse*.[261] Based on this, one might assume that a more lenient test might be applied to plants, and a stricter one to situations where animals would be subject to pain. In fact, the Opposition Division's suggestion in *PGS* that the tests would be applied this way[262] was roundly criticized by scholars[263] until it was reversed by the Board two years later.

254. *Id.*
255. *See supra* notes 146-49 and accompanying text.
256. *See supra* text accompanying notes 116-17 and 132-37.
257. *See supra* note 124 and accompanying text.
258. *See supra* notes 146-49 and accompanying text.
259. *See supra* Part III.B.
260. *See supra* Part III.B.1.a.
261. *See supra* Part III.B.2.a.
262. *Greenpeace Ltd. v. Plant Genetic Systems N.V.* (Opp Div. 1993), *supra* note 220, ¶ 3.7.
263. *See* Lionel Bently, *Sowing Seeds of Doubt on Onco Mouse: Morality and Patentability*, 5 KING'S COLLEGE L.J. 188, 188 ("The distinction developed by the Opposition Division [in *PGS*], that the *Onco Mouse* case is confined to situations involving animals which will inevitably be subject to pain . . . is supported neither by the *Onco Mouse* decision itself nor the structure of the E.P.C. . . . . [T]here is no reason therefore to suppose that [Article 53(a)'s] relevance is confined to inventions concerning animals.").

To further confuse matters, the EPO Opposition Division in 1994 applied the more lenient "public abhorrence" test with regard to patenting a DNA fragment encoding a human protein in the *Relaxin* case,[264] while in 1995 the Technical Board of Appeal in *PGS* employed for transgenic plants the stricter "unacceptability" test.[265] Although one might construe from these cases that the Examining and Opposition Divisions will apply the more lenient "abhorrence" test, while the Technical Board of Appeal will implement the stricter "unacceptability" test, there is no logic to such a system.[266] In truth, it is nearly impossible to determine at this point which test will apply when assessing the patentability of biotech inventions.

The Directive does not resolve the confusion as to whether the "public abhorrence" or "unacceptability" standard will be applied, even though, at first glance, a particular provision might seem to settle this question. Article 6.2(d) of the Directive denies patent protection on moral grounds for "processes for modifying the genetic identity of animals which are likely to cause them suffering without any substantial medical benefit to man or animal, and also animals resulting from such processes."[267] While this language might seem to indicate that the *Harvard/Onco-mouse* balancing test should be applied,[268] at least in cases challenging the patentability of genetically modified animals on moral grounds, it is not clear whether the Directive does indeed advocate the use of this test. As noted by one European scholar, the phrase "likely to cause . . . suffering" introduces ambiguity. It could mean that any pain caused to a research animal will instantly render an invention abhorrent, or, alternatively, that the level of pain incurred by the animal is weighed against the expected medical benefit in order to assess whether the invention is publicly acceptable.[269] Increasing the ambiguity inherent in the Directive's language is the removal from the Directive of a Recital that had appeared in an earlier version, and which pointed to the adoption of the *Harvard/Onco-mouse* "unacceptability" test.[270]

Thus, it is unclear which of the morality standards emerging from the EPO case law, the "public abhorrence" or the "unacceptability" test, is supported by the Directive. This failure of the Directive to provide any further guidance re-

264. *See supra* Part III.B.1.b.

265. *See supra* Part III.B.2.b.

266. *See* Bently, *supra* note 263, at 189 (stating that "Article 53(a) is a criterion of patentability and therefore equally applicable at the examination (at the E.P.O. or in national offices), opposition (at the E.P.O.) and revocation (at national offices or in court) stages").

267. Directive, *supra* note 3, art. 6.2(d), at 19.

268. *See* supra note 205 and accompanying text.

269. *See* Amanda Warren, *A Mouse in Sheep's Clothing: The Challenge to the Patent Morality Criterion Posed by 'Dolly'*, 20 EUR. INTELL. PROP. REV. 445, 445-46 (1998).

270. *See* 1992 Committee Report, *supra* note 45, at 9 (proposing insertion of language into the Directive requiring "a comparative assessment in which the usefulness of the invention on the one hand and any risks arising from it on the other, *together with any objections arising in terms of fundamental legal principles shall be taken into consideration*" and providing that "[i]nventions whose subject matter is animals which, owing to the phenotype or their genetic constitution, *cannot be kept under adverse effects on their health or which are unnaturally interspecific,* shall at all events be deemed incompatible with public order and consequently unpatentable") (emphasis added).

garding the interpretation of the Article 6 morality provision impedes its goal of harmonization.

IV.
THE DIRECTIVE HAS LIMITED UTILITY FOR PRESERVING THE RIGHTS OF MEMBER STATES TO CONSIDER MORALITY WHEN GRANTING A PATENT

Another stated goal of the Directive is to preserve the ability of the Member States to consider morality when determining whether to grant a patent.[271] Article 6 embodies the compromise reached between supporters of the biotech industry, who opposed the inclusion of a morality provision in patent law, and the Greens, who battled for the insertion of Article 6 in the Directive. However, examination of Article 6 leads to the conclusion that the Directive does not provide a significant method of protecting morality, a point upon which, ironically, both opponents and proponents of patents on life forms agree.[272]

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271. *See supra* notes 9-10 and accompanying text.

272. It should be noted that these two groups cite different reasons for deeming the Article 6 morality/*ordre public* provision ineffective. Opponents of patents on life forms decry the Directive for failing to protect morality sufficiently. *See infra* Part IV.A. Conversely, those in favor of broad patent protection for biotech inventions cite the arguments of scholars who contend that the inclusion of any morality provision in patent law, no matter now carefully drafted, is by definition superfluous, since the grant of a patent by an E.U. Member State does not authorize the patent holder to implement his or her invention, but simply allows the holder to prohibit third parties from exploiting that invention for industrial and commercial purposes. *See, e.g.*, ARMITAGE & DAVIS, *supra* note 150; Crespi, *supra* note 168, at 434-35; Schatz, *supra* note 25, at 11-16. Even the EPO has in the past espoused the view that patent law is not the proper vehicle for assessing morality, although this decision has been reversed. *See, e.g.*, *Harvard/Onco-mouse Decision of 14 July 1989, supra* note 193, at 11 (stating that "the patent law is not the right legislative tool for regulating problems which may arise" with respect to the morality of an invention). Every invention, whether patented or not, is of course subject in each Member State to a broad array of existing legislation and regulations that determine directly whether scientific, technical or medical practice should be prohibited in the interests of public health and safety, environmental protection, animal welfare, the preservation of genetic diversity, and compliance with ethical standards. Indeed, this view is explicitly recognized in Recital 14 of the Directive, which provides that "[w]hereas a patent for invention does not authorise the holder to implement that invention, but merely entitles him to prohibit third parties from exploiting it for industrial and commercial purposes," therefore:

> substantive patent law cannot serve to replace or render superfluous national, European or international law which may impose restrictions or prohibitions or which concerns the monitoring of research and of the use or commercialisation of its results, notably from the point of view of the requirements of public health, safety, environmental protection, animal welfare, the preservation of genetic diversity and compliance with certain ethical standards.

Directive, *supra* note 3, ¶ 14, at 14. Since such legislation already restricts or prohibits the use of certain inventions and controls the way research is conducted in the Member States, these scholars contend that it is inappropriate for those opposed to the biotechnology industry to use patent law as a way to achieve their political ends, via the inclusion of an ethical provision in the Directive. *See* ARMITAGE & DAVIS, *supra* note 150; Crespi, *supra* note 168, at 434-35; Schatz, *supra* note 25, at 11-16. By the same token, the refusal of a patent application on moral grounds does not mean that the invention cannot be exploited. Instead, the invention is merely in the public domain, and, as such, can be used by anyone. Thus, according to this view, patent law is entirely superfluous in preventing any abuses or risks that a given biotechnological invention would incur. Rather, the concepts of *ordre public* and morality will be rooted in already existing legal and moral codes, which will vary among the Member States. For this reason, Article 53(a) of the EPC and the corresponding national provisions are hardly ever used in practice. *See* Schatz, *supra* note 25, at 12.

A. *Limited Efficacy of the Directive With Respect to Protecting Morality*

First, the morality provision of the Directive excludes entirely objections in principle, under either the stricter "unacceptability" test or the more lenient "public abhorrence" test. For example, opponents of patents on life forms cannot object to such patents per se, in light of Article 3.1 of the Directive, which provides that "inventions which are new, which involve an inventive step, and which are susceptible of industrial application shall be patentable even if they concern a product consisting of or containing biological material or a process by means of which biological material is produced, processed or used."[273] Accordingly, Article 6 does not ensure a comprehensive moral assessment, since it excludes the consideration of the moral and ethical beliefs of those vehemently opposed to patents on life forms generally. Certainly, there is something incongruous about granting E.U. citizens legal standing under the Directive to challenge biotech patents on the grounds of morality and/or *ordre public*,[274] while at

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In response, other scholars have declared that the principle function of a morality provision in patent law is to deny the imprimatur of the state to "immoral" biotechnological inventions. A particularly compelling statement of this idea was articulated by Cornish, who declared that:

> [t]he state, as granting authority, cannot disclaim responsibility for the inventions for which it grants protection. It cannot hide behind the negative character of the patent right in order to avoid deciding whether a particular idea is inherently too repellant or dangerous to deserve this form of incentive. The power to refuse a patent on grounds of morality or public policy may need to be used cautiously. It is an appropriate step only where all the significant uses of the information are objectionable, and not only where some are. But the objection is rightly contained in the law and courts should not interpret it out of existence.

See CORNISH, *supra* note 3, at 195. *See also* Bently, *supra* note 263, at 190 (stating that "to ignore the morality question is to provide incentives to direct investment towards immoral and dangerous inventions (and possibly away from positive ones)"). *But cf.* Schatz, *supra* note 25, at 12 ("The purpose of Art. 53(a) EPC is to prevent the impression being given that an invention whose exploitation would be contrary to legal fundamentals or offend the decency of any reasonable person bears the seal of state approval. More than that it will and can not do.").

In this author's view, with the passage of the Directive, the morality/*ordre public* provision in patent law can no longer be considered superfluous. Because the Directive requires Member States to provide more aggressive patent protection, *see supra* notes 89-91 and accompanying text, and *infra* notes 276-80 and accompanying text, Member States are likely to resort to the Directive's Article 6 in order to preclude patents on certain life forms. For example, now that Article 5 of the Directive provides for the patenting of material of human origin, which is strongly opposed by many E.U. Member States, *see supra* note 20 and accompanying text, the morality provision is likely to be used to avoid the obligation to provide patent protection for such inventions. *See* Andrew Scott, *The Dutch Challenge to the Bio-Patenting Directive*, 21 EUR. INTELL. PROP. REV. 212, 215 (1999) (noting that the *ordre public* or morality doctrine might be invoked by Member States wishing to avoid patenting of material of human origin). Such is already the case in France, which amended its Intellectual Property Code by Law No. 94-653 on July 29, 1994 so as to declare unpatentable "the human body, its parts and products and the knowledge of the entire or partial structure of the human gene, as such, . . . as inventions, the publication or exploitation of which would be contrary to *ordre public* or morality." Joseph Straus, *Patenting Human Genes in Europe - Past Developments and Prospects for the Future*, 26 INT'L REV. INDUS. PROP. & COPYRIGHT L. 920, 922 n.8 (1995).

273. Directive, *supra* note 3, Article 3.1, at 18. *See also* note 159, *supra*.

274. E.U. citizens, unlike their U.S. counterparts, possess legal standing to challenge the morality of biotech inventions, under both the Directive and the EPC. *See* Breffni Baggot, *Legislating a Transgenics Revolution*, INTELL. PROP. MAG., May 1998, LEXIS, General News Library, Magazines & Journals File. *See also Animal Legal Defense Fund v. Quigg*, 932 F.2d 920 (Fed. Cir. 1991) (denying a U.S. animal rights group standing to challenge the U.S. Patent and Trademark Office's (PTO) Notice of April 7, 1987, regarding the PTO's intent to recognize the patentability of animals).

the same time precluding such a proceeding if it is based on opposition to life patents per se. Indeed, those groups most likely to mobilize and finance such a legal action often oppose life patents on absolute terms.

As a consequence of this limitation of the Directive, the Netherlands, which strictly circumscribes the patenting of biological material,[275] brought an action against the European Parliament demanding annulment of the Directive on several grounds.[276] While the Netherlands has challenged the Directive on procedural grounds,[277] the underlying purpose of this suit is to oppose the E.U.'s enactment of a Directive that prohibits the Netherlands from maintaining its traditional opposition to life patents per se,[278] and instead creates substantive rights beyond those previously available in national law.[279] Some European scholars agree that the Directive does indeed create new rights, and, as mentioned previously, one has suggested that, with the Directive, "E.U. institutions are pursuing the goal not only of harmonising intellectual property legislation, but also, and at least as vigorously, of strengthening it at the same time."[280]

A second shortcoming of Article 6 is that, even if the stricter "unacceptability" test is used, it can be argued that the public benefit to be gained by an invention is not an appropriate yardstick by which to determine the morality of an invention, especially when the subject matter of the invention is a living creature. As one scholar noted with respect to the application of the morality principle in the *Harvard/Onco-mouse* case:

> [i]t is surely an indictment of the importance placed by the EPO on the assessment of the issue of morality that the only way it seems able to address the issue of morality is by looking at factors which would seem to be more relevant to one of the granting criteria and which do not address properly any true question of what is morally correct.[281]

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275. *See* Bostyn, *supra* note 59, at 14 n.61 (stating that the Dutch government has "often held, in contradiction to the text of the Dutch Patent Act . . ., that plants are not patentable"), at 24 n.18 (describing Article 3 of the Dutch Patent Act of 1995, which provides that "animals can only be patented in very specific circumstances, *i.e.* if a licence has been granted for specific types of research pursued on these animals").

276. Case C-377/98, *Netherlands v. Parliament*, 1998 O.J. (C378) 13, was brought before the European Court of Justice in October 1998. Italy has since joined the case as well. *See Netherlands Files Suit to Cancel EU Patenting of Plants and Animals*, AGENCE FRANCE PRESSE, Oct. 19, 1998, LEXIS, World News Library, European News Services File; Scott, *supra* note 272, at 212. The Netherlands had been the only Member State to vote against the Directive, although Belgium and Italy abstained. *See* Patrick Farrant & Vicki Salmon, *Netherlands Seeks End to EU Biotech Directive*, IP WORLDWIDE, July-Aug. 1999, LEXIS, General News Library, Magazines & Journals File.

277. *See* Case C-377/98, *Netherlands v. Parliament*, 1998 O.J. (C378) 13. *See also* Scott, *supra* note 272 (describing the grounds for the Netherlands's challenge to the Directive).

278. *See supra* note 275 and accompanying text.

279. *See supra* note 91 and accompanying text.

280. *Id.* It should be noted that, although the Directive does not explicitly establish a maximum limit on ethical review that Member States may not exceed, an individual Member State opposed to life patents, such as the Netherlands, will not be able to eviscerate entirely its obligations under the Directive to provide national patent protection for biotechnological inventions by simply declaring that all controversial biotechnological inventions are counter to *ordre public* and morality. *See supra* note 130 and accompanying text.

281. Margaret Llewelyn, *Industrial Applicability/Utility and Genetic Engineering: Current Practices in Europe and the United States*, 16 EUR. INTELL. PROP. REV. 473, 478 (1994). The

This scholar declared that the *Harvard/Onco-mouse* decision did not appear "to be addressing any issue of morality, but merely to be applying one expedient definition for the purposes of justifying giving one company the right to commercially exploit an animal," while conceding that "[i]t is difficult to say how morality should be defined in relation to a system which has to be applied in a practical sense."[282]

Third, even if opponents of patents on life forms were to embrace the *Harvard/Onco-mouse* "unacceptability" standard, which requires "a careful weighing up of the suffering of animals and possible risks to the environment on the one hand, and the invention's usefulness to mankind on the other,"[283] the E.U. would have to confront further procedural and substantive issues in order to determine which inventions are a public benefit and which are not. With respect to the process of reaching such a decision, the question arises whether the balancing test should be performed at the time of the patent application. If so, the E.U. must determine whether such a showing is to be left solely to the inventor, or, if other interested parties are to be consulted, who they are and at what point they are to be involved. Alternatively, the weighing of the possible advantages of an invention against its potential for harm could instead be addressed only after the patent grant has taken place, when the opponents of the patent dispute its validity.[284] As noted by one scholar, "[i]f this latter is the case then it is difficult to justify the argument of weighing benefit against suffering if the only time the issue is looked at is when objectors to the patent are able to finance an opposition."[285]

Further complications of the "unacceptability" standard arise in the form of ambiguous substantive guidelines. Consensus has yet to be reached throughout the E.U. as to what sort of benefits flowing from an invention are weighty enough to tip the balance in favor of a finding of patentability. In the *Harvard/Onco-mouse* case, the Examining Division allowed the patent on the grounds that it would be tantamount to immorality to deny it,[286] since to do so would discourage the patent holders from carrying out further research and marketing any resulting drugs useful for cancer treatment.[287] The Examining Division's decision comports with the prevailing view among E.U. citizens, who generally

granting criteria to which Llewelyn refers are novelty, nonobviousness and usefulness. *See supra* note 97 and accompanying text.

282. Llewelyn, *supra* note 281, at 478. This view fails to recognize, however, the competing ethical theory of utilitarianism, which, as expressed by Jeremy Bentham, one of its most influential proponents, states that a good or moral act is one that results in the greatest happiness for the greatest number. DAVID BAUMGARDT, BENTHAM AND THE ETHICS OF TODAY 171 (1952). Arguably, transgenic plants and animals that solve problems such as human hunger and disease could be considered moral and ethical under this theory.

283. *See supra* note 205 and accompanying text.

284. Llewelyn, *supra* note 281, at 479.

285. *Id.*

286. The Examining Division held that "[t]he provision of a type of test animal useful in cancer research and giving rise to a reduction in the amount of testing on animals together with a low risk connected with the handling of the animals by qualified staff can generally be regarded as beneficial to mankind." *See Harvard/Onco-mouse Decision of 3 April 1992*, *supra* note 151, at 528.

287. *See supra* Part I.B.

favor biotechnological development of pharmaceuticals.[288] However, another issue that arises under the *Harvard/Onco-mouse* balancing test is whether food production is a significant enough public benefit to outweigh harm to animals.[289] Even though such a question is likely to be answered affirmatively by developing nations,[290] one wonders whether increasing food production in developing nations will be the primary goal of biotechnology, or, rather, whether products such as meat with a lower amount of fat or cholesterol will instead be developed for wealthier nations. Moreover, given the resistance throughout the E.U. to genetically modified foods, such benefits may prove theoretical rather than actual, since there is no assurance that members of the public would indeed consume such food.[291]

Thus, opponents of life patents fear that Article 6 of the Directive might prove inadequate to protect morality, even if the stricter "unacceptability" test suggested by the *Harvard/Onco-Mouse* case is implemented. Certainly, an examination of the four cases decided under Article 53(a) of the EPC,[292] on which Article 6 of the Directive is modeled nearly verbatim, suggests as much, since none of the inventions at issue was denied patent protection on moral grounds. In light of the Directive's allusions to increasing patent protection,[293] there is reason to believe that national patent offices will be just as likely as the EPO has been to favor strong patent protection for biotechnological inventions, leading to further schisms with Greens and other opponents of patents on life forms.

V.
Proposed Revisions to the E.U. Directive on the Legal Protection of Biotechnological Inventions

In its efforts to achieve harmonized patent protection while simultaneously preserving the ability of Member States to consider morality when evaluating a patent application, the Directive surpasses the EPC, in that it attempts to create and *enforce* a consistent level of biotechnology patent protection throughout the E.U. Nonetheless, the Directive cannot fully realize these dual goals until it overcomes obstacles presented by the Article 6 morality provision. First, Article 6 will impede harmonization until the E.U. clarifies whether the "public abhorrence" or the "unacceptability" test ought to be applied in the assessment of patent applications. Second, the citizenry will not embrace Article 6 as an adequate protection for morality unless certain changes are made either in the Directive or in the understanding of which vision of morality will prevail. Although the Directive was nearly ten years in the making, it nonetheless requires further revision before it will have its intended impact.

288. *See generally* George Gaskell et al., *Worlds Apart? The Reception of Genetically Modified Foods in Europe and the U.S.*, 285 SCIENCE 384 (1999).

289. *See supra* note 81 and accompanying text.

290. *See* Declan Butler, *Biotech Industry Seeks 'Honest Brokers,'* 398 NATURE 360, 360 (1999) (noting that some developing nations have "attacked opposition to gene technology as a northern luxury").

291. *See id.* (noting that European consumers are generally wary of genetically modified foods).

292. *See supra* Part III.B.

293. *See supra* notes 89-91, 276-80 and accompanying text.

A. *Achieving Harmonization Through Clarification of the Morality Test*

Most important, the Directive must be altered so as to apply a consistent moral standard, "public abhorrence" or "unacceptability." Member States' national courts and patents offices, drawing upon the inconsistent case law applied by the EPO in the four cases assessing inventions on the grounds of morality and *ordre public*, will otherwise be confounded as to which test is appropriate. The E.U. ought not to wait for case law to interpret which test will be applied, as this will simply delay harmonization. Moreover, it is the role of the citizenry, acting through its elected legislative body, not the courts, to define how morality is to be assessed.

A close reading of the language of the Directive, specifically, Article 6.2(d), indicates that the Directive contemplates adoption of the *Harvard/Oncomouse* "unacceptability" test, at least for the highly controversial category of inventions involving transgenic animals. As stated, this standard calls for a balancing of the advantages of an invention against harm to the animal. There are several advantages to the implementation of such a test.

First, the "unacceptability" test acknowledges that an innovative technology's advantages are accompanied by a countervailing collection of dangers, not only to the well-being of any animals involved in experimentation, but also to society's moral and ethical standards, the environment, and public health and safety. Through the political debate surrounding the enactment of the Directive, citizens in the E.U. have demonstrated, if not an absolute consensus on such issues, an ardent desire to interject them into the public discourse and to carefully assess these potential risks, while simultaneously seeking to enhance the E.U.'s competitiveness in the biotechnology industry. In this way, the E.U. demonstrates a cultural approach fundamentally different from those of the U.S. and Japan, and E.U. law must reflect this viewpoint.

Second, as noted by several scholars, a state's denial of a patent to an invention deemed "unacceptable" functions to deny the state's imprimatur to an invention deemed to contravene morality or public policy. Just as in the U.S., where a court will refuse to enforce a racially discriminatory restrictive covenant burdening real property in order to deny the state's tacit acceptance of racial animus,[294] so has the E.U. chosen to deny patent protection to certain biotech inventions in order to avoid the appearance of official governmental approval of such creations.

Finally, it is apparent from a review of past cases assessing the morality of biotechnological inventions that the EPO has felt pressure to declare such inventions morally acceptable. Of the four inventions opposed on moral grounds, none has ultimately been denied patent protection on this basis. Moreover, national courts and patent offices in the Member States have made virtually no use of the morality provisions incorporated in their own patent codes. Clearly, there is overwhelming pressure upon those charged with evaluating patents in the E.U. today not to thwart the struggling E.U. biotech industry as it races to keep

294. *See Shelley v. Kraemer*, 334 U.S. 1 (1948).

pace with its U.S. and Japanese counterparts. The morality criteria will not be interpreted in ways that interfere with patentability, regardless of what test is adopted. Therefore, the stricter "unacceptability" test should be applied to provide greater efficacy to the morality provision.

The "unacceptability" test is more difficult to administer than the alternative, however, since it is easier for a diverse group to agree on what is "abhorrent" than on what is merely "unacceptable." For this reason, the E.U. must further explicate the "unacceptability" test.

B. Attaining Adequate Protection of Morality Through Refinement of the "Unacceptability" Test

The "unacceptability" test used to administer the Directive's Article 6 morality provision requires some clarification in order for it to furnish proper guidance to the national courts and patents offices administering it. First, opponents of life patents per se may not be satisfied with the morality provision's efficacy in precluding such patents. Because the Directive employs language indicating that patent protection must be provided for biotechnological inventions under national patent law, it appears that a nation such as the Netherlands, which strictly circumscribes patents on life forms, cannot avoid the obligation to furnish patent protection for transgenic plants and animals. For this reason, as stated above, the Netherlands and Italy are presently pursuing a legal challenge to the Directive before the European Court of Justice. This case, commenced just after the Directive's enactment, challenges the extent to which the E.U. can require Member States to offer patent protection beyond that previously available under their national law. The Court has not indicated how or when it will decide this case, but the general opinion is that this suit will not diminish the patent protection instituted by the Directive. Thus, the Greens and others opposed to life patents may indeed be forced to accept that opposition to patent protection on life forms per se does not constitute a cognizable claim under the Directive.

Second, assuming that opposition to patents on life forms per se is not a tenable position under the Directive, the E.U. must clarify what types of inventions will be considered so "unacceptable" as to be unpatenable. In this vein, the Directive enumerates in Article 6.2 a representative sample of inventions that shall be considered unpatentable on the grounds of morality. Such lists should not inhere in legislation, however, because technology, and, to a lesser degree, cultural norms are constantly changing. The codification of rules in legislation which would attempt to establish categories of eternally immoral inventions is essentially impossible and impractical. Moreover, national courts do not possess particular expertise in assessing either the uses of technology or the moral and ethical views prevailing in society. The Commission's twelve-member European Group on Ethics in Science and New Technologies (EGEST), a supranational body created pursuant to the Directive, is more qualified to handle this task. The EGEST can then operate with flexibility, altering its assessments of morality and public policy to take account of technological innovations and

changes in social mores. The EGEST must be granted adequate resources to handle its broad mandate, which includes the review of a range of technological issues, including information technology and biotech.

Finally, although the EGEST is intended to be free from political and national interests, it ought to furnish E.U. citizens with the opportunity to make their views known during that body's deliberative process, possibly via a system of regional offices. Twelve individuals cannot render definitive decisions on ethics and morality without at least considering the conflicting views in society at large. At the present time, as stated previously, E.U. citizens cannot formally challenge, or lodge support for, a patent until it has been granted. Since the controversy concerning patenting living organisms shows no signs of abating, the Directive must encourage public dialogue, even if some constituencies remain opposed, either in whole or in part, to the Directive.

CONCLUSION

With the enactment of Directive 98/44/EC of the European Parliament and of the Council of 6 July 1998 on the Legal Protection of Biotechnological Inventions, the E.U. has celebrated what it hoped would be the end of the arduous process of reconciliation between supporters of the E.U. biotech industry, on the one hand, and advocates of strict controls of patents on life forms, on the other. However, analysis of the Directive reveals that the Article 6 morality provision is likely to impede the Directive's dual goals. First, though the Directive mandates a minimum level of patent protection for biotech inventions, Article 6 is exceedingly vague as to the standard that will be applied in order to determine whether an invention ought to be denied patent protection on the grounds of immorality. Consequently, Article 6 will be subject to conflicting interpretations, thereby precluding its first stated goal: harmonization throughout the E.U. Member States. The Directive is also likely to prove inadequate with respect to its second stated goal, the preservation of the right of patent offices and courts in each Member State to deny patent protection to any invention deemed contrary to morality or public policy.

Thus, the enactment of the Directive is not the culmination of the debate over biotechnology patent law in the E.U., but is a starting point for future refinements and enhancements of the morality provision. The Directive must be amended so as to clarify which test of morality is to be applied by national courts and patent offices. In addition, language in the Directive enumerating particular inventions that must be considered immoral should be eliminated, so as to allow the EGEST, the supranational body charged with evaluating the ethics and morality of particular inventions, maximum flexibility in reaching its conclusions. Finally, E.U. citizens must be permitted to express their views to the EGEST as that body evaluates particular technologies. In this way, the Directive will at last achieve its twin goals of harmonizing E.U. patent law while protecting the uniquely European view of ethics and morality.

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The International Recognition of Judgments: The Debate between Private and Public Law Solutions

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by
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INTRODUCTION AND SUMMARY OF ARGUMENT

The recognition and enforcement of judgments rendered by the courts of other sovereigns is a central tool of trade integration. Traders seek the security provided by the enforcement of legal rights and the provision of an adequate remedy. Accordingly, without secure means by which that remedy may be given effect, exporters may undervalue the gains from trade. Consequently, they may fail to take advantage of trading opportunities that would otherwise be socially beneficial, taking into account both the gains for individual traders and the benefits that would flow to third parties. At the same time, the inability of importers to vindicate their legal rights through the effective enforcement of judgments would also distort incentives for trade, leading exporters not to appreciate fully the costs of their activities and encouraging them to exploit trading opportunities that would be better left unrealized. Self-help mechanisms may contribute to resolving some of these problems,[1] but it is a basic proposition that some level of public intervention is necessary to facilitate socially optimal trade, although one can argue about what precise remedial rules achieve socially preferred results.[2]

Domestic legal systems address the problem of achieving socially optimal contracting through a variety of means. Public law, such as environmental pro-

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1. *See generally* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (analyzing the conditions under which dispute resolution operates without judicial enforcement); Shuba Narasimhan, *Modification: The Self-Help Specific Performance Remedy*, 97 YALE L.J. 61, 95 (1987) (describing nonperformance in some contractual modifications as a kind of self-help specific performance).

2. *Compare* Lon L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages, pt. 1*, 46 YALE L. J. 52 (1936) (advocating the reliance principle, rather than expectancy, as a plausible option in many cases), *with* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 257 (1979).

tection statutes and labor law, does the main work of addressing the negative externality problem, although law and economic scholars argue that judge-made law has already done much of this work in common law systems[3] and public choice theorists argue that interest-group rent-seeking behavior in public law-making actually distorts socially optimal common law rules.[4] Yet, publicly created remedial systems affecting private incentives for contracting do address the cost of unrealized contracting opportunities against welfare losses flowing from the negative externalities of contracting, albeit imperfectly. In robust democracies, such as the United States, the political process ultimately addresses these issues either through tacit acquiescence in common-law rules or through legislative or executive intervention, including both statutes creating new private rights to judicial remedies[5] and statutes affording the government the right directly to seek relief on behalf of public interests.[6] Some argue, moreover, that "the political system manages to overcome the inherent advantages of special interests"[7] through "mass politics" in so-called "republican moments"[8] during which legislative outcomes avoid special interest capture. What label one attaches to such outcomes – ranging from social welfare maximization[9]; a discursively justified[10] (or morally discovered[11]) conception of the common good; or, less pre-

3. *See generally* RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW (4th ed. 1992).

4. For the seminal expositions of this position, *see* JAMES BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965) [hereinafter OLSON, COLLECTIVE ACTION]. *See generally* DANIEL FARBER & PHILIP FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991) (critiquing so-called public choice theory).

5. *See, e.g.*, 15 U.S.C. § 15d, which creates a private right of action and aggregate damages for a private person injured by violation of U.S. competition laws. Roughly stated, the private right of action here forces private monopolists to internalize the cost to society of pricing goods at values above the marginal cost of production. *See generally* HERBERT HOVENKAMP, ANTITRUST LAW (2d ed. 1999) [hereinafter Hovenkamp, ANTITRUST LAW]. Another useful example is the judicially recognized private right of action for fraud in the issuance of and transfer of stocks that is calculated to deter such fraud, in large part because of the positive externalities that flow from maintaining the integrity of capital markets. *See generally* 15 U.S.C.A. § 780; *compare* Silver v. New York Stock Exchange, 373 U.S. 341 (1963) (holding that excluded securities dealer was entitled to limited exemption from application of antitrust laws due to securities law policy of authorizing self-regulation of securities markets).

6. The Department of Justice has exclusive criminal jurisdiction under federal antitrust law, but has concurrent jurisdiction with the Federal Trade Commission to seek civil remedies. State attorneys general have authority to vindicate interests of consumers residing within their state by Sherman Act suits seeking damages or equitable relief. *See* 15 U.S.C. § 15 (1998).

7. Daniel A. Farber, *Politics and Procedure in Environmental Law*, 8 J.L. ECON. & ORG. 59 (1992); reprinted in THE FOUNDATIONS OF ENVIRONMENTAL LAW 236 (Richard L. Revesz ed., 1997).

8. *Id.* at 238-39.

9. *See* BUCHANAN & TULLOCK, *supra* note 4.

10. *See, e.g.*, JURGEN HABERMAS, FACTS AND NORMS (1996) (elaborating his conception of "discursive justification" through ideal speech situations); Joshua Cohen, *The Economic Basis of Deliberative Democracy*, SOC. PHIL. & POLICY 25, 33 (emphasizing that choices must be made in "a deliberative way," and not "simply conform to the preferences, convictions, and ideals of citizens") (emphasis omitted).

11. *See, e.g.*, JACQUES MARITAIN, MAN AND THE STATE (1951) (locating a conception of the common good through natural law reasoning).

cisely but more intuitively, the judgment of the "People"[12] – may depend on one's overall political and legal theory. It is enough to say that such decisions by a self-governing community are practically and normatively legitimate,[13] notwithstanding the public choice critique, even if particular applications of some judicially or legislatively made rules reflect interest group rent-seeking rather than satisfy some criterion of legitimacy.

At the international level, things are not quite so simple. With the emergence of a global trading system, the international judgments recognition process masks profound value conflicts. This is so because of the wide divergence in national values on issues ranging from the propriety of the exercise of jurisdiction by national courts; the fairness of varying procedures or remedies, such as the jury system or punitive damages; to even the location of the boundary between trade and non-trade concerns, such as the boundary between human rights and comparative advantage in labor costs. To the extent that domestic political judgments about tradeoffs between competing values are embedded in judicial judgments, political tensions are bound to emerge as these domestic judgments seek recognition and enforcement in other states. International tensions rise if foreign judgments are not recognized and domestic tensions rise if they are recognized in defiance of national values. Ultimately, such conflicts

12. *See, e.g.*, BRUCE ACKERMAN, WE THE PEOPLE: FOUNDATIONS (1991) (employing republican theory to account for constitutional amendment in the U.S. outside the formal procedures prescribed in Article V of the U.S. Constitution reflecting the deepest convictions of the American people acting collectively on the basis, at least in part, of their ideals). Ackerman's conception of constitutional politics bears some resemblance to the ideal theory advanced by John Rawls, under which principles of justice governing the basic structure of a society can be discovered on the basis of rational choices by individuals under conditions of moderate uncertainty as to their individual interests, the so-called "veil of ignorance." *See* JOHN RAWLS, A THEORY OF JUSTICE (1971).

13. Staking out a rough position on how to use the concept of "legitimacy" would seem to be necessary for developing the argument of this paper. Focusing on the descriptive component of legitimacy, it would seem useful to draw on Max Weber's rational-legal conception of legitimacy in this context, for rules on recognition and enforcement of judgments must be based on rule-like commands even if the specific deviations from rules of recognition and enforcement at the municipal level may reflect "traditionally" or "charismatically" grounded practices, such as marriage or gambling laws. *See generally*, MAX WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 152, 324-86 (Talcott Parsons ed., 1947) (defining "legitimacy" in terms of actual compliance and describing as ideal types the forms of "legitimate" authority – charismatic, traditional, and rational/legal – as resting on different forms of belief that are offered as justifications for compliance with the commands of an authority). A useful frame of reference for discussing normative legitimacy is contained in John Rawls' most recent work, which deals with the question of bridging belief systems that are fundamentally incompatible if applied thoroughly yet may share sufficient common attributes to form the basis for cooperation in limited spheres of interaction. *See, e.g.*, JOHN RAWLS, THE LAW OF PEOPLES (1999) [hereinafter RAWLS, THE LAW OF PEOPLES] (outlining a conception of political discussion in democratic societies intended to accommodate the participation and membership in the same political society of groups holding inconsistent "comprehensive views," that is, views of the good, including for example those grounded in religious conceptions). It is important that Rawls seems to suggest that a range of modes of justification – from Habermas' conception of discursive justification to Maritain's neo-Thomist view of the common good – can form the basis for normative justification at the level of the state. *See id.* at 142 nn. 28-29. Further, Rawls' recognition that even Islam is amenable to participation in public discourse with other comprehensive conceptions suggests that his basic methodology can be extended to global political ordering. *See id.* at 151 n. 46. This is so even if Rawls himself thinks that his arguments are limited to a particular kind of community not yet found universally. For a related critique of Rawls' international political philosophy, *see* FERNANDO R. TESON, A PHILOSOPHY OF INTERNATIONAL LAW 105-26 (1998).

must be resolved through particular institutions or a mix of institutions – taking into account that both wholly private, market-based approaches and wholly public, political approaches will have costs. In short, international recognition of judgments is an issue ripe for comparative institutional analysis.[14]

Institutional Alternatives

This article explores institutional alternatives for balancing the competing trade and non-trade concerns at the national and global levels in relation to the recognition and enforcement of judgments. It argues against a private international law convention of the kind that is currently being negotiated at the Hague Conference on Private International Law, and against quasi-constitutional and constitutional solutions, such as those employed by the European Union and the United States. Rather, the article argues that managing the tensions between trade and non-trade values and between state autonomy and globally established standards can best be achieved through a supplementary agreement in the World Trade Organization (WTO).

With comparative institutional analysis must come recognition that the question of whether to achieve efficiency or distributive justice hinges on defining the distribution of political voice and power. This requires one to consider the underlying view of the types of political actors meriting representation in the political community within a state. Likewise, a theory of international political process is necessary in order to define the balance between state autonomy to define those tradeoffs and the cosmopolitan or global perspective in assessing the tradeoffs between efficiency and distributive justice. One might draw on the intuitions of Hedley Bull, who thought that one can understand international politics in terms of competing frames of reference. At one end of the spectrum there is international anarchy, in which the only meaningful unit of social solidarity is the state. At the other end is cosmopolitan international society, in which states do not play meaningful roles. Finally, in an intermediate position is international society, in which the society of states plays a useful role in the mediation of international conflict.[15] In short, one can classify the costs of various institutional alternatives in terms of whether effects on efficiency and distributive justice are determined from the standpoint of individuals forming communities within states, the states within the community of states, or individuals forming communities across states, perhaps even conceived as communities formed within a hypothesized world state (the so-called *civitas maxima*).[16]

14. *See* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994) [hereinafter KOMESAR, IMPERFECT ALTERNATIVES] (analyzing the advantages and disadvantages of political, market and adjudicative processes as decision-making alternatives).

15. HEDLEY BULL, THE ANARCHICAL SOCIETY: A STUDY OF ORDER IN WORLD POLITICS (1977) [hereinafter BULL, THE ANARCHICAL SOCIETY].

16. *See generally* NICHOLAS G. ONUF, THE REPUBLICAN LEGACY IN INTERNATIONALIST THOUGHT (1998) (esp. ch. III); Nicholas Greenwood Onuf, *Civitas Maxima: Wolff, Vattel and the Fate of Republicanism*, 88 AM. J. INT'L L. 280 (1994) (attempting to recover the forgotten civic republican foundations of international law's formative period).

At one extreme is the traditional approach of an agreement between states, which appears to ignore interests in global efficiency and distributive justice. At the initiative of the U.S. Government,[17] and largely because of concerns that the U.S. suffers a trade disadvantage relative to the European Community, such an agreement is now the subject of negotiation in a series of Hague Conventions on Private International Law (the Hague Conference).[18] The Hague Conference approach is designed, through the adoption of technical standards bridging the differences between national legal systems, to facilitate transnational litigation.[19] Its technical approach is reflected in the composition of the negotiating groups, which consist primarily of professional experts, and in the important role of the Hague Conference secretariat in performing its mandarin drafting functions.[20] However, like other "private" legislatures in the domestic law-making and standard-setting process,[21] international law-making through relatively nontransparent organizations that have little opportunity for broad public participation and produce statutes for domestic implementation generate outcomes producing either too much or too little controlling law.[22] They might produce too much by enabling the private interests that are disproportionately represented in the private law-making process to achieve gains at the expense of the public interest.[23] They might produce too little by yielding rules that are so

17. *See* Peter Pfund, *The Project of the Hague Conference on Private International Law to Prepare a Convention on Jurisdiction and the Recognition/Enforcement of Judgments in Civil and Commercial Matters*, 24 BROOK. J. INT'L L. 7 (1998) [hereinafter Pfund, *Project of the Hague Conference*] (special adviser to US Delegation reporting on status of the U.S. initiative). The precise U.S. negotiating position draws largely on the work of Arther T. von Mehren, a noted U.S. and international expert on private international law. *See* Arther T. von Mehren, *A New Approach for the Hague Conference?*, 57 LAW & CONTEMP. PROBS. 271 (1994) (proposing the mixed convention approach). For views of other national representatives and interested parties, *see* Maryellen Fullerton, *Enforcing Judgments Abroad: The Global Challenge*, 24 BROOK. J. INT'L L. 1 (1998) (summarizing symposium contributions); Peter North, *The Draft UK/US Judgments Convention: A British Viewpoint*, 1 NW. J. INT'L L. & BUS. 219 (1979) (noting collapse of earlier U.S-U.K. effort to negotiate a bilateral treaty).

18. Preliminary Draft Convention on Jurisdiction and the Effects of Judgments in Civil and Commercial Matters, adopted provisionally by the Special Commission of the Hague Conference, Oct. 30, 1999, at http://www.hcch.net/e/conventions/draft36e.html [hereinafter Preliminary Draft].

19. *See, e.g.*, Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, Feb. 10, 1969, 20 U.S.T. 361, 658 U.N.T.S. 163 [hereinafter the Hague Service Convention]; and Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, Oct. 7, 1972, 23 U.S.T. 2555, 847 U.N.T.S. 231 [hereinafter the Hague Evidence Convention].

20. *See* Pfund, *Project of the Hague Conference*, *supra* note 17.

21. *See* Alan Schwartz & Robert Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995).

22. *See generally* Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law* 39 VA. J. INT'L L. 742 (1999) [hereinafter Stephan, *Futility*] (extending the model of private legislatures to international lawmaking and examining a few illustrative cases); Paul B. Stephan, *Accountability and International Lawmaking: Rules, Rents and Legitimacy*, 17 NW. J. INT'L L. & BUS. 681 (1996); REGULATORY COOPERATION AND COMPETITION: THE SEARCH FOR VIRTUE (University of Virginia Legal Studies Working Paper Series, No. 99-12, 1999) (concluding with the bleak assessment that the "largely unchecked power of the legal profession to construct these rules makes it more difficult for the political process to correct poor choices of rules . . . ").

23. *See* Stephan, *Futility*, *supra* note 22, at 763-68 (discussing pro-defendant liability rules relating to international shipping emerging from the Hague process and distinguishing it from the results of the more pro-plaintiff Hamburg process); Malcolm Whincop, *The Recognition Scene:*

vague and confer so much discretion to implementing agencies or judiciaries that they either (1) replicate the status quo or (2) allow rent-seeking interest groups yet another opportunity to achieve disproportionate gains by influencing the exercise of discretion in the national implementation of the agreed upon international rules.[24] International private legislatures such as the Hague Conference thus raise serious legitimacy questions both at the international and domestic levels.

At the other extreme is the constitutional model of recognition and enforcement of judgments. One example of this constitutional model is that required of American courts by the Full Faith and Credit Clause of the U.S. Constitution.[25] The constitutional approach supposes the existence of a single political community for purposes of recognition and enforcement of foreign judgments. It therefore suppresses the differences among the political sub-communities that are embedded in the policies upon which those judgments are based. The constitutional character of this approach is exemplified in the current tendency toward deeper integration in the European Union and its apparent accompaniment by an effort to reformulate rules concerning recognition and enforcement of judgments as internal E.U. rules. New authority concerning judicial matters E.U. member states have extended to the E.U. under the recent Amsterdam amendments to the Treaty of Maastricht has made this possible.[26] The original EC treaty approach exemplified in the Brussels Convention,[27] and extended to the European Free Trade Association countries through the Lugano Convention[28] (together known as the Brussels/Lugano regime), is in the process of mutating into an E.U. rule commanding E.U. member states to implement the Brussels/Lugano rules as part of their national laws.[29] Because the regulation will be binding on E.U. member states and enforceable through the European Court of Justice, it will operate in

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Game Theoretic Issues in the Recognition of Foreign Judgments 23 MEL. U. L. REV. 416, 436 (1999) [hereinafter Whincop, *The Recognition Scene*] ("recognition conventions may extend the scope and coverage of political deals cut in domestic legislatures").

24. *See* Stephan, *Futility*, *supra* note 22, at 772-80 (discussing the vagueness and ambiguities of the UN Commission on International Trade Law's (UNCITRAL) Convention on the International Sale of Goods (CISG)); Whincop, *The Recognition Scene, supra* note 23, at 435-36 (drawing on Stephan's work, suggesting the Hague Conference negotiations may produce too much discretion: "given the [group] dynamics of expert bodies, they are likely to adopt provisions that repose discretion in decision-makers, such as judges, rather than specify outcomes that flow from described circumstances (that is, standards are preferred to rules)") (citing Schwartz & Scott, *The Political Economy of Private Legislatures, supra* note 21). *But see* Michael P. Van Alstine, *Dynamic Treaty Interpretation*, 146 U. PA. L. REV. 687 (1998) (defending these rules as laying the groundwork for supranational interpretation based on norms emerging from the global commercial community).

25. U.S. CONST. art. IV, § 2.

26. *See* Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1 [hereinafter Amsterdam Treaty].

27. Convention on the Recognition and Enforcement of Judgments in Civil and Commercial Matters, Sept. 27, 1968, 1972 O.J. (L 299) 32 [hereinafter the Brussels Convention]. For the consolidated, current text of the convention, *see* 1990 O.J. (C 189) 1, *reprinted in* 29 I.L.M. 1413.

28. Convention on Jurisdiction and Enforcement of Judgments in Civil Commercial Matters, Sept. 16, 1988, 1988 O.J. (L319) 9, *reprinted in* 28 I.L.M. 620 [hereinafter the Lugano Convention].

29. *See* Council Draft Regulation 5733/00 EC of 8 February 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters.

much the same way as the Full Faith and Credit Clause of the U.S. Constitution, under which the U.S. Supreme Court compels states to recognize and enforce each other's judgments.[30] For a similar effect on the global level, a treaty would need to be self-executing, enabling all interested individuals to invoke treaty rights to protect their substantive interests in the recognition and enforcement of foreign judgments. Even if such an intrusive instrument were negotiable in a single treaty, the necessary agreement on substantive policies and the tradeoffs among them would require a single, global political process capable of representing all individual and community interests.

This article proposes the following intermediate approach: a new multilateral agreement on recognition and enforcement of judgments as part of the World Trade Organization (WTO). The WTO is well suited to do the work of mediating between state-centric and cosmopolitan perspectives in addressing the problem of recognition and enforcement of foreign judgments. This is largely because the remedial regime of the WTO serves the purpose of mediating between the state-centric, private law conception reflected in the Hague Conference and the constitutional, public law conception suggested by the Full Faith and Credit Clause of the U.S. Constitution, which subordinates state interests in diversity to the homogenizing tendencies of a free trade policy. While WTO dispute resolution normally results in calls upon states to conform their conduct to the WTO's trade rules, these rulings have resulted in bargaining processes over remedies that very often take the form of substitutional relief such as compensatory tariff increases. The tension between a constitutional law approach and a private law or bargain conception of the WTO legal order parallels the contrast between public law's preference for compliance and private commercial law's preference for substitutional remedies.[31] Perhaps, as Kenneth Abbott states in reference to the GATT, the WTO's predecessor, "the role of international institutions of justice is to apply community policy, not merely to resolve private conflicts."[32] Yet, their role also may well be to moderate the formation of community policy in response to political lessons learned from the resolution of private conflicts.

The Argument for the WTO

There seems to be no doubt that the recognition and enforcement of judgments is an international trade issue, even though "[a]s yet, there has not been an international focus on whether absence of private law upgrades may in some

30. On the other hand, unlike the Full Faith and Credit Clause of the U.S. Constitution, which has ordinarily been interpreted not to have a public policy exception to take account of important policy differences between political communities, the Brussels/Lugano regime does contain a public policy exception to take account of those national differences (*see infra* note 97). Whether any regulation ultimately issued by the EC would follow the Brussels/Lugano model or the U.S. Full Faith and Credit Clause remains to be seen.

31. *See* Antonio F. Perez, *WTO and U.N. Law: Institutional Comity in National Security*, 23 YALE J. INT'L L. 301, 307-24 (1998) [hereinafter Perez, *WTO and U.N. Law*].

32. Kenneth Abbott, *GATT as a Public Institution: The Uruguay Round and Beyond*, 18 BROOK J. INT'L L. 31, 32 (1992).

cases be close to a non-tariff barrier to cross-border trade otherwise authorized under new trade agreements."[33] The attention the Hague Conference has recently given the subject makes this clear.[34] Negotiating a set of rules on the criteria for recognition and enforcement of foreign judgments would, therefore, seem to be within the competence of the WTO.

Placing the responsibility for this issue with the WTO would take advantage of the binding character of WTO commitments and their enforceability through the WTO Dispute Settlement Body (DSB). The WTO remedial system permits not only claims based on violations of a WTO rule yielding a prima facie showing of nullification or impairment of negotiated trade benefits but also so-called "non-violation" claims of nullification or impairment of benefits through measures not in themselves violative of WTO rules.[35] Even if rules of judgment recognition and enforcement were not made a part of the WTO law through negotiation of a new agreement governing recognition and enforcement of foreign judgments, it might still be possible to argue that discrimination against foreign judgments "resulting in nullification or impairment of market access rights" would give rise to a right to a WTO remedy. This would be contingent on trade benefits being negotiated in the next WTO negotiating round on the premise of nondiscriminatory recognition and enforcement of judgments protecting these trade opportunities.[36]

Placing the responsibility for this issue with the WTO could also take advantage of the administrative machinery of the WTO's Trade Policy Review Mechanism (TPRM) to monitor compliance with any agreed upon WTO rules,[37] providing a record of whether states have complied with their obligation not to discriminate against foreign judgments. Such a record could facilitate dispute resolution.

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33. Hal Burman & Don Wallace, Jr., *Private International Law : PIL Unification and International Economics: Crossroads in 2000?*, 29 INT'L LAW NEWS 17, 18 (Section of International Law and Practice, ABA, Winter 2000) [hereinafter Burman & Wallace, *Crossroads*].

34. *See generally* Ronald A. Brand, *Recognition of Foreign Judgments as a Trade Law Issue: The Economics of Private International Law*, *in* ECONOMIC DIMENSIONS IN INTERNATIONAL LAW: COMPARATIVE AND EMPIRICAL PERSPECTIVES 592 (Bhandari and Sykes eds., 1999) [hereinafter Brand, *Judgments as a Trade Issue*].

35. *See generally* JOHN H. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 348-49 (1995) (distinguishing prima facie cases from non-violation, nullification or impairment cases and citing examples).

36. *See* Burman & Wallace, *Crossroads, supra* note 33, at 18 (focussing on the possibility that violation of a UNCITRAL Convention on banking related issues would operate as an "impairment or nullification" of trade benefits and on the possibility of including a Multilateral Agreement on Investment in the WTO).

37. *See* Trade Policy Review Mechanism, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, LEGAL INSTRUMENTS – RESULTS OF THE URUGUAY ROUND, 33 I.L.M. 1154 [hereinafter TPRM]. *See generally* Andreas F. Lowenfeld, *Remedies Along with Rights: Institutional Reform in the New GATT*, 88 AM. J. INT'L L. 477 (1994); Miquel Montana i Mora, *A GATT with Teeth: Law Wins over Politics in the Resolution of International Trade Disputes*, 31 COLUM. J. TRANSNAT'L L. 103, 128-41 (1993); Michael K. Young, *Dispute Resolution in the Uruguay Round: Lawyers Triumph over Diplomats*, 29 INT'L LAW. 389, 396-406 (1995) (discussing move from power-oriented to rules-oriented approach in international trade).

Finally, a WTO-based approach could serve as a platform for a more transparent, politically-accountable and rational evolution of the law's accommodation of trade and non-trade concerns at cross-issue negotiations conducted at the global level. Meanwhile, it could preserve states' autonomy by acknowledging national discretion to refuse to enforce foreign judgments on public policy grounds, albeit at the price of WTO/DSB-authorized remedial countermeasures. This approach would be consistent with the practice of the many states that refuse to comply with WTO/DSB decisions finding certain practices illegal under GATT, because compliance with these decisions would violate the interests of core domestic constituencies.[38] Indeed, this approach would also preserve the option of defending national values through noncompliance, albeit at the price of a loss of trade concessions.[39] The discipline of paying a price for deviating from welfare enhancing trade rules would compel national political processes to address the value they attach to public policies compelling them to deviate from trade law, yielding either relaxation of the local public policy or renewed political effort at the WTO level for re-negotiation of global rules to accommodate the local policy. In any event, taking into account the global diversity of trade and related non-trade interests,[40] as well as the need for domestic political discretion to manage domestic political support for continuing trade integration,[41] a WTO-based approach to the recognition and enforcement of judgments would achieve the greatest level of trade benefits at the least political cost.

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38. The E.U.'s noncompliance with the WTO beef hormones decision seems to be a textbook example of a case where the domestic political cost of compliance, as perceived by the E.U., would exceed any possible retaliatory suspension of concessions the U.S. could impose. *See Merry-Go-Round*, THE ECONOMIST, May 13, 2000, at 75 ("despite its professed enthusiasm for free trade, the E.U. has shown little enthusiasm for obeying WTO rulings. Europeans stonewalled not just over bananas, but also over rulings on hormone-treated beef.").

39. *See* Judith Hippler Bello, *The WTO Dispute Settlement Understanding: Less Is More*, 90 AM. J. INT'L L. 416, 416-17 (1996) (arguing "WTO rules are simply not "binding" in the traditional sense," for "a government could renege on its negotiated commitment not to exceed a specified tariff on an item, provided it restored the overall balance of GATT concessions through compensatory reductions in tariffs on other items. That is, a government could change its mind about and raise a particular tariff, provided it offset such 'nullification and impairment' of the delicate GATT balance through compensatory tariff reductions."). *But see* John H. Jackson, *The WTO Dispute Settlement Understanding: Misunderstandings on the Nature of Legal Obligation*, 91 AM. J. INT'L L. 60, 61 (1997) (taking a contrary view about the "binding" quality of GATT obligations). For a critique of these views and argument for an intermediate position in the special case of the GATT national security exception, *see generally* Perez, *WTO and U.N. Law*, *supra* note 31.

40. *See* Alan O. Sykes, *The (Limited) Role of Regulatory Harmonization in International Goods and Services Markets*, 2 J. INT'L ECON. L. 49, 49-50 (1999) ("harmonization is inferior to a legal system that tolerates regulatory differences subject to legal constraints," which Sykes calls "policed decentralization").

41. *See* Alan O. Sykes, *Regulatory Protectionism and International Trade Law*, 66 U. CHI. L. REV. 1 (1999) [hereinafter Sykes, *Regulatory Protection*] (arguing that politically sophisticated trade agreements preserve national discretion to invoke regulatory measures that can serve non-protectionist policies even if those exceptions yield some protectionism and generally avoid supranational balancing of protectionist and non-protectionist effects as a test for legality).

An Argument to the WTO

More important, a WTO approach would strengthen the WTO itself, ultimately broadening participation in the WTO and thus increasing the legitimacy of its work. At one point, the GATT legal community approximated the Hague Conference in that it lacked binding force unless states enacted its rules. This was largely because the GATT's legal status as an international organization, and in turn the status of its dispute resolution system, was unclear from the very beginning.[42] This private law approach focussed on technical expertise and depoliticized policy-making, but permitted disproportionate influence by business interests.[43] A public law model, by contrast, expressly politicizes lawmaking and thereby includes a broader range of interests and examines a broader range of policy options through political debate. The public law model thereby opens the door to political participation in the law-creating forum rather than merely at the municipal level, as is the case in the Hague context. An important effect of integrating judgments into the WTO, therefore, could be to persuade those who hold non-trade values[44] and who see the WTO as an enemy to their agendas that non-trade interests can be vindicated through political action at the WTO.

By including the recognition of foreign judgments in the WTO trade regime, state practices deviating from global standards will increasingly come under scrutiny, which will generate information about their nature and purpose that will enlighten both domestic and international debate. Indeed, one of the arguments for addressing the question of judgments explicitly as a trade problem in the WTO context is that the WTO is developing into a vehicle for measuring compliance with trade obligations.[45] Members of the WTO are now required to allow the Trade Policy Review Body (WTO/TPRB) to review their "trade poli-

42. For contrasting views, *compare* JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS (2d ed. 1997) [hereinafter JACKSON, THE WORLD TRADING SYSTEM] (describing the anomalous legal status of the GATT as its "flawed constitutional beginnings" but describing the GATT process during this period favorably), *with* David Kennedy, *The International Style in Postwar Law and Policy: John Jackson and the Field of International Economic Law*, 10 AM. U. J. INT'L L. & POL'Y 671, 714 (1995) ("An imaginary trade constitution, liberal trade ideas, national and international political judgments, a decentralized regime of bargained reciprocity: Jackson presents all these as facts rather than commitments.").

43. *See* LORI WALLACH AND MICHELLE SFORZA, WHOSE TRADE ORGANIZATION?: CORPORATE GLOBALIZATION AND THE EROSION OF DEMOCRACY (1999) (Public Citizen's critique of the WTO's record during its first five years as eroding safety, labor and environmental laws and transferring power from domestic citizens' groups to private groups operating behind closed doors); *Lori's War: Interview with Lori Wallach*, FOREIGN POLICY, Spring 2000, 118 (explaining political strategy of Public Citizen and defending its conduct leading up to the Seattle Ministerial).

44. *See* Philip M. Nichols, *Trade Without Values*, 90 NW. U. L. REV. 658, 660 (1996) (arguing that, "as currently envisioned, [the WTO] fails to take into account the fundamental nature of societal values, and creates little or no space in which such laws can exist. This intemperance may diminish the already fragile support for the international trade regime, which in turn may hinder the ability of member countries to support the World Trade Organization."); Philip Nichols, *Forgotten Linkages: Historical Institutionalism and Sociological Institutionalism and Analysis of the World Trade Organization*, 19 U. PA. J. INT'L ECON. L. 461 (1998) (critiquing international trade law scholarship as focussing excessively on regime theory and institutional economics, rather than historical and sociological institutionalism, and thereby forgoing analysis of the impediments to effective trade law linkages to nontraditional trade law issues, such as business ethics or human rights).

45. *See supra* note 37.

cies and practices."[46] Although the WTO/TPRB's purpose is "to contribute to improved adherence by all Members to rules, disciplines and commitments" under the WTO, it is "not, however, intended to serve as the basis for enforcement of specific obligations under the Agreements or for dispute settlement procedures, or to impose new policy commitments on Members."[47] Nonetheless, claims of discriminatory treatment could be presented on the basis of objective evidence and measured against objective criteria employed by the WTO/TPRB. Even before a case could emerge before the DSB, one might expect that asymmetrical recognition and enforcement would emerge as an issue and that the data measuring such compliance would begin to be developed in a way that might prove useful later at the DSB. This is particularly the case as national governments and domestic and international interest groups begin to see a practical purpose for the collection of such data.

Perhaps, just as foreign judgments vindicating trade-related claims would be domestically-enforceable because of globally protected trade, thus strengthening individual rights to free trade,[48] judgments vindicating non-free trade interests harmed by trade could also be domestically-enforceable because of the rights enshrined in global trade law.[49] In avoiding private parties' direct access to the WTO dispute resolution procedures and continuing to rely on domestic adjudicatory authorities, however, this approach would avoid constitutionalizing tendencies.[50] It would also avoid the correlative legitimacy concerns of individual standing in WTO adjudication[51] that could arise at this preliminary stage in the development of a global society.[52] Nonetheless, enabling individuals and groups to vindicate non-trade interests through judicial action enabled by the

46. TPRM, *supra* note 37, at para. C.

47. *Id.* at para. A.

48. *See* Ernst-Ulrich Petersmann, *National Constitutions and International Economic Law*, *in* NATIONAL CONSTITUTIONS AND INTERNATIONAL ECONOMIC LAW 3, 38-44 (Meinhard Hilf & Ernst-Ulrich Petersmann eds., 1993) (arguing for judicial review of individual free trade claims as a check on mercantilist behavior by states).

49. *See* Philip M. Nichols, *Extension of Standing in World Trade Organization Disputes to Non-government Parties*, 17 U. PA. INT'L ECON. L. 295, 300-03 (1996).

50. *Cf.* Lawrence R. Helfer & Anne-Marie Slaughter, *Toward a Theory of Effective Supranational Adjudication*, 107 YALE L.J. 273, 287-90 (1997) (focussing on direct links, including standing for private persons in supranational adjudicatory bodies, with sub-national entities).

51. *See* Michael Laidhold, *Private Party Access to the WTO: Do Recent Developments in International Trade Dispute Resolution Really Give Private Organizations a Voice in the WTO?*, 12 TRANSNAT'L LAW. 427, 449 (1999) (arguing that recent examples of NGOs and others to submit views to the DSB regarding ongoing proceedings are insufficient and that more structural change is necessary, such as WTO/DSB appellate review of private party suits by private attorneys general seeking WTO enforcement in national courts); Andrea K. Schneider, *Democracy and Dispute Resolution: Individual Rights in International Trade Organizations*, 19 U. PA. J. INT'L ECON. L. 587 (1998) (analyzing generally the question of individual involvement in trade treaties).

52. *See* Philip R. Trimble, *Globalization, International Institutions, and the Erosion of National Sovereignty and Democracy*, 95 MICH. L. REV. 1944, 1951 (1997) (reviewing Thomas Franck's FAIRNESS IN INTERNATIONAL LAW AND INSTITUTIONS (1995), and calling into question the existence of a global community from which authoritative domestic law could directly flow without an intervening domestic political process); Jonathan Turley, *Dualistic Values in the Age of International Legisprudence*, 44 HASTINGS L.J. 185, 209-10 (1993) (calling into question canons of legislative construction favoring deference to international law in an era of increasing international lawmaking without the pedigree of domestic legitimacy).

WTO could have significant implications for the evolution of transnational civil society;[53] voice, of course, diminishes the tendency for disloyalty and exit.[54] Reducing the costs of the WTO for non-trade values could thus spawn a virtuous cycle of better political management of the tradeoffs between trade expansion and its negative effects on non-trade interests, such as labor and the environment.[55] Of course, there is a danger that the entry into an organization of those fundamentally opposed to its purposes could in the end destroy the organization or at least transform it into a creature that none of its creators would be able to recognize.[56] Yet evolution of the WTO's mandate to take account of the externalities of trade liberalization does not seem to be inconsistent with its basic mandate.

In sum, giving individual litigants affected by the negative externalities of trade a vested interest in trade rules at the WTO would hasten the erosion of the private law approach and instill a public law conception of international trade. A WTO agreement on recognition and enforcement of foreign judgments would also facilitate an increasingly broader and deeper global consensus on the tradeoffs between welfare maximization and distributive justice. WTO decision-making might better articulate and help implement a conception of the good global society.[57] Under this approach one avoids the extreme positions of, on

53. *See Conclusions and Implications*, Part IV, *infra* text and accompanying notes. In the important short term, moreover, inclusion of a judgments proposal in the agenda for the next negotiating round may well be necessary to secure continued support in the U.S. for continued institutionalization of world trade and, perhaps, even continued U.S. acquiescence in China's membership in the WTO, as the danger of low-cost PRC exports free from effective externalization of the costs of negligence in production looms on the American horizon.

54. *See* Eyal Benveniste, *Exit and Voice in the Age of Globalization*, 98 MICH. L. REV. 1681 (1999) (extending Albert Hirshman's insights in EXIT, VOICE AND LOYALTY (1970) to participation of under-represented groups at international organizations through global public interest organizations); *but see* Peter Spiro, *The New Global Potentates: Nongovernmental Organizations and the 'Unregulated' Marketplace*, 18 CARDOZO L. REV. 957 (1996) [hereinafter Spiro, *New Global Potentates*] (offering a more critical view of global public interest organizations as potentially unaccountable and antidemocratic).

55. *Cf.* Oona A. Hathaway, *Positive Feedback: The Impact of Trade Liberalization on Industry Demands for Protection*, 52 INT'L ORG. 575 (noting that interest group attitudes toward trade liberalization may be dynamic, such that progressive enmeshment in free trade tends to reduce the political support for protectionism as the groups that would suffer costs from increased free trade slowly change their practices so that further liberalization becomes less costly). Hathaway's insight about the effect of trade liberalization on protectionist groups arguably would work in the other direction as well, for increased participation of formerly protectionist groups in the WTO would tend to broaden the perspective of WTO policy-making.

56. Something like this might have happened to the International Convention for the Regulation of Whaling, which started out as a fisheries management regime but was transformed into an animal rights organization as the balance of power among the membership moved from states having an economic interest in the continuation of whaling to states lacking such an economic interest but philosophically committed to whale preservation. *See* ABRAM CHAYES & ANTONIA HANDLER CHAYES, THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS 130 (1995); *see also* Antonio F. Perez, *Who Killed Sovereignty? Or: Changing Norms Concerning Sovereignty in International Law*, 14 WIS. INT'L L.J. 463, 476-77 (1996) [hereinafter Perez, *Who Killed Sovereignty?*] (reviewing THE NEW SOVEREIGNTY and critiquing its failure to take account of such fundamental value conflicts).

57. For more about the good society concept, *see* Amitai Etzioni, *Law in Civil Society, Good Society, and the Prescriptive State*, 75 CHI.-KENT L. REV. 355 (2000) (distinguishing between a "civil" society, a "good" society and a "prescriptive" state; such that the civil society is grounded on

the one hand, radical state or private sector autonomy when private international law ignores community needs and, on the other, the eradication of state sovereignty or private sector autonomy when international organs impose public international law from above. Indeed, the ambiguous legal environment would reflect the ambiguous sources of value in the modern international legal system, sources that now require multiple modes of representation. These sources range from participation in policy-making of the society of states,[58] the society of peoples,[59] and the other forms of community that are emerging in global politics through non-territorially-based communities,[60] founded on criteria as diverse as membership in economic organizations, classes or businesses, religious faiths,[61] or perhaps even in internet chat-rooms.[62] Accordingly, increased legitimacy would flow both from a quasi-utilitarian standpoint, because WTO decisions would more likely then reflect the greatest good for the greatest number, and a quasi-republican standpoint, because WTO decision-making would also more likely represent the conclusions of reasoned debate at the global level.[63]

A Road Map

Part I of this Article provides context by analyzing the history of municipal approaches to the problem of recognition and enforcement of foreign country judgments and contrasting the constitutional and quasi-constitutional approaches – of the U.S. with respect to state court judgments and the E.U with respect to member state judgments – with the traditional private international law approach

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human autonomy, a good society relies primarily on informal means of social control to establish a balance of autonomy and duty forming the good character of its members, and a prescriptive state ordains and enforces the public spiritedness of its citizens). Etzioni's conception of a good society is the one most consistent with the vision of the international society of states and the emerging civil society of peoples articulated in this essay.

58. *See* BULL, THE ANARCHICAL SOCIETY, *supra* note 15.

59. *See* RAWLS, THE LAW OF PEOPLES, *supra* note 13.

60. *See* GIDON GOTTLIEB, NATION AGAINST STATE: A NEW APPROACH TO ETHNIC CONFLICTS AND THE DECLINE OF SOVEREIGNTY 7-47 (1993) (arguing that sovereignty can be fractioned, thus making possible multiple, overlapping sovereignties rather than the internal sovereignty of a single nation-state).

61. *See* COMMISSION ON GLOBAL GOVERNANCE, OUR GLOBAL NEIGHBORHOOD: THE REPORT OF THE COMMISSION ON GLOBAL GOVERNANCE (1995) [hereinafter COMMISSION, OUR GLOBAL NEIGHBORHOOD] (report of privately organized group of former world leaders describing the diffusion of sovereignty and the increasing role of transnational groups in global governance).

62. *See* FRANCES CAIRNCROSS, THE DEATH OF DISTANCE: HOW THE COMMUNICATIONS REVOLUTION WILL CHANGE OUR LIVES 257-79 (1997) (arguing that the telecommunications revolution is enabling the emergence of politics and governance outside of normal modes dominated by nation-states).

63. These arguments make no effort to prioritize between utilitarian or republican conceptions of the relationship between trade and other values, such as environmental or labor, affected by trade. *But see* MARK SAGOFF, THE ECONOMY OF THE EARTH: PHILOSOPHY, LAW, AND THE ENVIRONMENT (1988) (arguing that environmental values are misconceived as welfare maximization problems requiring governmental intervention to correct for market failure, and that they are rather "moral, aesthetic, cultural, and political" problems that must be "addressed in those terms"). Consistent with Rawls' view that public discourse should be conducted in terms that accommodate reasonable comprehensive views, including utilitarianism and republicanism, this paper assumes that comparative institutional analysis of the recognition and enforcement of judgments must invoke both utilitarian and republican arguments.

of courts in the U.S. with respect to foreign country judgments. It shows why the asymmetries in U.S. and E.U. policy, coupled with changing patterns of world trade, have focussed attention on recognition and enforcement of judgments as a trade issue. It then develops the argument that recognition and enforcement of judgments is now a global trade issue meriting attention in light of the potential inconsistency of current rules and practices with accepted principles of free and fair trade. Finally, it notes the increasing significance of civil litigation in areas related to trade that may need to be addressed in a full-blown trade approach to the problem of non-recognition and enforcement of judgments. Part II describes and evaluates efforts to address this trade issue through a multilateral treaty negotiated at the Hague Conference on Private International Law. It argues that a multilateral treaty is too inflexible to negotiate tradeoffs between trade and non-trade values and that it is unlikely to provide the basis for revisiting those tradeoffs, which in turn precludes legal adaptation to reflect the evolving views of relevant domestic and international constituencies. Part III considers whether a WTO regime is a suitable alternative for addressing the shortcomings of constitutional and private international law approaches. It considers the relative advantages and disadvantages of these institutional strategies in the resolution of the problem of the trade-related dimensions of recognition and enforcement of judgments. Finally, Part IV appends some final speculations concerning the implications of pursuing a WTO solution for emerging transnational civil society and governance.

I.
INTERNATIONAL PRIVATE LAW SOLUTIONS

The essential problem, from a U.S. perspective, is a perceived asymmetry in the relative recognition[64] and enforcement[65] of foreign judgments between the U.S. and the rest of the world, in particular major U.S. trading partners who are members of the European Union. The claim is that U.S. courts are generally receptive to enforcing foreign judgments, while foreign courts are inclined either not to enforce U.S. judgments or to otherwise discriminate against U.S. citizens by exercising exorbitant jurisdiction over them. The reasons for this phenomenon, if true,[66] are varied, but they flow in large part from unique features of U.S.

64. Recognition refers to the effect given by a domestic court to a foreign country judgment when the domestic court relies on the foreign ruling to bar litigation of a particular claim or issue on the ground that it has previously been litigated abroad. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS, §§ 93-98, ch. 5, topic 2 Introductory note (1971); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW, § 481 cmts. a & b (1987). *See generally* GARY BORN, INTERNATIONAL CIVIL LITIGATION IN UNITED STATES COURTS: COMMENTARY & MATERIALS 936 (3d ed. 1996) [hereinafter BORN, INTERNATIONAL CIVIL LITIGATION].

65. Enforcement refers to the effect given by a domestic court to a foreign country judgment when the domestic court relies on the foreign ruling to order compliance with the foreign award, typically a money judgment. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS, §§ 99-102, ch. 5, topic 3 Introductory note (1971); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW, § 481 cmts. a & b (1987). *See generally* BORN, INTERNATIONAL CIVIL LITIGATION, *supra* note 64.

66. But it is important to recognize that at present no statistical evidence exists to verify whether such a discrepancy truly exists in practice. *See, e.g.*, Friedrich K. Juenger, *A Hague Judgments Convention?*, 24 BROOK. J. INT'L L. 111, 115-16 (1998) [hereinafter Juenger, *A Hague Judg-*

constitutional law of jurisdiction and from the unique characteristics of the U.S. remedial system for tort liability. The effects of resistance to the U.S. legal system are exacerbated in Europe by the consolidation of the European Community, and now the European Union, into an international actor. Together with changing patterns of world trade, which now confront U.S. consumers with even more extreme discrepancies between U.S. legal culture and that of major East Asian U.S. importers, the trade effects may well be substantial for the U.S. Finally, these practices and effects, if not technically inconsistent with international trade law principles, conflict with the fundamental policies of the trade law regime and thus warrant a global solution. At the same time, any attempt to develop a solution will run headlong into the increased use of civil law judgments to vindicate international human rights and environmental norms, sometimes in conflict with trade-related interests.

A. *Sources of Asymmetry in U.S. Treatment of Foreign Judgments*

The common understanding is that U.S. practice in the recognition and enforcement of foreign judgments is rooted in the seminal U.S. Supreme Court decision *Hilton v. Guyot.*[67] The Court, noting that in France a U.S. judgment would be reviewed again on the merits, refused to give effect to a French judgment against a citizen of the United States. Justice Gray for the majority observed:

> The reasonable, if not necessary, conclusion appears to us to be that judgments rendered in France or in any other foreign country by the laws of which our own judgments are reviewable upon the merits, are not entitled to full credit and conclusive effect when sued upon in this country, but are prima facie evidence only of the justice of the plaintiff's claim. In holding such a judgment, for want of reciprocity, not to be conclusive evidence of the merits of the claim, we do not proceed upon any theory of retaliation upon one person by reason of injustice done to another, but upon the broad ground that international law is founded upon mutuality and reciprocity, and that by the principles of international law recognized in most civilized nations, and by the comity of our own country, which it is our judicial duty to know and to declare, the judgment is not entitled to be considered conclusive.[68]

The practical effect of the reciprocity requirement was, however, to create something of a Catch-22: if both the judgment rendering state (F1) and the judgment enforcing state (F2) adopted the reciprocity requirement, as Justice Gray supposed was a common practice among states,[69] then F1 would not give automatic

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ments Convention?] ("[T]he concededly anecdotal evidence I have been able to collect by reading foreign cases and literature suggests that European courts rarely render judgments against American citizens or enterprises that have no 'minimum contacts' with the foreign forum."); Russell J. Weintraub, *How Substantial is our Need for a Judgments-Recognition Convention and What Should We Bargain Away to Get It?*, 24 BROOK. J. INT'L L. 167, 170-71 [hereinafter Weintraub, *How Substantial is our Need*] (noting absence of empirical evidence substantiating claim that U.S. judgments are not recognized and enforced abroad and offering personal estimate that, although this may have been a problem in the past, it is no longer a significant problem for "judgments obtained by U.S. lawyers who follow proper procedures").

67. 159 U.S. 113 (1895).

68. *Id.* at 227-28.

69. Justice Gray noted:

effect to the judgments of F2, and F2 as a consequence would not give automatic effect to judgments of F1.

A game-theoretic treatment of the problem explains why neither the U.S. nor other states would have moved to enforcement of each other's judgments except on condition of reciprocity. One might argue that the situation took the form of the problem of the Prisoners' Dilemma.[70] In this classic of game theory, two criminals by cooperating and not informing on each other avoid extended sentences. However, each could suffer the so-called sucker's payoff of an extremely long sentence by not cooperating with the police while the other confessed. Meanwhile, the confessing player would receive an intermediate sentence that avoided the sucker's payoff but also forbore the opportunity to obtain the shortest possible sentence. Accordingly, it would be rational for each player to choose avoiding the sucker's payoff by confessing, because neither player would be assured of the other's cooperation. Making ordinary assumptions about risk aversion, the expected utility of non-cooperation would exceed the expected utility of cooperation, including the sucker's payoff.

The situation might not be so grim, for it has also been described as a so-called Stag Hunt, in which the incentives for defection are somewhat less than those under the expected utilities described in the Prisoners' Dilemma.[71] The Stag Hunt supposes that the sucker's payoff of catching only the rabbit rather than the cooperative payoff of capturing the stag renders the cost of non-reciprocal cooperation less onerous than that in the Prisoners' Dilemma. If this is so, one expects greater willingness to risk cooperation, and thereby suffer the sucker's payoff, in a Stag Hunt scenario than one would expect in a situation typified by Prisoners' Dilemma payoffs. Non-cooperation may nonetheless be a common strategy under Stag Hunt payoffs, since a modest payoff for individual action will always exceed the sucker's payoff, even if the Stag Hunt problem's payoffs are thought to generate only defensive incentives for defection.[72]

> In France and in a few smaller States . . . the merits of the controversy are reviewed, as of course, allowing the foreign judgment, at the most, no more effect than of being prima facie evidence of the justice of the claim. In the great majority of the countries on the continent of Europe . . . and in a great part of South America, the judgment rendered in a foreign country is allowed the same effect only as the courts of that country allow to the judgments of the country in which the judgment in question is sought to be executed.

Id. at 227.

70. *See* DOUGLAS BAIRD ET AL., GAME THEORY AND THE LAW 33 (1994); AVINASH K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS AND EVERYDAY LIFE 11-14, 89-115 (1991).

71. *See* Brand, *Judgments as a Trade Law Issue*, *supra* note 34, at 622-23 n.120 (discussing a Stag Hunt model of reciprocal enforcement of foreign country judgments).

72. *Id.* at 622-26. *See* Kenneth Abbott, *"Trust But Verify": The Production of Information in Arms Control Treaties and Other International Agreements*, 26 CORNELL INT'L L.J. 1, 4-8 (1993) (distinguishing between "offensive" and "defensive" incentives for defection); *see also* Whincop, *The Recognition Scene*, *supra* note 23, at 420 (distinguishing between games with payoffs giving rise to true cooperation problems, such as the Prisoners' Dilemma, and games giving rise to mere coordination problems, in which both players are better off employing a cooperative strategy but that strategy is not self-selecting).

Under either scenario, however, the logic of non-cooperation holds only under limited conditions, principally non-iteration and finite time horizons.[73] This is so because in an iterated or repeated game cooperation is possible through strategic signaling.[74] This signaling of future cooperation can induce cooperative commitments so long as players play under an indefinite time horizon, because it is only when the game has a fixed endpoint that one is able to calculate a series of moves resulting in a significant sucker's payoff at the end of the game. Because Axelrod showed that tit-for-tat could lead to cooperation even under Prisoners' Dilemma payoffs, tit-for-tat would *a fortiori* lead to cooperation under the more favorable Stag Hunt payoffs that some argue characterize the recognition and enforcement of judgments problem.

Thus, the reciprocity criterion stated in *Hilton v. Guyot* would seem reasonably calculated to employ a tit-for-tat strategy.[75] In other words, the U.S. courts would offer to reward cooperation and punish non-cooperation by the courts of other states. Moreover, shortly after *Hilton*, U.S. courts seemed to have already taken the first step of offering cooperation in a tit-for-tat strategy by relaxing the reciprocity requirement under exceptions stated in *Hilton* itself.[76] Such an approach would have signaled a willingness to cooperate, for it would have created uncertainty about the existence of the reciprocity requirement. This uncertainty could have induced foreign courts to find that U.S. courts would recognize and enforce foreign awards, but for the applicability of narrow exceptions. It is possible such a strategy, if maintained, would have resulted in the widespread recognition and enforcement of U.S. judgments in Europe and elsewhere. It is argued that the failure of U.S. courts to sustain a requirement of reciprocity over time is evidence that the problem was never really significant.[77] However, whether continued judicial insistence on reciprocity would have induced foreign states to recognize and enforce U.S. judgments or whether the failure to conform to a policy of reciprocity evidenced the absence of incentives for strategic behavior is more likely a moot question because intervening developments in U.S. law frustrated any chance to achieve those results.

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73. *See generally* ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984).

74. *See id.* at 27-54 (discussing the superiority of tit-for-tat strategies).

75. *See* Whincop, *The Recognition Scene*, *supra* note 23, at 424 ("The early law on recognition in the United States imposed a reciprocity requirement. Although the formal reason for this was described as 'comity', it is easier to understand as a punishment for defecting states.") (footnotes omitted).

76. One court in an early case treated the reciprocity requirement as dictum, since the Supreme Court might have denied enforcement on the ground that the F1 judgment was procured through fraud. *See* Johnston v. Compagnie Generale Transatlantique, 242 N.Y. 381 (Ct. App. 1926).

77. Analyzing early U.S. law for evidence of strategic behavior, Whincop reads the rapid departure from reciprocity as a general condition for enforcement in the U.S., as well as the U.K.'s consistent rejection of reciprocity, as evidence that the problem may never have been perceived as a Prisoner's Dilemma. *See* Whincop, *The Recognition Scene*, *supra* note 23, at 424. On the other hand, Whincop rejects the vested rights theory explanation for automatic enforcement of foreign judgments and the absence of a condition of reciprocity and thus acknowledges that the "process of judgment recognition provides the opportunity to choose not to recognise judgments thought to represent uncooperative behaviour." *Id.* at 424.

Rather, U.S. courts moved away from the reciprocity regime for unrelated reasons. In *Erie Railroad v. Tompkins*,[78] the Supreme Court abolished the general federal common law upon which *Hilton v. Guyot* was founded. Lower federal courts came to assume that the question of recognition and enforcement of foreign judgments was a question of state common law in the absence of controlling federal or state statutes.[79] Indeed, one reading of *Johnston v. Compagnie Generale Transatlantique*[80] is that a state interested in inducing foreigners to invest capital within its boundaries, by expressing a more favorable attitude than the federal government toward recognition of foreign money judgments, was prepared to place its own interests ahead of those of the nation as a whole.[81] In time, in light of criticism of the reciprocity requirement[82] and the absence of a reciprocity requirement in the Uniform Foreign Money Judgments Act (UFMJA),[83] the pattern of decisions applying state law was thought, with some exceptions, to dispense with the reciprocity requirement.[84] The absence of reciprocity as a general criterion thus opened the door to widespread recognition of foreign country judgments in the U.S., but without the ambiguous threat of non-recognition when foreign courts do not give reciprocal treatment to judgments rendered by U.S. courts. This arguably evidenced a competitive race-to-the-bottom among U.S. states in their relations with foreign judicial systems.[85]

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78. 304 U.S. 64 (1938). The continuing role of special federal common law relating to foreign relations or international law in the recognition and enforcement of foreign judgments in U.S. courts remains undetermined, although some courts have suggested in dictum that these considerations cannot be ignored. *See, e.g.*, Hunt v. BP Exploration Co. (Libya) Ltd., 492 F. Supp. 885 (N.D. Tex. 1980); *see generally* BORN, INTERNATIONAL CIVIL LITIGATION, *supra* note 64, at 961 (citing relevant authority).

79. Somportex, Ltd. v. Philadelphia Chewing Gum Corp., 318 F. Supp. 161 (E.D. Pa. 1970).

80. 242 N.Y. 381 (Ct. App. 1926) (pre-*Erie* New York state court case misreading the *Hilton v. Guyot* holding on this point as dictum and relying instead on the independent exception for fraud as a ground for nonenforcement).

81. *See generally* OLSON, COLLECTIVE ACTION, *supra* note 4. Olson's central argument is that one who cannot be excluded from a benefit does not have an incentive to contribute to its provision. Thus, a state's constitutional authority to exercise jurisdiction over foreign persons and render judgments against them to be enforced in-state or under the Full Faith and Credit Clause in a sister state undercuts the formation of a common front among U.S. states in recognizing and enforcing foreign judgments on the basis of reciprocity toward judgments rendered in any of the U.S. states.

82. *See, e.g.*, J. BEALE, CONFLICT OF LAWS 1385-1890 (1935) (views of chief reporter of FIRST RESTATEMENT OF CONFLICTS OF LAWS); Reese, *The Status in This Country of Judgments Rendered Abroad*, 50 COLUM. L. REV. 783, 790-93 (1950) (views of chief reporter of subsequent RESTATEMENT (SECOND) OF CONFLICT OF LAWS).

83. While the UFMJA did not contemplate a reciprocity requirement, some states' implementing legislation did contain provisions relating to reciprocity, either mandating reciprocity or treating it as a discretionary ground for denial of recognition. *See, e.g.*, GA. CODE ANN. §9-12-114(10)(1082) (2000) (reciprocity is a mandatory condition for recognition); TEX. CIV. PRAC. & REM. CODE ANN §36.005(b)(7) (1986) (lack of reciprocity is discretionary basis for non-recognition).

84. *See* BORN, INTERNATIONAL CIVIL LITIGATION, *supra* note 64, at 952-55 (detailing state and federal practice).

85. *Cf.* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992) (advancing a more limited prediction of merely marginally inefficient competition); *but see* Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Firm*, 6 J. LEGAL STUD. 251, 254-62 (1977) (advancing a race-to-the-top argument that state competition in producing corporate law was efficient). In

A second important development was the transformation of the U.S. legal system spawned by the revolution of U.S. jurisdictional law governing the reach of state courts into multi-state and multi-national transactions, which consequently increased the impact of the U.S. damages system. In part because of the growth of interstate commerce and the increased mobility of persons in the United States, the U.S. Supreme Court refocused the constitutional law of state court jurisdiction on the sufficiency of the defendant's contacts with the forum rather than on the Court's capacity to exercise power over that person.[86] This dramatically expanded the breadth of federal court jurisdiction in multi-state and international cases. The reasonable foreseeability of the effects of the foreign defendant's foreign conduct on the forum would ordinarily be sufficient to exercise jurisdiction, even if the Supreme Court opined that mere foreseeability would be insufficient to establish the reasonableness of the exercise of jurisdiction.[87] The expansiveness of U.S. jurisdictional law is thought to enable U.S. courts to exercise jurisdiction exorbitantly.[88] The impact of this perceived aggressive exercise of jurisdiction by state courts is magnified, moreover, by the extraordinary damages that U.S. courts are prepared to authorize, and U.S. juries are inclined to award, in products liability cases. The combination of these factors may so deeply ingrain European suspicions about the U.S. legal system that any attempt to provide an explanation of the limits the U.S. Due Process Clause imposes on U.S. state courts, particularly in international cases,[89] may well be met with disbelief. Those in other countries not conversant with the tension between the broadest possible readings of judicial statements and the more

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the foreign commerce context, balkanization of state policy is described in Peter J. Spiro, *Foreign Relations Federalism*, 70 U. COLO. L. REV. 1223 (1999); *but see* Crosby v. National Foreign Trade Council, 120 S.Ct. 2288 (2000) (holding that federal Burma sanctions legislation preempted state sanctions, largely because of the Executive Branch's capacity to speak for the U.S. in the negotiation of multilateral sanctions). *Crosby* thus evidences Supreme Court deference to a congressional judgment that uncoordinated state sanctions might yield a sanctions race-to-the-bottom.

86. *Compare* International Shoe Co. v. Washington, 326 U.S. 310 (1945) (focussing on "minimum contacts"), *with* Pennoyer v. Neff, 95 U.S. 714 (1877) (grounding jurisdiction on the court's physical power over the defendant). However, in upholding tag service of a defendant present in California, the Supreme Court has suggested that power over the defendant through the defendant's presence in the forum is still a sufficient basis for jurisdiction, irrespective of the reasonableness of the exercise of jurisdiction under minimum contacts analysis. *See* Burnham v. Superior, 495 U.S. 604 (1990) (Scalia, J., plurality opinion).

87. *See* World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980) (holding mere foreseeability insufficient for purpose of finding personal jurisdiction over regional automobile distributor under the Due Process Clause).

88. *See generally* Ronald Brand, *Due Process, Jurisdiction and a Hague Judgments Convention*, 60 U. PITT. L. REV. 660 (1999) [hereinafter Brand, *Due Process*] (attempting to dispel these notions through an exhaustive and convincing attempt to read U.S. due process jurisprudence narrowly).

89. It is argued, for example, that a European court would have asserted jurisdiction in the *Asahi* case, while the Supreme Court held that California could not under the Due Process Clause assert jurisdiction in a dispute between two foreign parties on an indemnification claim even though the tortious harm occurred in California. *See* Linda J. Silberman, *Judicial Jurisdiction in the Conflict of Laws: Adding a Comparative Dimension*, 28 VAND. J. TRANSNAT'L L. 389, 401 (1995).

nuanced and restrained reality of common-law adjudication may particularly disbelieve.[90]

In sum, the supervening legal developments undermined the effectiveness of a tit-for-tat strategy in securing the enforcement of U.S. judgments abroad. The U.S. system for determining whether jurisdiction is proper became grounded on constitutional concerns that are simply incomprehensible to most countries that do not constitutionalize this question, and this new constitutional analysis enabled the dramatic expansion of U.S. jurisdiction over foreign defendants.[91] At the same time, *Erie* suggested that states have authority to determine the conditions for recognition of foreign judgments in the U.S., which in turn disabled the U.S. as a whole from compensating with tit-for-tat responses for increased foreign non-recognition of U.S. judgments. Moving the carrots and sticks of recognition and enforcement policy from the federal government to the states may have disrupted the evolution of the tit-for-tat strategy initiated by the Supreme Court in *Hilton v. Guyot* as a rational response to a national problem of non-recognition and enforcement.

B. Sources of Asymmetry in E.U. Treatment of Foreign Judgments

In contrast, the courts of the E.U. countries have lacked an incentive, as well as the power arguably, to open their doors to the recognition and enforcement of U.S. judgments. They may lack the power to exercise the kind of discretion that common-law courts can exercise in implementing a tit-for-tat regime leading to mutual recognition, because the civil law tradition does not, in theory at least, empower courts to make the policy judgments that seem embedded in a tit-for-tat approach.[92] The courts of E.U. countries have lacked an interest in doing so because they have in effect been able to "free ride" on U.S. courts that grant recognition and enforcement of most E.U. judgments without the requirement of reciprocity. Finally, the constitutional evolution of the E.U. made cooperation with the U.S. even more difficult.

One might argue that, even if most U.S. jurisdictions had imposed a reciprocity requirement, it would not have been in the interest of most E.U. countries to respond to the U.S. reciprocity criterion by beginning to enforce U.S. judgments until recently. This is because U.S. firms traditionally had relatively more capital invested in Europe than European firms had invested in the U.S. The same could be said about a number of emerging capital-exporting countries around the world. Under these conditions, judgments against U.S. firms in Eu-

90. Brand, *Due Process, supra* note 88, at 687 ("To a lawyer from a civil law system, accustomed to the relative structure of code-type lists of jurisdictional rules, and reasoning from general principles often more certain than the concept of due process, [a] trip through U.S. case law must seem rather confusing.").

91. *See* Friedrich K. Juenger, *Constitutionalizing German Jurisdictional Law*, 44 AM. J. COMP. L. 521 (1996) (casting doubt on correctness of *Pennoyer v. Neff* approach of constitutionalizing jurisdiction).

92. *See* JACKSON AND TUSHNET, COMPARATIVE CONSTITUTIONAL LAW 663-66 (1999) (drawing on work of civilian scholarship to explain the resistance to "lawmaking" of courts in the civil law tradition).

rope were more likely to be immediately enforceable in Europe against the European assets of U.S. firms than U.S. judgments in the U.S. against foreign assets in the U.S. This relative asymmetry exposed U.S. firms to greater risk of judicial enforcement in European countries than European firms faced in the U.S. Thus, E.U. courts seeking to vindicate their nationals' interests had less incentive than U.S. courts seeking to vindicate the interests of U.S. nationals to cooperate in creating a non-negotiated regime for mutual recognition and enforcement of each other's judgments.[93]

Changing capital flows would in theory change these incentives, however. Admittedly, at first a state in the E.U. with few local assets in the territory of foreign creditors will have little incentive to deter such creditor states, such as the U.S., from adopting laws preferring local creditors.[94] However, the costs of non-cooperation for the E.U. would increase as U.S. creditors become better able to enforce their E.U. judgments against E.U. nationals operating in the U.S. against E.U. property located in the U.S. Thus, over time, as E.U. investments in the U.S. increased, the interests of E.U. courts in protecting their own nationals should have encouraged them to show greater receptivity toward recognition and enforcement of U.S. judgments.

Yet, even if the diminution of asymmetric investment stimulates a mutual recognition regime, this factor is clearly outweighed by the influence of the emergence of the European Economic Community in driving E.U. countries toward non-recognition of U.S. judgments. In contrast to the U.S. regime toward foreign judgments, the countries of the European Community negotiated an internal regime via a multilateral convention that discriminates against the recognition and enforcement of non-EC judgments. The so-called Brussels Convention was then extended to the countries of the European Free Trade Area (EFTA), many of which have since entered the E.U., through the so-called Lugano Convention. Taken together, the Brussels-Lugano Convention system comprised a unified law for the recognition and enforcement of EC/EFTA judgments.

More important, the E.U. has now taken steps to implement the Brussels Convention as a matter of E.U. law by issuing a draft regulation that will ultimately compel E.U. member states to implement the rules of the Brussels Convention as part of their national laws.[95] This will make compliance with the substance of the Brussels rules a right of individuals in the E.U., which may be enforced by the European Court of Justice (ECJ). The binding quality of ECJ decisions now effectively guarantees the E.U. common market and thereby pro-

93. Lucian Arye Bebchuk and Andrew Guzman have made a similar argument in the related context of assessing whether asymmetry of investment would prevent the evolution of national bankruptcy laws toward a globally welfare-enhancing universalist approach, rather than a territorialist approach under which states effectively prefer local creditors. *See* Bebchuk and Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. & ECON. 775, 805-07 (1999).

94. *See id.*

95. *See supra* note 29. As a matter of E.U. law, this approach appears to be legally sustainable. *See* Brand, *supra* note 34, at 617-18 (noting the acknowledgment in 1994 by the European Court of Justice of the relationship between trade law and judgments recognition and enforcement).

motes the continuing process of political integration. In sum, it might be assumed that the Brussels Convention rules will have effects similar to those of the Full Faith and Credit Clause of the U.S. Constitution in furthering economic and political integration and in further reducing the competitive opportunities of persons outside the E.U. Certainly the workings of the Brussels-Lugano system further the aims of European economic integration, although the retention of a public policy exception in the E.U. regime[96] seems to tolerate greater diversity than does the Full Faith and Credit Clause of the U.S. Constitution.[97]

C. Recognition and Enforcement of Judgments As a Trade Issue

The Brussels system, unlike the Full Faith and Credit Clause, explicitly discriminates against judgments rendered by foreign states. It does so by making some bases for non-recognition or non-enforcement of a foreign judgment inapplicable with respect to judgments rendered against a non-domiciliary of a Brussels-Lugano country.[98] If then, for example, a French court renders an award against a U.S. person not domiciled in an EC or EFTA country based on a jurisdictional ground that would deny the enforcement if rendered against a domiciliary of an EC or EFTA country, the judgment would, nonetheless, be enforceable against the U.S. citizen's assets anywhere in the EC or EFTA. The practical implications of this discrimination are clear with respect to the comparative risks faced by the U.S. person and an EC or EFTA person doing business in France. The U.S. person suffers greater legal risk of enforcement of any claims that might arise from the transaction. To the extent that the U.S. person and EC/EFTA person are competing for trade opportunities in France, the U.S. person will be at a relative disadvantage.

It is not clear, however, that this practice amounts to a violation of GATT's rules. As an E.U. scholar has argued, such measures may not conflict with GATT's nondiscrimination obligations because they are framed in terms of domicile rather than nationality.[99] Nonetheless, the preceding hypothetical crystallizes the undeniable effect of the increased legal risk, amounting to an unlevel playing field, for U.S. persons doing business with domiciliaries of E.U. and EFTA countries. Moreover, the effect of the Brussels rules may be to operate as a disguised discrimination against non-E.U. nations, which might well be actionable under the WTO.

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96. *See* Brussels Convention, *supra* note 27, art. 27(1).

97. In the language of dissenting Justice White in *Fauntleroy v. Lum*, the majority's rejection of a public policy exception to the Full Faith and Credit Clause "so enlarges that clause as to cause it to obliterate all state lines." Fauntleroy v. Lum, 210 U.S. 230, 239 (1908) (White J., dissenting).

98. *See* the Brussels Convention, *supra* note 27, art. 4; Lugano Convention, *supra* note 28, art. 4.

99. *See* Friedrich K. Juenger, *Judicial Jurisdiction in the United States and in the European Communities*, 82 MICH. L. REV. 1195, 1211 (1984) (criticizing this discrimination); *but see* MATTHIAS REIMANN, CONFLICT OF LAWS IN WESTERN EUROPE: A GUIDE THROUGH THE JUNGLE 71 (1995) [hereinafter REIMANN, A GUIDE THROUGH THE JUNGLE] (arguing that, because the discrimination is based expressly on domicile rather than nationality, it is not a violation of either the most favored nation or national treatment principles of the GATT).

The E.U. is now seeking to incorporate the Brussels/Lugano system into the body of E.U. law.[100] For this reason, recent scholarship has encouraged U.S. policymakers to renew efforts to achieve a treaty-based solution that strives for maximum enforcement of U.S. judgments abroad through the negotiation of a multilateral convention at the Hague Conference on Private International Law.[101] Moreover, as argued below, the jurisprudence of the WTO supports treating recognition and enforcement of judgments as a trade solution. Finally, while there appears to be no empirical confirmation of asymmetric recognition and enforcement of U.S. judgments in the E.U., and legal scholars appear to be divided,[102] there seems to be considerable interest and support in the U.S. practitioner community. Yet, U.S. trial lawyers appear more concerned about the risk that U.S. judgments will not be enforced in countries that are emerging as importers into the U.S., principally the countries of East Asia where large volumes of consumer products are produced and later brought to the U.S.[103] The products liability concerns are potentially staggering. This is because the U.S. Supreme Court gave U.S. practitioners further concern about the scope of the problem by suggesting in the *Asahi* case that foreign manufacturers could avoid personal jurisdiction in U.S. courts by keeping their operations out of the U.S. and importing through essentially judgment proof intermediaries.[104]

In sum, the appearance of asymmetry, combined with the perception of an emerging liability issue derived from changing global trade flows, has generated pressure in the U.S. for a global approach to recognition and enforcement of judgments as a trade problem and stimulated an effort to seek a solution at the Hague Conference on Private International Law. At the same time, trade-related interests face the challenge of an increasing public perception of the external costs of trade and attempts to vindicate those interests through litigation.

D. Human Rights and Environmental Interests in Judgments

The very expansiveness that drives U.S. jurisdictional and liability law with respect to trade-related interests has increased opportunities to use the federal courts to vindicate non-trade related interests. For example, American lawyers have recently utilized the Alien Tort Claims Act (the Act)[105] to challenge the labor practices of U.S. oil firms operating in Nigeria.[106] The Act has in the past been interpreted to permit suit by foreign plaintiffs against foreign defend-

100. *See supra* note 29.

101. *See* Brand, *Judgments as a Trade Issue*, *supra* note 34.

102. *See* Kevin M. Clermont, *Jurisdictional Salvation and the Hague Treaty*, 85 CORNELL L. REV. 89, 94 n.28 (1999). For additional discussion of the empirical question of asymmetric enforcement, *see* authorities cited in *supra* note 66.

103. *See* Matthew Vita, *Senate Approves Normalized Trade With China*, WASH. POST, Sept. 20, 2000, at A01.

104. Asahi Metal Industry Co. v. Superior Court of California, 480 U.S. 102 (1987).

105. 28 U.S.C. § 1350 (2000).

106. *See Go Global, Sue Local*, THE ECONOMIST, Aug. 14, 1999, at 54.

ants.[107] Buttressed by the Supreme Court's possible reaffirmation of transient or so-called "tag" jurisdiction,[108] the Act may well allow the U.S. human rights community to vindicate the rights of foreign persons through generous U.S. judgments. As U.S. case law makes clear, the punitive damages of U.S. remedies for common-law torts may well be available for analogous "torts" cognizable under the Act in violation of international law.[109] Similarly, emerging environmental law norms may well generate similar tort-like claims cognizable under the Alien Tort Claims Act.[110]

It is unnecessary, for purposes of this argument, to evaluate the ultimate merit of invoking the Act to serve these purposes. Suffice it to say that the practice of U.S. states in creating private rights of action to vindicate human rights norms, such as California's recent statute vindicating the interests of Holocaust survivors, suggests that future developments in this area are likely.[111] Creative lawyers can exploit these litigation opportunities to vindicate interests that are inadequately addressed through the political process, much as civil rights activists in the United States creatively invoked long-buried principles of racial equality in the U.S. Constitution to seek judicial remedies to entrenched discrimination. The enforcement of such "civil" judgments would arguably fall within the ambit of a treaty solution to the recognition of judgments grounded on commercial rights. Some kind of balance would need to be struck in defining the kinds of civil judgments that would further trade interests and those that would further non-trade interests. What protection each would receive under international law would need to be determined. Perhaps hardest of all, rules for dealing with cases in which both trade and non-trade interests are implicated would need to be fashioned. Yet, this is a matter of increasing importance as U.S. trade flows continue to shift toward non-European suppliers and export markets,[112] where the conflicts between U.S. and foreign environmental and labor values would seem to be the greatest.

II.
A Proposed Solution at The Hague Conference

Nonetheless, an attempt to address this problem in the context of a multilateral convention like the traditional Hague private law conventions is neither negotiable nor likely to be effective in achieving U.S. trade-related goals. The treaty would be ineffective largely because the means by which such treaties are

107. *See* Filartiga v. Pena-Irala, 630 F.2d 876 (1980) (holding an act of torture committed by an alien against an alien on foreign territory was nonetheless actionable in U.S. courts as a cognizable violation of the law of nations within the meaning of the Alien Tort Claims Act).

108. *See* Burnham v. Superior Court of California, 495 U.S. 604 (1990) (Scalia, J, plurality opinion).

109. *See* Filartiga v. Pena-Irala, 577 F. Supp. 860 (E.D. N.Y.1984).

110. *See* Legality of the Threat or Use of Nuclear Weapons, 1996 I.C.J. 241-42, para. 29 (July 8), 35 I.L.M. 809 (emphasizing the importance of international environmental obligations).

111. CAL. CIV. CODE § 354.5 (West 2000).

112. *See* International Trade Administration, US Foreign Trade Highlights, US Commodity Trade by Geographic Area, http:\\www.ita.doc.gov/d/industry/otea/usfth.

implemented and amended preclude the kind of legal mutation required in the politically-charged balance between trade and non-trade concerns. The treaty would be non-negotiable because, under a straightforward application of game theory, the negotiating dynamic of a multilateral convention discourages stakeholders from achieving optimal joint gains in trade and non-trade values. Finally, even if the treaty could be implemented and negotiated, the rules orientation of the Hague Convention model would encourage continued bilateral responses to conflicts concerning the treaties' implementation rather than a multilateral bargaining process in which rational and transparent negotiations might lead to better results.

A. *Barriers to Effective Implementation of a Hague Convention*

With respect to implementation, the central objection is that a Hague Treaty cannot serve effectively as a vehicle for political evolution. Once it is concluded, a Hague Convention would create permanent sets of proponents and opponents. If such a multilateral treaty ever did enter into force, changes in the political basis for supporting the tradeoff between trade and non-trade values would undercut support for the rules of the treaty reflecting the political consensus at the Hague Conference. Multilateral treaties of this kind are rarely, if ever, amended. Without an effective formal mechanism to adapt the treaty to respond to changing political views, the treaty would become anachronistic. It might be honored in the breach, through more frequent use of the escape devices that would inevitably be built into it. To the extent that judicial interpretation reflects changing political consensus in a particular country, the implementation of the treaty would vary substantially. This variation would defeat the treaty's chief objective of overcoming disincentives to cooperation among states in their pursuit of global free trade goals. In the absence of an agreed upon final interpreting mechanism, auto-interpretation of the treaty would erode its value in assuring a stable set of commitments, even if cabined by the doctrine of good faith.[113]

Moreover, it seems unlikely that mutation or common interpretation could be achieved through a supranational dispute resolution mechanism. States would probably not accept a final supranational arbiter of the disputes that would typically be governed by the treaty. For example, it was extremely difficult for the United States to agree to allow the Canada-U.S. Dispute Settlement Panel to determine whether U.S. courts were applying the appropriate standard under the Canada-U.S. Free Table Agreement in their assessment of antidumping and countervailing duty cases.[114] The domestic constitutional questions attending that issue are as yet unresolved. Moreover, that was a public law

113. *See* J. F. O'Connor, Good Faith in International Law 83 (1991); *but see* Antonio F. Perez, *Survival of Rights Under the Nuclear Non-Proliferation Treaty: Withdrawal and the Continuing Right of International Atomic Energy Safeguards* 34 Va. J. Int'l L. 749, 774-81 (1994) (questioning the utility of the concept of good faith in the case of auto-interpretation).

114. *See generally* Charles M. Gastle, *Policy Alternatives For Reform of the Free Trade Agreement of the Americas: Dispute Settlement Mechanisms*, 26 Law & Pol'y Int'l Bus. 735 (1995) (discussing the difficulties of dispute resolution in the area of antidumping cases).

controversy. Many would consider it even more problematic for the U.S. to agree to allow supranational case-by-case review of judicial interpretation of private law controversies where established domestic values are enshrined in common-law principles in property, tort and contract law. In the absence of supranational case-by-case review, however, states would be allowed to vary their interpretation of the treaty in accordance with their own values.

It is likely that states would find it difficult to balance effectively trade and non-trade values in this context. This is because the treaty would likely be implemented directly into national law with little, if any, additional legislative attention to the tradeoffs between trade and non-trade values. This is likely because treaty proponents would try to avoid complicating its adoption with what they perceive to be extraneous concerns. If, however, implementing legislation did address non-trade related concerns, the particular views expressed in each ratification process would lead to amendments that would undercut prospects for widespread ratification. On the other hand, if ratification were secured through a legislative strategy that did not formally address the balance between trade and non-trade concerns, the task of addressing those issues would devolve to an unelected and politically-unaccountable judiciary. The judiciary might lack the political capacity to adjust the meaning of the treaty to changing political conceptions, assuming it is even desirable for a judiciary to do so. One might risk reenactment of the era when U.S. federal courts struck down labor agreements as contracts that violated antitrust laws.[115] Moreover, the judiciary, especially the state judges who would hear most of the common-law claims subject to the proposed Hague Convention, would probably not have the experience in foreign legal systems and economic practices sufficient to assess the validity of certain business practices. Thus, even if some judges could apply provisions of the treaty that balanced trade and non-trade concerns to take account of changing domestic values, it is doubtful that most could get it right uniformly. The judicial error rate is bound to be significant.

B. Barriers to Effective Negotiation of a Hague Convention

Even if a Hague treaty could adapt to changing political circumstances, it is doubtful that the treaty could effectively balance trade and non-trade concerns, even at its inception. Because a multilateral treaty is not capable of mutating in meaning to correspond to a changing global political balance, stakeholders in the treaty would perceive the initial negotiation as a one-shot deal. Although proponents of trade and non-trade values would have an interest in cooperating to achieve their respective goals, stakeholders might perceive the situation as a Prisoner's Dilemma, in which cooperation involves risking exploitation during the implementation phase. For example, a proponent of labor rights attempting to invoke a treaty provision requiring enforcement of a judgment relating to defective products produced through substandard working conditions, might find that the domestic understanding of substandard working conditions varied

115. *See* HOVENKAMP, ANTITRUST LAW, *supra* note 5.

from the international understanding embedded in the treaty. An advocate of labor rights might fear that the non-enforceability of a judgment on substandard working conditions might further entrench the practice rather than raise the costs of employing it.

Game theory suggests, however, that iterated (repeat play) games – even Prisoners' Dilemma games – may foster cooperation that would not occur in single-play games. This is because iterated games allow players to signal their cooperation, reward reciprocal cooperation, and penalize non-cooperation. One might consider, therefore, whether a multilateral treaty that is perceived by stakeholders as a game that encourages non-cooperation might nonetheless permit cooperation in advancing both trade and non-trade values if it were perceived as an iterated game. Yet, this possibility is unlikely to be realized for several reasons.

First, the defined time horizon would undercut the perception of iteration. Admittedly, the stakeholders, particularly in countries like the United States which can treat a treaty as non-self-executing domestically, might perceive the negotiation as involving an additional requirement to implement legislation domestically. But game theory also predicts that an iterated game with a defined endpoint where most of the payoffs occur is functionally identical to a single-play game. This is because each player calculates whether the other player has the incentive and capacity to exploit efforts to cooperate. If so, the game reduces to the final moves of each player and, thus, a single-play game. Accordingly, for international stakeholders whose gains come from domestic treaty implementation, domestic implementation would not change the nature of the negotiating incentives at the international level.

Second, stakeholders in the multilateral negotiation might not perceive the domestic negotiation as a meaningful iteration of the same multilateral game. This would be true if, for example, non-trade-related stakeholders have substantially less access to the negotiation process and to the process of formulating the negotiating position of each national participant than they would have in the domestic implementation phase in the legislative process. Even in the United States, where public rights of participation are substantial, it is not clear that those who participate in U.S. multilateral negotiations are the same people who would influence domestic advice and consent to ratification. Public choice theory predicts, for example, that groups with lower costs of organizing, and therefore monitoring and participating in the negotiating and implementing processes, would have a relative advantage over groups with higher costs of organization in the bureaucratic process within the State Department controlling negotiation of the treaty compared to the relatively more transparent, legislative process for treaty ratification and implementation. This is true even though the negotiating process is informed by some political participation through the State Department Advisory Committee on Private International Law and its Study Groups on the Judgments Convention.

In fact, domestic negotiation might even be antithetical to the interests of the stakeholders prevailing at the multilateral negotiation, further weakening

their capacity to threaten retaliation against non-trade interests at the domestic implementation phase. Any savvy participant in the multilateral negotiating process would understand the boundaries for disciplinary retaliation in the domestic implementation phase and would therefore perceive significant room for deviating from prior commitments. Finally, politically savvy trade negotiators would know that domestic implementation could erode trade-related gains. The negotiator would therefore discount the value of negotiating partners' concessions and would make fewer commitments in return. Similarly, stakeholders relatively disadvantaged in the multilateral setting might have less of an interest in making concessions in the multilateral setting because they would believe that domestic implementation would give them an opportunity to achieve a relatively better result. Thus, knowing all this, the stakeholders who were relatively advantaged in the formulation of the U.S.'s multilateral negotiation position would not perceive the domestic negotiation on implementation to be a suitable vehicle for disciplining opportunistic behavior by other participants in the multilateral negotiation.

In sum, the negotiating dynamic of a single-play game is not improved, and appears likely to be worsened, by incorporating a domestic legislative phase of implementing a multilateral treaty produced at the Hague Conference. A multilateral treaty would likely be perceived as a single-play game because the limits on consensual mutation render each stage in the process a single-play game for the relevant sets of players. Game theory therefore predicts that stakeholders in the tradeoff between trade and non-trade values will engage in a sub-optimal level of cooperation in a negotiating setting like the Hague Conference on Private International Law.

This would not be a serious concern if all it signified was a failure to achieve gains that might otherwise be possible. However, to the extent the Hague process does succeed in achieving some tradeoff between trade-related and non-trade-related gains, it could have deleterious long-term effects. Any effort to increase the recognition and enforcement of judgments that create mainly trade-related gains would necessarily privilege or lock-in trade values against non-trade values. This is because proponents of trade liberalization might now oppose even a renegotiation that promised total welfare gains and even trade gains. If, by hypothesis in a renegotiation, externalized costs of trade are internalized to a greater degree than trade-related gains are created through the renegotiation, this second attempt to address the tradeoffs between trade and its externalities could reduce net returns for trade-related interests. Thus, trade-related stakeholders could prefer to forgo the opportunity to achieve greater absolute gains for trade because of the risk of suffering relative losses. In effect, any solution at the Hague Conference would raise the opportunity costs for trade interests succeeding in the Hague process of negotiating later at another forum structured as an iterated game where joint gains could be more easily achieved. Thus, the Hague Conference approach is not only unlikely to achieve the optimal level of joint gains but it is also likely to make achieving the optimal level of joint gains more difficult in any later negotiation for proponents of both trade

and non-trade concerns. A possible example of this phenomenon is the difficulty environmental interests now experience in protecting environmental values at the WTO.

C. *After the Hague: The Danger of Bilateralized Dispute Resolution*

Finally, even if it were possible to surmount the barriers to successful implementation of a multilateral convention like the Hague Conference model, the substance of the tradeoff could not be negotiated in terms that would facilitate a multilateral balance between trade and non-trade concerns. Because it would develop norms that would ultimately address courts, the Hague Conference would likely formulate rules rather than balancing principles. International negotiators prefer to formulate rules when creating directives to courts because they presume that rules are more acceptable to civil law cultures that purport to deny their judiciaries the power to make law. Accordingly, the likeliest result of the Hague Conference negotiation would be a framework of rules that purports to provide a specific resolution to each case. The failure to enforce the treaty rules in a particular case would constitute a breach. The rules orientation therefore compels a binary solution: either the treaty norm is followed or it is not.

Accordingly, the ordinary remedy for breach of obligations in civil law and public international law is an order of specific relief, such as specific performance in contract law and the duty to make reparations in international law. Substitutional relief like that rewarded in American contract law is not the ordinary case. Thus, the ordinary remedy for breach of a Hague Convention obligation would likely be an international tribunal's directive to comply with the treaty norm rather than some measure of damages for losses that the treaty was negotiated to protect. However, when a municipality favors one interest over another in a dispute between trade gains and the externalities of trade, the appropriate remedy should be measured in terms of the lost non-trade gains (in other words, the externalized costs of trade). Substitutional relief that compels a stakeholder to internalize the externalities of trade through the payment of compensatory relief would not be feasible under the international remedial law that has traditionally been applied; even if it were feasible to award substitutional relief for failure to comply with the treaty's requirements, it would be undesirable to measure harm to the interests protected by the treaty in terms of the losses to individual litigants who are denied the benefit of the treaty right. Awarding litigants damages calculated in terms of losses of treaty-protected interests that might bear no relation to the litigants' actual losses would be equally undesirable because it would produce either a windfall recovery or a grossly inadequate award from the litigant's perspective.

Moreover, any attempt by judicial authorities to consider a treaty's underlying desire to balance trade and non-trade interests would be seen as illegitimate, not only in rules-oriented civilian cultures that abjure judicial discretion but also in the United States under the evolving Supreme Court jurisprudence of choice of international law. On par with the highly context-sensitive choice-of-law revolution reflected in the work of the Restatement (Third) of the Foreign Rela-

tions Law of the United States for international conflicts of law, U.S. courts expressed receptivity to judicial interest balancing until the recent *Hartford Insurance* case.[116] In that case the U.S. Supreme Court moved away from a balancing approach and signaled a preference for bright-line rules. A rules approach to conflict between two states' laws informs political actors that they must accommodate their conflicting interests because the courts will not do that job for them. Accordingly, courts will likely eschew discretionary balancing of competing state interests in international cases following *Hartford Insurance.*

The net effect of (1) binary conceptions of the applicability of Hague Convention rules, (2) remedial laws that direct parties to give specific relief in the event of breach and (3) the inability of courts to balance the tradeoffs between trade and non-trade values embedded in the multilateral treaty is to drive the breaching and nonbreaching parties to treat the dispute in any individual case as a simple conflict over the recognition and enforcement of a trade-related judgment. The parties ignore the other state values and interests that might be implicated. More important, because the dispute is conceptualized as a private law dispute between citizens or domiciliaries of two interested states, any third state's interests in resolution of the dispute are ignored. Thus, resolution of disputes under the Hague Convention on a bilateral basis would defeat the objective of a globally-accepted tradeoff between trade and non-trade concerns.

The following section explains why the WTO can provide a framework for addressing the weaknesses of the Hague Convention approach and for exploiting the possibilities for more narrowly-tailored arrangements for balancing trade and non-trade concerns.

III.
THE WTO ALTERNATIVE TO THE HAGUE CONVENTION

The weaknesses of the Hague approach offer a roadmap for an alternative solution to the problem of discrimination against foreign country judgments in trade law. That solution falls, arguably, under the auspices of the WTO. Even if existing trade law is insufficient to give a WTO complainant a reasonable prospect of success, this article will now argue it is reasonable to reformulate and extend the substantive trade law of the WTO in order to achieve precisely the kind of security of trade expectations WTO law is generally designed to protect. This approach would draw on the WTO's recent innovations in lawmaking to reach into areas of domestic policy-making previously reserved to national discretion, such as antimonopoly policy in the telecommunications sector. A new WTO agreement could easily build on the technical work accomplished thus far at the Hague Conference. The precise structure of the mixed, double convention – with required bases of jurisdiction, enforceable in every participating state; permitted bases of jurisdiction, enforceable at the discretion of participating

116. *Compare* Hartford Fire Insurance v. California, 509 U.S. 764 (1993) (rejecting comity), *with* Restatement (Third) the Foreign Relations Law of the United States, § 403 (1987) (favoring comity).

states; and prohibited bases of jurisdiction – might be modeled on the Subsidies Code, a regime the WTO already has experience implementing. Relying on the subsidy model would invoke the conceptual apparatus of subsidy law, and there is already WTO doctrine that states that inferior remedial opportunities for trade-related rights can impair the competitive relationship secured through negotiated tariff reductions and, by parity of reasoning, negotiated non-tariff concessions. Finally, incorporating the issue of recognition and enforcement of foreign judgments into WTO law would relate the trade effects of non-recognition to the negotiated trade relationship between participating WTO countries; it would redefine a broad range of substantive law claims – such as environmental claims or child labor practices that operate as implicit subsidies – as claims affecting welfare measured along both trade and non-trade parameters and thus subject to WTO discipline when litigated outside the safe harbor jurisdictional rules incorporated into the WTO. Political interests operating at both national and supranational levels would then have an incentive to influence WTO negotiations in order to preserve jurisdictional practices that permit the vindication of non-trade values. Those political interests would then rather join the WTO than destroy it. This article will address each of these points in turn.

A. *Remedial Systems and the WTO: Violation and Non Violation Claims*

With time and experience, WTO law has developed into a complex, yet relatively clear, body of doctrine. Thus, according to a member of the WTO legal staff, it is now generally accepted by WTO member states that only dispute settlement claims based on nullification or impairment of the benefits secured during negotiating rounds may be brought under WTO law, despite language suggesting that claims are also possible if "attainment of any objective" of a WTO agreement "is being impeded."[117] A prima facie case of nullification or impairment of benefits may be established if a WTO rule is violated.[118] Otherwise, the complainant must show that its reasonable expectations of trade benefits were undercut by an unanticipated act by the defendant.[119] When the rules

117. *See* Werner Zdouc, *WTO Dispute Settlement Practice Relating to GATS*, J. INT'L ECON. L. 295, 297, nn.5-6 (1999) [hereinafter Zdouc, *WTO Dispute Settlement Practice*] (also noting that, in theory, GATT Article XXIII also provides for claims based on "the existence of any other situation," although the language has never been invoked in GATT or WTO dispute settlement).

118. GATT practice appeared to treat violation of a GATT rule as a prima facie showing, and arguably an "irrefutable presumption," of nullification or impairment of negotiated GATT benefits. *See id.* at 298, n.8 (citing WTO Panel Report on US – Taxes on Petroleum and Certain Imported Substances ("Superfund"), adopted on June 17, 1987, GATT B.I.S.D. 34S/136, 158, para. 5.1.9). One might question whether the presumption is truly "irrefutable" if at the remedial phase of a proceeding the complainant must still prove that its retaliatory suspension of concessions, assuming the defendant does not comply with a ruling requiring it to withdraw its offending measure, corresponds to the value of the benefits that were nullified or impaired.

119. The non-violation theory supposes that competitive opportunities bargained for in the negotiating round are vitiated by an otherwise WTO legal measure, such as creation or expansion of a free trade area or customs union. *See, e.g.*, EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, Jan. 25, 1990, GATT B.I.S.D. (37th Supp.) at 86 (1991) (Report of the GATT Panel). In theory, as Zdouc observes, the GATT dispute settlement system also has competence over "the existence of any other situation" that either nullifies or impairs benefits or impedes the attainment of any objective of a covered agreement. Zdouc, *WTO*

of the DSU are extended to dispute resolution for a WTO agreement, they apply to interpretation and enforcement of that agreement.[120] The violation and non-violation theories thus might give rise to two distinct methods of bringing the recognition and enforcement of foreign judgments into WTO law: first, through judicial innovation; and second, through legislative innovation.[121]

1. Judicial Lawmaking at the WTO/DSB

Judicial innovation could immediately introduce recognition of foreign judgments into the WTO/DSU domain based on an analogy to existing WTO precedent. The best available analogy for extending the law of the WTO to recognition and enforcement of foreign judgments, namely the core nondiscrimination principles of national treatment principle and most-favored-nation treatment, is *U.S. – Section 337 of the Tariff Act of 1930.*[122] This pre-WTO panel report concluded that the differences between U.S. procedures for the enforcement of foreign and domestic patent rights operated as a violation of the national treatment principle of GATT because section 337 provided domestic patent holders more immediate and extensive remedies with respect to imported products than were available to similarly situated foreign patent holders before federal district courts. The panel rejected the U.S. argument that the federal district court procedure's unfavorable elements and remedies were not discriminatory because section 337 relief for domestic holders of patents could be reduced on public policy grounds, restoring the balance of competitive opportunities.[123] One possible reading of the panel report, which the panel understood to be applicable also to cases outside the realm of intellectual property,[124] is that any dif-

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Dispute Settlement Practice, *supra* note 116, at n.6. But the absence of any evidence of claims based on such theories suggests that these possible claims should, for purposes of analysis of the recognition of foreign judgments, be subsumed under the non-violation, nullification or impairment of benefits theory.

120. *See* WTO/DSU, art. 3.2, which provides:

> The dispute settlement system of the WTO is a central element in providing security and predictability in the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of the Members under the covered agreements and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the DSB cannot add to or diminish the rights and obligations provided in the covered agreements.

See Adrian T. L. Chua, *Precedent and Principles of WTO Panel Jurisprudence*, 16 BERK. J. INT'L L. 171, 175 (1998) (affirming incorporation of GATT acquis) (citations omitted) [hereinafter Chua, *Precedent and Principles*].

121. *See generally* Joel P. Trachtman, *The Domain of WTO Dispute Resolution*, 40 HARV. INT'L L.J. 333 (1999) [hereinafter Trachtman, *Domain of WTO Dispute Resolution*] (analyzing the process of WTO lawmaking in the DSU and negotiating rounds through the two optics of incomplete contracting and the rules/standards dichotomy and arguing against lawmaking through judicial gap-filling of incompletely negotiated WTO agreements or judicial elaboration of standards in the absence of negotiated rules).

122. Nov. 7, 1989, GATT B.I.S.D. (36th Supp.) at 345.

123. *Id.* at para. 5.14; *see also* Chua, *Precedent and Principles*, *supra* note 120, at 194 (describing this holding).

124. Nov. 7, 1989 GATT B.I.S.D. (36th Supp.) at para. 5.5; *see also* Chua, *Precedent and Principles*, *supra* note 120, at 180 (describing this dictum).

ferences between judicial procedures and remedies for nationals and procedures and remedies for foreigners, such as the invocability of a public policy exception, violate the national treatment principle. This reading would be consistent with the WTO Appellate Body's emerging tendency to utilize common-law concepts of holding and dicta to describe the reasoning of panel reports as precedent.[125] It could also be supported by the Appellate Body's treatment of panel reports as subsequent practice, also capable of establishing the meaning of the GATT law carried over by the DSU and now applicable in WTO dispute settlement.[126]

Analyzing the trade impact of enforcement procedures may be equally applicable to the recognition of foreign judgments. Enforcing domestic judgments without the exceptions that are available under either federal law or state common or statute law accords a preference to domestic judgments thereby discriminating against claims that are adjudicated in foreign jurisdictions.[127] Claims brought in a foreign jurisdiction may be adjudicated there because that country's law provides a basis for jurisdiction that might be considered exorbitant in the enforcing jurisdiction.[128] Public policy grounds for non-enforcement of such exorbitant foreign judgments are in effect objections to a foreign jurisdiction's attempts to aid plaintiffs willing and able to exploit favorable foreign jurisdictional law. Arguably these practices burden either the most favored nation or national treatment principles by determining judicial enforcement rights on the basis of the improper criterion of nationality.

It is argued, however, that the national treatment norm is not necessarily violated when specific exorbitant grounds for the exercise of jurisdiction are applied against non-nationals solely because of their non-domiciliary status.[129] The effect of the domicile criterion may be to discriminate on the basis of nationality, but the fact that the measure permits, but does not require, nationality-based discrimination may protect it against being labeled a national treatment violation and thus prima facie a nullification or impairment of benefits. This is so because it now appears settled that the mere potential for discriminatory treatment is not sufficient to establish a violation.[130] More important, the trade-related features of the *U.S. – Section 337 of the Tariff Act* were plain on their face because the procedural and remedial advantages afforded to U.S. patent holders operated directly at the border and thus immediately affected the competitive relationship between domestic producers and foreign importers of pat-

125. *See* Chua, *Precedent and Principles*, *supra* note 120, at 181-82 (relying on Canada – Certain Measures Concerning Periodicals, June 30, 1997, W/T/DS31/AB/R, where the Appellate Body carefully distinguished prior panel reports and described some cited authority as obiter dicta, and as evidence of the precedential effect of pre-WTO GATT jurisprudence).

126. *See id.* at 185 (quoting statement to this effect in Japan –Taxes on Alcoholic Beverages, Appellate Body Report, Nov. 1, 1996, WT/DS8//AB/R, WT/DS10//AB/R, WT/DS11/AB/R, at 17).

127. *See supra* text accompanying notes 67 – 91 (discussing origins and evolution of U.S. law).

128. *See supra* notes 27-28 (identifying the so-called exorbitant grounds of jurisdiction under E.U. law).

129. *See* REIMANN, A GUIDE THROUGH THE JUNGLE, *supra* note 99, at 71.

130. *See* Chua, *Precedent and Principles*, *supra* note 120, at 191-93, n.141 (citing U.S. – Taxes on Petroleum and Certain Imported Products, *supra* note 116, para. 5.2.2).

ented products otherwise protected by U.S. intellectual property law. The same cannot be said for recognition and enforcement of judgments.

Nonetheless, the reasoning behind finding a violation of the national treatment principle may support a non-violation claim. Refusal to enforce a foreign judgment on public policy or other grounds may operate as a defensive trade measure that nullifies or impairs negotiated benefits without violating a rule of the WTO. In effect, then, undisciplined use of public policy or other exceptions may lead to a progressive undermining of the negotiated balance of advantages. This would occur because competitive opportunities created under WTO negotiations would not be exploited fully by private actors when the security of their trading interests would not be protected by judicial procedures and remedial systems that adequately vindicate their substantive rights. The jurisprudence of the GATT/WTO confirms that the actual effect on the competitive relationship established in a negotiating round would need to be proven under a non-violation theory.[131] More important, to make out a claim that the balance of advantages secured through the negotiated reciprocal tariff reductions was nullified or impaired, one would need to show that the nonrecognition and enforcement of a foreign judgment actually undercut a reasonable expectation of judgment enforcement that was actually part of the bargained-for exchange of trade concessions in a prior negotiating round.[132] It would be hard to show this for discriminatory non-enforcement of foreign judgments, a practice so settled in the fabric of international economic law as to defy any suggestion that world trade law has ever disciplined ordinary domestic rules relating to international judicial cooperation.

Moreover, it might be imprudent to extend the GATT *acquis* to the recognition and enforcement of judgments solely on the basis of a creative reading of GATT precedent. The concept of precedent is strictly speaking applicable only to judge-made law and is in tension with Article 3.2 of the DSU's command that dispute settlement systems must not affect the rights and duties of parties to the covered WTO agreements.[133]

2. *Legislative Innovation at the WTO*

New WTO legislation could draw on the evolving approach to the scope of activities subject to WTO disciplines evidenced in the new telecommunications regime. The so-called Reference Paper[134] incorporates competition law princi-

131. *See* Panel Report on Australian Subsidy on Ammonium Sulfate, adopted on April 3, 1950, GATT B.I.S.D. II/188, para. 12; Panel Report on EEC – Oilseeds, GATT B.I.S.D. 39S/91, 114-115, para. 77; Japan – Film, WT/DS44/R, at 391, para. 10.72 and 394, para. 10.82; *see also* Zdouc, *WTO Dispute Settlement Practice*, *supra* note 117, at 307 (summarizing WTO/GATT doctrine).

132. *See* EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds, *supra* note 117, at 128-29; *see generally* Zdouc, *WTO Dispute Settlement Practice*, *supra* note 117, at 306 (analyzing WTO doctrine).

133. *See* WTO/DSU, art. 3.2, *supra* note 120.

134. Reference Paper on Regulatory Principles of the Negotiating Group on Basic Telecommunications, Apr. 24, 1996, 36 I.L.M. 354, 367 [hereinafter the Reference Paper].

ples into the law of the WTO[135] and thus makes national regulatory policy on domestic market structure a potential matter of trade concern. WTO/DSB precedent suggests, however, that the extension of competition principles throughout the body of substantive WTO law would require more than reasoned elaboration of the national treatment principle as it relates to non-violation claims.[136] Admittedly, then, the Reference Paper only operates in a specific area of WTO law: trade in basic telecommunications services.[137] Moreover, it is not a WTO agreement in its own right. Rather, it is included in WTO law only when each Member specifically includes it in its offer for basic telecommunications services during the negotiating round.[138] Nonetheless, this legislative precedent suggests that domestic regulatory policy can be made a subject of bargaining, so that compliance with specific regulatory principles that have trade implications could be bargained for as a trade benefit in a WTO negotiating round.

The precise structure of the Reference Paper does not, however, supply a model for drafting an illustrative agreement on the recognition and enforcement of foreign judgments. The Reference Paper is based on policy science underlying competition law. It reflects a particular solution to a particular problem: the transformation of monopolized telecommunications industries in developing countries into free market-oriented entities. By contrast, the draft Hague Agreement suggests that it will be necessary to divide the exercise of judicial jurisdiction into categories that reflect the diversity of practices and domestic requirements of the world's various legal systems. For example, it would need to address the U.S.'s anomalous constitutionalization of personal jurisdiction[139] and its unsettled law with respect to the outer perimeters of federal non-legisla-

135. *See* Zdouc, *WTO Dispute Settlement Practice*, *supra* note 117, at 305-06 (stating that the Reference Paper holds governments "responsible for anti-competitive conduct by 'essential facilities' for, or 'major suppliers' of, telecommunications services even if actions of such entities have only a remote link to the government").

136. *See* Panel Report on Japan – Measures Affecting Consumer Photographic Film and Paper, DS/44, Jan. 30, 1998, adopted March 31, 1998 (rejecting non-violation claim by U.S. asserting that Japanese producer, Fuji Film, through a system of restrictive distribution arrangements, and with the acquiescence of the Japanese government through its failure to enforce Japanese competition law, foreclosed the U.S. importer, Kodak, from the Japanese market, thus effectively undercutting the competitive relationship the U.S. had obtained through bargained-for tariff reductions).

137. *See generally* General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, LEGAL TEXTS – RESULTS OF THE URUGUAY ROUND, 33 I.L.M. 44 [hereinafter the "GATS"]; Fourth Protocol to the GATS, Apr. 15, 1997, 36 I.L.M. 154 [hereinafter Fourth Protocol].

138. Laura B. Sherman, *"Wildly Enthusiastic" About the First Multilateral Agreement on Trade in Telecommunications Services*, 51 FED. COMM. L.J. 61, 87 (1998).

139. *See generally* Brand, *Due Process*, *supra* note 88; *see also* Russell J. Weintraub, *Negotiating the Tort Long-Arm Provisions of the Judgments Convention*, 61 ALB. L. REV. 1269 (1998) [hereinafter Weintraub, *Negotiating the Tort*] (arguing that, although treaty makers do not have constitutional authority to extend U.S. jurisdiction beyond constitutional limits, treaty makers do have constitutional authority to require federal and state courts to forgo the exercise of particular bases of jurisdiction, including the most problematic forms of jurisdiction – general, "doing business" and "transient," or so-called tag, jurisdiction).

tive preemption of a state's exercise of jurisdiction.[140] A model subtler than the Reference Paper is necessary to address these incompatibilities.

B. The Subsidies Code Model: Substantive and Procedural Dimensions

In contrast to the Reference Paper, which does not accommodate the diversity of practices among the world's legal systems, the WTO Subsidies Code[141] provides a model that accounts for these differences. It factors national regulatory policies into a baseline, a so-called level playing field, from which comparative advantages of nations are measured.[142]

A recent complaint before the WTO/DSB demonstrates that the subsidy concept can be extended to problems that amount to an asymmetrical exercise of jurisdiction. In *United States – Tax Treatment for Foreign Sales Corporations*,[143] the EC challenged the United States' creation of certain exemptions. The U.S. claimed that the exemptions were needed to compensate U.S. exporters for the trade disadvantages they faced because the U.S. employs a world-wide system of taxation and competing nations employ a territorial taxation system.[144] Asserting principles of "tax sovereignty," the U.S. went on to argue that "the WTO should not penalize a country using a world-wide system for incorporating elements of a territorial system," such as the exemptions for Foreign Sale Corporations, "in order to obtain comparable tax treatment for its exporters."[145]

The Panel rejected the U.S. arguments. The Panel Report asserted that, while the U.S. was free to maintain any type of tax system it wanted, the Subsidies Code mandated that a nation cannot "establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself."[146] In sum, the Panel Report acknowledged the tax, or jurisdictional, sovereignty of the United States, but nonetheless compelled the U.S. to pay for exercising this

140. *See* Michael D. Ramsey, *Escaping "International Comity,"* 83 IOWA L. REV. 893, 947-49 (raising the question whether the non-extraterritoriality and non-violation of international law interpretive canons apply in the absence of federal legislation to compel state courts to exercise restraint in exercising jurisdiction in foreign commerce cases). *See also* Crosby v. National Foreign Trade Council, 120 S.Ct. 2288 (2000).

141. Agreement on Subsidies and Countervailing Measures, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE LEGAL TEXTS – RESULTS OF THE URUGUAY ROUND, 33 I.L.M. 1125 [hereinafter the "Subsidies Code"].

142. *See* JACKSON, THE WORLD TRADING SYSTEM, *supra* note 42, at 237 (noting that at one point the Brazilians argued that their comparative advantage in trade was Brazil's capacity to absorb a greater amount of pollution than other countries).

143. WT/DS108/R, Oct. 8, 1999, 38 I.L.M. 173.

144. The Panel Report noted: "The United States argues that world-wide systems of taxation, such as that of the United States, place exporters at a disadvantage relative to exporters from countries with territorial tax systems, because, under a territorial system, whenever activities relating to an export transaction occur outside the territory of the taxing jurisdiction, income form such activities is not taxed." *Id.* at para 7.121, 38 I.L.M. at 205.

145. *Id.*

146. *Id.* at para. 7.122, 38 I.L.M. at 205.

right by not allowing it to bend WTO rules in order to compensate for the fact that the U.S. taxation system burdens U.S. exporters with trade disadvantages.

This reading of the Panel Report analysis of tax jurisdiction suggests that the Subsidies Code itself provides a workable model for a trade-related regime for global standards on the exercise of judicial jurisdiction. The Subsidies Code distinguishes between three types of subsidies: (1) expressly permitted or "non-actionable" subsidies (so-called "green light" measures), (2) expressly prohibited subsidies (so-called "red light" measures), and (3) an intermediate class of "actionable" subsidies (so-called "yellow light" measures) that may be permitted or prohibited depending on their effects on trade.[147] The Hague Conference proposal favored by the U.S. would make precisely this kind of distinction among bases of jurisdiction. It distinguishes among judgments that are: (1) expressly permitted and enforceable on the basis of jurisdiction, (2) permitted but not necessarily enforceable on the basis of jurisdiction, and (3) prohibited and thereby necessarily unenforceable on the basis of jurisdiction.

Thus, one could draw on the insights of *United States – Tax Treatment for Foreign Sales Corporations* to translate The Hague Conference proposal into a WTO agreement enforceable at the WTO/DSB. Judgments based on expressly permitted jurisdictional grounds would not violate trade law, while judgments based on prohibited grounds of jurisdiction would operate as violations of trade law and establish prima facie cases of nullification or impairment of benefits. By contrast, the exercise of jurisdiction to render a judgment on a basis that is neither expressly permitted nor expressly prohibited may or may not confer a trade advantage to the state authorizing that exercise of jurisdiction.

Whether or not a trade advantage is conferred may not even be clear in a particular case. States will therefore need to conduct overall assessments of the trade effects of the regular exercise of each basis for jurisdiction. If, for example, U.S. "doing business" jurisdiction were neither permitted nor prohibited, one might still imagine that even the threat of U.S. courts exercising "doing business" jurisdiction would require foreign firms to structure their activities so as to avoid the risk of U.S. litigation. This could in theory impose considerable costs on foreign firms. Yet, a state that wanted to claim that its trade rights had been violated would have to produce evidence of judicial practice and the actual use of the questionable bases of jurisdiction. Therefore, it would be imperative that the U.S. and other nations avoid conclusory reasoning about the discriminatory character of their trading partners' practices in recognizing and enforcing foreign judgments.[148] If the U.S. is not prepared to harmonize its jurisdictional practices with those of the rest of the world, then it must at least wish to demonstrate that its practices are not yielding adverse trade effects for its trading partners in the WTO. Ultimately, however, the U.S. might agree to trade off the right to exercise "doing business" jurisdiction, if it is so internationally offensive that persuading other nations to accept it could only be done at a prohibitively

147. *See generally id.* at 290-93.

148. *See* Juenger, *A Hague Judgments Convention?*, *supra* note 66, at 115-16; Weintraub, *How Substantial is Our Need*, *supra* note 66, at 170-71.

high cost in trade concessions.[149] This might happen either at the front end in the form of bargaining trade opportunities for rights to preserve national jurisdictional autonomy or at the back end of litigating claims that arise from the trade effects of those practices.

Moreover, domestic understanding of the questionable character of U.S. jurisdictional and other litigation practices will be enriched by the domestic political debate about the relevant policy tradeoffs, and this enriched debate may well minimize the deadening effect of xenophobia on political discourse. As the next section will argue, reducing this xenophobia is ultimately at the heart of the argument for moving the recognition and enforcement of foreign judgments from the Hague Conference to the WTO.

C. *Jurisdictional Law as the Mediator for Trade and Non-Trade Values*

A Subsidies Code model for incorporating recognition and enforcement of foreign judgments into the law of the WTO has two advantages: (1) it draws on the policy and precedent of WTO law and (2) it focuses attention on developing a calculus for balancing trade and non-trade values. These advantages lead to a third important advantage. Bargaining over specific tradeoffs will strengthen public interest in the WTO decision-making process and thereby increase the legitimacy of outcomes negotiated and enforced under the auspices of the WTO.

For example, those who believe that child labor unfairly subsidizes domestic production may be prepared to urge their national representatives and lobby foreign governments to expend scarce negotiating capital to secure either (1) substantive trade rules declaring such practices to be subsidies or (2) jurisdictional rules that facilitate domestic judgments against foreign producers engaging in such practices. These judgments would be enforceable under WTO law. Failure to respect this type of foreign judgment produced in accordance with agreed upon WTO rules would in turn authorize retaliatory suspension of trade concessions.

The preceding example serves to illustrate how trade and non-trade values can be mediated in the WTO.[150] In effect, one would monetize – in the cur-

149. *Cf.* Weintraub, *Negotiating the Tort*, *supra* note 139, at 1281 ("Whether or not the judgments project [at the Hague] reaches a successful conclusion, the process of negotiation will make clear to us in what ways our methods of adjudication are disapproved abroad. Such knowledge can have a salutary effect of causing us to revise some of the least attractive aspects of our administration of justice.").

150. Another possible example may well be the line of U.S. cases, beginning with Filartiga v. Pena-Irala, 630 F.2d 876 (2d Cir. 1980), which has culminated in the assertion of tag jurisdiction in Kadic v. Karadzic, 70 F.3d 232 (2d Cir. 1995), where an Alien Tort Claims Act suit was initiated against a visiting head of government of an unrecognized state for conduct allegedly constituting human rights and humanitarian law violations under international law and occurring on territory and affecting persons unconnected to the forum. This context does not appear to generate a claim of nullification and impairment of trade benefits. Rather than carve out of the WTO these kinds of potentially exorbitant attempts to exercise judicial and legislative jurisdiction, it would seem to be preferable to rely on the requirement that nullification and impairment of benefits be shown to deny a WTO plaintiff a right to a WTO remedy. Thus, there should be no danger that pure human rights cases, having no trade effects, would be chilled by the failure to include a human rights exception in a WTO agreement on recognition and enforcement of foreign judgments.

rency of tariffs and related concessions – the obligation to enforce judgments relating to conduct that may produce trade effects. The negotiating process would help define the scope of activities that produce trade effects in terms of the type of jurisdiction states are free to assert over the production or consumption effects of the imported products or services covered by the WTO. While some argue plausibly that (1) an exporting state's domestic policies with only domestic effects are not of international concern because they do not prevent global welfare maximization[151] and that (2) treating production processes as trade issues could unravel the international trade system by providing loopholes for disguised protectionism,[152] these questions should not be answered a priori. Rather, they should be determined within the international political process.[153]

IV.
CONCLUSIONS AND IMPLICATIONS: A CIVIC REPUBLICAN VISION

Addressing the recognition and enforcement of foreign judgments explicitly as a trade issue through a WTO agreement has two benefits. The first benefit relates to the political legitimacy of the WTO. The other concerns the quality of WTO decision-making. The legitimization argument turns on the premise that, as much as increased transparency of its legislative and adjudicatory functions will increase the procedural legitimacy of WTO decision-making, the WTO also needs to increase its substantive legitimacy. This means that interest

By contrast, civil judgments relating to human rights violations might naturally be included in the scope of a Hague Judgments Convention. *See* John F. Murphy, *Civil Liability of the Commission of International Crimes as an Alternative to Criminal Prosecution*, 12 HARV. HUM. RTS. L.J. 1, 56 (1999) (suggesting the issue be on the Conference's agenda). However, since a Hague Conference Convention would operate without the benefit of the additional requirement of a showing of nullification or impairment of trade benefits, the precise scope of coverage of such judgments would need to be defined. This difficult issue could well be a deal breaker in that context.

151. *See* Richard L. Revesz, *Federalism and Environmental Regulation: Lessons for the European Community and the International Community*, 83 VA. L. REV. 1331, 1335 (1997) ("[I]n the case of process standards not coupled with trade restrictions, there is no divergence between the in-state calculus and the global social calculus.").

152. *See* JACKSON, THE WORLD TRADING SYSTEM, *supra* note 42, at 237 ("Whether an importing nation could use border restrictions or taxes to equalize the price of imported goods with domestic costs of health and safety regulation is as yet an unresolved issue for the world trading system. It is an issue fraught with dangerous potential. If this principle were extended to many types of government regulation – for example, minimum wage or other labor regulations – it could be the basis of a rash of import restrictions, often defeating the basic goals of comparative advantage. Government regulations vary so greatly that the already difficult conceptual questions of the world's rules on subsidies would pale in significance beside the problems that the costs of regulation equalization would create").

153. *See infra* text accompanying notes 168-95 (relating the substance of WTO law and institutions to a republican conception of international political process); *see also* Steve Charnowitz, *World Trade and the Environment: A Review of the New WTO Report*, 12 GEO. INT'L ENVTL. L. REV. 523, 535 (2000) (criticizing the WTO Secretariat Report of Oct. 14, 1999 as failing to provide an integrated analytical structure that would recognize that "environmental and economic phenomena are two lenses for looking at the same phenomena"). Charnowitz calls for greater WTO attention to the enforcement aspects of the environmental dimension to welfare maximization, and he notes that vague WTO references to "structured cooperation" will not do. *Id.* at 534. In that spirit, the central thesis of this article is that making the domestic effects of the production process a matter of international enforcement cannot be separated from the stimulation of an international political process, that is, the WTO bargaining process.

groups need more than a voice in WTO decision-making. They need their interests tolerably satisfied. Judgments enforcement, if it effectively vindicates interests arising from the failure of import prices to reflect the true social costs of production and consumption, will provide WTO opponents with a reason to exercise whatever voice increased transparency gives them. Opponents of the current trade regime will then begin to see the WTO as an appropriate institutional vehicle through which to address their concerns.

Moreover, to the extent that effective policy-making supports political legitimacy, treating judgments recognition and enforcement as a WTO bargaining subject may also improve the quality of WTO lawmaking and adjudication. Transforming trade agendas at WTO negotiations into more inclusive discussions of trade and non-trade values should broaden the database for policy-making, thereby yielding a better balance of competing values. As the recent disruption at the WTO Millennium Round opening makes clear,[154] both an increased commitment to the WTO process from potential stakeholders and an increased sensitivity to non-trade concerns among trade negotiators are needed if the WTO is to succeed in the next negotiating round. Attempting to conceal value differences between nations and transnational groups by asking courts to continue to take primary responsibility for resolving value conflicts in specific cases is neither politically sustainable nor just.[155]

These benefits may not come without a cost, however. One consequence of including non-trade interests in WTO decision-making may be that the mode of expressing those interests is transformed. Outside of the WTO, non-trade interests employ a populist, grass-roots political style that draws on the moral sense of the community. The ethical demands that occur when citizens of first-world states encounter labor conditions in the developing world and the intergenerational ethical demands arising from abuse of the current world ecosystem make trade a matter of moral relevance. This lays the groundwork for a political style that Max Weber usefully described as an "ethic of ultimate ends."[156] This passionate style of politics confronts the established order and demands its reconstruction. It is not a style well suited to the kind of marginal decision-making that characterizes choice within an institution like the WTO. The Seattle protests in November 1999 proved that grassroots politics is a potent source of

154. *See After Seattle: A Global Disaster*, THE ECONOMIST, Dec. 11, 1999, at 19 (attributing the collapse of talks as much to U.S. arrogance and the inflexibility of E.U. negotiators as to the effect on these negotiators of the protests against WTO policies alleged to be insensitive to non-trade concerns).

155. *See* Philip J. McConnaughay, *Reviewing the Public Law Taboo in International Conflict of Laws*, 35 STAN. J. INT'L L. 255, 283-86 (1999) (arguing against judicial invocation of conflict of laws tools, such as comity, to address transnational public law disputes on grounds of courts' lack of democratic legitimacy, their institutional incompetence in achieving predictability, and the likely practical effect of preventing or discouraging explicit public regulation of important social problems through legislative action or international negotiation); *cf.* Russell J. Weintaub, *The Extraterritorial Application of Antitrust and Securities Law: An Inquiry into the Utility of a "Choice-of-Law" Approach*, 70 TEX. L. REV. 1799, 1817 (1992) (comity undercuts the capacity of political branches to negotiate agreements with foreign countries).

156. MAX WEBER, *Politics as a Vocation, in* FROM MAX WEBER: ESSAYS IN SOCIOLOGY 77, 120 (Gerth & Mills eds., 1976).

political creativity that is needed to overcome institutional resistance to change. The rationalization of non-trade politics therefore produces a potential downturn in political creativity.

Describing incorporation of non-trade values into the WTO law as "rationalization" may, however, conceal a potential advantage of making a place for their proponents at the WTO. The term "domestication" is perhaps more revealing even though it is overused in the literature of international law. In fact, it may unfortunately suggest that populist politics of this kind would be caged in a Weberian historical inevitability of bureaucratization, which in turn risks encouraging the mass, faceless politics of the corporatist states of the first half of the 20th century.[157] Moreover, "domestication" might suggest more of a domestic analogy than is warranted by the current development of international civil society. Nonetheless, "domestication," unlike "rationalization," suggests an important and, if one believes that pluralist politics is morally and pragmatically desirable, beneficial consequence of incorporating non-trade concerns into WTO law: the possibility that interest group politics will begin to overshadow subversive expression.

Nonetheless, even if non-trade values require some institutional recognition, some argue instead for the establishment of a separate non-trade organization to develop global standards for labor and the environment.[158] However, in the absence of an organization or organizations that could make non-trade policy, and thereby either merit some deference by the WTO[159] or impose some binding sanctions itself,[160] the WTO is the only player in town. Indeed, without WTO involvement, the international private sector cannot by itself insist that environmental and labor values be extended to reflect rationally the balance of needs and interests of all interested parties, rather than merely the precise correlation of power between business groups and host states.[161] Perhaps a strategy that locates trade and non-trade value protection in separate international institutions rests principally on the fear that protecting labor and environmental concerns through the mechanism of the WTO's dispute resolution system would allow countries to evade genuine trade commitments in order to increase protectionism under the pretext of non-trade values.[162] Yet this argument betrays a

157. *See* RALF DAHRENDORF, SOCIETY AND DEMOCRACY IN GERMANY 42 (1967) (in his now classic analysis of the origins of German Fascism, critiquing as unsound the then received capitalist-origins explanation, which, Dahrendorf argued, one "may trace back to Max Weber whose concept of capitalism with its preconditions in economic attitudes and consequences of bureaucratic organization displays traces of an historical necessity à la Hegel").

158. *See Why Greens Should Love Trade*, THE ECONOMIST, Oct. 9, 1999, at 17-18 (editorial suggesting there is a case for a global environmental agreement separate from the WTO).

159. *See* Perez, *WTO and U.N. Law*, *supra* note 31, at 377 (noting absence of such a regime in the environmental area).

160. *See, e.g.*, Dan C. Esty, *Stepping Up to the Global Environmental Challenge*, 8 FORDHAM ENVTL. L.J. 103, 111 (1996).

161. *But see* Jennifer L. Johnson, *Public-Private Convergence: How the Public Actor Can Shape Public International Labor Standards*, 24 BROOK. J. INT'L L. 291 (1998) (arguing for private, rather than public, sector management of norm evolution in this area).

162. *See Clueless in Seattle*, THE ECONOMIST, Dec. 4, 1999, at 17 (arguing that the Clinton Administration in arguing that labor and environmental concerns should be part of the Millennium

fear that a politically-accountable process at the WTO would yield outcomes different from those that global elites might prefer.[163]

We need not reach the merits here of whether increased protection of non-trade interests threatens to undermine the protection of legitimate trade interests at the WTO, because genuine concerns about the legitimacy of the WTO political process need to be satisfied first.[164] Creating real channels of representation for communities and interest groups is critical to sustaining the WTO's legitimacy. Indeed some argue that even transnational organizations risk disconnecting the representation of non-trade interests from its democratic roots and domestic electoral accountability when they focus their political activities on getting non-trade interests a voice in the WTO.[165] This critique draws on public choice theory's prediction that transnational private groups, whether they be corporations or non-commercial associations, organize and thereby achieve political results that might not otherwise flow from more broadly inclusive political processes disciplined by accountability to constituents.[166]

Increased transparency and accountability in WTO decision-making would, of course, mitigate the force of the public choice critique, particularly in WTO adjudication.[167] However, the inevitable secretiveness of WTO lawmaking

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Round negotiating agenda has conceded the erroneous premise of the protesters that free trade may not be welfare enhancing); *see also Who Needs the WTO?*, THE ECONOMIST, Dec. 4, 1999, at 74 (arguing that a WTO that allowed its dispute settlement system to be employed to further labor and environmental concerns would reduce free trade and undercut growth in the developing countries by authorizing retaliation by developed countries in the form of additional trade restrictions against developing country exports). *See also* Sykes, *Regulatory Protectionism*, *supra* note 41; JACKSON, THE WORLD TRADING SYSTEM, *supra* note 42, at 237.

163. *See* Perez, *Who Killed Sovereignty?*, *supra* note 56 (criticizing argument that international governance calls for reliance on the work of technocratic elites as its primary mode of legitimization).

164. *See* Philip M. Nichols, *Trade Without Values*, 90 NW. U. L. REV. 658, 660 (1996) (arguing that the WTO as currently constituted is incapable of addressing non-trade values, thus undermining the support of member states; Philip M. Nichols, *Extension of Standing in World Trade Organization Disputes to Non-Government Parties*, 17 U. PA. INT'L ECON. L. 295 (1996); G. Richard Snell, *The Trade Stakeholders Model and Participation by Nonstate Parties in the World Trade Organization*, 17 U. PA. INT'L ECON. L. 359 (1996).

165. *See Citizens' Groups: The Non-Governmental Order*, THE ECONOMIST, Dec. 11, 1999, at 21 (asking: "Are citizens' groups, as their many supporters claim, the first steps toward an 'international civil society, (whatever that might be)? Or do they represent a dangerous shift of power to unelected and unaccountable special interest groups?"); *see generally*, Spiro, *New Global Potentates*, *supra* note 54.

166. Embedded in public choice analysis are the assumptions that the distortions produced by public lawmaking would be greater than those of private lawmaking; or, equivalently, that the harms identified by the public choice critique would be outweighed by the benefits – that otherwise would not be achieved in a given institution – the so-called "public goods" critique. *See* Paul Stephan, *Interdisciplinary Approaches to International Economic Law: Barbarians Inside the Gate: Public Choice Theory and International Economic Law*, 10 AM. U. J. INT'L L. & POL'Y 745, 750 (1995) [hereinafter Stephan, *Barbarians*].

167. *See generally* Patricia Isela Hansen, *Transparency, Standards of Review, and the Use of Trade Measures to Protect the Global Environment*, 39 VA. J. INT'L L. 1017, 1021 (1999) (arguing for a revised standard of review in WTO environmental cases, which would "require national governments to balance the competing trade and environmental interests by means of transparent rules and procedures. In order to satisfy the requirement of transparency, governments must ensure that the decision making procedures that produce environmental trade measures afford a meaningful

would limit the degree to which increased transparency in WTO adjudication could remedy the biases of WTO lawmaking.[168]

Yet, a second-best theory offers a possible rebuttal to the welfare-reduction aspect of the public choice critique. An emerging literature that catalogues the underproduction of "global" public goods[169] suggests it may be warranted to tolerate the disproportionate influence of groups that stimulate the production of such goods. In other words, the political process failure of non-transparent and unaccountable groups stimulating the "overproduction" of measures protecting non-trade values at the WTO could in theory rectify a public goods failure in the "underproduction" of environment and labor protecting measures.[170] This question must ultimately be answered by a self-correcting political process, one that in extraordinary moments is capable of making informed judgments about whether and how to correct for ordinary politics' failure to achieve a global balance in the production of private and public goods.

In practice, then, the case for incorporation of non-trade values into the WTO dispute settlement system presupposes that WTO political and legal policy-making procedures accommodate global trade and non-trade interests effectively. This may be a questionable assumption, for no one can claim that the transnational political process – whether it be at the United Nations or the WTO – currently represents a world community of the kind that one usually associates with the modern nation-state. That said, one readily observes that many nation-states are characterized by a fragmented national political community and identity. They are separated into multiple *demoi* and identities, both in cases of dissolution of previously fictive national communities such as the former Yugoslavia[171] and in emerging consolidated supranational communities such as the European Union.[172] But global politics should not be based on the level of legitimacy experienced in former Yugoslavia. Neither would one want to em-

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opportunity for foreign interests to present their views, receive a reasoned response, and to obtain review in a neutral tribunal").

168. *See generally* Stephan, *Barbarians*, *supra* note 166.

169. *See generally* GLOBAL PUBLIC GOODS: INTERNATIONAL COOPERATION IN THE 21ST CENTURY (Inge Kaul, Isabelle Grundberg & Marc Stern eds., 1999).

170. There are, of course, examples of non-transparent, unaccountable processes which, although in large part produced private gains, at the same time unavoidably produced a public good that otherwise would be under-produced. *See, e.g.*, J. Lawrence Broz, *Origins of the Federal Reserve System: International Incentives and the Domestic Free-Rider Problem*, 53 INT'L ORG. 39 (Winter 1999) (arguing that the establishment of the Federal Reserve system as a public good, creating, among other things, a stable domestic currency, was made possible by the private benefits the system gave to money-center banks). Assuming that the private good and public good are true joint goods – that is, they cannot be produced separately – then the ancillary production of a private good may be a necessary evil in the optimal production of the public good. On this reasoning, gains achieved by environmental or labor activists may be necessary evils in the production of globally efficient levels of non-trade, public goods.

171. *See generally* SUSAN L. WOODWARD, BALKAN TRAGEDY: CHAOS AND DISSOLUTION AFTER THE COLD WAR (1995) (outlining the Bosnian crisis that developed in the multicultural states of the former Yugoslavia).

172. *See generally* J.H.H. WEILER, ESSAYS ON EUROPE (1995); *compare* MICHAEL WALZER, THICK AND THIN MORAL ARGUMENTS AT HOME AND ABROAD (1994) (meditating on the tension between a deeply-rooted or "thick" identity politics and a "thin" politics of common association in civil society based on more superficial compatibilities between otherwise distinct groups).

ploy the degree of coercion necessary to compel global compliance with norms that industrialized democracies would accept. As James Madison once argued, this would be "worse than the disease."[173]

We may therefore be left with the chicken-and-egg problem that good substantive rules presuppose good politics, which in turn presuppose good constitutional rules, which in turn presuppose good constitutional politics, which in turn presuppose the prospect of good substantive rules. This seems to be a very bleak picture, at least for now. However, one cannot assume that the quasi-market solution of choosing between trade and non-trade policies, either through competition between the WTO and a similar non-trade organization or through competition between trade and non-trade values, will always be superior to alternative institutional approaches.[174] A better comparative institutional analysis would account for the possibility that the transnational political process will transform into a process that more effectively disciplines parties that abuse WTO law and its dispute settlement system. This analysis would focus both on avoiding the exploitation of non-trade exceptions for protectionist purposes as well as accounting for the genuinely welfare-reducing effects of global free trade policies. It is impossible to determine *a priori* whether the WTO requires radical reformation before it can effectively address non-trade concerns, or whether it is timely to co-opt non-trade political groups when the transnational political process is only just beginning to address non-trade issues. It should be enough to dismiss as analytically incomplete any argument for excluding non-trade concerns from the Millennium Round negotiations that is based on a static conception of global governance. Governments may well break law in order to stimulate the creation of new and better law,[175] thus publicizing an issue that is incompletely addressed by black letter law.[176] Moreover, transnational networks of interest groups operating at the international institutional level may well produce the "social capital" necessary for the formation of a global civil society[177] that, by supplementing the activity of states, could help

173. THE FEDERALIST NO. 10 (James Madison) ("There are again two methods of removing the causes of faction: the one, by destroying the liberty essential to its existence; the other, by giving to every citizen the same opinions, the same passions, and the same interests . . . .").

174. *See generally* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES, *supra* note 14 (arguing that only comparative institutional analysis, that is analysis of costs of each institutional option, can provide an adequate basis for choosing an institutional alternative to achieve policy goals, because a costly institutional choice may yet be better than its even more costly alternatives).

175. *See* Thomas J. Schoenbaum, *International Trade and Protection of the Environment: The Continuing Search for Reconciliation*, 91 AM. J. INT'L L. 268, 312 (1997) (describing Tuna-Dolphin Ban as "creative unilateralism," notwithstanding 1993 GATT Panel Report deciding that the U.S. violated the national treatment rule and could not defend its extraterritorial attempt to protect dolphins under the GATT environmental and conservation exceptions).

176. *See* Trachtman, *Domain of WTO Dispute Resolution*, *supra* note 121, at 346-50 (developing incomplete contracting analysis of WTO dispute resolution).

177. *Cf.* Steve Charnovitz, *Two Centuries of Participation: NGOs and International Governance*, 18 MICH. J. INT'L L. 183, 285 (1997) (citing and analogizing to Robert Putnam's work about the role of civic organizations in creating the social capital necessary for robust democracy at the national level).

produce rules that are closer to the gravitational center of the global political process.[178]

In sum, when national and global politics work together with each ultimately representing the interests and values of individuals and communities, they constitute an evolving political system. As this system evolves, so must its concept of law. A theory of global law mapping this dynamic dimension would be, as James Madison put it, a "republican remedy for the disease most incident to a republican government."[179] Needless to say, the necessary global civic republican theory has not yet been fashioned,[180] but it is clear that civic republicanism's potential for addressing non-market values has already caught the attention of domestic theorists.[181] Indeed, only a republican theory accounting for transnational interest group politics could also account for the probable superiority of "legal," as opposed to international relations theory, approaches to globalization at a time when the state will remain the most important actor in global politics.[182] In other words, only republicanism respects both the center and the periphery. More importantly, only civic republicanism respects both cosmopolitan and nationalist loyalties, for the problem of dual or multiple loyalties will surely become a central fixture in virtually all trade-related issue areas, perhaps even the most sensitive national security areas,[183] of the emerging structure of global governance.

This article's proposal for an agreement on the recognition and enforcement of judgments that works as a baseline for the negotiation of tariff bindings is demonstrably superior to the private law approach of the Hague Conference on Private International Law. It takes into account the dynamic dimensions of the relationship between substantive WTO law and the domestic and global political processes that increasingly form the dual criteria for national negotiating positions. It recognizes the need for states to build domestic political support for the WTO through judiciaries capable of giving effect to private rights beyond

178. *See generally* COMMISSION, OUR GLOBAL NEIGHBORHOOD, *supra* note 61, at 25-62 (1995) (report of elite group of global notables, inter alia, discussing the role of private and non-governmental organizations in the emerging global political process).

179. THE FEDERALIST NO. 10 (James Madison).

180. *See generally* NICHOLAS GREENWOOD ONUF, THE REPUBLICAN LEGACY IN INTERNATIONAL THOUGHT (1998) (describing the loss and emerging rediscovery of civic republican conceptions of global community as the foundation for international law); *but see* John O. McGinnis, *The Decline of the Western Nation State and the Rise of the Regime of International Federalism*, 18 CARDOZO L. REV. 903, 918-19 (1996) (analogizing post-Cold War Bretton Woods institutions to 19th century U.S. free trade federalism, offering a conception of global governance as a regime of very limited government).

181. *See generally* Jane B. Baron and Jeffrey L. Dunoff, *Against Market Rationality: Moral Critiques of Economic Analysis in Legal Theory*, 17 CARDOZO L. REV. 431 (1996) (noting the "unlikely convergence" of anti-market perspectives in "such diverse contexts as environmental ethics, civic republicanism, and commodification theory").

182. *See* Peter J. Spiro, *Globalizations, International Law, and the Academy*, 32 N.Y.U. J. INT'L L. & POL. 567, 586-87 (2000).

183. *See generally* Linda Mabry, *Multinational Corporations and U.S. Technology Policy: Rethinking the Concept of Corporate Nationality*, 87 GEO. L. J. 563 (1999) (discussing the U.S. legislative response to the tension between national security and other interests in the production and control of highly sensitive U.S.-origin technology and the increasingly transnational identities and perspectives of multinational U.S. firms producing such technology).

mere parchment declarations. Most important, it recognizes that in building a global city-state, the *civitas maxima* of classical republican political theory, this political dimension must be coupled with the additional legal requirement that, under the imperative of avoiding globally-enforceable trade sanctions, the remedies of domestic legal systems must be enforceable everywhere the global political community extends.

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Defining Foreign Base Company Income: The Exclusions, Deductions, and Limitations

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Defining Foreign Base Company Income: The Exclusions, Deductions, and Limitations*

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Tax havens pose a challenge to tax policy by decreasing tax revenue and impeding allocational efficiency. To alleviate the problem of tax havens, the United States taxes its multinational corporations on much of the tax haven income derived by their foreign subsidiaries. Defining tax haven income, however, has proven difficult; the necessary provisions are among the most complex of the Internal Revenue Code. In this article, Professor Laity critically analyzes the exclusions, deductions, and limitations generally applicable in defining foreign base company income, the most significant component of tax haven income. Based upon his findings, he recommends several changes in the Code and its supporting administrative apparatus.

INTRODUCTION

This is the sixth article in a series dealing with the United States taxation of tax haven income.[1] As we shall see, the controlled foreign corporations of U.S. parent corporations generate several types of tax haven income. The United

1. The previous articles in this series are Eric T. Laity, *Defining Foreign Base Company Shipping Income and Oil-Related Income*, 20 VA. TAX REV. (forthcoming 2000) [hereinafter *Shipping Income*]; Eric T. Laity, *The Foreign Base Company Sales Income of Controlled Foreign Corporations*, 31 CORNELL INT'L L.J. 93 (1998) [hereinafter *Sales Income*]; Eric T. Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 NW. J. INT'L L. & BUS. 1 (1997) [hereinafter *Services Income*]; Eric T. Laity, *Defining the Passive Income of Controlled Foreign Corporations*, 21 N.C. J. INT'L L. & COM. REG. 293 (1996); and Eric T. Laity, *Anatomy of Sections 951(a)(1)(B) and 956 of the Internal Revenue Code*, 14 VA. TAX REV. 71 (1994).

States currently requires its parent corporations to include much of this income within their own earnings.[2] Of the various types of tax haven income derived by controlled foreign corporations, foreign base company income is the most significant. Previous articles in this series have analyzed the separate categories of foreign base company income, each with its own constellation of inclusions, exclusions, and ordering rules. This article continues the series by analyzing the exclusions, deductions, and limitations that apply across the various categories of foreign base company income. Each of the separate categories isolates a type of tax haven operation of the controlled foreign corporation. The adjustments of general application combine those tax haven operations into a single, virtual entity. The Internal Revenue Code then taxes the entity's income to the United States parent corporation.

This article contains five parts. Part One deals with the general exclusions from foreign base company income, the application of which determines the controlled foreign corporation's gross foreign base company income. As shown below, the exclusions attempt to prevent double taxation by the United States. Part Two analyzes the rules that determine the entity's adjusted gross foreign base company income. These rules measure the difference between the controlled foreign corporation's tax haven operations and its complete operations. The ensuing adjustments, if any, may either expand its foreign base company income to absorb almost all of the corporation's income, or eliminate the corporation's foreign base company income altogether.

Part Three addresses the identification and allocation of deductions, processes that determine the entity's net foreign base company income. Before allocating the controlled foreign corporation's expenses between its tax haven operations and its other operations, we must consider three factors: the categories of foreign base company income, the separate concerns of tax haven insurance income, and the subsequent effort of the corporation's United States shareholders to comply with the foreign tax credit limitation. Part Four examines an exclusion, a limitation, and other rules concerning the treatment of foreign base company income. The application of these final items determines the controlled foreign corporation's adjusted net foreign base company income. They take into account the profitability of the corporation's tax haven operations over time, the current financial success of the corporation's overall operations, and the over-inclusiveness of some of the definitions for tax haven operations.

The goals of this series of articles remain unchanged: (1) to restate the relevant law with greater clarity than the original sources but with minimal loss of precision, (2) to draw out the implications of the original sources, (3) to give examples illuminating the original sources and their implications, (4) to analyze the original sources critically, and (5) to offer recommendations for change in the relevant provisions of the Internal Revenue Code, Treasury Regulations, other administrative apparatus, and the case law.

2. *See* I.R.C. § 951(a)(1) (2000). Controlled foreign corporations generally consist of the foreign subsidiaries of U.S. corporations. By definition, a controlled foreign corporation also includes foreign corporations with other ownership structures. *See* I.R.C. § 957(a) (2000).

In keeping with these goals, I recommend a number of changes in statutory provisions and administrative rules. (The recommendations are listed in the table of contents of this article and summarized in Part Five.) In addition, I offer several other contributions to the literature on controlled foreign corporations. These include a nine-step process for analyzing a controlled foreign corporation's net foreign base company income, the proper coordination of the deficit rules with the current earnings and profits limitation, and an explanation of the relationship between the foreign tax credit limitation and the income derived from a foreign subsidiary's tax haven operations.

I.
EXCLUSIONS FROM GROSS FOREIGN BASE COMPANY INCOME

The three exclusions of general application to all components of gross foreign base company income address the matter of double taxation by the United States. Under the Internal Revenue Code's international provisions, an item of a controlled foreign corporation's income may be subject to two levels of tax. First, under Subpart N.II.B, the item is subject to being taxed directly to the controlled foreign corporation. The taxation usually occurs pursuant to Code sections 881 and 882. Second, the item is subject to being taxed to the corporation's United States shareholders under Subpart N.III.F. Here, the taxation generally takes place under Code section 951(a).

Two of the general exclusions address the coordination of these preceding levels of taxation. The exclusion in Code section 952(b) attempts to prevent an item of income from being taxed to both the controlled foreign corporation and its United States shareholders. As we shall see, it only partially succeeds. The exclusion under Code section 951(e)(1) attempts the reverse. By preventing subpart F from overriding a tax expenditure, it ensures that both types of taxpayers are not taxed on a certain type of tax-favored income. An adverse decision by the World Trade Organization under the General Agreement on Tariffs and Trade (GATT), however, has limited its effectiveness.

The remaining general exclusion seeks to prevent multiple taxation by the United States at the level of the United States shareholder. As an item of previously included income is distributed up a chain of foreign subsidiaries toward the ultimate shareholder, the exclusion under Code section 959(b) prevents the United States shareholder from being taxed repeatedly on the item.

A. U.S.-Source Effectively-Connected Income

Any United States-source income effectively connected with a controlled foreign corporation's conduct of a trade or business in the United States is excluded from the corporation's gross foreign base company income.[3] The United States generally taxes such income directly to the controlled foreign corpora-

3. I.R.C. § 952(b) (2000); Treas. Reg. § 1.954-1(a)(2) (2000).

tion.[4] As a result, the exclusion protects the corporation's United States shareholders from double taxation by the United States. If a treaty exempts an item of such income from the United States taxation of the controlled foreign corporation, or if it reduces the rate of the United States tax, the controlled foreign corporation loses the exclusion, and it must include the item in its foreign base company income.[5]

The exclusion fails to address two other categories of income derived by a controlled foreign corporation. (The U.S. taxes both types of income directly to the corporation.) Those categories are foreign-source effectively-connected income,[6] on the one hand, and U.S.-source income not effectively connected with the conduct of a U.S. trade or business,[7] on the other. With regard to the former, the Code uses a mechanism outside of subpart F to prevent double taxation by the United States. Code section 864 excludes foreign-source income that falls within a controlled foreign corporation's subpart F income from its effectively-connected income.[8] Consequently, the controlled foreign corporation's United States shareholders pay tax on such income, but the corporation does not.

In contrast, no mechanism to prevent double taxation by the United States exists with regard to U.S.-source income not effectively connected with the conduct of a trade or business in the United States. Currently, such income is taxed to the controlled foreign corporation under Code section 881, and to the corporation's United States shareholders under subpart F. Congress should expand the exclusion under Code section 952(b) to include U.S.-source income not effectively connected with the conduct of a trade or business in the United States.

Revenue Ruling 87-15 calls our attention to a second problem with the existing exclusion.[9] Presently, Code section 952(b) excludes U.S.-source income effectively connected with the conduct of a trade or business in the United

4. *See* I.R.C. § 882(a)(1) (2000) (providing that any foreign corporation, including a controlled foreign corporation, be taxed by the United States on its income effectively connected to its conduct of a trade or business in the United States).

5. I.R.C. § 952(b) (2000). A treaty exemption from the branch profits tax of Code section 884, on the other hand, does not cause the loss of the exclusion. *See* I.R.C. § 952(b) (2000). The Service takes the position that the statutory exclusion from gross income given by Code section 883(a) for certain shipping income has the same effect as a treaty exemption and therefore causes such income to fall within foreign base company income. Rev. Rul. 87-15, 1987-1 C.B. 248. The revenue ruling expresses sound tax policy. Code section 883(a), however, expressly excludes such income from taxation under the entire income tax subtitle of the Code, including the subpart F provisions. The ruling is therefore wrong as a matter of law. For a proposal to limit the scope of Code section 883(a) by statutory amendment, see *Shipping Income*, *supra* note 1 (forthcoming 2000).

6. *See* I.R.C. §§ 11(a), (d), 882(a) (2000).

7. *See* I.R.C. § 881(a) (2000).

8. I.R.C. § 864(c)(4)(D)(ii) (2000).

9. Revenue Ruling 87-15, 1987-1 C.B. 248 addresses the exclusion under Code section 883(a) of certain shipping income from section 882 taxation. In the ruling, the Service takes the position that the section 883(a) exclusion has the same effect as a treaty exemption under Code section 952(b), therefore causing such income to fall within foreign base company income. The enactment of Code section 887, however, has partly alleviated the Service's concern. It imposes a 4% tax on U.S.-source gross transportation income exempt from taxation under Code section 883(a). *See* I.R.C. § 887(a), (b)(1) (2000). For further discussion of Revenue Ruling 87-15, see *supra* note 5 and accompanying text.

states from the controlled foreign corporation's subpart F income. Yet, Code sections such as section 883(a) exempt components of such income from direct federal taxation. If the purpose of an exclusion from subpart F income is to avoid double taxation by the United States, we should not make the exclusion available for income not directly taxed to the controlled foreign corporation. Instead, we can respond to the ruling's concern by requiring that Code sections 881 or 882 tax the income before the exclusion becomes available under Code section 952(b).

> RECOMMENDATION ONE: Amend Code section 952(b) to exclude from the subpart F income of a controlled foreign corporation any item of income taxable to the corporation under Code sections 881 or 882, unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a United States treaty obligation.

B. Foreign Trade Income of a Foreign Sales Corporation

If a controlled foreign corporation is also a foreign sales corporation, its gross foreign base company income excludes its foreign trade income.[10] Foreign trade income generally consists of income derived from selling or leasing property exported from the United States or from rendering specified professional services.[11] The potential overlap between a foreign sales corporation's foreign trade income and its foreign base company income occurs primarily within the categories of foreign base company sales and services income.[12] The exclusion of foreign trade income preserves the beneficial tax treatment of foreign sales corporations. Without it, subpart F's denial of a deferral to controlled foreign corporations would override the Code's tax benefits for foreign sales corporations.

Despite appearances, those tax benefits do not constitute a conventional tax expenditure. The tax benefits available to foreign sales corporations attempt to offset the disadvantage to United States businesses of the United States' reliance on a worldwide income tax without the use of a national sales tax. Under GATT, a member country may withdraw export sales from the tax base of its national sales tax. It cannot, however, exclude the income arising from its export sales from its income tax base.[13] Hence, United States trading partners who rely in part on a national sales tax for funding may offer an exclusion from sales

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10. *See* I.R.C. § 951(e)(1) (2000).

11. *See* I.R.C. §§ 923(b), 924(a), 927(a)(1) (2000). The principal professional services involved consist of engineering and architectural services rendered in connection with a foreign construction project. *See* I.R.C. § 924(a)(4) (2000).

12. *Compare* I.R.C. §§ 923(b), 924(a) (2000) (defining foreign trade income to include income derived from selling property exported from the United States or from rendering specified professional services) *with* I.R.C. § 954(d), (e) (2000) (defining foreign base company sales and services income to include income derived from selling property exported from the United States by a related person or from rendering specified professional services on behalf of a related person).

13. The remission of a direct tax, such as an income tax, constitutes an export subsidy and violates Article XVI(4) of GATT. The remission of an indirect tax, such as a consumption tax, does not constitute an export subsidy. *Compare* United States Tax Legislation (DISC), Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) 98 (1977) (holding that the exclusion from income tax under I.R.C. §§ 991-997 was the remission of a direct tax and thus a subsidy in violation of Article XVI(4) of

tax. The United States, on the other hand, cannot offer such an exclusion. To the extent trading partners exclude foreign-source income from the taxable income of their residents for purposes of their income tax, and to the extent trading partners impose a heavier sales tax burden than do the individual states of the United States, United States companies may appear to suffer a disadvantage.

Nevertheless, the tax benefits for foreign sales corporations are still suspect in economic terms. Economists usually view sales taxes as falling on consumers, and not on the companies that collect them. They generally see income taxes as falling on the taxpayer.[14] An exclusion from sales tax thus benefits the consumer, while an exclusion from income tax benefits the exporter. Furthermore, the sales tax imposed by the consumer's own nation offsets the benefit to the consumer of the exclusion of export goods from the exporting nation's sales tax. Due to the difference between the incidence of a sales tax and an income tax, we could view the tax benefits for foreign sales corporations as constituting an export subsidy under GATT. Indeed, the European Union has successfully challenged the validity of the U.S. tax regime for foreign sales corporations.[15]

C. *Exclusion of Certain Dividends*

To determine the amount of foreign base company income taxable to a specific United States shareholder, a controlled foreign corporation will exclude all or part of any dividend received from another controlled foreign corporation from its own gross income.[16] The dividend is excluded to the extent the corporation paid it out of earnings and profits previously taxed to that United States shareholder under Code section 951(a)(1).[17] The recipient must also exclude from the dividend an amount equal to any ordinary income realized by a predecessor-in-interest to the United States shareholder pursuant to Code section 1248(a) or (f) when the predecessor disposed of its stock in the payor.[18] The exclusion prevents U.S. shareholders from paying multiple taxes on foreign base company income as it moves up a chain of subsidiaries in the form of dividends.[19]

GATT) *with* Zenith Radio Corp. v. United States, 437 U.S. 443 (1978) (holding that the remission of an indirect tax was not a subsidy under United States trade law).

14. *See, e.g., Zenith Radio Corp.*, 437 U.S. at 455-57.

15. *See* United States—Tax Treatment for Foreign Sales Corporations, WT/DS 108 (2000).

16. *See* I.R.C. § 959(b) (2000).

17. I.R.C. § 959(b) (2000). A successor-in-interest of the United States shareholder may also take advantage of the exclusion. I.R.C. § 959(b). The full amount of the payor's subpart F income used to compute the pro rata inclusions of the payor's United States shareholders becomes eligible for the exclusion when distributed. Rev. Rul. 82-16, 1982-1 C.B. 106. As a result, if the payor's ultimate shareholders include any persons who are not United States shareholders, as defined in Code section 951(b), the payor may distribute to another controlled foreign corporation subpart F income that has never been included in the United States tax base and that is now excluded from the recipient's gross foreign base company income.

18. *See* I.R.C. § 959(b), (e).

19. A separate exclusion applies to dividends paid out of the payor's foreign base company shipping income, one of the components of foreign base company income. *See* I.R.C. § 954(b)(6)(B) (2000). The exclusion does not require previous taxation of the income from which the dividend arises to the United States shareholder. *See id.* It can thus cause the income to escape

Typically, the exclusion comes into play when a subsidiary of a controlled foreign corporation pays a dividend to the controlled foreign corporation out of the subsidiary's subpart F income. The United States shareholder's income would have included the subsidiary's subpart F income at the time the subsidiary earned it. By virtue of the rule, however, the subsidiary may distribute its earnings in the form of a dividend to its immediate shareholder without causing the distributed earnings to be included a second time in the income of the United States shareholder. (Without the exclusion, the dividend would constitute foreign personal holding company income—one of the categories of foreign base company income—in the hands of the recipient.[20]) Although the dividend is excluded from the controlled foreign corporation's gross income with regard to the United States shareholder, it is nonetheless added to the recipient's earnings and profits.[21]

To determine whether a corporation has paid a dividend out of earnings and profits previously taxed to a United States shareholder, the Code and regulations provide tracing rules.[22] The rules treat the recipient of the dividend as receiving income previously taxed to the United States shareholder before receiving income still taxable to that shareholder.

U.S. taxation altogether. For a discussion of the exclusion and a related recommendation that Congress delete Code section 954(b)(6)(B), see *Shipping Income, supra* note 1 (forthcoming 2000).

20. *See* I.R.C. § 954(c)(1)(A) (2000).

21. *See* Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000).

22. *See* I.R.C. § 959(c), (e) (2000); Treas. Reg. § 1.959-3(b) (2000). The tracing rules divide the payor's earnings and profits into six categories and require the recipient and its United States shareholder to deem the dividend paid out of the six categories in succession, as I explain below.

The first category consists of the payor's current earnings and profits that the Code taxes to the United States shareholder under Code sections 951(a)(1)(B) and 956 (relating to earnings the payor invested in United States property). *See* I.R.C. §§ 316(a)(2), 959(c)(1)(A) (2000). The second category consists of the payor's accumulated earnings and profits that the Code taxed to the United States shareholder under those sections. *See* I.R.C. §§ 316(a)(1), 959(c)(1)(A) (2000). The third category consists of the payor's current earnings and profits attributable either to the payor's subpart F income or to any of the payor's subpart F income that the payor withdrew from qualified shipping operations and less-developed country operations, plus an amount of the payor's other current earnings and profits equal to the amount of ordinary income realized under Code section 1248(a) or (f) by a predecessor-in-interest to the United States shareholder. *See* I.R.C. §§ 316(a)(2), 951(a)(1)(A), 959(b), (c)(2), (e) (2000).

The fourth category consists of the payor's accumulated earnings and profits attributable either to the payor's subpart F income or to any of the payor's subpart F income that the payor withdrew from qualified shipping operations and less-developed country operations, plus an amount of the payor's other accumulated earnings and profits equal to the amount, if any, by which the ordinary income realized under Code section 1248(a) or (f) by a predecessor-in-interest to the United States shareholder exceeded the payor's current earnings and profits for purposes of the third category. *See* I.R.C. §§ 316(a)(1), 951(a)(1)(A), 959(b), (c)(2), (e) (2000). The fifth category consists of the payor's remaining current earnings and profits, if any. *See* I.R.C. §§ 316(a)(2), 959(c)(3) (2000). The sixth category consists of the payor's remaining accumulated earnings and profits. *See* I.R.C. §§ 316(a)(1), 959(c)(3) (2000).

Once the recipient and the United States shareholder have established these six categories, the tracing rules require those entities to allocate the dividend among the categories in the order given above, exhausting the earnings and profits in each category before moving on to the next category. *See* I.R.C. § 959(c) (2000). Within a category consisting of accumulated earnings and profits (which are the second, fourth, and sixth categories above), the dividend is allocated among the accumulated earnings and profits in the reverse order in which the payor accumulated those earnings and profits. *See* I.R.C. § 361(a) (2000); Treas. Reg. § 1.959-3(b) (2000).

II.
ADJUSTED GROSS FOREIGN BASE COMPANY INCOME

Now that we have considered the matter of potential double taxation by the United States, we are ready to measure the difference between the full operations and the tax haven operations of the controlled foreign corporation. We must measure the difference *before* we take deductions into account. Once we have considered the ramifications of the difference, we might not need to allocate and apportion deductions. If the difference between the corporation's tax haven operations and its full operations is great, the first adjustment eliminates most of a controlled foreign corporation's foreign base company income. If the difference is slight, the second adjustment increases foreign base company income to absorb almost all of the controlled foreign corporation's income.[23]

A. *The* De Minimis *Rule*

If the total of gross foreign base company income and a controlled foreign corporation's section 953 insurance income equal less than 5% of the controlled foreign corporation's entire gross income, a *de minimis* rule will generally reduce gross foreign base company income to zero.[24] The *de minimis* rule applies, however, only if the sum of the corporation's gross foreign base company income and its section 953 insurance income equals less than $1,000,000.[25] And even when the *de minimis* rule does apply, it fails to reduce the corporation's foreign base company income from related-person factoring or portfolio debt. Such components of foreign personal holding company income[26] are exceptions to the *de minimis* rule.[27]

An anti-abuse rule prevents taxpayers from fracturing their tax haven operations among several controlled foreign corporations for the purpose of sheltering all of their foreign base company income under the *de minimis* rule.[28] The *de minimis* rule removes only foreign base company income and insurance in-

23. For taxable years beginning prior to January 1, 1987, if the branch rule treats a branch as a separate corporation, a controlled foreign corporation must apply the *de minimis* and full-inclusion rules separately to the branch and the remainder of the corporation. Treas. Reg. §§ 1.954-0(a)(3), 1.954A-1(d)(4) (2000). No such requirement appears in the regulations governing subsequent taxable years. *See* Treas. Reg. §§ 1.954-1(b)(4), 4.954-1(b)(4) (2000). *But see* S. REP. No. 87-1881, at 246 (1962) ("Determinations, such as those required under section 954(b)(3) . . ., as to such branch income shall be made as though such branch were a separate controlled foreign corporation.").

24. I.R.C. § 954(b)(3)(A) (2000). We can generally determine the gross income of a controlled foreign corporation in the same way as the gross income of a domestic corporation. Treas. Reg. § 1.952-2(a)(1) (2000). The gross income of a manufacturing, merchandising, or mining business usually consists of the business' total sales less the cost of goods sold. Treas. Reg. §§ 1.61-3(a), 1.952-2(c)(4) (2000). Thus, whether direct labor costs should calculate into a controlled foreign corporation's gross income from the engineering, fabrication, and installation of offshore drilling platforms depends on whether the corporation derives sales income or services income from its operations. Rev. Rul. 86-155, 1986-2 C.B. 134, 135.

25. I.R.C. § 954(b)(3)(A) (2000).

26. *See* I.R.C. §§ 864(d)(1), (2)(C), 954(c)(1)(A) (2000).

27. Treas. Reg. § 1.954-1(b)(1)(i)(C) (2000). For a discussion of related-person factoring, see *Services Income, supra* note 1, at 27-34.

28. *See* Treas. Reg. § 1.954-1(b)(4) (2000).

come from a controlled foreign corporation's subpart F income. The other types of subpart F income, such as boycott income, remain unaffected by it.[29]

B. *The Full-Inclusion Rule*

If the corporation's gross foreign base company income and gross section 953 insurance income together exceed 70% of the corporation's total gross income, a second adjustment—the full-inclusion rule—generally recharacterizes all of a controlled foreign corporation's remaining gross income as adjusted gross foreign base company income.[30] The full-inclusion rule has two exceptions. To begin with, it does not recharacterize the controlled foreign corporation's U.S.-source effectively-connected income as adjusted gross foreign base company income. Such income remains outside the bounds of foreign base company income.[31] Nor does the full-inclusion rule prevent the application of the high-tax kickout rule. Consequently, items of the controlled foreign corporation's income included in its gross foreign base company income solely by application of the full-inclusion rule may face removal from the corporation's net foreign base company income if they are subject to a high rate of foreign income tax.[32] No formal anti-abuse rule prevents a taxpayer from using a pair of related controlled foreign corporations to isolate foreign base company income from other income in order to shelter the other income from the effects of the full-inclusion rule.[33]

The full-inclusion rule causes some items of gross income to become subject to double taxation by the United States. Although the operation of the full-inclusion rule excludes U.S.-source income effectively connected with the conduct by the controlled foreign corporation of a trade or business in the United States, two other categories of income remain affected by the rule. They consist of foreign-source income effectively connected with the controlled foreign corporation's conduct of a trade or business in the United States and U.S.-source income taxable under Code section 881.

By amending the regulations, we can easily avoid the problem of double taxation. The enactment of Recommendation One by Congress would provide

29. *See* I.R.C. § 954(b)(3)(A) (2000). The three types of subpart F income not subject to the *de minimis* rule are boycott income, bribery expenditures, and pariah-state income. *See* I.R.C. § 952(a)(3)(B), (4), (5) (2000).

30. *See* I.R.C. § 954(b)(3)(B) (2000). No part of the corporation's remaining gross income is recharacterized as adjusted gross insurance income. Treas. Reg. § 1.954-1(b)(1)(ii) (2000).

31. Treas. Reg. § 1.954-1(b)(1)(ii) (2000).

32. *See* I.R.C. § 954(b)(3)(B), (4) (2000); Treas. Reg. § 1.954-1(b)(1)(ii), (d)(6) (2000). *See infra* Part IV.C for a discussion of the high-tax kickout rule.

33. Such a rule does exist for taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. *See* Treas. Reg. §§ 1.954-0(a)(2), 4.954-1(b)(4) (2000). The anti-abuse rule in effect for those taxable years is discussed in Private Letter Ruling 89-29-031 (April 24, 1989). Note that the current anti-abuse rule contained in Treasury Regulation section 1.954-1(b)(4) applies only to the *de minimis* rule, unlike the rule given in Treasury Regulation section 4.954-1(b)(4), which applies to both the full-inclusion rule and the *de minimis* rule for taxable years beginning after December 31, 1986 and on or before November 6, 1995.

the necessary statutory basis for the amended regulation, which I state as follows:[34]

> RECOMMENDATION TWO: Amend Treasury Regulation section 1.954-1(b)(1)(ii) to exclude any income taxable to the controlled foreign corporation under Code sections 881 or 882 from recharacterization as gross foreign base company income pursuant to the full-inclusion rule of Code section 954(b)(3)(B).

III.
DEDUCTIONS: NET FOREIGN BASE COMPANY INCOME

Once we have compared the controlled foreign corporation's tax haven operations to its complete operations and made the required adjustments to the corporation's gross foreign base company income, we may turn to the analysis of the corporation's net foreign base company income. This category of income consists of the corporation's adjusted gross foreign base company income, less various deductions.[35] Although the general idea of reducing foreign base company income by its attendant expenses is simple enough to express, the exact process requires nine steps: (1) the identification of the corporation's possible deductions; (2) the offset of interest income and expense between related controlled foreign corporations; (3) the division of the corporation's adjusted gross foreign base company income into specific items of income; (4) the isolation of any same-country insurance income within the corporation's adjusted gross foreign base company income; (5) the isolation of the corporation's deductions related to its same-country insurance income; (6) the allocation and apportionment of deductions to the corporation's same-country insurance income that also constitutes foreign base company income; (7) the allocation and apportionment of deductions that relate to less than all of the controlled foreign corporation's gross income as a class; (8) the allocation and apportionment of related-person interest expense; and (9) the allocation and apportionment of all remaining deductions.[36]

The multi-step process exhibits two unusual characteristics. First, the process associates deductions with particular categories of a controlled foreign corporation's foreign base company income, and not simply with its foreign base company income as a whole. The focus on discrete categories of income stems from a general prohibition against allowing a deficit in one category of foreign base company income to offset a surplus in another category.[37] As a result of the ban, the taxpayer must compute the net amount in each category separately.

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34. *See supra* Part I.B for the text of Recommendation One.

35. *See* Treas. Reg. § 1.954-1(a)(5) (2000).

36. *See* Treas. Reg. § 1.954-1(c) (2000). Treasury Regulation section 1.954-1(c)(i) suggests that the process consists of four steps. However, after analyzing those four steps and the remaining material of Treasury Regulation section 1.954-1(c), it becomes clear that the full process consists of nine discrete steps.

37. This requirement is implicit in Code section 954(b)(5). It requires the reduction of five individual categories of foreign base company income by separately allocable deductions, rather than the reduction of the composite foreign base company income by such deductions. Treasury Regulation section 1.954-1(c)(1)(ii) makes the requirement explicit. A loss within a particular category of foreign base company income may, however, reduce the overall subpart F income inclusion

Second, the process not only links expenses to separate categories of foreign base company income, but also to specific items of income within each category. By working at this level of detail, the process prepares the controlled foreign corporation's foreign base company income for eventual analysis by the corporation's United States shareholders under the foreign tax credit limitation.[38]

A. *Identifying Possible Deductions*

We may begin the process of calculating a controlled foreign corporation's net foreign base company income by identifying the expenses available to reduce the corporation's adjusted gross foreign base company income.[39] To identify the available deductions, one generally treats the controlled foreign corporation as if it were a domestic corporation.[40] The regulations supply the necessary directives about the controlled foreign corporation's books of account, accounting principles, tax accounting methods, translation of amounts into United States dollars, and foreign exchange gain or loss.[41] But the regulations do not treat the controlled foreign corporation as a domestic corporation in all respects. Departures from the principles applicable to domestic corporations in-

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through the workings of the earnings and profits limitation of Code section 952(c); *see infra* Part IV.B.

An exception exists to the general rule that a deficit in one category of foreign base company income cannot offset income in another category. *See* Treas. Reg. § 1.954-2(g)(3) (2000). Under Treasury Regulation section 1.954-2(g)(3), a controlled foreign corporation's United States shareholders may elect to exclude foreign currency gain or loss from the corporation's foreign personal holding company income. They must then include the gains and losses in the specific categories of subpart F income to which such gains and losses relate. Such an election may result in the reduction of an item of foreign base company income by a related foreign currency loss, a loss which would otherwise reduce the corporation's foreign personal holding company income.

Although the regulations refer to a second exception, *see* Treas. Reg. §§ 1.954-1(c)(1)(ii), 1.954-2(g)(4) (2000), the reference in fact relates to a limited offset within the single category of foreign personal holding company income. The offset may occur if the controlled foreign corporation's United States shareholders elect, under Treasury Regulation section 1.954-2(g)(4), to treat as foreign personal holding company income all of the corporation's foreign currency gains and losses from section 1256 contracts that, in the absence of Code section 988(c)(1)(D), would constitute section 988 transactions. If the shareholders have made the election, and the corporation has a net loss in its foreign currency transactions, the loss may be apportioned to and offset other elements of foreign personal holding company income. Treas. Reg. §§ 1.954-1(c)(1)(ii), 1.954-2(g)(2)(i) (2000). Without the election, only the controlled foreign corporation's net foreign currency gain is included in its foreign personal holding company income. I.R.C. § 954(c)(1)(D) (2000).

38. The foreign tax credit limitation requires the separation of a United States shareholder's taxable foreign-source income into nine categories (or baskets, in the working language of U.S. international tax lawyers). *See* I.R.C. § 904(d)(1), (3)(B) (2000). The categories differ from the five categories of foreign base company income, and an analysis under the foreign tax credit limitation therefore requires the shareholder to re-divide a controlled foreign corporation's foreign base company income into a different set of categories.

39. We could also begin by dividing the controlled foreign corporation's adjusted gross foreign base company income into specific items of income. However, in light of the later step of offsetting interest payments between related controlled foreign corporations, beginning with the identification of deductions is preferable. The interest offset will reduce the amount of income that must be broken into separate items of income, thus reducing the effort involved in that complex step.

40. *See* Treas. Reg. § 1.952-2(b)(1) (2000).

41. *See* Treas. Reg. § 1.952-2(c)(2) (2000).

clude both a denial of the capital loss carryback and carryover[42] and a denial of the net operating loss deduction.[43] If the controlled foreign corporation also constitutes a foreign sales corporation, calculation of the corporation's net foreign base company income does not take into account the deductions apportioned or allocated to its foreign trade income.[44]

B. Interest Offsets Between Related Controlled Foreign Corporations

Interest paid by the controlled foreign corporation to a related controlled foreign corporation offsets any interest income received from the other corporation.[45] The corporation can only offset interest payments; no other type of payment can be offset.[46]

C. Defining Items of Foreign Base Company Income

Having offset interest income and expense between related controlled foreign corporations, we may now divide the corporation's adjusted gross foreign base company income into separate items of income, as those items are defined by regulation.[47] Depending on the type of income involved, we use one of two methods for defining a foreign corporation's items of income.

First, for a controlled foreign corporation's foreign personal holding company income that also constitutes passive income for purposes of the foreign tax credit, we define an item of income by crossing the seven components of foreign personal holding company income with the following four groups of income:[48] (1) income from sources within the controlled foreign corporation's country of operation;[49] (2) income from sources outside the corporation's country of operation and subject to a foreign withholding tax rate of 15% or more;[50] (3) foreign-source income subject to a foreign withholding tax rate of less than 15% but more than zero;[51] and (4) foreign-source income subject to no foreign withholding tax.[52] In addition to the twenty-eight items of income that may result from this matrix, specific circumstances may create more items of income. We must

42. *See* Treas. Reg. § 1.952-2(c)(5)(i) (2000).
43. *See* Treas. Reg. § 1.952-2(c)(5)(ii) (2000).
44. *See* I.R.C. § 951(e)(1) (2000). The Code eliminates the entire deduction from consideration under subpart F, and not simply the portion of the deduction allocated and apportioned to foreign sales income. *See id.* The Code is overly broad, of course, but in light of the World Trade Organization's ruling against the foreign sales corporation regime as a whole, *see supra* note 15 and accompanying text, amending the Code provision is not worthwhile.
45. *See* Treas. Reg. §§ 1.904-5(k)(2), 1.954-1(c)(1), 1.954-2(b)(4)(ii)(B)(2) (2000).
46. *See* Treas. Reg. § 1.954-1(c)(1) (2000).
47. *See* Treas. Reg. § 1.954-1(c)(1)(i)(A) (2000).
48. *See* Treas. Reg. § 1.954-1(c)(1)(iii)(B) (2000). Treasury Regulation section 1.954-1(c)(1)(iii)(A)(1) refers to only five types of foreign personal holding company income. Subsequent to the regulation's promulgation, however, the Taxpayer Relief Act of 1997 added two additional components to foreign personal holding company income, for a total of seven. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1051, 111 Stat. 788, 940 (amending I.R.C. § 954(c)(1)).
49. Treas. Reg. §§ 1.904-4(c)(4)(i), 1.954-1(c)(1)(iii)(B) (2000).
50. Treas. Reg. §§ 1.904-4(c)(3)(i), 1.954-1(c)(1)(iii)(B) (2000).
51. Treas. Reg. §§ 1.904-4(c)(3)(ii), 1.954-1(c)(1)(iii)(B) (2000).
52. Treas. Reg. §§ 1.904-4(c)(3)(iii), 1.954-1(c)(1)(iii)(B) (2000).

segregate any item of rent or royalty to which we directly allocate an item of rent or royalty expense as a separate item of income.[53] We must also segregate a controlled foreign corporation's distributive share of partnership income from a partnership not subject to the look-through rules, but only if the distributive share constitutes passive income under Treasury Regulation section 1.904-5(h)(2)(i).[54] That will generally hold true if the partner has less than a 10% interest in the partnership.[55]

Second, in the case of the controlled foreign corporation's foreign base company income other than its passive foreign personal holding company income, we separate the income into the 108 items of income created by crossing the nine categories (or baskets) of the foreign tax credit limitation with the twelve kinds of foreign base company income.[56] Those twelve kinds of income consist of the seven components of foreign personal holding company income, the four categories of foreign base company income other than foreign personal holding company income, and the extra category of full-inclusion foreign base company income.[57] The aggregate income in each of the 108 categories constitutes a single item of income.[58]

By applying the two methods described above, a given corporation can potentially separate its foreign base company income into more than 136 items. Although simply using the five categories of foreign base company income would seem sufficient for calculating the corporation's net foreign base company income,[59] the foreign tax credit limitation requires a United States shareholder to divide its subpart F inclusion among the various baskets specified by Code section 904(d)(1).[60] The detailed breakdown of a controlled foreign corporation's foreign base company income thus facilitates the United States shareholder's task.

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53. *See* Treas. Reg. §§ 1.904-4(c)(5)(i), 1.954-1(c)(1)(iii)(B) (2000).

54. *See* Treas. Reg. §§ 1.904-4(c)(5)(ii), 1.954-1(c)(1)(iii)(B) (2000).

55. *See* Treas. Reg. § 1.904-5(h)(2)(i) (2000).

56. *See* Treas. Reg. § 1.954-1(c)(1)(iii)(A) (2000) (listing ten of the twelve kinds of foreign base company income).

57. *See id.* Full-inclusion foreign base company income consists of the controlled foreign corporation's income that is characterized as foreign base company income solely by virtue of the full-inclusion rule of Code section 954(b)(3)(B); *see supra* Part II.B for a discussion of such income.

58. *See* Treas. Reg. § 1.954-1(c)(1)(iii)(A) (2000). The number of items of income defined by this second matrix will actually total less than 108. Certain categories of foreign base company income fall within only some of the nine baskets of the foreign tax credit limitation. For example, foreign base company shipping income falls entirely within the shipping income basket for purposes of the foreign tax credit limitation. *See* I.R.C. § 904(d)(1)(D), (2)(D) (2000). The controlled foreign corporation with more than one qualified business unit for purposes of Code sections 985 to 989 (dealing with foreign currency transactions) may have to compute its items of income separately for each unit. *See* Bruce W. Reynolds & Gary J. Melcher, *New Subpart F Regs. Impose Data-Gathering Burdens on Shareholders*, 6 J. INT'L TAX'N 532, 533 (1995). A controlled foreign corporation with more than one qualified business unit should also consider the branch rule of Code section 954(d)(2). *See Sales Income, supra* note 1, at 110-127, 145-148.

59. The five categories of foreign base company income consist of foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income. *See* I.R.C. § 954(a) (2000).

60. *See* I.R.C. § 904(d)(3)(B) (2000).

D. *Isolating Same-Country Insurance Income*

After defining the controlled foreign corporation's separate items of adjusted gross foreign base company income, we should isolate the items that constitute same-country insurance income. We must isolate such income because the method of allocating and apportioning deductions to it differs from the method used for the rest of the corporation's foreign base company income.[61] A controlled foreign corporation derives same-country insurance income by insuring risks within its country of incorporation.[62] Part or all of a controlled foreign corporation's same-country insurance income may fall within its foreign base company income. For example, same-country insurance income might fall within foreign personal holding company income, a category of foreign base company income.[63] One should not confuse same-country insurance income with section 953 insurance income, a separate component of subpart F income. A controlled foreign corporation derives section 953 insurance income by insuring risks located outside its country of incorporation, not within it.[64]

E. *Isolating Deductions Related to Same-Country Insurance Income*

From the deductions we identified in Step A, we now isolate the deductions related to the controlled foreign corporation's same-country insurance income within its adjusted gross foreign base company income. We need to isolate those deductions because their allocation and apportionment differs from that of other deductions.[65] Isolating the deductions makes it possible to compute the corporation's net foreign base company income derived from same-country insurance income.

F. *Allocating and Apportioning Deductions Related to Same-Country Insurance Income*

To allocate and apportion the deductions related to the controlled foreign corporation's same-country insurance income that is also adjusted gross foreign

61. *See* Treas. Reg. § 1.954-1(c)(2) (2000).

62. *See id.*

63. *See* I.R.C. § 954(c) (2000). *But see* I.R.C. § 954(i) (2000) (excluding the qualified insurance income of a qualified insurance company from the definition of foreign personal holding income for purposes of subsection (c)(1)). From the ordering rules of Treasury Regulation section 1.954-1(e)(4), we may infer that at least some types of insurance income, before the application of ordering rules, can also fall within foreign base company shipping income or foreign base company oil-related income. *See* Treas. Reg. § 1.954-1(e)(4)(A), (B) (2000). (The specific ordering rules of Treasury Regulation section 1.954-1(e)(4) need updating. For a discussion of the rules and a recommended solution, see *Shipping Income, supra* note 1 (forthcoming 2000).)

64. *See* I.R.C. § 953(a)(1) (2000).

65. *Compare* Treas. Reg. § 1.954-1(c)(1)(i)(B), (D) (2000) (reducing the amounts of items of income other than passive foreign personal holding income by the expenses allocable and apportionable to the items under sections 861, 864 and 904(d)) *with* Treas. Reg. § 1.954-1(c)(2) (2000) (using the method set forth in Code section 953 to allocate and apportion deductions relating to foreign base company income that concerns insurance or indemnity contracts).

base company income, we use the rules prescribed for allocating and apportioning expense to section 953 insurance income.[66]

Some of those deductions may also relate to the corporation's foreign base company income that is not same-country insurance income. If so, two different methods of allocation and apportionment govern the deductions. First, we must allocate and apportion the deductions to the same-country insurance income according to the rules of Code section 953.[67] But we must also allocate and apportion the deductions to the corporation's other foreign base company income according to the rules of Code sections 861, 864, and 904(d).[68] Inconsistent allocations thus become a possibility. In what order should we apply the two methods? The Code and regulations fail to inform us.

I see three possible solutions to this ordering problem. (1) The first possibility would give priority to the allocation and apportionment of deductions to same-country insurance income. Thus, we might use the specialized method of Code section 953 to allocate and apportion a deduction among the following three categories of income: same-country insurance income that is also foreign base company income, section 953 insurance income,[69] and all of the controlled foreign corporation's other income. Then we would use the generic method of Code sections 861, 864, and 904(d) to allocate and apportion the amount of the deduction already allocated and apportioned by the specialized method to all other income of the corporation. We would distribute it between the corporation's foreign base company income that is not also same-country insurance income, on the one hand, and its income that is not foreign base company income, on the other. (The second step could also incorporate the allocation and apportionment of expense among the separate items of income of foreign base company income, as required by Steps G and I below.)

(2) A second possible solution involves giving priority to the allocation and apportionment of deductions to foreign base company income. Thus, we could initially use the generic method to allocate and apportion a deduction between all foreign base company income (including same-country insurance income), and all other income of the controlled foreign corporation. Then, we would need to implement a second level of allocation and apportionment in two phases. First, we would use the specialized method of Code section 953 to allocate and apportion that part of the deduction already allocated and apportioned to foreign base company income between same-country insurance income and all other foreign base company income. Second, we would use the specialized method to allocate and apportion that portion of the deduction already allocated and apportioned to all income other than foreign base company income. We would distribute it between Code section 953 income and all other income that is not

66. *See* Treas. Reg. § 1.954-1(c)(2) (2000).

67. *See* Treas. Reg. § 1.954-1(c)(2) (2000).

68. *See* Treas. Reg. § 1.954-1(c)(1)(B), (D) (2000).

69. Section 953 insurance income is a relevant category since it, like foreign base company income, is taxed to the controlled foreign corporation's United States shareholders on a net basis. *See* I.R.C. §§ 952(a)(1), 954(b)(3)(C) (2000).

foreign base company income. (We would then need a third level of allocation and apportionment to distribute expense according to Steps G and I among the separate items of foreign base company income.)

The complexity of the second possible solution argues against its adoption. The proposal also contains another drawback. It would prevent the use of the specialized section 953 method to allocate and apportion deductions between section 953 insurance income and any same-country insurance income that constitutes foreign base company income. Because they lie in different classes of income during the first round of allocation and apportionment, we would initially allocate and apportion deductions relating to both kinds of insurance income according to the generic method, not the specialized one.

(3) The third possible solution keeps the two kinds of insurance income together during the first round of allocation and apportionment. First, the proposal allocates and apportions the deduction, using the generic method, among three classes of income: insurance income generally (including section 953 insurance income and any same-country insurance income that is also foreign base company income), foreign base company income that is not same-country insurance income, and all other income. Then, using the specialized method, we would allocate and apportion the amount of the deduction allocated and apportioned to insurance income generally among the categories of section 953 insurance income, same-country insurance income that is also foreign base company income, and all other insurance income. (We could build the allocation and apportionment required by Steps G and I into the first level of allocation and apportionment.)

We can evaluate the three proposals on the basis of their simplicity and their exploitation of the specialized method of allocating and apportioning deductions to insurance income and their simplicity. The first and third proposals have the merit of preserving the use of the specialized method in the allocation and apportionment of deductions between section 953 insurance income and same-country insurance income. The second proposal does not. The first proposal has the additional merit of using the specialized method to control the initial allocation and apportionment of deductions to any type of insurance income. The third proposal does not. The first and third proposals are simpler than the second proposal, since the second proposal requires three levels of allocation and apportionment. But I am unable to determine, *a priori*, whether the first proposal is simpler than the third proposal. In the case of allocating and apportioning deductions, complexity adds significantly to the compliance costs of taxpayers and the administrative costs of the government—costs that detract from fiscal efficiency.

On the basis of the first method's simplicity and exploitation of the specialized method of allocation and apportionment for deductions related to insurance

income, I suggest that we adopt it.[70] This could be done by amending a regulation.

> RECOMMENDATION THREE: This recommendation contains two parts. First, amend Treasury Regulation section 1.954-1(c)(1) by adding the following phrase at the beginning of the first sentence of the provision: "Subject to § 1.954-1(c)(2)." Second, amend Treasury Regulation section 1.954-1(c)(2) by adding the following sentence at the end of the provision: "In the event that such a deduction also relates to gross foreign base company income not so attributable, the deduction shall first be allocated and apportioned under the rules of Code section 953 to foreign base company income that is so attributable; the remaining portion of such a deduction shall then be allocated and apportioned under the rules of Code sections 861, 864, and 904(d) to foreign base company income that is not so attributable."

G. Allocating and Apportioning Certain Other Deductions

Next, we turn to the computation of the controlled foreign corporation's net foreign base company income not derived from same-country insurance income. The remaining steps of the process of reducing a controlled foreign corporation's adjusted gross foreign base company income by its attendant expenses concern the allocation and apportionment of deductions related to such income. We now allocate and apportion the deductions definitely related to less than all of the controlled foreign corporation's gross income as a class to the controlled foreign corporation's items of adjusted gross foreign base company income.[71] We use the method of allocation and apportionment given under Code sections 861, 864, and 904(d).[72]

H. Related-Person Interest Expense

We then turn to the deduction for related-person interest expense allocable to passive income under Treasury Regulation section 1.904-5(c)(2).[73] Such interest expense consists of interest paid by the controlled foreign corporation to any of its United States shareholders.[74] The Code and regulations allocate and apportion this interest to the separate items of the controlled foreign corpora-

70. I may be giving undue deference to the Code section 953 method of allocating and apportioning deductions related to insurance income. I invite comment on this point from readers.

71. *See* Treas. Reg. § 1.954-1(c)(1)(i)(B) (2000).

72. *Id.*

73. *See* Treas. Reg. § 1.954-1(c)(1)(i)(C) (2000).

74. *See* Treas. Reg. § 1.904-5(c)(2)(i) (2000). Such related-person interest expense consists of interest paid by the controlled foreign corporation to any related person to whom the foreign tax credit look-through rules apply. *Id.* The look-through rules apply only to the United States shareholders of the corporation. *See* I.R.C. § 904(d)(3)(A) (2000). As a result, only interest paid by the controlled foreign corporation to any of its United States shareholders qualifies as related-person interest.

For tax years beginning after December 31, 2002, the look-through rules will also apply to shareholders in non-controlled section 902 corporations. *See* I.R.C. § 904(d)(4) (2000). However, no controlled foreign corporation can also constitute a non-controlled section 902 corporation. *See* I.R.C. § 904(d)(2)(E)(i) (2000). Furthermore, by definition, a shareholder in a non-controlled section 902 corporation owns at least 10% of the voting stock of the corporation. *See* I.R.C. §§ 902(a), 904(d)(2)(E)(i) (2000). In the case of a controlled foreign corporation, such a shareholding makes the shareholder a United States shareholder. *See* I.R.C. § 951(b). Thus, even for tax years begin-

tion's passive foreign personal holding company income.[75] Apparently, we are to use the method of Code sections 861, 864, and 904(d) to allocate and apportion related-person interest expense. Related-person interest expense may not reduce passive foreign personal holding company income below zero.[76] We must therefore allocate the remainder of related-person interest, if any, among the categories of income other than passive income.[77]

I. Allocating and Apportioning the Remaining Deductions

Having allocated and apportioned the deduction for related-person interest expense allocable to passive income, we now address the controlled foreign corporation's remaining deductions. We must allocate and apportion the remaining deductions to the items of the corporation's adjusted gross foreign base company income: (1) items of passive foreign personal holding company income and (2) the other items of the controlled foreign corporation's adjusted gross foreign base company income.[78] In allocating and apportioning these final deductions, we must use the method of Code sections 861, 864, and 904(d).[79]

J. The Treatment of Losses

Once we have reduced the individual items of the controlled foreign corporation's adjusted gross foreign base company income by their attendant expenses, we may generally consolidate the net items into the five categories of foreign base company income. In general, a loss within a given item of income may offset the income left within another item of income, as long as the two items of income fall within the same category of foreign base company income. A loss within one category of foreign base company income may not offset income within another category.[80]

There is an exception to the general rule permitting losses to offset income within a category of foreign base company income. In the case of foreign personal holding company income, the Code confines some components of foreign personal holding company income to the excess of gains over losses.[81] As a

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ning after December 31, 2002, related-person interest expense consists of interest paid by the controlled foreign corporation to any of its United States shareholders.

75. *See* I.R.C. § 954(b)(5) (2000); Treas. Reg. § 1.954-1(c)(1)(i)(C) (2000). *See supra* Part III.C for a description of the separate items of a controlled foreign corporation's passive foreign personal holding company income. Except to the extent provided by regulation, interest paid or accrued by the controlled foreign corporation to another controlled foreign corporation related to one of the first corporation's United States shareholders must also be allocated to the first corporation's passive foreign personal holding company income. I.R.C. § 954(b)(5) (2000). Treasury Regulation section 1.954-1(c)(1)(i)(C) makes no mention of such interest. It thus appears that one must still allocate such interest to the controlled foreign corporation's passive personal holding company income.

76. *See* Treas. Reg. § 1.904-5(c)(2)(ii)(C), (D) (2000).

77. *See* Treas. Reg. § 1.904-5(c)(2)(ii)(D) (2000).

78. *See* Treas. Reg. § 1.954-1(c)(1)(i)(D); (iii)(A), (B) (2000).

79. *See* Treas. Reg. § 1.954-1(c)(1)(i)(D) (2000).

80. *See* Treas. Reg. § 1.954-1(c)(1)(ii) (2000).

81. The components include foreign currency gain, gain from commodities transactions, and gain from the disposition of certain property. *See* I.R.C. § 954(c)(1)(B), (C), (D) (2000).

result, it limits the availability of a loss to reduce income within a category. The Code does not permit the components to have a negative balance. Any surplus losses within such a component of foreign personal holding company income cannot be used to offset income elsewhere within foreign personal holding company income.

We should keep in mind, however, that losses not offsetting income may still affect the total inclusion of the controlled foreign corporation's United States shareholders through the workings of the current earnings and profits limitation.[82]

IV.
ADJUSTED NET FOREIGN BASE COMPANY INCOME

To arrive at a controlled foreign corporation's adjusted net foreign base company income, we must make four adjustments to its net foreign base company income.[83] These adjustments cannot occur until the corporation's foreign base company income has been reduced by its attendant expenses. Consequently, the adjustments must wait until the determination of the controlled foreign corporation's net foreign base company income.

The deficit rules make the first adjustment. They take into account previous deficits incurred by the controlled foreign corporation in its tax haven operations, together with certain current deficits incurred by selected affiliates in their tax haven operations.[84] Incurring a deficit in a tax haven operation may seem like an oxymoron, but recall that at least two categories of foreign base company income may have significant start-up costs or experience significant price swings in the cost of raw materials: foreign base company shipping income and foreign base company oil-related income.

Two other adjustments link the income of the controlled foreign corporation's tax haven operations to the financial success of the corporation's complete operations. The following discussion considers whether such a linkage should occur. Subjecting a controlled foreign corporation's tax haven income to tax may be advisable, despite the existence of offsetting losses in the corporation's other operations. The adjustments either limit foreign base company income to the controlled foreign corporation's current earnings and profits,[85] or recapture as foreign base company income any amounts previously excluded from the corporation's foreign base company income by the current earnings and profits limitation.[86]

The fourth adjustment excludes highly-taxed income from the tax base of foreign base company income.[87] Although such income arguably belongs

82. *See infra* Part IV.B.
83. *See* Treas. Reg. § 1.954-1(a)(5), (7) (2000).
84. *See* I.R.C. § 952(c)(1)(B), (C) (2000).
85. *See* I.R.C. § 952(c)(1)(A) (2000).
86. *See* I.R.C. § 952(c)(2) (2000).
87. *See* I.R.C. § 954(b)(4) (2000). Note, however, that the exception does not apply to foreign base company oil-related income as defined in Code section 954(a)(5).

outside the category of tax haven income, it has fallen within the sweep of subpart F through the broad mechanisms the subpart uses to describe tax haven operations.

A. *The Deficit Rules*

Under the primary deficit rule, the United States shareholder benefits from past losses incurred by the controlled foreign corporation within its tax haven operations. Under a secondary rule, the shareholder may benefit from current tax haven losses incurred by certain affiliates of the controlled foreign corporation.

1. *The Primary Rule*

In general terms, the primary deficit rule reduces the United States shareholder's subpart F inclusion by past losses in the controlled foreign corporation's tax haven activities. More precisely, the rule reduces the shareholder's inclusion attributable to any of the five categories of foreign base company income or section 953 insurance income by the shareholder's pro rata share of a deficit in the corporation's accumulated earnings and profits attributable to activity giving rise to that type of income, subject to various requirements.[88] A deficit may only offset subpart F income arising from the same type of activity that gave rise to the deficit.[89] For example, a deficit arising from activity that, if profitable, would have generated foreign base company sales income may only offset foreign base company sales income. Furthermore, foreign personal holding company income and section 953 insurance income may only experience offsets if the controlled foreign corporation engages in specified lines of business. To offset a deficit against section 953 income, the corporation must predominantly engage in the active conduct of an insurance business. To offset a deficit against foreign personal holding company income, the corporation must predominantly engage in the active conduct of either an insurance business or a banking, financing, or similar business.[90] A controlled foreign corporation may

88. *See* I.R.C. § 952(c)(1)(B) (2000). The corporation must have constituted a controlled foreign corporation during the year in which it incurred the deficit. *See* I.R.C. § 952(c)(1)(B)(ii) (2000). In calculating its pro rata share of a deficit, the United States shareholder must use the smaller of its ownership interests from the current year and the deficit year. I.R.C. § 952(c)(1)(B)(iv) (2000). Depending on the category of foreign base company income involved, a shareholder may reach for deficits from various years. A shareholder may reach deficits incurred during activities giving rise to foreign base company shipping income or foreign personal holding company income if they arose in a tax year beginning after 1986. *See* I.R.C. § 952(c)(1)(B)(ii) (2000). In contrast, a shareholder may reach deficits incurred during activities giving rise to foreign base company oil-related income if they occurred in tax years beginning after 1982. *See id.* Finally, a shareholder may reach deficits incurred during activities giving rise to either foreign base company sales income or foreign base company services income if they were incurred in tax years beginning after 1962. *See id.*

89. *See* I.R.C. § 952(c)(1)(B)(ii)(I) (2000).

90. *See* I.R.C. § 952(c)(1)(B)(iii)(V), (VI); (v), (vi) (2000). The corporation must meet the predominant line of business criterion both during the year in which it incurs the deficit and the year in which the deficit rule applies. *See* I.R.C. § 952(c)(1)(B)(v), (vi) (2000).

not use a deficit to offset a subpart F inclusion to the extent that the deficit has offset subpart F inclusions in past years.[91]

2. *The Secondary Rule: An Election*

Deficits incurred by a small set of persons related to the controlled foreign corporation in their own tax haven operations may also decrease the United States shareholder's subpart F inclusion.[92] In this case, the reduction occurs within the controlled foreign corporation's subpart F income; it affects the shareholder's inclusion only indirectly.[93] Unlike the primary deficit rule, which is mandatory, the secondary rule is optional at the election of the controlled foreign corporation.[94] Moreover, the related person's deficit must occur in the person's current earnings and profits, rather than in the person's accumulated earnings and profits.[95] Before the controlled foreign corporation elects to take the deduction, the available deficits in the controlled foreign corporation's accumulated earnings and profits must have already reduced the shareholder's subpart F inclusion under the primary deficit rule.[96] The deficits transferred from the related person must offset income arising from the same kind of activity as gave rise to the deficits.[97] Thus, a controlled foreign corporation must use a deficit of a related person arising from activity that, when profitable, gives rise to foreign base company oil-related income only to offset the corporation's foreign base company oil-related income.

The related person must consist of a corporation incorporated in the same foreign country as the controlled foreign corporation.[98] Furthermore, the related corporation must either wholly own, or be wholly-owned by, the controlled foreign corporation.[99] The ownership may occur directly, or indirectly through one

91. *See* I.R.C. § 952(c)(1)(B)(ii)(II) (2000).

92. *See* I.R.C. § 952(c)(1)(C)(i) (2000).

93. *See id.*

94. *Compare* I.R.C. § 952(c)(1)(B)(i) (2000) (stating that the amount of the shareholder's inclusion *shall* be reduced [emphasis added]) *with* I.R.C. § 952(c)(1)(C)(i) (2000) (stating that a controlled foreign corporation *may elect* to reduce the amount of its subpart F income [emphasis added]).

95. *See* I.R.C. § 952(c)(1)(C)(i) (2000). The relevant earnings and profits are those of the related person for a taxable year ending with or within the taxable year of the controlled foreign corporation with respect to which United States tax is being determined for the United States shareholder.

96. *See* I.R.C. § 952(c)(1)(C)(iii) (2000).

97. *See* I.R.C. § 952(c)(1)(C)(i) (2000). In Stanford v. Commissioner, 152 F.3d 450 (5th Cir. 1998), the taxpayer argued unsuccessfully that a deficit incurred by a controlled foreign corporation in rendering administrative and managerial services to its wholly-owned subsidiary should offset the subsidiary's foreign personal holding company income derived in the active conduct of a banking business. The taxpayer argued, in the language of the statute, that the deficit of the parent controlled foreign corporation was "attributable to" the subsidiary's banking business, since the subsidiary used the parent's services in that business. The Fifth Circuit held that the deficit was not so attributable. *Id.* at 459. Instead, the court required that an entity engaged in a qualifying activity generate the offset. *Id.* at 463 (J. Benavides dissenting). Note that the parent's administrative and managerial services, if profitable, would not have generated foreign personal holding company income.

98. I.R.C. § 952(c)(1)(C)(ii) (2000).

99. *Id.*

or more intermediate companies in a chain.[100] Finally, the two corporations cannot be sibling corporations; that is, the relationship between them must consist of more than having a common parent corporation.[101] Under these conditions, the related person will itself constitute a controlled foreign corporation.

Code section 952(c)(1)(B) is unclear as to whether a controlled foreign corporation must have an overall deficit in its accumulated earnings and profits before its United States shareholder must use the primary deficit rule. Furthermore, Code section 952(c)(1)(C) is unclear as to whether a related person must have an overall deficit in its current earnings and profits before the controlled foreign corporation may elect to use the secondary deficit rule. If our goal is to measure a corporation's tax haven income accurately over time, an overall deficit should not be required in either case. Moreover, the Code refers to "any deficit" in the earnings and profits of a given year.[102] Such language suggests that a corporation may have multiple deficits in a single taxable year and that the existence of a relevant deficit is to be determined activity by activity. The following recommendation would adopt this reading of the Code:

> RECOMMENDATION FOUR: Provide in regulations under Code section 952(c)(1)(B) and (C) that the deficit rule of section 952(c)(1)(B) applies even if the controlled foreign corporation has no overall deficit in earnings and profits during the year in which the corporation has a deficit attributable to a qualified activity; and that the deficit election of section 952(c)(1)(C) is available even if the qualified chain member has no overall deficit in earnings and profits during the year in which the member has a deficit attributable to a qualified activity.

3. *Coordinating the Deficit Rules with the Current Earnings and Profits Limitation*

The deficit rules act independently of the current earnings and profits limitation; they reduce the shareholder's subpart F inclusion regardless of whether the corporation's subpart F income is reduced by the current earnings and profits limitation. Furthermore, a qualified deficit reduces the shareholder's subpart F inclusion, even if the corporation's current earnings and profits exceed the sum of its current subpart F income and any deficit in its accumulated earnings and profits. The current earnings and profits limitation focuses on losses incurred by the controlled foreign corporation outside its tax haven operations. The deficit rules, on the other hand, focus on losses incurred within tax haven operations. Finally, whereas the limitation concerns the corporation's losses contemporaneous with its tax haven income, the primary deficit rule addresses the losses that precede the corporation's current tax haven income.

The Code does not truly specify the order of application of the deficit rules and the current earnings and profits limitation. Instead, it merely implies that one should apply the primary deficit rule after the current earnings and profits limitation. The deficit rule reduces the shareholder's inclusion, which presup-

100. *Id.*
101. *Id.*
102. I.R.C. § 952(c)(1)(B)(ii), (C)(i) (2000).

poses prior application of all limitations of the controlled foreign corporation's subpart F income. But the Code also requires that the controlled foreign corporation, rather than the shareholder, apply the secondary deficit rule after application of the primary rule. (Treasury Regulation section 1.954-1(a)(5) calls for application of the primary deficit rule when computing the controlled foreign corporation's subpart F income. The regulation postdates the addition of the primary and secondary deficit rules to Code section 952(c).)

The order of application makes a difference. Consider the controlled foreign corporation with current-year net foreign base company oil-related income of $1000, current earnings and profits of $700 reflecting losses in its other operations, and a deficit of $400 in past years from its foreign base company oil-related operations. Does its adjusted net foreign base company income equal $300 or $600? If the corporation must first offset its current foreign base company oil-related income with the deficit attributable to its past foreign base company oil-related activity, and then apply the current earnings and profits limitation, its adjusted net foreign base company income equals $600. On the other hand, if the corporation must first apply the limitation and then the offset, its adjusted net foreign base company income equals $300. The $600 figure should be the correct answer. The corporation has derived tax haven income of $600 over the years, and the amount of its current earnings and profits justifies conceptualizing the entire amount as a current dividend (of sorts) to the United States shareholder.

Thus, the appropriate order of application seems to consist of a reduction in the corporation's subpart F income by application of the deficit rules, and then by the application of the current earnings and profits limitation. No regulations have yet been promulgated for the deficit rules. When promulgated, however, the regulations should reflect this order of application.

> RECOMMENDATION FIVE: Provide in regulations under Code section 952(c)(1)(B) and (C) that the controlled foreign corporation's net foreign base company income is to be reduced first by the application of the rule given in Code section 952(c)(1)(B), then by the application of the rule given in Code section 952(c)(1)(C) if the corporation elects to use that rule, and then by the application of the limitation given in Code section 952(c)(1)(A).

B. Current Earnings and Profits Limitation

The deficit rules take into account losses that a controlled foreign corporation incurs in its tax haven operations. The current earnings and profits limitation, on the other hand, concerns losses incurred by a controlled foreign corporation in its non-tax haven operations. The limitation restricts a controlled foreign corporation's subpart F income, which includes its foreign base company income, to the corporation's earnings and profits for the current tax year.[103] To the extent the controlled foreign corporation has incurred losses in its non-tax haven operations during the current year, the losses reduce the corpo-

103. I.R.C. § 952(c)(1)(A) (2000).

ration's overall earnings and profits below the level of the earnings and profits attributable to its tax haven operations.

Under the limitation, the Code treats a subpart F inclusion as if it were a dividend distributed by the controlled foreign corporation to its United States shareholders. Since the Code treats an actual distribution by a corporation to its shareholders as a dividend for tax purposes only to the extent of the corporation's earnings and profits,[104] the earnings and profits limitation on subpart F income defines the deemed dividend under subpart F. As with a number of subpart F features, the correlation between a subpart F inclusion and a dividend is imprecise, and the pairing only serves as a general analogy.[105]

Should we allow losses from non-tax haven operations to offset the controlled foreign corporation's earnings from its tax haven operations? If the goal of subpart F is to suppress tax haven operations, the limitation does not make sense. The Code should tax a controlled foreign corporation's earnings from tax haven operations regardless of the corporation's overall profitability. On the other hand, if subpart F simply attempts to remove the benefit of tax deferral from legitimate activities and to tax United States shareholders currently on the income available for repatriation, the limitation makes more sense. Of course, subpart F has multiple and conflicting purposes, reflecting its legislative history. The subpart arguably serves three purposes: (1) to suppress foreign base company sales and services income, (2) to tax currently, but not suppress, foreign base company shipping and oil-related income, and (3) to treat foreign personal holding company income as a frequently legitimate type of revenue subject to manipulation as to source.

Even if the limitation makes sense on the basis of taxing earnings available for repatriation, the Code should expand the limitation to reflect a controlled foreign corporation's potential distribution of dividends from accumulated earnings and profits. Accumulated earnings and profits not previously taxed to the United States shareholder are attributable to profitable non-tax haven operations in past years. The Code should add those earnings to the corporation's current earnings and profits for purposes of the limitation. Because the limitation does not take accumulated earnings and profits into account, it gives an incentive to United States shareholders, in any year in which the controlled foreign corporation incurs losses in its non-tax haven operations, to route foreign base company sales and services transactions through the corporation in order to generate foreign base company sales and services income up to the amount of the loss.

I recommend retaining the limitation, but expanding the pool of earnings and profits available to cover a subpart F inclusion to the controlled foreign corporation's accumulated earnings and profits. At the same time, we should preserve the possibility of a nimble subpart F inclusion; that is, a subpart F inclusion covered by the corporation's current earnings and profits even when

104. *See* I.R.C. § 316(a) (2000).

105. For some of the differences between a constructive dividend and a subpart F inclusion, see AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 214-21 (1987).

the corporation has a deficit in its accumulated earnings and profits in excess of its current earnings and profits.

> RECOMMENDATION SIX: Amend Code section 952(c)(1) to provide that a subpart F inclusion shall be limited to the sum of the controlled foreign corporation's current earnings and profits plus the positive balance, if any, of its accumulated earnings and profits.

For purposes of the limitation, the Code calculates the earnings and profits of the controlled foreign corporation in much the same way as the earnings and profits of a domestic corporation. The taxpayer must then make adjustments to take into account matters distinctive to subpart F and to prevent double taxation by the United States of items within the controlled foreign corporation's income. I take these matters up below.

1. Defining Current Earnings and Profits

Calculation of the earnings and profits of a controlled foreign corporation resembles the calculation of the earnings and profits of a domestic corporation.[106] In computing earnings and profits for purposes of subpart F, the Code relieves controlled foreign corporations of several requirements incumbent upon domestic corporations.[107] As with domestic corporations, controlled foreign corporations compute their current earnings and profits without regard to distributions made to shareholders during the year.[108] The controlled foreign corpo-

106. I.R.C. § 964(a) (2000). The regulations specify the various changes the controlled foreign corporation must make to its book accounting principles and tax accounting standards to calculate its earnings and profits. The regulations also detail the manner and effect of making tax elections on behalf of the controlled foreign corporation. *See* Treas. Reg. §§ 1.964-1(a), (b), (c) (2000); Temp. Treas. Reg. § 1.964-1T(g) (2000). In the event the branch rule of Code section 954(d)(2) treats a branch of the controlled foreign corporation as a separate corporation, the branch and the remainder of the controlled foreign corporation reunite into a single entity for purposes of the current earnings and profits limitation. Treas. Reg. § 1.954-3(b)(3) (2000). For a methodology for computing a controlled foreign corporation's earnings and profits, see Mark A. Kramer, *Calculating Earnings and Profits Under Code Section 964*, 26 INT'L TAX J. 1, 11-16 (2000).

107. Most controlled foreign corporations need not compute their earnings and profits on the assumption of straight-line depreciation. *See* I.R.C. §§ 312(k)(4), 964(a) (2000). Corporations that derive 20% or more of their gross income from sources within the United States are the exception to the rule. *See* I.R.C. § 312(k)(4) (2000). Unlike domestic corporations, controlled foreign corporations may generally calculate their earnings and profits without regard to changes in their LIFO recapture amounts. Additionally, they may use the installment and completed contract methods for recording income. I.R.C. §§ 312(n)(4), (5), (6), 952(c)(3) (2000). To the extent the three alternative calculation methods increase the controlled foreign corporation's earnings and profits by an amount previously distributed by the corporation to its shareholders, the corporation may not use them. I.R.C. § 952(c)(3) (2000).

108. *Compare* I.R.C. § 316(a)(2) (2000) (computing a domestic corporation's earnings and profits without diminution for distributions made during the taxable year) *with* Treas. Reg. § 1.952-1(c)(1) (2000) (computing a controlled foreign corporation's earnings and profits without diminution for distributions made during the taxable year). The similarity in treatment of a domestic corporation and a controlled foreign corporation seems puzzling at first sight. Surely, one might think, a distribution made to a United States shareholder by a controlled foreign corporation ought to reduce any subpart F inclusion of the shareholder. Both the distribution and the subpart F inclusion, one might reason, are included in the United States shareholder's gross income. Thus, preserving the appearance of identical treatment for domestic and foreign corporations would apparently result in double taxation of the United States shareholder by the United States. The puzzle is solved by Code section 959(a). The section excludes a distribution from a United States shareholder's gross income

ration cannot reduce its earnings and profits by the amount of any bribes constituting subpart F income.[109] Nor may a controlled foreign corporation reduce its earnings and profits by the amount of foreign income taxes it pays.[110] A controlled foreign corporation computes its earnings and profits in its functional currency, translating the earnings and profits into United States dollars only when it must take the earnings and profits into account for purposes of determining a United States shareholder's tax (*i.e.*, when it uses the earnings and profits to calculate the limitation on the controlled foreign corporation's subpart F income).[111]

The controlled foreign corporation may not reduce its earnings and profits by the amount of its highly taxed income excluded from its foreign base company income by Code section 954(b)(4). If not for the requirement that the taxpayer apply the earnings and profits limitation to the corporation's foreign base company income prior to the application of the high-tax exclusion, the failure to deduct the highly taxed income might lead to the substitution in the subpart F inclusion of an equal amount of income otherwise excluded by the earnings and profits limitation.[112]

2. *Adjustments to Current Earnings and Profits*

Once the controlled foreign corporation has calculated its current earnings and profits, it must reduce them by blocked income and increase them by distributions received from other controlled foreign corporations excluded from the recipient's gross income by Code section 959(b).

a. *Blocked Income*

Currency or other restrictions imposed by a foreign country may prevent the controlled foreign corporation from distributing earnings and profits to its U.S. shareholders. For purposes of the earnings and profits limitation, the corporation must reduce its current earnings and profits by the amount of such

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to the extent the distribution is made out of a controlled foreign corporation's subpart F income previously taxed to the United States shareholder. Despite the exclusion provided by section 959(a), the United States shareholder may recognize a foreign exchange gain or loss at the time of the actual distribution due to a fluctuation in exchange rate between the time of the taxable inclusion and the actual distribution. The Code characterizes the gain or loss as ordinary and treats it as having the same source as the taxable income inclusion. I.R.C. § 986(c)(1) (2000).

109. *See* I.R.C. §§ 952(a), 964(a) (2000).

110. *See* Treas. Reg. § 1.954-1(d)(7)(ii) (2000).

111. I.R.C. § 986(b) (2000). The controlled foreign corporation must use the averaged exchange rate for its taxable year. I.R.C. § 989(b)(3) (2000). The appropriate exchange rate for an inclusion under Code section 951(a)(1)(B), which governs an investment in United States property as described in Code section 956, is the spot rate on the last day of the controlled foreign corporation's taxable year. I.R.C. § 989(b) (2000).

112. *See* Treas. Reg. §§ 1.952-1(e)(4), 1.954-1(a)(5), 1.954-1(d)(4)(ii) (2000). Note, too, that the earnings and profits limitation applies to all kinds of subpart F income, while the high-tax exclusion applies to only two kinds (namely, foreign base company income and insurance income). Hence, the computation of adjusted net foreign base company income must await the application of the earnings and profits limitation across all kinds of subpart F income.

blocked earnings and profits.[113] The controlled foreign corporation does not need to be a first-tier subsidiary of the United States shareholder. The shareholder may hold its stock in the corporation indirectly, via a shareholding in an intermediate foreign corporation.[114] According to the Code, *any* foreign country may impose the legal restrictions that block the distribution of the earnings and profits to the United States shareholder of a controlled foreign corporation.[115] As a result, a currency restriction imposed by a foreign country on distributions made by a corporation intermediate between the controlled foreign corporation and its United States shareholder would satisfy the statutory provision.[116]

A foreign currency restriction might not consist of an outright ban on currency conversions. Some restrictions take the form of a licensing requirement, with requests for licenses being refused when the nation's central bank needs to conserve its foreign currency reserves. To qualify under the restriction, the controlled foreign corporation must demonstrate that it sought a license, and that the government turned down its request.[117] Thus, a controlled foreign corporation that has no intention of making a distribution and does not apply for a license to convert currency into United States dollars causes its United States shareholder

113. I.R.C. §964(b) (2000). The restriction must generally consist of either a restriction on the conversion of foreign currency into United States dollars or a ban on the distribution of dividends. Treas. Reg. § 1.964-2(b)(2) (2000). The relevant period for testing whether a restriction exists is the last ninety days of each tax year and the first sixty days of the following tax year. Treas. Reg. § 1.964-2(b)(1) (2000). The regulations will ignore a currency restriction unless it is accompanied by a ban on the export of property of a type normally owned by the controlled foreign corporation for use in its business and readily converted into United States currency. Treas. Reg. § 1.964-2(b)(3) (2000). Furthermore, the regulations will ignore a currency restriction if a conversion into United States dollars occurs, despite the legal restriction. Treas. Reg. § 1.964-2(c)(2)(ii) (2000). Finally, the regulations will ignore restrictions imposed voluntarily. Treas. Reg. § 1.964-2(b)(4) (2000).

Voluntary restrictions include the restriction created by the payment of a stock dividend that reduces the corporation's earnings and profits. *Id.* (A stock dividend unaccompanied by a reduction in the par value of the issuer's stock constitutes an example of such a dividend.) The allocation of earnings and profits to a reserve also creates problems. Although the regulations will not respect an arbitrary reserve, Treas. Reg. § 1.964-2(b)(4) (2000), they will respect a mandatory reserve under foreign law, Treas. Reg. § 1.964-2(b)(5) (2000). They will respect the mandatory reserve only to the extent the year's required increase in the reserve exceeds the controlled foreign corporation's accumulated earnings and profits. Treas. Reg. § 1.964-2(b)(5)(i) (2000). For this purpose, the controlled foreign corporation's accumulated earnings and profits do not include undistributed income already taxed to a United States shareholder under either subpart F or the foreign personal holding company provisions. Treas. Reg. § 1.964-2(b)(5)(ii) (2000).

114. *See* I.R.C. §§ 958(a), 964(b) (2000).

115. *See id.*

116. If the controlled foreign corporation can pay a dividend directly to the United States shareholder (and thus avoid a restriction imposed on the intermediary in the chain of ownership), and if the United States shareholder owns 80% or more of the stock of the controlled foreign corporation either directly, indirectly, or by attribution, the corporation may not treat the earnings and profits as blocked. *See* Treas. Reg. § 1.964-2(b)(2) (2000). For example, a foreign currency restriction might block a first-tier foreign subsidiary from paying a dividend to the United States shareholder. It might not, however, block the first-tier subsidiary from directing a second-tier subsidiary to remit any dividend otherwise payable to the first-tier subsidiary directly to the United States shareholder, in satisfaction of the first-tier subsidiary's obligation to the United States parent. In such a case, the foreign currency restriction would not reduce the second-tier subsidiary's earnings and profits.

117. *See* Treas. Reg. § 1.964-2(b)(6) (2000). If it can demonstrate the futility of such a request, the controlled foreign corporation can refrain from making the application. *Id.*

to have a full inclusion of subpart F income. In contrast, the controlled foreign corporation that intends to make a distribution and seeks such a license, only to have a partial distribution approved, shelters the remainder of the intended distribution from subpart F.[118]

Upon removal of the restriction blocking the distribution of the controlled foreign corporation's earnings and profits, the income of the United States shareholder will include the subpart F income attributable to those earnings and profits.[119]

b. Distributions Received from Other Controlled Foreign Corporations

Any dividend received from another controlled foreign corporation and excluded from the recipient's gross income by Code section 959(b) increases the controlled foreign corporation's earnings and profits.[120] The other corporation pays such a dividend out of earnings and profits attributable to income already taxed to the United States shareholder.[121] The recipient does not necessarily add the dividend to its current earnings and profits. Instead, it must credit the addition to its earnings and profits for the year in which the United States shareholder was taxed on the payor's earnings.[122] The addition retains its character under the groupings of Code section 959(c).[123] Such treatment prevents the imposition of a second United States tax on the U.S. shareholder when the recipient distributes the additional earnings and profits to its own shareholders.

In general, any distribution received from another controlled foreign corporation becomes part of the earnings and profits of the recipient, even if the recipient must exclude the distribution from its gross income.[124] Code section 312(f)(2) provides the two exceptions to the general rule. The first exception applies if the distribution reduces the recipient's basis in the stock with respect to which the distribution is made. The second exception applies if the distribution causes the reallocation of the recipient's basis in such stock between the stock and any property received in the distribution.[125] In either case, the recipient cannot include the distribution in its earnings and profits.

118. *See* Treas. Reg. § 1.964-2(c)(5)(b) (2000).

119. *See* Treas. Reg. § 1.964-2(c)(1)(i) (2000). For purposes of the current earnings and profits limitation, one adds the released earnings and profits to the earnings and profits for the year in which the corporation derived the released earnings and profits. Treas. Reg. § 1.964-2(c)(1)(ii) (2000).

120. *See* Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000). The full amount of the dividend is not included in the controlled foreign corporation's earnings and profits. Instead, the corporation must first subtract the amount of any foreign taxes paid with respect to the distribution. *See* Treas. Reg. § 1.959-3(d) (2000). The foreign taxes include any withholding taxes imposed on the distribution, in addition to any foreign income taxes imposed on the recipient on the basis of residence. *See id.*

121. *See supra* Part I.C for an analysis of the exclusion for certain distributions under Code section 959(b).

122. *See* Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000).

123. *See* Treas. Reg. § 1.959-3(b) (2000).

124. *See* I.R.C. §§ 312(f)(2), 964(a); *see also* Rev. Rul. 86-33, 1986-1 C.B. 287 (stating that a controlled foreign corporation must include a dividend excluded from its gross income by virtue of Treasury Regulation section 1.955A-3(c)(1) in its earnings and profits).

125. I.R.C. §§ 312(f)(2) (2000).

3. *Application of the Limitation*

When the current earnings and profits limitation reduces a controlled foreign corporation's subpart F income, the corporation must allocate the reduction among the various elements of its subpart F income. The limitation comes into play when the corporation incurs losses in its non-tax haven operations. The losses reduce the corporation's overall earnings and profits for the taxable year from its level of earnings and profits based solely on its subpart F income.

The allocation process attempts to reduce the elements of the corporation's subpart F income most closely allied to its losses. More precisely, the process allocates the reduction in a corporation's subpart F income to items of subpart F income derived from operations most similar to the operations creating the losses. The baskets established by the foreign tax credit limitation help determine similarity. The corporation must generally allocate the reduction to items of subpart F income falling within the same baskets as the losses.

Recall that a United States shareholder must allocate its portion of a controlled foreign corporation's subpart F income among the various baskets used to calculate the foreign tax credit limitation.[126] When allocating the reduction in its subpart F income under the current earnings and profits limitation, the controlled foreign corporation anticipates its shareholder's use of the baskets.[127] The application of the limitation is best understood as postulating an identical set of baskets at the level of the controlled foreign corporation. We might refer to those baskets as the "controlled foreign corporation" or "CFC" baskets.

After a preliminary step, the process of allocation proceeds in two stages.

a. *The Preliminary Step: Classifying Baskets*

The controlled foreign corporation begins the process by allocating its subpart F income, calculated prior to the application of the limitation, among the CFC baskets.[128] The corporation then allocates its current earnings and profits among those baskets.[129] It compares the subpart F income in each basket to the current earnings and profits in the basket, classifying the baskets according to the results of the comparison. The first class of basket consists of those without earnings and profits, or even a deficit in earnings and profits.[130] The second class of basket consists of CFC baskets with earnings and profits that are less than the subpart F income in the same baskets.[131] The last class of basket consists of all remaining baskets containing any subpart F income. They have less subpart F income than current earnings and profits.[132]

The allocation of the reduction in the controlled foreign corporation's subpart F income then proceeds in earnest. The first stage of the process requires

126. *See* I.R.C. § 904(d)(1), (3) (2000).
127. *See* Treas. Reg. § 1.952-1(e)(1) (2000).
128. *See id.*
129. *See id.*
130. Treas. Reg. § 1.952-1(e)(1)(i) (2000).
131. Treas. Reg. § 1.952-1(e)(1)(ii) (2000).
132. *See* Treas. Reg. § 1.952-1(e)(1)(iii) (2000).

allocation of the reduction in subpart F income *among* the various CFC baskets. The second stage requires allocation of the reduction *within* each CFC basket affected by the first stage of allocation.

b. First Stage: Allocation Among Baskets

The first stage consists of three possible rounds of allocation. In the first round, the controlled foreign corporation allocates the reduction to the baskets of the first classification.[133] If the subpart F income in the first classification of baskets exceeds the reduction required by the limitation, the corporation prorates the reduction among the baskets of the first classification on the basis of the subpart F income contained in the baskets.[134]

If the subpart F income in the first classification of basket does not fully absorb the reduction required by the limitation, the corporation proceeds to the second round of the first stage. In the second round, the corporation allocates the excess reduction to the second type of basket, to the extent of the subpart F income contained in those baskets.[135] If the amount of subpart F income in the second type of basket exceeds the amount of the required reduction, the corporation prorates the reduction among the baskets on the basis of the subpart F income in each basket. It disregards the amount by which a specific basket's subpart F income exceeds that basket's current earnings and profits.[136] In particular, the reduction in a basket's subpart F income may amount to more than the excess of the basket's subpart F income over the basket's earnings and profits. The second round of allocation may thus leave a basket with less subpart F income than its current earnings and profits.[137]

If the first two classifications of baskets fail to fully absorb the reduction required by the current earnings and profits limitation (meaning no subpart F income remains in any of the baskets of the second classification), the controlled foreign corporation moves to the third round and allocates the remaining reduction to the last kind of CFC basket.[138] Again, if the amount of subpart F income in the baskets of the third classification exceeds the amount of the reduction allocated, the corporation prorates the reduction among the baskets according to the amount of subpart F income in each basket.[139]

133. *See id.*

134. *See id.*

135. *See* Treas. Reg. § 1.952-1(e)(1) (2000).

136. *See id.*

137. During the second round of allocation, the process may leave baskets with less subpart F income than earnings and profits, which would make the baskets identical to those in the third classification. Nevertheless, the corporation does not interrupt the second round to include baskets of the third classification. The allocation process will proceed to baskets of the third classification only if the second round exhausts all of the subpart F income contained in baskets of the second classification.

138. *See* Treas. Reg. § 1.952-1(e)(1) (2000).

139. *See id.*

c. Second Stage: Allocation Within Baskets

The corporation must now allocate the reduction distributed to each CFC basket among the categories of subpart F income within each basket.[140] There are sixteen possible intra-basket categories of subpart F income. They consist of the four categories of subpart F income other than foreign base company income, the four categories of foreign base company income other than foreign personal holding company income, the category of full-inclusion foreign base company income, and the seven categories of foreign personal holding company income.[141] Based upon the amount of subpart F income in each category, the corporation performs a pro rata allocation among the sixteen categories.[142]

The two-stage process ultimately allocates the reduction in subpart F income among specific items of the controlled foreign corporation's income, as those items are defined in Part III.C. Recall that the controlled foreign corporation had to separate its foreign base company income into items of income in preparation for allocating and apportioning its deductions against its foreign base company income. It defined the separate items of income by crossing the baskets of the foreign tax credit limitation with the various kinds of foreign base company income. The application of the current earnings and profits limitation achieves a similar result. By first allocating the necessary reduction among the CFC baskets (which mirror the baskets of the foreign tax credit limitation), and then among the categories of subpart F income within each CFC basket, the process isolates the separate items of income defined in Part III.C. Both the process of allocating deductions and the process of applying the current earnings and profits limitation anticipate the United States shareholder's need to analyze its subpart F inclusion under the foreign tax credit limitation. The need justifies much of the remarkable complexity in the two processes.

C. The Exclusion for Highly-Taxed Income

If a foreign country has imposed a tax on an item of income at an effective rate greater than 90% of the highest marginal rate of the United States corporate income tax, the United States shareholders of a controlled foreign corporation may elect to exclude the item of income from the corporation's net foreign base company income.[143] Items of income that fall within the definition of foreign

140. Treas. Reg. § 1.952-1(e)(2) (2000).

141. Treas. Reg. §§ 1.952-1(e)(2), 1.954-1(c)(1)(iii)(A)(1), (2) (2000). Foreign personal holding company income now includes seven categories, rather than the five categories listed in Treasury Regulation section 1.954-1(c)(1)(iii)(A)(1) (2000). *See supra* note 47, regarding the amendment of Code section 954(c) by The Taxpayer Relief Act of 1997.

142. *See* Treas. Reg. § 1.952-1(e)(2) (2000). Thus, the process treats the sixteen intra-basket categories as equal in rank. That is, one does *not* first prorate among the five divisions of subpart F income, then prorate the reduction allocated to foreign base company income among its five subdivisions, and then prorate the reduction allocated to foreign personal holding company income among its seven subdivisions. The corporation prorates the entire reduction allocated to a CFC basket just once among the sixteen categories of subpart F income.

143. *See* Treas. Reg. § 1.954-1(d)(1) (2000). The effective rate of foreign taxation is determined by reference to the amount of foreign taxes that would be deemed paid with regard to the item of income by the United States foreign tax credit if the item were taxed to the corporation's United

base company oil-related income, however, are not eligible for the election.[144] Nor is portfolio interest within the meaning of Code section 881(c).[145] Although the exclusion is not available for highly-taxed items of foreign base company oil-related income or portfolio interest, it is unlikely that such highly-taxed items will attract substantial U.S. tax for the United States shareholders. When the items are included in the shareholders' income, the United States foreign tax credit will minimize the United States tax levied upon them.[146]

Shareholders may elect to exclude highly-taxed income on an item-by-item basis, with the exception of highly-taxed passive foreign personal holding company income.[147] They must make the election with regard to all such income or none of it.[148] When they make the election on the basis of individual items of income, the items are defined in the same manner as they are for allocating and apportioning the controlled foreign corporation's deductions.[149] As a result, even when shareholders make the election on the basis of individual items of income, a certain blending of foreign tax rates may occur. The blending takes place when those items consist of composites of income arising from a number of separate transactions.[150]

States shareholders. *See* Treas. Reg. § 1.954-1(d)(3) (2000). For purposes of the computation, the foreign tax credit limitation is ignored, except with regard to any foreign personal holding company income that falls within the passive basket of the limitation; for those items of income, the amount of foreign taxes deemed paid is adjusted to the amount taken into account for purposes of applying the high-tax kickout from the passive basket of the foreign tax credit limitation. *Compare* Treas. Reg. § 1.954-1(d)(3)(i) (2000) (concerning the treatment of income other than passive foreign personal holding company income) *with* Treas. Reg. § 1.954-1(d)(3)(ii) (concerning the treatment of passive foreign personal holding company income). The amount of foreign taxes so calculated is not reduced by a subsequent reduction in the actual foreign tax arising from a distribution by the controlled foreign corporation of earnings attributable to the item of income. Treas. Reg. § 1.954-1(d)(3)(i) (2000). Hence, the computation of the foreign tax paid ignores the effect of a foreign country's integration of its corporate and individual income taxes via a reduction in corporate tax upon a distribution of corporate earnings. In the event of a distribution, the effective rate of foreign tax is determined separately for each corporation in the chain of distribution. Treas. Reg. § 1.954-1(d)(2) (2000). The foreign tax base for the computation is increased by the amount of foreign taxes deemed paid with regard to the item of income, rather than by the amount actually paid or accrued under foreign tax principles. Treas. Reg. § 1.954-1(d)(2)(ii) (2000).

144. I.R.C. § 954(b)(4) (2000).

145. Treas. Reg. § 1.954-1(d)(1) (2000). This regulatory provision appears to lack statutory authority. Perhaps the regulation's rationale lies in the United States' failure to tax portfolio interest to the controlled foreign corporation. The drafters of the provision may have concluded that the income should not receive the additional benefit of the deferral of shareholder taxation. *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 223 (1987). In the context of the high-tax kickout, however, such reasoning seems misplaced. The required high rate of foreign tax substantially assures that the United States shareholder has not received the benefit of deferring U.S. income tax. The U.S. foreign tax credit will absorb almost all of the U.S. tax otherwise due on the income.

146. *See* I.R.C. § 960(a)(1) (2000).

147. *Compare* Treas. Reg. § 1.954-1(d)(1) (2000) (referring to individual items of income) *with* Treas. Reg. § 1.954-1(d)(4)(i) (2000) (requiring the aggregation of passive foreign personal holding income).

148. Treas. Reg. § 1.954-1(d)(4)(i) (2000).

149. *See* Treas. Reg. § 1.954-1(d)(1) (2000). *See supra* Part III.C for the definition of items of income used to allocate and apportion the controlled foreign corporation's deductions.

150. A limited blending of foreign tax rates may also occur by virtue of the requirement that one use the Code section 960 rules to determine the effective rate of foreign taxation. *See* Treas.

1. *Coordinating the Exclusion with Other Rules*

We determine the effective rate of foreign tax after applying the current-year earnings and profits limitation.[151] The limitation may reduce the amount of a specific item of income, but will not reduce the amount of foreign tax paid with regard to that item; hence, the limitation indirectly increases the rate of foreign tax borne by the now-reduced item of income.[152] Furthermore, the workings of the high-tax exclusion may override the full-inclusion rule. If a high-tax election excludes net foreign base company income attributable to more than 90% of a controlled foreign corporation's adjusted gross foreign base company income (as measured prior to the application of the full-inclusion rule), the regulations suspend the operation of the full-inclusion rule.[153]

2. *The Exclusion and the Foreign Tax Credit*

Although the availability of the foreign tax credit may seem to make the high-tax exclusion redundant, the high-tax exclusion gives the United States shareholder greater flexibility in its foreign tax credit planning. The exclusion avoids a loss of foreign tax credit when the foreign tax credit limitation prevents the crediting of the foreign tax assessed on the highly taxed item of income. It permits the United States shareholder to defer the foreign tax credit until the controlled foreign corporation makes a distribution. Ideally, the corporation will make the distribution at a time when the foreign tax credit limitation favors the shareholder. The high-tax exclusion may also benefit the United States shareholder by separating, for purposes of the foreign tax credit limitation, items of income from several controlled foreign corporations. It can thus prevent the undesirable blending of income.

D. *Current Earnings and Profits Recharacterized as Inclusions*

If a controlled foreign corporation must reduce its subpart F income by the current earnings and profits limitation, it will recapture the foregone subpart F income in subsequent years, when the corporation's current earnings and profits exceed the corporation's current subpart F income.[154] Recaptured amounts are not subject to the *de minimis*, full-inclusion, or high-tax rules.[155] We therefore

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Reg. § 1.954-1(d)(3) (2000). The rules include the pooling of foreign taxes over a multi-year period, but they remain subject to the separate-baskets requirement of the foreign tax credit. *See* I.R.C. §§ 902(a), (c)(2), 904(d)(1), 960(a)(1) (2000).

151. *See* Treas. Reg. § 1.954-1(d)(4)(ii) (2000).

152. *See* Treas. Reg. § 1.954-1(d)(4)(iii) (2000).

153. *See* Treas. Reg. § 1.954-1(d)(6), (7)(ii) (2000). The controlled foreign corporation may use its adjusted gross insurance company income in conjunction with its adjusted gross foreign base company income to meet the more-than-ninety-percent test.

154. I.R.C. § 952(c)(2) (2000). The current earnings and profits subject to recharacterization include earnings and profits attributable to income that would fall within subpart F income but for the operation of the *de minimis* rule. *See* Treas. Reg. § 1.954-1(a)(7) (2000). The controlled foreign corporation's full-inclusion income in past years does not reduce the corporation's recharacterization requirement. Treas. Reg. § 1.954-1(b)(3) (2000).

155. *See* Treas. Reg. § 1.954-1(a)(7) (2000).

apply the high-tax rule before recharacterizing any surplus current-year earnings and profits as subpart F income.

1. Allocating the Recaptured Amount

When the current earnings and profits limitation reduces a controlled foreign corporation's subpart F income, the amount of the reduction in each item of income reduced by the limitation becomes a recapture account.[156] The items of income consist of those defined for purposes of allocating and apportioning the corporation's deductions.[157] When the corporation generates a surplus in its current earnings and profits over its current subpart F income, it must complete a pro rata allocation of the surplus amount among its recapture accounts.[158] The proration of the recaptured amount can thus produce small amounts of recapture over a large number of recapture accounts. The recaptured amounts become subpart F income for the United States shareholder and retain their separate categorizations in the hands of the shareholder.[159]

2. Effect of Distributions on Recapture Accounts

Distributions made by the controlled foreign corporation may reduce the amounts held in recapture accounts.[160] When Code section 959(c)(3) deems a distribution to be made out of earnings and profits not yet taxed to a United States shareholder, the distribution is deemed to be made first out of the amounts held in recapture accounts, and then out of the corporation's earnings and profits.[161] To the extent the distribution is deemed to be made out of recapture accounts, the corporation and its United States shareholders must prorate the distribution among those accounts.[162]

In a year in which the controlled foreign corporation generates a surplus of current earnings and profits over its current subpart F income and makes a distribution to its shareholders, recapture of the subpart F income occurs before the analysis of the distribution.[163] The recaptured amounts—now taxed to United States shareholders as subpart F income—subsequently fall within Code section 959(c)(2). They are then deemed distributed before any of the controlled foreign corporation's earnings and profits described by Code section 959(c)(3).[164] As a result, the Code still requires distribution of suspended amounts before distribution of earnings and profits not yet taxed to United States shareholders.

156. *See* Treas. Reg. § 1.952-1(f)(2)(i) (2000). *See supra* Part IV.B.3 for the allocation among a controlled foreign corporation's items of income of a reduction in its subpart F income due to the current earnings and profits limitation.

157. *See* Treas. Reg. § 1.952-1(f)(2)(i) (2000). *See supra* Part III.C for an analysis of a controlled foreign corporation's items of income. Such items do not arise from individual transactions, but instead consist of aggregates of income falling within certain groupings.

158. *See* Treas. Reg. § 1.952-1(f)(2)(ii) (2000).

159. *See id.*

160. Treas. Reg. § 1.952-1(f)(2)(iii) (2000).

161. Treas. Reg. § 1.952-1(f)(3)(ii) (2000).

162. *Id.*

163. Treas. Reg. § 1.952-1(f)(3)(i) (2000).

164. *See* I.R.C. § 959(c) (2000).

Before crediting the suspended amounts to the distribution, however, the corporation must first recapture the amounts, and the Code must tax those amounts to the United States shareholders.

V.
CONCLUDING OBSERVATIONS AND SUMMARY OF RECOMMENDATIONS

The activities of a controlled foreign corporation that give rise to foreign base company income do not necessarily exhaust the corporation's activities. To calculate foreign base company income, the Code in effect creates a synthetic entity within the confines of the controlled foreign corporation. It then measures the synthetic entity's net income. To facilitate the process, the Code provides for a number of exclusions, deductions, and limitations on foreign base company income. Some of the adjustments measure the difference in identity between the synthetic persona and the controlled foreign corporation. If the difference is slight, the Code enlarges the synthetic persona, and the persona completely displaces the actual entity (the full-inclusion rule). If the difference is great enough, the synthetic persona drops away (the *de minimis* rule).

Other adjustments isolate the synthetic entity's net income arising from the controlled foreign corporation's activities. The adjustments occur in three steps. First, the Code allocates and apportions the deductions of the controlled foreign corporation between the entity's tax haven operations and its other operations. The Code also bounds the tax affairs of the synthetic persona by a key determinant of the actual entity—the current earnings-and-profits limitation. Finally, the Code's high-tax exclusion adjusts the boundary between the controlled foreign corporation and its synthetic persona. It does so by ending the tax-haven analysis of items of net income for which the effective tax rate in the foreign jurisdiction proves substantially the same as the effective tax rate in the United States.

In this article, I have recommended six changes in the law governing the taxation of the United States shareholders of controlled foreign corporations. RECOMMENDATION ONE generalizes the language of Code section 952(b) to improve the coordination of the corporate and shareholder levels of U.S. taxation of the controlled foreign corporation's income. RECOMMENDATION TWO amends the regulations concerning the full-inclusion rule to complement the change proposed by Recommendation One. RECOMMENDATION THREE amends the regulations to solve an ordering problem in the allocation and apportionment of deductions simultaneously related to two different kinds of income: adjusted gross foreign base company income that is also same-country insurance income, and adjusted gross foreign base company income that is not same-country insurance income.

Recommendations Four and Five consist of regulations to be promulgated under Code section 952(c)(1)(B) and (C). RECOMMENDATION FOUR provides that no overall deficit in earnings and profits need occur before a controlled foreign corporation becomes subject to the primary deficit rule. It also states that

no overall deficit in the earnings and profits of a related person is required before the controlled foreign corporation may elect the benefit of the secondary deficit rule. RECOMMENDATION FIVE coordinates the application of the deficit rules with the application of the current earnings and profits limitation: the controlled foreign corporation ought to apply the primary deficit rule first, the secondary deficit rule second (if the corporation elects to use it), and the current earnings and profits limitation last. Finally, RECOMMENDATION SIX amends Code section 952(c)(1) to expand the current earnings and profits limitation. That limitation should include the controlled foreign corporation's accumulated earnings and profits as a measure of the permissible income inclusion for the corporation's United States shareholders.