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CONTENTS

Articles

PRECEDENT AND PRINCIPLES OF WTO PANEL JURISPRUDENCE
Adrian T. Chua 171

ON THE GROWTH OF THE ANTITRUST IDEA
Lawrence A. Sullivan & Wolfgang Fikentscher 197

IMMIGRATION CHALLENGES AND OPPORTUNITIES IN A POST-TRANSITION CUBA
Matias F. Travieso-Diaz 234

SOURCES OF FUNDS AND RISK MANAGEMENT FOR INTERNATIONAL ENERGY PROJECTS
David Blumental 267

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Adrian T. Chua

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Precedent and Principles of WTO Panel Jurisprudence

By
Adrian T. L. Chua*

ABSTRACT

The central pillar of the GATT/WTO multilateral trading system is the dispute settlement mechanism codified in the WTO Agreement. However, forty-five years after the adoption of the first GATT panel report, the legal status of GATT interpretations underlying panel decisions remains controversial. In light of the substitution of legal for political legitimacy in the Dispute Settlement Understanding, this issue has assumed importance for the credibility of the WTO system. This paper examines these implications and addresses the legal status of panel interpretations from constitutional, political and practical perspectives. It illustrates the legal effect of panel decisions with a critical analysis of the panel-created competitive conditions principle and its related rules.

I. INTRODUCTION

The central pillar of the WTO multilateral trading system and its "most individual contribution"[1] is the dispute settlement mechanism contained in the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU").[2] The DSU does not simply codify the dispute settlement procedures under the General Agreement on Tariffs and Trade ("GATT") regime, but represents a significant shift to a rule-based model of dispute settlement.[3] It estab-

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1. Renato Ruggiero, WTO Director-General, *WTO, Settling Disputes* (visited Dec. 29, 1997) <http://www.wto.org/wto/about/dispute1.htm>. *See also* Brett Albren, *The Continued Need for a Narrowly-Tailored, Rule-Based Dispute Resolution Mechanism in Future Free Trade Agreements*, 20 SUFFOLK TRANSNAT'L L.J. 85, 106 (1996).

2. Dec. 15, 1993, 33 I.L.M. 112 (1994). The DSU is incorporated into the WTO Agreement through its inclusion in Annex 2.

3. The DSU reforms have received extensive discussion in the literature. For a detailed description, see Kenneth Abbott, *The Uruguay Round and Dispute Resolution: Building a Private-Interests System of Justice*, 1992 COLUM. BUS. L. REV. 111 (1992); Ivo van Bael, *The GATT Dispute Settlement Procedure*, 22 J. WORLD TRADE 67 (1988); Eric Canal-Forgues & Rudolf Ostrihansky, *New Developments in the GATT Dispute Settlement Procedures*, 24 J. WORLD TRADE 67 (1990); Norio Komuro, *The WTO Dispute Settlement Mechanism: Coverage and Procedures of the WTO Understanding*, 12 J. INT'L ARB. 81 (1995); Miquel Mora, *A GATT With Teeth: Law Wins Over Politics in the Resolution of International Trade Disputes*, 31 COLUM. J. TRANSNAT'L L. 103 (1993); Debra Steger, *WTO Dispute Settlement: Revitalization of Multilateralism After the Uruguay Round*, 9 LEIDEN J. INT'L L. 319 (1996); Kendall Stiles, *The New WTO Regime: The Victory of Pragmatism*,

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lishes a right to be heard by an independently constituted dispute settlement panel,[4] a standing Appellate Body to hear appeals from issues of law,[5] and the automatic adoption[6] and enforcement of panel rulings.[7] The most important element of the dispute settlement mechanism is the compulsory jurisdiction of the dispute settlement panels. The function of the panels is to make an objective determination of the facts and the applicability of the WTO Agreement.[8] Unlike the International Court of Justice which has on average decided one contentious case each year since 1945,[9] GATT dispute settlement panels resolved more than 100 cases between 1947 and 1994.[10] Since the implementation of the DSU in 1995, the WTO has received over 100 trade disputes[11] with 28 cases proceeding to a dispute settlement panel.[12] However, forty-seven years after the adoption of the first GATT panel report,[13] the legal status of GATT interpretations underlying panel decisions remains controversial.[14] This issue has important implications for the functioning of the WTO system. First, for legal principles to be distilled from panel jurisprudence and for such principles to be of utility in future cases, GATT interpretations underlying past panel reports[15] must have some legal effect. Absent some form of legal authority or precedential effect, outcomes of cases would lack consistency and predictability, rendering any study of panel jurisprudence pointless.

More importantly, the objective of the WTO Agreement is to raise standards of living, ensure full employment, and increase real incomes through expanding production and trade in goods and services.[16] This requires certainty

4 J. INT'L L. & PRAC. 3 (1995); Jeffrey Waincymer, *GATT Dispute Settlement: An Agenda for Evaluation and Reform*, 14 N.C.J. INT'L L. & COM. REG. 81 (1989); Michael Young, *Dispute Resolution in the Uruguay Round: Lawyers Triumph Over Diplomats*, 29 INT'L LAW. 389 (1995).

4. DSU art 6.

5. DSU art. 17.

6. DSU art. 16.

7. DSU art. 22.

8. DSU art. 11.1.

9. Between 1946 and 1997, the International Court of Justice heard 63 contentious cases, which is an average of 1.2 cases a year.

10. Panels within the framework of GATT are listed in WTO, ANALYTICAL INDEX: GUIDE TO GATT LAW AND PRACTICE 772-787 (1995). The GATT dispute settlement process has become the most widely used dispute settlement mechanism between states. *See* Mora, *supra* note 3, at 105; Ernst-Ulrich Petersmann, *Settlement of International and National Trade Disputes Through the GATT: The Case of Anti-Dumping Law*, *in* ADJUDICATION OF INTERNATIONAL TRADE DISPUTES IN INTERNATIONAL AND ECONOMIC LAW 77, 88 (Ernst-Ulrich Petersmann et al. eds., 1992).

11. *Disputes Reach Century Mark*, WTO FOCUS, Aug. 1997, at 1; *Overview of the State-of-Play of WTO Disputes* (visited Dec. 19, 1997) <http://www.wto.org/wto/dispute/bulletin.htm>.

12. Steger, *supra* note 3, at 331.

13. The first reported panel report was *Complaint by Norway concerning the Treatment by Germany of Imports of Sardines*, Oct. 31, 1952, GATT B.I.S.D. (1st Supp.) at 30. Before that, working parties were used to resolve disputes.

14. Adrian Chua, *The Precedential Effect of WTO Panel and Appellate Body Reports*, 11 LEIDEN J. INT'L L. 45 (1998); John Jackson, *The Legal Meaning of a GATT Dispute Settlement Report: Some Reflections*, *in* TOWARDS MORE EFFECTIVE SUPERVISION BY INTERNATIONAL ORGANIZATIONS 149 (Neils Blokker & Sam Muller eds., 1994); Mora, *supra* note 3, at 162.

15. In this paper, a reference to panels or panel reports includes a reference to the Appellate Body and Appellate Body reports respectively.

16. Preamble to the WTO Agreement, Dec. 15, 1993, 33 I.L.M. 13 (1994).

and predictability to allow entrepreneurs to make efficient investment and market development decisions.[17] In this regard, the dispute settlement system "is a central element in providing security and predictability to the multilateral trading system."[18] It has long been recognized[19] that the rationale for a tribunal following its previous decisions is that it "makes for certainty and stability, which are of the essence of the orderly administration of justice."[20] If the WTO Agreement is interpreted in an *ad hoc* way, without regard to previous decisions, uncertainty will arise as to whether government policies are inconsistent with the WTO Agreement. Such uncertainty will deprive panel reports of the practical value desired by contracting parties,[21] and impair the achievement of GATT/WTO objectives. On the other hand, a general recognition of the persuasive force of previously adopted panel reports will result in "the development of a comprehensive body of law which . . . can be used not only as direct evidence of specific rules of law . . . but also as indicative of the method and the spirit in which" future cases might be resolved.[22] Hence, the objectives of the GATT/WTO multilateral trading system require that panels follow their previous decisions unless there is good reason to do otherwise.

This argument is supported by the substitution of legal for political legitimacy in the dispute settlement process. The success of such a rule-based system requires that panels and the Appellate Body produce a jurisprudence that is legally credible and commands the respect of WTO members.[23] It is a fundamental principle of the administration of justice in most legal systems that like cases be decided consistently.[24] Legal credibility can hardly be achieved if judicial decisions are inconsistent, affronting even the most elementary sense of justice. Following previously adopted reports unless there is good reason to do otherwise[25] contributes to legal credibility by avoiding the appearance of excess judi-

17. U.S. Manufacturing Clause, May 15/16, 1984, GATT B.I.S.D. (31st Supp.) at 74, para. 39; Japan – Measures on Imports of Leather, May 15/16, 1984, GATT B.I.S.D. (31st Supp.) at 94, para. 55; EEC – Panel on Newsprint, Nov. 20, 1984, GATT B.I.S.D. (31st Supp.) at 114, para. 52; Norway – Restrictions on Imports of Apples and Pears, June 21, 1989, GATT B.I.S.D. (36th Supp.) at 306, para. 5.6; Japan – Taxes on Alcoholic Beverages, Appellate Body Report, Nov. 1, 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, 34; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, issued Nov. 25, 1997, WT/DS56/R, para. 6.29; ROBERT HUDEC, ENFORCING INTERNATIONAL TRADE LAW: THE EVOLUTION OF THE MODERN GATT LEGAL SYSTEM 261 (1993); John Jackson, *The Birth of the GATT-MTN System: A Constitutional Appraisal*, 12 LAW & POL'Y INT'L BUS. 21, 26 (1980); Jackson, *The Legal Meaning of a GATT Dispute Settlement Report*, *supra* note 14, at 152; Mora, *supra* note 3, at 129.

18. DSU art. 3.2.

19. RUPERT CROSS & J.W. HARRIS, PRECEDENT IN ENGLISH LAW 11 (1991); Alan Goodhart, *Precedent in English and Continental Law*, 50 L.Q. REV. 40, 58 (1934); MOHAMED SHAHABUDDEEN, PRECEDENT IN THE WORLD COURT 40 (1996).

20. HERSCH LAUTERPACHT, THE DEVELOPMENT OF INTERNATIONAL LAW BY THE INTERNATIONAL COURT 14 (1958).

21. See statements of delegates in Section III.

22. LAUTERPACHT, *supra* note 20, at 18.

23. Chua, *supra* note 14, at 46.

24. SHAHABUDDEEN, *supra* note 19, at 41.

25. U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, Oct. 4, 1994, DS44/R, para. 81.

cial discretion which may be perceived as an *ex post* rationalization for a conclusion influenced by *realpolitik* considerations.

In light of this, two questions arise: can and do panel decisions have legal effect beyond the dispute in question? The paper examines the legal effect of panel reports at three levels. Section II looks at the status of panel reports in light of the nature and sources of panel jurisdiction. Section III examines the attitudes of the contracting parties about the legal effect of panel reports. Turning from the constitutional and political levels to panel practice, Section IV analyzes the approach of panels to previously adopted reports. Section V develops the principle of subsequent practice as a legal basis for the precedential effect of panel reports. Finally, the legal effect of panel interpretations is illustrated in Sections VI and VII with a critical analysis of the panel-created competitive conditions principle and its related rules.

II.
THE LEGAL STATUS OF PANEL AND APPELLATE BODY REPORTS

A. Panel Jurisdiction Under the WTO Agreement

Under the WTO Agreement, Article IX:2 confers on the Ministerial Conference and the General Council exclusive authority to adopt interpretations of the GATT. Further, under Article 3.9 of the DSU, nothing in the dispute settlement procedures prejudices the rights of parties to seek authoritative interpretations of the GATT through Article IX:2. Since such an exclusive authority has been established so specifically, the inference is that such authority does not exist by implication or inadvertence elsewhere.[26] The fact that the power to adopt authoritative interpretations has been exercised on several occasions supports this argument. A leading example in this regard is the interpretation of "nullification or impairment" under GATT Article XXIII:1(a). Recourse to dispute settlement procedures under Article XXIII:1 depends upon proof that some benefit accruing to the party under the GATT has been "nullified or impaired." In *Uruguayan Recourse to Article XXIII*,[27] the panel noted that where a GATT provision has been breached, that breach constitutes a prima facie nullification or impairment under Article XXIII:1. Subsequent panels have consistently applied the *prima facie* breach principle to Article XXIII:1(a).[28] Thus in *U.S. Tax Legislation (DISC)* and the other three *DISC* cases, panels treated the statement in *Uruguayan Recourse* as "precedent."[29] This principle was codified by the

26. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 13-14.

27. Nov. 16, 1962, GATT B.I.S.D. (11th Supp.) at 95, para. 15.

28. *See, e.g.*, EEC – Program of Minimum Import Prices, Licenses and Surety Deposits for Certain Processed Fruits and Vegetables, Oct. 18, 1978, GATT B.I.S.D. (25th Supp.) at 68, para. 4.20; Norway – Restrictions on Imports of Certain Textile Products, June 18, 1980, GATT B.I.S.D. (27th Supp.) at 119, para. 17; EEC – Restrictions on Imports of Apples from Chile, Nov. 10, 1980, GATT B.I.S.D. (27th Supp.) at 98, para. 4.24; EEC – Imports of Beef from Canada, Mar. 10, 1981, GATT B.I.S.D. (28th Supp.) at 92, para. 4.9; Spain – Tariff Treatment of Unroasted Coffee, June 11, 1981, GATT B.I.S.D. (28th Supp) at 102, para. 4.11.

29. U.S. – Income Tax Legislation, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 98, para. 80; Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 114,

GATT Council in 1979.[30] The concept was also included in Article 3.8 of the DSU which states that "where there is an infringement of the obligations assumed under a covered agreement, the action is considered prima facie to constitute a case of nullification and impairment."

The inquiry into the legal status of panel reasons at the constitutional level does not end with Article IX:2 of the WTO Agreement: Article XVI:1 states that the WTO shall be guided by the decisions and customary practices of the GATT. Similarly, under Article 3.1 of the DSU, members affirm their adherence to the principles applied under Article XXIII (the dispute settlement provision) of the GATT. That the GATT *acquis*[31] is incorporated into the WTO system is supported by the practice of WTO panels relying on principles contained in GATT panel reports.[32] "Indeed, the most striking aspect of the WTO is the extent to which it preserves and consolidates the body of law and practice which has evolved out of the GATT."[33] It is hence necessary to ascertain the nature and source of panel jurisdiction before the WTO Agreement in order to determine the legal status of panel reasons.

B. Panel Jurisdiction Prior to the WTO Agreement

Ascertaining the source of panel jurisdiction before the WTO Agreement is problematic because the constitutional framework[34] for administering the GATT was never adopted. As a result, the GATT did not have a formal organizational constitution but functioned wholly through the customary practice and "deci-

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para. 58; Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 127, para. 45; Income Tax Practices Maintained by the Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 137, para. 45.

30. Understanding on Notification, Consultation, Dispute Settlement and Surveillance; Annex to the 1979 Understanding: Agreed Description of the Customary Practice of the GATT in the Field of Dispute Settlement, Nov. 28, 1979, GATT B.I.S.D. (26th Supp.) at 210, Article 5.

31. The term *acquis*, commonly used in EC law, has found its way into the jurisprudence of the WTO Appellate Body (*See, e.g.*, Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 14; India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, Appellate Body Report, issued Dec. 19, 1997, WT/DS50/AB/R, para. 43). In EC jurisprudence, *acquis communautaire* refers to "the whole body of rules, principles, agreements, declarations, resolutions, positions, opinions, objectives and practices concerning the European Communities . . . whether or not binding in law, which has developed since their establishment and which has been accepted by the Community . . . as governing their activities." Mary Footer, *The Role of Consensus in GATT/WTO Decision-Making*, 17 NW. J. INT'L L. & BUS. 653 (1996-1997).

32. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 14; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.24; India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, Appellate Body Report, *supra* note 17, para. 35.

33. Footer, *supra* note 31, at 653.

34. The International Trade Organization ("ITO") was designed to administer the GATT in 1947. However, it never came into being largely because the U.S. Congress failed to approve the ITO Charter. Between 1948 and the entry into force of the WTO Agreement in 1995, the GATT did not come into force and has operated through the Protocol of Provision Application, 55 U.N.T.S. 308 (1947). The failure of the ITO is documented in KENNETH DAM, THE GATT: LAW AND INTERNATIONAL ECONOMIC ORGANIZATION 10-14 (1970); ROBERT HUDEC, THE GATT LEGAL SYSTEM AND WORLD TRADE DIPLOMACY 59-61 (1990); JOHN JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS 34 (1989).

sions" of the Contracting Parties under Article XXV.[35] Article XXV confers power on representatives of member states meeting as the "Contracting Parties" to take joint action to facilitate the operation of the GATT. This includes the power to establish panels whose function is to assist the Contracting Parties in resolving disputes by recommending appropriate GATT-consistent solutions.[36] In 1960, the Contracting Parties established the Council of Representatives ("the Council") whose responsibilities included examining panel reports and making recommendations on their adoption to the Contracting Parties.[37] In 1968, the Council's authority was expanded to cover the adoption of panel reports.[38] Between 1968 and the entry into force of the WTO Agreement in 1995, panel reports have been adopted by the Council or at the annual Session of the Contracting Parties when this would afford more timely action.[39]

It is therefore apparent that panel reports are recommendatory in nature.[40] A report which has not been adopted by the Council or its successor, the DSB, has no legal status in the GATT/WTO system.[41] Unadopted reports can nevertheless provide guidance as the opinion of experts.[42] Since the DSU, unadopted reports that have yet to be considered by the DSB have significant persuasive value since such reports must be adopted within 60 days of their issuance unless there is a consensus against adoption.[43] Once the Council or DSB has adopted a report, its recommendations become the authoritative determination of the GATT rights and obligations of the parties to the case.[44] However, whether

35. HUDEC, ENFORCING INTERNATIONAL TRADE LAW, *supra* note 17, at 7; Mora, *supra* note 3, at 118.

36. Decision on Procedures Under Article XXIII, Apr. 5, 1966, GATT B.I.S.D. (14th Supp.) at 18, Article 5; Understanding on Notification, Consultation, Dispute Settlement and Surveillance; Annex to the 1979 Understanding: Agreed Description of the Customary Practice of the GATT in the Field of Dispute Settlement, *supra* note 30, Articles 3 and 6(ii); Understanding on Rules and Procedures Governing the Settlement of Disputes, *supra* note 2, Article 11.1.

37. Decision of the Contracting Parties Establishing the Council of Representatives, June 4, 1960, GATT B.I.S.D. (9th Supp.) at 8.

38. Decision of the Contracting Parties, adopted at the Twenty-Fifth Session in 1968, SR.25/9, p. 176-177.

39. WTO, ANALYTICAL INDEX, *supra* note 10, at 761.

40. Indeed, the concluding paragraph of almost every panel report begins with the phrase "[t]he panel recommends that the Contracting Parties . . ."

41. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 15; William Davey, *Dispute Settlement in GATT*, 11 Fordham Int'l L.J. 52, 60 (1987); Jackson, *The Legal Meaning of a GATT Dispute Settlement Report*, *supra* note 14, at 156; Pierre Pescatore, *The GATT Dispute Settlement Mechanism: Its Present Situation and Its Prospects*, 27 J. WORLD TRADE L. 5, 14 (1993).

42. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 15; Jackson, *The Legal Meaning of a GATT Dispute Settlement Report*, *supra* note 14, at 156. Indeed, panels and the Appellate Body have relied on interpretations in unadopted reports. *See, e.g.*, U.S. – Standards for Reformulated and Conventional Gasoline, Appellate Body Reported, May 29, 1996, WT/DS2/AB/R, 18.

43. DSU 16.4, 17.14. Panel reports must be adopted within 60 days of their issuance unless one of the disputants formally notifies of its decision to appeal. Appellate Body reports must be adopted within 30 days of their issuance to members.

44. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 14; OLIVER LONG, LAW AND ITS LIMITATIONS IN THE GATT MULTILATERAL TRADE SYSTEM 77 (1985); ERNST-ULRICH PETERSMANN, THE GATT/WTO DISPUTE SETTLEMENT SYSTEM: INTERNATIONAL LAW, INTERNATIONAL ORGANIZATIONS AND DISPUTE SETTLEMENT 75 (1997).

legal reasons underlying adopted recommendations can be considered authoritative interpretations of the GATT or in any way applicable to subsequent disputes remains unanswered at the constitutional level.

III.
THE APPROACH OF THE CONTRACTING PARTIES TO ADOPTED REPORTS

The approach of the contracting parties to previously adopted reports is diverse and lends little assistance to the inquiry. It has been argued that "neither the manner [in which panel reports] were made nor the manner they were adopted . . . entitle the precise legal rulings in such decisions to binding effect on future controversies."[45] The members of the EEC, now the European Union, who view GATT dispute settlement as a non-adjudicative, diplomatic process take this view.[46] Thus during the Uruguay Round, EEC delegates stated that results of the panel process should not have precedential effect.[47] Similar statements were made by the EEC representative in discussion on the adoption of *Japan – Restrictions on Imports of Certain Agricultural Products*[48] where the panel's findings were stated to be "limited to the specific measures under examination."[49]

The major problem with this argument is that it assumes contracting parties can adopt panel conclusions in isolation from the legal reasons behind them. This distinction is highly artificial. The *EEC Oilseeds Follow-Up Report* recognized that conclusions of a panel cannot be severed from their underlying reasoning.[50] In discussion on the adoption of *Spain – Measures Concerning Domestic Sale of Soyabean Oil*,[51] the U.S. representative stated that "[t]here was not. . . [an] aspect to any panel report that was perhaps more important than the resolution of a particular dispute: panel reports, explicitly and of necessity, interpret Articles of the General Agreement . . . when the Council adopted a report, those interpretations became GATT law."[52] In discussion on the adoption of *Canada – Administration of the Foreign Investment Review Act*,[53] the Indian representative, supported by the delegations of Brazil, Chile, Pakistan, Colombia, Nicaragua and Peru, implicitly acknowledged the precedential effect of

45. HUDEC, ENFORCING INTERNATIONAL TRADE LAW, *supra* note 17, at 263; Steger, *supra* note 3, at 320.

46. Ronald Brand, *Competing Philosophies of GATT Dispute Resolution in the Oilseeds Case and the Draft Understanding on Dispute Settlement*, 27 J. WORLD TRADE L. 117, 121 (1993); Mora, *supra* note 3, at 131; R. Phan ran Phi, *A European View of the GATT*, 14 INT'L BUS. LAW. 150 (1986); P. Trimble, *International Trade and the "Rule of Law,"* 83 MICH. L. REV. 1016, 1017 (1985); Young, *supra* note 3, at 390.

47. TERENCE STEWART (ed.), THE GATT URUGUAY ROUND: A NEGOTIATING HISTORY 1986-1992, 2727 (1993).

48. Mar. 22, 1988, GATT B.I.S.D. (35th Supp.) 163.

49. Minutes of the GATT Council, C/M/217, at 20.

50. Jan. 25, 1990, GATT B.I.S.D. (37th Supp.) 86, para. 77.

51. This panel report was not adopted.

52. Minutes of the GATT Council, C/M/152 at 8.

53. Feb. 7, 1984, GATT B.I.S.D. (30th Supp.) at 140.

panel reports by stating that the dispute concerned two developed parties and adoption of the report could not contribute to the evolution of case law applying to less developed parties.[54] Similarly, the Korean representative stated that panel reports were not limited to the particular regime in question but "once adopted, constitute a precedent."[55] Further, the EEC representative in its request for consultations on *Chile – Internal Taxes on Spirits* stated that a previous panel "has made very clear findings and constitutes a precedent applicable in the present instance to Chilean taxation of spirits."[56] In their submissions to panels, parties have also referred to previously adopted reports as "precedents."[57]

IV.
THE PRECEDENTIAL EFFECT OF ADOPTED REPORTS

A. Precedent in Panel Jurisprudence

Despite these references to "precedents," to state that a doctrine of binding precedent, in the common law sense, exists in panel jurisprudence is misleading. There are prominent cases where applications of legal rules to identical facts have not been followed. The leading example[58] is *EEC – Restrictions on Imports of Dessert Apples – Complaint by Chile.*[59] It concerned an EEC market intervention scheme intended to fix the prices of apples. The scheme's operation and targets were essentially price-related. The issue was whether the scheme was justified under Article XI:2(c)(i)), which provides an exception for import restrictions on agricultural products which were necessary to enforce governmental measures restricting the quantities of the like domestic product permitted to be marketed or produced. The same parties litigated the same measure in relation to the same product nine years earlier in *EEC – Restrictions on Imports of Apples from Chile.*[60] The earlier panel held that the scheme fell within the Article XI:2(c)(i) exception. However, the subsequent panel "did not feel it was legally bound by all the details and legal reasoning of the 1980 Panel report,"[61] hence it was not relieved of the responsibility to carry out its own

54. Minutes of the GATT Council, C/M/174 at 16.

55. Minutes of the GATT Council, C/M/236.

56. Communication from the EC representative, Oct. 30, 1989, DS9/1.

57. *See, e.g.,* Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 3.21 and 3.22.

58. *See also* U.S. – Section 337 of the Tariff Act of 1930, Nov. 7, 1989, GATT B.I.S.D. (36th Supp.) at 345, where the panel found that section 337 could not be justified as a "necessary" measure under Article XX(d) to secure compliance with U.S. patent laws. An earlier panel, U.S. – Imports of Certain Automotive Spring Assemblies, May 26, 1983, GATT B.I.S.D. (30th Supp.) at 107, came to the opposite conclusion.

59. June 22, 1989, GATT B.I.S.D. (36th Supp.) at 93.

60. *Supra* note 28. An earlier panel in the EEC – Program of Minimum Import Prices, Licenses and Surety Deposits for Certain Processed Fruits and Vegetables, *supra* note 28, decided that a similar scheme in relation to fresh tomatoes did not fall within the Article XI:2(c)(i) exception.

61. EEC-Restrictions on Imports of Dessert Apples - Complaint by Chile, *supra* note 59, para. 12.1.

examination of the issue.[62] It departed from the earlier panel's decision, holding that the scheme fell outside the exception.[63]

However, the fact that the doctrine of binding precedent does not apply does not mean that panel decisions have no precedential value. A system of precedents exists in most legal systems where there is a substantial body of case law.[64] The common law doctrine of binding precedent is merely one of several ways in which a system of precedents may operate.[65] An examination of panel practice indicates that legal reasons of previously adopted panel reports are generally followed by subsequent panels unless there is good reason for deciding otherwise.[66] This is exemplified by panels' interpretation of "like products" in the context of one of the fundamental principles in GATT: the national treatment obligation. Primarily expressed in Article III, this obligation requires the treatment of imports, once they have entered the country and cleared customs, to be no worse than that of domestically produced goods. Article III:2, one of the most frequently litigated GATT provisions, states:

> The products of . . . any contracting party imported into . . . any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied directly or indirectly, to like domestic products.

"Like domestic products" is neither defined in the GATT, nor has it been authoritatively interpreted by the Contracting Parties. Rather, its meaning has evolved through customary panel practice. The Working Party on *Border Tax Adjustments*[67] stated that in determining whether two goods are "like products," it is relevant to consider the products' end-uses in a given market, consumers' tastes and habits, and the products' properties, nature and quality.[68] This ap-

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62. *Id.* para. 12.10.

63. *Id.* para. 12.17.

64. CROSS & HARRIS, *supra* note 19, at 10-36; RENEE DAVID & HENRY DE VRIES, THE FRENCH LEGAL SYSTEM: AN INTRODUCTION TO CIVIL LAW SYSTEMS 113-121 (1958); Goodhart, *supra* note 19, at 41; HAROLD GUTTERIDGE, COMPARATIVE LAW: AN INTRODUCTION TO THE COMPARATIVE METHOD OF LEGAL STUDY AND RESEARCH 113 (1946); SHAHABUDDEEN, *supra* note 19, at 8-9.

65. The common law doctrine of binding precedent is often compared to the *jurisprudence constante* model of the civil law system. Under the French model, the practice of courts does not become a source of law until it is definitely fixed by the repetition of consistent precedents on a single point. However, decisions can never be solely justified by reference to a single prior decision. It is possible for the *Cour de Cassation* to set aside the ruling of a lower court founded exclusively on a past decision for "lack of legal basis" (*defaut de base legale*). *See* DAVID & DE VRIES, *supra* note 64, at 113-121; SHAHABUDDEEN, *supra* note 19, at 8-9.

66. *See, e.g.*, Norway – Restrictions on Imports of Apples and Pears, *supra* note 17, para. 5.6; Canada – Import Restrictions on Ice Cream and Yoghurt, Dec. 4, 1989, GATT B.I.S.D. (36th Supp) at 68, para. 62; U.S. – Denial of Most-Favored-Nation Treatment as to Non-Rubber Footwear from Brazil, June 19, 1992, GATT B.I.S.D. (39th Supp.) at 128, paras. 6.13, 6.15-6.17; U.S. – Measures Affecting Alcoholic and Malt Beverages, June 19, 1992, GATT B.I.S.D. (39th Supp.) at 206, para. 5.39; Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 20, 22 and 25; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, paras. 6.24 and 6.31; India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, Appellate Body Report, *supra* note 31, para. 37.

67. Dec. 2, 1970, GATT B.I.S.D. (18th Supp.) at 97.

68. *Id.* para. 18.

proach has been followed by almost all subsequent adopted reports.[69] In each case, past panel decisions were referred to and expressly followed. Indeed, referring to previously adopted reports, the panel in *Japan—Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*—stated that such an interpretation was "clearly established" by "past GATT practice."[70]

Apart from following interpretations in previously adopted reports, other customary practices reveal panels' awareness that their legal reasons may be used as precedents. First, this is exemplified when they expressly limit the applicability of their reasons to the measures in question. Thus, in *U.S. – Section 337 of the Tariff Act of 1930*, the panel emphasized that whilst its observations relating to the application of section 337 may be applicable to cases outside the field of intellectual property, its findings and conclusions are limited to patent-based cases.[71] In *EEC – Regulation on Imports of Parts and Components*,[72] the panel examined whether anti-circumvention duties imposed by the EEC fell under the Article XX(d) exception which provides that nothing in the GATT shall prevent adoption of measures "necessary to secure compliance with laws and regulations which are not inconsistent with the provisions of this Agreement." The panel construed its terms of reference so narrowly as to prevent itself from considering whether the laws in question were "not inconsistent" with the GATT. Its analysis of Article XX(d) proceeded on the assumption that the laws sought to be enforced by the anti-circumvention duties were consistent with the GATT. The panel emphasized that this assumption was limited to that case and "without prejudice to any examination of these regulations in any other dispute settlement proceeding."[73] Similarly, the panel in *Japan – Restrictions on Imports of Certain Agricultural Products*, in applying the term "enforcement of governmental measures" in Article XI:2(c)(i), took into account the practice of "administrative guidance" which is a traditional Japanese government policy tool based on consensus and peer pressure. In view of this special characteristic of Japanese society, the panel stressed "its approach in this particular case *should not be interpreted as a precedent* in other cases where societies are not adapted to this form of enforcing government policies."[74] Thus by expressly limiting the applicability of their decisions to subsequent cases, panels implicitly acknowledge that, despite the absence of the doctrine of precedent in panel juris-

69. *See, e.g.*, EEC – Measures on Animal Feed Proteins, Mar. 14, 1978, GATT B.I.S.D. (25th Supp.) at 49, para. 4.1-4.3; Spain – Tariff Treatment of Unroasted Coffee, *supra* note 28, para. 4.5-4.7; U.S. – Taxes on Petroleum and Certain Imported Substances, June 17, 1987, GATT B.I.S.D. (34th Supp.) at 136, para 5.1.1; Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages, Nov. 10, 1987, GATT B.I.S.D. (34th Supp.) at 83, paras. 5.5-5.6; U.S. – Measures Affecting Alcoholic and Malt Beverages, *supra* note 66, paras. 5.23-2.26; U.S. – Standards for Reformulated and Conventional Gasoline, May 20, 1996, WT/DS2/9, para. 6.8; Japan – Taxes on Alcoholic Beverages, Appellate Body Reports, *supra* note 17, at 22.

70. *Supra* note 69, para. 5.5.

71. *Supra* note 58, para 5.4.

72. May 16, 1990, GATT B.I.S.D. (37th Supp.) at 132.

73. *Id.* para. 5.13.

74. *Supra* note 48, para. 5.4.1.4 (emphasis added).

prudence, their reasons and findings may have precedential effect in practice. Indeed, some panels have gone further and used the term "precedent" to describe the reasons of previous panels.[75]

Second, panels have been asked on several occasions to rule on measures that have expired or been withdrawn.[76] Panels have justified their decisions to grant such rulings on various grounds, including the fact that the case involved "questions of great practical interest," as well as the risk that the party in question may impose similar import restrictions in the future.[77] The Appellate Body has continued this practice in *U.S. – Measures Affecting the Imports of Woven Wool Shirts and Blouses from India*[78] where U.S. transitional safeguard measures challenged by India were withdrawn prior to the completion of the panel process. India requested the panel to continue its work and upon the release of the report, India notified the DSB of its decision to appeal certain issues of law in the report. Parties request, and panels grant rulings on withdrawn measures in the belief that these rulings have practical value for future implementation of the GATT.[79] These reports can only be of such practical value if parties believe that the reports' reasons have precedential effect and are likely to be followed in subsequent disputes.

The more legalistic approach to GATT interpretation following the introduction of an Appellate Body to review issues of law has led to a strengthening of the precedential effect of previously adopted reports. This is exemplified by the recent introduction of a distinction between *ratio decidendi* and *obiter dicta* in panel jurisprudence. In *Canada – Certain Measures Concerning Periodicals*,[80] the U.S. cited four panel reports as authorities for its interpretation of Article III:8(b). The Appellate Body distinguished three of the reports. In relation to the fourth report, the Appellate Body found that the statement relied upon by the U.S. was *obiter dicta* and hence not binding. If panel reports did not have significant precedential effect, there would be no need to carefully rationalize the decision not to apply the principle enunciated by previous panels. Implicit in the Appellate Body's distinguishing of cases and its distinction between *ratio*

75. *See, e.g.*, U.S. – Income Tax Legislation (DISC), *supra* note 29, para. 80; Income Tax Practices Maintained by France, *supra* note 29, para. 58; Income Tax Practices Maintained by Belgium, *supra* note 29, para. 45; Income Tax Practices Maintained by the Netherlands, *supra* note 29, para. 45; EC – Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region, unadopted, Feb. 7, 1985, L/5776, para. 4.35; EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins (Follow Up), *supra* note 50, para. 144.

76. *See, e.g.*, EEC – Measures on Animal Feed Proteins, *supra* note 69; U.S. – Prohibition of Imports of Tuna and Tuna Products from Canada, Feb. 22, 1982, GATT B.I.S.D. (29th Supp.) at 91; EEC – Restrictions on Imports of Apples from Chile, *supra* note 28; EEC – Restrictions on Imports of Dessert Apples – Complaint by Chile, *supra* note 59; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.9.

77. *See* U.S. – Prohibition of Imports of Tuna and Tuna Products from Canada, *supra* note 76; EEC – Restrictions on Imports of Dessert Apples – Complaint by Chile, *supra* note 59. See the submission of the U.S. in Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.14. *See also* PETERSMANN, *supra* note 44, at 139.

78. Appellate Body Report, April 25, 1997, WT/DS33/AB/R.

79. HUDEC, ENFORCING INTERNATIONAL TRADE LAW, *supra* note 17, at 262.

80. Appellate Body Report, June 30, 1997, WT/DS31/AB/R.

and *obiter* is the recognition that legal reasons in panel reports should be followed unless there is good reason for deciding otherwise.[81]

B. Japan – Taxes on Alcoholic Beverages Appellate Body Report: The Appellate Body's Approach to Precedent

The precedential value of previously adopted reports was raised formally for the first time in *Japan – Taxes on Alcoholic Beverages*.[82] The panel held that reports adopted by the GATT Council and DSB are an integral part of GATT 1994 on two grounds. First, adopted reports constituted[83] "subsequent practice" under Article 31(3)(b) of the Vienna Convention on the Law of Treaties[84] which states that "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" *shall* be taken into account when interpreting the treaty. The panel accepted Article 31(3)(b) as part of the "customary rules of interpretation of public international law" which it was bound to use, under Article 3.2 of the DSU, in interpreting the GATT. The effect of construing past reports as "subsequent practice" is to require panels to interpret the GATT in light of any previously adopted reports on the provision in question.

Second, adopted reports constituted "other decisions of the Contracting Parties to GATT 1947" under paragraph 1(b)(iv) of Annex 1A incorporating GATT 1994[85] into the WTO Agreement.[86] This incorporates all panel reports adopted prior to the WTO Agreement into GATT 1994 itself, together with GATT 1947 and other Understandings on the interpretation of the GATT. This renders past panel reports binding on future panels as provisions of GATT 1947 itself. The U.S. appealed, claiming the panel erred in incorrectly characterizing adopted panel reports as "subsequent practice" under the Vienna Convention and "decisions of the Contracting Parties" under paragraph 1(b)(iv) of the language incorporating GATT 1994 into the WTO Agreement. The EEC, as intervening third party to the dispute, supported the U.S. position.

The Appellate Body rejected the panel's finding on this issue.[87] It found "subsequent practice" within the meaning of Article 31(3)(b) of the Vienna Convention requires a "'concordant, common and consistent' sequence of acts or pronouncements sufficient to establish a discernible pattern implying the parties' agreement regarding its interpretation."[88] Hence, an isolated act, such as the

81. To draw the distinction between *ratio* and *obiter* is "to accept the doctrine of *stare decisis* at a theoretical level." CROSS & HARRIS, *supra* note 19, at 17. *See also* SHAHABUDDEEN, *supra* note 19, at 110, 152-164.

82. *Supra* note 17.

83. *Id.* para. 6.10.

84. 1155 U.N.T.S. 331 (1969).

85. GATT 1994 is incorporated into the WTO Agreement through its inclusion in Annex 1A of the Agreement. GATT 1994 is defined in Annex 1A as including the provisions of GATT 1947 as well as instruments falling within the categories listed in paragraph 1(b) of Annex 1A. One such category is "other decisions of the Contracting Parties to GATT 1947."

86. Japan – Taxes on Alcoholic Beverages, *supra* note 17, para. 6.10.

87. *Id.* at 13-15.

88. *Id.* at 13.

adoption of a panel report, is generally not sufficient to establish subsequent practice. The Appellate Body held that the character and legal status of panel reports has not changed since the WTO Agreement came into force:

> Adopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute.[89]

Hence, panel jurisprudence indicates that even though legal reasons of previously adopted reports are not binding in the same way as common law precedents, they are followed by subsequent panels unless there is good reason for deciding otherwise. Such an approach is similar to the practice of the International Court of Justice.[90]

V.
THE SUBSEQUENT PRACTICE PRINCIPLE: A LEGAL BASIS FOR THE PRECEDENTIAL EFFECT OF ADOPTED REPORTS

Given the desirability of certainty and predictability, and absent a doctrine of binding precedent, on what legal basis do past panel reasons have precedential effect? It is important to establish clear grounds for the precedential effect of panel reasons to enable parties to predict which reasons will be applied in future disputes. This section argues that despite the decision of the Appellate Body in the *Japan Alcohol Case*, the principle of subsequent practice constitutes a basis for the precedential effect of previously adopted reports.

Article 3.2 of the DSU requires panels to interpret the WTO Agreement in accordance with "customary rules of interpretation of public international law." Kuyper notes there is "little doubt that the drafters of this provision intended it to be an indirect reference to the principles of Articles 31 and 32 of the Vienna Convention, but the Convention as such could not be referred to because several WTO Members are not party to it."[91] Indeed, like other international tribu-

89. *Id.*

90. *See* Barcelona Traction, Light and Power Company Limited (Belg. v. Spain), Second Phase, 1970 ICJ 3, 38 (Feb. 5); Application for Revision and Interpretation of the Judgment of 24 February 1982 in the Case Concerning the Continental Shelf (Tunis. v. Libya), 1985 ICJ 191, 207 (Dec. 10); Land, Island and Maritime Frontier Dispute (El Sal. v. Hond.), Application for Permission to Intervene, 1990 ICJ 3, 4 (Feb. 28); Interpretation of Peace Treaties with Bulgaria, Hungary and Romania, 1950 ICJ 221, 233 (Advisory Opinion of Jul. 18) (dissenting opinion of Judge Read); GERALD FITZMAURICE, THE LAW AND PROCEDURE OF THE INTERNATIONAL COURT OF JUSTICE 583 (1986); LAUTERPACHT, *supra* note 20, at 9-14; S. ROSENNE, THE LAW AND PRACTICE OF THE INTERNATIONAL COURT 612 (1985); SHAHABUDDEEN, *supra* note 19, at 110.

91. Pieter Jan Kuyper, *The Law of GATT as a Special Field of International Law*, 25 Neth. Y.B. Int'l L. 227, 232 (1994).

nals,[92] the Appellate Body has recognized that Article 31 has attained the status of customary international law.[93]

Article 31(3)(b) of the Vienna Convention states that "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" *shall* be taken into account when interpreting the treaty. This rule has been applied as a principle of international law by the International Court of Justice.[94] Two issues arise as to its applicability to the adoption of panel reports by the GATT Council and now the DSB. First, the preliminary question arises as to whether the acts of an organ established by a treaty can constitute subsequent practice of the parties to that treaty. Judges Lauterpacht and Spender have noted the artificiality of arguing that the practice of an organ established under a treaty can constitute "subsequent practice of the parties" under this principle.[95] In relation to the Charter of the United Nations,[96] Judge Spender stated that the practice of an organ such as the General Assembly cannot be equated with the practice of the member states under this principle. He based his objection on the fact that in such organs, majority rule prevails and so determines the practice.[97] Where the practice was opposed by individual parties who have been outvoted, the requisite agreement of the parties does not exist.[98] This objection, if valid, does not apply to the practice of the GATT Council before the WTO Agreement since the adoption of panel reports could only occur by the consensus of the contracting parties. However, since the establishment of the DSB, panel reports are automatically adopted in the absence of a consensus against adoption.[99] This casts doubt on the applicability of the subsequent practice principle to reports adopted under the new system.

Given that the subsequent practice principle is capable of applying to decisions of the GATT Council, at least prior to the DSU, can the adoption of panel reports by consensus constitute "subsequent practice" establishing the agreement

92. International Court of Justice: Certain Expenses of the United Nations, 1962 ICJ 151, 158 (Advisory Opinion of Jul. 20); Territorial Dispute (Libya v. Chad), 1994 ICJ 6 (Feb. 3); Golder v. United Kingdom, 57 I.L.R. 201, 213-214 (European Court of Human Rights 1975); Inter-American Court of Human Rights: Restrictions to the Death Penalty, 70 I.L.R. 449, 466 (1983).

93. U.S. – Standards for Reformulated and Conventional Gasoline, Appellate Body Report, *supra* note 42, at 17; Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 10; India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, Appellate Body Report, *supra* note 31, para. 46.

94. Competence of the International Labor Organization in Regard to International Regulation of the Condition of Labor of Persons Employed in Agriculture, 1922 PCIJ (Ser. B) No.2, at 39; Corfu Channel (U.K. v. Alb.), Merits, 1949 ICJ 4, 25 (Apr. 9); International Status of South West Africa, 1950 ICJ Rep. 128, 135 (Advisory Opinion of Jul. 11); Temple of Preah Vihear (Cambodia v. Thail.), 1962 ICJ 6, 34 (Merits, Judgment of June 15); Certain Expenses of the United Nations, *supra* note 92, at 160, especially the Separate Opinion of Judge Sir Percy Spender at 189; Military and Paramilitary Activities In and Against Nicaragua (Nicar. V. U.S.), 1984 ICJ 392, 408-411 (Nov. 26).

95. Certain Expenses of the United Nations, *supra* note 92, at 160 and 189 (separate opinion of Judge Sir Percy Spender).

96. 1976 Y.B.U.N. 1043.

97. Certain Expenses of the United Nations, *supra* note 92, at 192 (separate opinion of Judge Sir Percy Spender).

98. T. SATO, EVOLVING CONSTITUTIONS OF INTERNATIONAL ORGANIZATIONS 30-33 (1996).

99. DSU Art. 16.4.

of the parties to interpretations contained in the reports? In this regard, the Appellate Body's statement in the Japan Alcohol Case is critical. It stated:

> The essence of subsequent practice in interpreting a treaty has been recognized as a "concordant, common and consistent" sequence of acts or pronouncements which is sufficient to establish a discernible pattern implying the agreement of the parties regarding its interpretation. An isolated act is generally not sufficient to establish subsequent practice; it is a sequence of acts establishing the agreement of the parties that is relevant.[100]

It concluded that the decision to adopt a panel report is an isolated act which cannot constitute subsequent practice and cannot be recognized as constituting a definitive interpretation of the relevant GATT provisions.

On its face, this statement appears to reject the view that the subsequent practice principle is capable of applying to the adoption of panel reports.[101] However, a careful analysis of the Appellate Body's statement indicates that it does not deny the applicability of the principle *per se*. Rather, it noted that the principle did not apply generally to a decision to adopt a panel report because such an isolated decision does not amount to a "sequence of acts sufficient to establish a discernible pattern implying the agreement of the parties" to the legal reasoning contained in that panel report. The statement does not exclude the adoption of several panel reports which contain the same interpretation crucial to the finding in each case, from constituting the requisite consistent sequence of acts establishing the agreement of the parties to that interpretation of the GATT. Indeed, a leading example of this approach is the adoption of the principle that the national treatment obligation protects competitive conditions rather than trade volumes. The existence of the principle and its associated rules support the subsequent practice principle as a basis for the precedential effect of previously adopted reports.

VI.
THE COMPETITIVE CONDITIONS PRINCIPLE

One of the most frequently applied principles in panel jurisprudence is the notion that, absent an express intention to the contrary, GATT provisions protect competitive conditions between imported and like domestic products, not expectations of trade volumes. Although this principle is not expressed in the GATT, it is regarded as well-established[102] and practically binding on subsequent panels because it constitutes the *ratio decidendi* of a long line of consensually-adopted panel reports. Despite its significance, the scope and content of this principle is not immediately apparent from individual panel reports, nor has there been any major discussion of this principle in the secondary literature.

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100. *Supra* note 17, at 13.

101. *See also* Jackson, *The Legal Meaning of A GATT Dispute Settlement Report*, *supra* note 14, at 157; PETERSMANN, *supra* note 44, at 75-76.

102. Canada – Certain Measures Concerning Periodicals, Appellate Body Report, *supra* note 80, at 19.

A. *Defining the Competitive Conditions Principle*

The competitive conditions principle originated from Article III of the GATT which is the primary expression of the national treatment obligation. It requires the treatment of imported goods, once they have entered the country and cleared customs, to be no worse than that of domestically produced goods, especially in regard to internal taxes and regulation. Article III's purpose is to prevent "indirect protection,"[103] that is, the use of internal taxes and other regulatory measures to undermine negotiated tariff concessions.[104] This provision was the subject of the first reported GATT dispute, *Brazil—Internal Taxes*.[105] Brazil conceded that its tax law discriminated between imports and like domestic products. However, since the tax measure had little or no impact on import volumes, Brazil argued that the measure did not "afford protection to domestic production"[106] and hence did not nullify or impair benefits[107] accruing under Article III:2. This argument was rejected by the contracting parties on the ground that what is relevant is the effect of the impugned measure on trade opportunities. Article III was "equally applicable whether imports from other contracting parties were substantial, small *or non-existent*."[108] This broad interpretation of Article III is the first statement of the principle that the GATT protects competitive relationships, not trade volumes.

The issue arose for consideration again in *U.S. – Taxes on Petroleum and Certain Imported Substances*.[109] The U.S. did not contest the claim by Canada, the EEC, and Mexico that an excise tax imposed at a higher rate on imported petroleum products than on domestic substitutes was inconsistent with Article III:2. Its defense was that the tax differential of 3.5 U.S. cents per barrel was so small that its trade effects were minimal or nil, and hence did not nullify or impair benefits accruing to the complainants under the GATT.[110] The panel rejected this, stating that the trade effects of the measure were irrelevant to the question of nullification and impairment. The mere exposure of a product to a risk of discrimination is itself a form of discrimination.[111] Article III:2 protects the competitive relationship between imported and like domestic products, not expectations of trade volumes.[112] A similar approach was applied in *U.S. - Measures Affecting Alcoholic and Malt Beverages* where the panel held that

103. Italian Discrimination Against Imported Agricultural Machinery, Oct. 23, 1958, GATT B.I.S.D. (7th Supp.) at 63, para. 11.

104. Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 17. This is consistent with the statements of delegates to the Tariff Agreement Committee at the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment 1947 (EPCT/TAC/PV.10 at 3 and 33).

105. June 30, 1949, GATT B.I.S.D. II/181.

106. GATT Art. III:1.

107. GATT Art. XXIII.

108. Para. 16 (emphasis added).

109. *Supra* note 69.

110. *Id.* para. 5.1.2.

111. 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, para. 151; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 95.

112. Para. 5.1.9.

even if only 1.5 percent of domestic output benefits from the lower tax rate, that discrimination constitutes a breach of Article III:2.[113] The national treatment obligation is not conditional on a trade effects test nor is it qualified by a *de minimis* standard.[114]

This principle has been applied to Article III:2,[115] other paragraphs of Article III,[116] as well as Articles II,[117] XI,[118] and XXIII:1(b).[119] In each case panels have referred to earlier pronouncements of the principle as settled law. In its two most recent reports, adopted July 30, 1997 and September 25, 1997, the Appellate Body accepted this principle as "well-established" in panel jurisprudence.[120] GATT provisions are to be interpreted in light of the principle protecting competitive conditions between imported and like domestic products: absent express intention to the contrary, GATT provisions protect competitive conditions, not trade volumes. The trade impact of an impugned measure is irrelevant to the question of nullification and impairment. What is relevant is the *potential* impact of the measure rather than the actual consequences for specific imported products.

B. The Mandatory Nature of the Principle

Given that most rules of international law may, in their application between states, be modified or dispensed with by agreement between them,[121] the ques-

113. *Supra* note 66, para. 5.6.

114. *Id.* para. 5.6. *See also* Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 25.

115. Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages, *supra* note 69, para. 5.11; Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 25; EC – Regime for the Importation, Sale and Distribution of Bananas, Appellate Body Report, Sept. 25, 1997, WT/DS27/AB/R, para. 253.

116. Italian Discrimination Against Imported Agricultural Machinery, *supra* note 103, para. 12; Canada – Administration of the Foreign Investment Review Act, *supra* note 53, para. 6.6; U.S. – Section 337 of the Tariff Act of 1930, *supra* note 58, para. 5.13; Canada – Import Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Authorities, Mar. 22, 1988, GATT B.I.S.D. (35th Supp.) at 37, para. 5.6; U.S. - Measures Affecting Alcohol and Malt Beverages, *supra* note 66, para. 5.31; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 99.

117. EEC- Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, para. 151; EEC – Import Regime for Bananas, unadopted, Feb. 11, 1994, DS/38/R, para. 135 (*quoted with approval in* Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, paras. 6.29 and 6.46).

118. Panel on Japanese Measures on Imports of Leather, *supra* note 17, para. 55; U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2.

119. Treatment by Germany of Imports of Sardines, *supra* note 13, para. 9; Other Barriers to Trade, Mar. 3, 1955, GATT B.I.S.D. (3rd Supp.) at 222, 224; EEC – Production Aids Granted on Canned Peaches, Canned Pears, Canned Fruit Cocktail and Dried Grapes, unadopted, Feb. 20, 1985, L/5778, para. 77; U.S. – Trade Measures Affecting Nicaragua, unadopted, Oct. 13, 1986, L/6053, para. 5.6; EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, paras. 150-151.

120. Canada – Certain Measures Concerning Periodicals, Appellate Body Report, *supra* note 80, at 19; EC – Regime for the Importation, Sale and Distribution of Bananas, Appellate Body Report, *supra* note 115, para. 253. *See also* India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, Appellate Body Report, *supra* note 31, para. 40.

121. ROBERT JENNINGS & ARTHUR WATTS, OPPENHEIM'S INTERNATIONAL LAW, 1292 (9th ed. 1992).

tion arises as to whether parties can contract out of the application of the uncodified[122] competitive conditions principle. In *EEC – Payments and Subsidies Paid to Processors of Oilseeds and Related Animal-Feed Protein*,[123] the EEC argued that as between the parties that signed it, the Agreement on Interpretation and Application of Articles VI, XVI and XXIII prescribed the appropriate interpretations of those provisions. Pursuant to this, the EEC sought to displace the competitive conditions principle, arguing that Article 8:4 of the Subsidies Code no longer protected competitive conditions but protected expectations of trade volumes. The panel rejected this argument. It noted that previous panels have consistently applied the competitive conditions principle, and held that any agreement between the parties must be interpreted in conformity with it.[124]

This decision has two important implications. First, it demonstrates that the competitive conditions principle is so entrenched in panel jurisprudence that it is practically binding on subsequent panels as well as the contracting parties. Second, it sheds light on the legal status of panel-created principles. Whilst it is premature to draw analogies between these principles and the rules of *jus cogens*,[125] the *EEC Oilseeds* decision suggests that derogation by agreement of the disputants is not permitted from the competitive conditions principle. A definitive answer awaits the outcome of a case where the disputants agree on terms of reference which expressly prohibit the panel from applying the principle. In light of the compulsory jurisdiction of panels,[126] prohibiting derogation from the competitive conditions principle may be imposing too strict a discipline on a system with "the most shallow habits of obedience."[127] The viability of such a prohibition depends on the rationale and credibility of the principle from which derogation is not permitted.

C. The Rationale of the Principle

Article III:1, the provision from which the competitive conditions principle was first derived, provides that internal taxes and other regulations should not be applied to imported or domestic products "so as to afford protection to domestic production." The ordinary meaning of the phrase "so as to afford protection" implies some causal connection between the impugned measure and the protective effect on domestic production. This requirement is supported by Article

122. The competitive conditions principle as developed in this paper is distinguished from the *prima facie* breach concept codified in Article 3.8 of the DSU. Article 3.8 provides that where an infringement of a GATT provision is shown, there is a presumption that the breach has nullified or impaired benefits under the GATT. It is essentially an evidential rule which applies only to violation complaints under Article XXIII:1(a). The competitive conditions principle is a substantive principle of law which applies whether or not a violation of the GATT has occurred.

123. *Supra* note 111.

124. *Id.* para. 154.

125. Article 53 of the Vienna Convention on the Law of Treaties provides that a treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of international law. *See also*, JENNINGS & WATTS, *supra* note 121, at 1292; PAUL REUTER, INTRODUCTION TO THE LAW OF TREATIES 183 (1995); IAN SINCLAIR, THE VIENNA CONVENTION ON THE LAW OF TREATIES 21 (1973).

126. DSU art. 23.2(a).

127. HUDEC, ENFORCING INTERNATIONAL TRADE LAW, *supra* note 17, at 358.

XXIII:1, the provision by which disputes are submitted to the panel process. It provides that a party may bring a complaint before the contracting parties where any benefit accruing to it "is being nullified or impaired" by the conduct of another party. The reasons for which panels have rejected this textual interpretation for the broader principle protecting competitive relationships rather than trade volumes sheds light on their interpretive approach.

1. Security and Predictability

Having recognized the importance of security and predictability in trade relations in efforts to achieve the objectives of the GATT,[128] panels rejected the above textual interpretation because it "would lead to great uncertainty about the conditions of competition between imported and domestic products and thus defeat the purposes of Article III."[129] The competitive conditions principle was required "not only to protect current trade but also create the predictability needed to plan future trade."[130] The importance panels attach to the predictability of competitive conditions indicates that panels are not merely resolving each dispute as commercial arbitrators. Rather, they are conscious of their role[131] in achieving the wider objective of security and predictability in international trade relations.

2. Administrative Necessity

Second, the competitive conditions principle provides an example of the panels' pragmatic approach in interpreting the GATT. Requiring proof that the impugned measure caused actual detriment imports would render the GATT unadministrable. Evaluating the trade effects of a measure would require speculation on consumer purchasing behavior and production plans of firms in the hypothetical situation where the impugned measure is absent.[132] Whilst some parties have provided panels with econometric analyses of the effects of impugned measures,[133] the reliability of such analyses is questionable.[134] *U.S.* –

128. U.S. Manufacturing Clause, *supra* note 17, para. 39; Japan – Measures on Imports of Leather, *supra* note 17, para. 55; EEC – Panel on Newsprint, *supra* note 17, para. 52; Norway – Restrictions on Imports of Apples and Pears, *supra* note 17, para. 5.6; EEC – Import Regime for Bananas, *supra* note 117, para. 135; Japan – Taxes on Alcoholic Beverages, Appellate Body Report, *supra* note 17, at 34; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.29.

129. U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 98.

130. Panel on Japanese Measures on Imports of Leather, *supra* note 17, para. 55; U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2; EEC - Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, para. 150; EEC – Import Regime for Bananas, *supra* note 117, para. 135 (*quoted with approval in* Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.29).

131. DSU Art. 3.2.

132. Canada – Administration of the Foreign Investment Review Act, *supra* note 53, para. 6.6.

133. For example, Canada in Canada – Import Restrictions on Ice Cream and Yoghurt, *supra* note 66, provided the panel with econometric analysis to support its claim that in the absence of government restrictions, production would be higher by 31 to 39 percent. The panel did not have to decide the issue on the basis of the analysis.

Taxes on Petroleum and Certain Imported Substances[135] best illustrates the problem. The U.S. imposed an excise tax on imported petroleum at a higher rate than on like domestic products. The tax discrimination was 3.5 U.S. cents, or about 0.19 percent of the purchase price. It had no effect on prices as exporters absorbed the extra amount. The U.S. argued that the minimal trade impact could not constitute a violation of Article III:2. The panel rejected the argument noting that the U.S. could bring the tax on petroleum in conformity with the GATT in a number of ways: raising the tax on domestic products, lowering the tax on imports, or fixing a new common tax rate for both imported and domestic products. Each solution would have different trade results.[136] Hence, it is logically impossible to determine the difference in trade impact between the impugned tax and one consistent with the GATT. As a result, it is impossible to determine the trade impact resulting from the non-observance of Article III:2.[137] Therefore, panels have taken a pragmatic approach to the national treatment obligation: the GATT cannot be interpreted as protecting trade volumes or individual producers; administrative necessity requires that it only protects the competitive conditions between imports and like domestic products.

3. State Sovereignty

Prior to the DSU reforms, the establishment of panels and adoption of reports required a consensus among the contracting parties. This meant that panels were conscious of the need for their reasons to be politically acceptable in order for the reports to be adopted. A manifestation of this awareness is the argument that a state's liability to claims under the GATT should not depend on factors which it does not control. Arguably, this line of reasoning is not unique to the GATT system but is merely an application of the general principle that a government cannot be liable for an injury which it did not commit, or for not preventing a loss when it is out of its power to prevent it.[138] In any event, it is impossible to accurately determine the extent to which a decline in trade is attributable to the impugned measure as opposed to other factors such as economic conditions, changes in consumer tastes and product quality. Since governments cannot predict with precision the trade impact of their measures, making liability dependent on whether a measure has caused a decline in imports would expose them to liability dependent on factors beyond their control.[139]

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134. D. Hendry and G. Mizon, *Procrustean Econometrics: Or Stretching and Squeezing Data, in* Modelling Economic Series: Readings in Econometric Methodology (Clive Granger ed., 1990); Michael McAleer, Adrian Pagan and Paul Volker, *What Will Take the Con Out of Econometrics?*, 75 American Economic Review 293 (1985).

135. *Supra* note 69.

136. This is due to the different elasticities of demand for imports and domestic substitutes. The elasticity of demand measures the responsiveness of consumer demand to a change in price.

137. U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para 5.1.9.

138. Corfu Channel, *supra* note 94, at 18 and 52; Bin Cheng, General Principles of Law As Applied By International Courts and Tribunals 218 (1953).

139. EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, para. 151.

VII.
APPLICATIONS OF THE COMPETITIVE CONDITIONS PRINCIPLE

The competitive conditions principle is not merely a subsidiary means of filling gaps in the GATT. It has provided a coherent basis for the incremental development of specific rules directed at achieving greater certainty in competitive conditions. This section examines three of these rules.

A. Mandatory and Discretionary Legislation

By making a violation of the GATT dependent on a change in competitive conditions rather than on a change in trade volumes, the competitive conditions principle renders the mere exposure of a product to a risk of discrimination itself a form of discrimination.[140] This has given rise to the rule that legislation mandating the executive to take action inconsistent with the GATT is a violation *whether or not* the legislation has been applied, whereas legislation merely giving the executive the possibility to act inconsistently with the GATT would not, by itself, constitute a violation. The security and predictability which the competitive conditions principle seeks to achieve cannot be attained if contracting parties could not challenge legislation mandating a breach of the GATT until administrative acts implementing it had actually been applied to their trade.[141] The importance of this rule is that it permits parties to challenge the GATT-consistency of mandatory legislation as a means of preventing adverse effects, not merely to obtain redress *ex post*.[142]

The rule was first enunciated in *U.S. – Taxes on Petroleum and Certain Imported Substances*,[143] where the GATT-consistency of the U.S. Superfund Amendments and Reauthorization Act 1986 ("the Superfund Act") was challenged. The Act imposed a tax on certain imported substances such as petrochemicals and inorganic chemicals. However, the tax was not to take effect until two years after the date of the challenge. The U.S. objected to the examination of the tax because it had no immediate effect on trade and hence could not cause nullification or impairment under Article XXIII. The panel rejected this argument, noting that the GATT not only protected current trade, but was also intended to create the predictability needed to plan future trade. This objective cannot be achieved if parties could not challenge existing legislation mandating a breach of the GATT until the administrative acts implementing it had actually been applied to their trade.[144]

In the same case, the panel considered the GATT-consistency of the Act's enforcement provision. The Act required importers to provide sufficient infor-

140. *Id.* para. 151; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 95.

141. U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2.

142. U.S. – Section 337 of the Tariff Act of 1930, *supra* note 58, para. 5.13; EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, para. 151; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.45.

143. *Supra* note 69.

144. *Id.* para. 5.2.2.

mation regarding the chemical inputs of taxable substances to enable the authorities to determine the tax liability. Failure to furnish such information resulted in a penalty of 5 percent of the appraised value of the imported substance. The Act permits the Secretary of the Treasury to prescribe by regulation, in lieu of the 5 percent rate, a rate which would equal the amount that would be imposed if the substance were produced using the predominant method of production. No such regulation had been issued at the time of the panel decision. The panel considered that the penalty of 5 percent would be inconsistent with the national treatment principle in Article III:2 because it would impose a higher rate on the value of imported substances. However, unlike the provision imposing the tax itself, the provision imposing the penalty was not mandatory. It provided the tax authorities with the possibility of avoiding the need to impose the penalty by issuing regulations in place thereof. Thus, the panel held that the existence of the provision as such does not constitute a violation of the GATT.[145]

Subsequent panels have frequently and uniformly applied this two-limbed rule.[146] Like the general principle protecting competitive conditions, this rule originated from an interpretation of Article III, but has since been applied to GATT obligations generally.[147] It is now well established that legislation mandating GATT-inconsistent action is a violation *per se*, whilst legislation conferring a discretion on the executive to take GATT-inconsistent action can only be challenged if the legislation has been implemented. Whether legislation is mandatory or discretionary is a matter of construction.[148] "Mandatory legislation" imposes on the executive authority requirements that cannot be modified by executive action.[149] In *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*,[150] the U.S. argued that Thai legislation providing for a higher tax ceiling (80 percent as opposed to 60 percent) on imported cigarettes was inconsistent with the national treatment obligation. The panel rejected this because the tax ceilings referred to the maximum rate that *could* be imposed. The authorities could apply the legislation in a GATT-consistent way. Hence, the maximum rates that could be levied under the legislation need not be non-

145. *Id.* para. 5.2.9.

146. U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2; EEC – Regulations on Imports of Parts and Components, *supra* note 72, para. 5.25; Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes, Nov. 7, 1990, GATT B.I.S.D. (37th Supp.) 200, para. 84; U.S. – Measures Affecting Alcoholic and Malt Beverages, *supra* note 66, para. 5.39; U.S. – Denial of Most-Favored-Nation Treatment as to Non-Rubber Footwear from Brazil, *supra* note 66, para. 6.13; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 118; Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, *supra* note 17, para. 6.45.

147. *See, e.g.*, Article I: U.S. – Denial of Most-Favored-Nation Treatment as to Non-Rubber Footwear from Brazil, *supra* note 66, para. 6.13, and Article VIII:1(a): U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 118.

148. U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, paras. 122-123.

149. U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2; U.S. – Denial of Most-Favored-Nation Treatment as to Non-Rubber Footwear from Brazil, *supra* note 66, para. 6.13.

150. *Supra* note 146.

discriminatory.[151] Where the legislation is ambiguous and capable of a range of interpretations, violation *per se* is avoided if one of the possible interpretations allows the executive to act consistently with the GATT.[152]

Whilst the first limb of this rule relating to mandatory legislation is clearly consistent with the competitive conditions principle, it is questionable whether the second limb relating to discretionary legislation is also consistent. A corollary to the principle is that the mere exposure of a product to a risk of discrimination is itself impermissible discrimination under Article III. Legislation conferring a discretion on the executive to discriminate against imports in a GATT-inconsistent way exposes imports to a risk of discrimination, whether or not the discretion has been exercised. The second limb, which allows such legislation to stand absent a GATT-inconsistent exercise of the discretion, creates uncertainty over future competitive conditions and hence is inconsistent with the object of the GATT. Certainty requires that discretionary legislation be subject to challenge whether or not the discretion has been exercised.

B. Unfilled Quotas: Violation Per Se

Article XI prohibits the use of import restrictions such as quotas and non-tariff barriers. It is designed to bring about a general elimination of quantitative restrictions which, in effect, block the functioning of the price mechanism.[153] An interpretive rule arising from the competitive conditions principle is that the very existence of an import quota is an infringement of the GATT whether or not the quota has been filled.

In *Japan—Measures on Imports of Leather*,[154] the panel accepted the U.S. argument that Japanese restrictions on imports of certain semi-processed and finished leather were inconsistent with Article XI.[155] Japan's defense was that the existence of the quotas themselves did not necessarily mean that benefits accruing to the U.S. had been nullified or impaired under Article XXIII. Japan pointed out that U.S. exporters had not filled the large quota opened for them and hence the quota could not be said to have limited U.S. exports to Japan. Indeed, the panel found that U.S. exports of leather to Japan had in fact increased considerably both in percentage terms and in absolute figures in the period under consideration.[156] However, the panel held that the mere existence of a quantitative restriction on imports is a nullification or impairment whether or not it has actually impeded imports.[157] This is a concrete application of the general principle that the GATT protects competitive conditions, not trade

151. *Id.* para. 84.

152. U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 123.

153. Long, *supra* note 44, at 9.

154. *Supra* note 17.

155. *Id.* para. 44.

156. *Id.* para. 53.

157. *Id.* para. 55.

volumes. Subsequent panels have endorsed, and treated as settled, the rule that unfulfilled quotas are GATT violations *per se*.[158]

C. *Rejection of Balancing of Trade Effects*

A corollary to the competitive conditions principle is the rejection of the argument that in deciding whether a nullification or impairment has occurred, more favorable treatment to some products can be balanced against less favorable treatment to others.

The rule was first stated in *U.S. – Section 337 of the Tariff Act of 1930*.[159] In the U.S., all claims of patent infringement against domestic products were dealt with in federal district courts. Section 337 set up a separate procedure, before the United States International Trade Commission, applicable only to imported products alleged to infringe a U.S. patent. Infringement claims against imports could also be brought in a federal court. However, patent owners often preferred Section 337 because it was faster and provided more sweeping border remedies. The EEC claimed that this meant that imports were receiving less favorable treatment than domestic goods and hence violated Article III:4 of the GATT. In defense, the U.S. argued that any unfavorable treatment of imports was offset by more favorable elements of treatment relating to differences in the elements of the cause of action, procedure and the possibility that relief under Section 337 might be modified on public policy grounds, which possibility did not exist in federal district courts. Rejecting this argument, the panel held that the national treatment obligation in Article III:4 has to be understood as applicable to each individual imported product. The panel rejected any notion of balancing more favorable treatment of some imports against less favorable treatment of other imports.[160] This rule has been reaffirmed and extended to other GATT provisions by subsequent panels[161] and the Appellate Body.[162] Similarly, more favorable treatment of one contracting party cannot be cited as justification for less favorable treatment of another.[163]

If the balancing of trade effects was allowed, it would entitle a party to derogate from its obligation in respect of one product, or in respect of one party, on the ground that it accords more favorable treatment in some other case, or to some other party. Balancing trade effects in deciding whether a violation of the GATT has occurred implicitly accepts the proposition that liability depends on proof that the impugned measures caused a decline in trade volumes. Such a

158. *See, e.g.,* U.S. – Taxes on Petroleum and Certain Imported Substances, *supra* note 69, para. 5.2.2; EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, *supra* note 111, para. 150.

159. *Supra* note 58.

160. *Id.* para. 5.14.

161. U.S. – Denial of Most-Favored-Nation Treatment as to Non-Rubber Footwear from Brazil, *supra* note 66, para. 6.10; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 98.

162. Canada – Certain Measures Concerning Periodicals, Appellate Body Report, *supra* note 80, 30.

163. Norway – Restrictions on Imports of Certain Textile Products, *supra* note 28, para. 15.

rule would prompt the same objections which gave rise to the competitive conditions principle. It would also create uncertainty over the competitive conditions between imports and like domestic products and thus defeat the security and predictability desired by contracting parties. Therefore, it is a corollary to the competitive conditions principle that in deciding on whether a nullification or impairment has occurred, more favorable treatment to some products cannot be balanced against less favorable treatment to others.

It flows from this that an imported product need not be treated less favorably than *all* domestic equivalents for a violation of Article III to occur. It is sufficient that imports are treated less favorably than some domestic equivalents.[164] Thus, in *U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco*, under the statutorily mandated averaging formula for calculation of the impugned tax, the tax on imported tobacco will always be higher than one type of domestic tobacco and lower than another type of domestic tobacco where there is any price differential between the two types of domestic tobacco. This does not prevent it from being in violation of the GATT.[165]

VIII.
CONCLUSION

This paper has shown that although panel interpretations of the GATT are not binding on subsequent disputes, in practice, they have significant precedential value. For the subsequent practice principle to apply to a particular line of legal reasoning, that reasoning must form the *ratio decidendi* of a sufficient number of consensually-adopted panel reports so as to constitute a "concordant, common and consistent" sequence of acts sufficient to establish the agreement of the parties to that reasoning. This practice provides greater certainty as to the GATT-consistency of government regulations, thus creating the conditions for firms to invest in exploiting new market opportunities created by the WTO Agreement. Further, the more precise knowledge of how future disputes will be resolved assists states in the conduct of their trade relations, and promotes acceptance of the stricter discipline of the rule-based system.

Whilst it is tempting to draw analogies between the role of precedent in panel jurisprudence, and the common law doctrine of *stare decisis* or the civil law concept of *jurisprudence constante*,[166] it is premature to do so. With only seven Appellate Body reports adopted so far, the Appellate Body's impact on the precedential value of panel reports remains uncertain. Without any limitation on the right to appeal from issues of law, panel interpretations of the GATT are likely to decline in significance whilst Appellate Body interpretations are

164. U.S. – Measures Affecting Alcoholic and Malt Beverages, *supra* note 66, para. 5.17; U.S. – Measures Affecting the Importation, Internal Sale and Use of Tobacco, *supra* note 25, para. 95-98.

165. *Supra* note 25, para. 95-98.

166. Under the *jurisprudence constante* model, the practice of courts does not become a source of law until it is definitely fixed by the repetition of consistent precedents on a single point. This is contrasted with the common law approach where courts are more likely to rely on a single case as sufficing to establish a legal principle. See DAVID & DE VRIES, *supra* note 64, at 113-121; SHAHABUDDEEN, *supra* note 19, at 10-11.

likely to command greater respect by panels which are now subject to the Appellate Body's legal filter. However, the precise value of previously adopted reports is not crucial in itself. As Hersch Lauterpacht observed, "the power of judicial precedent is in the long run not greater than the inherent value of the legal substance embodied in it."[167] In this regard, this paper has analyzed the scope and content of the competitive conditions principle. The principle and its related rules have been directed at achieving security and predictability in international trade relations. More importantly, they have sought to achieve this, not through accepting narrow interpretations which restrict trade, but by construing GATT obligations with a bias in favor of open markets. This is most evident in the imposition of liability for GATT-inconsistent trade restrictions whether or not they have had an impact on trade flows. Such an approach has the merit of recognizing what economists since the time of Adam Smith[168] have understood: free trade promotes the efficient allocation of resources and makes possible higher standards of living across nations.

167. Hersch Lauterpacht, *The So-Called Anglo-American and Continental Schools of Thought in International Law*, 12 BRIT. Y.B. INT'L L. 31, 52 (1931).

168. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

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Lawrence A. Sullivan

Wolfgang Fikentscher

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On the Growth of the Antitrust Idea

By
Lawrence A. Sullivan*
Wolfgang Fikentscher**

Antitrust is an ambiguous term, especially in an international setting. It refers to a competition policy dealing with business structure and conduct and, more broadly, with the appropriate role of business in modern life. To describe antitrust, then, one must assume a context. One must identify both the government (or governments) whose policy is being considered and a particular historical stage of development. Furthermore, one should be aware of the fact that the meaning of the term antitrust changes depending on various factors: the nation, the time period, the state of technology, the capacity and social demands on business, the overall business culture, the currently accepted economic theories, as well as the overall national concerns and values. Only after accounting for all of these various factors can a description of antitrust begin to be complete.

Historically, and in most current manifestations, antitrust is linked to liberal conceptions about the economic and political function of the market. Antitrust is also a highly adaptable instrument. While its basic role is to protect open, competitive markets, it can be useful, or potentially so, as applied to markets at various stages of development, even to market segments embedded in socially controlled economies. Antitrust is also flexible in another sense. Markets may be valued for many reasons, both economic and political. Antitrust can be defined selectively to emphasize one set of values or another. In the years since World War II antitrust has spread quite widely. This facilitates trade and commerce, reinforcing integrative tendencies in a world which often seems at risk of shattering. The spread of antitrust has been largely through national or (as in the case of the EC) regional initiations, not through any broader international activity. There have been efforts, however, to deal with antitrust on a wider basis and it is perhaps time, once again, for antitrust to be placed on the international agenda.

Our purposes here are ambitious. We try to provide a sophisticated conception of what antitrust is all about. To do this we compare and describe the current state of antitrust in three particular regimes, and also the major develop-

* Professor of Law, Southwestern University Law School, Los Angeles, California.
** Professor of Law, University of Munich Law School; Visiting Professor, University of California School of Law, Berkeley, California.

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mental stages and dynamic influences that have, in each of these regimes, brought antitrust to its current state. We focus upon two systems where, today, antitrust is significant: The United States and the Federal Republic of Germany. In evaluating the potential of transnational antitrust as an integrative force in the world economy, it is important to keep in mind both the deeply liberal roots of antitrust and its flexibility. In Part I we discuss the American antitrust development.

A sub-theme of this comparative inquiry is the influence of the earlier American antitrust system upon the German and EC systems, a matter tinged with irony. The American antitrust system has been an important model for both Germany and the EC, yet their developmental paths have varied considerably. By the 1970's American antitrust had reached a complex, multi-valued, and seemingly robust state. During the 1980's, however, the American system was pruned into a simpler and narrower policy instrument. During that same dynamic period German and EC antitrust grew increasingly complex and multi-valued. Eventually these two systems diverged, each followed its own developmental course. While we emphasize this developmental dichotomy, we try not to overstate it, but rather to explain it in terms of differences in the factors—economic, theoretical, and political—which inevitably influence the development of antitrust policy in each system.

Parts II and III emphasize the spread of antitrust internationally. The antitrust systems in Germany (II) and the EC (III) are the best established of the systems that were created after World War II.

The growth, as we note, has been mainly, but not entirely, an extension of antitrust among market-oriented democracies. In Parts IV and V we briefly identify some of the many unresolved issues to which antitrust inevitably gives rise.

With respect to the liberal democracies, two of the more salient issues are these: Does antitrust tend to lock liberal, western democracies into relying solely on market-oriented solutions to deal with their developmental issues, thus diminishing the realm of industrial policy? Can antitrust play a significant role in breaking down trade barriers and facilitating international market integration, through the WTO or otherwise?

With respect to former and still existing socialist countries there are other questions: Will indigenous, socialist antitrust systems facilitate national planning by providing market-validated cost data? Can a national antitrust policy in a "socialized state" serve the interest of the state by preventing sub-optimal performance in liberalized sectors?

Finally, there is the question whether antitrust policy utilized in other nations or in the developing nations themselves would facilitate or inhibit economic progress in the developing nations. While much of what we will cursorily say on all of these issues is cautious and tentative, we are optimistic, by and large, about the potential value of sensible antitrust policy for developed democracies, for the socialist and transient states and for the developing countries.

I.
AMERICAN ANTITRUST DEVELOPMENT

A. Antitrust Genesis

While there is an earlier English and American common law tradition, and even an ancient Roman "antitrust" law[1], antitrust had its genesis in America as a social response to industrial development and change. Before 1870, the American industrial structure was still simple. Owner-artisans produced goods with a small number of employees, often family members or neighbors or apprentices learning the trade. Though the development of technology and the factory system progressed rapidly — as a result of the government's greater need, and hence, increased purchases during the civil war — the scale of enterprise remained modest and the manufactured products reached the public only after a series of market transactions. Manufacturers purchased needed inputs, sold their output to wholesalers who, in turn, resold to retailers who stocked the products that consumers would ultimately buy. However, as urban populations exploded, marketing opportunities expanded through national communication and transportation networks, and as production technologies advanced apace, growth increased quickly. Domestic and foreign savings accumulated, the capital market developed, and new industries underwent ambitious expansion. Firms that had once been local and isolated found themselves operating as major players in regional and national markets, with large work forces, substantial sunk capital, and significant competition. As over-expansion and volatile demand led to periods of "cut throat" competition, price fixing "pools" became common. When these proved unstable— vulnerable both to "cheating" and to new entry – horizontal consolidation was attempted and proved to be a more effective way to avoid both over-expansion and non-remunerative prices during periods of weak demand.

The first successful industry-wide consolidation was achieved through the efforts of John D. Rockefeller in the petroleum industry. After consolidating horizontally in the form of a trust, Standard Oil expanded vertically, both backward to inputs and forward through the marketing chain. By doing this, Standard Oil became the prototypical modern "big business." As other industries followed this "trustification" process, the face of American industry transformed rapidly. The small, locally owned and managed firm gave way to the new, vast bureaucratic firm managed by hired technocrats.

Laborers, small entrepreneurs, and farmers responded to these developments with apprehension. The political debate had many facets. People generally valued the rapid economic expansion that the nation underwent and many conceded a good deal to the apparent efficiency and technological progress of

1. Ulpian, D. 48, 12, 2 (lex Julia de annona); C.4, 59, 2 (constitution of Emperor Zenon, 483 A.D.; H. v. BRUNN, VOM KARTELLRECHT DER RÖMER, 47 (1938); PIOTRECOSKI, CARTELS AND TRUSTS: THEIR ORIGIN AND HISTORICAL DEVELOPMENT FROM THE ECONOMIC AND LEGAL ASPECT (1933); REINHOLD TRINKNER, DIE KARTELLGESETZGEBUNG DES CORPUS JURIS JUSTINIANI IM VERGLEICH ZUM MODERNEN RECHT 860 (1973).

the new large firms. But the trusts were often aggressive as well as efficient, and both price gouging and tactical excesses were not beyond them. As stories of such abuses became widespread, hostility towards the trusts grew. In 1888, both the Democratic and Republican party platforms contained antitrust planks, and the Sherman Antitrust Act was passed in 1890 with widespread support.

The political and legislative history of that enactment has been much explored. While there was diversity of opinion among the public and in the Congress, the commonly held goals were the preservation of competition in order to protect buyers from excessive prices, assuring that markets remained open, and protecting competitors from abusive tactics. As James May has shown, these goals were seen as directly linked to those goals associated with the then dominant, liberal, constitutional tradition. The constitution the nation knew in 1890 was atuned to protect economic opportunity, property, contract, and political liberty from the excesses of governmental power. Accordingly, antitrust would protect these same values from the excesses of the new "autocrat[s] of trade." It, too, would be informed by the classical economic conviction that to assure the common welfare, markets should remain open and competitive. Moreover, the implicit assumption was that the efficiency and progressiveness for which the trusts were valued could be obtained without giving up competitive markets and without having to tolerate tactical excesses from large and powerful firms. It was felt, and sometimes even understood theoretically, that political and economic freedom were related, and that a commonwealth must protect and develop both.

At its inception, then, antitrust was a uniquely American institution. It sought to advance a variety of libertarian economic and political values, and to do so by neither mandating nor by constraining the end results of business activity, but rather by assuring that the industrial and business processes remained competitive. Problems, such as the relationships between scale economies, the potential for entry, and monopoly pricing, were either dimly perceived or not perceived at all. The strategy was to embody common law conceptions in the statute and to let the courts work out the problems deductively when they were encountered in specific, fact-intensive industrial contexts. It was assumed, apparently, that courts could perform this role as effectively and in much the same way that under the constitution they had protected the populace against the excesses of bureaucratic Government.

B. Laissez-Faire and Industrial Organization

Thus launched, American antitrust went through several developmental stages. These were influenced, of course, by judicial attitudes and by the state of theoretical knowledge (or belief) prevailing from time to time. As Professor May shows, figures like Justices Peckham and White, who strongly influenced the development of the law, may have disagreed about the appropriate limits of judicial discretion, but they shared core beliefs that are reflected in their constitutional and antitrust opinions and votes. For each of them, and for the American courts generally in the early part of this century, both the constitution and

antitrust decisions were informed by classical, *laissez-faire* thinking. Both the constitution and the Sherman Act were placed in the service of "a natural right-based political and economic order that simultaneously tended to ensure opportunity, efficiency, prosperity, justice, harmony, and freedom."[2]

But antitrust development was not solely in the hands of judges. The level and direction of antitrust enforcement was probably influenced even more by the beliefs and commitments held, and the compromises made, in the executive branch.

The ambivalence in the public's attitude toward the trusts, apparent since their inception, persisted. Indeed, as big business grew more common and the economy expanded more quickly, public uncertainty about the constraints on large firms increased. At any rate, enforcement agencies were slow to challenge the trusts and when they first did the result was not an unqualified success. During the first decade of the Sherman Act, cartels were challenged, but consolidation and related vertical integration – the very process of "trustification" which led to the statute – were not contested. In consequence, an even greater consolidation movement occurred after the Sherman Act was passed. Trust development was being challenged in the second stage — indeed, quite aggressively during the Teddy Roosevelt and Taft administrations — but with limited success in the courts. In a series of cases involving railroad consolidations the courts seemed to hold that mergers among significant competitors in a concentrated market were *per se* unlawful. Relatedly (or, perhaps, by way of contrast) the Court, upon announcing the "rule of reason," held in the *Standard Oil*[3] case that the attainment of monopoly power, other than by ordinary methods of industrial development, was unlawful. However, shortly thereafter, in the *Steel*[4] case, the court held that attaining dominance by consolidation did not violate the act, at least in circumstances where the only abuse shown preceded consolidation and where the firm's post-consolidation power was eroding in response to normal market forces.

By this time, major lines of legal doctrinal development were in place. Certainly cartelization – horizontal price fixing by unintegrated firms — and in all probability other cartel activities, such as market division or the assignment of production quotes, were *per se* unlawful. Also, consolidation that led to monopoly was clearly unlawful when followed by abusive competitive tactics. Furthermore, consolidation was probably unlawful even without such tactics if challenged as soon as monopoly was achieved. Yet it was apparently not unlawful if abuses were avoided and power seemed to be eroding.

Later in this century, antitrust enforcement was largely aborted during the First World War and during the Harding-Coolidge years. President Hoover, elected in 1928, conceded only a marginal role to antitrust. While he opposed blatant cartelization, he believed that the cooperative exchange of technological

2. James May, *Antitrust in the Formative Era: Political and Economical Theory in Constitutional and Antitrust Analysis, 1889-1918*, 50 OHIO STATE L.J. 258, 391 (1989).
3. Standard Oil Co. of New Jersey v. U.S., 221 U.S.1, 31 S.Ct. 502, 555 L.Ed. 519 (1911).
4. U.S. v. U.S. Steel Corp., 251 U.S. 417, 440 S.Ct. 293, 364 L.Ed. 343 (1920).

and market information would assure both orderly and progressive markets, and would also keep small firms viable by providing them with the skills and information they needed to be progressive.

Franklin D. Roosevelt (FDR), elected following the Great Depression, took an even dimmer view of antitrust. The initial response during his administration – the enactment of the National Industrial Recovery Act – was aimed at aborting antitrust almost completely. The Act encouraged cartelization, but also encouraged the organization of labor and the establishment of industry-wide codes of fair practice. These, it was hoped, would lead the country out of the depression.

Despite that unpromising beginning, the most significant years in American antitrust development began during FDR's presidency. First, drawing upon the liberal, *laissez-faire*, constitutional tradition with which the enactment of the Sherman Act was itself linked, the Supreme Court held the National Recovery Act (NRA) legislation unconstitutional.[5] Second, advisers to the President, like much of the nation, grew increasingly concerned about developments in Nazi Germany. A widely held American perception was that concentration and cartelization in Germany had facilitated Hitler's effort to draw industry into the service of the Nazi state. This invited the inference that cartels, whatever their economic merits or demerits in a time of economic crisis, were a grave political risk, especially given the existence of numerous links between leading American firms and German cartels.

Roosevelt responded with characteristic boldness both in the legislative and the executive realms. He proposed, Congress provided for, and he appointed a Temporary National Economic Committee charged with gathering and analyzing all available factual information about industrial concentration and its dangers. This step fueled much of the antitrust discussion that occurred during and after the Second World War and led, in 1950, to the passage of a new anti-merger law. Roosevelt appointed Thurman Arnold, the very model of the aggressive antitrust enforcer, as Assistant Attorney General in charge of the Antitrust Division of the Justice Department. These moves initiated the period of structural consensus — a stable, energetic antitrust enforcement — which began in the late 1930's and lasted into the 1970's.

C. Structural Consensus

1. Structure, conduct, performance

During that lengthy period, the original intentions of the framers of the antitrust statutes were methodically tested and generally successfully. By the time the structural consensus began, the orthodox theoretical position among American antitrust enforcers was no longer the unstructured classical view accepted by Congress in 1890. Nor was it the newer neo-classical position which

5. Concerning these early decision on the New Deal *see*, e.g., LOCKHART, ET AL., CONSTITUTIONAL LAW: CASES, COMMENTS, QUESTIONS, 83-91 (8th ed., 1996).

identified competition with the rigorous theoretical assumption that it was necessary to convert buyers and sellers into powerless price followers.

Rather, both antitrust enforcers and courts drew from the insights of industrial organization economics which stressed the relationship between: (1) market structure (level of concentration among buyers and sellers; extent of product differentiation; high or low barriers to entry; extent of vertical integration); (2) conduct (or behavior) in the marketplace (determined by examining whether firms colluded on price or engaged in interdependent pricing, as well as examining the character of strategic activity: investment in excess capacity, product variation intended to inhibit interconnections, predatory litigation or advertising, etc.); and (3) performance (productive, allocative and distributive efficiency, stability and fairness).

The basic insight of industrial organization economics was that the higher the level of concentration, the greater was the likelihood that there would be anticompetitive conduct and socially unsatisfactory performance, such as allocatively inefficient prices well in excess of cost, wasteful expenditures (so called "x-inefficiencies" and "rent-chasing" expenditures, such as investment in unneeded capacity intended to deter entry), and socially inadequate research and development (or even product manipulation undertaken not for progressive, but for rent-chasing purposes).

Drawing on these insights, relating them to the language of the statutes, and mindful of the simplifications needed to fashion a manageable, understandable, and reasonably cohesive set of antitrust norms, Congress, antitrust enforcement officials, scholars, lawyers, and courts all made their contributions toward the development of the law during the consensus period.

In 1950, Congress passed a tough antimerger law.[6] For years thereafter the enforcement agencies during both Republican and Democratic administrations enforced it vigorously, and the Courts responded in ways consistent with the legislative intent. From 1950 to 1980, throughout the administrations of six successive presidents, merger policy included certain norms. First, a market or submarket under the law was any line of commerce in any section of the country in which participating firms have some advantage over other firms. Mergers of any significant competitors (say a 4% firm with a 5% firm) within a market could be successfully challenged. So could mergers of substantial buyers and sellers in concentrated markets where competitors of either the substantial buyer or seller would be foreclosed from a significant source of supply or demand. Second, market extension mergers between leading firms could be successfully challenged if they contributed to further entrenching a leader or if, but for the merger, de novo entry might occur. Indeed, even conglomerate mergers were suspect where reciprocal restraints might result.

During the same period, the case law concerning monopolization was developed and refined. The extent of power was to be inferred from concentration data in a well-defined "relevant market." If monopoly power existed, or its

6. Celler-Kefauver Act of December 29, 1950, 1184, 64 Stat. 1125.

achievement was threatened, then all "exclusionary," "restrictive," or "anticompetitive" conduct violated section 2 of the Sherman Act.

For several reasons, a concrete monopoly and supra-competitive pricing by a monopolist were not alone unlawful. Monopoly may, in a narrow market, be the only way to attain efficient scale. Even in wider markets the hope of monopoly and supra-competitive returns may spur competitive efforts. It was argued that it would be unfair and inefficient to punish a firm that gained monopoly by the very conduct the law encourages.

Furthermore, to forbid supra-competitive pricing by an otherwise innocent monopolist would require courts to continually engage in economic regulation, for which they are ill-equipped. But once it was shown that a monopolist had gained, protected, or expanded its power by conduct that need not be tolerated for the reasons summarized above, the law reacted strongly. The remedy was not to regulate the power and restore or establish competitive conditions. If this could be done with reasonable effect by enjoining conduct that proved essential to maintain the monopoly, a conduct remedy might do. But if only divestiture would effectively end the power, divestiture was in order.

This area of the law – the control of monopolization – was not as precise and predictable as was merger law. Market definition would often be contentious. Courts had some discretion in deciding whether monopoly power, or the danger of it, had been proved. Conduct evaluation was also – indeed, remains – something less than a precise art. But there can be little question that throughout the consensus years the rules constraining the conduct of powerful American firms were formidable. Nor can it be doubted that these norms caused leading firms to temper their more aggressive competitive impulses.

Concerted conduct by firms competing horizontally was also evaluated rigorously during the consensus years. Cartel-like activity was *per se* unlawful. In concentrated markets any conduct likely to facilitate cartelization or oligopolistic interdependence in pricing was subject to challenge. Boycotts, or other forms of concerted aggression, directed against horizontal competitors were also unlawful, regardless of any showing of market power. The competitive process requires that markets be open to entry. Existing firms may not blockade them.

Rules against vertical restraints were also strict, and were aimed at protecting dealer independence as well as the allocation and other efficiency values associated with competition. Restraints that hindered the pricing option of downstream firms were *per se* unlawful. So, for a time, were those restricting other marketing options. Restraints that limited the access of horizontal competitors to outlets or inputs were also *per se* unlawful. And, of course, any vertical restraints shown to significantly restrain horizontal competition at any level would violate the rule of reason.

It would not do to overstate the harmony of this structural consensus period. while differences of enforcement emphasis were apparent between one administration and another, the structure-conduct-performance paradigm dominated throughout. The technical debate, discussion (and sometimes confusion) that went on amongst economists was basically committed to that paradigm, and

this commitment had its reflection in policy. Some enforcement officials were tougher than others, points of emphasis sometimes shifted, and adherents to the consensus often parted company and debated particular points of economics, policy or legal judgement. Yet throughout the period the beliefs held in common were more significant than those held in opposition. Structural antitrust was alive and well, whether it was Eisenhower, Kennedy, Johnson, Nixon, Ford or Carter occupying the Oval Office.

2. Structural consensus ideology

Can one specify the convictions and beliefs so widely shared during the period of structural consensus and determine their sources? To attempt to do so is, in some degree, to speculate. Yet some of the relevant factors can be confidently identified. We have already mentioned industrial organization economics.

At a minimum, industrial organization economics played a role that theoretical knowledge often plays in policy development: it provided a rationale for the policy with protective appeal. But more than this can be inferred; industrial organization economics was a particularly useful rationale for the widely accepted policy because it shared some basic characteristics with the prevailing policy attitudes.

Industrial organization economics is an inductive system that makes the study of particular industries compellingly evident. It avoids excessive rigor in its formulations. In the traditional paradigm, industrial organization economics identifies the tendencies of significant relationships, and its generalizations do no more than point in a direction. They invite either fact-intensive inquiries into particular cases — as in those involving monopoly conduct or practices facilitating interdependence — or the fashioning of general rules with the full knowledge that it will result in some false positives as well as many accurate ones, as in the case of horizontal merger norms. Industrial organization economics is, moreover, a bold, confident, and ambitious mode of inquiry. It does not hesitate to try and understand the particular, to identify what is of value, what is obsolete, and what might be changed.

These features of this mode of inquiry fit remarkably well with the politically dominant attitude in America during the consensus years. The country, too, was bold and confident. People thought that they could figure things out, preserve what was right, and eradicate or improve what was wrong. In large numbers, moreover, they thought there were social responsibilities — things that could and should be done through government. Peace was to be restored, tyranny contained, and democratic nations revitalized. Civil rights were to be achieved for all, poverty abolished, cities beautified, the environment purified, and prosperity protected by fine-tuning the economy. All this was to be done by a socially responsible government.

However, there were, no doubt, other strands of thought that fed into this consensus. The old constitutional notion — that government should leave markets alone and not interfere with individual economic initiative and mobility —

had faded long ago. But during the consensus period another view came into its full flower: that those possessed of private economic power should be constrained.

A notion sometimes called populist came into play. There were those who mistrusted big business in any form, and some who were revolted by any display of wealth and power. The consensus was wide enough to allow both groups elbow room. During much of the consensus period, enforcement efforts kept to terrain where claims of moral rectitude, or of judicious and fair minded law enforcement could be made.

Enforcement, by and large, was aimed at conduct, and mostly conduct that would be publicly regarded as inappropriate. Price fixing and other forms of cartelization certainly met this standard, as did predatory pricing. Many vertical restraints subject to challenge were perceived to be unfair. Mergers, at least by big firms, were and still are viewed with suspicion, and are seen as manifestations of greed. While a few residual areas of enforcement (small mergers and information exchanges in concentrated markets) may not themselves evoke sympathetic public responses, antitrust is generally regarded by the public and many, if not most business people, as a system of fair rules for the competitive arena.

No state of affairs persists indefinitely. During the 1970's one could identify strains in the consensus. Some enforcement efforts exceeded the cautious bounds assumed above. Neoclassical theorists of the "Chicago School" — long critical of traditional enforcement but mostly ignored — became more prominent. What they wrote and said began to shape, if not the law, then at least the agenda for debate and discussion. In a few important opinions, the Supreme Court moved away from earlier pro-enforcement holdings. In other cases, important lower courts rendered decisions for defendants that probably would not have been reached a decade earlier. With hindsight, one can say conditions were right for significant change.

D. Chicago School

Change — indeed a revolution in enforcement policy – began with the election of President Reagan in 1981. He appointed prominent Chicago School theorists to head the Antitrust Division and the Federal Trade Commission (FTC), and named three of them to the federal appellate bench. Chicago theory became federal antitrust policy in the enforcement agencies.

Enforcement ceased. Merger guidelines were revised and even sometimes ignored as enforcement agencies approved mergers that seemed clearly vulnerable under settled law. A major monopoly case against IBM was abandoned on the threshold of victory in 1982, contrary to the results of a settlement unfavorable for IBM before the European Commission in a similar case.[7] Enforcement energies were turned to fashioning guidelines that articulated why vertical restraints should not be challenged, to acting as *amicus curiae* in favor of defendants in private litigation, to pressing for legislative revisions that would weaken

7. Commission v. IBM, WuW 686, 964 (1984).

existing law, and to developing, articulating, and litigating to obtain acceptance of theories that would reduce the standing of private parties to challenge antitrust violations.

Just as industrial organization economics has affinities with the belief system that yielded the structural consensus, so Chicago theory has affinities with the belief system that fashioned the revolution. Chicago theory is attuned to one goal — efficiency, mainly allocative efficiency. Important aspects of productive efficiency, for example waste that is often associated with non-competitive markets, is largely ignored, and dynamic efficiency is often wholly ignored.

Chicago theory assumes that all market conduct is rational, profit-maximizing conduct. That being so, all conduct is either efficient conduct or monopolizing conduct. Chicago theory applies a simple test to differentiate between the two: does the conduct discernibly result in a reduction in output and a consequent increase in price? If yes, then it is monopoly conduct. As such, it should be forbidden unless it yields productive efficiencies which outweigh the allocative inefficiencies. (This is where productive efficiencies are taken into account). If productive efficiencies are attained, and exceed the allocative inefficiencies, it does not matter that price has gone up, even if all the efficiency benefits go to the monopolists and none to the consumers. Theory cannot attribute greater social value to a dollar in the hands of a monopolist than to a dollar in the hands of a consumer. If the conduct does not reduce output and increase price it is by definition efficient. Efficiency is the residual category.

The related policy attitude of the administration that adopted the Chicago theory is nearly the opposite of the attitude that formed the earlier consensus. The new attitude assumes that markets, however they may be structured, are very robust, self-correcting institutions. It also assumes that government intervention into markets almost always arises out of capture by private interests seeking to use the government as a means of distorting market allocation. Either that, or the intervention is simply ill-informed and inept. The new attitude relies for public support on anti-government ideology. And sufficient support there has been.

Just as Americans have been ambivalent about private power, so too have they been ambivalent about Government power. If the consensus period was one of confidence, the Reagan years were of doubt and concern. Americans had seen two earlier governmental policies go wrong. The war on poverty, the model cities program, and fighting crime proved only to be partly successful. They had seen that even success and progress in the protection of civil rights could yield its own backlash. They had seen scandal in high places — indeed in the highest. They had seen disastrous decisions with respect to Vietnam. All the while, America could no longer manufacture products with the same degree of skill as other manufacturing nations — cars included. In such an environment, the call to "get the government off the back of business," had a certain appeal. So did the assertion that efficiency should be the sole concern — that America cannot afford to indulge itself with economic policies aimed at other goals. So the pendulum swung. With Baxter, Ginsberg and even Rill, with

Scalia, Bork, Easterbrook and Posner, the Chicago ideology came to ascendancy throughout the enforcement agencies and to some extent in the courts.

One can only speculate whether Chicago thinking will remain influential and if so for how long. The Chicago position on vertical restraints and on private antitrust standing have both been largely, if not completely successful in the courts, though subject to considerable criticism in Congress, which could lead to eventual modification. The Chicago position on mergers has not really been tested in the courts because mergers are now so seldom challenged. The few judicial materials available tell a mixed story. The Chicago position on horizontal restraints and on monopolization has not been notably successful in the courts. While one can hardly predict a rapid return to consensus thinking and policy, neither can one assume that Chicago thinking continues to dominate in the enforcement agencies or the courts. There are indications that even the more rigorous price theory analysts are, today, going beyond the over-broad assumptions on which Chicago School antitrust analysis has been based.

II.
THE GERMAN ANTITRUST DEVELOPMENT

A. The Inception of Antitrust Through the Havana Charter and the Decartelization Law

American antitrust, in a form much closer to that which it had during the consensus years than to its present ambiguous form, has spread among other nations. This diffusion of law and legal philosophy was made possible by the Havana Charter of 1945, which provided for the International Trade Organization ("ITO"). As such, the Havana Charter never went into force. A review of the transfers of laws in legal history demonstrates that such a diffusion, one effectuated via an unsuccessful international instrument, is a rather special case.[8]

Chapter V of the Havana Charter contains an international antitrust law. The insight of the drafters was that it made little sense to regulate tariffs without dealing with business concentrations, cartels, and their trade practices.[9]

The Western Allied occupation powers were convinced that the norms of Chapter V, by facilitating international trade, would aid post war recovery in

8. There are some comparative accounts on what is called transfer or reception of law. Here follow some examples: A survey on the spread of civil and common law in A.T. VON MEHREN & JAMES R. GORDLEY, THE CIVIL LAW SYSTEM 3 (2nd ed. 1997); on the acceptance of common law in the world *see* K. ZWEIGERT AND HEINZ KÖTZ, EINFÜHRUNG IN DIE RECHTSVERGLEICHUNG AUF DEM GEBIETE DES PRIVATRECHTS, 214, 237 (3rd ed. 1996); on various ways of legal transfer *see* M. Alliot, Über die Arten des "Rechts-Transfers," *in* ENTSTEHUNG UND WANDEL RECHTLICHER TRADITIONEN, 161 (Fikentscher, Franke, and Köhler eds., 1980); a view from anthropology is contributed by L. POSPÍSIL, ANTHROPOLOGY OF LAW: A COMPARATIVE THEORY (1974), in particular Chapter 6 (Internationalization vs. Enforced Legal Transfer); and from legal history WOLFGANG WIEGAND, STUDIEN ZUR RECHTSANWENDUNGSLEHRE DER REZEPTIONSZEIT (1977); *W. Wiegand, Reception of American Law in Europe*, 39 AM. J. COMP. L. 229 (1991); W. Wiegand, *Americanization of Law: Reception or Convergence?, in* LEGAL CULTURE AND THE LEGAL PROFESSION 137-152 (Lawrence M. Friedman and Harry N. Scheiber eds., 1996).

9. The text of Chapter V is set forth in Appendix A, United Nations Publications Sales N° 1948, II D. 4 (*Reprinted in* A. GLEISS AND WOLFGANG FIKENTSCHER , WUW 245-252 (1953).).

Germany and Europe as a whole. They also apparently thought that free market norms were related to a democratic constitution. Therefore, they used Chapter V as a basis for decartelization statutes in their respective occupation zones, thus eliminating a broad range of practices in restraint of trade which had been common in Germany.

By doing so, they indirectly influenced the present German law against restrictive trade practices, as well as Article 85 the EC Treaty. Both the West German anti-trust law and the EC Treaty went into force on January 1, 1958. Consequently, substantive provisions of Chapter V of the Havana Charter on restrictive trade practices had a significant impact on the present status both of German law and European economic law.

The German decartelization law became the only legal binding form of Chapter V of the Havana Charter. From February 12, 1947, to May 5, 1955, the decartelization law was part of the legislation of the occupation powers. From May 5, 1955, to December 31, 1957, the same legislation became federal law of the Federal Republic of Germany.[10] On January 1, 1958, a new Law Against Restraints of Competition, drafted and enacted by authorities of the Federal Republic of Germany, went into force and repealed the three occupation laws. The German law was prepared, in part on the lines and on the basis of the philosophy of the occupation statutes. Thus, the present German Law Against Trade Restraints (GWB) is–maternally–a daughter of the Allied occupation legislation, a grandchild of the Havana Charter and great grandchild of U.S. American antitrust law.

Since its enactment, the Law Against Trade Restraints has been amended six times. In 1966, cooperation between small and medium-sized enterprise was made easier.[11] Moreover, section 22 on abuses of market dominating positions was expanded from an enumerative list of abuse. There was a controversy whether the abuse was to occur on the same market which was dominated or whether an effect on a third market by the abuse would be sufficient. The text of the amendment decided on the latter theory.

By the second amendment in 1973, apart from minor additions, the Law underwent five major changes.[12] Again, the control over market-dominating enterprises was considerably expanded. Resale price maintenance for trademarked goods was abolished and, taking French and Canadian law as a model,

10. On the basis of the Paris Protocol of October 23, 1954, Bundesgesetzblatt (Federal Gazette) 1955 II 213; for American Occupation Zones, the decartelization statute of the Military Government Law N° 56 of February 12, 1947, *in* ABl, Apr.1, 1947, at 2, *in* R. HEINKEN, SAMMLUNG DER VOM ALLIIERTEN KONTROLLRAT UND DER AMERIKANISCHEN MILITÄRREGIERUNG ERLASSENEN PROKLAMATIONEN (n.d.); for the British Occupation Zone, the decartelization law was the Military Government Ordinance N° 78 of February 12, 1947, ABI 16, p. 412; for the French Occupation Zones, the decartelization law was the Military Government Ordinance of N° 96 of June 9, 1947, Jour., Off. p. 784; the texts of the U.S. law and the British Ordinance were identical; the French version was slightly different. For details *see* A. GLEISS & WOLFGANG FIKENTSCHER, WuW 525-533 (1955). On January 1, 1955, the Law Against Restraint of Competition of June 27, 1957 (BGBI. I 1081) ended the era of occupation antitrust.

11. Law of September 15, 1965 (BGBl. S.1363).

12. Law of August 5, 1973 (BGBl I S. 918).

compulsory contracting was provided for the marketing of goods to retailers, who needed these goods to be competitive. In this way, the prohibition on resale price maintenance was made difficult to evade by refusing delivery to retailers who sold at low prices. Section 25 was extended to make concerted actions (Gentlemen's Agreements, "Gary Diners") an offense. A more effective merger control was introduced. Finally, in the third amendment of 1976, merger control for press mergers was profoundly strengthened.[13] Since then, press mergers have become a risky business in the Federal Republic. Hardly any case taken up by the *Federal Cartel Office* and brought before the court has been won by the defendant.

The fourth amendment of 1980, among other tightening provisions, stiffened merger control and the discrimination prohibitions.[14] It also limited the exemptions for banking, insurance, and utility corporations.

A fifth amendment followed in 1989.[15] Under section 26, al. 2, a compulsory contracting phrase in favor of retailers was restricted to small and medium-sized retailers. (Goods could now be kept out of the hands of large retailers known to be price cutters). The presumptions in section 26, al. 2 and 3, were made more precise. Predatory behavior against small and medium-sized competitors was more clearly prohibited (section 26, al. 4 and 5, formerly section 37, al. 3, a provision originally added to the Law by the amendment of 1980). Section 47 entitled the Federal Cartel Office to act under Articles 87, 88, and 89 of the EC Treaty.

A sixth amendment went into force on January 1, 1999.[16] It streamlined the whole Law Against Restraints of Competition — which in some of its chapters had become unorganized by the impact of earlier amendments, and partially renumbered sections, integrated important case law reduced the number of exemptions from the law and, to some degree, harmonized German and European antitrust law. The main changes introduced by the sixth amendment include the identification of competition and the market in section 1 (and thus the adoption of the theory of the subjective market), the enactment of a limited rule of reason for cartels in Section 7[17] (new), and the replacement of a regulation proscribing administrative abuse[18] by legislation prohibiting[19] the abusive exercise of a market dominating position.[20] As a result, it is now possible to bring private

13. Law of June 28, 1976 (BGBl. I S. 697).

14. Law of April 26, 1980 (BGBl. I S. 458).

15. Law of November 12, 1989 (BGBl. I S. 2486).

16. Law of August 26, 1998 (BGBl. I S. 2546); for a discussion of the essential features of the sixth amendment *see* Rainer Bechtold, *Das Neue Kartellgesetz* NJW 2769-2774 (1998). The *Gesetz zur Bereinigung wirtschaftsrechtlicher Vorschren* [Law for the Rearrangement of Legal-economic Rules], v. 27.2.1985 (BGBl. I S. 457), while it was not a substantive amendment to the Law Against Restraints of Competition, it did rephrase some of its provisions without changing their contents; some authors count it as the 5th amendment, which would make the 5th amendment of 1989 the 6th, and the 6th amendment of August 26, 1998, would become the 7th amendment.

17. *Cf.* Article 85, number 3, EC Treaty.

18. The old version of Section 22.

19. The new version of Section 19.

20. *Cf.* Article 86 EC Treaty.

law suits alleging market-dominating behavior under section 35. There are no longer any restrictions on antitrust arbitration. Also, there is closer scrutiny of discriminatory behavior (including sales below cost), mergers, and denied access to essential facilities. Finally, the future seat of the Federal Antitrust Authority will now be in Bonn, instead of Berlin.

B. The West German Development in Antitrust Philosophy

1. The Freiburg School and the Discussion of Economic Value Systems

But this descent does not tell the entire story. Antitrust, a transplant from a failed international treaty forced on a defeated nation by an occupying power, has thrived in Germany to a remarkable degree. The reason lies in German political and economic culture. Besides its maternal lineage, German antitrust also had a father; the so-called Freiburg School. The Freiburg School had been constrained during the Nazi period but came to life after the war. The teachings of the Freiburg School, also termed the German "Neoliberalism" or "ORDO-Liberalism," developed after 1936 primarily in the Freiburg University Faculty of Economics. There is an "outer" story of Freiburg, and an "inner" story. Both should be told because there not much is widely known of either of them.[21]

2. The Public Story of the Freiburg School

In 1933, the year the of the national, socialist *Machtergreifung*, Professor Walter Eucken who taught economics at the University of Freiburg met the two law professors, Franz Böhm and Hans Grossmann-Doerth. Franz Böhm had just published his seminal book *Wettbewerb und Monopolkampf* [Competition and the Struggle for Monopoly] in which he attempted to define the interrelation of economic liberalism and "the positive legal order." Grossmann-Doerth had written against the abuse of the adhesion contract. Franz Böhm was a very good friend of Heinrich Kronstein.[22] In 1932, Kronstein had just published his book *Die abhängige juristische Person* [The Dependent Corporation], which was to become another classic. Here, for the first time in German law, a modern critical theory of law against the possible abuse of the corporate entity was developed ("piercing the corporate veil"). Kronstein had to leave Germany in 1934 to escape persecution, as had Wilhelm Roepke and Alexander Rüstow, other friends of Eucken, Böhm and Grossmann-Doerth. In 1936, these three began to publish a monograph series *Ordnung der Wirtschaft* [Order of the Economy], which later, in 1948, grew into the *ORDO-Jahrbücher*, the basic theoretical journal of the ORDO-Liberalism, developed by the Freiburg School.

21. For details *see* ANDREAS HEINEMANN, DIE FREIBURGER SCHULE UND IHRE GEISTIGEN WURZELN, MÜNCHEN (1989), *and* David J. Gerber, *Constitutionalizing the Economy: German Neoliberalism, Competition Law, and the "New" Europe*, 42 AM. J. COMP. L. 25-84 (1994), *and* DAVID J. GERBER, LAW AND COMPETITION IN TWENTIETH CENTURY EUROPE: PROTECTING PROMETHEUS (1998).

22. Heinrich Kronstein to Wolfgang Fikentscher in 1966: "We knew each other from sandbox."

In spite of repeated persecution, attempts by Nazi authorities to stop their research enterprise were never carried to a successful end. The Freiburg Faculty of Economics was regarded as "a kind of natural park of liberal economic theory."[23] Soon, a larger group of like-minded writers and researchers assembled around the three founders.[24] Among the younger followers and contributors was Professor Ludwig Erhard who later in 1949 became the first German minister of economics after the war, and the German chancellor to follow Konrad Adenauer. Thus, it was Erhard and Müller-Armack who developed from ORDO-liberal thought the concept of *Soziale Marktwirtschaft*, which was to be the economic system that essentially — although in varying forms — remained an unchallenged, all-party platform from the founding of the Federal Republic of Germany in 1949 until today.

Soziale Marktwirtschaft, the basic principle underlying German antitrust policy from its beginning to this day, insists that there be a close link between a liberal economic order that values property, freedom of contract, and economic mobility, and a political order that builds on democracy and personal liberty. Interestingly enough, *Soziale Marktwirtschaft* thus brings together in a theoretical, even philosophical manner, essentially the same insights and elements that were pragmatically combined when the Sherman Act was passed. The liberal constitutional regime that was in place in America at that time protected its citizens' political and economic liberty from undue interference by the government. The Sherman Act, on the other hand, was a law that curtailed economic liberty by protecting its citizens from undue interference by those exercising private economic power.

3. The Private Story of the Freiburg School

The Freiburg School of thought took shape in an environment of dictatorship after 1933, when it was exposed to political persecution. Fortunately, the Freiburg School of thought fit reasonably well into the broader development of post-World War II German law and legal theory. Freiburg neoliberalism was linked to the post-war development of German law in the following way: German tradition already had a theoretical, but practically influential, feature that combined the three factors of property, contract, and competition. All three to-

23. G. SCHMÖLDERS, PERSONALISTISCHER SOZIALISMUS. DIE WIRTSCHAFTSORDNUNGSKONZEPTION DES KREISAUER KREISES DER DEUTSCHEN WIDERSTANDBEWEGUNG. DEMOKRATISCHE EXISTENZ HEUTE, (1969). For other literature besides HEINEMANN and GERBER, *see supra* note 21; on the rise and teaching of the Freiburg School *see* WOLFGANG FIKENTSCHER, WETTBEWERB UND GEWERBLICHER RECHTSSCHUTZ. DIE STELLUNG DES RECHTS DER WETTBEWERBSBESCHRÄNKUNGEN IN DER RECHTSPORDNUNG (1958); FRANCOIS BILGER, LA PENSÉE ECONOMIQUE LIBERALE DANS L'ALLEMAGNE CONTEMPORAINE (1964); FRITZ HOLWARTH, ORDNUNG DER WIRTSCHAFT DURCH WETTBEWERB, ENTWICKLUNG DER IDEEN DER FREIBURGER SCHULE, SCHRIFTENREIHE DES INSTITUTS FÜR ALLGEMEINE WIRTSCHAFTSFORSCHUNG DER ALBERT-LUDWIGS-UNIVERSITÄT FREIBURG (1985).

24. These included Edith Eucken-Erdsiek, Constantin von Dietze, A. Friedrich Lutz, Bernard Pfister, Hans Gestrich, Fritz W. Meyer, Adolf Lampe, Karl-Friedrich Maier, Leonhard Miksch, K. Paul Hensel and Alfred Müller-Armack, who, in 1948, proposed to Ludwig Erhard the renaming of Neo- (or ORDO-) liberalism as "Social Market Economy," in order to make it politically easier to sell to the German electorate.

gether were thought of as the basis of general, private, and commercial law. These three factors came together as a result of a four-stage developmental process:

(1) In 1923, Professor Martin Wolff from the Berlin University School of Law, published a groundbreaking article on how the traditional Roman law concept of property[25] changed in response to the then new German Constitution of 1919. The Constitution made property both a basic right, an entitlement of the individual, and also an instrument that was to be used for the benefit of society.[26] Thus, property was now embedded in a social context that the German Republic needed for it to continue functioning.[27] Wolff's article introduced into the German legal tradition an idea that is still part of German property law; that property rights, including contractual rights, should be construed in ways consistent with the needs of society.

(2) Sometime around 1927, Wolff's student, Heinrich Kronstein, integrated this line of thought into the field of corporate entity and business combines.[28] Thereafter, as a result of the publication in 1932 of Heinrich Kronstein's book, *Die abhängige juristische Person*, the corporation was widely understood to be a concept responsive to the legal and sociological purposes of a modern society.[29]

(3) As has been said, Heinrich Kronstein and Franz Böhm were friends since boyhood and consequently, they exchanged views on what Kronstein was attempting to accomplish with his book *Die abhängige juristische Person.* Now it was Franz Böhm, professor of law, who extended the idea of the individual's and corporate property's socio-economic functionality to contract and competition. Martin Wolff's inclusion of contractual rights in the constitutional sense of property prepared the ground for such an extension. Böhm, however, radicalized the functionality of the contract system for societal purposes. In 1927, Böhm tied contract to competition when he wrote an article on the "problem of economic power."[30] From 1924 to 1931, Böhm served in various capacities in the Cartel Department of the *Reichswirtschaftsministerium* [Reich Ministry of

25. § 903 Bürgerliches Gesetzbuch (Civil Code).

26. Article 153 German Constitution ("Weimar Constitution") (1919).

27. MARTIN WOLFF, REICHSVERFASSUNG UND EIGENTUM, FESTSCHRIFT FÜR KAHL, 3-30 (1923).

28. It is uncertain whether it was Wolff's or Kronstein's idea to apply the limiting principle of property to the concept of the corporation. Fikentscher thinks it was Kronstein's for the following reasons: In his doctoral dissertation on *Heimstättenrecht* [a sort of homestead law], which Kronstein wrote under the supervision of Wolff in 1923 and 1924, Kronstein tried to analyze some concepts of property law "historically and sociologically," but Wolff insisted that he should drop this and concentrate instead on the positive law; KRONSTEIN, BRIEFE AN EINEN JUNGEN DEUTSCHEN [Letters to a Young German, an autobiography] 91 (1967). Later, apparently, Martin Wolff became convinced that the young Kronstein was able to handle the approach which he, Wolff, had so successfully applied in 1923 on a broader basis, permeating the whole of civil law. *See also* WOLFGANG FIKENTSCHER, GATT – GRUNDSÄTZE, PROPERTY RIGHTS UND DER SCHUTZ DES FREIEN UND LAUTEREN WETTBEWERTS, FESTSCHRIFT RUDOLF LUKES, KÖLN ETC. 377-394 (1989).

29. In the common law tradition, this notion is older, and dates back to the "chartered corporation" of the 17th century.

30. Franz Böhm, *Das Problem der wirtschaftlichen Macht*, 3 DIE JUSTIZ 324 (1927/1928) *reprinted in* FRANZ BÖHM, REDEN UND SCHRIFTEN, KARLSRUHE, 25 (1960).

Economics]. Böhm's book, *Wettbewerb und Monopolkampf* [COMPETITION AND THE STRUGGLE FOR MONOPOLY] (1933), laid the foundation for German jurisprudence's theory that a working system of civil and commercial contracts requires state-protected competition.

(4) After World War II, as a member of the Christian Democratic Party, Böhm became a Member of the Federal Diet and was one of the primary initiators and defenders of the 1958 German antitrust law.[31]

The theme of property rights, including contractual rights, and their relation to a competitive system was raised in several studies which accompanied the aftermath of the Havana Charter, the Allied decartelization laws for Germany based on the Havana Charter, and the rise of a German antitrust law. This resulted in a linkage between an individual's right to participate in a free economy, as protected by antitrust rules and rules against unfair trading, and its rights in tangible, intangible, and contractual property.[32]

Thus, antitrust law became a central component of German constitutional and private law. It was derived from a constitutional understanding that insisted upon a socially conditioned framework for property, contract, and corporate law on the one hand, and a framework for competition law on the other in which property rights and antitrust were seen as being complementary to one another, each being essential to the shaping of the private law.

From here, a final synthesis was envisaged: Legal rules established to safeguard free and fair competition presuppose that ownership of tangible, intangible, and contractual property rights are the aims of competition. Property rights, however, are not entitlements for their own sake that provide their owners with an unlimited assignment of power. Their justification and strength depend on competition.

Property rights in this sense include both rights in tangible and intangible property and rights in contracts that have been freely and fairly negotiated between parties with comparable bargaining power. They also include lasting property rights, for example, in chattels, land, intellectual property, and estates in general. This system implies that there is a conditioning of the parts that form

31. His student and friend Ernst-Joachim Mestmäcker, a professor in Münster, later Bielefeld, and the first President of the German Monopoly Commission, then Director of the Max-Planck-Institute for Foreign and International Private Law at Hamburg, became influential in the application and development of both German and European antitrust law.

32. *See generally* E.-J. MESTMÄCKER, DER BÖHM-Entwurf eines Gesetzes gegen Wettbewerbsbeschränkungen, (1955); OSKAR LEHNICH, DIE WETTBEWERBSBESCHRÄNKUNG, (1956); BIEDENKOPF, CALLMANN AND DERINGER, AKTUELLE GRUNDSATZFRAGEN DES KARTELLRECHTS, (1957); O. LIEBERKNECHT,' PATENTE, LIZENZVERTRAGE UND VERBOT VON WETTBEWERBSBESCHRÄNKUNGEN (1953); RUDOLF LUKES, DER KARTELLVERTRAG, DAS KARTELL ALS VERTRAG MIT AUßENWIRKUNG (1959); K. BORCHARDT & W. FIKENTSCHER, WETTBEWERB, WETTBEWERBSBESCHRÄNKUNG, MARKTBEHERRSCHUNG (1957); W. FIKENTSCHER, WETTBEWERB UND GEWERBLICHER RECHTSSCHUTZ (1958); E. STEINDORFF, ZWECKMÄßIGKEIT IM WETTBEWERBSRECHT (1959); E.-J. Mestmäcker, UBER DIE NORMATIVE KRAFT PRIVATRECHTLICHER VERTRÄGE, JZ 441(1964). For a recent summary *see* W. FIKENTSCHER, PROPERTY RIGHTS UND LIBERTY RIGHTS: NORMATIVER ZUSAMMENHANG VON GEISTIGEM EIGENTUM UND WIRTSCHAFTSRECHT, Festschrift Helmut Schippel 563-568 (1996). Of course, there are differences as to the weight given to the Freiburg School influence.

it: There can be no legitimate property rights without free and fair competition[33], nor free and fair competition without property rights.[34] For German law, this has been the philosophy of antitrust from its initial formulation in the context of the Freiburg teachings, after 1933, up until today.

One of these teachings of the Freiburg School is that liberty, if not protected by law, may abolish itself.[35] Kronstein's and Böhm's critique of the abuse of corporate power and monopoly provided economic examples. Hitler's election as a dictator, achieved under the liberal and democratic Weimar constitution (1919), was a political illustration of the same phenomenon.

Meanwhile, in the background, Freiburg ORDO-liberalism developed a legal–economic model of a society which, in controlling its economy, tries to protect long-term liberty. This model was based on the premise that liberty, unplanned and unprotected, tends to degenerate. The Freiburg School holds that freedom can only be maintained if it is legally established. It must be protected and controlled in such a way that it could not be abused and result in a lack of freedom. The primary legal instrument a government should use to achieve this general aim in the economic field is antitrust or, in Franz Böhm's terms, a legal order establishing and safeguarding competition. ORDO-liberalism asserts that without a vigorous antitrust doctrine, freedom cannot be claimed in good conscience.[36]

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33. *See supra* II.B. It should be noted, however, that the mainstream property rights theorists, especially in the U.S.A., would either speak of competitive standing as just another "property right," thereby not treating the idea of property rights and the liberty to engage in free and fair competition as opposites, or would simply not discuss the problem at all. *See, e.g.*, THE ECONOMIC FOUNDATIONS OF PROPERTY LAW (Bruce Ackerman ed., 1976); A.M. Polinsky, *Controlling Externalities and Protecting Entitlements: Property Rights, Liability Rules, and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979). More tending to the dichotomy: "[. . .] property [is] the institution that, by allocating things to people, give liberty over things [. . .]. Property law thus established [. . .] a market structure for allocating resources," R. COOTER ET AL., LAW AND ECONOMICS, 117 (1988); in their 2nd edition of 1997, p. 106, the text has been condensed.

34. There are some German antitrust theorists who place competition above property expectations. They are sometimes jokingly referred to as the defenders of the "pure doctrine." These "pure doctrine" defenders, however, overlook the dependency of competition on something over which to compete, i.e., property, whether tangible or intangible.

35. This "paradox of liberty" or "liberal paradox," an idea discussed in Plato, was restated in KARL R. POPPER, THE OPEN SOCIETY AND ITS ENEMIES 1 (1945). On the role of the "paradox of liberty" in antitrust *see* W. Fikentscher, *Germany: Proposed Antitrust Legislation and Price Discrimination*, AM. J. COMP. L. 523, 523 (1953); W. FIKENTSCHER, WETTBEWERB UND GEWERBLICHER RECHTSSCHUTZ 307 (1958); W. FIKENTSCHER, DIE FREIHEIT UND IHR PARADOX, GRÄFELFING (1997) (on the freedom paradox in politics and economics); A. HEINEMANN, DIE FREIBURGER SCHULE UND IHRE GEISTIGEN WURZELN (1989); David J. Gerber, *Constitutionalizing the Economy: German Neoliberalism, Competition Law and the New Europe*, 42 AM. J. COMP. L. 25-84 (1994). DAVID J. GERBER., LAW AND COMPETITION IN TWENTIETH CENTURY EUROPE, *supra* note 21. Popper, however, never mentioned the Freiburg School.

36. In the thirties, the Freiburg School consisted of several "circles." Each was devoted to elaborating concrete ideas and legislative measures to be implemented after Germany would have lost the war. Membership in the *Freiburger Kreise* [circles] was only partly congruent with the faculty of Freiburg University. *See* sources cited *supra* notes 21 to 24. The Freiburg School and the Freiburg circles were resistance groups who worked under the constant threat of persecution and arrest. One of the Freiburg circles, the *Arbeitsgemeinschaft Erwin von Beckerath*, even succeeded in using the rooms and the financial resources of the *Akademie fur Deutsches Recht* [Academy of German Law] in Munich, a Nazi institution for the preparation of the *Volksgesetzbuch* [People's

It was historically unique that the ideas of the Freiburg School's theorists became the country's socio-economic reality. Franz Böhm became a representative in the German Diet and participated in the preparation of the German Law against Trade Restraints. Alfred Müller-Armack, a man who described the Freiburg School's neoliberalism as a *"Soziale Markwirtschaft,"* or "social market economy" with "social" meaning the defense of the conditions of economic liberty, including antitrust, became the Federal Secretary of Economics. One day after the Currency Reform of June 20, 1948, Ludwig Erhard, as Director of Economic Affairs for the Occupation Authorities in the Western Zone of Occupation, promulgated the repeal of the restrictionist laws enacted by the occupation forces for the administration of the devastated post-war German economy. When Erhard was disciplined by his Allied superiors on the grounds that he had no authority to change occupation law, he answered: "I did not change it, I abolished it."[37]

A considerable number of younger teachers and researchers of law and economics, as well as practitioners, politicians, officeholders, and members of parliament were educated and influenced by this first generation of the "Freiburgians." Today, they are to be found in both of the two large democratic parties, the Christian Democratic Union (in Bavaria: Christian Social Union), and the Social Democratic Party of Germany (SPD). This is not the place to list names for this second generation of neoliberals "German style."[38]

However, one should be mentioned here, Professor Kurt H. Biedenkopf, Prime Minister of the German state ("Land") of Saxony, a student of Heinrich Kronstein, whose theory of the subjective right drives the Freiburg doctrine to a logical extreme.[39] In short, Biedenkopf states that the contents of a subjective right[40] are inversely proportional to the economic power of the owner of the

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Law Book], to further their cause. After the attempted assassination of Hitler on July 20, 1944, the Gestapo discovered the draft legislation that the circles had been working on in anticipation of the defeat of Germany. Constantin von Dietze and Adolf Lampe were arrested and transferred to Gestapo jails in Berlin. *See* Christine Blumenberg-Lampe, *Das wirtschaftspolitische Programm der "Freiburger Kreise," in* VOLKSWIRTSCHAFTLICHE SCHRIFTEN, 208 (1973); BEARBEITET VON BLUMENBERG-LAMPE, CHRISTINE, FORSCHUNGEN AND QUELLEN ZUR ZEITGESCHICHTE, DER WEG IN DIE SOZIALE MARKTWIRTSCHAFT. REFERATE, PROTOKOLLE, GUTACHTEN DER ARBEITSGEMEINSCHAFT ERWIN VON BECKERATH 1943-1947 (1986). They were liberated in April 1945 by the Allied forces. Walter Eucken got away with an investigation in October 1944.

37. Schickling, ENTSCHEIDUNG IN FRANKORT: LUDWIG ERHARDS DURCHBRUCH ZUR FREIHEIT 89 (1978). Erhard pled for German economic reform, including a currency reform, as early as 1945.

38. It would be misleading to call them "neoclassicists" because neoclassic economics can be defined by the neglect of the importance of the liberty paradox; for details *see* W. FIKENTSCHER, DIE FREIHEIT UND IHR PARADOX (1997).

39. KURT BIEDENKOPF, UBER DAS VERHÄLTNIS WIRTSCHAFTLICHER MACHT ZUM PRIVATRECHT, FESTSCHRIFT FRANZ BÖHM, 113 (1965).

40. The subjective right, in German jurisprudence, is the entitlement of a person with the power to cause a result whenever the law makes the causing of the result dependent on the will of the person. In other words, the subjective right is the main vehicle of private autonomy. Therefore, subjective rights embrace what in Anglo-American tradition is called "property rights," but they add to them the liberties cast into legal form to acquire and to transfer property rights. *Cf.* BAUMANN, J., EINFÜHRUNG IN DIE RECHTSWISSENSCHAFT, 251 (8th ed. 1989). An approximate translation for the subjective right: "Hohfeldian claim."

right. Thus, rights have variable contents. The more power, the less potent the right, and vice versa.

This concept may be difficult to handle in everyday legal practice.[41] But as a general principle of antitrust, as a general formula for the relation of law and might, the concept has its merits. It contributes to the understanding of what law is about: The taming and redistribution of power.

In historical and international comparison, the Freiburg School model of legally established and protected freedom of economy has become of considerable importance. It provided for the philosophy of German economic recovery after World War II in general, and German antitrust and its Law Against Trade Restraints of 1958 in particular, serving as a common denominator for all shifts in West German economic (including antitrust) policy since 1948.[42] To some extent, it has also influenced the antitrust policy of the European Union.

C. Substance of German Antitrust Law[43]

German antitrust, embodied in the Act Against Restraints of Competition (GWB) that became effective on January 1, 1958, has on the whole remained consistent with the Freiburg tradition.[44]

The central concept of the law is the "restraint of competition." This notion comprises restrains of trade effecting competition by concerted actions, horizontal and vertical loose associations, concentrations, and monopolies. Competition is seen as the independent striving to achieve commercial advantage among competitors (sellers or buyers) by offering the best possible terms of trade. Therefore, at least two competitors must strive for the business of a third party, thereby involving themselves in competitive tension. Competition includes actual and potential competition (contestable markets, market entry). Since Janu-

41. *See* W. FIKENTSCHER, VERTRAG UND WIRTSCHAFTLICHE MACHT, FESTSCHRIFT WOLFGANG HEFERMEHL ZUM 65. GEBURTSTAG 54, 41-57(1971).

42. For an account of these policy shifts between 1958 and 1988, *see* Michael Lehmann, *Das Prinzip Wettbewerb, Ein gemeinsames Gesetz für Biologie, Ökonomie und Wirtschaftsrecht*, JZ 61-67 (1990); Kartte & Holtschneider, *Konzeptionelle Ansätze und Anwendungsprinzipien im Gesetz gegen Wettbewerbsbeschränkungen – Zur Geschichte des GWB, in* HANDBUCH DES WETTBEWERBS 193 (Cox, Jens & Markert eds., 1981). For the time after 1988, some hints are given in Gerber, *Constitionalizing, supra* note 21, at 75. There is need for a more elaborate review of that period.

43. *See also* W. Fikentscher, *Part III: Cartel Law (Restrictive Practices Law), in* BEIER, SCHRICKER & FIKENTSCHER, GERMAN INDUSTRIAL PROPERTY, COPYRIGHT, AND ANTITRUST LAW (3rd ed. 1996).

44. After a number of amendments, the present text of the Law bears the date of August 26, 1998, BGBl. I S. 2546. For details *see supra* notes 10-16. Several enforcement regulations have been issued, for example, on costs of proceedings and on the cartel register. The German Act Against Restraints of Competition is, of course, not the only cartel law in force in Germany. To the extent that trade between the Member States of the European Economic Community (EC) is affected, the cartel law of the EC Treaty (Arts. 85-92 EC Treaty) and of the European Coal and Steel Community (Arts. 65-66 ECSC Treaty) apply. European cartel law is enforced both by the Commission of the European Communities in Brussels and by national antitrust agencies. National courts also decide questions of nullity and of recovery for damage in cases that resort to European jurisdictions. Appeals (*Beschwerde, Rechtsbeschwerde*) against decisions of the German cartel authorities may be made to the tribunals at the state and federal levels (*Oberlandesgerichts*). Further, the German courts decide private actions arising under the Act Against Restraints of Competition, and those brought concerning cartel agreements or decisions of cartels.

ary 1, 1999 (sixth amendment) restraint of competition and market influence are treated as identical, and the objective market-influence-test has been given up.

Compared with US antitrust law, which addresses formal categories (loose associations, cartels, naked cartels, tyings, mergers, etc.) German antitrust law focuses on the abstract but economically essential concept of "restraint of competition" also giving less attention to legal categories such as contract, decision, boycott, corporate merger, codes of ethics, etc.

The system of sanctioned restraints of competition is as follows: The restraints of competition comprise restraints by conduct (competition is being restrained, *Wettbewerb wird beschränkt*) or by circumstance (competition is already restrained, *Wettbewerb ist beschränkt*).

The classic example of restraint of competition by conduct is a price cartel, by which several sellers agree to raise prices in order to exact so-called "cartel rents"; it is prohibited by section 1 of the GWB. Similarly, "binding rents" are drawn from vertical restraints of competition by conduct and controlled under sections 14 and 15. The prototype of a restraint of competition by circumstance is a natural monopoly: an enterprise that is subject to insubstantial competition or none at all; the abuse of a dominant position in the market is prohibited by section 19 of the GWB to prevent it from earning "monopoly rents." The Act Against Restraints of Competition governs restraints by conduct in sections 1-18, and 21-27, subjecting them basically to a prohibition principle with certain exceptions. The law subjects restraints of competition by circumstance to the prohibitions and regulations of conduct in sections 19 and 20 (discriminations).

In contrast to American antitrust law and the decartelization law effective in Germany until 1958, the present law in Germany does not include a general "rule of reason" principle. There is no general exception of "commercial reasonableness" to the two basic prohibition and abuse principles. Instead, all exceptions are in principle specifically enumerated in the law. The number of exceptions is therefore not capable of being increased. This has correctly given German cartel law the reputation of being particularly stringent. However, on January 1, 1999, a general proviso in favor of useful cartels was introduced into section 7.

To the extent that restraints of competition by circumstance result from either one of two particularly high degrees of restraint of competition, "market domination" or a "controlling market position," either one held by one or more enterprises, the law may prohibit abusive conduct based on that domination or position under section 19 of the GWB. This provision establishes rebuttable presumptions as to the existence of such restraints of competition, and it contains a non-exhaustive list of prototypes of abuse.

Pressure to enter a cartel, boycotts, active and passive discrimination, exploitation of dependent relationships, and predatory practices are prohibited by sections 21-23.

Anticompetitive agreements lead either to a combination between enterprises which remain economically independent (cartels and other restrictive agreements), or their loss of economic independence (by forming a multi-corporate

enterprise – *konzern*; or by entering into a merger – *fusion*). Anticompetitive integrations of both kinds are subject to control or prohibition under sections 35-43 of the GWB. The cartel authority must prohibit the forming of a *konzern* or a merger if it creates or strengthens a market dominating position.[45] In deciding whether or not to do so it considers the likely competitive effect of the agreement. This *Zusammenschlußkontrolle* [merger control] has become one of the most important fields of application of the law.

There are also two classes of anticompetitive agreements in which the partners remain economically independent. Those who compete with one another are named "cartels" (sections 1-13 of the GWB). Those which do not are referred to as "vertical agreements." The "vertical agreements" are governed by sections 4-18 of the GWB. Accordingly, the freedom to choose one's contracting partner is protected against abuse under Section 16,[46] while restraints on the contents of agreements lead to the affected agreements being voided under section 14. Only the price of published matter may be fixed[47]and these prices are subject in turn to control against abuse.[48] Restrictions on the right to conclude patent and know-how agreements and on the contents of such arrangements are governed separately[49]; the contractual restraints may not exceed the scope of the legal monopoly.

Terms of business, structural crises, rationalization, specialization, small business cooperation, and in some cases "reasonable" cartels may be permitted or authorized (sections 2, 3, 4, 5, 6, 7 of the GWB). An even more far-reaching, seldom utilized, general exception (the so-called Minister Cartel) is provided for by Section 8. While there is no general "rule of reason" (and hence no *per se* doctrine) in German cartel law these authorization provisions mitigate the apparent stringency.

Further exceptions allow rules of competition for businesses and professional associations ("codes of ethics") which encourage conduct that conforms with the principles of fair and undistorted competition. Business and professional associations may file such rules of competition. After examination by the cartel authority, designed to prevent the indirect establishment of cartels by such rules of competition (Sections 24-27) these rules are entered into a register. While a code of standardization that might be challenged under American law may receive approval, provisions that signify or threaten cartelization are forbidden.

Finally, sections 28-31 contain so-called "industry" or "field exceptions," by which certain provisions of the law, principally sections 14 and 15, are declared inapplicable to specifically designated branches of industry. These general exemptions are in turn subjected to control against abuse. Such industry exceptions apply to agricultural cooperatives, banking and credit institutions,

45. Section 36 (1) GWB.
46. Previously Section 18.
47. Section 15 GWB.
48. Section 15(3) GWB.
49. Section 17-18 GWB.

insurance companies, copyright collection societies, and the television rights to sporting events. In most of these fields, however, control by specialized independent agencies, as well as cartel authority over abuse of dominant position and merger control are applicable.

D. Policy Changes under the German Law Against Trade Restraints

Since its enactment in 1958, German Antitrust Law underwent various minor, but significant changes of policy. Altogether, five successive policies can be distinguished, some of them overlapping and in part being followed today.

1. The "Workable Competition" Period (about 1958-65)

The government's "official motivation" that accompanied the draft of the Law Against Restraints of Competition that the government presented to parliament prior to its enactment, says that the general purpose of the Law is "to safeguard complete competition to the largest possible extent."[50] However, under the influence of the then popular American concept of "workable competition," and in order to harmonize the concept of competition in the new Law with the old German Law Against Unfair Competition of 1909, the cartel authorities and the courts quickly began to use a pragmatic workable competition concept, not as a second best of "perfect competition" but as the "best" guideline for applying the Law.

This concept presupposes the potential for some market influence as a requirement for active strategies in the market place, and thus for competition itself. The workable competition concept was used in three alternative theoretical forms: As the model of "intensive competition" (*intensiver Wettbewerb*),[51] as a concept of "effective competition" *(wirksamer Wettbewerb)*,[52] and as a concept of "pragmatic competition" (*praktischer Wettbewerbsbegriff*). The latter was oriented, in principle, at the wide, heterogeneous oligopoly (the form of the market where buyers and sellers look for alternative offers and one's success amounts to the detriment of the other).[53]

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50. *Amtliche Begründung zum Regierungsentwurf des GWB, Bundestagsdrucksache II/1158*, at 22, WuW 462 (1952), *reprinted in* MÜLLER-HENNEBERG ET AL., GEMEINSCHAFTSKOMMENTAR ZUM GWB, 1 AUFL. KÖLN, ETC. 1035 (1958). *See*, however, the postulation of imperfect competition as the Law's guideline in the Federal Diet, LANGEN, DAS KARTELLGEZETZ 54 (2nd ed., 1957).

51. HAERRY, DER INTENSIVE WETTBEWERB (1954); H.E. LAMPE, WETTBEWERB, WETTBEWERBSBEZIEHUNGEN, WETTBEWERBSINTENSITAT (1979); HAERRY, DIE WETTBEWERBSINTENSITAT ALS WIRTSCHAFTTLICHES BEURTEILUNGSKRITERIUM, WIRTSCHAFTSDIENST 254 (1980).

52. *See, e.g.*, HEUSS, ALLGEMEINE MARKTTHEORIE (1965); KAUFFER, INDUSTRIEOKONOMIK, EINE EINFÜHRUNG IN DIE WETTBEWERBSTHEORIE 147 (1980).

53. K. BORCHARDT & W. FIKENTSCHER, WETTBEWERB, WETTBEWERBSBESCHRÄNKUNG, MARKTBEHERRSCHUNG 10 (1957); W. FIKENTSCHER, WETTBEWERB UND GEWERBLICHER RECHTSSCHUTZ, DIE STELLUNG DES RECHTS DER WETTBEWERBSBESCHRÄNKUNGEN IN DER RECHTSORDNUNG 36 (1958); 2 W. FIKENTSCHER, WIRTSCHAFTSRECHT 193 (1983); O. SANDROCK, GRUNDBEGRIFFE DES GESETZES GEGEN WETTBEWERBSBESCHRÄNKUNGEN 98 (1968), prefering the term "polypoly."

2. Structure, Conduct, Performance School (1962 – The Present)

After 1960, responding to developments in industrial organization economics mainly in America,[54] a more refined concept of effective competition took hold. Authorities and courts began to analyze the efficiency of competition with the help of the structure, conduct, and performance tests.[55] However, this paradigm, which was central to analysis in the U.S. for several decades, had less influence in Germany. The performance test always remained controversial, and the appropriateness of the structure and the conduct tests became more and more doubtful as time went by. And while the paradigm was integrated into the concepts that prevailed after 1965, it was only one of several.

3. The "Functioning Competition" Concept (about 1965-1982)

Together with other causes, the economic decline in the middle of the 1960's laid the ground for the "Great Coalition" of CDU/CSU (which was, on the federal level, the main governing party combination since the foundation of the Federal Republic) and the Social Democratic Party (SPD). A reorientation of the economic policy, including antitrust, was in demand. Three factors contributed to what would become the concept of "functioning competition" (*funktionsfähiger Wettbewerb*), an expression coined by Erhard Kantzenbach, who would soon become the second President of the Monopoly Commission (following E.J. Mestmäcker).

The first factor was the recognition that complete competition, still the official goal of the Law, was not a realistic legal guideline. Public policy should, in any given structural situation, look for the highest possible intensity of competition that is feasible. Inevitably, this intensity will be found somewhere between "atomistic" competition and narrow oligopoly and monopoly. In general, then, the wide and heterogeneous oligopoly should be the goal. The second factor was the decline of the influence of the structure, conduct, and performance tests that were gradually being identified with the workable competition concept as a whole.[56] The third factor was the desire to give a more "socialist" or "leftist" touch to the new antitrust policy, and for some time this was found in John Galbraith's theory of countervailing powers. As a result of these shifts in accent within the concept of "social market economy," under the key-word of *funktionsfähiger Wettbewerb*, German antitrust became less dogmatic, more critical of size (merger control was effectuated in 1973) and, on the whole, more refined. However, this did not render the German antitrust system any less effective.

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54. *Supra* section I.c.1.

55. *See* Sosnick, *A Critique of Concepts of Workable Competition*, 72 Q.J. ECON. 380 (1958), with a survey of 26 market structure, conduct and performance tests that had been proposed till then by 18 authors; Michael Lehmann, *supra* note 42.

56. E. KANTZENBACH, DIE FUNKTIONSFÄHIGKEIT DES WETTBEWERBS (2nd ed. 1967); E. Kantzenbach & Kallfas, *in* COX ET AL., *supra* note 42, at 108; for the reasons why Kantzenbach's concept did not take a firm hold on German antitrust policy *see* V. EMMERICH, KARTELLRECHT 12 (7th ed. 1994), *and* MICHAEL LEHMANN, *supra* note 42.

4. *The Concept of "Competitive Liberty" as a Counterpoint to "Functioning Competition"*

"Functioning competition" became the guideline not only for the antitrust policy under the Great Coalition, but also for some time after 1969, when the Social Democratic Party took over the federal administration. During the 1970s and thereafter, however, some commentators insisted that the approach based on functioning competition was too dirigiste, too pretentious as to having all the necessary information — in short, too "state-interventionist." At the same time, there was continued discontent with the older workability and industrial organization ("structure, conduct, performance") concepts. No doubt there was some truth to these objections. Pragmatic compromises are rarely wholly satisfactory. In time, critics developed a new formulation that was soon called "neoclassics" or the "concept of competitive liberty" (*Konzept der Wettbewerbsfreiheit*). These critics were re-evaluating older theories of Wilhelm Röpke,[57] Erich Hoppmann,[58] and F.A. v. Hayek.[59] They pleaded for a concept of competition that was process-oriented, dynamic, and aimed at political and economic liberty. They conceded that such a concept would take ephemeral monopolies as a trade-off. As long as some realistic freedom remained to enter the market place, those monopolies would disappear in the long run. Hayek's competition as a (*zieloffener Wettbewerb*) "discovery procedure" (*Entdeckungsverfahren*) became the ideal to be followed.

Apparently, this approach has much in common with Chicago school analysis, and some regard the "concept of economic liberty" as a side branch of Chicago economic thought. However, some defenders of the neoclassical approach (Emmerich[60] and Schmidtchen[61]) show at least one distinctly German characteristic, a characteristic with antecedents much earlier than Chicago antitrust, and not emphasized by Chicago: the awareness of the link between economic and political liberty that developed from the Freiburg school.[62] Still, a close relationship between American neoclassics and German "competitive liberty," in other words, the lack of confidence in regulating competition both by cartel agencies and by private business associations, can be detected in Ernst-

57. WILHELM RÖPKE, THE PROBLEM OF ECONOMIC ORDER (1951).

58. ERICH HOPPMANN, ZEITSCHRIFT DES BERNISCHEN JURISTENVEREINS 102, 249 (1966); ERICH HOPPMANN, JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 179, 286 (1966); ERICH HOPPMANN, FESTSCHRIFT FÜR TH. WESSELS 145 (1967); ERICH HOPPMANN, SCHRIFTEN DES VEREINS FÜR SOCIALPOLITIK, NEUE FOLGE 48, 49 (1968); ERICH HOPPMANN, WETTBEWERB ALS AUFGABE-NACH 10 JAHREN GWB 61(1968); ERICH HOPPMANN, JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 184, 397 (1970).

59. AUGUST FRIEDRICH VON HAYEK, DIE THEORIE KOMPLEXER PHÄNOMENE 25 (1972); AUGUST DIE VERFASSUNG DER FREIHEIT 30 (1971); AUGUST FRIEDRICH VON HAYEK, Der Wettbewerb als Entdeckungsverfahren, Kieler Vorträge Neue Folge, Heft 56 (1968); FREIBURGER STUDIEN 249 (1969).

60. V. EMMERICH, *see supra* note 56, at 19.

61. DIETER SCHMIDTCHEN, JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 191, 428 (1976/77); DIETER SCHMIDTCHEN, WETTBEWERBSPOLITIK ALS AUFGABE (1978); *see also* the Report on the *Wettbewerbskolloquium, Freiheitliche Politik für Markt und Staat, in* WuW 207 (1988). *See also* LEHMANN, *supra* note 42, thinks that the functioning competition test has had its best days.

62. *See supra* II.2.

Joachim Mestmäcker's influential monograph *Der verwaltete Wettbewerb* [The Regulated Competition].[63]

The concept of *economic liberty* as a discovery procedure has thus far received some acclaim in the courts but little from the cartel authorities. Under the influence of Hoppmann's thinking, some cases dealing with alleged price abuses by pharmaceutical firms, holding narrow oligopolies, were decided in favor of the defendants.[64] These cases weakened, to a considerable degree, the applicability of section 19[65] of the Law against Restraints of Competition, the provision against the abuse of dominant positions.

The objection that the concept of economic liberty favors, at least in its practical results, some kind of monopoly power is not the only criticism that has been leveled against it. In dissertation, C.W. Neumann has demonstrated that Erich Hoppmann, upon close examination, defines competition by liberty, and liberty by competition. Therefore, Hoppmann's approach appears to be tautological, and hence theoretically unsound.[66] In sum, the concept of economic liberty, after having made some inroads into the functionability concept, has never been accepted as the general antitrust policy in the Federal Republic. To a great extent, German neoclassics have remained on the edge.

5. *The Policy after 1982: Market Optimizing Antitrust*

Following the election of a conservative CDU/CSU/FDP coalition administration in 1981 — the *Wende* ("the turn") — another reorientation took place in general antitrust policy. It has not yet received a fixed label, but it could be called "market optimizing antitrust."

The new approach is eclectic and pragmatic. It adopts from "Freiburg" a general philosophy, from Kantzenbach's functionalism a general orientation toward the wide, heterogeneous oligopoly, and from the concept of economic liberty the "discovery" approach to competition and the special emphasis on freedom of market entry.

Another feature of this market optimizing policy is the conscious decoupling of German antitrust from the U.S. pattern. Specifically, the efficiency-oriented antitrust teachings of the Chicago School of Economics are

63. E.J. MESTMÄCKER, DER VERWALTETE WETTBEWERB, EINE VERGLEICHENDE UNTERSUCHUNG ÜBER DEN SCHUTZ VON FREIHEIT UND LAUTERKEIT IM WETTBEWERBSRECHT (1984).

64. BGHZ 68, 23 — Valium/Librium; BGHZ 76, 142 — WuW/E; BGH 1678 – Valium II; KG WuW/E OLG 1599 – Vitamin B 12.

65. Previously Section 22.

66. CARL WOLFGANG NEUMANN, HISTORISCHE ENTWICKLUNG UND HEUTIGER STAND DER WETTBEWERBSTHEORIE. KRITISCHE BESTANDSAUFNAHME ZUM DISPUT ZWISCHEN "FUNKTIONSFÄHIGEM WETTBEWERB" UND "NEUKLASSISCHEM/FREIEM WETTBEWERB" UM EIN ANGEMESSENES WETTBEWERBSKONZEPT, EINSCHLIEßLICH DER DOGMENHISTORISCHEN WURZELN, SCHRIFTEN ZUM WIRTSCHAFTS-, ARBEITS- UND SOZIALRECHT 225 (1982). His work has favorably been received; *cf.* TOLKSDORF, WuW 704 (1983). Emmerich himself lists a number of difficulties the concept of economic liberty is encountering, among them the dilemma of a multi-valued antitrust. Emmerich, *supra* note 56, at 20.

more or less officially rejected. The assumption is that they would not deliver antitrust results acceptable to the Federal Republic of Germany.[67]

Again, another tendency of present German antitrust is a careful interpretation of the relevant market concept, with the aim of strengthening an active antitrust policy.[68]

E. The Present Situation

The present status of German antitrust law may be characterized as follows. There are four salient points.

a) The bulk of antitrust litigation is to be found in two fields: In the distribution business, and in the field of merger control (press and media mergers forming an area of special interest and importance). Two more fields of litigation deal with the old classic cartels and other horizontal agreements – their number seems to have decreased – and the antitrust law of the licensing business. The latter sub-field received the nickname "green cartel law" because two leading journals on the law of intellectual property and competition bear green covers.[69] The "green cartel law" is under strong EC influence.

b) A major issue under discussion is the general role that *administrative action* should play in conserving competition. There have been favorable remarks by an American author about the appropriateness and effectiveness of German antitrust administration, in comparison with the American experience.[70] A not so favorable evaluation of the "German line" has been made by Ernst-Joachim Mestmäcker who is convinced that the cartel authorities give too much protection to small competitors, as distinguished from giving protection to competition.[71] Mestmäcker's study is, essentially, a criticism of the seemingly inevitable fact that, in order to keep competition free from state interaction, state interaction must take place. This reflects Judge Robert Bork's policy at war with itself, that is, the so-called antitrust paradox.[72]

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67. Wernhard Möschel, *Divergierende Entwicklungen im amerikanischen und deutschen Kartellrecht*, 12 WIRTSCHAFTSWISSENSCHAFTLICHES STUDIUM 603-609 (1983); Werhard Möchel, *Antitrust and Economic Analysis of Law*, 140 ZEITSCHRIFT F.D. GES. STAATSWISSENSCHAFT 156-171 (1984); Utz Toepke, *Antitrust-Spruchpraxis* (1981/82), *in* SCHWERPUNKTE DES KARTELLRECHTS 137 (1981/1982); Utz Toepke, *Antitrustpraxis* (1986/87), *in* SCHWERPUNKTE DES KARTELLRECHTS 91 (1986/87); UTZ TOEPKE, *FIW Forschungsinstitut für Wirtschaftserfassung*, in SCHWERPUNKTE DES KARTELLRECHTS 67-81 (1987/88), thinks that under President Bush the policy of the Chicago School as applied by Antitrust Division and FTC continued to be followed. Also, the courts were likely to follow this approach since many court positions have been filled under President Reagan with judges of this line. This would also hold true for the Supreme Court. On the other hand, the legislative bodies in which the Democrats are in the majority could work as countervailing powers by the enactment of stricter laws

68. MONOPOLKOMMISSION, ÖKONOMISCHE KRITERIEN FÜR DIE RECHTSANWENDUNG, Hauptgutachten V(1982/83), Baden-Baden 1984; NOMOS, at 23 and 195.

69. GRUR and GRUR Int.

70. JAMES MAXEINER, POLICY AND METHODS IN GERMAN AND AMERICAN ANTITRUST LAW: A COMPARATIVE STUDY (1986); *see also* John O. Haley, *Antitrust Sanctions and Remedies: A Comparative Study of German and Japanese Law*, 59 WASH. L. REV. 471-508 (1983).

71. ERNST-JOACHIM MESTMÄCKER, *see supra* note 63.

72. ROBERT H. BORK, THE ANTITRUST PARADOX, A POLICY AT WAR WITH ITSELF (1978).

In reality, Bork's paradox is a misunderstanding, because the real paradox in economic law is that economic liberty tends to abolish economic liberty (Plato's and Popper's freedom paradox).[73] Inhibiting the results of this paradox – monopoly – is not in itself paradoxical: Deregulation requires *stricter* antitrust regulation. In other words, the paradox does not concern antitrust, rather liberty. Using Winston Churchill's metaphor, Robert Bork did not exactly "slaughter the wrong pig"; rather, using a German adage, he "embarked on the wrong steamer."

Once Wolfgang Fikentscher embarrassed a Hayekian scholar by asking him: "What happens when aimless competition, as a process of discovery, discovers the monopoly?" After some thinking, the scholar answered, not without some irritation: "Then the state must interfere, what else?" Fikentscher was reminded of Mestmäcker's "administered competition" and replied: "This is the point where we antitrust people *start* thinking."

For Mestmäcker, German antitrust practice has been flooded by administration. "Administered competition seems to be the only possible competition left."[74] In terms of antitrust philosophy, his position is somewhat in line with Hayek's and Hoppmann's concepts. The problem with this approach is that the ideals proclaimed are fixed high in the skies of regulated freedom. In other words, the unreality of perfect competition may not have entirely lost its fascination with these authors. To one who sees competition as a matter of a just equilibrium of small entitlement holders vying with each other for success, the seemingly ominous "administration of competition" means what the Freiburg School was always pleading for: creating and safe-guarding competition by law.[75]

c) Finally, the ongoing integration into the Common European Market is foreshadowing the future of German antitrust. This integration demands compromises, and for the Federal Republic of Germany and its antitrust policy, these compromises sometimes mean allowing more restrictive behavior than would be permissible under German law. Examples are the law of joint ventures[76] and merger control.[77]

On the other hand, the European legislative practice of "block" or "group exemptions" to Article 85, Section 1, has contributed to legal predictability, in spite of many minor questions of interpretation and doubt. On the whole, it may be regarded as superior to the crude German instrument of Section 6 of the Law against Trade Restraints. In some respects, a "Europeanization" of German anti-

73. *See supra* notes 35 and 38.

74. MESTMÄCKER, *supra* note 63, at 30.

75. *See also* Gunther Teubner, *Verrechtlichung – Begriffe, Merkmale, Grenzen, Auswege, in* VERRECHTLICHUNG VON WIRTSCHAFT, ARBEIT AND SOZIALER SOLIDARITAT: VERGLEICHENDE ANALYSEN, 290, 331 (Zacher et. al. eds., 1984), where problems of legalizing competition are discussed. It is exactly this *Verrechtlichung* [legalizing] of antitrust that Maxeiner, *supra* note 70, believes is better solved and administered in German antitrust law than in U.S. antitrust law.

76. ERNST STEINDORFF, WETTBEWERB DURCH GEMEINSCHAFTSUNTERNEHMEN, Betriebsberater, Beilage 1 zu Heft (8/1988).

77. *Forschungsinstitut für Wirtschaftsverfassung und Wettbewerb* e.V. (ed.), Europäische Fusionskontrolle, Referate der Informationstagung in Brüssel am, Skript 10 (21./22. 6. 1988).

trust would lead to stricter antitrust control, e.g., an abolition of "sectorial exceptions," and an even more effective prohibition of monopoly abuse with the consequence of private cease and desist claims, disgorgement of profits, and damage claims.

There is the plea that the Common Market should have a common antitrust law.[78] The fallacy of this claim may be that business culture and psychology in Europe are different. French diversity, British pragmatism, and the high degree of German organizability, when applied to business, may lead to different results, and may therefore require distinctly different standards of antitrust law on the national level.[79] This, of course, does not foreclose an appropriate and effective EU or even a wider, multilateral, transnational, antitrust.

III.
European Community (EC) Antitrust: A Brief Comparison

At the regional level in Europe, there are cartel rules of the European Community (EC), of the European Community of Steel and Coal (ECSC), and of the European Atomic Community (EAC). The most important is EC antitrust. It is contained in Article 3(g), Article 3(a), Article 6, and Articles 85-94 of the EC Treaty plus a large number of implementing regulations, decision, recommendations, and administrative announcements. EC law is directly applicable in the Member States and thus entitles and obligates the citizens of these states.[80] The application of EC antitrust requires that trade between the Member States be affected. Pure intra-state situations are not covered. Although EC law may tend to weaken German control of mergers or joint ventures, EC antitrust is, in general, as strict as the German law and, in certain respects, appears to be stricter.

Though less directly than the German law, EC antitrust can also be traced to the Havana Charter and, in a sense, to the American tradition. Indeed, because Havana Charter antitrust can be viewed as aiming toward widening international integration through trade, EC antitrust has a special relationship to the Havana Charter tradition. The basic goal of the Treaty of Rome is European market integration, and the EC antitrust law is put explicitly to the service of that goal. It must be recognized, nevertheless, that there is a great deal that is not known about the genesis of EC antitrust or about the forces that influenced its early development. While some suspect a strong German influence simply because of the signatory parties, only Germany had a strong antitrust tradition. Others see the United States as influencing the Treaty of Rome at least in this respect.

There is also a functional explanation for Articles 85 and 86. A commitment was being made to assist Europe economically. If the signers were to rely on the dirigiste tradition, which is strong, for example, in France, and anticipate

78. Ernst Steindorff, *Chaos der europäischen Fusionskontrolle nach Phillip Morris?*, *in* FORSCHUNGSINSTITUT ETC., *supra* note 77, at 23.

79. Even on the subnational level East Germany, after unification, needs considerably more protection from vertical restraints than West Germany.

80. Art. 189, al. 2 EC Treaty.

unifying Europe through industrial policy, they would have forced upon themselves an impossible task of working harmoniously to resolve planning issues in which their respective national interest might often collide. Alternatively, they agreed to unleash the more automatic forces of competitive markets to start the work of integration.

Therefore, antitrust in the United States, in Germany and in the EC is certainly one genus and may fairly be described as one species. In all three systems, the basic, underlying commitment is to maintain competition in order to attain and protect important social goals for the economy. For all three systems the basic concept, *competition*, has the same essential meaning: competitive commercial and industrial conduct that constrains and reduces the economic power exercised by any single firm or combination of firms.

There are, of course, differences not just of legal detail but also in underlying policy formulation among the three systems. These, moreover, may change over time, such that two of the systems (or all three) may be more alike at one time than another, or one system may appear to be more like an older version of another of the systems than it is like the present version. There are three differences and similarities — including at least some of their dynamic characteristics – which are best explained in terms of cultural attitudes, as well as political and economic commitments and beliefs. Let us first examine some legal differences, and then some developmental differences.

IV.
Some Differences in U.S., German, and EC Antitrust

A. *Contrasting Legal Approaches*

There are conceptual differences between U.S. antitrust and that of both Germany and the EC. These differences have led to divergent theoretical explications and can lead to different practical results. The more important of these include:

1. *The Subjective Market Concept*

At a high enough level of generality the definition of a relevant market (commonly used as the starting point for an antitrust evaluation) is the same in U.S., German, and EC theory and practice. The market is defined by three constituents — subject matter (including substitutes), geographic area, and time. In U.S. law and practice these three factors are viewed from an objective, sometimes even statistical, point of view. Preferable bases for decision are cost data series suggestive of the existence of cross elasticities or their lack, expert economic evaluation, and sometimes market research data.

EC and German antitrust theory and practice both tend to prefer what is called the "subjective market concept" or, synonymously, the "demand concept"

(*Bedarfsmarketkonzept*).[81] This means that the view of the participants on the other side of the market exchange is constitutive for defining the market as to subject matter, area, and time. Only what forms an alternative for a certain demand, or supply, is encompassed by the market. The case law uses the term "functional exchangeability."[82] In effect, this approach gives to administrations and courts a greater discretionary power of market evaluation and a capacity to rely on the view of market participants. At the same time, there is less need to rely on economic, statistical, or consumer survey expertise. To an American eye, this enhanced discretion of enforcement agencies greatly reduces legal certainty and predictability.

The U.S. approach prefers, in German antitrust terminology, the "objective market concept." Of course, statistics are widely used in both German and EC antitrust administrative and court proceedings. But on the whole, they are not regarded as nearly so compelling or decisive as they currently seem to be in America. They are seen, rather, as arguments that may support one or another alternative-based "subjective" (demand- or supply-viewed) market definition in a particular case.

2. *No* Per-se/*Rule of Reason Distinction*

In the U.S., the *per se* rule and the rule of reason have tended in recent years to fade one into one another. Nevertheless, both analytical concepts retain validity in U.S. law. Neither German nor EC statutory law knows this dichotomy at all, whereas European antitrust theory discusses them thoroughly.

However, both German and EC law make another basic distinction that on first sight may be related to this dichotomy. In European antitrust, provisions are distinguished as being derived either from the "prohibition principle" (*Verbotsgesetzgebung*), or from the "abuse principle" (*Mißrauchsgesetzgebung*).

The prohibition principle implies that a certain restrictive activity is, to begin with, prohibited. The burden of proof is on the defendant to demonstrate that there are factual and legal reasons for the alleged restraint. The abuse principle, by contrast, gives everybody permission to go ahead with the restrictive conduct in question — subject, however, to the allegation that in a particular instance the restraint will, by the evidence produced by the plaintiff, be shown to

81. *Cf.*, WOLFGANG FIKENTSCHER, MEHRZIELIGE MARKTWIRTSCHAFT SUBJEKTIVER MÄRKTE: WIDER DAS EUROPA- UND DAS WELTMARKTARGUMENT, FESTSCHRIFT MESTMÄCKER 567-578 (1996). For a differing view *see* TH. BAUMS & ULRICH HUBER, FRANKFURTER KOMMENTAR ZUM GESETZ GEGEN WETTBEWERBSBESCHRÄNKUNGEN MIT EINER DARSTELLUNG AUSLÄNDISCHER KARTELLRECHTSORDNUNGEN, (3rd ed. 1994), 30th update, Sec. 1 GWB, Nos. 127-129, 388, 392. Section 1 GWB, as amended as of January 1, 1999, decided the issue in favor of Fikentscher; *see* text following *supra* note 16.

82. 59 BGH WuW/E 991 — Papierfiltertüten —; BGH WuW/E 1440 — Vitamin B12 —; BGH WuW/E 117: Valium —; BGH WuW/E 1714 — Mannesmann/Brueninghaus —; and many more. The same test is applied by the Court of the European Communities: The alternative, exchangeability, in the eyes of the demanding or the supplying party is conclusive: EuGH Coll. 1978, 282 — United Brands —; EuGH Coll. 1973, 248 — EuGH Coll. 1975, 1379 — General Motors —; etc.

be abusive. Hence, when this principle applies, the burden of proof is on the cartel authorities or, in private law suits, on the private plaintiff.[83]

The difference between the *per se* approach and the "prohibition principle" is that under the prohibition principle a certain restraint of competition may be prohibited and therefore presumably illegal even outside of any *per se* situation. A counterproof by the defendant that, for exceptional reasons, the prohibition should not apply remains admissible.

The difference between the rule of reason and the "abuse principle" is that under US antitrust law, absent a *per se* situation and thus within the range of the rule of reason, the plaintiff must assert not only the prima facie illegality of the offense but also its unreasonableness. Thus the burden of fact of (un)reasonableness is on the plaintiff. This, together with the competition-neutral "objective market concept" used in the U.S., may be responsible for the costly paperwork involved in typical U.S. antitrust litigation.

Under the European abuse principle, a restraint of competition is prima facie legal, and the plaintiff has to demonstrate that this prima facie legality under the law is being abused.

Given the difference between the two systems of antitrust, the rule of reason was understood to be an exception to the general prohibition of a restraint of competition law under German and related EC law, (the facts to be established by the defendant), whereas in the US the rule of reason became an evaluation mechanism.

After 1947, the former rule of reason concept was developed in Germany under the Allied occupation decartelization statutes that forbade every restraint of competition unless it was "reasonable." However, the rule of reason was not transplanted to the German Law against Restraints of Competition in 1958. Article 85.3 of the EC Treaty may nevertheless be considered a formalized and specialized rule of reason (formalized by a decision by the EC Commission) in the European sense. Germany has not yet followed suit. Sections 7 and 8 of the Law do not contain a general "rule of reason," in spite of some similarity with article 85, al. 3 of the EC Treaty.

3. Sanctions for Monopolizing

A third difference between U.S. and German and EC antitrust is that in the United States, legal requirements and legal consequences are combined, especially in monopolization cases. When a firm has committed "monopolization" in violation of section 2 of the Sherman Act, the monopoly should be eliminated. If this can be achieved in a short enough time by a conduct remedy, that course may be followed. However, if a conduct remedy will not rapidly dissipate the power, the court should order divestiture. This may, at least psychologically, induce many judges to resist finding monopolization when the facts leave

83. The legal consequences under the abuse principle vary from an order to cease and desist (e.g., Section 6), to the modification of a contract (e.g., Section 1, al. 1, no. 2), to the imposition of conditions (Section 40, al. 3), etc.

open the possibility of alternative interpretations. Finding monopolization might lead to dismemberment of a successful firm.

By contrast, the main legal consequence of monopolizing in German and the EC is to compel the monopolist to engage in competitive-like behavior. Divestiture or dissolution is not ordered as a consequence of a restraint of competition by circumstance (as opposed to conduct). The Law attempts to stop the abuse of the dominant power. This makes authorities and courts more inclined to confirm the requirements of monopolizing.

4. Plurality of Purposes

German and EC antitrust have always been "multi-valued." There is seldom, if ever, an argument presented that the sole goal, even in a particular case, ought to be efficiency. Efficiency is just one legislative goal among others. Other legislative goals for German antitrust are to maximize the number of competitors; to promote the freedom of market entry; to protect small business against unfair inroads made by big industry or trade; to increase the plurality of publicized opinions in press merger cases; to protect the environment; to increase employment; and to achieve international competitiveness.

Most of these are also EC goals, as is, of course, the goal of market integration. The "Chicago School" ideology has never had a significant influence on German and EC antitrust. This is not to say that all the legislative policies listed above are indiscriminately followed in a given antitrust case. It is acknowledged that they may conflict with one another. The main goal in solving these policy conflicts is still to assure as much competition as possible. Other values, however, may be weighed against this paramount goal. In America, by contrast, it is sometimes asserted that only (short-term) efficiency counts. Moreover, even when American courts recognize that competition is valued because it is instrumental in attaining other social and economic values in addition to efficiency, they tend to focus solely on maintaining the competitive process. Other public values — say, health, safety, or the environment — cannot be used as a basis for mitigating antitrust law.

The European multi-valued antitrust philosophy may have a negative effect on pure economic policy-setting. There is considerable criticism when the German Minister of Economics overrules, for non-economic reasons, the Federal Cartel Authority policy on mergers. Indeed, this is an issue that will make the decision of the Federal Cartel Authority, and the final decision of the Minister of Economics on appeal, a matter of prime interest to everyone concerned with German antitrust.

B. Contrasting Developmental Themes

1. Political and Economic Liberty

A striking point is the considerable similarity between the liberal constitutionalism that developed in America during the pre-New Deal years and the Freiburg school of thought with which German antitrust is so closely associated.

Both traditions link political and economic liberty. Both see the protection of the individual against powerful private economic interests as an analogue to the protection of the individual against undue state intrusion. Both value competition as instrumental to the attainment of a range of related political and economic objectives. Even the Freiburg concept "*Soziale Marktwirtschaft*" had analogues in both American constitutional and American antitrust law. The antitrust prohibition of non-ancillary competitive restraints (even of resale price maintenance and some refusals to deal) and the constitutional concept of a business affected with a public interest come to mind as examples where, in terms of Freiburg theory, rights of property and contract must be exercised in ways consistent with the social goals of the market. Still, Freiburg thought is more central to everyday antitrust practice and its development over time than the now discounted "societal antitrust" ingredients of U.S. policy.

2. Multi-value Theory

In Germany, basic multi-valued Freiburg commitments have continued to exist in modernized forms, even despite marked political changes and marked changes in economic theory. In America, however, the multi-valued antitrust tradition is under attack. The reason for this might be that the German intellectual style is more given to comprehensive theorizing and to maintaining theoretical consistency, while the American approach is easier to adopt and is more pragmatic.

Even in the debate on critical legal thought, one finds more rigorous theorizing on the German side and more result-oriented advocacy on the American side. However, such an explanation seems facile, because other influences can be identified. For example, the American antitrust tradition has been buffeted by a variety of other cultural changes over a full century, while German antitrust is essentially a post-war phenomenon. Moreover, the link in America between anti-trust and liberal constitutionalism was severed in the New Deal era when the Roosevelt court undid much of the earlier constitutional prohibitions against economic power in the interest of the welfare state.

The "Chicago revolution," which overtook American antitrust in the 1980's, at least in the enforcement agencies, is in no sense a return to the antitrust conceptions of the earlier, liberal days, and does not bring American antitrust into a closer link with German and EC tradition. Quite the contrary on both counts: Chicago theory, by focusing solely on allocative efficiency, and by rejecting fairness, economic crises, stability, market access, and mobility as legitimate bases for protecting the competitive process, would purge antitrust of the pieces that have sustained it, politically, for a century, and would thereby radically differentiate American antitrust from the multivalued traditions prevailing elsewhere.

EC, as well as German antitrust, is also being buffeted by "micro-theoretical" commentators who focus solely on efficiency. In academic and professional discussion in the EC, as well as in Germany, these commentators are affecting the agenda to some extent. Setting the agenda, as American experience

shows, is the beginning of influence. However, in both Germany and the EC, it is not only a deeply ingrained tradition that forecloses making efficiency the sole value. Explicit provisions of the governing law do as well, for they point unerringly to concerns about fairness and, in the EC, about integration. Also, a favorite argument made by Chicagoans asserts that an antitrust aimed at multiple values gives courts such an excess of discretion that it places them in a legislative role. If the judicial focus is on protecting the competitive process with the intent of promoting all the goals associated with competition, rather than on playing off goals against one another in particular, the dilemma vanishes. Even if goal weighting were involved, however, the EC Commission is institutionally well equipped to engage in that process. Will efficiency become a more important antitrust goal for the EC when integration is more fully achieved through harmonization, a common industrial policy, and other Council and Commission measures? Perhaps so, but there is little reason to suppose allocative efficiency will become the sole or even a dominant goal.

V.

THE SPREAD OF ANTITRUST THROUGH INTERNATIONAL AGREEMENTS AND THROUGH IMITATION: THE WORLD TRADE ORGANIZATION.

We have noted already the direct impact of Chapter V of the Havana Charter on German antitrust and its indirect influence on EC antitrust. Most nations have their antitrust laws today. These antitrust laws differ in legal scope and legislative policy. Will an international antitrust emerge in the international community?

Perhaps the strongest reason for thinking that the time is right for international antitrust is the nearly world-wide proliferation of anti-cartel policies.

All of the individual steps leading to the expansion of the antitrust idea into all parts of the world cannot be described here. The counterpoint to this growing body of national antitrust laws is an international antitrust law that aims at coping with the growth of the international economy. While bilateral cooperation among enforcement agencies has become common, the task of negotiating a meaningful multilateral agreement is formidable indeed, particularly in light of the divergences between U.S. and European antitrust highlighted in this article.[84]

The agenda of the World Trade Organization (WTO) includes the creation of a number of basic rules of international antitrust. In 1993, a private group of experts submitted a *Draft International Antitrust Code* to the General Agreement on Trade Tariffs (GATT), the predecessor of the WTO, in order to stimulate discussion and to demonstrate the feasibility of internationally applicable

84. *See, e.g.*, the Agreement between the European Communities and the Government of the United States of America on the application of positive Comity Principles in the enforcement of their Competition Laws, of Jan. 24, 1997, <http://europa.eu.int/en/comm/dg04/interna/poscopr2.html>. The dropping of the standard of market influence and the sole use of the standard of "restraint of competition" in the rephrased Section 1 of the law, as of January 1, 1999, might be regarded as indicative of this development; *see supra* note 81.

antitrust rules. The co-authors of this article participated in its preparation. While complete consensus among participants from Europe, Asia and the Americas was not possible (indeed, there was some disagreement among the co-authors of this article), large areas of common ground were identified.

Since the presentation of the *Draft International Antitrust Code* to GATT in July 1993, the discussion about the necessity of an International Antitrust Code has continued. The last statements of this sort were the short version of the 25th *Report on European Competition Policy of the European Commission* from April 1996 and the Communication of the Commission of the European Communities to the Council of Ministers, *On the Way to an International Competition Law*.[85] The European Commission declares itself in favor of a multilateral agreement on minimal standards, a binding obligation on positive comitas gentium and a modern dispute settlement procedure.[86] This position is based on the report of a group of experts[87] – convoked by the European Commission – in which two members of the International Antitrust Code Working Group took part (Ulrich Immenga and E.-U. Petersmann). Although the political comments on the realization of a binding International Antitrust Code are rather cautious, they are also optimistic. With the coming into force of the Plurilateral World Trade Organization Agreement on Trade-Related Aspects of Intellectual Property Protection (TRIPs Agreement), the WTO system contains for the first time detailed antitrust rules applicable to private enterprises.[88] The Ministerial Conference of the WTO, held in December 1996 in Singapore, created a Committee on Competition whose task will be to study the feasibility of a WTO competition code. This shows that the adoption of a binding international antitrust law is possible and is on the international agenda.

85. *On the Way to an International Competition Law*, KOM 284 fin. (June 18, 1996).
86. Number 230 of the Competition Report; Communication, at 4.
87. Communication 359 fin. (July 12, 1995).
88. Art. 40 of TRIPs on anti-competitive practices in IP-licenses.

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Immigration Challenges and Opportunities in a Post-Transition Cuba

By
Matias F. Travieso-Diaz, Esq.*

TABLE OF CONTENTS

I. Introduction 235
A. Overview 235
B. Cuba-U.S. Immigration Trends Before The Cuban Revolution 236
II. Post-Revolution Immigration Trends And Policies 238
A. Introduction 238
B. U.S. Policies From 1959 To 1994 239
C. Cuba-To-U.S. Immigration Trends From 1959 To 1994 ... 240
1. First Stage 240
2. Second Stage 241
3. Third Stage 241
4. Fourth Stage 241
5. Fifth Stage 242
D. Changes In U.S. Immigration Policy After The "Balsero" Crisis 244
E. Implementation Of The U.S.-Cuba Immigration Agreement 247
F. Current Status Of Cuba-To-U.S. Immigration 249
III. The Challenges And Opportunities Of A Post-Transition Immigration Regime Between Cuba And The United States ... 251
A. Introduction 251
B. A Potential U.S. Approach To Cuban Post-Transition Immigration 252
1. Introduction 252
2. The Mexican Model 253

* Partner, Shaw, Pittman, Potts & Trowbridge (Washington, D.C.). J.D., 1976 Columbia University; Ph.D. 1971 Ohio State University; M.S. (1967), B.S. (1966) University of Miami. An earlier version of this paper was presented at the Eighth Annual Meeting of the Association for the Study of the Cuban Economy in Miami, Florida, on August 6, 1998. The author gratefully acknowledges the assistance of John Barton and Pablo Yacub in the preparation of this paper.

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3. Permanent Immigration Of Cubans Into The United States 254
4. Categories Of Non-Immigrant Visas Allowing Work In The United States 256
a. Introduction 256
b. Professional Worker Visas 256
c. Intra-Company Transferees 257
d. Treaty Traders And Investors 257
e. Other Visa Categories Allowing Cubans To Work In The United States 258
5. Other Categories Of Temporary Visas 259
a. Non-Immigrant Business Travel 259
b. Educational And Cultural Exchange Programs 259
6. Handling Of Illegal Immigrants 260
7. Legislative Approach 260
C. Cuba's Immigration Policy In A Post-Transition Environment 261
1. Introduction 261
2. Cuban Policy Regarding Permanent Immigration Of Cuban Expatriates 262
3. Cuban Policy Towards Non-Immigrants 263
IV. Conclusions 264

I.
INTRODUCTION

A. Overview

Upon the loss of its main trading partners when socialism collapsed in Eastern Europe in the late 1980's and early 1990's, Cuba was forced to implement a set of limited economic measures to counteract the most serious effects of the crisis on the economy.[1] The changes made do not, however, amount to true reforms and have left the country in a state of stagnation, with the country's economy operating at a very low level of capacity.[2] Those who study the Cuban economy are essentially unanimous in predicting that a transition to a free-market economy is the only way in which the island is going to recover from its current crisis.[3]

When a transition to a free-market economy does take place in Cuba, policy makers in both the United States and Cuba will have to address immigration

1. For a recent article describing the status of Cuba's limited economic changes, see Jorge Perez-Lopez, *The Cuban Economy in Mid-1997*, *in* 1997 CUBA IN TRANSITION — PAPERS AND PROCEEDINGS OF THE SEVENTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 1.

2. *Id.* at 7.

3. *See, e.g.*, Gerardo Gonzales, *Remarks on the Current Cuban Economic Situation*, *in* 1996 CUBA IN TRANSITION — PAPERS AND PROCEEDINGS OF THE SIXTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 14.

issues early on in the transition. Recent history suggests that countries that have made successful free-market transitions have been helped along by the inflow of foreign investment, the privatization of state-owned enterprises and, in general, by the free flow of goods and people across national borders. In order for Cuba to follow this model, it will need to design and implement an open and efficient immigration policy. Although such a policy must take into account numerous political, social, and economic issues, it is of primary importance that, whatever immigration policy is set in place during the transition, it allow workers, investors and visitors to move with relative freedom in and out of Cuba. Indeed, as a practical matter, "moving goods and services in international commerce also involves moving the people who trade in those goods and services."[4] Accordingly, Cuba must develop an immigration policy that opens the country's doors to those who can make a positive contribution to its economic recovery.

Given the large Cuban population in the United States and the close proximity of Cuba to U.S. borders, the United States also has a significant interest in Cuban immigration issues. On the one hand, a strong and free Cuba will provide new opportunities to investors, offer U.S. businesses new markets, and be a potential source of skilled workers. On the other hand, there is a significant risk of a mass exodus of Cubans to the United States if economic conditions take a turn for the worse: this is a common occurrence in countries during the early phases of their free-market transitions. U.S. immigration policy towards Cuba should therefore be designed to allow Cubans meeting certain criteria to work temporarily in the United States, while controlling the entry of legal and illegal permanent immigrants. Thus, in addition to lifting the trade embargo currently in place[5] and developing new economic relationships with Cuba, the United States will also have to craft a new immigration policy towards Cuba that implements these potentially conflicting objectives.

This paper seeks to suggest what the respective immigration policies of the United States and Cuba should be during Cuba's free-market transition. The programs suggested here are offered in the hope that current immigration policies will be changed as soon as practicable once the transition gets under way, so that the existing confrontational approach can swiftly give way to cooperation in achieving both countries' common objectives in this important area.

B. Cuba-U.S. Immigration Trends Before The Cuban Revolution

In the first half of the twentieth century, the United States developed a comprehensive system to deal with the concerns raised by the growing immigra-

4. Gene McNary, *Moving Goods and People in International Commerce: Remarks of the Honorable Gene McNary*, 2 DUKE J. COMP. & INT'L L. 247 (1992).

5. The United States has had in place since 1962 a strict embargo on trade with, and on economic assistance to, Cuba. Proclamation No. 3447, 27 Fed. Reg. 1085, 3 C.F.R., 1059-63 Comp., p. 157 (1962). Pursuant to this embargo, it is virtually impossible for all but a narrow category of enterprises and individuals to do business with Cuba. *See generally* Matias Travieso-Diaz, *Actions Needed for Lifting the U.S. Trade Embargo Against Cuba*, 3 U. MIAMI Y.B. INT'L L. (1995). Clearly, the embargo prohibitions will need to be lifted before Cuba's transition to a free-market economy can be successfully accomplished.

tion pressures on the country. Controlling the influx of undocumented aliens, unskilled workers, and persons likely to become public charges became the prime objective of U.S. immigration policies between the late 1800s and World War II.[6] When the Cold War began, the U.S. expanded its immigration policy to admit refugees, especially those emigrating from communist countries.[7]

Throughout the first half century of Cuba's independence (1902-1959), there was no separate U.S. immigration policy towards Cuba. Cuban immigration was part of the overall U.S. immigration apparatus. From the immigration standpoint of the United States, Cuba was not a problem country because the flow of Cubans to the United States was relatively small and there was little illegal immigration.[8] Thus, it was not until after the Cuban Revolution in 1959 that the United States had the need and the incentive to establish a distinct immigration policy towards Cuba.

Likewise, the relatively small number of Cubans seeking to leave the island for the United States did not warrant Cuba's formulation of a policy towards those of its citizens who migrated. The only important limitation was that, under the 1940 Constitution, a Cuban national that adopted the citizenship of a foreign nation lost his Cuban citizenship.[9] Even then, a Cuban who lost his

6. The U.S. federal government first established immigration restrictions in 1875, by not allowing Asian nationals to immigrate into the United States without government consent. Immigration Act of 1875, 18 Stat. 477, ch. 141 (1875). In 1917, Congress passed the Immigration Act of 1917, which codified the immigration restrictions that had developed over the years and established a literacy requirement by excluding any adult who could not read the English language. 39 Stat. 874 (1917). This Act also established entry barriers against those individuals deemed likely to become a public charge. In 1921, Congress further restricted immigration through enactment of the Quota Act, which created a quota system that capped immigration from a foreign country to 3 percent of foreign-born persons of the same nationality already residing in the United States (as determined by the 1910 Census). Act of May 19, 1921, ch. 8, 42 Stat. 5 (1921). Thus, three main limitations in U.S. immigration policy had already been established by 1921: exclusion of specific types of immigrants; barriers to immigration, such as literacy or economic self-sufficiency requirements; and the regulation of immigration through quotas based on natural origin or other factors. Kathryn M. Bockley, *A Historical Overview of Refugee Legislation: The Deception of Foreign Policy in the Land of Promise*, 21 N.C. J. INT'L L. & COM. REG. 253, 258 (1995) [hereinafter Bockley].

7. In the wake of World War II in 1945, the Displaced Persons Act was enacted, which attempted to deal with the refugee crisis produced by the war in Europe, but "singled out those fleeing from communist or communist dominated countries as the most deserving for refugee status." Bockley, *supra* note 6, at 262. For the first time, a U.S. refugee admission policy was developed, and was intended to serve as a tool to advance the interests of democracy in the developing conflict between the United States and the Soviet Union. Then, in 1952, Congress passed into law the Immigration Nationality Act of 1952 ("INA"), also known as the McCarran-Walter Act, Pub. L. No. 82-414, 66 Stat. 163 (codified as amended at 8 USC §§ 1101-1524 (1998)). The INA consolidated prior immigration laws and removed their discriminatory elements. Dave McCurdy, *The Future of U.S. Immigration Law*, 20 J. LEGIS. 3, 5 (1994) [hereinafter McCurdy]. The legislation also provided for the first time the opportunity for skilled individuals and relatives of legal residents and citizens of the United States to be admitted into the United States. Bockley, *supra* note 6, at 264.

8. Of the one million Cubans presently in the United States, fewer than 70,000 immigrated before the Cuban Revolution in 1959. U.S. 1990 Census, *reprinted in* Silvia Pedraza, *Cuba's Refugees: Manifold Migrations*, 1995 CUBA IN TRANSITION — PAPERS AND PROCEEDINGS OF THE FIFTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 311, 315 [hereinafter Pedraza].

9. Under Cuba's constitutions, both pre- and post-revolution, a Cuban citizen who becomes a citizen of another country loses his Cuban citizenship. CONSTITUCION DE LA REPUBLICA DE CUBA (1940) [Constitution] art. 15 (Cuba), *translated in* 1 CONSTITUTIONS OF NATIONS 610, 612 (Amos J.

Cuban citizenship could petition the Minister of State to reinstate his Cuban citizenship status upon returning to the island.[10] Not until Castro took power did Cuba institute restrictive measures regarding emigration.

II.
POST-REVOLUTION IMMIGRATION TRENDS AND POLICIES

A. Introduction

This section provides a brief summary of the dramatic emigration processes that have taken place since the triumph of the Cuban Revolution in 1959. While the Cuban exodus is relatively recent and well documented, it is important to understand how it developed and how it led to the current immigration regime between Cuba and the United States. This understanding is important because some variation of the present framework is likely to be in place as the free-market transition begins in Cuba.[11]

Shortly after the new revolutionary regime came to power, Cuban nationals started to leave the island at a growing pace. The driving forces behind the exodus were sometimes political and sometimes economic, although in many cases both factors were present. The vast majority of the Cuban émigrés came to the United States.

The first stages of the migration saw Cubans being driven out of their country by the radical policies of the revolutionary regime.[12] Since 1980, however, economic necessity has become the predominant factor motivating Cubans to emigrate. Faced with an ever-deteriorating standard of living and little chance of social mobility, Cubans sought to come to the United States in hope of a better life.[13]

The social composition of the immigrants also changed over time. In the early stages, many of those who immigrated to the United States were either members of the economic and intellectual elite, or members of the middle class who were discontent with or fearful of the new regime.[14] By comparison, the Cubans who have come to the United States in the post-1980 stages of the exodus typically belong to the lower social and economic classes, although such terms have relatively little meaning in Cuba's current society.[15]

The evolution of U.S. immigration policy towards Cuban nationals parallels, to some degree, the shift in the socio-economic makeup of the Cuban immi-

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Peaslee ed., 2d ed. 1956); *see* CONSTITUCION DE LA REPUBLICA DE CUBA (1992) art. 32 (Cuba), *in* Gaceta Oficial (Aug. 1, 1992). *See also* REGLAMENTO DE CIUDADANÍA ("Citizenship Regulations"), *Gaceta Oficial* (Mar. 3, 1944), art. 33 [hereinafter REGLAMENTO].

10. *See, e.g.,* REGLAMENTO, *supra* note 9, art. 35.

11. The discussion in this section is largely based on the paper by Pedraza, *supra* note 8, and on Miguel González-Pando, *Development Stages of the Cuban Exile Country*, *in* 1997 CUBA IN TRANSITION — PAPERS AND PROCEEDINGS OF THE SEVENTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 50 [hereinafter Gonzalez-Pando].

12. Pedraza, *supra* note 8, at 312-13.

13. *Id.*

14. Gonzalez-Pando, *supra* note 11, at 51.

15. Pedraza, *supra* note 8, at 312-13.

grants and their motivation for coming to the United States. The United States encouraged the influx of Cuban immigrants for over three decades when to do so was consistent with the country's international political objectives. Since the end of the Cold War, there has been less of a need for an open door policy towards refugees from Communism, as well as increased public opposition to allowing foreigners to burden the national and local economies.[16] Accordingly, following the disintegration of the Soviet Bloc and the trend towards economic-driven immigration from Cuba, the United States has erected new barriers against large-scale Cuban immigration.

B. U.S. Policies From 1959 To 1994

It was the policy of the United States from 1959 to 1994 to allow relatively free entry of Cuban nationals into the country, regardless of whether the individuals seeking entry would qualify for admission under existing immigration standards. Once the two nations severed diplomatic relations in 1961, Cubans were permitted to come to the United States on a parole basis, without the need to obtain visas, and were admitted as refugees even if they came illegally. No attempts were made by the U.S. Coast Guard to intercept or turn back to Cuba those traveling from Cuba in rafts or small vessels.[17]

Once in the United States, arriving Cubans did not experience some of the hardships suffered by other immigrant groups. They were given financial assistance under a special program approved by Congress for their benefit.[18] In addition, the many Cubans who entered the country as parolees were given preferential treatment in attaining legal immigrant status: In 1966, Congress passed the Cuban Refugee Adjustment Act, which allowed Cubans to adjust their status to that of permanent U.S. residents two years after arriving in the United States, without leaving the country.[19] Unlike other asylum seekers, Cubans could adjust their status to that of permanent residents without showing a well-founded fear of persecution on account of race, religion, nationality, membership in particular social group, or political opinion.[20] This preferential treatment eased the integration of the Cuban exile population into the United States.[21]

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16. These issues are further discussed in Section II-D, *infra.*

17. Bockley, *supra* note 6, at 269.

18. Migration and Refugee Assistance Act of 1962, Pub. L. No. 87-510, 76 Stat. 121 (1962).

19. Cuban Refugee Adjustment Act, Pub. L. No. 89-732, 80 Stat. 1161 (1966).

20. The Cuban Refugee Adjustment Act eliminated the need to individually screen Cubans, many of whom entered the United States illegally by boat, to determine whether they feared persecution if they were returned to Cuba. Congress in effect decided that because Cuba under Castro was Communist, in general no Cuban should be deported. The nationals of no other country had at the time the same screening exemptions. *The U.S. Humanitarian Entry Program Lacks Coherence: Hearings before the Subcomm. on Int'l. Operations and Human Rights of the House Comm. on Int'l Relations*, 105th Cong., (1998) (statement of Don Stein, Executive Director, Federation for American Immigration Reform).

21. Pedraza, *supra* note 8, at 323.

C. Cuba-To-U.S. Immigration Trends From 1959 To 1994

There are over one million Cubans in the United States, of whom over 750,000 are first-generation immigrants.[22] The flow of these Cuban immigrants was intermittent, varying in response to changes in Cuba's willingness to allow those discontent with political and economic conditions in the country to emigrate. The Cuban migration during this period falls into five distinct stages.

1. First Stage

In the first stage of the exodus, occurring between 1959 and 1964, nearly 200,000 Cuban nationals fled their country and came to the United States.[23] Those that fled in the months immediately after the Revolution tended to be Batista supporters, political opponents of Castro, and members of the non-political elite.[24] With time, the exile categories grew to include middle class professionals, merchants and other business people, and skilled workers.[25] Many Cubans fleeing to the United States during this early phase believed that their exile would be temporary and were certain that the United States would take measures to depose Castro due to the "geopolitical interest Americans had historically shown in its Cuban neighbors."[26] As expected, the United States took great interest in ousting Castro, especially after diplomatic relations between the United States and Cuba were severed in early 1961.[27]

U.S.-Cuba relations became dangerously strained in the fall of 1962 during what became known as the Cuban Missile Crisis. Upon discovering Soviet missile installations in Cuba, the United States imposed a naval blockade to interdict further Soviet arms shipments to the island. The crisis dissipated when the Soviets agreed to remove the nuclear weapons and the United States made several promises, including not to invade Cuba.[28]

The Cuban Missile Crisis took a significant toll on Cuban immigration to the United States. At the outset of the crisis, all direct commercial flights between the United States and Cuba came to a halt and were not subsequently resumed. From that point on, Cubans seeking to migrate to the United States had to go through an intermediate country, or make a perilous boat trip to Florida. These barriers slowed the Cuban exodus until the mid-1960's.

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22. 1990 U.S. Census, *reprinted in* Pedraza, *supra* note 8, at 317.

23. *Id.*

24. Gonzalez-Pando, *supra* note 11, at 51.

25. Pedraza, *supra* note 8, at 313-14.

26. Gonzalez-Pando, *supra* note 11, at 52.

27. The United States did not break diplomatic ties with Cuba until January of 1961, when Castro gave the United States two days to reduce the staff of its embassy in Havana to only eleven people. The day after Castro made this demand, the Eisenhower administration severed diplomatic and consular relations between the United States and Cuba. GILLIAN GUNN, CUBA IN TRANSITION — OPTIONS FOR U.S. POLICY 14 (1993).

28. *Id.*

2. Second Stage

In the fall of 1965, Castro opened the port of Camarioca to Cubans with relatives in the United States.[29] Through Camarioca, these Cubans were free to travel to the United States; Cuban-American exiles could return to Cuba to retrieve their family members at Camarioca. About 5,000 Cubans fled in a few weeks, after which the United States put an end to the Camarioca boat lifts.[30] However, shortly after the end of the Camarioca boat lifts, the United States and Cuban governments agreed on a "Memorandum of Understanding," which allowed Cuban nationals to leave the island for the United States.[31] Preference was given to immediate relatives of Cuban exiles wishing to reunite with their families.[32] Additionally, the U.S. and Cuban governments agreed on the establishment of the *Vuelos de la Libertad*, an airlift that took Cuban nationals from Varadero to Miami. More than 260,000 Cuban nationals arrived in United States before Castro officially terminated the airlift in April of 1973.[33]

3. Third Stage

By terminating the airlifts in 1973, Castro again imposed a virtual suspension on Cuban immigration to the United States. From 1975 to 1979, only about 33,000 Cuban nationals were able to reach American soil.[34]

4. Fourth Stage

After holding a meeting with a group of Cuban-American exiles in November 1978, Castro agreed to lift restrictions on visits to Cuba by émigrés. As a result, Cuban exiles were able to return to their country of birth for the first time since immigrating to the United States. The Cuban-Americans who visited Cuba left a lasting impression of prosperity with their countrymen, which would fuel the interest of many in migrating to the United States for years to come.[35] At a time when there was social stagnation in Cuba, the return of the Cuban exiles showing outward signs of financial success persuaded many on the island, particularly the young, that they should come to the United States.[36]

29. *See generally*, Gonzalez-Pando, *supra* note 11, at 55; Pedraza, *supra* note 8, at 315. By that time, Cuba had instituted strict immigration controls under which exit visas were granted only to elderly people. *See* AMNESTY INTERNATIONAL, UNITED STATES/CUBA: CUBAN "RAFTERS" - PAWNS OF TWO GOVERNMENTS, AI Doc. No. AMR 51/86/94 (1994) [hereinafter "AMNESTY"]. The mass migration that started in 1965, like the one that occurred in 1980 (*see infra*) were *ad hoc* exceptions to the Cuban government's enforcement of its immigration control policies.

30. Gonzalez-Pando, *supra* note 12, at 55.

31. Pedraza, *supra* note 8, at 319.

32. *Id.*

33. Gonzalez-Pando, *supra* note 11, at 56.

34. 1990 U.S. Census, *reprinted in* Pedraza, *supra* note 8, at 319.

35. The impact of the visitors — and their gifts to family and friends — shocked the communist regime to its ideological core. The exiles, whom Castro had repeatedly called *gusanos* (worms), were now welcomed as beneficent *mariposas* (butterflies) by their countrymen. Gonzalez-Pando, *supra* note 11, at 61.

36. Pedraza, *supra* note 8, at 318-20.

In 1980, the Cuban Government lifted its exit restrictions and opened the port of Mariel to those Cubans desiring to depart.[37] The Cuban-Americans responded by mobilizing boats to pick up their relatives. However, along with relatives being retrieved, Cuban officials put some of the country's *persona non grata,* such as criminals and mental patients, on the boats headed to the United States. An estimated 125,000 *"Marielitos"* made their way to the United States before the outflow was again halted by the Castro regime.[38]

Many of the *Marielitos* did not resemble the Cuban immigrants that had previously arrived in the United States. In prior stages of the exodus, the majority of the immigrants were white and had been, prior to the Revolution, members of the Cuban upper and middle classes. The *Marielitos,* on the other hand, included many blue-collar workers and social outcasts and, for the first time, included a high proportion of people of color.[39]

President Carter did not close the border to this new vintage of Cuban immigrants. Although some of the *Marielitos* had served jail sentences and others were institutionalized for mental illness, President Carter stood fast on maintaining the government's open door policy to Cuban immigrants, even though Congress was at the same time enacting a new statute intended to limit refugee admissions.[40]

Acceptance of the *Marielitos,* however, did not extend to the general public. Within a short time after their arrival, the Greater Miami area suffered a housing shortage and an increase in crime. The *Marielitos* were soon denounced by much of the American press as being the cause of the economic turmoil in the Southern Florida, even though only about two percent of the *Marielitos* were considered to be serious criminals.[41]

5. Fifth Stage

After the end of the Mariel boat lifts, there was another lull in Cuban emigration. During the period from 1982 to 1990, fewer than 75,000 Cuban nationals arrived in the United States. Cuban emigration remained at low levels until the early 1990's, when communism collapsed in Eastern Europe.

The downfall of communism in the Eastern Bloc had severe consequences for the Cuban economy. Starting in the 1960's, Cuba had become increasingly dependent on trade with, and economic subsidies from, its Eastern Bloc allies,

37. Gonzalez-Pando, *supra* note 11, at 61.

38. *Id.* at 62.

39. Pedraza, *supra* note 8, at 318-19.

40. Refugee Act of 1980, Pub. L. No. 96-212, 94 Stat. 102 (codified as amended in scattered sections of 8 U.S.C. (1998)).

41. Pedraza, *supra* note 8, at 319.

particularly the U.S.S.R.[42] With the fall of communism, Cuba was left with an enfeebled economy, resulting in great privations for the Cuban people.[43]

In 1994, the economic crisis reached its most critical point. As conditions worsened, discontent mounted, and a growing number of people risked their lives and fled from Cuba in boats or rafts. One group seeking to escape hijacked a ferryboat, which was immediately sunk by the Cuban Coast Guard, eliciting international condemnation over the attendant loss of life.[44] The sinking also provoked anti-government demonstrations in Cuba.[45] In response to the growing unrest, on August 5, 1994, Fidel Castro announced the end of government efforts to prevent people from leaving the country by sea.[46]

The removal of exit restrictions resulted in an immediate rush of Cubans towards the high seas that "threatened to reach the proportions of the Mariel boat lift."[47] President Clinton responded to the growing crisis by ending the open-arms policy that had granted automatic asylum to Cubans who arrived in the United States since before the days of the *Vuelos de la Libertad.* On August 19, 1994, Clinton announced that the United States would henceforth bar entry into the United States of Cuban *balseros* (rafters). Instead of allowing them to enter the country, the U.S. Coast Guard was ordered to capture the *balseros* at sea and transport them to the Guantanamo Bay Naval Base or other U.S. refugee camps for eventual repatriation to Cuba.[48]

In the following weeks, the immigration crisis intensified as *balseros* continued to endanger their lives by fleeing Cuba in inadequate rafts through shark-infested waters, despite President Clinton's announcement that all Cubans inter-

42. With the fall of the Soviet Union, "Cuba lost socialist economic aid of more than $6 billion annually." Carmelo Mesa-Lago, *Cuba's Economic Policies and Strategies for the 1990s, in* CUBAN COMMUNISM 1959-1995, 187 (Irving Louis Horowitz ed., 1995).

43. *See generally,* Carmelo Mesa-Lago, *The Economic Effects on Cuba of the Downfall of Socialism in the USSR and Eastern Europe, in* CUBA AFTER THE COLD WAR 133, 133-88 (Carmelo Mesa-Lago ed., 1993). Concomitant with the weakening of its economy, Cuba started to reduce incrementally the age limit for those allowed to emigrate legally. Since 1992, all Cubans over 20 years old have been eligible to apply for exit visas. AMNESTY, *supra* note 29.

44. The Cuban government claimed that the sinking of the ferryboat was accidental. However, survivors claim that the boat was pummeled by the water cannons from three of the government's tugs and then rammed by one of the vessels. The boat sank, and 37 of its passengers drowned. In the three weeks following this incident, three other passenger ferries were hijacked, along with an airplane and a military vessel. Geoffrey W. Hymans, *Outlawing the Use of Refugees as Tools of Foreign Policy,* 3 ILSA J. INT'L & COMP. L. 149, 152 (1996) [hereinafter Hymans].

45. On August 5, 1994, rumors that a ferryboat was going to be hijacked to Florida drew more than 500 people to Havana docks, and the most serious anti-government riot since Castro assumed power occurred. *Id.* at 153.

46. "Castro answered the riot by declaring, through the government news agency Prensa Latina, that 'we will stop blocking the departure of those who want to leave the country' and that 'we cannot continue to guard the coasts of the United States.'" *Id.*

47. Sonia Mikolic-Torreira, *The Cuban Migration Agreement: Implications of the Clinton-Castro Immigration Policy,* 8 GEO. IMMIGR. L.J. 667 (1994) [hereinafter Mikolic-Torreira].

48. *See generally,* CUBA - U.S. RESPONSE TO 1994 CUBAN MIGRATION CRISIS, GAO/NSIAD 95-211 (Sep. 1995); David Gavilan, *¿Y Qué Pasó? ('And then what Happened?'): The Plight of Cuban Detainees at Guantanamo Bay,* 4 Cardozo J. Int'l & Comp. L. 451 (1996) [hereinafter Gavilan].

cepted at sea would be sent to refugee camps indefinitely.[49] Meanwhile, U.S. and Cuban representatives met to discuss an agreement that would curb the flow of *balseros* while admitting an increased number of Cubans into the United States legally.[50]

The crisis was not resolved until September 9, 1994, when the United States and Cuba entered into the Cuban Migration Agreement. In what both countries publicized as an agreement aimed at saving human lives, Cuba and the United States agreed upon measures to encourage legal immigration.[51] The United States promised to admit at least 20,000 Cuban immigrants annually.[52] In exchange, Cuba agreed to take effective measures to deter unsafe departures. With Cuba clamping down on departures by sea, the number of *balseros* declined dramatically and the exodus came to an end by December of 1994.[53]

D. Changes In U.S. Immigration Policy After The "Balsero" Crisis

The stated basis for the end of the U.S. open door policy towards Cuban illegal immigration was a desire to avoid the loss of human lives.[54] However, there were other reasons for the United States' reversal of its Cuban immigration policy. For instance, allowing Cubans to immigrate to the United States ceased to have major foreign policy implications after the fall of the Soviet Union.[55]

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49. By August 24, 1994, rafters were departing from the Havana *Malecon* (waterfront) "in full view of government office buildings and large crowds of onlookers." Hymans, *supra* note 44, at 153. Indeed, the departures appeared to be occurring with the cooperation of the Cuban authorities. Robert Suro, *Havana Giving Tacit Approval to Rising Tide of Rafters,* WASH. POST, Aug. 24, 1994, at A24.

50. Cuba may have had as its agenda to force discussion of the U.S. embargo. As one observer noted:

> Castro [used] the exodus in the way that the Kim dynasty in North Korea used its program to build atom bombs as a lever to prod the United States to open wide-ranging talks. But U.S. negotiators have refused to discuss Cuba's loudest demand — easing of the American trade embargo.

Daniel Williams, *Cuban Response to U.S. Immigration Offer Outlandish*, WASH. POST, Sept. 5, 1994, at A14. However, ultimately, the United States succeeded in limiting the discussion in that and subsequent meetings (of which there have been nine rounds since 1994) to the terms of the immigration accord and their implementation. U.S. DEP'T ST. PRESS RELEASES, June 25, 1998; Nicole Winfield, *U.S., Cuba Talk Migration Issues,* ASSOCIATED PRESS, June 29, 1998.

51. For a discussion of the terms of the Immigration Agreement, *see* Mikolic-Torreira, *supra* note 47; Joint Communique on Migration, Sept. 9, 1994, U.S.–Cuba, 5 U.S. Dep't State Dispatch 37 (1994).

52. This promise to establish a 20,000 visa floor was a broadening of the previously-existing immigration agreement between the United States and Cuba, under which there was a *ceiling* of 20,000 visas to be issued to Cuban nationals. Joint Communique Between the United States of America and Cuba, Dec. 14, 1984, U.S. - Cuba, T.I.A.S. No. 11,057. While that ceiling was increased in 1990 to 27,845, in reality, the neither figure was ever reached; in 1993/1994, prior to the crisis, only 2,700 visas were granted to Cubans. AMNESTY, *supra* note 29; Patrick Costello, *Cuba: Reforms, Migration and International Reforms*, WRITENET COUNTRY PAPERS, Nov. 1995, Section 3.4 (no page citations available).

53. David Hancock, *Influx of Cuban Rafters Ends; Zero in December,* MIAMI HERALD, Jan. 9, 1995, at 1B. In all, approximately 32,000 Cubans were picked up at sea by the U.S. Coast Guard during the crisis and confined in the Guantanamo Bay Naval Base and a U.S. military base in Panama. Gavilan, *supra* note 48, at 452-53.

54. Mikolic-Torreira, *supra* note 47, at 668.

55. As an analyst put it:

During the Cold War, granting political asylum to a person fleeing a communist country served to highlight the negative aspects of Socialism and underscore the advantages of the American way of life. However, with the fall of the Soviet Union, the incentive to grant political asylum to Cubans disappeared.

In addition, the Clinton Administration apparently saw the stemming of the immigration tide as a way to force Cubans on the island to work towards bringing about a democratic transition. In a June 1995 speech, the President defended his policies as follows:

> We simply cannot admit all Cubans who seek to come here. We cannot let people risk their lives on open seas in unseaworthy rafts . . . . Regularizing Cuba migration also helps our efforts to promote a peaceful transition to democracy on the island. For too long, Castro has used the threat of uncontrolled migration to distract us from this fundamental objective. With the steps we've taken, we will be able to devote ourselves fully to our real long-term goal.[56]

Another important factor in the equation was the growing anti-immigrant bias that developed in the United States at about the same time the *balsero* crisis was unfolding. California led the way in the anti-immigrant sentiment, as reflected by the 1994 passage of Proposition 187, which barred undocumented immigrants from public education, social services and non-emergency health care.[57] Governor Pete Wilson and other proponents of the measure sought to "send a message" to the federal government, and presumably to the immigrant community, about immigration.[58] Wilson's message was loud and clear: Cali-

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> Immigration and particularly asylum policy were viewed as part of the overall foreign policy efforts against the Soviet Union and its sphere of influence. Emigration on one side and granting political asylum was encouraged. Indeed, the arrival of each political refugee from the Soviet Bloc was viewed as reaffirmation of the validity of our own system. Similarly, the Freedom Flotilla was viewed as a blight on the Cuban revolution and a validation of our foreign policy. In addition, for the Cuban refugees, their journey was a logical extension of their unhappiness with the revolution.

Boswell, Richard, *Throwing Away the Key: Limits on the Plenary Power?*, 18 MICH. J. INT'L L. 689, 695-96 (1997).

56. Clinton Defends Cuba Policy, ASSOCIATED PRESS, Jun. 27, 1995. *See also,* John Lantigua, *Clinton Defends Policy*, MIAMI HERALD, Jun. 28, 1995, at 1B.

57. *See* Tanya Broder and Clara Luz Navarro, *A Street Without an Exit: Excerpts from the Lives of Latinas in Post-187 California,* 7 HASTINGS WOMEN'S L.J. 275, 277 (1996) [hereinafter *Street*]. Sponsors of Proposition 187 knew that certain provisions would probably be deemed unconstitutional, such as denying elementary and secondary education to undocumented children. Such a denial appeared to be inconsistent with the U.S. Supreme Court's decision in Plyer v. Doe, 457 U.S. 202 (1982), which required that K-12 education be available to all children, notwithstanding their immigration status. *Id.* Similarly, Proposition 187 appeared to violate the Omnibus Reconciliation Act of 1986, which mandated that undocumented immigrants be given "emergency health care, including pregnancy services, under the Medicaid program." Jonathan C. Dunlap, *The Absent Federal Partner*, SPECTRUM, January 1, 1994 at 6 [hereinafter Dunlap].

58. *Street, supra* note 57, at 277 and n.8. Governor Wilson, enraged with the cost imposed by illegal immigration on his state and the failure of the federal government to take effective measures, described Proposition 187 as "the two-by-four we need to make them take notice in Washington." Roberto Suro, *California's SOS on Immigration*, WASHINGTON POST, Sept. 29, 1994, at A1. Commentators have seen the anti-immigration mood in California and elsewhere as being at least in part racially motivated and directed against Hispanics. *Street, supra* note 57, at 278 and n.11; Thomas D. Jones, *A Human Rights Tragedy: The Cuban and Haitian Refugee Crisis Revisited,* 9 GEO. IMMIGR. L.J. 479, 482 (1995).

fornia no longer welcomed immigrants, and was not prepared to help finance the costs of having a growing immigrant population.[59]

The anti-immigrant backlash was also an important campaign issue in Florida, where images of destitute *balseros* arriving on the State's shores prompted concerns about their impact on the local economy.[60] Florida's incumbent Governor, Lawton Chiles, made opposition of mass immigration from Cuba an issue in his 1994 re-election campaign. When President Clinton announced in November 1994 that he would allow the entry of 10,000 of the Cubans interned at the Guantanamo Bay Naval Base and in Panama on humanitarian grounds, Governor Chiles kept to his campaign promise of erecting barriers to the Cuban exodus.[61] In response to the arrival of the new immigrants, Chiles filed a suit for nearly $1 billion against the United States, claiming that the federal government should pay the State's cost of admitting illegal immigrants because the federal authorities failed to prevent illegal immigration.[62] Even though the suit was dismissed, Chiles claimed that the "lawsuit was successful in that it raised awareness of the extraordinary impact of illegal immigration on border states like Florida."[63]

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59. In 1993, the General Accounting Office testified to Congress that for the previous year "the total cost to state and local governments for providing kindergarten through 12th-grade education, emergency Medicaid [and other social services]. . . in California, Texas, Illinois, New York and Florida was estimated at $2.39 billion." Of these costs, California absorbed about $1.7 billion. Dunlap, *supra* note 57.

60. A 1996 report by the Center for Immigration Studies appeared to lend support to many of the economic concerns raised by Florida's anti-immigrant forces. Some of the report's findings were summarized in the press as follows:

> By the year 2020, Florida's population will jump 57 percent to 22 million. The state's public schools will be crowded with an additional 750,000 students, and its roads clogged with nightmarish traffic.
>
> And a 30 percent growth in foreign immigration will be to blame for much of the problem afflicting the state.
>
> * * *
>
> By 2020, whites will make up 58 percent of Florida's population, down from 73 percent in 1990.

Report: State has Immigrant Problem; the Study says that by the 2020 the Schools will be Jammed and the Roads will be Clogged, ORLANDO SENTINEL, Jan. 19, 1996, at D4. Whether or not the report's findings are given credence, they served to fuel the anti-immigration sentiment in Florida.

61. In response to Clinton's announcement, Ron Sachs, a spokesman for Governor Chiles stated that "if a large number of refugees are allowed into the country, Chiles would demand full reimbursement from Washington for the cost of providing services to the new immigrants and would seek to replace the families outside Florida." David Adams, *U.S. may Allow 10,000 Cubans into Florida,* ST. PETERSBURG TIMES, Nov. 16, 1994, at A1.

62. Florida was one of several states to file suit against the United States. Other states with high immigrant populations, such as California, Arizona, New Jersey, New York and Texas, also sued the federal government separately. One article depicts the suits as governors' courting the anti-immigrant vote in those states:

> Accompanied by a blaze of publicity, the states filed separate suits in 1994 arguing they should be reimbursed for the costs of illegal immigrants. At the time, the states' governors were running for re-election and polls showed widespread public resentment of illegal immigration.

Maria Puente, *Court Rejects Florida Case on Illegal Aliens, State Sought Federal Funds,* USA TODAY, May 14, 1996, at 5A.

63. *Id.*

E. Implementation Of The U.S - Cuba Immigration Agreement

The United States ultimately did not make good on its threat to return to Cuba the *balseros* it seized in 1994. Instead, in May 1995, after holding secret meetings with Cuba, the Clinton Administration reversed its Cuban immigration policy by announcing that the United States would admit the 21,000 refugees still being held at the Guantanamo Bay Naval Base, but would in the future send back to Cuba all "illegal immigrants" found at sea.[64] In so doing, the United States created a remarkable disparity of treatment between the Cubans who are intercepted at sea — who are almost invariably returned to Cuba— and those who manage to touch American soil. In most instances, members of this latter group are given asylum in accordance with the Migration and Refugee Act of 1962, which remains in effect.[65]

The new policy was described as having been prompted by many factors, including the high cost of keeping the refugees detained in Guantanamo, the recurring threat of riots among the detainees, and the sense that the majority of the population supported curbing illegal immigration.[66] Indeed, while the change in immigration policy was received with indignation by many in the

64. Daniel Williams and Ann Devroy, *Serious Alarm Bells Led to Talks with Cuba*, WASHINGTON POST, May 5, 1995, at A4; The White House, Joint U.S.-Cuba Statement, May 2, 1995; Ann Devroy and Daniel Williams, *In Reversal, U.S. to Accept Cubans Held at Navy Base,* WASHINGTON POST, May 3, 1995, at 1A.

65. Thus, since its May 1995 agreement with Cuba, the United States has returned over one thousand refugees captured at sea to Cuba. *U.S. Returns Over 1,000 Cubans Since 1995,* REUTERS, Jun. 17, 1998. At least some of the returned refugees are reported to have faced harassment upon their return to Cuba. *2 Cubans Report Harassment,* FT. LAUDERDALE SUN SENTINEL, May 27, 1995, at 12A.

By contrast, every year an increasing number (which in 1998 exceeded 800) of Cubans — many of them smuggled by third parties— make it to land in the United States and, in most instances, are granted political asylum. John Nordheimer, *Those Reaching Shore Gain Legal Advantage,* N.Y. TIMES, Aug. 28 1994, at A12; Andres Viglucci, *Loophole Could Limit Reparation: Cubans Who Reach U.S. May Get to Stay,* MIAMI HERALD, May 5, 1995, at A1; Andres Viglucci, *U.S. Eases Up on Refugee Detentions,* MIAMI HERALD, Dec. 11, 1995, at 1B; Manny Garcia, *Cubans Land on Beaches to Open Arms,* MIAMI HERALD, Sept. 24, 1996, at 1A; Deborah Ramirez, *Smuggling Operations on Rise From Cuba,* FT. LAUDERDALE SUN-SENTINEL, June 18, 1998, at 5B; Angus McSwan, *Summer Brings Waves of "Boat People" to Florida,* REUTERS, June 17, 1998; Andres Viglucci, *Smuggling Seen in Refugee Rise 2 Arrested; Boat Seized,* MIAMI HERALD, June 25, 1998, at 1A; Mike Clary, REFUGEE SURGE THREATENS U.S.-CUBA MIGRATION PACT, L.A. TIMES, Dec. 31, 1998, at A5; *but see,* Liz Balmaseda, *Rescue Not a Happy Ending,* MIAMI HERALD, June 24, 1998, at 1B.

66. *See* Steven Greenhouse, *U.S. Will Return Refugees to Cuba in Policy Switch,* N.Y. TIMES, May 3, 1995, at A1; Tom Fiedler and Alfonso Chardy, *Goal of 'No More Mariels' Led to Clinton's Painful Choice,* MIAMI HERALD, May 3, 1995, at 15A. The point was driven by a subtle change in semantics. The Cubans seeking shelter in the United States, who for over thirty years had been described as "exiles," "refugees," "freedom seekers," and other terms with positive connotations, became in official U.S. government parlance "migrants" and "illegal immigrants." *See, e.g., Cuban Migration Policy: Hearings before the Subcomm. on Western Hemisphere of the House Comm. on Int'l Relations,* 104th Cong. (1995) (statement of Doris Meissner, Commissioner, I.N.S.). These terms had previously been applied to justify the return of undocumented aliens (such as Haitians) seeking to enter the United States by boat to their country of origin, *see* Exec. Order No. 12, 807, 57 Fed. Reg. 23, 133 (1992); Elizabeth Harris, *Economic Refugees: Unprotected in the United States by Virtue of an Inaccurate Label,* 9 Am. U.J. INT'L L. & POL'Y 269, 280 & n.73 (1993). Before 1994, the term had apparently not been applied to Cuban rafters.

Cuban-American community, a poll taken in Miami shortly after the new policy was announced found that "nearly half of Cuban Americans in Dade [County] agree with other county residents that immigration from Cuba should be sharply limited."[67]

The United States has lived up to the commitments under the immigration agreements it reached with Cuba in 1994 and 1995. Virtually all of the more than 30,000 rafters who were interned in 1994 were eventually admitted into the United States, although the process was not completed until January of 1996.[68] The United States has also kept its promise under the 1994 Cuban Migration Agreement to admit 20,000 Cuban immigrants annually, in addition to those Cuban nationals admitted as the next of kin to United States citizens through the visa processing system.[69] Visas are granted to people with close relatives in the United States, people who qualify for political asylum, people qualifying for visas as relatives forming part of the same household as others granted visas, and other immigrants selected by lottery.[70]

The State Department needed to make certain changes in its practices in order to increase the number of Cubans legally entering the United States. These changes include loosened criteria for granting asylum to Cubans, broadened parole powers for the State Department, and an increased number of Cuban immigrant visas selected by lottery.[71]

To implement the changes, Attorney General Janet Reno employed her emergency powers to raise the number of Cubans admitted each year beyond the legal ceiling. Immigration law permits the Attorney General to grant parole in cases of emergency or in the public interest. In the past, the Attorney General limited the use of this parole power to situations in which an individual needed the services or protection of the United States, such as a cancer victim needing a bone marrow transplant. Reno, however, expanded the use of this parole power.

The United States also broadened its asylum guidelines. The eligibility requirements for Cubans seeking asylum were loosened to include certain people that did not meet the well-founded fear of persecution required by U.S. immigration law. According to the new guidelines, Cubans were eligible for asylum if they had been human-rights activists, had experienced religious discrimination, had been consigned to work camps in the period from 1965 to 1968, or had

67. John Lantigua and Stephen Doig, *Limit Cuba Immigration? Yes, Most in Survey Agree,* MIAMI HERALD, May 15, 1995, at 1A.

68. John Lantigua, *Guantanamo: Mission Accomplished,* MIAMI HERALD, Jan. 19, 1996, at 1B.

69. *U.S. Fulfills Migration Pact with Cuba,* REUTERS, Aug. 22, 1995; Carol Rosenberg, *New Visa Lottery Will Help Cubans Migrate to U.S.,* MIAMI HERALD, Jun. 6, 1998 [hereinafter Rosenberg].

70. Mimi Whitefield, *New Rules on Cuban Immigration Released,* MIAMI HERALD, Oct. 13, 1994, at 21A. This is not to say, however, that everyone who is granted a visa actually emigrates to the United States. Thousands of the people granted visas are ultimately prevented from leaving the country by the high exit fees charged by the Cuban government ($500 per adult, $400 per child, payable in dollars only), the costs of transportation, and other hurdles. Andres Viglucci, *Costly Exit Fees Keep Some Cubans From Using Visas*, MIAMI HERALD, Aug. 9, 1998, at 1A [hereinafter "*Fees*"].

71. Mikolic-Torreira, *supra* note 47, at 669.

experienced curbing of the exercise of their vocations as a result of their perceived or actual political beliefs.[72]

Additionally, through the immigration lottery and the increased number of lottery visas granted to Cuban nationals, the United States kept its vow to take an active course in promoting legal Cuban immigration while effectively tackling many concerns that arose from the Mariel boat lift. The increased number of lottery visas allowed many Cubans to legally immigrate to the United States although they may not have otherwise qualified.[73] This opened the door to the United States to those in Cuba who lacked an immediate relative with legal status in the United States and did not suffer sufficient persecution to qualify for political asylum. On the other hand, the lottery requirements served as a filter of the Cubans admitted to the United States. The lottery applicants were required to meet two of the following five criteria: completion of high school; minimum of three years work experience; possession of job skills; familial ties in the U.S.; and demonstrated interest in migration to the U.S. before October 1, 1994.[74] Applicants were also required to pass a medical screening and an interview establishing their ability to support themselves.[75] By way of these requirements, the United States took precautions to exclude criminals and possible welfare recipients. Although these restrictions limited the pool of Cubans able to qualify for lottery visas, more than enough visa applications were submitted to enable the United States to fulfill its promise of granting more than 20,000 visas annually to Cuban nationals.[76]

F. Current Status Of Cuba-To-U.S. Immigration

The U.S. government's handling of the *balsero* crisis sent a clear message that the United States would no longer provide an unlimited safe haven for discontent Cubans. Many, therefore, expected that the U.S. government's policy would become more restrictive with time, and that it would become more difficult for Cubans to enter the United States as well as for those in the United States to adjust their status. The anticipated hardening of the U.S. stance concerning Cuban immigration, however, did not take place. Cubans still enjoy the preferential treatment that began when President Johnson established an open-door policy to Cuban immigrants.[77] There are sound legal and political reasons

72. *Id.* at 668.

73. In 1994, the United States granted 8,400 visas to Cuban nationals seeking to immigrate to the United States. Since 1994, nearly 29,000 Cubans were granted U.S. visas under the lottery system. Rosenberg, *supra* note 69. The total number of immigrant visas granted to Cubans since 1994 exceeds 42,000. *Fees*, *supra* note 70.

74. Andres Viglucci, *Lottery Will Open U.S. Door to Cubans*, MIAMI HERALD, Mar. 12, 1996, at 5B; *INS Announces Details of Special Cuban Migration Program,* PR NEWSWIRE, Nov. 4, 1994.

75. *Id.*

76. 189,000 Cubans applied for the first lottery in 1994, and 435,000 applied for the second one in 1996. Rosenberg, *supra* note 69.

77. In fact, the number of Cuban refugees adjusting their status to permanent U.S. residents nearly doubled the first year the new immigration policy went into effect, from 12,355 in 1995 to 22,542 in 1996. U.S. Immigration and Naturalization Services, Statistical Yearbook of Immigration and Naturalization Service, 1995, U.S. Government Printing Office: Washington, D.C. 1997, tbl. 10, p. 51.

why such treatment should continue, at least as long as the current regime retains its repressive policies against those who seek to escape the country.[78]

By contrast, those seeking to immigrate to the United States from other countries have not received a warm reception. In recent years, Congress has attacked illegal immigration through the Anti-Terrorism and Effective Death Penalty Act of 1996 ("Anti-Terrorism Act")[79] and the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 ("IIRIRA").[80] The Anti-Terrorism Act tightens admissibility standards by means such as expanding the term "aggravated felony" to include conduct that in the past would not have barred an alien from legally immigrating to the United States. For its part, contrary to previous law, the IIRIRA makes an alien inadmissible if he entered the United States without having been admitted or paroled. Thus, both acts create new obstacles for aliens seeking legal immigrant status in the United States.

Cubans have not been adversely affected by the latest tightening of the U.S. borders to immigrants. Instead, Cubans have had a much different experience than immigrants from other countries. For instance, in April of 1996, when moves were made to repeal the Cuban Refugee Adjustment Act, the Senate voted by a margin of 62-37 to retain the legislation in place until a democratic government is in place in Havana, and legislation to that effect was enacted.[81] This indefinite retention of the Cuban Refugee Adjustment Act preserves the preferential treatment of Cuban nationals in the United States, at least until the end of the communist rule.

Moreover, as part of the District of Columbia Appropriation Act of 1998, Congress passed the Nicaragua Adjustment and Central American Relief Act ("NACARA"),[82] extending immigration privileges to Cuban nationals. The new law requires a Cuban national seeking to adjust his status to that of a permanent resident to have resided in the United States since December 1, 1995, rather than the former one year requirement set under the Cuban Refugee Adjustment Act. However, applicants for status adjustment under NACARA are not subject to the provisions of section 245(c) of the INA, which bars aliens from adjusting if,

78. Because of well-founded fears of persecution should they return to the island, obtaining political asylum in the United States remains critical for Cuban citizens who leave their native country to escape political persecution. Andrew Bonavia, *United States v. Rodriguez-Roman: Prosecuting the Persecuted*, 22 N.C. J. INT'L L. & COM. REG. 1039, 1040 (1997) [hereinafter Bonanvia]. U.S. courts have upheld the Cuban exiles' claim to political asylum based on fear of reprisal for abandoning their country. In a recent court decision, the Ninth Circuit Court of Appeals ruled that asylum should be granted to Cubans who fear persecution for violating their country's exit restrictions, Rodriguez v. INS, 98 F.3d 416, 418 (9th Cir. 1996). In the Rodriguez case, the asylum seeker had presented evidence of the consequences of being returned to Cuba after fleeing from the island. *Id.* at 419. Such a person could expect "many years in prison for the crimes of looking for freedom and [sic] possibly be shot." *Id.* at 420. In prison, he would be subject to atrocious conditions including abuse amounting to a "moral death," denial of family visits and medical attention, and forced sharing of cells with violent and deranged inmates. *Id.* at 420. The Ninth Circuit Court of Appeals agreed that Rodriguez had a considerable fear of persecution based on his departure and held that he and others like him should be granted political asylum in the United States. *Id.* at 429.

79. Pub. L. No. 104-132, 110 Stat. 1214 (1996).

80. Pub. L. No. 104-208, 110 Stat. 3009 (1996).

81. Pub. L. No. 104-208, Title VI, § 606, 110 Stat. 3009-695, 8 USCA § 1255 note (1996).

82. Pub. L. No. 105-100, Title II, § 201, 111 Stat. 2160 (1997).

inter alia, they worked in the United States without authorization or remained in the United States beyond their authorized stay. Also, Cuban nationals who entered illegally are eligible for amnesty under NACARA.[83] Such amnesty is not available to nationals of other countries.

III.
THE CHALLENGES AND OPPORTUNITIES OF A POST-TRANSITION IMMIGRATION REGIME BETWEEN CUBA AND THE UNITED STATES

A. Introduction

Although one cannot predict with certainty the reaction of the U.S. government to the start of Cuba's democratic transition, its immigration policy towards Cuba is unlikely to remain the same once the process gets under way. For over three decades, the United States has accepted hundreds of thousands of Cubans, bypassing the standard rules for granting asylum or admitting aliens as permanent residents. This preferential treatment given to Cuban immigrants will almost certainly cease with the end of communism in Cuba, unless the political conditions on the island remain unstable and warrant continuation of some program for the handling of refugees. The Cuban Refugee Adjustment Act, for example, is scheduled to be repealed upon the establishment of a democratic government in Cuba.[84] Since the immigration policy of this country is to provide uniform treatment to aliens seeking admission, regardless of their country of origin, Cuban nationals may well find themselves facing the same barriers that citizens from other countries presently experience in seeking to migrate to the United States.

Nevertheless, because of the unique relationship between the two countries, special legislation will likely be enacted (together with an eventual treaty) to properly address the interests and concerns of both the United States and Cuba in the area of immigration as Cuba undergoes its transition to democracy. The terms of that legislation and treaty will be dictated by several factors.

First, U.S. policy toward Cuba in the last forty years has been motivated exclusively by the interest of the United States in fighting Communism and replacing the current Cuban government with a democratic regime. If the transition is perceived as a move towards democratization, the political objectives that have driven U.S. immigration policy toward Cuba will have been achieved. Immigration policy will then be driven primarily by economic rather than political factors. Accordingly, travel restrictions will be liberalized and preferential treatment programs will be reexamined and probably phased out.

Second, immigration is a politically explosive issue in the United States, particularly in those states in which most immigrants have traditionally settled.

83. *See* Adjustment of Status for Certain Nationals of Nicaragua and Cuba, 63 Fed. Reg. 27,823 (1998) (codified at 8 C.F.R. pts. 3, 240, 245, 274a, 299).

84. As noted earlier, *see* note 81, *supra* and associated text, the Cuban Refugee Adjustment Act has been repealed prospectively; the repeal will be effective upon a determination by the President under Section 203 (c)(3) of the LIBERTAD Act (22 U.S.C. §6063(c)(3) (1998)) that a democratically elected government is in power in Cuba.

Any new immigration proposals relating to Cuba are likely to be surrounded by substantial controversy. Legislators are therefore bound to consider Cuban immigration proposals both on their merits and in light of their political ramifications.

Third, although both countries will be working toward the goal of facilitating Cuba's economic recovery through the unimpeded flow of people between the two countries, the challenges they will confront are very different. Whereas Cuba's main objective will be to attract new investors and specialized workers, the United States will focus primarily on balancing its need to facilitate Cuba's transition through open immigration policies, with the somewhat conflicting goal of limiting Cuba-based immigration to manageable amounts.

Finally, immigration in the United States is already governed by a comprehensive policy that, with minor exceptions, applies equally to all countries: even Mexico and Canada are given few special immigration privileges despite their participation in the NAFTA.[85] Thus, while immigration from Cuba may be the subject of special provisions, those provisions will have to be of limited duration so that policy toward Cuba becomes consistent with the overall U.S. immigration policy. Like aliens from other countries, Cuban aliens seeking to enter the United States will be considered on the basis of their individual qualifications as opposed to their country of origin.

Cuba, for its part, must develop an immigration strategy that fosters the movement of goods, ideas and people across its borders during the transition. Once it becomes apparent that Cuba intends to liberalize its economy and commit to a democratic form of government, foreign investors and Cuban expatriates will seek to visit Cuba in substantial numbers. During the transition, it is essential that Cuba encourage such visits by developing an open and efficient immigration policy.

B. A Potential U.S. Approach To Cuban Post-Transition Immigration

1. Introduction

It is probably not in the national interest of either country to continue fostering permanent migration of Cuban nationals into the United States, even for a limited time, during the transition. Rather, given the need to rebuild Cuba, U.S. policy should encourage the temporary, business-oriented movement of Cubans in and out of the United States. Programs should be instituted to allow the free movement of business travelers and to allow Cubans to work in the United States for periods long enough to gain technical and administrative skills necessary to succeed in a restructured Cuban economy.

85. See Kevin Johnson, *Free Trade and Closed Borders: NAFTA and Mexican Immigration to the United States*, 27 U.C. DAVIS L. REV. 937, 940-941 (1994) [hereinafter "Johnson"] ("[W]hile NAFTA provides for a reduction of restraints on trade with the hopes of increasing commerce between the three nations, it for the most part does not deal with the flow of people between those same nations.").

Under this approach, the current refugee programs would be eliminated and concentration of immigration policies would shift from political to economic goals. Congress would establish new visa and immigration policies which would allow Cubans to travel and work in the United States for limited periods of time, without issuing them permanent immigrant visas. This approach would result in no net increase in the number of Cubans migrating permanently to the United States, and may actually result in fewer permanent Cuban immigrants, because some Cubans who qualify for permanent visas may opt for temporary visas instead. The elements of this approach are described below.

2. The Mexican Model

Although the situations of Mexico and Cuba are very different and likely to remain so, the relations between both countries and the United States raise many of the same immigration issues. Both have weak economies relative to that of the United States, both are located at or close to U.S. borders, and both have been the source of large numbers of legal and illegal immigrants to the United States. As a consequence, it is logical to assume that once the Castro regime no longer commands special treatment, U.S. policy makers will approach immigration from Cuba much as they have approached Mexican immigration.[86] Thus, if nothing else, U.S.-Mexican immigration policy provides some guidance as to the boundaries within which policy makers should stay, given the political climate in the United States.

Despite its seemingly natural link to free trade, immigration was not addressed in any meaningful manner by the NAFTA.[87] Consequently, "many commentators maintain that the NAFTA was not designed with the intention of creating a freedom-of-movement-of-person regime. On the contrary, it is an agreement specifically encouraging the freedom of movement of goods, capital, and services, and which in conspicuous silence excludes persons from its regime."[88] Thus, with a few minor exceptions,[89] Mexicans are not given preferential immigration treatment. The limited immigration scope of the NAFTA "reflects the tension between the goals of preserving national autonomy, border security, and protecting the permanent employment of each Party's domestic labor force on the one hand, and encouraging the liberalization of trade on the other."[90] Although somewhat contradictory, the U.S.-Mexican immigration policy is designed to encourage free and open trade across a relatively closed border.

86. *See generally* The North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., 32 I.L.M. 289, 296-456, 612-799 [hereinafter "NAFTA"].

87. See Johnson, *supra* note 85.

88. Noemi Gal-Or, *Labor Mobility Under NAFTA: Regulatory Policy Spearheading the Social Supplement to the International Trade Regime,* 15 ARIZ. J. INT'L & COMP. LAW 365, 366 (1998).

89. NAFTA creates a special category of temporary "TN" visas for which only Mexican and Canadian workers are eligible. Mexicans are limited to only 5,500 TN visas annually, so this program does not significantly affect U.S.-Mexican immigration trends. *See* NAFTA, *supra* note 86, ch. 16 & app. 1603.D.1; 8 C.F.R. § 214.6(c)(1992).

90. Ellen G. Yost, *NAFTA: Temporary Entry Provisions — Immigration Dimensions*, 22 CAN.-U.S. L. J. 211, 211 (1996).

The issues are virtually identical for Cuba. On the one hand, the United States has an important national interest in facilitating the transition to a strong free-market Cuba. An economically strong Cuba would consolidate what will most likely be a new democratic regime, offering new markets to U.S. businesses. Perhaps more importantly, a strong Cuba would eliminate the need of Cubans to seek work abroad, and thereby mitigate the labor, security and cultural problems that many perceive immigration to cause. An immigration policy that promotes the free movement of skilled workers between the United States and Cuba has the potential for helping advance these interests. Nonetheless, once the immigration policy toward Cuba starts to be evaluated primarily as an economic matter, rather than a political one, the United States is unlikely to view Cuban immigration issues much differently than it did those presented by NAFTA. Therefore, in order to stand a chance of generating the requisite political support for passage, any proposal addressing immigration during the transition must be consistent with the existing immigration policy of the United States toward Mexico and the rest of the world.

3. *Permanent Immigration of Cubans into the United States*

The permanent immigration policy of the United States is relatively inflexible and very unlikely to be modified to cater to Cuba's needs during the transition. Moreover, to the extent that the goal of both the United States and Cuba is to allow Cubans to gain training, experience, and new skills that they can later use to rebuild Cuba, permanent immigration should be discouraged. Nonetheless, because many Cubans will still be eligible to immigrate permanently into the United States, it is important to examine briefly how the global U.S. immigration policy will apply to Cubans during the transition.

U.S. immigration policy is driven primarily by four principles: family unification, harboring of refugees, cultural diversity and employment. Of the roughly 800,000 permanent immigrants that enter the United States each year, the vast majority enter through a program based upon one of these principles.[91] Although a few special programs are tailored to address the needs of specific ethnic groups or nationalities, for the most part the policy applies equally to all countries.

Family unification, currently accounting for over 62% of all new immigrants, is clearly the cornerstone of the permanent immigration system.[92] Of those 62%, over half enter as spouses, children or parents of U.S. citizens. There are unlimited visas available to these close relatives of U.S. citizens.[93]

The remainder of the 62% is comprised of immigrants sponsored by either U.S. residents or by more distantly related U.S. citizens. Despite the issuance of approximately 200,000 visas to applicants falling in the latter category, some

91. *See* Prepared Testimony of Susan Martin, Executive Director U.S. Commission on Immigration Reform Before the Judiciary Committee Subcommittee on Immigration and Claims, U.S. House of Representatives, Federal News Service (May 17, 1995).

92. *Id.*

93. *Id.*

family members can expect to wait up to thirty years before they can legally enter the United States.[94] Nonetheless, in both family unification categories, the large number of Cubans already residing in the United States will allow Cubans to benefit substantially from family-oriented visa programs. There is no reason to believe that this trend will change during the transition.

Approximately 16% of current permanent immigrants arrive as refugees, many of whom originate in Cuba.[95] If we accept the premise that forms the basis for this paper, *i.e.*, that during its transition Cuba will observe democratic principles, few Cubans are likely to qualify as refugees.

In an effort to promote diversity from countries which have not traditionally supplied many immigrants to the United States, Congress has provided for 55,000 visas to be issued by lottery.[96] However, given that nearly 6.5 million people are competing for these "diversity" visas, few Cubans are likely to gain entry into the United States under this program.[97] Moreover, because Cuba is not an "undersubscribed" country, its citizens will probably not receive any preferential treatment from the United States in the interest of cultural diversity.

Finally, and most relevant to this discussion, 140,000 permanent visas are granted each year through employment-based programs, all of which are subject to limitations that protect the U.S. labor market.[98] Most of these visas are granted to applicants who can demonstrate through publications, academic or work credentials, or other means, that they are among the best in their fields, who are able to make substantial contributions to society in the United States, or who are high-level executives in international companies. If none of these criteria are met, applicants must show that they intend to fill a position for which there are no qualified U.S. workers available.[99] Additional programs are also available for applicants intending to invest money in or otherwise benefit the U.S. economy in some way.

Although there are limitations on the number of such visas, the number of visas issued is normally well below the limit, for the eligibility criteria are stringent enough to effectively curtail permanent immigration for employment reasons from any country. Nevertheless, any Cuban that meets the substantive requirements of the employment-based programs will be eligible for permanent admission into the United States.

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94. *Id.* The amount of time an applicant can expect to wait depends largely upon which country he or she is from. Quotas are assigned to each country, and certain countries' limits are quickly reached each year.

95. Alan Reynolds, Address Before the Judiciary Committee Subcommittee on Immigration and Claims, U.S. House of Representatives, *in* FEDERAL NEWS SERVICE (April 21, 1998).

96. *Id.*

97. *Id.*

98. *Id. See also,* American Immigration Lawyers Association (AILA), 1 1998-99 IMMIGRATION & NATIONALITY LAW HANDBOOK 278-296 (1998) [hereinafter "HANDBOOK"].

99. HANDBOOK, *supra* note 98, at 296.

4. *Categories of Non-Immigrant Visas Allowing Work in the United States*

a. *Introduction*

As noted earlier, U.S. policy should focus primarily upon providing opportunities for Cubans to work or study in the United States for limited periods of time.[100] This strategy is appropriate for several reasons:

(1) It does not permanently drain Cuba of skilled workers who would otherwise be able to make significant contributions to the development of a democratic free-market Cuba. Rather, it allows those workers to acquire additional technical and administrative skills and experiences in the United States over a period of years that they can subsequently use to benefit Cuba;

(2) It temporarily relieves the burden on what will likely be a fragile democratic regime to provide the Cuban population with benefits and jobs. Moreover, Cubans working in the United States will continue to be able to send money home to support relatives in Cuba during the transition;

(3) It is much easier to gain political support for temporary work and study programs than for policies promoting permanent immigration.

The following discussion examines some of the temporary work categories that could benefit Cubans during the transition period.

b. *Professional Worker Visas*

The most useful vehicle for Cubans to enter and work in the United States during the early years of the transition could be the "H-1B" visa.[101] H-1B visas would be available to professional workers from Cuba who have at least a bachelors degree, or equivalent work experience. The main obstacles to Cubans obtaining H-1B visas are:

(1) The prevailing wage requirement mandates that an employer pay any foreign national at least the "prevailing wage" for a given type of work.[102] To the extent that these wages are set too high, U.S. companies may lack an incentive to hire workers from Cuba.

(2) The H-1B applicant must already have a job lined up in the United States. This should not be overly burdensome, for it is to be expected that skilled Cuban workers will be in demand in the United States, especially given the large number of potential Cuban-American employers in the United States and Cuba's geographic proximity.

(3) There is a limit on H-1B visas — no more than 65,000 may be issued in any one given year.[103] In 1997, for the government fiscal year ending on

100. Temporary non-immigrant visas are provided for in the Immigration and Naturalization Act of 1952.

101. INA §§ 101(a)(15)(H), 212(n), 8 USC § 1101(a)(15)(H); 8 C.F.R. § 214(h).

102. Employers must file a Labor Condition Application with the U.S. Department of Labor attesting that it intends to pay the H-1B workers at least the "prevailing wage" in the geographical area of employment for the position that worker is expected to fill. HANDBOOK, *supra* note 98, at 171; 8 U.S.C. §1182(n)(1)(A); 20 C.F.R. § 655.730(b)(3).

103. HANDBOOK, *supra* note 98, at 174.

October 1, the cap was reached by mid-August.[104] In 1998, all 65,000 visas had been issued by early May.[105]

c. Intra-Company Transferees

A second type of non-immigrant work visa (the "L-1" visa) is available for Intra-Company Transferees.[106] Employees of a U.S. company or affiliate who have worked abroad for one continuous year during the preceding three years in an executive, managerial or specialized knowledge capacity, are eligible to be transferred to the United States to work in a similar capacity for an affiliate of that same company.[107] These L-1 visas are likely to become increasingly important as the economies of Cuba and the United States become more intertwined. As more foreign investment enters Cuba, more Cuban employees will become eligible to work in the United States. Conversely, as more workers return to Cuba with newly-developed skills and work experience, more foreign investors will be willing to invest in Cuba. The primary advantage of this visa over the H-1B visa is that it is limited neither by quotas nor by prevailing wage requirements.

The main drawback of the L visas is that they will not be available during the early stages of the transition, because U.S. companies will not have been established in Cuba long enough for their Cuban staffs to satisfy the one year employment requirement. On the other hand, the eventual availability of these visas should provide an incentive to U.S. employers to hire capable Cuban employees early and give them management responsibilities right away, so they can be available for transfer, if desired, to the company's facilities in the United States.

d. Treaty Traders and Investors

A class of non-immigrant visas ("E visas") is available to Treaty Traders and Investors.[108] Applicants must demonstrate intent and capacity either to engage in substantial trade and commerce in the United States, or to invest in and develop a new and substantial enterprise that would benefit the U.S. economy. Treaty investors and traders must also be from a country with which the United States has a treaty of commerce and navigation, a free trade agreement or a bilateral investment treaty.

The basic concept behind the E visas is that they should be granted to those who generate significant trade or those who invest in the U.S. economy, and either directly or indirectly create jobs. Assuming the United States and Cuba

104. *Id.*

105. Notice: Fiscal Year 1998 Numerical Limitation Reached for H-1b Non-immigrants, 63 Fed. Reg. 25,870 (1998).

106. INA § 101(a)(15)(L); 8 C.F.R. § 214.2(l) (as amended by 56 Fed. Reg. 61117-37 (Dec. 2, 1991)).

107. HANDBOOK, *supra* note 98, at 202.

108. 8 U.S.C. § 1101(a)(15)(E) (1998); 8 C.F.R. § 214.2(e) (1998).

enter into some type of trade agreement, this visa category may apply.[109] While this program has the potential to increase the aggregate number of Cubans working in the United States, the portion of the program that gives immigration benefits to investors serves U.S. interests largely at the cost of Cuba's development. Because the money of Cuban investors could be better spent in Cuba, the E-class visa program would not be helpful to facilitate Cuba's transition. Also, as a practical matter, it would be some time before Cuban entrepreneurs developed the means to qualify as investors. On the other hand, the trader portion of the E-visa category is arguably beneficial to both countries and generates jobs in both. Therefore, as a policy matter, it should be encouraged.

e. Other Visa Categories Allowing Cubans to Work in the United States

The U.S. government may determine that the national interest of the United States is best served by allowing more Cubans to enter and work in this country temporarily during the transition than would be possible under the existing immigration system. If such a decision is reached, Congress may implement several measures, including the following:

- Increase the H-1B quota to allow the issuance of more visas to skilled or professionally trained Cuban workers. For example, inspired by the need to attract technical workers, at the time of this writing, Congress was considering a bill entitled "The American Competitiveness Act."[110] This bill recognizes that there is a serious shortage of highly skilled workers in the United States, and that this shortage threatens the competitiveness of American businesses. Although the bill is inspired by the need to attract more technical workers from Asia, Cubans would also benefit from an increase in the number of H1-B visas available.
- Establish a TN-like visa category for Cubans. This would allow Cubans to enter the United States independently of whether the H-1B numerical limit has been reached. Although Congress can legally provide for as many special TN-like visas as it deems appropriate, it may be faced with strong protests from Mexico if the number of visas set aside for Cubans is set at or above Mexico's limit of 5,500.
- Develop special visa programs for those foreign visitors with special knowledge or ability. Generally, "O" visas allow scientists, athletes or artists of

109. It would be important to Cuba's economic recovery to negotiate a trade agreement with the United States as early in the transition as possible. *See* MATIAS F. TRAVIESO-DIAZ, THE LAWS AND LEGAL SYSTEM OF A FREE-MARKET CUBA — A PROSPECTUS FOR BUSINESS 183-84 (1997).

110. S. 1723, 105th Cong. (1998). A similar bill containing somewhat different provisions (the "Temporary Access to Skilled Workers and H-1B Nonimmigrant Program Improvement Act of 1998," H.R. 3736) is also pending in the House. The sponsors of the two bills, Rep. Lamar Smith (R-Texas) and Sen. Spencer Abraham (R-Mich.) announced on July 24, 1998 that they had agreed on a compromise settling their differences over the inclusion of new requirements aimed at protecting U.S. workers. Smith's bill (H.R. 3736) would have required employers seeking to hire under the H-1B program to attest that they had first attempted to recruit U.S. workers for the jobs and that they had not laid off U.S. workers from the jobs they were seeking to fill with foreign workers. Under the compromise, the current 65,000 cap would be raised to 95,000 in 1999, 105,000 in 2000, and 115,000 in 2001 and 2002. BNA DAILY REP'T FOR EXECUTIVES, Jul. 27, 1998. President Clinton, however, has threatened to veto the bill on the grounds that it does not provide adequate training and protection for American workers. William Branigin, *House Sets Aside Bill to Allow Hiring of More Foreign Workers*, WASHINGTON POST, Aug. 1, 1998, at A2.

> extraordinary ability to work in the United States.[111] O visas may prove useful to talented Cubans who do not qualify for E, H or L visas, but who might benefit from working temporarily in the United States. Also, in addition to the O visas, other programs may be developed to encourage the immigration of former government employees who may possess valuable or sensitive information deriving from Cuba's relationship with the former Soviet Union. To the extent that the United States has an interest in obtaining or protecting such information, it may consider allowing those officials to enter the United States under "O"-type visas.[112]

All of the above initiatives have the potential to help both Cuba and the United States. They provide a means for Cubans to work in the United States, but only to the extent that those workers are needed to further economic interests. These initiatives should be less controversial than other immigration issues in that they should not deprive U.S. workers of jobs and are consistent with the interests of the U.S. economy.

5. Other Categories of Temporary Visas

a. Non-Immigrant Business Travel

If Cuba is to make a successful transition, it is essential that Cuban business people be able to travel unimpeded to the United States. Whether it be to attract foreign investors, negotiate with U.S. businesses or recruit skilled workers, Cubans need to be able to enter and exit the United States with relative ease to conduct business. These needs should be adequately met by the existing B-1 visa program, which allows travelers to enter the United States temporarily to engage in business if they comply with certain procedural requirements. As long as consular officers do not find that potential travelers have the intent to settle in the United States, B-1 visas should be routinely granted to all Cubans having legitimate business to conduct in the United States.[113]

b. Educational and Cultural Exchange Programs

In order to help meet Cuba's immediate need for trained professionals during the transition, the United States might establish a special type of education-related visa that Cubans working or studying in certain fields could obtain. A program could be created that would allow Cuban workers and students to enter the United States temporarily to acquire skills and experience determined to be lacking in Cuba. Cubans who fell into one of the categories on the "skills list" would be eligible for a "J" type of visa as long as they were sponsored by a U.S. citizen, lacked intent to abandon their residence abroad, and agreed to leave the

111. 8 U.S.C. §1101(a)(15)(O) (1998); 8 C.F.R. § 214.2(o) (1998).

112. A similar program was implemented following the collapse of the Soviet Union, under which an immigration category was established to allow scientists or engineers of the former Soviet Union who had "expertise in a [defense-related] high-technology field" to more easily enter the United States. *See* 8 C.F.R. § 204.10 (1997).

113. Visitors traveling with a B-1 visa cannot intend to work or settle in the United States. 8 U.S.C. § 1101(a)(15)(B) (1998); 8 C.F.R. § 214.2(b) (1997).

United States for at least two years following the expiration of their visa.[114] (These requirements are designed to increase the probability that foreign workers will use their newly acquired skills in their home countries.) The broad guidelines for granting J visas provide ample leeway to tailor a program specifically to meet the needs of a free-market Cuba.[115]

6. Handling of Illegal Immigrants

U.S. immigration policy will also have to address the fact that a free and open Cuba will give rise to increased illegal immigration. The U.S. is currently negotiating with Mexico about ways to strengthen border security and decrease illegal immigration. However, the problem that exists with Mexico (and potentially with Cuba) is that the interests of the United States and Mexico are directly opposed in this area. Mexico has neither the money nor the interest to curb the illegal immigration of workers (generally of lower socio-economic classes) for whom it cannot provide jobs.

A similar situation is likely to arise in Cuba. Indeed, with the large population of Cuban-Americans and Cuban immigrants already in the United States, the opportunities for Cuban visitors to stay in this country after the expiration of their visas are likely to be large, potentially undercutting other programs intended to provide an orderly flow of temporary visitors. This is a problem that will need to be faced through increased enforcement action by the U.S. immigration authorities.

7. Legislative Approach

Immigration is currently an extremely explosive issue in the United States, especially in states like Florida, where many immigrants tend to settle. Regardless of the economic rationale for allowing Cuban workers in the United States, Congress is certain to have difficulty generating support for any legislation or agreement that substantially increases the number of Cubans who qualify for visas and that appears to threaten U.S. jobs. The best strategy may be to link the expanded temporary work visa provisions with strong entry controls and anti-illegal immigration policies. Such a strategy would allow all sides of the immi-

114. Currently, immigration laws define a "J-1" category of exchange visitor, who is an alien, as follows: One who has a residence in a foreign country which she has no intention of abandoning; a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill; or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Director of the United States Information Agency, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training. 8 U.S.C. § 1101(a)(15)(J) (1998).

115. Examples of J-1 programs currently in existence include: (1) Students may enter the United States to complete up to 24 months of post-secondary study and 18 months of practical training work authorization upon completion of their studies. Post-doctoral training is permitted for 36 months after the degree is awarded; (2) Professors, researchers and international and government visitors may be granted a J-1 visa to participate in conferences, workshops, etc.; (3) Alien physicians may take a residency of up to 7 years; (4) Camp counselors, teachers, specialists and au pairs may work temporarily in the United States. 22 C.F.R. § 514 (1998).

gration dispute to feel they have accomplished their aims, and might result in the enactment of useful legislation.

C. *Cuba's Immigration Policy In A Post-Transition Environment*

1. Introduction

Since the first wave of Cubans immigrants arrived in the United States, a desire to return to their native country has nested in the hearts of many Cubans in exile.[116] While many Cuban-Americans believe that they will be unable to return to their homeland while the Castro regime is in power, there has been movement on the Cuban side to facilitate short-term visits to the country by Cubans residing abroad.[117] In late 1978, the policy towards Cuban exiles experienced a turn for the better when Cuba lifted restrictions on émigré travel to Cuba.[118] In 1994, additional assurances were given that no action would be taken against those Cubans who returned after attempting to immigrate illegally.[119] However, those who have left Cuba illegally still have reason to fear reprisal and imprisonment from the Cuban government despite its agreement to cease such punishment. Cuba's "illegal exit" and "illegal entry" laws remain in effect and the government's assurances of non-punishment are insufficient to ensure the safety of exiles who return to Cuba.

Upon its transition to democratic rule, Cuba is expected to repeal most, if not all, of the existing travel restrictions and allow Cuban exiles to return freely to the island.[120] Once the travel restrictions on Cuban exiles seeking to return to

116. In a survey conducted by a Spanish-language television station in Miami, "one in five Cubans in the metropolitan area said they would return home, although the results are regarded . . . more as coming from the heart than the head." Laura Parker, *Radio Marti Director Ousted as Exiles Discuss Returning to Cuba,* WASHINGTON POST, Mar. 13, 1990, at A3. In economic terms, Cuban-Americans contribute hundreds of millions of dollars annually in remittances to their impoverished relatives in the island. U.S. Dep't of State, BACKGROUND NOTES: CUBA 5 (Apr. 1998).

With the Pope's visit to Cuba in January 1998, many Cuban expatriates saw a glimmer of hope for reunification with their Cuban relatives. Indeed, as one reporter summarized, Pope John Paul II's pilgrimage sought, among other goals, Cuban reunification. "John Paul's trip to Cuba was aimed not just at persuading Cuban leader Fidel Castro to open up his socialist regime, or at scolding U.S. authorities for a devastating 37-year-old embargo, but also to help unify 14 million Cubans and Cuban-Americans. . . ." Alfredo Corchado, *Cubans, Cuban-Americans see Hope for Reconciliation in Visit: John Paul's Message Stresses Forgiveness,* DALLAS MORNING NEWS, Jan. 26, 1998, at 10A.

117. The United States, however, continues to impose restrictions on travel to Cuba by exiles. The Cuban Asset Control Regulations ("Regulations"), promulgated by the Office of Foreign Assets Control ("OFAC") of the U.S. Department of the Treasury, implement the U.S. trade embargo against Cuba. Cubans who have become U.S. citizens or permanent residents are prohibited under current U.S. law from traveling to Cuba without obtaining a license from OFAC. According to the Regulations, licenses are only granted to journalists, official government travelers, members of an international organization of which the United States is also a member, and persons traveling once a year to visit close relatives in Cuba. *See* 31 C.F.R. § 515.560 (1998).

118. Gonzalez-Pando, *supra* note 11, at 56.

119. Bonavia, *supra* note 78, at 1040.

120. On November 6, 1995, Cuba loosened travel restrictions by allowing Cuban émigrés to remain in Cuba indefinitely or travel back and forth as many times as they want as long as they renew their visitors permit every two years. Exiles living in the United States cannot take advantage of these relaxed Cuban regulations because U.S. law permits them to travel to Cuba only by obtaining a specific license from OFAC, unless they visit close relatives. Tracy Eaton, *Cuban Exiles Win Right to Return Home*, NEW ORLEANS TIMES-PICAYUNE, Nov. 7, 1995, at F11.

their native country are lifted by both the United States and Cuba, the demand for opportunities to travel to Cuba is likely to be enormous.[121] Such travel is likely to be limited only by the physical ability to transport and accommodate the visitors in Cuba. A massive reverse exodus raises important policy questions for a future transition government. The next section explores some of these questions.

2. *Cuban Policy Regarding Permanent Immigration of Cuban Expatriates*

The mass return of Cuban exiles to the island on a permanent basis is likely to be fraught with difficulties. One obstacle to the repatriation of the Cuban exiles is their legal status upon returning to Cuba. Presently, the Cuban Constitution provides that one loses Cuban citizenship by becoming a citizen of a foreign country, and holding a dual citizenship is not allowed.[122] Thus, unless the new constitution or other transition period statute provides otherwise, those Cuban émigrés who have become naturalized citizens of other countries, including the United States will have to renounce the other country's citizenship and apply for reinstatement of their Cuban citizenship.[123]

Whether as reinstated Cuban citizens or as resident aliens, a large number of Cuban expatriates, mainly Cuban-Americans, are likely to want to settle permanently on the island. This raises the question of whether the Cuban economy will be able to accommodate a mass return of expatriates. In the post-transition period of Nicaragua, for example, the president voiced concerns over repatriation and the inability of its country's fragile economy to support a mass return of exiles.[124] Cuba's economy is also likely to be in severe distress at the time of

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121. Cuban exiles are eager to return to the island for various reasons, which include reuniting with relatives, revisiting their birthplace, and contributing to its political and economic growth. Achy Obejas, *Miami, Havana: Jealous Rivals Pope's Visit Pushes Resentments to Fore*, CHICAGO TRIBUNE, Jan. 19, 1998, at N1.

122. CONSTITUCION DE LA REPUBLICA DE CUBA, *supra* note 9, art. 32.

123. It has been argued, based on the presumed continued vitality of Cuba's 1940 Constitution (which, in Article 15(a), states that those Cubans who acquire another country's citizenship lose their status as Cubans), that this automatic loss of citizenship should not apply to Cuban exiles who have opted to become citizens of their country of residence. The rationale for this argument is that to do so would bar the exiles from "participating in the Cuban political process." Jose D. Acosta, *El Marco Jurídico-Institucional de un Gobierno Provisional de Unidad Nacional en Cuba*, *in* CUBA IN TRANSITION — PAPERS AND PROCEEDINGS OF THE SECOND ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 61, 82 (August 1992). However, the opposite argument appears more persuasive. This argument states that the provision mandating automatic loss of Cuban citizenship for those who opt to become citizens of another country should remain in effect precisely to protect the Cuban political process from undue influence by those who have sworn allegiance to a foreign country. In this context, it is instructive to recall that the process for regaining Cuban citizenship that was in place before 1959 was anything but automatic. It required a formal re-application for citizenship, followed by one year of continuous residence in Cuba, followed by another formal appearance before a public official, in order for the reinstatement of citizenship to become effective. REGLAMENTO, *supra* note 9, art. 35.

124. With an estimated per capita income of $465, Nicaragua is the second poorest country in the Western Hemisphere. U.S. Dep't of State, NICARAGUA COUNTRY REPORT ON HUMAN RIGHTS PRACTICES FOR 1997, *released by* the Bureau of Democracy, Human Rights, and Labor, January 30, 1998. After the Sandinistas were removed from power, the Nicaraguan government reacted to its

the transition. However, unlike other groups of returning émigrés, Cuban-Americans have largely achieved a high standard of living and are unlikely to become a burden on Cuba's economy should they choose to return permanently to the island. To the contrary, they will be capable of returning with capital to invest in Cuba.[125] Nonetheless, a transition Cuban government will need to impose admission criteria based on absence of criminal record and financial self-sufficiency before allowing Cuban-Americans or other foreign nationals to settle permanently on the island.[126]

3. *Cuban Policy Toward Non-Immigrants*

Cuba must develop an immigration policy that will promote the movement of goods, ideas and people across its borders. Once it becomes apparent that Cuba intends to liberalize its economy and to commit to a more democratic form of government, foreign investors and Cuban expatriates will seek to visit Cuba in substantial numbers. During the transition, it is essential that Cuba encourage such visits by developing an open and efficient immigration policy. That policy should include the following features:

- Cuban expatriates who are citizens of other countries should be treated as "foreign investors," so that they are eligible for any special benefits given to such investors.[127] Even though granting Cuban expatriate investors privileges unavailable to resident nationals could lead to resentment from people on the island, this is a necessary consequence of the likely treatment as aliens of those who have lost their Cuban citizenship by becoming citizens of other countries.

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economic dilemma by pleading for hundreds and thousands of exiles to return and rebuild the country: on December 16, 1996, "President-elect Arnoldo Aleman . . . invited hundred of thousands of Nicaraguans abroad to return to their country and said they would be allowed to bring back their money and belongings tax-free." REUTERS, *Nicaraguan Exiles Told to Return, Bring Assets,* FT. LAUDERDALE SUN-SENTINEL, Dec. 17, 1996, at A16. Nevertheless, the Nicaraguan government realized that its weak economy could not support a mass return of its exiles, even with the economic assistance that was given by the U.S. Therefore, Nicaraguan President Aleman extended a plea to the United States, calling for the U.S. government not to begin a mass deportation of Nicaraguans living illegally in the United States, and cautioned that the exile return must be gradual. *Id.* The mass repatriation concerns among Central American leaders dates back to the November, 1994 enactment of California's Proposition 187. *See, e.g.* Tracy Wilkinson, *Central America; Leaders Worry: After Prop. 187, The Deluge; Latin Presidents Fear a Massive Return of Citizens. They Hope to Lobby Clinton at Upcoming Miami Summit, American Leaders Fear Mass Return to Their Nations,* L.A. TIMES, Nov. 26, 1994, at A2.

125. The poverty rate for people of Hispanic origin was 30.3% in 1995 and 29.4% in 1996. U.S. Census Bureau, March Current Population Survey, Poverty 1996. In contrast, only 16.5% of all Cuban immigrants fall below the poverty line. *See* Pedraza, *supra* note 8, at 323.

126. While it may be argued that Cuba may not deny admission into the country to those of its nationals residing abroad, it would appear that, at least with respect to those who have lost their Cuban citizenship, Cuba has the right to impose and apply immigration standards to prevent unfit persons from settling in the country. Indeed, before the Revolution, Cuba denied the right to acquire its citizenship to individuals who had been convicted of a felony, those of "dubious morality," and those who advocated doctrines or principles "incompatible with the current organization of the Cuban state or with its democratic regime and form of government." REGLAMENTO, *supra* note 9, arts. 25, 29.

127. *See generally* Matias F. Travieso-Diaz & Steven R. Escobar, *Cuba's Transition to a Free-Market Democracy: A Survey of Required Changes to Laws and Legal Institutions*, 5 Duke J. Comp. & Int'l L. 379, 414-15 (1995).

- Foreign investors should have the ability to employ foreign personnel, particularly for key positions.[128] The Cuban government should therefore refrain from unduly limiting the number of foreign personnel a company can bring into the country, or imposing unreasonable time limits on their visas. It is likely that there will be an acute shortage of skilled management personnel in Cuba during the transition to a market economy, so foreign managers will be necessary to operate foreign investors' enterprises until the local population acquires the requisite management and business skills.[129] Allowing foreign managers to enter and work in Cuba serves a dual purpose. *First*, it introduces Cuban workers to modern work practices necessary to compete in the global marketplace. *Second*, it assures foreign investors that they will have the personnel that they need to effectively operate their businesses.
- The visa structure should be open and simple to administer. In contrast to the United States, Cuba will not be affected by large-scale migrations of uneducated or impoverished workers, at least not from the United States. As a result, Cuba should eliminate all visa requirements for short-term pleasure or business trips originating in the United States and other developed countries.[130] Doing away with the need for visas avoids expending scarce resources in the administration of the immigration program, and allows foreign investors easy access to the island. While Cuba should seek reciprocal arrangements with the United States and other countries, the importance of foreign investment to Cuba is such that Cuba should unilaterally eliminate visa requirements even if reciprocal treatment is not granted by the United States and other developed countries.[131]
- The Cuban visa structure should not establish special visa categories for particular classes of foreign investors. An example of a special type of visa is the "alien entrepreneur" visa program in the United States, which reserves a certain number of immigrant visas for investors "who establish new commercial enterprises in the United States, invest at least $1,000,000 . . . and employ at least ten Americans."[132] This type of special incentive is warranted only if a restrictive business visa structure is in place, which should not be the case in Cuba during the transition to a market economy; both large and small investors should be allowed easy access to the island.

IV.
CONCLUSIONS

For the last forty years, the United States and Cuba have used immigration as a foreign policy weapon. For most of that period, the interests of both countries, although diametrically opposed in most respects, coincided in encouraging large numbers of disaffected Cubans to leave the island and come to the United States. The arriving Cubans, whether they followed the legal procedures set by

128. *See* IBRAHIM F. I. SHIHATA, LEGAL TREATMENT OF FOREIGN INVESTMENT: THE WORLD BANK GUIDELINES 155, 159 (1993).

129. Matias F. Travieso-Diaz & Alejandro Ferrate, *Recommended Features of a Foreign Investment Code for Cuba's Free Market Transition*, 21 N.C. J. INT'L LAW & COM. REG. 511, 557 (1996).

130. There are several countries in close proximity to Cuba having large impoverished populations. Unskilled migrants from those countries, under favorable conditions, may seek to relocate in Cuba. For that reason, some sort of visa structure must be retained to control the entry of immigrants who may become public charges.

131. *See Opening the Door for Business Travel to a Free-Market Cuba*, 1 FREE MARKET CUBA BUS. J. 8 (Shaw, Pittman, Potts & Trowbridge), Spring/Summer 1992, at 7.

132. 8 U.S.C. § 1153(b)(5) (1990).

both countries or came without observing legal formalities, were received in the United States with open arms and were helped along in becoming part of American society.

After 1994, the interests of both Cuba and the United States changed and, though still generally opposed, again coincided in their approach to immigration: no longer did either country have an interest in fostering a mass exodus of Cubans to the United States. Thus, the current arrangement was reached. It contemplates a limited, orderly migration of Cubans towards the United States under established visa procedures, with relatively infrequent instances of "illegal immigrants" attempting (and in some cases successfully making) an unauthorized escape to the U.S. shores.

While the current situation is stable, there is no guarantee that this stability will endure. As has already happened repeatedly, events in Cuba could at any moment upset this delicate balance that has been achieved. As long as there is an impoverished population in Cuba and a government that uses emigration as an escape valve to rid itself of malcontents, there is always the possibility that another Camarioca or another Mariel will occur, testing the resolve and the moral principles of whoever is running the U.S. government at the time.

When Cuba makes the long-awaited transition to a free-market, democratic society, the governments of both countries will have the opportunity to develop, for the first time in half a century, immigration policies that are not dictated by political considerations but by the desire to contribute to Cuba's economic reconstruction. At that moment, and for a period whose duration will be determined by the length of the transition, the United States should put in place special programs such as those described in this paper. These programs should allow qualified Cubans to enter the United States on a temporary basis and make an economic contribution here, while preparing them to take their newly developed skills and economic resources back to the island. This form of assistance to Cuba's transition will be perhaps as important and considerably less costly than the economic aid programs that have already been promised and will undoubtedly be made available to Cuba by the United States and other international donors.[133]

Cuba must help the process along by establishing an open and efficient immigration policy that provides the greatest possible ease of transit in and out of the country to business people, consistent with maintaining public order and security. No artificial limitations should be placed on the number of people who travel from the United States to Cuba, on the length of their stay, or on the activities they are allowed to conduct on the island, including the hiring of domestic and foreign personnel. The legal status of Cuban-Americans who seek to return to Cuba should also be addressed, but however this thorny issue is solved, Cuba should not discourage the flow of people, goods and ideas from the Cuban-American community to the island. Specific measures should be taken to

133. Letter to Congressional Leaders Transmitting the Report Entitled "Support for a Democratic Transition in Cuba," 11 WEEKLY COMP. PRES. DOC. 112 (Jan. 28, 1997); *see* 22 U.S.C. § 6062 (1998).

encourage foreign investors from all over the world to travel to Cuba to investigate business prospects and establish operations. In short, Cuba should take all reasonable steps to ensure that immigration does not become another obstacle in what is likely to be a difficult road to democracy and economic stability.

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David Blumental

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Sources of Funds and Risk Management for International Energy Projects

By
David Blumental*

This paper examines how energy companies can take advantage of new opportunities to develop projects in emerging economies using the project finance mechanism. In particular, this paper looks at the various sources of funding available to multinational corporations for international projects as well as ways to control the risks inherent in such projects in order to fashion the best possible financing package.

TABLE OF CONTENTS

I. Overview–Opportunity, Financing & Special Challenges In Emerging Economies 269
A. Marketization, Opportunity & New Financing Forms 269
B. The Relationship between Risk and Funding 271
C. Special Challenges and Risks in Emerging Economies 271
D. General Prerequisites for Obtaining Funding 272
II. Sources Of Funding 273
A. Generally 273
B. Funding in Various Energy Industries 273
C. Traditional Financing Models 274
D. Combining and Sourcing Equity and Debt 275
E. International Multilateral Institutions 276
1. International Monetary Fund 276
2. World Bank 276
a. International Development Association 277
b. International Finance Corporation 277
(1) IFC's Involvement in the Energy Sector 278
(2) IFC Financing Standards and Requirements ... 278
c. Multilateral Investment Guarantee Agency (MIGA) 279

* University of California, Berkeley School of Law (Boalt Hall), J.D. Candidate 1999; A.M. Stanford University, 1991; B.A. Middlebury College, 1988. The author will be joining Vinson & Elkins L.L.P. as an associate in the Business and International Law Section in Fall 1999. Special thanks are owed to Mr. Craig Murray, Mr. Jere Overdyke, Yong Xiao, Ziruo Chen, Handel Lee, Seth Gustafson, Morgan Fong, and Feng Li.

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d. How the World Bank Processes a Loan 279
e. The World Bank Guarantee 279
F. Borrowing from Regional Development Banks 280
G. Bilateral Source—National Governmental Institutions 280
1. Export Financing & Credit 281
a. U.S. Export-Import Bank 281
b. Export Finance in the Energy Sector and Project Finance 282
c. How to apply for U.S. Export-Import Bank Assistance in Project Finance 282
2. Development Assistance 283
a. U.S. Trade & Development Agency 283
b. Overseas Private Investment Corporation 284
(1) Project Finance Eligibility 284
(2) Clients, Project Evaluation, and Application Procedures 284
(3) Form of Financing 285
H. Private Commercial Funding 285
1. Domestic Capital Markets 285
2. International Commercial Banks 285
3. International Equity Markets 286
4. International Bond Markets 286
5. Specialized Energy Funds 287
6. Credit Rating Agencies 287
III. Types Of Risk And Risk Management 287
A. Risks Inherent at Various Phases of Project Construction .. 287
1. Development Stage 287
2. Construction Risk 287
3. Operation & Maintenance Phase 288
B. Local Business Environment 288
C. Ways to Manage Risk Ex Ante 289
1. Structuring the Project 289
2. Allocation of Risk Through Contract Terms and Provisions 290
a. Price Protection 290
b. Currency Fluctuation Risk 290
c. Achieving Certainty in Dispute Resolution 290
3. Investment Insurance 291
a. National Governmental Agencies 291
(1) OPIC 291
(2) U.S. Exim Credit Insurance 292
b. Multilateral International Institutions 292
(1) Multilateral Investment Guarantee Agency 292
(a) Term and Coverage 292

(b) Applying for MIGA Political Risk Insurance 292
c. Private Insurance 293
IV. How To Put Together A Financeable Project 293
A. Evaluation of Project and Business Environment 294
B. Financial Viability 294
C. Technical Viability 295
D. Potential Environmental Liabilities 295
E. "Financial Engineering" 295
1. Ownership Structure 295
2. Sourcing Financing 295
3. Security Arrangements 295
V. Conclusion 296

I.
OVERVIEW–OPPORTUNITY, FINANCING & SPECIAL CHALLENGES IN EMERGING ECONOMIES

A. Marketization, Opportunity & New Financing Forms

During the past decade, the globalization of business and investment, combined with rapid economic growth in many developing countries, has spurred the soaring demand for energy in emerging economies in Latin America and East Asia. China, for example, has surpassed most of the industrialized countries to become the world's second-largest energy consumer after the United States.[1]

To meet the huge increase in demand for energy, emerging economies have rushed to increase oil production, gas transmission, and electric power generation capacity.[2] The tremendous scale of the investment required to finance the development of oil production, gas transmission, and electric power generation facilities has hastened the shift toward free market reform and privatization of the energy sector in many emerging economies.[3] To avoid incurring prohibitively large debt and to attract the necessary technology and know-how, governments have dismantled their traditional public monopolies, loosened regulation and encouraged private international investment in the energy sector.[4] Gas transmission and electric power generation, in particular, are areas in which government-owned or controlled utilities now cooperate with energy companies. The governments in developing countries commonly offer these concessions to investors under "build, operate, and transfer" ("BOT") or "build, own, operate,

1. *See* Handel Lee et al., *Preparing Itself for the Next Century*, 65 PETROLEUM ECONOMIST 19 (1998) (discussing reform of China's petroleum industry).

2. *See generally*, THE PETROLEUM ECONOMIST, LTD., THE GUIDE TO WORLD ENERGY PRIVATISATION (1995).

3. *See Energy Privatisation: World Review*, *id.*, at 123-68.

4. *See generally*, THE GUIDE TO WORLD ENERGY PRIVATISATION, *supra* note 2; HOSSEIN RAZAVI, FINANCING ENERGY PROJECTS IN EMERGING ECONOMIES (1996).

and transfer" ("BOOT") arrangements.[5] Under these models, government utilities generally sign a "take or pay" off-take agreement with the independent power producer ("IPP") or gas pipeline operator which provides the project with a guaranteed income stream for a set term. At the end of the term, the debt has been repaid, the equity investors have received their return, and the project assets are transferred to the host government.[6]

This shift has created a wealth of new opportunities for energy companies and private and institutional investors. Access to flush U.S. and international capital markets, combined with American engineering skill and state-of-the-art technology, has given U.S. companies an advantage in competing for a share of the international energy development market. Since the early 1990s, many U.S.-based energy companies have ventured into Latin America and Asia.

The need for increased capital to exploit opportunities in global emerging markets has driven the development of new approaches to obtaining financing. The most highly-touted of these is project finance. Project finance is an approach that integrates a mixture of equity and debt financing from different sources, all of which derive their return on equity or debt service strictly from the revenue stream of the underlying project over a ten to twenty-five year period.[7]

The principal difference between the project finance approach and traditional corporate financing, and the biggest advantage to the developer, is that project finance is limited recourse or nonrecourse "off-balance sheet" financing.[8] In traditional corporate financing, the lenders have recourse to all of the project sponsor's assets and revenues. The structure of a project finance transaction limits the lender's security to the assets and cash flow of the project itself, under the rubric of a project company formed specifically to construct, own and operate the project facility.

Because no single project encumbers the sponsor's balance sheet, energy companies effectively gain access to far more capital than under the traditional corporate finance approach, while maintaining their general creditworthiness. In a typical project finance transaction, the project sponsor contributes twenty to forty percent of the total project investment as equity, with the remainder of the required capital infused as project debt.[9] The sponsor may also raise equity on international or local equity markets, or through various multilateral and governmental institutions. Debt financing may include commercial loans, suppliers' credit, international bond offerings, and loans from multilateral or governmental

5. *See* PAUL E. COMEAUX & N. STEPHEN KINSELLA, PROTECTING FOREIGN INVESTMENT UNDER INTERNATIONAL LAW: LEGAL ASPECTS OF POLITICAL RISK 129 (1997), for additional general background on BOT, BOOT, and other concessionary forms.

6. *See id.*, *supra* note 5, at 129; Nina N. Hoque & J. Michael Robinson, *An Examination of the Build, Operate and Transfer Model for International Projects in Emerging Markets in* INTERNATIONAL INFRASTRUCTURE PROJECTS X-1 (1995); and J. Michael Robinson, *The Build, Own, and Transfer Model for International Projects in Emerging Markets*, 8 INT'L Q. 126 (1996).

7. On project finance generally, see PETER K. NEVITT, PROJECT FINANCING (6th ed. 1997). *See also* RAZAVI, *supra* note 4, at 3-11.

8. *See* RAZAVI, *supra* note 4, at 3-11. *See generally* NEVITT, *supra* note 7.

9. *See* NEVITT, *supra* note 7.

institutions. With the right development approach, a project sponsor can create a financeable project package tailored to each project, obtain financing, and maximize its return for a number of projects without detriment to its own balance sheet.

B. The Relationship between Risk and Funding

While the project finance model offers many advantages over traditional corporate financing approaches, significant risks remain at each phase of the project's development. Lenders are risk-averse by nature. Their fear is heightened where the debt is nonrecourse or limited recourse, and the borrower's risk is limited to its own equity investment. In order to obtain financing, and to give the lenders sufficient comfort, the project structure itself must take risk factors into account. Identifying, analyzing, and mitigating risk are one of the most critical aspects in structuring and funding a successful international energy project. Risks, including political risk and currency fluctuation risk, exist at all phases of the project. Project sponsors and their counsel must work prospectively to structure the investment in a way that reduces and mitigates risk to the greatest possible extent. Accordingly, the relationships between the project's parties and the instruments required are quite complex. The true skill in developing project finance deals lies in the "financial engineering" that will comfort lenders while raising the most capital possible.[10]

C. Special Challenges and Risks in Emerging Economies

Before taking advantage of the tremendous opportunities created by soaring demand for energy resources and facilities, energy companies must recognize and address the special risks and challenges that arise when developing projects in emerging economies. These risks stem primarily from the local business environment and can create problems and increase total project costs at every stage of a project's existence. To a large extent, the local business environment is defined by the limits of the host country's resources. The level of infrastructure development and the availability of capital, raw materials, skilled labor, local managerial talent all determine the type and levels of risk that investors will face. The risks faced by any project can be divided into two categories: commercial risk and political risk. In practice, however, the distinction may be difficult to draw, particularly when the contract counter-party is a government agency or other government-controlled entity.

To recognize and deal with these risks, a project sponsor needs developers who possess knowledge of the local political environment and business culture and who can communicate effectively with their local counterparts. It is critical for project sponsors to have developers fluent in the local language or to retain reliable translators with experience in project development. Not only must project sponsors educate themselves on the host country's situation, they also must be prepared to spend considerable time and effort educating their local

10. *See generally* RAZAVI, *supra* note 4, at 11.

counterparts and partners about the mechanics of financing and the reasons for lenders' demands. Local parties are usually unfamiliar with the complexities of project financing for energy projects through international organizations and international capital markets. The ability to understand local concerns and communicate between local parties and financiers is of paramount importance.

Commercial risks are those risks inherent in any business, distinct from the prevailing political climate. Such risks include the risks of drops in consumer demand, unpredictable and changing costs for inputs, insolvency of purchasers, and cost overruns. In developing countries, however, these risks are exacerbated by limited infrastructure and telecommunication facilities.[11]

Political risk, on the other hand, comprises a wide range of governmental action which adds to the overall risk of the project in two ways.[12] First, reform of industry management and administrative structures often do not keep pace with the government's pro-investment, market-oriented policies. Overlapping, inflexible, or vague lines of authority tend to delay the obtaining of approvals and permits, thereby raising costs. Second, the lack of transparent laws and regulatory regimes can produce uncertainty for investors when it comes time to price electric power or oil and gas. This regulatory ambiguity also makes it more difficult to comply with environmental regulations and local tax codes.

Together, political risk and economic instability can drive up costs, reduce revenues, and in extreme cases, result in the total loss of capital.[13] Consequently, investors will demand a higher return where the risk is greater. At the same time, investors must devise an investment structure which allows them to spread the risk inherent in any project with their counter-parties, insurers, and partners.

D. General Prerequisites for Obtaining Funding

In order to ensure successful financing for a project, energy developers should engage in a two-step inquiry. The first step is to determine the underlying economics of a project based on available information. If the project appears to be viable, the project sponsor should conduct research and exercise due diligence to identify what risks arise from the local business and political environment. These should be, in turn, factored back into the project economics. If, after factoring in the risks of a given project, the project remains viable, one must determine the financial structure of the project. In this second step of the inquiry, one must make such determinations as the project's ownership structure. Further, one must identify sources of funds to be used and find investors and lenders. Also, one must determine the project's ideal debt-to-equity ratio. Finally, one must ascertain the basic package of project documents to be negotiated, including the security documents necessary to collateralize the project's assets in the host country.

11. *See* COMEAUX & KINSELLA, *supra* note 5, at xxvii n. 46.
12. *See* RAZAVI, *supra* note 4, at 15.
13. *See id.*

II.
SOURCES OF FUNDING

A. *Generally*

In recent years, changing market conditions and rising costs have changed the way funds are sourced for international energy projects. As a basic industry, energy projects, whether oil production, natural gas transmission, or electric power generation, have access to equity and debt funding from diverse sources. These sources including multilateral institutions, regional development banks, export-import banks, commercial banks, institutional investors, equity and bond markets, equipment suppliers' credit, and other ad hoc sources.[14] Because commercial banks are now careful to limit their exposure to the risk inherent in lending to projects in developing countries, most projects ultimately obtain funding from a mix of public and private sources

Institutionally, multilateral organizations and regional development banks have shifted their traditional focus and now provide numerous services and facilities designed to support private investment in the energy sector. Although the actual amounts that multilateral institutions commit to energy projects are usually relatively small, they serve to give private investors comfort and confidence and thus pave the way for commercially-sourced funding.[15]

Bilateral agencies and the export-import banks of developed countries, including the U.S. and Japan, now provide funding to private entities in the form of suppliers' credit, buyers' credit, and guarantees.[16] Because these agencies exist to promote their own nations' exports, this support is generally limited to use for the purchase of that country's equipment and products.[17]

Commercial financing refers to funds from commercial banks and other institutional investors as well as capital raised through equity and bond offerings. Beyond risk aversion, commercial banks are also subject to certain structural and regulatory constraints which necessitate a financing package that includes other sources. Principally, energy projects require large investment and debt service over a relatively long term. Commercial banks, however, are limited in the amount of long-term loans they can fund due to country risk limits, sector limits, and reserve requirements.

B. *Funding in Various Energy Industries*

Changing market conditions in the 1990s have caused oil companies to reduce their own investment in projects. Oil companies are no longer willing to fund new projects solely from their own balance sheets. Accordingly, oil companies have adopted new financing instruments and strategic partnership

14. *See id.* at 29.
15. This process is known as mobilization.
16. *See* U.S. Exim website (visited June 15, 1998) <www.exim.gov>; *see also* JExim website (visited June 15, 1998) <www.japanexim.go.jp>.
17. U.S. Exim website (visited June 15, 1998) <www.exim.gov>; *see also* JExim website (visited June 15, 1998) <www.japanexim.go.jp>; RAZAVI, *supra* note 4, at 67-79.

arrangements with local interests to fund exploration, develop new production facilities, and limit exposure in any given country.

In the electric power industry, private project finance investment has focused on greenfield projects[18] and renovation/expansion of existing generation facilities. There has been a general trend towards separating generation from transmission and distribution networks. Transmission and distribution ("T&D") is still viewed as a natural monopoly best managed by government utilities. Also, because new investment in T&D is focused on renovating or expanding existing facilities, not on creating discrete, new projects, the project finance mechanism is perhaps not the best vehicle for funding T&D. The project finance mechanism is far better suited to the development of new generation facilities, because it can be structured as a discrete project with a predetermined income stream based on a fixed term, fixed price "take or pay" power purchase arrangement with the local utility.

Financing in the natural gas industry combines elements of oil and of power development. Upstream exploration and production is driven by private investment, while downstream T&D has generally retained its natural monopoly characteristics. This is changing, however, and certain U.S.-based energy companies have been involved in the privatization of gas pipeline construction and operation.

C. Traditional Financing Models

Nonrecourse or limited recourse project finance is now widely accepted as an alternative to traditional recourse corporate financing. Traditional financing approaches gave lenders recourse to all of the borrower's assets and cash flow. Project finance, on the other hand, is "off balance sheet" financing that limits recourse to the assets and cash flow of the underlying project. The result is that companies do not have to carry project debt on their balance sheets and are able to pursue several projects simultaneously. Nonetheless, as a practical matter, project finance is very often structured on a hybrid, limited recourse basis.

During the riskiest phases of the project — construction and start-up — the project sponsor is committed to providing contingent financial support beyond its equity investment,[19] typically in the form of a payment guaranty. At the completion date, once the facility has passed all completion tests, the sponsor's payment guaranty is released, and the lenders' rights convert to nonrecourse status. Most often, however, sponsors will continue to provide limited support in the form of performance guarantees regarding the fulfillment of obligations of their subsidiaries and affiliates.

18. Greenfield refers to projects constructed from the ground up, where the site was only a "green field" prior to construction.

19. *See generally* RAZAVI, supra note 4, at 5.

D. Combining and Sourcing Equity and Debt

Determining the proper ratio and the sources of equity and debt financing are key steps in designing the structure of project finance energy projects. Generally, total project investment is 20-40% equity and 60-80% debt financed.[20] This mixture relates back to the question of how project risk is to be distributed among the parties. Between project sponsors and lenders there is a natural tension surrounding this issue. Lenders naturally prefer project sponsors to commit more equity to a project. The more equity a project sponsor invests, the greater the proportion of the project risk it undertakes. The project sponsor, however, wants to reduce its exposure and save as much of its capital as possible to invest in other projects. The tension between the interests of the lenders and those of the project sponsors plays out during the negotiation of the loan documents and project structure. Several factors influence the determination of the debt to equity ratio: the creditworthiness of the sponsors, the location and economics of the project, and the risks inherent in that project.

In this area, just as in the development of project finance itself, necessity drives innovation. The huge investments and long-term nature of energy project investment have forced project sponsors to broaden the search for financing. Equity financing now often includes funds raised not just from the sponsor, but also from investment funds, multilateral institutions like the International Finance Corporation ("IFC"), regional development banks, and international and local equity markets.[21] Projects structured as joint ventures between project sponsors and local public utilities add a new dimension because the local partner's funding may come from the host government or from the public lending arms of the World Bank or regional development banks.[22]

Similar creativity and innovation go into structuring the debt financing. Because commercial banks remain cautious about making large infrastructure investments in developing countries, and because of the structural problems commercial banks face in making such large, long-term loans, traditional commercial financing alone cannot provide sufficient debt financing for large energy projects. Syndicated bank loans increase the funds available, but they cannot resolve the timing constraints on commercial banks. Energy projects still generally require financing for longer periods than the standard five to ten year commercial loan maturity. Other common sources of debt financing include institutional investors (pension funds, insurance companies, and mutual funds), government-sponsored energy funds, the IFC, private investment departments of regional development banks, international and local bond markets, and suppliers' credit.[23] However, these sources of financing also come with challenges in timing.

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20. *See id.* at 3-11. *See generally* NEVITT, *supra* note 7.
21. *See* RAZAVI, *supra* note 4, at 7.
22. *See id.* at 8.
23. *See id.* at 9.

E. International Multilateral Institutions

The International Monetary Fund ("IMF") and its sister organization, the World Bank, are the two foremost multilateral institutions involved in project finance. In particular, the IMF and the World Bank continue to have a strong impact on the macroeconomic and monetary policies that form the backdrop to the successful financing of energy projects.

1. International Monetary Fund

The IMF is a nonprofit institution that belongs to the governments of the 179 countries which make up its membership. The IMF has no direct role in financing international energy projects.[24] Yet its influence on developing countries' economic and monetary policies is profound, both as a source of stability and as an impetus for market reforms.

By helping economies maintain the value of their currencies, the IMF helps create the stability that is critical to the successful development, financing, and operation of large international energy projects. With such projects, payment for energy will usually be made in local currency and must be converted to dollars in order to service the project debt and provide investors with their returns. While project sponsors and lenders have developed mechanisms to reduce the risk of currency fluctuations, its unlikely that a contractual solution between the parties would address fully the problems created by a total collapse of the local currency. In such instances, support from multilateral institutions such as the IMF is crucial to salvaging international energy projects.

2. World Bank

Commonly referred to as the World Bank, the International Bank for Reconstruction and Development and its three affiliates, the International Development Association ("IDA"), the International Finance Corporation ("IFC"), and the Multilateral Investment Guarantee Agency ("MIGA") play a central role in international energy project financing.

Although the World Bank cannot lend directly to private sector enterprises, it emphasizes building free market systems, and through member state governments it supports development in oil, gas, electric power and other rapidly privatizing sectors.[25] It may finance the equity or debt share of the public sector in joint venture public/private projects and can provide political risk and foreign exchange convertibility guarantees. Further, the World Bank's prestige can facilitate relations with the host government as well as give lenders and outside investors greater comfort.

The World Bank lends $17-20 billion annually. Of this amount, approximately $2-3 billion goes to electric power and $1 billion to oil and gas projects. In recent years, the World Bank has shown renewed interest in oil and gas projects, especially natural gas.

24. *See* IMF website (visited June 15, 1998) <www.imf.org>.
25. *See id.*

a. International Development Association

Established in 1960, the IDA is the World Bank's concessional lending arm, providing interest-free long-term loans to the poorest developing countries in order to alleviate poverty and create a base for sustainable growth. The IDA lends only to countries whose 1996 per capita income was less than $925 and which are unable to borrow from the World Bank on market terms.[26] The IDA credits have maturities of 35-40 years with a 10-year grace period on repayment of principal.[27] Credits are subject to a service charge of 0.75 percent on undisbursed balances, but are interest-free. The IDA has lent over $100 billion since 1960 and currently lends an average of $5-6 billion per year. The eighty countries currently eligible to borrow from the IDA represent 3.3 billion people, or 69% of the world's population.[28]

Because its loans are long-term and interest-free, the IDA relies principally on contributions from donor governments to finance its poverty reduction program. The IDA lends to governments or entities with government affiliations. In recent years, the IDA has taken an interest in projects combining public and private investment, but a project in an eligible country must reduce poverty and encourage development to qualify for IDA lending. Finally, the IDA serves an important function in coordinating information and aid from other multilateral organizations.

b. International Finance Corporation

The IFC is the World Bank's private enterprise development arm, and is perhaps the most important World Bank affiliate with which potential project sponsors should be familiar. The IFC was established in 1956, and its approach differs significantly from that of the World Bank, proper. The IFC will lend directly to private companies and cannot accept repayment guarantees from host country governments.

The IFC may fund equity investments in private businesses, and it also may provide debt financing for projects. Through mobilization, the IFC also plays a key role in attracting other investors and lenders to a project. IFC syndication gives commercial banks the comfort they require to extend commercial loans in developing countries.[29] As the lender of record in the syndication, the IFC's special privileges as a multilateral institution will extend to the commercial banks in the syndication. They will be exempt from payment of local taxes, insulated against political risk and may have greater access to local political leadership. The IFC is responsible for exercising due diligence on a project and for coordinating legal documentation. The IFC also administers the loans and

26. *See* IDA website (visited June 15, 1998) <www.worldbank.org/html/extdr/idao.html>. *See generally* RAZAVI, *supra* note 4, at 43-44.

27. *See* IDA website (visited June 15, 1998) <www.worldbank.org/html/extdr/idao.html>. *See generally* RAZAVI, *supra* note 4, at 43-44.

28. IDA website (visited June 15, 1998) <www.worldbank.org/html/extdr/idao.html>.

29. *See* IFC website (visited June 15, 1998) <www.ifc.org>; *see also* RAZAVI, *supra* note 4, at 46-47.

collection of payments from the borrower, distributing these payments pro rata among itself and the other banks. This means, in effect, that a default on any portion of the loan is a default to the IFC. All of this gives commercial lenders a greater degree of comfort.[30]

(1) IFC's Involvement in the Energy Sector

The IFC has helped to develop debt and equity financing instruments that are applicable to energy industry investments.[31] The IFC has encouraged other investors and lenders to join it in international BOT and "build, own, operate" ("BOO") projects and has facilitated solutions for legal, financial, contractual, and technical problems between project sponsors and host governments. It has helped develop specialized energy sector investment funds with institutional investors and mutual funds. The IFC's Global Power Fund brings private international funds to private power projects in developing countries. The IFC has also assisted private companies in obtaining financing from international equity and bond markets.

(2) IFC Financing Standards and Requirements

The IFC is dependent upon the commercial success of the projects it helps finance, and the IFC's procedures for evaluating and approving projects reflect this. Because the IFC cannot accept governmental guarantees of repayment, it focuses narrowly on the economic return and commercial practice of a project rather than on broader issues of regional economic policy and development. The IFC's approach aims to improve the overall business environment one project at a time.[32] The IFC achieves this through a strong credit review prior to involving international lending institutions.

The IFC lends to projects for terms of seven to ten years at commercially determined interest rates and fee structures. The IFC will finance only up to a maximum of 25% of a greenfield project, and a bit more for expansions of existing facilities. The project sponsor must reimburse all the costs the IFC incurs in exercising due diligence and evaluating the project. The typical IFC equity holding is 5-10% with an exit horizon four to five years after the project's "close of development."[33]

As an equity investor, the IFC will not take a controlling or majority position, nor will it actively involve itself in the day to day operations and management of the project. A long-term investor, the IFC's shares are treated as domestic or neutral in determining national ownership.[34]

30. *See* RAZAVI, *supra* note 4, at 46-47.
31. *See id.* at 47-49.
32. *See id.* at 48; *see also* IFC Website (visited June 15, 1998) <www.ifc.org>.
33. A project's "close of development," or "C.O.D.," refers to the time when the principal project contracts are executed, and the project shifts to the construction and financing phases.
34. *See* RAZAVI, *supra* note 4, at 49.

c. Multilateral Investment Guarantee Agency (MIGA)

MIGA was established in 1988. MIGA seeks to encourage foreign investment in developing countries by providing political risk investment guarantees. MIGA provides investors and lenders insurance against the risks of breach of contract by host governments, currency transfer difficulties, expropriation, and other governmental *force majeure*. Over 150 countries are members of MIGA, which is backed by $1 billion in authorized capital. Specific types of project risks covered and procedures for obtaining MIGA guarantees will be covered later in this paper.

d. How the World Bank Processes a Loan

The World Bank's lending criteria are strict. Financing from the World Bank requires a sovereign guarantee, which means that the Bank does not provide private financing. The Bank has a formal loan application process whereby it identifies and evaluates a project, negotiates the loan, and then brings the project to the Bank's Board of Executive Directors.[35] Although the World Bank negotiates and lends only to governments, private project sponsors can play a role in identifying potential projects to the Bank. Once a project is identified, a government may, either on its own or with the aid of a consultant, define its objectives for the project, the amount of borrowing, and its eventual allocation. A government then packages these into an overall project presentation.[36]

The World Bank then conducts an independent evaluation of the economic, financial, technical, and environmental aspects of the project. The Appraisal Report produced forms the basis on which the Bank can negotiate with a government and produce the legal documentation necessary to extend the loan. Negotiated agreements with governments may also include commitments to carry out regulatory and market reform of the energy sector and to encourage broader development.[37] All negotiated agreements are subject to final approval by the Bank's Board of Executive Directors in Washington, D.C. Factors in the Board's vote to approve a loan include the feasibility of the project and the broader political agenda of individual members. The structure of the World Bank evaluation process, however, ensures that most projects that reach an Executive Board vote are feasible and will be approved.[38]

e. The World Bank Guarantee

Since the mid 1990s, the World Bank has placed greater emphasis on its guarantee function to give commercial lenders the comfort they need to extend loans to projects. The World Bank now offers partial guarantees to private lenders. Partial guarantees cover: (i) compliance with negotiated pricing and

35. *See id.* at 38-39; *see also* World Bank website (visited June 15, 1998) <www.worldbank.org>.
36. *See id.*
37. *See id.* at 40.
38. *See id.* at 41.

payment for outputs by government-controlled utilities or purchasers; (ii) the importation of fuel, equipment, and other goods; (iii) compensation for the adverse impact on projects caused by governmental actions; and (iv) foreign exchange convertibility problems.[39] Because World Bank guarantees are designed to help developing countries attract capital, they cover up to 100% of a private lender's principal and interest. They do not, however, protect an investor's equity, nor do they cover loans issued by other multilateral or bilateral organizations.[40]

These guarantees protect private lenders from breach of government contractual obligations and *force majeure* events. Lenders, however, continue to bear the risk of other adverse events. In this way, the World Bank lends its prestige to private lenders in that area of risk in which private lenders need the most help — dealing with sovereigns, an important aspect of most energy deals.

F. Borrowing from Regional Development Banks

Regional development banks are owned by the governments of their member states.[41] They were first established in the 1950s and 1960s and were patterned after the World Bank. Their project implementation procedures generally mirror those of the World Bank. Like the World Bank, regional development banks have as their mission the alleviation of poverty and the promotion of economic growth and social development in their respective regions. However, in response to the surge in private infrastructure investment, regional development banks have come to figure into the financing mix of international energy projects. Two regional development banks in particular, the Inter-American Development Bank and the Asian Development Bank, have established private sector investment arms to support energy projects in their regions.

G. Bilateral Source—National Governmental Institutions

Industrialized countries have set up bilateral agencies both to support investment and technical assistance in developing countries, and to promote the export of domestic products and technology abroad. Given the high degree of technical complexity of modern energy projects, the assistance of bilateral sources in providing equipment financing is of significant importance.

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39. *See* World Bank website (visited June 15, 1998) <www.worldbank.org>; *see also* RAZAVI, *supra* note 4, at 42.

40. *See* World Bank website (visited June 15, 1998) <www.worldbank.org>; *see also* RAZAVI, *supra* note 4, at 42.

41. The regional development banks are: the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, the Nordic Development Fund, the OPEC Fund for International Development, the Islamic Development Bank, the Arab Fund for Economic and Social Development, and the Arab Bank for Economic Development in Africa.

1. Export Financing & Credit

Member states of the Organization for Economic Cooperation and Development ("OECD") have all established export credit agencies and programs. These provide concessional financing for the export of goods and services by their own companies in the form of a loan to the purchaser of the equipment or as a credit to the supplier/manufacturer. An agreement reached by OECD members limits the potential price-distorting effects of such credits.[42]

a. U.S. Export-Import Bank

The U.S. Export-Import Bank ("U.S. Exim") is a government-held corporation first established in 1934 to stimulate the American economy during the Depression. It was reestablished in 1945 to help American companies participate in the post-War reconstruction of Europe and Asia. In over sixty years, U.S. Exim has supported more than $300 billion in U.S. exports.[43]

U.S. Exim works to promote American business by supplementing private capital. Part of its statutory mandate is to provide export financing support when the private market is unwilling to take the lead because of the size or risk of the transaction.

Among the services provided by U.S. Exim are working capital guarantees, which cover 90% of the principal and interest on commercial loans given to small and medium sized U.S. exporters. A project sponsor can use a U.S. Exim working capital guarantee to help improve its financing terms in negotiations with project lenders.

In addition, U.S. Exim guarantees 100% repayment of commercial loans to creditworthy foreign buyers of American goods and services. U.S. Exim may also guarantee payment on cross-border leases. The guarantees provided by U.S. Exim help to protect project participants against political and commercial risks.

Further, U.S. Exim provides direct loans to foreign purchasers of American goods and services. Such loans are competitive and fixed-rate, in line with OECD guidelines.

Finally, U.S. Exim provides export credit insurance to protect against payment default by foreign buyers. Short term policies cover 90-95% of the commercial risk and 100% of the political risk associated with default by a foreign sovereign entity, foreign exchange inconvertibility, cancellation of export-import licenses, delay in transfer of payments, and war or civil disturbance. Capital goods may be insured up to five years under a medium-term policy which covers 100% of principal and interest on the financed portion.

42. The OECD Consensus or "Arrangement on Guidelines for Officially-Sponsored Credits" was reached in 1978. *See* RAZAVI, *supra* note 4, at 69.

43. *See* US Exim website (visited June 15, 1998) <www.exim.gov/history.html>.

b. Export Finance in the Energy Sector and Project Finance

Both U.S. Exim and its Japanese counterpart, the Export-Import Bank of Japan ("JExim"), serve important functions in funding project finance-type electric power and gas projects. U.S. Exim established a Project Finance division in 1994 to help U.S. companies compete in energy and infrastructure projects. Since its creation, the division has approved nine project finance transactions representing $2.6 billion in U.S. exports.[44]

Bilateral agencies such as U.S. Exim provide financing to an importing entity, usually the project company, through direct lending, on-lending,[45] or interest rate equalization.[46] Direct loans are normally tied to the purchase of equipment from manufacturers in the country of the export credit agency. U.S. Exim provides these services pursuant to OECD conditions. JExim also provides untied loans whose terms do not have to follow OECD conditions.

c. How to Apply for U.S. Export-Import Bank Assistance in Project Finance

U.S. Exim processes applications on an expedited basis. The application process for project finance transactions differs somewhat from the traditional financing application process.[47] U.S. Exim will consider project finance transactions in countries which are closed to traditional support due to economic conditions. However, the project sponsor needs to show structures in place to mitigate certain risks. For example, one such structure is the use, with host government's approval, of offshore escrow accounts to retain the project's hard currency revenues and ensure debt service.[48] U.S. Exim's application procedures also require that project sponsors have significant experience in project finance and have an equity investment in the project. Finally, U.S. Exim requires that when the primary off-take purchaser is a government-owned utility, the availability of coverage is subject to U.S. Exim's country limitation schedule.

Interested project sponsors should address themselves to U.S. Exim's Business Development Division. After an initial meeting, the application procedure will move forward in several stages. On the project sponsor's application, including an executive summary of the project, U.S. Exim may issue a Project Finance Letter of Interest. These letters of interest give projects sponsors a certain degree of leverage when they go to negotiate with other sources of projects funding.

The next step is to determine whether U.S. Exim will go forward with a full evaluation of the project. The project sponsor must submit a standard

44. *See* US Exim website (visited June 15, 1998) <www.exim.gov/mpfprogs.html>.

45. On-lending refers to a financial transaction whereby one bank lends money to another bank so that the second bank can lend the funds to a third party, in this case, the project sponsor.

46. Interest rate equalization occurs when a bilateral agency compensates commercial banks who extend fixed low interest loans to importers for the difference between the fixed rate and market interest rate.

47. Traditional financing application procedures are listed at the U.S. Exim website, <www.exim.gov/95howto.html>.

48. U.S. Exim website (visited June 15, 1998) <www.exim.gov/mpfprogs.html>.

Commitment Application Form as well as attach detailed materials concerning all aspects of the project.[49]

U.S. Exim will review the above material within five to ten days to decide if it wants to proceed. If U.S. Exim decides to go ahead with full evaluation of the project, it will retain an outside financial advisor to exercise two-phase due diligence. At this time, the project sponsor will be required to sign a contract with U.S. Exim and pay an evaluation fee, as well as sign an indemnity agreement with the financial advisor. The evaluation will be completed within forty-five days, and U.S. Exim, if satisfied with the results of the evaluation, will issue a Preliminary Project Letter. The Preliminary Project Letter indicates that U.S. Exim is prepared to extend a financing offer and begin negotiating general terms and conditions. At this point, U.S. Exim will work with the project sponsor towards a final commitment to finance.

2. *Development Assistance*

Member states of the OECD all have development assistance programs. Of these, the United States and Japan contribute the largest in overall funds. Programs are publicly funded and assistance is granted to developing countries based on standards that vary among donor countries. U.S. assistance aims to protect international stability by encouraging environmental protection and institutional development. Funds are usually applied to specific needs or projects, including balance of payments, specific project investments, and technical assistance.

a. U.S. Trade & Development Agency

The U.S. Trade & Development Agency ("TDA") provides grant funding for large project feasibility studies in developing countries. A grant must be requested by a government entity in the developing country for work to be undertaken by a U.S. company. The TDA will consider whether the study is likely to identify large-scale export opportunities for U.S. companies. Grants for studies related to oil, gas, and electric power normally range between $500,000 and $1 million. Once a grant request is approved, the TDA selects an American company on a competitive bidding basis and will pay grant fees to that company directly.

49. Project sponsors must demonstrate to U.S. Exim that the project's economics and financial structure are feasible and that all necessary agreements are in place, or substantially so. Further, project sponsors must demonstrate that all the project's participants are capable of performing their respective obligations. Also, project sponsors must prove that the host country's legal and regulatory regimes are amenable to the project and are sufficiently stable to support long-term debt exposure. Finally, the technology employed in the project must be proven and reliable. These requirements are listed in great detail on US Exim's Project Finance website, <www.exim.gov/mpfprogs.html>.

b. Overseas Private Investment Corporation

A body of the U.S. government established in 1969, the Overseas Private Investment Corporation ("OPIC") provides project financing through loans, equity, insurance, and loan guarantees. It also provides political risk insurance and advisory services in support of U.S. investment and exports. OPIC may provide up to $400 million of total support to a project, up to $200 million of which may be for financing or insurance. Out of OPIC's total portfolio, 11% is committed to the oil and gas sector and 30% to the power sector.

(1) Project Finance Eligibility

OPIC, per its statutory mandate, offers medium to long-term financing for new projects or expansion and renovation of existing facilities. Eligible projects must have a positive effect on U.S. employment, be financially sound, and bring significant economic and social benefit to the host country. OPIC can provide up to $200 million in financing in the form of loans and loan guarantees to any one project, and it does not require that a foreign project be wholly American-owned. However, OPIC will not provide financing to projects where a foreign government holds controlling shares, nor will it finance projects that can access sufficient commercial funds. OPIC publishes a list of eligible countries in which it will finance projects.[50]

(2) Clients, Project Evaluation, and Application Procedures

OPIC's clients are exclusively American companies. OPIC does not provide inter-government aid or grants. OPIC currently has about 400 active clients, including small, medium and large U.S. businesses, and demand is growing with increased U.S. interest in large-scale infrastructure projects in Latin America, Asia, and elsewhere in the developing world.[51]

In evaluating projects, OPIC considers certain broader policy issues. OPIC looks to whether the project will contribute to the development of the fundamentals of a market economy in the host country by increasing the availability of higher quality goods and services, improving labor skills, transferring technology and managerial skills, and generating foreign exchange earnings or savings.[52]

Application procedures are relatively straightforward and require three to six months to complete, depending on the complexity of the project. Project sponsors should start by submitting an application Form 115, attaching a business plan outlining project costs, proposed financing, *pro forma* financial statements, and underlying assumptions. OPIC's website contains a detailed ex-

50. The OPIC Country List can be found on OPIC's website, <www.opic.gov/subdocs/info/ctrylist.htm>.

51. A list of OPIC clients and their projects can be found on OPIC's website, (visited on June 15, 1998) <www.opic.gov/subdocs/info>. General information on OPIC Project Financing is available in the revised *OPIC Program Handbook*, which can be obtained from OPIC by mail or on the worldwide web at: <www.opic.gov/subdocs/what/ph-fin.htm>.

52. *See* OPIC website (visited on June 15, 1998) <www.opic.gov/subdocs/what/ph-intro.htm>.

planation of what the business plan should include, and Form 115 may also be directly downloaded from the website.

(3) Form of Financing

OPIC financing is limited recourse. As such, OPIC relies not on foreign sovereign guarantees but on the cash flow of the project. It therefore closely assesses the economic, financial, and technical feasibility of each project. The amount of financing provided is determined depending on the host country's level of development, the project's requirements, and the extent to which the financial risks and benefits are shared among the investors and other lenders.

OPIC financing takes the form of direct loans and loan guarantees. Loan guarantees are issued to U.S. financial institutions that are more than 50% beneficially owned by U.S. citizens, corporations, or partnerships. Where a loan guarantee is provided, OPIC may also assist a project company in locating the underlying commercial loans. OPIC-guaranteed loans are backed by the full faith and credit of the United States and are classified as eligible U.S. government securities. Interest rates vary depending on OPIC's assessment of the project's risks, and also reflect long-term U.S. capital market rates. OPIC generally requires senior creditor treatment, *pari passu* with other senior debt holders.

H. Private Commercial Funding

A variety of instruments allow project sponsors to access private commercial funding for international energy projects. While multilateral or bilateral agencies provide prestige which gives lenders comfort, private financing is usually necessary in order to obtain sufficient funding. The optimum financing package should include some or all of these commercial sources in tandem with multilateral or bilateral sources of financing.

1. Domestic Capital Markets

Domestic capital markets in developing countries have grown rapidly in the 1990s and can offer access to a host country's domestic savings either through public equity or bond offerings, or by attracting domestic investors or debt financing. The principal difficulty of reliance upon domestic capital markets is their instability, particularly in the wake of the current Asian financial crisis.

2. International Commercial Banks

International commercial banks are now more cautious about the projects in which they are willing to get involved. In addition to a project's economics and a basic contractual structure that ensures a sufficient cash flow, banks will also insist on a stringent security package and on mechanisms to shift or share risk with other lenders. Accordingly, syndicated loans have become a popular way to achieve the level of comfort necessary for commercial banks to extend long-term loans. A number of banks will loan to a project under identical terms and conditions. One bank, sometimes the IFC, will act as an administrative agent for

the banks. Interest rates are negotiated as a fixed spread above some benchmark, usually LIBOR. Certain contractual provisions can mitigate the risk of debt service caused by a floating interest rate, including longer repayment periods and multicurrency repayment options. The primary advantage of syndicated debt is that it gives project sponsors access to the large loans they need to fund an energy project without the costs incident to a bond offering.

3. International Equity Markets

As with multilateral and bilateral agencies, international capital markets are much more receptive to recognized and experienced project sponsors. In the United States, Security and Exchange Commission ("SEC") Rule 144A permits certain qualified institutional investors to purchase securities not registered with the SEC. However, these securities may not be freely traded for three years after they are purchased. Generally, under Rule 144A, foreign companies issue equity in the United States by means of American Depositary Receipts ("ADR")[53] issued by a U.S. bank. ADRs can be traded on national exchanges, but are privately placed. The underlying shares are held by a custodian bank in the home country.

4. International Bond Markets

International bond markets in the United States, the United Kingdom, Japan, and Europe are all available to raise capital for international energy development projects. Each has distinct advantages. Bonds for international projects may be considered domestic or foreign, depending on which entity issues them. Bonds may be publicly-issued or privately-placed, and many project sponsors opt for privately-placed bonds because they are subject to less government regulation.

In the United States, publicly-offered bonds must be registered with the SEC, and the borrower must be rated by a credit rating agency, such as Moody's or Standard and Poor's ("S&P"). However, SEC Rule 144A offers privately placed foreign bonds a way around otherwise restrictive SEC regulations. Project sponsors can offer bonds to qualified institutional investors, raising capital quickly without adverse regulatory or tax consequences.[54]

Eurobonds can be issued in any convertible currency and sold to institutional investors. Eurobonds also offers project sponsors freedom from SEC disclosure requirements and other regulations. Also, Eurobonds may offer tax treatment more favorable than that of bonds issued publicly in the United States by a foreign corporation.

53. ADRs are receipts for the shares of a foreign-based corporation held by a U.S. bank entitling the share holder to all dividends and capital gains. ADRs are a convenient alternative to buying shares directly in overseas markets. ADRs represent ownership interest in foreign issuers and are negotiable. For an excellent overview of ADRs, see Securities and Exchange Commission, *American Depository Receipts* 56 Fed. Reg. 24420 (1991), *reprinted in* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 110-18 (5th ed., 1998).

54. For an overview of Rule 144A, see RICHARD W. JENNINGS, et al., SECURITIES REGULATION (8th ed. 1997).

Both national energy companies in developing countries as well as international energy companies have tended toward privately placed bonds under Rule 144A. As with other commercial sources of financing, bond issues are greatly aided by the participation in the project of a multilateral organization.

5. Specialized Energy Funds

Both domestic government-sponsored and private funds attempt to attract private investment and financing to the energy sector. Many private funds are focused on energy section investments in a specific region. For example, the IFC's Global Power Fund invests equity and provides subordinated debt and completion guarantees for construction of power projects.

6. Credit Rating Agencies

In conjunction with bond offerings to raise capital for specific projects, Moody's, Standard & Poor's, and other credit rating agencies have begun rating project-specific financing to determine whether the project structure will support timely payments of principal and interest to bondholders. The rating agencies will analyze the local legal and regulatory environment and scrutinize the principal project documents: off-take agreements, fuel contracts, and operation and maintenance agreements. Further, these credit agencies will give overall assessments as to how well the parties have managed the project and mitigated important project risks.

III.
TYPES OF RISK AND RISK MANAGEMENT

A. Risks Inherent at Various Phases of Project Construction

1. Development Stage

At the development stage the sponsor faces the risk of rejection of the project by either the host government or by its potential lenders. Commonly cited grounds are that the project is commercially weak or not viable. Host governments may also reject the project if the terms excessively favor the foreign party, or if it decides the project will not achieve desired social or economic goals. Lenders may reject the project based on the project sponsor's failure to obtain necessary approvals, licenses, permissions, or due to other risks inherent in the local political or economic system.

The risk of rejection and failure at this stage is high and borne solely by the project sponsor. But up-front costs may not be that high, depending on how far along the development process has gone.

2. Construction Risk

The risk that construction will not be completed on schedule, within budget, and according to specifications is great; and the costs associated with that risk are high. Normally, a project has already obtained financing by the

construction stage, so the risk of failure to complete construction is shared both by the project sponsors and by the lenders. This is the most critical risk stage for the lenders because in nonrecourse financing, they have recourse only to the project assets. As such, the lenders take on proportionally greater risk, depending on the debt to equity ratio. At this stage their security interests are of little value. Hence, to mitigate their risk, lenders often ask for recourse at this stage or otherwise require sponsors to cover construction contingencies.

Project sponsors, in turn, limit their exposure through completion bonds and liquidated damages, provided for in their contract with the general contractor. These contracts, often termed, Engineering, Procurement and Construction Contracts ("EPC"), are generally "turnkey" contracts. At the completion date, the EPC contractor provides the sponsor with a complete facility that is tested and ready for the sponsor to begin production. Project sponsors may also purchase insurance to cover construction risk.

3. Operation & Maintenance Phase

At this stage, risk remains but is less than that present at earlier stages of the project.[55] Remaining risks include political risk, and the risk that the project may experience a technical failure during operation. Further, necessary raw materials and inputs may suddenly become scarce. Also, market demand and prices for energy may fluctuate, thereby affecting the project's revenues. In addition, there may be an intervening change in tax rates or subsidies. Finally, as noted above, a project's revenues are usually denominated in local currency whereas its debt payments may be denominated in a foreign currency, thus creating foreign exchange risk.

The project company can hedge against these risks through various contractual and guarantee arrangements. First, the risk of a sudden dearth of raw materials may be mitigated by supplier guarantees with price escalations passed on to the ultimate off-take purchaser. To guard against the risk of equipment failure, a project company can obtain guarantees from its equipment suppliers for equipment performance. Also, a project company may obtain multilateral or bilateral agency political risk guarantees from the organizations discussed above. Offshore accounts to hold foreign currency can protect against foreign exchange risk. Finally, take-or-pay contracts with local utilities for fixed terms at fixed prices (usually with a built-in escalation for floating operation costs) help a power project guarantee demand.

B. Local Business Environment

The differences in local business environments between industrialized and developing countries cause the most concern and uncertainty for lenders and project sponsors alike. The assumptions underlying a project's economics usually include continued political stability and economic growth in the host country. At best, such projections can take into account only a limited degree of

55. *See generally* RAZAVI, *supra* note 4, at 11.

uncertainty. However, in developing countries, political and legal institutions as well as legal processes and remedies are often incomplete and inchoate. Rapid economic growth creates wealth, but it also has the potential to generate social displacement and disenfranchisement that can topple a seemingly stable regime.

The most fundamental risk is instability of the political system. Political risk insurance and contractual arrangements can be of some help in dealing with the unexpected. The best approach for sponsors, however, is to examine the local situation closely before investing in a project and to avoid investing in countries with unstable regimes or economic systems. Indonesia is an example of a country where the political system seemed more than stable enough to support the country's booming economy. Yet when the government failed to deal with the severe financial crisis beginning last summer, the economy fell apart, and the Suharto regime followed.

Expropriation is the risk that the host government will seize and nationalize the project's property rights. Even where it is compensated, the amount of compensation will likely not satisfy all of the project's debts and equity. Creeping expropriation is often a greater fear than outright seizure. This occurs gradually through increased taxes, fees, and other regulation.

The host government may also breach various commitments it has made to the project to waive fees and taxes or to provide surrounding infrastructure necessary for the project. Project sponsors have little recourse in this situation. The potential damage to the host government's international reputation may deter this type of breach to some degree, but as was the case in India, nationalistic politics can often prevail over diplomacy, comity and respecting commitments.[56] A host country may prohibit the repatriation of profits abroad and insist that profits be invested in other local projects. Lenders, of course, depend on expatriation of profits for debt service and will not lend where it is not possible. A change in policy after the project is in construction or operation would likely constitute governmental *force majeure*.

C. *Ways to Manage Risk Ex Ante*

1. *Structuring the Project*

Critical to the success of a project finance deal is the "financial engineering," which structures the transaction in a way that recognizes and minimizes risks. Any risk that could adversely affect the project's net cash flow must be addressed and allocated to creditworthy, qualified parties. Parties who can best bear a certain risk should undertake that risk contractually, but they must have sufficient incentive to do so. The EPC contractor, for instance, should take on the bulk of completion risk at the construction phase.

According to some experts, project sponsors should, as a general rule, minimize exposure to political risk by minimizing the assets present in the project's

56. Gregg Jones, *The Remaking of India: Economy Perks Up after Government Rolls Back Socialist Policies*, DALLAS MORNING NEWS, Aug. 10, 1997, at 1H.

host country.[57] In addition, opening the project to local participation further reduces political risk by tying the financial interests of the local population to the success of the project.[58] Finally, borrowing and purchasing political risk insurance from international multilateral and national governmental agencies can discourage undue political interference by the host government, thereby reducing political risk.[59]

2. Allocation of Risk Through Contract Terms and Provisions

The complex contractual structure of any project finance transaction is driven by the need to allocate risks to the parties who can best bear them.

a. Price Protection

An off-take agreement, for example, will likely provide price protection for the project company in the form of price escalators, either keyed to inflation (or consumer price benchmark) or set by a predetermined formula. For power projects, fuel price risk is also borne by the off-take purchaser. If fuel prices rise, the project company simply passes through the increased cost to the purchaser by increasing the energy payment component of the power tariff accordingly.

b. Currency Fluctuation Risk

The off-take agreement may also provide for currency fluctuation adjustments. Even where a tariff is denominated in local currency, the price may be referenced to dollars, calculated at the exchange rate as of a certain benchmark date. The critical point to negotiate is which party, the purchaser or the seller, will absorb the difference should the local currency fall against the dollar. Many times, as a local utility, the purchaser may be unwilling or unable to pay more for its off-take, often because its own revenues come from transmission and distribution and from sales to consumers. The project company, on the other hand, must maintain its net cash flow at all costs to ensure debt service. The result is an often contentious point of discussion during negotiations.

c. Achieving Certainty in Dispute Resolution

One of the most important ways to limit risk is to ensure prospectively that there will be certainty in the event the parties cannot resolve disputes between them amicably. This applies most forcefully to the project company and the off-take purchaser, who will each perform under the main contract for many years. Parties should be careful to provide in their contracts for international arbitra-

57. *See, e.g.*, Philip R. Stansbury, *Planning Against Expropriation*, 24 INT'L LAW. 678 (1990); *see also* COMEAUX & KINSELLA, *supra* note 5, at 130-31.

58. *See* Richard M. Mosk, *Expropriation: What to Do About It?*, 5 CAL. INT'L PRAC. Fall-Winter 1993-94, at 11, 14.

59. *See* Joseph P. Hadley, *Use of Political Risk Insurance in Connection with Project Financings, in* INTERNATIONAL INFRASTRUCTURE PROJECTS VIII-3 (1995); *see also* COMEAUX & KINSELLA, *supra* note 5, at 130-31.

tion under the United Nations Commission for International Trade Law ("UNCITRAL") or International Chamber of Commerce ("ICC") rules in a neutral third country. Preferably, the parties should choose a country whose business and arbitration laws are firmly established. Above all, that country chosen should be a signatory to the New York Convention on Recognition and Enforcement of Arbitral Awards ("New York Convention").

U.S. companies and their counsel are often wary of arbitration because they see it as merely an international analog to domestic alternative dispute resolution ("ADR"). They are concerned that arbitrators will decide matters by splitting the difference rather than adjudicating on the merits. It is absolutely crucial, however, to recognize that important differences exist between international commercial arbitration and domestic ADR. First and foremost, the New York Convention provides an international framework which ensures that an arbitral award made in one country can be enforced in another so long as each country is a signatory to the Convention. The New York Convention itself, first signed in 1958, now comprises well over one hundred nations worldwide. In fact, the New York Convention is the only comprehensive, mutually reciprocal system for ensuring enforcement of awards arising out of international commercial disputes. The New York Convention offers the optimal solution to the difficulties of either suing a local party, especially a local government entity, in local courts, or bringing suit against that party in a American court, and then trying to enforce the judgment.

Project sponsors should confirm that the local law of the host company permits international arbitration in such disputes. Sometimes, if the project company is registered as a local company, it may be considered a purely domestic entity under local law, despite 100% foreign ownership. Therefore disputes between it and another local entity may not be subject to international arbitration. Project sponsors and their counsel should also be sure that they understand the different consequences of the choices of arbitral rules, applicable substantive law, and place of arbitration — *lex arbitri* — on the arbitration process and eventual enforcement of an award.

3. Investment Insurance

a. National Governmental Agencies

(1) OPIC

OPIC, under its statutory mandate, can offer up to $200 million in political risk insurance to any one project. OPIC insurance covers political risks, including currency inconvertibility, nationalization, expropriation and "creeping" expropriation, and political unrest. OPIC also offers specialized insurance coverage for certain industries including oil and gas exploration, development, and production. Exploration coverage is broader than expropriation coverage, and covers arbitrary changes or breaches of key project agreements by the host government. OPIC can also cover against seizure of bank accounts and/or equip-

ment imported to perform a service or off-take agreement signed with a government-controlled entity.[60]

(2) U.S. Exim Credit Insurance

In addition to OPIC, a project sponsor may also purchase investment insurance from U.S. Exim to cover both commercial and political risk.

b. Multilateral International Institutions

(1) Multilateral Investment Guarantee Agency

Project sponsors also have access to investment insurance through MIGA. MIGA guarantees investors and lenders insurance against the risks posed by deleterious action taken by the project's host country. The risks include breach of contract, expropriation, currency inconvertibility, and other *force majeure.*

(a) Term and Coverage

MIGA's standard term for insurance is fifteen years, noncancellable by MIGA. MIGA insurance covers both equity and debt financing. For the equity portions, MIGA insurance covers up to 90% of investment plus an additional 180% for the earning stream of the investment. For debt, MIGA insurance covers up to 90% of the principal plus the interest accruable over the term of the loan. Premium rates and fees vary depending on the project and type of coverage purchased. MIGA coverage is limited to $50 million per project, and $150 million per country. MIGA insurance may be sought in conjunction with private and other multilateral or national political risk insurance coverage.

(b) Applying for MIGA Political Risk Insurance

The procedure to process a MIGA application is relatively simple and straightforward, and can be initiated by submitting a Preliminary Application for Guarantee before any investment is irrevocably committed.[61] Based on this information, MIGA will make a provisional determination regarding the eligibility of the investor and the project. If MIGA is satisfied at this initial stage of the project, it will send a Notice of Registration along with a Definitive Application for Guarantee to the project sponsor.

Once investment and financing plans take shape, the project sponsor should complete and return the Definitive Application, attaching relevant project documents, including contracts and studies on feasibility and environmental impact. There is an application fee payable to MIGA at this juncture, the amount of which ranges from $5,000-25,000, depending on the amount of the guarantee sought.

60. *See* OPIC website (visited on June 15, 1998) <www.opic.gov> and *OPIC Handbook* at 25. *See also* COMEAUX & KINSELLA, *supra* note 5, at 158-59.

61. The Preliminary Application Form is also available on MIGA's website at: <www.miga.org/miggu/prelim.htm>.

Upon receipt of the Definitive Application, and before it makes a guarantee, MIGA, as a World Bank affiliate, is required to obtain the approval of the host country.

c. Private Insurance

Private political risk insurance is a growing market, and there are more insurance choices emerging to meet that market demand. Private insurance may cover a project's assets or its contracts. Contract insurance generally covers loss due to contract cancellation caused by political violence or uprising, repudiation of the contract, and currency inconvertibility. Asset coverage includes protection against nationalization or other expropriation of assets, as well as other local political risks like strikes, arbitrary cancellation of permits and approvals, and labor uprisings.[62]

In some ways, private insurance coverage is superior to government or multilateral political risk insurance. First, it does not require approval of the host country's government. Second, it is more flexible and provides coverage to a broader range of insured parties. However, it is considerably more expensive and too short-term for some projects.[63]

4. Project Parties' Support

In addition to contractual solutions to the problem of risk, parties may insure themselves. For example, a guarantee from the project sponsor's parent corporation, an escrow account, letter of credit, or set-off rights can mitigate project risk.

The project sponsor may, in addition to its equity investment, make certain limited guarantees to eliminate risk. Such guarantees may include a completion guarantee (i.e., a contingent commitment to put in more equity), cost overrun funding, performance bonds, and clawback of equity distributions.[64]

Finally, a certain amount of risk may eventually be borne by the project's lenders. Though lenders are naturally risk-averse, market factors and their interest in a project and confidence in the project's participants may make them willing to take on a certain amount of risk. As the banks will profit from a successful project, it is reasonable that they should undertake some risk for that profit.

IV.
How To Put Together a Financeable Project

Because projects, host countries, project sponsors, and other conditions vary so greatly, it is difficult, if not impossible, to come up with a uniform, "one

62. *See* Comeaux & Kinsella, *supra* note 5, at 182.

63. *See* Peter F. Fitzgerald, *Overview of Risks in International Financing*, 707 PLI/Comm 7, 16 (1995) (stating that private insurance may be too short-term for some projects).

64. In a clawback of equity agreement, the project sponsor agrees to disgorge any dividends which the project company has paid out to it in the event of certain circumstances. The effect of a clawback agreement is to give lenders an additional level of comfort.

size fits all" approach to developing and financing international energy projects. Nevertheless, there are some general points worth noting.

Project sponsors and their counsel should keep in mind that in working in foreign countries, particularly developing countries with newly emerging economies, significant differences in language, business culture, and legal traditions create different project development dynamics. The legal systems in emerging economies are often themselves emerging and generally do not offer the certainty that American statutory and case law does. Negotiation and approval processes generally proceed at a slower pace than in the United States. Recognizing and working with these differences may be crucial to the success of a particular project.

In conjunction with these factors, the project finance approach has its own imperatives. Of paramount importance to project sponsors are the needs to protect the net revenue stream, create a complex web of contractual arrangements, and mitigate the various political and commercial risks inherent in projects. These goals will very often directly conflict with the need to forge long-term partnerships with local counter-parties and host government entities. The project sponsor has to recognize each of these diverse interests and balance them so that each group is satisfied.

Below are a few thoughts on how to approach these challenges.

A. Evaluation of Project and Business Environment

Project sponsors should bring an understanding of international business and markets and familiarize themselves as quickly as possible with the local situation. Project sponsors should assess the host country's actual interest and support for a specific project. Identifying local officials and business leaders who will facilitate relations with government agencies is crucial to the success of a project. The project sponsor must be able to bridge different worlds. Without spending sufficient time and resources to understand the local political, economic, and business situation, a project sponsor is liable to incur greater costs down the road when more resources have been committed to the project.

B. Financial Viability

Beyond knowledge of the host country, international energy project sponsors must realistically assess the likely returns of their projects. Project sponsors in upstream oil and gas projects should determine whether the projected prices for crude oil and natural gas over the term of the main project contract will be sufficiently stable to guarantee the net revenue stream necessary to service the debt. Downstream gas transmission and distribution or oil refining projects must determine the stability of both the supply of natural gas or crude oil and the market for gas and finished oil products. For power generation projects, similar considerations apply. In all of these instances, project sponsors must weigh all costs, including opportunity costs and development costs, against the potential

returns. The greater the extent to which the risks discussed above can be allocated through contract, the more likely a project is to be financially viable.

C. *Technically Viability*

On completion of construction, the facility must be able to operate according to stipulated performance standards. If, due to technical defect or equipment failure, it cannot, the project could suffer fatal setbacks from lost revenues and potentially breach any off-take agreement. This risk is magnified by the limited availability of repair service and replacement parts in developing countries. For this reason, lenders will insist on proven and reliable technology.

D. *Potential Environmental Liabilities*

Project sponsors should take special care to ensure they meet all environmental standards and are aware of any imminent changes in local environmental laws and regulations that could adversely affect the project.

E. *"Financial Engineering"*

1. *Ownership Structure*

The ownership structure will vary depending on the type of project, its size and location. The project company, usually an entity formed in the host country, may include local interests as shareholders, or may be a joint venture with government utilities or agencies. The structure on the international level will vary according to such concerns as tax treatment, liability, and accounting standards.

2. *Sourcing Financing*

Project sponsors should seek financing from as many different sources as possible. Multilateral institutions, regional development banks, and bilateral agencies can provide important support, which gives private commercial lenders and investors the confidence they require to participate in the project.

3. *Security Arrangements*

When financing in developing countries, banks seek a complete security arrangement to protect them from the broad range of commercial and political risks outlined above. During their exercise of due diligence, lenders will be particularly concerned with their actual ability to enforce their secured interest and foreclose in the event of a default.

Project sponsors need to mobilize all the available multilateral support, bilateral export credit, and risk insurance that can be obtained in order to convince lenders that revenue projections can be met and that the project's assets can be repatriated. The contractual arrangements should ensure that lenders will not bear the burden of the cost overrun or revenue shortfall, and that the lenders will be kept whole. The project sponsor must be willing to pledge its equity to the lenders. The project must securitize the project assets to the lenders' benefit.

And the project parties must often consent for the project sponsors to assign all of their contract rights to the lenders. The lenders' objective is to ensure that if there is an event of default, and they foreclose, they will be able to take over and continue to operate the ongoing concern, rather than liquidating the project company.

V.
CONCLUSION

During the past decade, the trend towards privatization of infrastructure and basic utilities has spread from Europe and the United States to many emerging economies, particularly in Latin America and Asia. As these developing countries undergo unprecedented, rapid economic growth, private investment in these traditionally publicly-owned and operated sectors has emerged as the most viable means for national and local governments to meet soaring demand for energy and basic utilities. Governments have, in turn, dismantled public monopolies, loosened regulation, and encouraged foreign direct investment in the development of modern energy, water, communication, and other facilities.

This trend presents a wealth of opportunities for multinational energy companies, financial institutions, associated companies, and other international organizations. At the same time, the unique and often significant risks — political and economic — in emerging economies require actors to devise investment structures that mitigate and allocate such risk in a cost-effective and prudent manner. For a project whose total investment may range from several hundred million to several billion dollars, fund sourcing is inextricably linked with the effective management of market-specific and country-specific risks. To this end, familiarity with both the political and economic environment of the host country and with international capital markets is crucial. No less important is understanding the roles that various international organizations and national governmental institutions can play in financing international projects — whether through direct debt or equity financing, risk management devices, or export credit support. "Financial engineering" is the art of combining all of these elements into a viable project structure.

This paper provides an overview of the function of the project finance mechanism in bringing advanced technology and modern facilities to emerging economies. I have specifically avoided any value judgment as to whether this approach represents the best development model for emerging economies. I note, however, that public welfare is not mutually exclusive with multinationals' corporate profits. Moreover, governments in emerging economies do retain important industry-specific, environmental, and regulatory checks which allow them to safeguard public interests. Indeed, the advent of international investment often motivates important regulatory reform.

Useful Worldwide Web Addresses

Asian Development Bank	www.asiandevbank.org
International Finance Corporation;	www.ifc.org
Multilateral Investment Guarantee Agency	www.miga.org
Preliminary Application for Guarantee	www.miga.org/miggu/prelim.htm
United States Export-Import Bank	www.exim.gov
Japan Export-Import Bank	www.japanexim.go.jp
Overseas Private Investment Corporation (Adobe Reader necessary to download Application for Financing and Request for Registration of Political Risk Insurance)	www.opic.gov
International Monetary Fund	www.imf.org
The World Bank (International Bank for Reconstruction and Development)	www.worldbank.org
Inter-American Development Bank	www.iadb.org
International Development Association	www.worldbank.org/html/extdr/idao.html
The European Bank for Reconstruction and Development.	www.ebrd.org
The European Investment Bank	www.eib.org
The Nordic Development Fund	www.um.dk/english/undenrigspolitik/udviklingspolitik/multilateralism/strategies/banks/banks.2.5.html
The OPEC Fund for International Development	www.opec.org/opecfund.htm