Scrutinizing Internal and External Dimensions of European Law

Les dimensions internes et externes du droit européen à l'épreuve

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Modèle OCDE ou les lignes directrices sur les prix de transfert – sont formellement approuvés par une grande majorité des États membres de l’UE et leurs principaux partenaires internationaux. Alors que la *soft-law* de la Commission ne représente que le point de vue d’une institution européenne et, souvent, son point de vue n’est pas unanimement partagé par les États membres. En outre les instruments non contraignants de l’UE peuvent aborder un sujet – la sphère juridique européenne – sur lequel la seule interprétation contraignante revient à la Cour.

Malgré les limites de l’approche *soft-law* que nous venons de souligner, dans des matières comme la fiscalité, où il est impératif de trouver des alternatives à l’incapacité politique à légiférer, l’UE ne peut que continuer à soutenir ses politiques par des outils non législatifs. Seule une réforme des traités, qui compenserait la renonciation au droit de veto des États membres sur la politique fiscale européenne (avec un pouvoir de contrôle accru par le Parlement européen) pourrait rétablir un équilibre institutionnel correct et redonner aux instruments contraignants leur rôle régulateur, même en matière fiscale.

Pour évaluer l’impact des instruments de *soft-law*, il sera également utile de suivre les travaux du *Forum conjoint des prix de transfert* qui, au cours des deux prochaines années, examineront comment les différents codes de conduite et lignes directrices adoptés depuis sa création en 2002 ont été mis en œuvre par les États membres. Cet exercice permettra de confirmer ou d’infirmer l’utilité des instruments de *soft-law* dans la mise en œuvre d’une politique fiscale européenne visant à faciliter le développement du marché unique en supprimant les obstacles fiscaux.

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59 Le groupe d’experts dénommé *Forum conjoint des prix de transfert* assiste et conseille la Commission européenne sur les questions fiscales liées aux prix de transfert. Il s’agit d’un exemple intéressant de contribution à la régulation administrative en matière fiscale puisque l’ensemble des travaux a fait l’objet de propositions de *soft-law* de la Commission (*codes de conduite*), adoptées par le Conseil.

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The main focus of this paper is the issue of growing departures from the principle of legal equality of economic actors in several important areas of private law and the rapid proliferation of special treatment granted to entities that are "too big to fail", "systemically important" or "too interconnected", to be treated equally. Such special treatment is usually bestowed on large-scale and sophisticated business players. As a result, legal inequality of participants of private law relations has deepened. Paradoxically, such unequal status of business actors has been introduced under the banner of freedom of contract, despite the fact that equality of business actors is still proclaimed to be one of the main foundations of a free-market economy and private law. Equally surprising is the fact that the growing list of exceptions from these principles have been achieved not by way of contract or self-regulation but as a result of lobbying aimed at "negotiating" legislative privileges, frequently orchestrated by way of secret negotiations.

Examples of deviations from the principle of equality will be illustrated by examples in the field of bankruptcy law, intellectual property and arbitration. Limited exceptions to the principle of equal treatment have been recognized in the past but principally in the form of special treatment of weaker parties (persons), such as victims of bodily injuries in tort actions, employees, minors entitled to alimony claims, consumers' rights against professional business actors, minority shareholders vis-à-vis dominant shareholders, etc. The principle of special treatment of the weaker party is dictated by the traditional postulate of fairness, one of the foundations of modern civil law heritage.

This Article focuses on the phenomenon of the growing role of special treatment and "bounties" granted to those business actors who are, by-and-large, economically strong and sophisticated market participants.

The Article analyses a few examples of departures from equality in private law. Because of a lack of uniform definition of civil law, I use this term throughout this paper to embrace such areas as bankruptcy law and intellectual property. Fortunately, in civil codes, the process of this curious affirmative action aimed at improving the status of the stronger parties in the field of substantive and procedural laws has been less visible to date. Privileged status bestowed to firms that are "systemically important" (for instance, in the domain of tax law) is beyond the scope of this essay but examples of tax cuts and preferential tax treatment for super-rich individuals are equally controversial. In the aftermath of the financial crisis, assumptions and socio-economic consequences of these modern bounties have been subjected to critical analyses by lawyers and economists, in particular in the United States. For instance, several recent studies illustrate the point that the bankruptcy priorities granted to netting agreements accelerated the financial crisis.3

I also illustrate the growing role of secret or at least non-transparent lobbying aimed at establishing special status for the most powerful industries. Lobbyists seek to obtain special legal status for their clients, try to limit their transparency obligations and scrutiny of regulators. Lobbying aimed at granting super priorities to parties of financial transactions, intellectual property owners and foreign investors illustrate this trend.

2. Special Treatment of Financial Transactions in Bankruptcy Law

A. The Objectives of Close-out Netting Legislation

During the last 25 years financial institutions have developed new legal instruments aimed at reducing their risk exposure when trading in derivatives, swaps, repurchase contracts ("repos") and other new financial instruments, in particular in the event of insolvency of a counterparty. Various types of netting transactions employ mechanisms similar to the traditional set-off but they are functionally and conceptually different from the latter concept. Close-out netting is usually described as an umbrella agreement covering a bundle of financial contracts between two parties, who have agreed that upon the occurrence of a predefined event (default), the party "in the money" (i.e. the non-defaulting party), all non-performed contracts covered by the netting agreement shall become due and the party which is "out of the money" shall pay a net amount to the non-defaulting party. Depending upon the terms and conditions of the umbrella agreement, often described as the "master agreement", close-out netting occurs automatically or at the election of the non-defaulting party. As a rule, the calculation of the net result of all unperformed obligations is performed by the party which is "in the money". The single net payment obligation constitutes the only obligation in lieu of all terminated contracts covered by the master agreement.3

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Netting is mainly a product of banks and other financial institutions that offer such agreements to other financial institutions or firms of the “real” economy. During the last two decades the denomination of “close-out netting” has become widely used in the standard agreements elaborated by market associations, such as International Swaps and Derivatives Association (ISDA), International Capital Market Association (ICMA) and European Banking Federation (EBF). This paper analyses the consequences of the special status of the close-out netting and its underlying transactions in the event of insolvency of a party to the umbrella (master) agreement.

B. How and Why Financial Contracts have been insulated from Bankruptcy Disciplines?

I. Arguments Pro and Contra Privileged Status of Financial Transactions (Eligible Parties and Eligible Transactions)

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

Banks and other financial institutions have long tried to receive special treatment in bankruptcy laws. In the United States, for instance, some financial transactions were insulated from the rigors of bankruptcy law in the Bankruptcy Code (1978). Despite a gradual expansion of the scope of the special status of financial transactions in the 1980s and 1990s, until the Bankruptcy Abuse Prevention and Consumer Protection Act 2005, substantial uncertainty surrounded the range of transactions and parties eligible for such statutory “safe harbours”. Also, judges sometimes applied a functional analysis of transactions upon which defendants claimed their insulation from such bankruptcy disciplines as automatic stays, limitations on preferential and fraudulent transfers, and of ipso facto clauses.5

The US Bankruptcy Reform Act (2005) radically expanded the definition of protected financial transactions. The statutory list of contracts “liberated” from bankruptcy disciplines covers, inter alia, swaps, forwards, commodity contracts, repurchase agreements (repos) and securities contracts. Morrison and Riegel opined that the concept of “protected parties” has become meaningless in the context of the “laundry list” of the names of popular financial transactions which were granted privileged status in the bankruptcy law.6 The reform of 2005 granted the discussed privileges not only to banks and other regulated financial institutions such as commodity brokers, forward contract merchants, stockbrokers but to all “financial participants, defined as a cleared organization or an entity that entered protected financial transactions worth at least USD 1 billion in national value (or USD 100 million in mark-to-market value) anytime during the preceding 15 months.” This was just one example of the new principle that the big deserves should be treated with more respect than lower class creditors.

The “safe harbours” for financial transactions advocated by financial institutions and propagators of netting have been justified as necessary instruments for the protection of financial markets, including over the counter (“OTC”) markets. Without these protections parties to derivatives transactions, swaps and close-out netting agreements would be subject to the automatic stays for extended periods and the bankruptcy administrator (trustee of a bankrupt entity) would be allowed to assume “in-the-money” contracts and reject “out-of-the-money” contracts in an effort to perform a successful restructuring the debtor. These characteristic powers of the bankruptcy administrator have been described ominously by the interested industry as “cherry picking”. According to this view, losses from exposure to “cherry picking” and other bankruptcy rigors would undermine the stability of the financial markets.

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6 Ibid., at p. 28.

7 § 907(b) (i) (3), as codified at 11 USC § 01 (22A).
The second rationale for special treatment of parties to financial transactions is that repos, derivatives and, in particular, the netting agreements that may cover a dozen or more underlying contracts are too complex and too interconnected to be treated in the same way as other contracts. The complexity rationale is sometimes merged with the argument that many financial institutions function merely as middlemen. The whole clearing chain would become paralyzed if a broker were to be exposed to bankruptcy law restrictions.  

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

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

The fifth rationale, which silenced “any lingering objections” was the need to avoid systemic risks resulting from “domino failures” if the financial transactions were subject to the automatic stay and “cherry picking”. Any delay to terminate a derivative contract or to net all contracts covered by a close-out netting agreement would have a crippling effect in the market due to the contagion effect.

The US Bankruptcy Reform Act (2005) was approved almost without any opposition although it dramatically enlarged the list of protected parties and eligible transactions, subject to special treatment. It insulated the counterparties to these contracts not only from the “cherry picking” and automatic stays but also from ipso-facto and constructive fraud rules (i.e. rules sanctioning debtor’s payments and preferences granted on the eve of bankruptcy to related parties). Even the majority of US academics were silenced by the “systemic risk” rationale. However, in all fairness, some authors rightly observed that the policy underlying the overgenerous treatment of financial transactions by the Bankruptcy

Reform Act (2005) is slippery. They pointed out that it is doubtful whether the new rules would assure market stability. Some critics expressed doubts as to whether drastic restrictions of the judicial functional analysis and granting special treatment to a “laundry list” of transactions that fit formal definitions developed by financial markets may actually reduce systemic risks. They observed, for instance, that protection for leveraged buy outs (LBOs) does little, if anything, to reduce systemic risks. Finally, they also expressed concern that extending protection to any margin payments, settlements under a securities contract or any transfer under a derivative contract – even if made on the eve of bankruptcy and/or between related parties, except for cases involving actual proof of fraud – may result in pre-bankruptcy looting by insiders and make the task of the defrauded creditors more than troublesome.

Following its success in the US, the financial institutions soon persuaded market regulators and policy makers in other jurisdictions to adopt similar “netting friendly” laws. The crusade orchestrated by the ISDA has resulted in a proliferation of “netting friendly” reforms of bankruptcy laws. By the middle of 2011, the netting agreements and the underlying financial transactions had been “liberated” from the impact of bankruptcy laws in more than 40 countries. The EU Directive Amending the Settlement Finality Directive and the Financial Collateral Arrangements Directive provides that credit claims constitute an eligible type of collateral to financial collateral arrangements. However, the EU legal framework making references to netting does not provide for substantive rules in the field of bankruptcy law.

A prominent executive of the ISDA explains that close-out netting is an essential component of the hedging activities of financial institutions and other users of derivatives. He rightly stresses that swap dealers and

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8 Arguments presented in favour of special treatment of financial transactions are discussed by Skeel and Jackson, supra note 2, pp. 8-11. See also Morrison and Riegel, supra, note 5, pp. 1-5.
10 Ibid., at p. 11.
other traders try to limit their exposure by maintaining a matched (balanced) book of offsetting transactions: “The result of this hedging activity is that, (…) the aggregate of derivatives activity includes a large number of inter-dealer and other hedge transactions that function largely to adjust risk positions and limit exposure to market movements”.17 The author points out that dealers do not wish to retain their exposures to unanticipated market movements. Legislative recognition of close-out netting that provides for insolation of such agreements from the intervention of an insolvent administrator’s “cherry picking”, “claw-back” claims in case of payments made by the insolvent entity on the eve of bankruptcy and other bankruptcy law rigors, radically limits the risk of the eligible parties (i.e. non-defaulting counter-parties to financial transactions that obtained privileged status by “netting-friendly” laws).

According to the Bank for International Settlements close-out netting reduces risk exposure of the non-defaulting party up to 85%.18 According to the British Bankers’ Association, enforceable netting agreements would reduce the risk and capital requirements of their members for such transaction by 95-97%.19 Thus, the objectives of the crusade aimed at assuring legal certainty for close-out netting master agreements elaborated by the ISDA are clear. Their main goals are twofold: (1) to minimise the risk of financial intermediators and (2) reduce the capital requirements of banks and other regulated financial institutions doing business in the field of netting (e.g. capital requirements under the Basel rules).

The result of close-out netting consisting in the reduction of risk and credit exposure from gross to net exposure under all contracts covered by the master agreement looks fine, as long as one forgets who bears the risk of insolvency (bankruptcy) of the defaulting party in the event of termination of the master agreement. But why only financial intermediators should be allowed to set off their claims under dozens of transactions when the remaining creditors are not allowed to exercise such right in the context of bankruptcy? Why do sophisticated financial dealers deserve special treatment and may avoid unwanted exposure when other creditors are subject to bankruptcy stay rules and should bear a higher risk? The propagators of netting usually do not discuss these issues or even reject the argument that the current status of eligible financial parties constitutes a case of unequal treatment of creditors.

17 Ibid.

The adverse macro-economic consequences associated with the growing privileges to eligible financial parties granted by Congress since 1978 were identified by a few legal scholars who expressed skepticism about the soundness of the policy of granting bankruptcy priorities. Several early studies alerted legislators that if the risk of one class of creditors is lowered by Congress, it would be transferred to passive and less sophisticated creditors such as consumers, tort claimants and employees.20 These and other negative consequences of unequal treatment of creditors in bankruptcy laws materialized during the financial crisis. The frequently stressed rationale that special treatment of netting and other financial transactions in the insolvency law is justified to keep systemic risk in check and avoid “fire sales”, which could result from the application of the bankruptcy law, looks rather unpersuasive, if not deeply discredited. The evidence from the crisis analysed in several legal and economic studies, published during last five years, demonstrates that the decisions to leave the market of derivatives largely unsupervised and special treatment of financial transactions in bankruptcy law did not contribute to keep systemic risk under control. On the contrary, solid data have been compiled which indicate that these legislative decisions constituted factors that had accelerated the crisis. Several scholars in the field of bankruptcy law presented evidence that the privileges granted to the “eligible parties” by the US bankruptcy law reform in 2005, that had been justified as keeping systemic risks in check, actually exacerbated the systemic risk. They triggered “fire sales” of collaterals of such defaulting parties as Bear Stearns, Lehman Brothers and A.I.G. by the parties “in the money” (e.g. J.P. Morgan and Goldman). Studies of the collapse of Bear Stearns and Lehman Brothers demonstrate how the statutory exclusions of the automatic stays first encouraged the non-defaulting parties to terminate their contracts and then to sell vast volumes of collaterals.21 J.P. Morgan’s actions on the eve of Lehman Brothers’ bankruptcy are the best example of the effects of the statutory immunities from the automatic stay rule. The “party-in-the-money” terminated the contract with Lehman, froze billions in securities and cash, and demanded an additional US 5 billion payment. Due to special treatment of derivatives, the party-out-of-money (Lehman) could not stop its privileged creditor from

21 For the sake of brevity, I use the terms “bankruptcy law” and “insolvency law” as synonyms.
22 Roe, supra note 2, at Skeel and Jackson, supra note 2, pp. 12-13.
sells the assets by filing for bankruptcy and the bankruptcy administrator could not “claw-back” even if a transaction was made a few hours before bankruptcy, except in the case of actual fraud, which is almost impossible to prove.

The argument that the special treatment of the eligible financial transactions constitutes an effective mechanism reducing the contagion risk in case of insolvency of systematically important financial firms is also refuted by economic studies. A recent analysis of AIG’s debacle concludes that the “safe harbours” replaced systemic risk in one segment of the market “by another form of systemic risk involving ‘fire sales of qualified financial contracts and liquidity funding spirals’.”

According to recent studies, the main defect of the privileges granted to the eligible financial transactions consists in that they undermine market discipline because they offer the eligible parties super-priority rights. Unlike the other creditors, even many secured creditors, the privileged financial creditors can enforce their claims on the eve of bankruptcy, in particular they can seize collaterals, whilst other creditors, subject to statutory stay rules, must wait for a decision of the bankruptcy administrator. Their special status gives them, inter alia, a broadly defined set-off right. Finally, whilst they are insulated from the bankruptcy administrator’s power to assume or reject the underlying contracts covered by master close-out netting templates, they usually can choose whether or not to terminate such agreement.

The authors of these studies demonstrated that creditors of Lehman, AIG, Bear Stearns and other failed financial institutions displayed surprisingly low risk-awareness, if not negligence. They explain the surprisingly insufficient attention to the creditworthiness of their clients by such preeminent Wall Street investment banks as Goldman and J.P. Morgan. The bankruptcy privileges dampened their incentive to screen and monitor the risks associated with their transactions. Mark J. Roe demonstrated that the super-priorities function as disincentives for market discipline and indirectly subsidize high risk derivatives and repurchase markets. He and other authors conclude that the US Bankruptcy Code privileges decrease the derivatives and repo players ex ante market discipline.

There is ample evidence that the privileges granted to the eligible financial parties have neither increased the systemic stability of the financial markets nor reduced contagion effects. On the contrary, bankruptcy super-priorities contributed to the financial crisis, encouraged simultaneous liquidation of collaterals during the crisis, and exacerbated the information gap because the discussed special rights discourage counterparties from conducting solid financial audits. The disincentives to market discipline caused by these privileges encouraged knife-edge, systematically dangerous financing. This is illustrated, for instance, by Goldman’s financing of AIG’s and JP Morgan’s overnight crediting of Bear Stearns. The latter firm’s insolvency illustrates the problem. Bear’s counterparties were willing to finance it for several years by way of overnight repos, until the debtor collapsed. Characteristically, both parties relied upon the Bankruptcy Code-created incentives and switched from traditional forms of financing (e.g. loans) to privileged repos. As a result, the percentage of Bear’s repos financing climbed from 6% of its total liabilities in 1989 to 18% on the eve of its insolvency in 2008 (i.e. eight times its equity).

Thus, the only assumption made by the advocates of special treatment of the eligible financial transactions have become “flash”, namely, the forecast that the bankruptcy law reforms have contributed to the phenomenal growth of repo and derivatives market. In 2006 total financial sector debt was about twenty times larger than in 1981. During the same period, the interest rate derivatives market increased nearly forty times. The rapidly growing asymmetry between the sluggish growth of the “real” economy and that of the financial sector raises serious questions about the social cost of the “pollution” caused by the systemic tail risk created by privileges granted to the financial actors and imperfections of the market regulatory schemes. Even “insiders” in the financial industry recommend examination of the costs of investment banking “pollution” and the role of regulations in tackling this externality.

24 Compare the description of J.P. Morgan’s tactics in Bear Stearn’s insolvency, by Roe, supra, note 2, at p. 8.
26 Netting agreements frequently give them a “wait and see” option.
27 Ibid., at p. 16.
II. Post-Crisis Developments

The obvious fact that benefits granted to the eligible parties in bankruptcy law are bestowed at the cost of the other creditors is usually discreetly disregarded by the advocates of special treatment of close-out netting agreements in insolvency laws. But in 1999 Federal Deposit Insurance Company presented a reform proposal according to which the bankruptcy priorities for the eligible financial transactions were to be limited to 90% of the relevant debt. The proponent of the reform in the US Congress pointed out that, if enacted, the law would put pressure on lenders financing even large firms to check what sort of shape the firm is in, because no one was paying attention to Lehman. This modest reform that required the privileged creditors to share only 10% of insolvency risk with all remaining creditors was effectively attacked by the ISDA and other advocates of the “too big to fail?” fortress. They argued that the proposal would reduce leverage and liquidity in the repo market, destroy close-out netting and limit the growth of shadow banking. These politically successful warnings that the derivatives and repos markets packed in close-out netting templates might collapse or shrivel without the powerful bankruptcy super-priorities show to what extent the rapid growth of these markets resulted from the privileged status and shifting of the risk onto other creditors rather than from their business ingenuity.

The financial crisis subjected the privileged status of the eligible financial transactions to a practical stress test. The basic assumptions of the policy makers and lobbyists of the special treatment of financial transactions have been, to put it mildly, undermined. However, the main reform passed by Congress “demonstrates how remarkable the neglect of bankruptcy is”. The Dodd-Frank Act established a new resolution regime for systematically important financial institutions that fall into insolvency but the new regulatory powers are outside the Bankruptcy Code. The Act borrowed a few provisions from the Bankruptcy Code (e.g. provisions modelled on fraudulent conveyances and preferences rules) but the new regulatory schemes that provide, inter alia, that swaps shall be traded by clearing houses, left the privileged status of the privileged credit 


The opposition to this modest reform proposal is described in detail by Roe, supra, note 3, pp. 30-31.

Skeel and Jackson, supra, note 2, at p. 2. The authors comment refers to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 113-203, cited as “Dodd-Frank Act”.

financial transactions in bankruptcy law largely untouched. It only provides for studies of bankruptcy law.

Both the Dodd-Frank Act and the proposals made by the Financial Stability Board (FSB), a platform of international cooperation of financial institutions in Bern, provide that all systemically important financial market infrastructures should be subject to effective resolution regimes which provide, inter alia, that the resolution authority should have the power to order a short stay, for example for a period not exceeding two business day. The FSB proposals recognise that termination rights under close-out netting could result “in a disorderly rush for the exits that creates further market instability and frustrates the implementation of resolution measures aimed at achieving continuity”. But it proposes cosmetic modifications of the privileged status of close-out netting. The modest competencies of the resolution authority include the powers to shortly stay such rights but only where they arise solely by reason of entry into resolution or in connection with the use of such resolution powers and provided that the substantive obligations under the contract and provision of collateral, continue to be performed. The resolution authority would be permitted to transfer all contracts covered by a close-out netting agreement (no “cherry-picking” powers). After such transfer and a short period of stay, the early termination right of the netting counterparty is preserved against the acquiring entity. If the contracts are not transferred to a “healthy” firm or a public entity, the early termination right may be exercised.

In the event the resolution authority transfers a cluster of contracts covered by a netting template, the transferee will assume all the rights and obligations of the transferor. Paradoxically, the privileged counterparty will be in a more advantageous position than before the transfer because it will be able to enforce all its contractual rights to a commercially entity or the public authority burdened with the task of performing all obligations of a “systematically important” but insolvent financial institutions. The achievement of the objectives set forth in the FSB proposals is highly doubtful. The cosmetic limitations on early termination rights of “eligible financial transactions”, combined with burdening the healthy “bridge” or public entities with all obligations of the insolvent entity, create a real risk of contagion when the privileged creditor

32 See §§ 202(c) and 216.
33 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011 at p. 42.
34 Ibid., at p. 41.
35 Ibid., at p. 41.
36 Ibid., at p. 42.
rushed to enforce its contractual rights. The declarations of continuity of systemically important financial services, and assurances of an orderly exit of non-viable firms and fair allocation of losses without exposing taxpayers to loss, set forth in the Preamble of the 2011 FSB proposals, are, putting it mildly, doubtful. The proposed powers for the resolution authority are much weaker than those of the insolvency administrator. The FSB proposals expressly adopted a key ISDA demand, namely, "no cherry-picking" powers should be granted to the resolution authority.\(^{41}\)

It is tempting to imagine what would have happened if the FSB-promoted rules had been in place during the recent financial crisis. Imagine such resolution authority decisions made during a 48-hour stay on whether or to whom the super-priorities of creditors of AIG, Bear, and Lehman should be transferred. Also, consider the contagion effect of J.P. Morgan terminating its contractual rights and disposition of USD 25 billion collateral against Goldman just hours after the short stay. Imagine the consequences of enforcement of termination and other netting related rights by counterparties directed against a carefully selected "bridge" company that would have assigned such a risky portfolio as that which burdened AIG in 2008.

In all fairness, at least one essential objective elevated in the Preamble of the FSB 2011 document seems to be realistic. The Preamble emphasizes that losses of insolvent financial firms should be allocated to firm owners (shareholders) and "creditors in a manner that respects the hierarchy of claims."\(^{42}\) Although, the privileged early termination rights granted to parties "in the money" by "netting friendly" laws are discretely not mentioned in the Preamble, privileges bestowed to financial contracts (collectively, early termination rights) retain their super-priority status in Annex IV of the FSB document. Thus, the quasi-feudal hierarchy of entitlements has been even strengthened, despite the lessons of the crisis.


In 2008, the financial industry supported by the ISDA, approached UNIDROIT, the oldest UN organization specializing in the field of harmonization of private law, with a draft proposal for a convention on close-out netting. However, UNIDROIT decided to postpone the adoption of the project. Several members of its Governing Council expressed doubts regarding the proposed idea of supporting the concept of unconditional enforceability of a laundry list of derivatives and swaps in case of insolvency of a counter-party to a close-out netting agreement. When the Governing Council reconsidered the project at its 88th session in 2009, some members raised concerns but a study group on the netting of financial instruments was set up at the next session of UNIDROIT in 2010. In May 2012, the Draft Principles and Rules on the Netting of Financial Instruments\(^{43}\) were presented to the Governing Council, along with the UNIDROIT Secretariat’s proposal to submit the draft of a non-binding instrument to UNIDROIT Member States for further consideration.\(^{44}\)

Whilst I share the proposition that harmonization of the close-out netting constitutes a reasonable objective and that the proposed rules are not ripe for elaborating an international convention, I had and I continue to have serious doubts regarding key proposed rules. My principal objections concern the proposed rules on enforceability of close-out netting and on formal requirements thereof.

Principles 4-6 of the UNIDROIT Draft Principles on Netting cover form requirements, use of standardized terms, and reporting obligations. They provide that the statutory formalities other than "in writing" requirements would hamper enforceability of netting provisions in a cross-jurisdictional context. Principle No. 6 proclaims that a failure to comply with a reporting duty "should not affect the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of the contracts and the close-out netting provision". I agree that the sanction of invalidity may be viewed as inappropriate, but the exclusion of all possible sanctions of enforceability and effectiveness against third parties of not only the netting agreements but also all the underlying contracts raises serious doubts. For instance, a sanction of ineffectiveness of certain high risk derivative instruments, until they are reported or registered in a public register, may undermine an effective supervision of the financial market by regulatory authorities. Furthermore, requirements of reporting and/or disclosure of such contracts, including those applicable to close-out netting provisions, promote transparency and protect legitimate interests of third parties (e.g. general creditors and customers of parties to close-out netting provi-

\(^{40}\) Ibid., at p. 3 (preamble).
\(^{41}\) Ibid., at p. 42.
\(^{42}\) Ibid., at p. 3.
sions). General creditors should be able to verify whether its current or future commercial counter-party is subject to a netting arrangement because this means that a cluster of its contracts is substantially exempt from equal treatment of creditors in the event of insolvency. Moreover, a netting provision may be concluded in breach of an earlier covenant.

During the works of the UNIDROIT Study Group on Netting, representatives of banks and the ISDA, and even some market regulators, argued that sanctions of ineffectiveness or inadmissibility in the event of a failure to comply with disclosure requirements would be inconsistent with the principle of speedy conclusion of financial transactions that are often made by phone or e-mail. In my opinion, “the deal done – bonus paid” canon of the current banking practice does not justify a recommendation that States should not introduce, for instance, a requirement of electronic reporting of certain high risk contracts to be recorded in a trade repository. Such requirements may be justified as a precondition of not the validity but only enforceability or effectiveness against third parties of some carefully selected high risk or large scale of transactions. The sweeping exemption proposed in Principle 6 covers not only the netting provision but all contracts covered by a close-out netting provision. The “no-formalities, deal done principle” is dangerous not only to third parties but also to the financial institutions. The myth of effective internal supervision by banks has been seriously undermined not only during the financial crisis but also recently.45

The UNIDROIT Draft Principles on Netting provide for very broad definitions of “eligible parties” and “eligible transactions”. The latter term covers not only a long list of financial transactions but also contracts for the sale or delivery securities, money market instruments, units in a collective investment scheme, currency, any precious metal or any other fungible commodity, and any other type of contract designated to that effect under the relevant law (Principle 3d) and e). This endless list goes well beyond “financial transactions”. The main justification that “financial transactions” are systemically important disappears. UNIDROIT Principles, if adopted, would encourage parties to enter into two or three artificially connected transactions in order to assure the non-defaulting party special treatment in the event of insolvency. In all likelihood, they will need ISDA members to prepare a netting package.

The enlarged list of eligible transactions set forth in Principle 3 speaks against the proposal proclaiming that States shall abstain from imposing sanctions of ineffectiveness and inadmissibility in evidence of certain derivative instruments and securities in the event of a failure of registration or disclosure of not only netting provisions but also the underlying contracts. Such sanctions may be justified for prudential reasons aimed at assuring transparency and protection of third parties. Publicly available information that a company is a party to a netting agreement is frequently more important to a potential counter-party than information that one or more of its assets are subject to a floating lien or mortgage. Ineffectiveness is frequently imposed by laws of OECD countries in case of violation of reporting derivatives and specific capital market transactions. Thus, for instance, a failure to disclose the transfer or acquisition of shares by a shareholder may even entail a sanction of invalidity of the transaction or the suspension of the right to exercise the voting rights from shares whose acquisition was not reported by the parties.46 The ISDA also discovered that Slovakia passed a new law which provides that certain financial contracts entered into with Slovakian public entities shall be disclosed under the sanction of non-enforceability as of January 2012.47 As a practicing lawyer, I was often confronted with clients’ questions about what the sanctions are for disregarding a reporting obligation. Many companies accept the risk of a fine in order to benefit from hiding a transaction. It is widely reported that investment banks are frequently willing to devise equity derivatives to potential clients as tools for secretly acquiring shareholdings in listed companies.48 Therefore, the sanction of invalidity or ineffectiveness is employed by legislators in order to assure observance of reporting/disclosure obligations.

During the works of the Study Group on Close-out Netting we have not analysed in depth the economic or systemic consequences of the proposal to recommend the elimination of the sanctions of ineffectiveness or a prohibition of any “enforcement requirements beyond those specified in the close-out netting provision itself” (Principle 7 a)). This sweeping exemption would disregard not only requirements of approvals by a judge during bankruptcy proceedings but also discourage the adoption of statutory rules providing that certain derivatives shall be traded by central counterparties (CCPs). Thus, UNIDROIT Principle

45 Following the lessons of affairs of Nick Nelson of Baring, Jerome Kerviel of Société générale, Kweku Adoboli of UBS, J.P. Morgan lost more than 5 billion USD due to improper supervision of high risk transactions which resulted in the sharp fall of the value of the bank’s shares until the discovery of the affair. So far, J.P. Morgan was viewed as a unique bank whose internal monitoring was almost perfect.

46 See, for instance, § 21(4) of the German Aktiengesetz and Article 6 § 3 of the Polish Code of Commercial Companies.

47 Werner, supra, note 18, at p. 54. Characteristically, the author, director of the ISDA, points out that such measures constitute a source of concern.

7(a) overlooks that regulators have been proposing, albeit with limited success so far, that a majority of derivatives should be moved to CCPs. The UNIDROIT draft seems to justify, subject to several conditions, that the competent authorities may only order a short "stay contractual acceleration or termination rights that may arise under a close-out netting provision" (Principle 8).

The UNIDROIT draft provides that "the law should ensure that the close-out netting provision is enforceable in accordance with its terms, before and after the commencement of an insolvency proceeding in relation to one of the parties. Without the generality of the foregoing – a) the law should not impose enforcement requirements beyond those specified in the close-out netting provision itself." (Principle No. 7a). In the opinion of the financial industry and ISDA representatives, this is the most important principle. However, it raises difficult policy questions. A plain language interpretation of this principle implies that the basic function of the legislators is to enforce close-out netting arrangements in accordance with their terms. In other words, States should refrain from imposing any enforcement requirements or mandatory rules in this field. Such radical limitations of legislative powers is fully consistent with the ISDA Guide for Legislators that advise States to pass "netting friendly" laws that should remove obstacles to robust enforcement of the favoured contracts. These "primary obstacles" include insolvency laws, mandatory provisions enacted for the protection of debtors or certain categories of debtors outside insolvency laws, general principles of contract law and gaming laws. Thus, ISDA legislative proposals not only treat some general principles contract law as "obstacles" but recommends that netting agreements and the underlying contract should be insulated from restrictions concerning gaming laws.

Comments to the UNIDROIT Draft, Principle No. 7, try to qualify the textual interpretation of the proposed rule explaining that "close-out netting is not shielded against every rule of commercial or insolvency law". Some official comments to the UNIDROIT draft note that close-out netting provisions would not be allowed to trump certain other fundamental rules, for instance, those relating to misrepresentation, fraud, or actio Pauliana. However, Principle 7 expressly provides that the operation of the close-out netting should not be impaired by principles of equal treatment of creditors or the constructed fraud con-cept when the defaulting party makes payment or gives preference on the eve of its insolvency.

It is worth mentioning that leading restatements of lex mercatoria and the law of contracts stress the principle of freedom of contract but also contain an important qualification that the autonomy of the parties is limited by the public policy mandatory laws and the parties may exclude or modify the application of the soft law principles, except as otherwise provided therein. Such limitations are totally disregarded in the UNIDROIT Principles on Netting. They emphasize only the freedom of contract principle because it is convenient to ISDA members but fail to encompass any rule aimed at protecting the public interest or eliminating practices which are basically unfair and have been held unenforceable in leading jurisdictions. Several members of the Study Group argued that the UNIDROIT Principles should address the issue of walk-away clauses which provide that the net payment is payable only to the party that terminated the netting agreement but no payment at all should be paid to the bankrupt estate, even if it is a net creditor. Such a drastically unequal treatment of parties would be permissible under UNIDROIT DRAFT Principle 7. By contrast, US and EU laws treat "walk-away" clauses are unenforceable. The majority of the Study Group has also decided to drop the issue of limiting a non-defaulting party's indefinite "power to wait and see". Certain netting agreements grant the non-defaulting party the right to withhold payments upon the default of its counterparty while at the same time not allowing the defaulting party to terminate the contract. It is worth contrasting this approach with the ISDA criticism of the bankruptcy administrator's powers to delay its decision to assume or reject contracts and its argument that a temporary stay ordered by a resolution authority should be limited to a maximum of two days, even in the case of insolvency of a systematically important financial institution.

The ISDA frequently justifies its proposals aimed at assuring its members a right to "jump the queue" during insolvency and retain eve-of-bankruptcy fraudulent conveyances by pointing out that the powers of the administrator of the estate to assume or reject the debtor's con-

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41 UNIDROIT – C.D. (91) 5(c) Add. 1, p. 19.
42 Ibid., pp. 19-20.
43 See, for instance, Articles 1.4 and 1.5 of the UNIDROIT Principles of International Contracts and Article 1.102 of the Principles of European Contract Law.
44 See, Doc 4, p. 13.
45 § 210 (c) (8) (F) of the Dodd-Frank Act and Annex III, Section 3(b) iii of the EU Directive 2000/12/EC of 20 March 2000.
46 Compare Werner, supra, note 14, at p. 50.
tracts amount to arbitrary “cherry picking”. But it is worth contrasting these powers of “cherry picking”, exercised in the interest of the estate and all creditors, with the “netting friendly” laws that grant super-priorities principally in the interests of the financial industry. Indeed, ISDA lobbying efforts are basically not aimed at assuring “cherry-picking” privileges for its members but to secure them a whole “piece of the cake”. To achieve this objective, the ISDA supported a long list of lucrative transactions, insulated from equal treatment of creditors. The UNIDROIT list of “eligible transactions” proposed by the ISDA extends beyond financial transactions and covers, inter alia, contracts for the sale or delivery of currency, gold, silver, platinum, palladium, or any other precious metal, and any other fungible commodity. The foregoing list of “mega-exceptions” to bankruptcy law disciplines, has little in common with the “systematically” important financial transactions. On 9th May 2013, the Governing Council approved the Draft Principles elaborated by the Committee of governmental experts subject to a few critical voices.

3. Patent and other Intellectual Property Rights

A. ACTA and the New EU Patent Package

Over the last 40 years, we have witnessed a significant strengthening of intellectual property rights. It was in the mid-1980s, particularly as a result of US pressure and subsequently due to the standards established under TRIPS, that the majority of its signatories had to incorporate laws ensuring effective protection of patent and other intellectual property rights. It soon turned out that the net beneficiaries of the new rules were firms from the US and a few other developed countries, whilst their markets have remained closed or difficult to penetrate by exporters of agricultural products and industrial goods from developed countries. In the course of the last two decades Intellectual Property Alliance continued its lobbying efforts aimed at extending the scope and duration of IP rights and sanctions for their violations. Recently, however, these repeated blanket extensions of patent and copyright terms have met with growing criticism in the US and EU. The phenomena of “patent thickets” and “patent trolls”, coupled with a rapid increase in litigation, prompted even the Supreme Court of the United States to limit to some extent the traditional “patent friendly” interpretation of patent laws.59 Below, I will briefly discuss two interrelated questions: Do newest initiatives of the advocates of strengthening IP rights equally treat large firms and SMEs? Is the process of lobbying sufficiently transparent?

The Anti-Counterfeiting Trade Agreement (“ACTA”) is a multilateral agreement. It was secretly negotiated and signed almost exclusively by developed countries.60 Although ACTA is aimed at beefing up TRIPS, it was negotiated outside the WTO forum because the signatories were afraid that developing countries would this time demand trade concessions. Whilst the obligatory provisions of ACTA largely overlap with those of the EU directives, some of the ACTA provisions on criminal sanctions are not clear and conflict with freedom of information and privacy rights guaranteed by some Member States.61 Numerous academics deplored the fact that the ACTA initiative was a “club approach of like-minded countries which excluded other globally important partners (e.g. Brazil, India, China and Russia) in the effort to impose agreed rules via bilateral agreements”.62

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

But the phenomena of secrecy, lack of transparency and proper representation of all interested parties during negotiations aimed at bestowing new economic privileges have continued apace. The current negotiations of a draft agreement for the unitary EU patent, and a draft agreement for a Unified Patent Court provide another illustration of this

57 Principle 3d.
60 They are Australia, Canada, Korea, the US, Japan, Morocco, New Zealand, Singapore and the EU.
62 Ibid., at pp. 53-55.
trend. Basically, the long discussed idea of a unitary patent covering the entire EU market is sound, despite the fact that it will create new imbalances and strengthen the competitive positions of a few of the most developed EU economies, as well as innovative firms from the US and Japan. New Member States ought to be prepared to make reasonable sacrifices in the interests of a long-term development of the single market. However, they should not be expected to support a new patent project which is deeply flawed and unduly favours mainly large patent owners. First, inevitable imbalances will increase because the project provides that the new unitary European patents covering 25 EU Member States will be granted in English, French and German. Thus, the hitherto universally followed requirement that a monopoly right be granted in exchange for the disclosure of the best method of practicing the invention and that, in principle, its specification should be published in the official language of the jurisdiction where protection is sought will be abandoned in the interests of the most advanced EU Member States and third countries whose official language is English, French or German (e.g. the US, Canada and Australia).

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

The third important principle respected in the EU conventions to date (namely, that a defendant shall be sued in a local court and may have to defend his/her case in the local language) will be also abandoned. The importance of the official language is illustrated by the fact that a compromise Spanish and Polish proposal suggesting the use of one official language (i.e. English) was rejected by those countries whose official languages are German and French. The need to use a foreign language means that the patent system’s information function will not be fully satisfied. It will also cause lack of legal transparency, which favours foreign patentees not only by giving them the said legal privileges but also forcing other market actors to operate at the risk of patent infringement. This is not only because the UK, France and Germany, the main beneficiaries of the new language regime, will be exempt from the traditional requirements of publication and conducting legal proceedings in the official language of the territory where the exclusive right is sought or enforced. The consequences of the new uniform patent package are best characterized by H. Ulrich: “[T]he language regime produces direct and indirect costs over the lifetime of a patent for those who are not at full ease with its language, and it favours those who are familiar with it. It distributes advantages and disadvantages (...) it enables the linguistic beneficiaries (...) to cover the entire EU-market, including the language territories of the non-beneficiaries by an exclusivity at no extra cost, extra effort of care and risk avoidance, which the non-beneficiaries seeking EU-wide act exclusion are asked to cover extra costs, which other members of the majority are not willing to make themselves”. As in the case of the bankruptcy super-priorities, the new language regime not only bestows legal privileges for the strongest business actors but also shifts the costs of the reform to their weaker competitors.

Fourth, several prominent patent law experts demonstrated that the reduction of translation costs, advocated by the proponents of the uniform project, will mainly benefit a relatively small number of dominant firms which seek to obtain a large number of patent applications. These imbalances will be exacerbated on the level of Member States whose official language is English, French or German, in particular, those States where the three branches of the Unified Patent Court will be located (i.e. Paris, Munich and London).

Hundreds of experts, including some Member States, criticized the new patent package, citing major gaps, lack of legal clarity and doubts regarding the process of recruitment of competent judges to be appointed to the new patent court. Even the basic rationale for the new patent system, namely lowering costs of obtaining patents, is being challenged. During the Polish Presidency (i.e. the second half of 2011), a promise was made “to allow all Member States that they keep their current renewal fee income while at the same time ensuring that those Member States which currently have a low renewal fee income will significantly

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64 The European Patent Office in Munich grants roughly half of its patents to US and German firms, and about 2% to applicants. Italian firms obtain about 3% of these grants. Polish firms received about 0.03% of such patents in 2011.
65 Italy and Spain, whose R&D potentials are much stronger than those of Poland and other new Member States, refused to join the new patent project and challenged it before the Court of Justice.
67 Ibid., at pp. 21-22.
68 Ibid., pp. 13-14. The criticism that the largest firms will be the main beneficiaries of the project while advantages for SMEs are delusive was also expressed in the House of Commons of European Scrutiny Committee document: The Unified Patent Court: Help or Hindrance, HC 1799 (3 May, 2012), pp. 26-29, 39-41.
increase their renewal fee income”. Thus, if the patent renewal fees income of some Member States remain the same and fees of other EU countries significantly increase, the promise that the SMEs will pay less cannot be true. The majority of SMEs are interested in obtaining patent protection only in their domestic markets or in a few countries but they will bear the costs of obtaining patents and renewal fees in the whole European Community.

Fifth, the new EU patent package will multiply transaction costs resulting from the unclear coexistence of three types of patents in the uniform market: (i) the new European patents with unitary effects granted in 25 countries, (ii) the “old” European patents granted by the European Patent Office in Munich (the latter monopolies constitute a “bundle” of national patents designated by the applicant), and (iii) purely local patents issued by national patent offices. Such an unusual combination of exclusive rights will lead to a multiplication of the number of patents in every EU country, thus multiplying so-called “patent thickets”, where “patent trolls” will be able to bring infringement suits also against SMEs. Many defendants will not be able to defend their rights in a foreign language and before a court located abroad. Even in countries where only one type of patent is available, the proliferation of patents due to unduly liberal standards of “novelty” and non-obviousness harms the public creating “innovation gridlock”. Today, companies compete more in the courtroom than in the market place. Patent “thickets” are particularly harmful to start-ups. A top European IP expert stresses “the unitary patent has been conceived of by interested circles mainly for the new forms of portfolio or pool based exploitation of patents as assets sold or licensed on standard terms by patent subsidiaries of large firms. The unitary patent virtually is not subject to any public interest lien (…)”.

Not surprisingly, the negotiations of the European patent package were conducted largely in secrecy. Opinions of industry, especially SMEs, university circles and judges, were disregarded. Dr. J. Pagenberg, a member of the EU Commission’s Committee of Experts, withdrew from this body at the end of 2011. He protested against negotiations behind “closed doors”, the refusal to disclose drafts of the negotiated documents and refusal to address the questions and proposals made by future users of the system. Pagenberg also concludes that, apart from numerous imperfections, the EU patent package takes into account the interest of the multinational corporations only, and disregards those of SMEs and individual inventors. The latter users of the new system should be able to apply for uniform protection in a few countries of their choice, “combined with an efficient and affordable court system close to home and their local language”. The EU patent package was adopted in 2013 when France, Germany and UK agreed that the Unitary Patent Court (“UPC”) would be split into three central divisions located in Paris, Munich and London. Bulgaria, Poland and Spain have not joined the project. Spain instituted a challenge before the Court of Justice alleging that the EU patent project violates Art. 118 of the Lisbon Treaty. Whilst the doubts regarding the costs of the new EU patent system for stakeholders, in particular SMEs, are growing, benefits for the economies of the three countries that will host the branches of the UPC show an interesting distribution pattern. A recent publication of the UK Government indicates that the unitary patent will lead to direct benefits to the UK business of up to £40 million per year while the location of the UPC branch in London will benefit the economy up to £200 million per annum. The important point to note is that an inquisitive journalist discovered that the latter large sum represents additional income expected by the UK legal profession which was generally critical of the EU project until London has become the host of the pharma division of the UPC.

4. Bilateral Investment Protection Treaties and Arbitration (BITs)

I subscribe to the view that sees investor-protection institutions to be very important to industrial development. Judicial and administrative institutions that efficiently protect property rights and investments are prerequisites of sustainable development. But bestowing special privileges to foreign investors undermines the fundamental principle of equality of business actors and discriminates local business. Moreover,

70 IPhone, uCopy, iSue, “Not every innovation deserves a patent”, The Economist, 1 September 2012, at p. 9.
71 Ullrich, supra, note 66, at p. 57.
72 Pagenberg, supra, note 69, pp. 2 and 17-19. Professor Nowicka, who teaches intellectual property at A. Mickiewicz University (Poznań), showed me a reply from the EU Commission. The enclosed text of the uniform patent package contained only the Preamble and titles of all chapters, with the remaining contents deleted. Her criticism of the secrecy of the negotiation process echoes reservations made by Pagenberg and Ullrich.
73 Ibid., at p. 22.
it encourages the most efficient domestic firms to “emigrate” abroad at least by way of investing shares in their domestic companies in foreign held parent companies, thus obtaining a privileged status under the protective umbrella of BITs. It also transfers wealth from emerging markets to capital exporting countries.

In 1905, the US Secretary of State, E. Root, a Peace Prize Winner, argued that foreign investors cannot demand more rights that their local competitors: “When a man goes into a foreign country to reside or to trade he submits himself, his rights, and interests to the jurisdiction of the courts of that country (...). It is very desirable that people who go into other countries shall realize that they are not entitled to have the laws and police regulations and methods of judicial procedure and customs of business made over to suit them, or to have any other or different treatment than that which is accorded to the citizens of the country into which they have gone; so long as the government of that country maintains, according to its own ideas and for the benefit of its own citizens (...).”75 The Calvo Doctrine provided that foreign investors may not seek protection abroad. A resolution of the General Assembly of United Nations of December 12, 1974 incorporated essential aspects of that doctrine in the Charter of Economic Rights and Obligations of States. But the BITs have completely reversed these legal standards. They have established preferential legal standards aimed at granting special status to foreign investors. Their privileges involve, inter alia:

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

- protection by a plethora of capacious and sweeping clauses such as “fair and equitable treatment”, “the MFN treatment”, “full protection and security” and assurances of “justified expectations of the investor”.

As admitted by the arbitral tribunal in EURECO v. Slovakia,77 these concepts do not mirror protection available under EU Law. Several arbitral tribunals have held that the host country may not introduce legislative or other measures against “justified expectations” of the investor. Some courts of capital-exporting countries have issued decisions which have contributed to a deepening discrimination of host

countries in arbitration fora. For instance, the Paris Court of Appeal gave a very broad meaning to the term of “foreign investment” as “any kind of asset invested in connection with economic activities”.78 Moreover, the court ruled that a legal action taken by the Czech Republic against the investor who concluded a lease contract in violation of Czech mandatory law amounts to a breach of a fundamental right of the foreign investor “such as the right to legal security that the state must provide under fair and equitable treatment and under which investors’ legitimate trust and expectations must be protected”.79 This shocking decision amounts to a proclamation of a new investor’s right consisting in dispensing him from respecting the host country’s laws and imposing a duty on the host country to abstain from taking legal action against the investor.80 The Paris Court of Appeal explained that filing a legal action violated the investor’s “legitimate trust and expectations” protectable under the BIT, regardless of its legitimacy under Czech law.81

BITs are incompatible with the host country’s constitutional principles of equality of business actors. Intra EU BITs are difficult to reconcile with Article 18 of the Treaty on the functioning of the European Union because they discriminate against firms from those Member States which do not benefit from such treatment in a given EU country. The Czech Republic brought a case before the EU Tribunal arguing that BITs are inconsistent with the Lisbon Treaty. Several authors and NGOs criticize the substantive law and procedural privileges granted to foreign investors.82 Several World Bank and UNCTAD studies demonstrate that there is no evidence that the BITs materially increase foreign investment.83 Critics of BITs point, inter alia, to the contrast in the economic

76 As quoted by P. Duprey, at p. 603.
77 A commentator rightly stressed that enforcement of one’s right is recognized by French courts as a fundamental constitutional right but it was refused to the host country because the Czech Republic failed to prove that the arbitral award violated international public policy.
78 Ibid.
80 Ibid.
performance of Argentina, a country that was persuaded to execute more than 40 BITs and was exposed to dozens of foreign investment suits, and that of Brazil which has refused to sign such agreements.

5. Concluding Remarks

How can one explain the fact that policy decision makers are so easily “captured” by vested interests groups, despite the lesson of the recent financial crisis and evidence presented in studies that demonstrate the adverse consequences of departures from the principle of equal treatment of business actors? First, the power of lobbying organizations representing financial institutions, top intellectual property firms, and capital exporting countries, stems from their financial resources and political leverage. Thus, the invisible hand of the market has been gradually replaced by the visible hand of the lobbyist.

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

Third, policy makers and executives of international organizations where economic reforms are prepared, and even market regulators, are usually inclined to approve proposals submitted by well-organized industries. My own hindsight teaches that the “gatekeepers” are usually recruited from the ranks of the supervised industries. Frequently, those officials dream of being hired by the industry they regulate. Moreover, officials of central banks and other market regulation authorities are often persuaded that granting privileges to firms in the sectors of economy subject to their control will assure a smooth functioning of the relevant sector.45

International organizations equipped with the task of preparing re-form proposals and new conventions should try to avoid the trap or even avoid creating the impression that their fora are used to promote vested interests. When certain initiatives are financed by organizations representing vested interests and their recommended experts are paid from such sources, the host organization should at least assure the presence of reputable critics of the industry proposals. At a minimum, the opposing views should be considered and given thorough explanations in a final

report. Unfortunately, both in the case of the recent EU patent package negotiations and works on UNIDROIT Principles on netting, these standards have not been observed. The subsequent studies, and the final explanatory memorandum accompanying the UNIDROIT Draft Principles on the Netting of Financial Instruments submitted to Member States do not contain a single reference to critical legal and economic studies of netting super-priorities, despite specific requests made during the works of the Study Group.46 Such organizations like UNCITRAL and UNIDROIT are underfinanced and their executives are in a difficult situation. During the recent Uniform European Patent negotiations, the EU Commission explained that the opinions of hundreds of law professors, judges and SMEs were dismissed as the voice of alleged lobbyists or “interest parties”.46

The problems with the close-out netting priorities, extensions of terms of protection of IP rights, and the recent uniforms European patent package is not that the two pertinent industries do not provide social benefits but that the new privileges are coupled with transferring costs to other business actors and consumers without solid cost analyses. Just like other critics of the bankruptcy superpriorities, I recognize the advantages of the close-out netting but I also see the pernicious effects of the sweeping bankruptcy privileges which enable sophisticated market actors to jump the queue of creditors in the event of their counterparty insolvency.47 Whilst some special rules are justified (for instance, the treatment of a bundle of contracts covered by a netting agreement as a functional unity that should exempted from “cherry picking”), preferences on the eve of bankruptcy should be abolished and other privileges curtailed. Unfair covenants, such as “wait and see” and “walk away” clauses, should be prohibited. If the close-out netting agreements are equally important as the core banking business, then all repos and derivatives players should contribute to a special guaranty fund protecting taxpayers from the burden of bailing them out in case of insolvency. Without compelling evidence to the contrary, netting eligible transactions should be treated like other transactions. The list of “eligible transactions” shall be curtailed and sanctions for breach of transparency requirements should be effective.

Similarly, owners of intellectual property should learn from the lessons of ACTA and the EU unitary patent negotiations. Demanding

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

46 However, the UNIDROIT Governing Council recommended that the Chairman’s critical observations be included in the materials submitted to UNIDROIT Member States.

47 Pagemer, supra, note 69, at p. 2.

48 Roe, supra, note 2, at p. 38.
exclusive rights of unduly long duration and special remedies that are not available to holders of other property rights have already resulted in massive protests of consumers and the establishment of political parties promoting piracy. Criteria for granting patents shall be rigorously applied to avoid a proliferation of exclusive rights. Sham patents harm the public in many ways. They create innovation "gridlocks" and multiply costs by forcing firms to fight in courtrooms, instead of in the market place.\footnote{See iPhonc, iCopy, iSue, supra, note 70, at p. 9.}

A return to the principle of equal legal treatment of business players, subject to justified exceptions, constitutes an essential ingredient of a meaningful reform. Hitherto privileged segments of the economy, in particular the financial sector actors, should be most interested in such reform if they believe in free competition on an even playing ground and in diminishing the perverse incentives to make fast-and-hard deals without carefully checking the financial conditions of their counterparties relying on the bankruptcy super-priorities. For the financial industry, whose services and products are absolutely vital for the modern economy, it is also a prerequisite for recovering the confidence and respect of the public.

To date, meaningful reforms have stopped half-way and the elimination of the privileges constitutes the most difficult issue. Paradoxically, the UNIDROIT Close-Out Netting Project and the drafts of the EU uniform patent proposals demonstrate that industries having vested interests in the status quo try to "capture" the policy decision makers and obtain new privileges or "dilute" reforms. They defend the old privileges with the vigour of the French aristocracy that resisted reforms before the French Revolution and the Polish nobility that defended their privileged status before Poland's partition. Both groups were very much attached to their privileges and were also deeply convinced that they were "too powerful to fail" and "systemically important".

There are signals that some executives of the financial industry see the need to implement reforms that require sacrifices. Sandy Weill, the founder of the modern Citi Corporation, the largest global universal bank, publicly supports the Volcker rule that requires separation of investment banking from traditional core banking. Support has been growing for similar "ring-fencing" proposals in Europe (e.g. Vicker and Liikanen twin initiatives). Leaders of Citi (V. Pandit and M. Corbat) have been restructuring this universal bank with the aim of strengthening the role of the traditional banking and reducing the risky derivatives-trading.\footnote{Financial Times, 20 August 2012.}

P. Singer, the Chairman of Elliot Associates (a lead US hedge fund) and a top contributor to Governor Romney’s election fund, has recently outlined proposals for a deep reform of the banking system that goes beyond the Volcker rule.\footnote{Ibid., Capitalism in Crisis, Financial Times, 6 February 2012.} He concluded that "conservatives who believe in free markets should also believe in sound fair markets".\footnote{Financial Times, 16 August 2012.} N. Lawson, the UK’s chancellor of the exchequer in the 1980s, also sees that the twin doctrines of “too big to fail” and “systemic importance” undermined market discipline, and fostered greed and incompetence in the financial sector. Industry leaders should realize that reforms imposed from outside are usually more painful and frequently implemented too late.