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International organized business fraud – the practice of money laundering



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Introduction

The organized business fraud is a real and extremely dangerous phenomenon in the contemporary world. The level of knowledge of business fraud is not adequate to the danger it poses. The public is still perceiving the business fraud in terms of stereotypes.

The purpose of this Paper is to show that the organized business fraud is an area of extremely complicated structure spreading to different categories of criminal acts. In the world, there are many forms of organized crime. Forms and types of a given crime involve a different historical background as well as social and economic conditions for springing up of criminal organizations. In individual countries, the organized crime has a diversified nature. These differences are primarily due to local factors which translate into the ways and areas of criminal activity.

Organized crime is currently common not only in countries like USA or Italy, but is present throughout the world. We meet with organized crime in both well developed countries (Western Europe, China, Japan) and developing countries (Latin America, Asia, Africa).

Increasingly often, organized crime has the international nature and groups active in different parts of the world are to a greater or lesser extent linked with each other and undertake joint criminal ventures.

It is important that while cross-border legal aid is provided by professional attorneys they are aware of the fact that the present stage of organization of criminal groups is showing by, inter alia, entering into criminal arrangements with representatives of public administration bodies of higher and higher level, politicians, involving high class specialists in criminal activities, e.g. tax and investment advisers, lawyers of reputable law offices, employees of IT companies, technically-oriented scientists, bankers.

Organized crime is striving to create mutual links between the legal and illegal sphere of the domestic economy. A peculiar security zone is created around criminal organizations being made up of various advisers, officials or financiers. The purpose of such security zone is to take advantage of legal loopholes, liberalism of legal decisions and economic rules.

The organized business fraud can entirely or partly coincide with legal economic or political structures of one or many countries.

The essence of money laundering consists in taking action aimed at putting into legal commercial or financial circulation of the money or other legal tender, securities or more generally property derived from criminal activity or other illegal sources.

Thus, professional attorneys may become a tool of uneven and merciless activities of criminal groups operating in the international arena and orientated to carrying out all activities related to money laundering.

This study points out to general threats ensuing from the extension of territorial range of activities of criminal organization members. In particular, areas will be shown where money laundering can be carried out as well as international legal regulations with respect to a definition of organized crime. In addition, in order to give a brief outline of the Polish legal system, the Polish legal regulations will be referred to providing penalties for activity within a criminal association.

By crossing the borders of one country, organized crime has become a part of globalization processes making it important for the awareness of money laundering practices among the public to be the greatest possible, particularly among those persons whose profession often requires them to take action of the cross-border nature.

I. Definition of organized crime

To include particular offences in the definition of organized crime is a very controversial and complicated problem on account of a diversity of crime forms.

All attempts to define organized crime cropping up in the international doctrine of law have taken two directions. The first one, supported by representatives of Interpol, is to define organized crime by pointing out to three elements: **corporate structure, activity aimed at making a profit and activity of an illegal nature**, involving intimidation and corruption. This approach to the definition of organized crime was based on the analysis of Sicilian criminal organizations and the American Cosa Nostra.

Another approach to the definition of organized crime is based on the **analysis of threats resulting from such crime**, therefore taking account of the significance of the problem and transnational nature of crimes committed by criminal organizations as well as pointing out to specific criminal acts – terrorism, drugs trafficking, arms trade and slave trade, crimes against the environment and cultural

legacy, computer crimes, corruption, legalization of proceeds derived from crimes.

The assumptions underlying the second approach to the definition of organized crime are based on the concept of *criminal enterprise* and predominantly borrow terms from economics to describe the conduct of members of a criminal association.

In my opinion, both approaches to an attempt to define organized crime taken individually do not produce an in-depth definition. At the same time, attention should also be given to the forms that the organized crime can take (the phenomenological element pointed to by, among others, H.J. Schneider).

Analysis of the forms of organized crime is based on presentation of criteria for determination of distinctive features of organized crime – the structure of needs of every society, selection of activity, unwritten code of criminal organization members.

In view of the foregoing, it has to be pointed out that only the compilation of features distinguishing organized crime considered as part of the above approaches can produce a consistent and complete range of behaviours involved in the concept of organized crime.

The United Nations Convention against Transnational Organized Crime of 15 November 2000 introduces a definition of a prescriptive nature.

Pursuant to Article 2a of the United Nations Convention against Transnational Organized Crime, “*an organized criminal group shall mean a structured group of three or more persons, existing for a period of time and acting in concert with the aim of committing one or more serious crimes or offences established in accordance with this Convention, in order to obtain, directly or indirectly, a financial or other material benefit*”.

Among the main characteristics of this kind of crime, the European Commission rates: cooperation of at least three persons existing for a longer or unspecified period of time; perpetrators suspected or sentenced for committing serious criminal offences; activity aimed at obtaining a benefit or seizing power. In addition, the following is mentioned: performance of a specific task or a specific function by each of the members of a group, the use of various forms of internal discipline and control, the use of violence or other means, in order to intimidate, wield influence on politicians, administration of justice, economy, media by corruption or application of other means, the use of business structures, money laundering, the carrying out of activities on an international scale.

The above features of organized crime are also presented by the Council of Europe's Group of Specialist on Organized Crime.

Many forms of criminal activity can be singled out in the international operations of organized crime. Among these, the three are essential:

- money laundering
- corrupt practices
- drugs trafficking.

While estimating factors that determine organized crime, the main tendencies can be pointed out in activities of modern criminal groups. In particular, these are:

1. the merging of different categories of crime within one criminal group. The focus of interest of a criminal group is dependent on the market situation, contacts and personal, financial and marketing potential, technical equipment etc, thus making organized crime become a bridge between common crime and business fraud;
2. improvement in methods of operating in different sectors of economy and social life. This results in creation of new criminal mechanics repeatedly taking advantage of "loopholes in the law" and imperfections in the control system;
3. accumulation of illegal capital and practice of money laundering by means of the financial system;
4. internationalization of criminal groups and expansion of territories controlled by individual criminal groups;
5. entering into criminal arrangements with representatives of the public administration bodies of still higher level, politicians, involving the first-class specialists in criminal acts, e.g. tax and investment advisers, lawyers of reputable law offices, employees of IT companies, technically-oriented scientists, bankers;

6. corruption of government officials, Prison Service officers, prosecutors, employees of tax offices.

Thereby, it has to be noted that the catalogue of criminal acts does not have the character of a complete list especially as organized groups are often involved in a variety of crimes turning their interest to all activities bringing in a profit. The types of crimes mentioned above and backed up by statistical data are only examples serving as an illustration of the areas of activity of organized groups. It is still extremely difficult to compile the so called *dark list of crimes* per different type of crimes committed by organized groups but the extent of such crimes is extremely large.

Let us add that in accordance with the opinions widespread among the public, organized crime is associated with armed robbery, drugs trafficking or extortion of protection money. You couldn't be further from the truth. It is just organized business fraud (so called white-collar crimes) that poses a great threat to the interests of the State Treasury, jeopardizes interests of all participants in economic circulation (not only material interests), both entrepreneurs and consumers.

Moreover, such type of crime gives rise to the loss of confidence in the economic system, particular institutions and has a considerable influence on the international economic policy of the state. Obviously, the fact that pathological ties of corruption are created by members of business fraud organizations should not be passed over, which ties undisclosed and unpunished have become the disease of the globalized society of the 21st century.

II. The practice of money laundering

1. Business fraud, organized crime versus the practice of money laundering

Business fraud has been distinguished from the group of criminal acts particularly on a perpetrator's account. E.H. Sutherland introduced the concept of white-collar crimes which crimes are characterized by the fact that the perpetrators have been well-respected persons in society enjoying high social status and simultaneously have been engaging in criminal acts as part of their business activity.

The subjective concept of business fraud has next been criticized by supporters of the objective concept, i.e. attempt at distinguishing business fraud on account of the acts committed by perpetrators. Thus, the definition has been conceptualized being orientated towards the act, and not the perpetrator.

The criminological concept of defining business fraud points to the features distinguishing organized crime:

- occurrence of substantial material and non-material losses;
- absence of the element of violence making it possible to conceal business fraud under the pretext of legal activities,
- the aggrieved parties are not only the undisclosed natural persons but also the whole branches or institutions of the economic and financial system (the consequence of which is the impression of there being no casualties);
- a significant number of perpetrators come from the upper middle class – the feature being manifested by a good professional background for the commission of crimes and deep awareness of perpetrators' rights in possible lawsuits.

Those from among business frauds should be distinguished which are linked to organized crime. The features linking both phenomena are:

- generation of high losses on a worldwide scale in connection with extremely high profits of criminal groups which are then invested in further criminal activity as well as legal investments;
- penetration of criminal group members into the state, administration, economic structures and international organizations;
- long period and recurrence of criminal acts,
- organized nature of operations – planning, preparation, completion;
- secret nature of criminal activities making both legal and illegal acts similar.

Organized business fraud is often closely linked with laundering of money derived from another type of criminal activity but in many cases the latter makes a separate field thereof.

Legalization of proceeds derived from criminal activity is the subject of EU legal regulations and international conventions and subject to penalization under provisions of the Polish law.

Money laundering is an extremely harmful phenomenon first of all threatening the freedom of economic circulation. This practice demonstrates great mobility on the international scene. The manner and scope of the organized crime activity is often comparable to the lawful activity of international concerns.

Organized crime is favoured by the freedom of migration of people, transfer of goods and services guaranteed by the Treaty on European Communities and progressive liberalization of capital movement all over Europe and worldwide.

The threat to the contemporary world economy is that after being “legalized” proceeds derived from crimes (e.g. by establishment of new business entities) are being invested both in entertainment, building services, casinos, professional sports as well as material goods, real estate, luxury goods. Such investment of proceeds derived from crime is a particular investment for the future.

In the European doctrine of criminal group behaviours, it is pointed out that diversification of the investment portfolio of criminal groups is a sign of protection against a situation where as a result of administration of justice members of criminal organizations would be deprived of a portion of proceeds derived from crime. Moreover, by spreading the risk of losing proceeds derived from crime among many entities criminal groups are investing in legal business.

The aforementioned activities are aimed at converting the capital accumulated by the commission of criminal acts into the legal forms of investment. Giving the proceeds derived from crime the appearance of legality criminal groups can register their “legal” activity with tax offices or other administrative bodies.

In view of the above, **by money laundering a succession of activities should be called being aimed at giving the capital derived from crime the appearance of legality.**

2. How money laundering is carried out

Money laundering is substantially facilitated, *inter alia*, by:

- imperfections and loopholes in the law;
- failure of the employees of the banking sector to do their duties;
- errors in combating the practice of money laundering;
- absence of an agreement between financial institutions;

Here, phases of the practice of money laundering will be outlined – initial phase, placement, camouflage, integration.

Initial phase is connected with the fact that most often the proceeds derived from crime are being laundered in a country other than the country where such proceeds funds have been generated. A high profit may become a subject of control proceedings conducted by tax authorities which in consequence may lead to the disclosure of proceeds derived from crime. And so, physical reallocation of the capital from the place where it has been received to another country may increase the probability that the source of income will not be disclosed. In the initial phase, the following forms of reallocation are singled out being connected with crossing borders:

- transport of cash;
- transfer in the form of consumer goods;
- direct electronic fund transfers;
- compensation;
- indirect banking.

The real first stage of money laundering is a **placement**. This stage consists in actually placing cash revenues from illegal sources in the financial system. The placement is favoured by the evasion of financial regulations relating to the registration of payments of a specified amount or suspicious transactions.

The most popular form of placement is to make a big number of deposits below the limit requiring a given transaction to be registered (smurfing). Shop smurfing consists in a purchase of consumer goods being made abroad by groups of a few persons; then the goods are being sent to the country of origin of the illegal capital and sold there while profits are paid into a bank account as an income from sales.

Therefore, placement will predominantly consist in *structuring* – breaking the whole big amount down into many smaller amounts which will not be subject to the registration procedure.

The laundering of dirty capital can also be carried out by establishment of a business entity for the sole purpose of legalization of the proceeds derived from crime (*shell accounts, shell corporations*) by outsiders, fictitious persons or members of criminal groups.

A frequent occurrence is also a hostile takeover of a given institution in order to cause it to become bankrupt and go into liquidation. Such takeover allows to misuse the list (limit) of the transactions that are exempted from registration which exemptions exist in the legislation of some countries and are reserved for a specified category of financial institutions (*exempt transactions*).

Another form of placement is blending – a mixing of the capital derived from crime with a legal source of income. This form is favoured by carrying out business activity in the form of a restaurant, hotels, cinemas, cosmetic and hairdressing services.

The next stage is a **camouflage (stratification)**. The purpose is to separate illegal funds from the source thereof by stratification of financial transactions oriented to cover the bookkeeping trail (*paper trail*) and guarantee anonymity of persons involved in this practice (*layering*).

An international transfer is aimed at camouflaging the illegal source of money without having to bring the money to the country of origin. At this stage, it is common to use electronic fund transfers (EFT).

The last stage (**integration**) consists in putting income derived from illegal sources into the legal economic circulation without arousing suspicion and on the pretext of legality (acquisition of real estate, donations into accounts of public utility organizations). The integration is aimed at providing a new legal origin for the capital derived from crime.

The most frequent method is to evaluate objects below or above their market prices (transfer prices). For example, a criminal officially acquires an asset at a price lower than the market price thereof and unofficially gives the seller the missing portion of the market price. Then, he sells the asset at a higher market price and the amount representing the difference in prices becomes legal.

Another method is to use shell companies or phoenix companies controlled by a criminal group. These companies render fictitious or actual services to each other inflating the value of a service or sell assets to each other at prices not reflected in the market prices. As part of these practices, double bookkeeping is created – official and actual.

At this stage, criminals most often use services or assistance of professionals. The parties to the practice of money laundering employ investment advisers, bankers, lawyers often unaware of the fact that the services are provided to criminals. The phases of the practice of money laundering as described above coincide with the triple phase model presented in the materials of the U.S. Customs Service, British Bankers Association, The White House, U.S. Office of the Controller of the Currency. The triple phase model provides for the existence of three phases – placement, layering and integration.

It should be remembered that due to the fact that the organized business fraud is of a dynamic nature, the process of the practice of money laundering is dependent on many factors – social, economic, national. That is why it is extremely difficult to point to the methods and manners of money laundering.

International organizations such as Financial Action Task Force on Money Laundering – FATF annually publish studies concerning the latest methods of money laundering.

The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is therefore a 'policy-making body' created in 1989 that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas.

3. International problem

The practice of money laundering has a transnational character. Therefore, the necessity of preventing and combating this kind of crime results from the very nature of this practice.

For the practice of money laundering to be effectively combated, it should involve the cooperation among all countries, and not only those united in the European Union. Public officials of many countries should form associations for the fight against business fraud.

The system of countering money laundering currently consists in involvement of as big a number of institutions as possible that are in a position to identify the practice of money laundering. The present systems are indirectly directed at organized international criminal groups that pose a serious threat to the national and economic structures.

The international cooperation is not limited merely to the assistance in respect of the penal law procedure and provision of the information of a criminal nature and also covers skill-sharing or running training course and providing technical assistance.

The new methods used by members of criminal groups indicate that criminals increasingly often make use of activities of entities offering services involving establishment of trust funds or establishment of companies in “tax havens”.

At present, there is no global strategy of combating organized crime, and a fragmentary nature of regulations is brought about under the influence of the current need for action.

From the point of view of effectiveness of the fight against organized crime, not only involved in the practice of money laundering, it is essential that a consistent system is created if only at the level of the European Union.

The process of European integration is a dynamic phenomenon. The European Union covers an increasingly big number of the member states’ fields of life, it is long after it lost its exclusively economic character. The member states of the European Union more and more often submit to the shared regulations governing issues both in the field of foreign policy, social, economic affairs and security and justice. The shared regulations make the European Union a system of interrelations of a legal, procedural, legislative and institutional nature.

The national laws frequently incorporate the community law which spreads to wider and wider areas if only such as family, administrative, civil or penal law regulations.

The basis for activities of the Community is a budget sourced from taxes of citizens of the member states. Therefore, there is a need for special instruments to be introduced effectively protecting finances of the community. For over thirty years, the member states have been trying to cooperate in working out a consistent policy on the protection of economic interests.

By its own nature, the criminal law is a field of law that is the least readily subjected to the community regulations. The criminal law which is a manifestation of the sovereignty of the authority of the state in the member states over their citizens is with considerable opposition being deleted from the catalogue of instruments making up the national empire. On the other hand however, the number of crimes, and the extent thereof, which have affected and are still affecting the EU budget have forced the member states in recent years to cooperate more closely with each other to protect it.

The need to prepare a draft of a legal instrument such as **Corpus Iuris** has resulted from an in-depth analysis of the phenomenon of crime directed against economic interests of the European Communities. The absurdity of the situation has been discerned in which borders of the member states are open wide to criminals while being tightly closed to the institutions responsible for fighting them.

Corpus Iuris does not pretend to the title of the Pan-European penal code but is only a modest collection of penal rules intended to operate within the future unified jurisdictional area. As a result of the work done, a draft code has been prepared adopting with considerable freedom ideas, institutions and specific solutions from different legal systems.

Article 280 of the European Communities Treaty is an important community regulation that would make it possible to adopt Corpus Iuris as an instrument of combat against fraud that does harm to the financial interests of the Communities.

Article 280 § 1 of the European Communities Treaty provides for an obligation of the member states to take the same measures against perpetrators of fraud to the detriment of financial interests of the Communities as they take against perpetrators of fraud that does harm to their own internal financial interest. Most of the member countries have complied with this requirement. The extent of criminalization of such acts continues to be different in individual countries. The Article comprises a so called principle of assimilation of penal regulations. However, while being characterized by

considerable simplicity of formulation and application, this principle applied separately, in various areas, does not guarantee effectiveness of repressive measures. Because first of all the assimilation is to consist in coordination of activities of the member states, cooperation between their relevant administrative services.

The existing community regulations give a realistic chance to implement the draft of *Corpus Iuris* which in a uniform and consistent manner makes the fight against crimes directed at the finances of the European Union more real and effective. In view of the above, it seems to be legitimate to devise a legal instrument covering penal commercial law if only in the form proposed by the authors of the draft of *Corpus Iuris*.

III. International regulations

1. United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances of 20 December 1988 (Vienna Convention)

The fundamental provisions of the convention include an obligation imposed on the parties thereto to penalize acts related to illicit traffic in narcotic drugs covering also the laundering of money derived from such activities. The convention does not directly use the term “money laundering” but expressly describes this phenomenon in Article 3 section 1 b c.

Pursuant to Article 3 1 b and c of the Vienna Convention, the practice of money laundering shall be understood as:

- The conversion or transfer of property, knowing that such property is derived from any offence or offences or, or from an act of participation in such offence or offences, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an offence to evade the legal consequences of his actions;
- The concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from an offence or offences, or from an act of participation in such an offence or offences;
- Subject to its constitutional principles and the basic concepts of its legal system:

- a) The acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from an offence or offences , or from an act of participation in such offence or offences;
- b) The possession of equipment or materials or substances listed in Table I and Table II annexed to the Vienna Convention, knowing that they are being or are to be used in or for the illicit cultivation, production or manufacture of narcotic drugs or psychotropic substances;
- c) Publicly inciting or inducing others, by any means, to commit any of the offences established in accordance with this Article or to use narcotic drugs or psychotropic substances illicitly;
- d) Participation in, association or conspiracy to commit, attempts to commit and aiding, facilitating and counselling the commission of any of the offences established in accordance with this Article.

In the Vienna Convention, the practice of money laundering is presented in a concise way. Because the provisions thereof focus on crimes related to drug trafficking. The Vienna Convention deals with crimes committed with direct intent, i.e. oriented at a specific aim, which is to conceal or disguise the true origin of funds or to aid a person who in any way cooperates in the commission of an offence and to evade criminal or financial liability. It is worth stressing that pursuant to the Vienna Convention aid of any kind alone in this practice, also in the form of counselling, constitutes an offence.

Article 5 of the Vienna Convention points out to the aggravating circumstances involved in the commission of an offence and the practice of money laundering such as participation in the commission of an offence by an organized criminal group of which a criminal is a member, the use of force or weapons by a criminal, the fact that a criminal holds a public office and the offence is connected with that office, participation of a criminal in the commission of other international organized criminal acts.

The Vienna Convention introduces a certain minimum with respect to penalization of the practice of money laundering.

2. Council of Europe Convention No. 141 on laundering, search, seizure and confiscation of the proceeds from crime (Strasbourg Convention)

The Strasbourg Convention is the first international legal instrument which officially uses the term “laundering”.

Article 6 section 1 of the Strasbourg Convention obligates its signatories to provide for the internal law to penalize a certain category of acts which have been described as money laundering. A sine qua non is the intentional commission of a specified category of acts.

The aforementioned category of acts comprises:

- the conversion or transfer of property, knowing that such property is proceeds, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of the predicate offence to evade the legal consequences of his actions;
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, knowing that such property is proceeds;
- the acquisition, possession or use of property, knowing, at the time of receipt, that such property was proceeds;
- participation in, association or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the offences established in accordance with Article 6 of the Strasbourg Convention.

The term “proceeds” used in the Strasbourg Convention shall be understood as any material benefit derived from criminal offences. The said term should be construed to include property of any description, whether corporeal or incorporeal, movable or immovable, and legal documents or instruments evidencing title to, or interest in such property.

The regulations contained in the Strasbourg Convention are similar to the provisions of the Vienna Convention. Only the scope of primary offences is wider.

Pursuant to the Strasbourg Convention, the conduct that was not provided for in the Vienna Convention may be subject to penalization by decision of the parties, particularly in situations where a perpetrator should have expected that specific property represented a benefit derived from the commission of an offence, acted in order to obtain an economic advantage or to facilitate continuation of criminal activity.

3. Directive of the Council of the European Communities of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering (91/3008/EEC)

The promotion of international cooperation between judicial and legislative bodies is recognized by the European Union as a basis for effective combating money laundering. The need to adopt specific coordinating measures at the level of the European Union market arises from the international nature of crime involved in the freedom of capital movement and of provision of financial services existing in the area of the European common market. In this context, effective combating the practice of concealing the criminal origin of financial resources, ignoring the coordination and cooperation on the international level can produce insignificant results.

The primary reason for the adoption of the Directive 91/308/EEC was to protect confidence in the financial and credit institutions.

Pursuant to Article 1 section 1 C of the Directive 91/308/EEC, money laundering means the following acts when committed intentionally:

- the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such activity to evade the legal consequences of his action;
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from criminal activity or from an act of participation in such activity;
- the acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from criminal activity or from an act of participation in such activity;

- participation in, association to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the actions mentioned above.

The criminal activity is any form (both gradual and phenomenal) of participation in the commission of a “serious offence”.

The Directive 91/308/EEC expressly states that it is irrelevant where the primary offence has been committed.

Also other instruments of the community law contain the definition of money laundering referred to in the Directive 91/308/EEC. Article 1 section 1 of the Second Protocol to the Convention on protection of financial interests of the European Communities of 19 June 1997 where the definition of money laundering was used in respect of benefits derived from fraud as well as active and passive corruption.

After attempts on the WTC of 11 September 2001 as well as terrorist attacks in Madrid (2004) and London (2005), Germany proposed to adopt an international agreement allowing, inter alia, access to the police databases of the EU states.

The Prüm Treaty was signed on 27 May 2005 between Belgium, Germany, Spain, France, Luxembourg, Holland and Austria. Due to the fact that the Treaty is an international agreement concluded outside the EU legal system, Germany who in the first half of 2007 held the presidency of the EU initiated the implementation of the Prüm Treaty regulations within the EU legal framework.

On 12 June 2007, Ministers of the Interior of twenty five states of the European Union adopted most of the provisions of the so called Prüm Treaty on the stepping up of cross border cooperation in combating terrorism and organized crime. Basing on the agreement reached, the police of all EU countries will create a data exchange base on DNA and digital records of fingerprints simultaneously providing mutual access to information about vehicles, personal data of citizens etc.

At present, verification of identity of a suspected foreigner takes even as long as several days – after the system is implemented, the time will be shortened to several minutes.

Incorporation of the Prüm Treaty into the community law (acquis communautaire) has been one of priorities of the German leadership in the Union. The German Minister of Interior Wolfgang Schaueble assessed the result of negotiations as a “sensational turning point”.

However, the critics maintain that the system will contribute to the limitation of the EU citizens' privacy. The European Data Protection Supervisor, Peter Hustinx, emphasizes that the criteria for personal data protection would have to be specified. At the same time, he does not negate the general idea of the system.

On 6 August 2008 in the Official Journal of the European Union, the two Prüm decisions were published: Council Decision 2008/615/JHA of 23 June 2008 on the stepping up of cross-border cooperation, particularly in combating terrorism and cross-border crime and Council Decision 2008/616/JHA of 23 June 2008 on the implementation of Decision 2008/615/JHA on the stepping up of cross-border cooperation, particularly in combating terrorism and cross-border crime (together with the "Enclosure").

Provisions of the aforementioned decisions permit the DNA, fingerprints and vehicle registration data to be exchanged among the EU member states. The new regulations, for example, will permit individual DNA profiles to be compared with those found in the databases of the other member states as part of the investigation conducted. The Council Decision does also provide for the personal data to be exchanged among the member states in order to prevent terrorist attacks and contains stipulations about the joint action of the police.

At present, work is under way to implement the Council Directive 2008/615/JHA of 23 June 2008 on the stepping up of cross-border cooperation, particularly in combating terrorism and cross-border crime.

4. Policy Statement of the Basel Committee on Banking Supervision of 12 December 1988

The Basel Committee on Banking Supervision was created in 1974 in connection with the turbulence of a financial nature involving the collapse of Bankhaus Herstatt in Germany.

The regulations contained in the Policy Statement represent a standard maintained by self-respecting banks, financial and regulatory institutions all over the world. They are aimed at preventing the confidence in individual banks to be undermined, and as a consequence in the whole banking system in a given country, by finding out their links or just a suspicion of their being linked with criminal activity.

The Policy Statement does not contain a definition of the practice of money laundering. In this respect, it refers to national and international regulations. However, it describes the general characteristics of the phenomenon involved in the operation of a bank. It points out to a number of principles aimed at countering the use of the banking sector by criminals. From among these, the following should be mentioned in the first place: the “get to know your client” principle, cooperation with government agencies, compliance with the law and professional ethics, adherence to the Policy Statement.

5. 40 recommendations of the Financial Action Task Force

FATF is a special working group that was formed in 1989 during the summit of 7 major industrial nations in Paris. The main objective motivating members of this organization was to set the standards that would next be approved by national authorities and consistently enforced in the international arena. The FAFT recommendations are continuously subject to enhancement basing on annual reports of individual countries.

The recommendations have been divided into 5 groups:

1. The first group covers the activities necessary to improve the national legal systems of combating the offence of money laundering. Each country should first penalize the laundering of proceeds derived from the traffic in drugs specified in the Vienna Convention and from other offences involved in this traffic and then consider penalizing proceeds from all serious offences, particularly those that yield substantial profits. The state is to adopt legal regulations making it possible to confiscate the property subjected to laundering, proceeds and tools used or intended to be used in the commission of an offence or an equivalent thereof.
2. The second group concerns banks and other non-bank financial institutions. Basing on the official credible documents, financial institutions should establish identity of a client but should not operate anonymous accounts. Identification data of regular clients should be recorded particularly in case of accounts being opened or bank books issued, safe-deposit box being rented or cash transactions of a substantial value being conclude.
3. The third group refers to the cooperation of entities operating in the area of financial transactions with authorities competent to combat money laundering. In case suspicious transactions are uncovered, the conduct should be based on the three principles:

- clients should not be warned that the transaction commissioned by them has been reported as being suspicious;
 - the institution which reports a transaction as being suspicious should comply with recommendations of authorities who have received the report;
 - a transaction should not be executed in spite of the fact that the suspicious transaction has not been reported.
4. The fourth group relates to the measures which the states should take in order to monitor financial transactions. The recommendations point out to the need for creation of a system where cash transactions worth in excess of a specified amount would be reported to the main government institution having a computerized database.
5. The fifth group relates to the international cooperation in combating money laundering. International organizations such as Interpol should, by cooperating with relevant national authorities, collect and distribute information about new techniques of money laundering. A crucial role should also be occupied by international cooperation in providing legal aid in matters involving the offence of money laundering.

Recent activities of FATH relate to the elaboration of the final draft of recommendations to the life assurance companies and intermediaries, using a risk-related approach, on the phenomenon of money laundering as well as financing of terrorism.

6. United Nations Convention of 15 November 2000 against international organized crime (Palermo Convention)

The Palermo Convention being one of the most important international legal instruments on combating organized crime is a Polish initiative.

On 31 May 1996, the then President of the Republic of Poland presented at the 5th session of the Commission for the Prevention of Crime and Administration of Justice in Vienna “The Draft of a UN Master Convention against Organized Crime”.

The draft was then the subject of work of the ad hoc Committee formed under Resolution 53/11 of the General Assembly dated 9 December 1998.

On 15 November 2000, the Palermo Convention was adopted in the 55th Session of the United Nations General Assembly. The Palermo Convention became effective on 29 September 2003. The Republic of Poland signed the Palermo Convention on 12 December 2000 while the consent to ratify it was given by the act of 19 July 2001 on ratification of the United Nations Convention against international organized crime (Journal of Laws of 2000, No. 90, item 994).

The Palermo Convention repeats the regulations of the Vienna Convention relating to the definition of money laundering. However, the said practice is presented in the Palermo Convention by far more elaborately as compared to the Vienna Convention. For it is not limited exclusively to drugs offences.

Article 6 section 1 of the Palermo Convention provides that each Party State shall adopt, in accordance with the fundamental principles of its domestic law, legislative and other measures which may appear to be necessary to recognize as an offence the following acts when committed intentionally:

- the conversion or transfer of property, knowing that such property represents the proceeds from crime, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of a primary offence to evade the legal consequences of his actions;
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property represents the proceeds from crime;
- subject to the basic concepts of its legal system:
 - a) the acquisition, possession or use of property, knowing, at the time of receipt, that such property represent proceeds from crime;
 - b) participation in, association or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the specified offences.

So a criminal benefit is any property derived or obtained, directly or indirectly, from the commission of an offence.

The aforementioned shows that the authors of the Convention intended to criminalize money laundering to an extremely large extent by creating a chance for the convention to be signed by a bigger number of states.

The issues of prevention as well as prosecution and penalization of organized crime is regulated in the Palermo Convention in a comprehensive way. The Palermo Convention imposes an obligation on the Party States to penalize participation in an organized criminal group, money laundering, corruption of public officials, offences against the administration of justice. The Party States are also obligated to provide for liability (this may be civil, criminal or administrative liability) of legal entities for the participation in offences which are subject to penalization under the Convention.

The Palermo Convention also contains regulations concerning measures to combat money laundering (Article 7), measures against the offence of bribery (Article 8, 9) and obligates the Party States to provide for an obligation to confiscate any property obtained from the commission of offences covered by the Palermo Convention.

In addition, the Palermo Convention identifies the basic forms of international cooperation. Here attention should be drawn, inter alia, to the extradition and mutual legal aid, formation of joint inquiry and investigation groups, utilization of special inquiry and investigation techniques, interrogation employing communication technologies.

The Palermo Convention does not pass over the need to provide witnesses with a means of protection and victims with protection and assistance.

IV. Polish legislation

1. Definition of organized crime and the practice of money laundering

Pursuant to Article 258 § 1 of the Polish Penal Code, the one who participates in an organized criminal group or association with the aim of committing a crime or a tax offence shall be liable to the penalty of imprisonment of from 3 months up to 5 years.

The offence provided for in Article 258 of the Polish Penal Code (of any type) **is of a general nature**. The law does not require a perpetrator to have any specific characteristics distinctive of him/her.

Aspect of the offence as to the doer involves both variants of intent. **The participation alone is not of an intentional nature. It then will be enough for a perpetrator when participating to anticipate and agree that an organized group or association is aiming at committing offences.** So a precondition for perpetrator's liability is action with culpable intent in the form of *dolus directus* or *dolus quasi – eventualis*.

In accordance with one of the views presented in the doctrine, for an offence to exist under Article 258 of the Polish Penal Code *“it is necessary to participate in an organized group or criminal association. The participation shall consist in being a member of a group or association, accepting the principles governing them and carrying out orders and assignments given by persons being adequately higher in the hierarchy of the group or association. Identification of a member with the group or association is also essential here, while he does not remain there entirely passive”*. Another view confirmed by the Polish judicature assumes that it is not necessary for a perpetrator to take any action aimed at committing the intended offence. It will be enough for him to remain within the organization structure of the group or association and to perform there some auxiliary duties or even not to perform any duties but only to be ready to perform them should the need arise.

Participation in an organized group or criminal association represents *delictum sui generis* and therefore the regulation in question penalizes only the very membership of an illegal organization and does not provide for liability for specific criminal acts committed by its members. A perpetrator – member of an association or organized group shall be liable irrespective of **whether or not he as a member of the association has committed the offence the association has been created to commit**. On the other hand, a member of the group should not be liable for all offences committed by means of such organization structures but only for those in which he participated.

The scope of a concept of **“participation”** in an organized group aiming at committing offences **covers not only the formal membership of such illegal structure but also participation in committing such offences as the group was formed to commit** (so ruled the Appellate Court in Lublin in the judgment of 23 July 2002, in the case, file ref II AKa 148/01).

The “**participation**” shall consist, inter alia, in the membership of a group or association, **acceptance of the rules governing them and carrying out orders and assignments** given by persons being adequately higher in the hierarchy of the group or association.

The “**participation**” may consist in joint criminal operations, **planning thereof, holding meetings, devising a structure**, seeking out hideouts, using pseudonyms, obtaining supplies required by a group or association to achieve the aims planned as well as **taking action to prevent perpetrators being detected**. Here the following should also be counted: sharing the loot or, in a case in point – sharing remuneration – derived from the commission of offences.

It should also be noted that the term “**participation**” **does not necessarily mean a formal entry to an association in the capacity of a member**. It should rather be based on participation in meetings of the association, providing it with financial help, for example by making an apartment, vehicle available to it, transferring money.

In view of the content of Article 258 § 1 of the Polish Penal Code, it is necessary to characterize the terms “organized group” or “association” aiming at committing offences.

In addition to criminal liability for participation in an association aiming at committing an offence Article 258 § 2 of the Polish Penal Code introduced also participation in an organized group having such aim. In the opinion of the legislator, the organized group aiming at committing an offence was to be characterized by a lower level of organization than the association aiming at committing an offence.

In order to determine the content of the term “organized criminal group” assessments may also be helpful being done from the psychological viewpoint (connections between members of the group, mutual assistance, protection, unifying aim of obtaining funds for a living, alcohol and entertainment as well as criminal activity) and sociological point of view (community holding common values, maintaining its identity separate from the society and its structures) – so ruled the Appellate Court in Lublin in the judgment of 23 July 2002 in the case, file ref II AKa 148/01.

The organized group is both a group of perpetrators organized for the purpose of committing offences in a continuous manner, that is of a similar kind, and a group formed to commit several offences, on the understanding that “the fruit thereof may be a source of income existing for some time”. **Such group should be made up of at least three perpetrators. They should be united by their common willingness to commit offences as well as readiness to carry out such activities in favour of the group as may help them committing offences.**

An essential issue is the level of group organization. The condition must be met that there is a basic internal organization structure for an organized group is something more than a co-perpetration or a loose group of persons intending to commit an offence. First of all, the degree of group stability should be taken into account as well as organizational bonds under a mutual agreement, planning of offences, acceptance of aims, fulfilment of the needs of the group, accumulation of tools to commit offences, division of roles, modus operandi. So neither a group of acquaintances who renew contact in order to make a short-term criminal business transaction nor a circle of criminals carrying out the same activity unless they maintain organizational contact with each other, will be a criminal group. However, the opinion should be concurred with that since the level of group organization has not been determined by the legislator, a low level of the group organization will be enough, if it permits to commit offences and have a permanent source of income.

In the Polish literature, there is no unanimity as to whether it is necessary for an organized group to exist that such group has its leader. A proposition should be agreed with that such leader does not have to be a permanent leader; it is also not required for the leader to organize such group. On the other hand, it is rightly noted that not always a hierarchy and subordination exist within an organized group while stability of its structure is essential, whether vertical - with a leader, or horizontal – with a permanent circle of participants acting in accordance with the rules established.

An association aiming at committing an offence is unanimously recognized in the literature as a higher organization form as compared to a group.

The characteristics thereof, in addition to an agreement of perpetrators, are organization forms more stable than in case of a group, designated management and defined discipline of members which – it is important – provides for **consequences of the failure to carry out** orders of the management. And so, persons acting within the association are acting in order to implement certain ideas, guidelines and programmes recognizing the designated management and submitting to the discipline defined. *“To assume that a certain group of people forms an “association”, it is not important whether a need existed therein to enforce organizational discipline but whether it was provided for at all. The equals sign may not be drawn between voluntary submission to the authority of another person and an obligation under the agreement to carry out orders of such person with the accepted consequences of the refusal to carry them out”* (cf. judgment of the bench of 7 judges of the Supreme Court of 23 March 1992 in the case , file ref II KRN 433/91).

A criminal group and an association aiming at committing offences demonstrate many similarities such as internal organization and willingness to jointly commit offences. However, substantial differences exist between a group and an association among which a more stable organization structure should be counted, recognition of the leadership based on hierarchy and the defined discipline of members in case of an association.

Pursuant to the judgment of the Appellate Court in Lublin, Poland in the case, file ref II AKa 146/02 *“the regulation of Article 258 § 1 of the Penal Code provides that the one shall be subject to criminal liability who participates in an organized group or association having the aim of committing offences. There is no doubt that seeing through the statutory features of an offence under Article 258 § 1 of the Penal Code may involve certain difficulties. After all it is not facilitated by the dynamics of a situation characteristic of informal structures aimed at achieving permanent or short-term objectives and camouflage, role and mutual relations between members of a group as well as the absence in the regulation in question of a definition of the level of group organization. Indeed, the regulation only distinguishes between a criminal group and a criminal association which shows that a criminal group is a form of organization more casual than a criminal association. Hence, the decision as to whether we deal with an organized criminal group or a criminal association should be based on examination of this question from the functional as well as structural point of view”*.

All offences provided for in Article 258 of the Polish Penal Code are of a formal nature. For them to be committed, the causative act alone is sufficient. The commission by a group or an association of an offence for which to commit they were formed is not an effect of an offence under Article 258 of the Polish Penal Code but a separate offence.

Each of the offences provided for in Article 258 of the Polish Penal Code is devoid of the subject of a direct act.

The aim of activity of an organized group or association has been defined by the legislator as “the commission of an offence or fiscal offence”.

It should be assumed that it is not necessary for the aim of an organized group or association to be the commission of a substantial number of offences but the aim of committing one, though serious, offence will be sufficient to meet this prerequisite. Moreover, it is stressed that a prohibited act is being committed by merely joining a group or forming it while it is not required that the aim of “committing an offence or fiscal offence” be achieved.

First of all, it is noted that in the light of Article 258 § 1 of the Polish Penal Code liability of a perpetrator arises still before an offence is committed, it has only to be the aim of activity of a group or association. In addition to participation in committing an offence the participation alone in an association or organized group is punishable being understood as membership of an association or organized group and the commission of an offence being the aim of an association or group is not a prerequisite of the offence. On the other hand, it is emphasized that provision of money or making accommodation available for meeting of a group do not have to constitute perpetrator's participation but only aiding in committing an offence under Article 258 § 1 of the Polish Penal Code. However, the mere facilitation of an offence for which to commit a group or association has been founded should not be qualified as aiding in the participation in a group or association but aiding in the committed offence being the aim of the group or association.

It should be noted that an offence under Article 258 § 1 of the Polish Penal Code remains in real concurrence with an offence committed as part of activity of a group or association. And so, a perpetrator's conduct having the features of an act under Article 258 § 1 of the Polish Penal Code does not result in the absorption of crimes committed by an organized group or association as a form of accomplishment of its stated objective.

Offences committed as part of activity of a group or association should be qualified in accordance with the regulations that govern perpetrator's conduct and despite being engaged in as a form of accomplishment of its objective, without cumulative qualification under Article 258 of the Polish Penal Code. An offence under Article 258 § 1 of the Polish Penal Code is a formal offence, and in addition "the commission of an offence being a form of accomplishment of the aim of a group is not an effect thereof", and an offence of lasting nature because "unlawfulness of conduct continues as long as membership of a group does and shall not require other criminal acts to be committed" (cf judgment of the Supreme Court of 22 May 2007 in the case ref WA 15/07).

Since money laundering is a phenomenon accompanying organized crime, and even a basis thereof, it would be difficult to pass over a solution contained in the applicable penal code and relating to this subject. Article 299 of the Polish Penal Code the content of which has been amended by Article 43 of the act of 16 November 2000 on the countermeasures against putting into circulation of property derived from illegal or undisclosed sources, regulates the prosecution of the offence of money laundering in a multidimensional manner specifying six different forms of this offence.

Money laundering consists in acts aimed at concealing the true origin or real owner of funds and at allowing them to be safely put into legal economic and financial circulation.

Proceeds and other property mentioned in Article 299 of the Polish Penal Code (currencies, securities or other foreign exchange, property rights or movable or immovable property) which are the object of this practice are derived, as a rule, from crime, including especially organized crime, or from legal sources but with intent to avoid taxation.

The essence of money laundering consists in taking action aimed at putting into legal economic or financial circulation of money or other currencies, securities or more generally property derived from criminal activity or other illegal sources. So pursuant to the content of the regulation, the conduct of a perpetrator can take the form of any act on the understanding that such act can prevent or make it much more difficult to establish the criminal origin or location of objects of an executory act, to detect, attach them or adjudicate on forfeiture thereof. Aspect of the offence as to the doer includes both variants of intent.

The ascertainment of the criminal origin of object of the deed consists in establishing the fact that the benefits referred to in the regulation are derived, directly or indirectly, from offences by another person and is made in all phases of criminal proceedings apart from public criminal law also in petty offences law and penal revenue law. The source of origin must be a culpable prohibited act – an offence. It is sufficient for at least one person being a party to an act involving a given benefit to be proved guilty of culpable conduct.

Here, measures aimed at combating organized crime should but briefly be discussed as provided for in the Polish legislation.

The Penal Code of 1997 currently in force contains a lot of measures directed, directly or indirectly, at organized crime. Here, the following can be mentioned:

- 1) penalization of participation in an organized group or association aiming at committing an offence regardless of whether a perpetrator has committed any offence as a member of such group and association;
- 2) clause exempting a member of a criminal group or association from punishment if active repentance is shown;

- 3) obligatory extraordinary toughening of punishment meted out on a perpetrator who has made the commission of offences his permanent source of income or commits an offence acting in an organized group or association aiming at committing an offence as well as to a perpetrator of an offence of a terrorist nature;
- 4) extension of periods justifying conditional release from serving the full sentence of imprisonment up to the end of $\frac{3}{4}$ of the punishment adjudicated;
- 5) obligatory extraordinary mitigation of punishment or even conditional stay of the carrying out of a sentence with regard to a perpetrator cooperating with other persons in committing an offence, in case the perpetrator discloses information to the body entitled to prosecute relating to persons participating in the commission of such offence and essential circumstances thereof;
- 6) obligatory forfeiture of the material benefit derived from the commission of an offence or the equivalent thereof.

In addition to the measures pointed out above, classification is also worth mentioning of the offence of money laundering (Article 299 of the Polish Penal Code) accompanying, as already mentioned, organized crime and a possibility of a fine being adjudicated in addition to imprisonment being substantially heavier in case of a sentence, inter alia, for this offence – Article 309 of the Polish Penal Code.

An important element of the fight against crime, not only organized one, is to dispossess perpetrators of objects derived directly from an offence as well as benefits obtained from criminal activity. In the penal statute currently in force, two instruments have been provided for being aimed at dispossessing offenders of the benefits obtained illegally.

Apart from forfeiture of objects derived from crime, the Penal Code provides also for the forfeiture of material benefits derived, if only indirectly, from the commission of an offence. Such forfeiture is possible on the strength of Article 45 of the Polish Penal Code and applies to both benefits derived from an offence directly as well benefits derived from an offence indirectly, that is, obtained in exchange for benefits derived from an offence directly. Thus, a possibility has been provided for to decree the forfeiture of any type of fruits of an offence – those obtained in an indirect way as well. A total or partial forfeiture shall not be decreed, if a benefit or an equivalent thereof is subject to the return to the aggrieved party or another entity.

It should be noted that with regard to a perpetrator who has obtained, if only indirectly, a material benefit of a substantial value from the commission of an offence for which he has been sentenced the current Polish legislation makes a presumption that until the moment a sentence, if only not yet legally valid, is passed the property which the perpetrator entered into possession of or to which he gained any title at the time of committing an offence or after it has been committed, is a benefit obtained from the commission of an offence unless the perpetrator or another interested person provides evidence to the contrary.

2. Bodies competent in cases involving prevention of money laundering

Pursuant to the Constitution of the Republic of Poland, the Republic of Poland guarantees safety of its citizens. The objective of public authorities then is to guarantee safety to the citizens, including protection of such interests as life, health, property etc involving also the fight against crime threatening these interests.

The bodies competent in cases involving prevention of money laundering are the Finance Minister and the General Inspector of Financial Information holding the rank of an undersecretary of state appointed at the Finance Minister's request by the President of the Council of Ministers.

The Inspector General is performing his duties with the help of the organizational unit sectioned off within the structure of the Finance Ministry. Employees or functionaries subordinate to the minister of interior and minister of defence may be delegated by relevant ministers to perform tasks in this organizational unit. The duties of the Inspector General include obtaining, gathering, processing and analysing the information that he has gained, and on the basis thereof taking action preventing money laundering, in particular examination of the progress of transactions, taking action in order to stop a transaction where there is a justified suspicion that it is aimed at money laundering, informing competent bodies about such transactions having been made or likely to be made (prosecutor, police) and providing these bodies with duly prepared and substantiated notices of the suspected commission of an offence.

The prosecutor's office, despite its indisputable significance in the system of legal protection bodies, is not established according to the constitution and consequently the duties and powers of one of the most important state bodies are not determined by the legal norm highest in the hierarchy but by a statutory

regulation only. The objective of prosecutor's office is to maintain law and order as well as to prosecute crimes. The Public Prosecutor General and his subordinate prosecutors are performing their duties by, inter alia, cooperation with state agencies, state organizational units and voluntary organizations in preventing crime and other violations of law.

Prevention of organized crime is being dealt with by the National Office for Organized Crime operating within the structure of the National Public Prosecutor's Office.

The units subordinate to the National Office for Organized Crime are Departments II in Appellate Public Prosecutor's Offices and Departments VI for Combating Organized Crime in District Public Prosecutor's Offices.

The duties of the Internal Safety Agency [ABW] include:

- identifying, preventing and countering threats damaging internal security of the state and its constitutional order and in particular sovereignty and international position, independence and inviolability of its territory as well as defences of the state;
- identifying, preventing and detecting crimes such as, inter alia, espionage, terrorism, breach of state secret, offences damaging the economic basis of the state or corruption of persons performing public functions if this can damage security of the state.

3. Suspicious business transactions

The Polish act on countermeasures against putting into financial circulation of property derived from illegal or undisclosed sources and against financing of terrorism defines money laundering as (putting into financial circulation of property derived from illegal or undisclosed sources) – it is a deliberate conduct consisting in:

- an exchange or transfer of property derived from activity of a criminal nature or from participation in such activity in order to disguise or conceal the illegal origin of such property or providing assistance to a person who takes part in such activity in avoiding legal consequences of such acts;

- disguise or concealment of the true nature, source, location, movement or rights attached to the property derived from activity of a criminal nature or participation in such activity;
- acquisition, entering into possession of or use of property derived from activity of a criminal nature or participation in such activity;
- complicity, attempt to commit, aiding or abetting in cases of conduct mentioned in the above sections, also if the acts involved in obtaining property derived from illegal or undisclosed sources being put into financial circulation have been committed in the territory of another state.

It is worth pointing out that Article 2 point 9 of the act on countermeasures against putting into financial circulation of property derived from illegal or undisclosed sources and against financing of terrorism contains, for the purposes of that act, a definition of the concept of putting into financial circulation of property derived from illegal or undisclosed sources which is a translation of Article 1 section C of the Directive 91/308/EEC.

A suspicious transaction is an untypical, extraordinary transaction the circumstances of which indicate that funds may originate from illegal or undisclosed sources, irrespective of the value of such transaction and its nature, e.g. value of real estate being the object of the transaction differs from the market price, transactions are carried out despite unfavourable conditions (costs), transaction are carried out despite the absence of an obvious economic objective, a client does not want to disclose information required for identification, transaction is inconsistent the nature of activity carried out by the client (in case of a legal entity).

An obliged institution (inter alia, banks, branches of foreign banks, electronic funds transfer institutions, branches of foreign electronic funds transfer institutions and clearing agents, investment companies and fiduciary banks, foreign legal entities carrying out brokerage activities in the territory of the Republic of Poland, investment funds, **notaries with respect to notarial deeds involving transactions in property, advocates practising their profession, legal advisers practising their profession on a freelance basis, foreign lawyers providing legal aid on a freelance basis**, auditors practising their profession, **tax advisers practising their profession**) receiving client's instruction or order to carry out a transaction the equivalent of which exceeds EUR 15,000 is obligated to register such transaction also when it is being carried out by means of more than one operation the circumstances of which indicate that they are interrelated.

If an act has been performed constituting a transaction the circumstances of which indicate that funds may originate from illegal or undisclosed sources the said institution is obligated to record such transaction in the transaction register.

Data to be recorded in the transaction register shall be entered therein immediately, not later however than on the day following the day when a transaction is carried out.

In case the obliged institution receives an instruction or order to carry out a transaction in respect of which there is a justified suspicion that it may involve committing the offence of money laundering, it is obligated to notify the General Inspector of Financial Information immediately in writing.

It is an obligation of the obliged institution to qualify a given transaction as being the one in respect of which there is a justified suspicion that it may involve committing an offence due to the absence of a definition of such transaction in the act and of an indication of how it should be identified.

The General Inspector of Financial Information may pass a written request on to the obliged institution to stop a transaction or block an account if the information in his possession gives evidence of activities being aimed at putting property derived from illegal or undisclosed sources into financial circulation.

Simultaneously, the General Inspector of Financial Information notifies a relevant prosecutor of the suspected commission of an offence and provides him with information and documentation relating to the transaction being stopped or the account being blocked.

The obliged institution is obligated to inform the General Inspector of Financial Information immediately about an account being maintained in favour of persons justifiably suspected of involvement in committing acts of terrorism as well as about the transaction to which such persons are a party.

Moreover, it is an obligation of the obliged institution to properly protect and keep the transaction register, documents relating to the transactions registered and the information required for identification.

The transaction register, documents relating to the transactions registered as well as the information required for identification shall be kept for a period of five years counting from the first day of the year following the year in which the last entry connected with a transaction was made.

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Counterfeit Goods: How Did We Get Here and Where Will We Go Next?



Analyzing Current Enforcement
Trends against Trademark Counterfeiting

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Chapter 1: Introduction

It is well established that trademark counterfeiting has grown to become a global problem, expanding from traditional luxury goods, including designer handbags and watches to every genre of consumer goods including baby formula, pharmaceuticals and automobile parts. Purchasing a counterfeit product is as simple as travelling to a particular city neighborhood or accessing the Internet from your home. The anonymity of the sellers and purchasers of counterfeit products, coupled with the ease of manufacture and availability of these products has created an unprecedented enforcement challenge for intellectual property owners throughout the world.

The exclusive rights afforded a trademark owner provide an incentive to invest and develop the goods or services used in connection with the mark. However, the more valuable a trademark becomes, the more likely a target it becomes to unauthorized reproduction. Famous trademark owners, and in particular, luxury good manufacturers, have done an incredible job of promoting their trademarked products and the quality associated with them, to almost their own detriment. Consumers attribute such value to these goods that in certain instances, they will purchase a poorly assembled counterfeit version just to give the appearance of being able to afford the real thing. Counterfeit products would not exist if the trademark being copied did not associate any value to the product.

In many countries, including the United States, brand owners have been forced to seek new enforcement strategies in order to maintain pace with the growing counterfeit market, including ways to identify the sources of the counterfeit goods for purposes of direct infringement, as well as means of holding third parties liable for contributory infringement. This has resulted in legislation and common law rulings that highlight and attempt to address the degree of urgency trademark owners face: protect your trademark rights or risk losing the valuable goodwill accumulated through costly development of the brand.

This paper discusses the current trends in trademark enforcement and analyzes the source of the problem - how can the current laws sufficiently protect trademark owners and consumers from becoming victims to the counterfeit market? International Organizations such as the European Union, World Intellectual Property Organization, and World Trade Organization have established minimum requirements for member countries in connection with intellectual property protection and enforcement, including civil and criminal penalties. These standards constantly need to be updated and enforced in order to be effective in stopping the presence of counterfeit products in the global economy. It is clear that additional strategies and penalties are necessary since there remains a significant supply and demand for counterfeit products.

Several nations have considered: should any responsibility reside with the consumer or should the enforcement burden be borne solely by the trademark owner? Countries with anti-counterfeiting legislation uniformly hold manufacturers and suppliers liable for trademark infringement. In the U.S., the trademark owners and law enforcement agencies are responsible for policing counterfeit goods. But only the manufacturers, importers and sellers of the counterfeit goods can be held liable. Contrasting with U.S. law, France and Italy have recently amended their anti-counterfeiting statutes to include civil and criminal penalties for consumers who purchase counterfeit products. To be effective, is this the direction anti-counterfeiting efforts must take, or can trademark owners eliminate counterfeit products by using current civil and criminal procedures to attack only their source?

Chapter 2: What is a Counterfeit and Why Do We Buy Them?

Throughout the world, there are varying definitions of what constitutes a counterfeit product, but this article employs the definition provided in the World Trade Organization's TRIPS (Trade-Related Aspects of Intellectual Property Rights) Agreement, which is largely consistent with the U.S. definition. "Counterfeit trademark goods" is defined as:

any goods, including packaging, bearing without authorization a trademark which is identical to the trademark validly registered in respect of such goods, or which cannot be distinguished in its essential aspects from such a trademark, and which thereby infringes the rights of the owner of the trademark in question under the law of the country of importation.¹

Counterfeit goods are purposely designed to replicate, assimilate or mimic genuine goods in order to capitalize on the fame and goodwill the registered trademark developed through years of use. They are also commonly referred to as "fakes," "look-a-likes" and "replicas," among others terms.

The counterfeit marketplace is continually expanding, permeating all areas of the global economy. No industry is immune from the presence of counterfeit products. In 1985, counterfeiting was considered the "world's fastest growing and most profitable business."² In the mid-1980's, governments began

¹ Agreement on Trade-Related Aspects of Intellectual Property Rights, Dec. 15, 1993, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments - Results of the Uruguay Round vol. 31, 33 I.L.M. 81, note 14 (1994) (hereinafter TRIPs). *See also* 15 U.S.C. § 1116 (d)(1)(B)(i).

² GENE M. GROSSMAN & CARL SHAPIRO, COUNTERFEIT-PRODUCT TRADE, THE AMERICAN ECONOMIC REVIEW, Vol. 78, No. 1, p.59 (March 1988)(*quoting* BUSINESS WEEK, December 16, 1985).

acknowledging the surging problem of counterfeit products and began adopting anti-counterfeiting legislation.³

Trademark owners also responded by becoming more sophisticated in the detection and prevention of counterfeit products by developing discrete security details to distinguish authentic products from counterfeit products. However, the manufacturers of counterfeit products kept pace with current technology and security tools. Frequently, the counterfeit versions are so similar a trained expert is required to distinguish the difference:

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As a result, trademark owners must expend significant resources to out-smart counterfeiters by constantly developing new features. This includes, for example, adapting new patterns that are simply too expensive to copy, and imbedding sophisticated microchips on handbags and clothing.⁵

³ See Trademark Counterfeiting Act, 18 U.S.C. § 2320 (1984).

⁴ Counterfeit Quiz, CONSUMER REPORTS, January, 2008, available at <http://www.consumerreports.org/cro/money/shopping/shopping-tips/counterfeit-products-1-08/counterfeit-quiz/counterfeit-products-counterfeit-quiz.htm>.

⁵ Viva Chen, *Italy's Fashion Houses Wake up to the Impact of Counterfeit Goods*, August 22, 2006, available at <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1156164650031>.

The ease of locating and purchasing counterfeit goods evolved with the popularity, accessibility and anonymity of the Internet in the early to mid 1990s. Capitalizing on the popularity of this new resource, online communities such as the “Replica Watch Collector Club” and “The Replica Collector” were created, along with other transient websites exclusively featuring (and in some instances openly announcing) counterfeit products.⁶ This new level of access introduced counterfeit goods to every home that had Internet access- the counterfeit market was no longer limited to a few select street corners in a limited number of cities.⁷ Counterfeiters seized the opportunity to facilitate and streamline sales of their goods and quickly permeated the Internet. The prevalence of counterfeit products has expanded so much, they have become a fixture in the market, no longer limited to hidden store fronts and Internet sales; counterfeit products are sold in trendy shops in resort and tourist areas.⁸ The rise in the quality level is directly affecting brand owners- consumers even select counterfeits over authentic products because they view the quality of the counterfeit as being comparable to the original.⁹

Common consumer perception is that luxury designers simply charge too much for their products.¹⁰ Serving as justification for this form of theft of property, consumers purchase fake products by rationalizing that if the trademark owner simply did not charge so much for its goods, they could (or would) buy the real thing. However, the prevalence of counterfeit products has also created confusion among the public as to what constitutes a real or fake product and whether or not it is illegal to purchase or sell counterfeit goods. The average consumer is arguably not well versed in the intricacies of trademark law or the current trends among counterfeiters. Some consumers believe that counterfeiting is limited to fake watches or handbags- they do not necessarily realize that it extends to potentially hazardous products such as cell phone batteries, airline parts or healthcare products.¹¹ This justifiably raises the level of concern, particularly where the nature of the counterfeit product is so well concealed. But there seems to be a sharp distinction between counterfeit luxury goods and counterfeit pharmaceuticals, even though both are illegal products.¹² The former is sometimes disregarded as a victimless crime.

⁶ Richard Brown, *A Brief History of Replica Watches: How the Internet Builds Community Around Counterfeit Goods*, available at <http://knol.google.com/k/richard-brown/a-brief-history-of-replica-watches/24euhkg2oamr0/4#>.

⁷ *Statement on Trademark Counterfeiting*, U.S. Senate Comm. on Foreign Relations, February 12, 2002.

⁸ Chen, *supra* note 5.

⁹ Chen, *supra* note 5.

¹⁰ See Rebecca Quick & Ken Bensinger, *The Dark Side of e-commerce More Counterfeiters are Using the Internet to Hawk Designer Fakes*, THE WALL STREET JOURNAL ONLINE, 2001.

¹¹ See Matthew Benjamin, *A World of Fakes Counterfeit Goods Threaten Firms, Consumers, and National Security*, US NEWS & WORLD REPORT, July 6, 2003.

¹² Peggy E. Chaudry & Stephen A. Stumph, *Getting Real About Fakes*, THE WALL STREET JOURNAL, August 17, 2009, R4.

Unconcealed counterfeit goods, such as those found on self-identified counterfeit websites (which typically use the term “replica” in order to avoid causing alarm among consumers), need to be distinguished from the disguised counterfeit products passed off as a legitimate product, although both are unauthorized and illegal copies. Certain online marketplaces, such as eBay.com, offer little assistance in differentiating (for obvious reasons discussed in detail below) real and counterfeit products, leading to significant confusion since consumers often believe they are purchasing an authentic product, perhaps only at a discounted price.¹³ This contrasts with the sale of counterfeit handbags displayed on a portable table on a street corner. Far less doubt exists that these products are counterfeit goods. However, where the means of purchase appears legitimate, such as through popular e-commerce websites like eBay, a purchaser may not realize the item is counterfeit.

This concealment erodes consumer perception of the legitimate products, especially when the purchased counterfeit item does not meet consumer expectations or where exclusive limited authentic designs are duplicated in mass quantities and made available to the general public.¹⁴ Even worse is when the counterfeit product causes actual physical harm (or in extreme cases death) to the unsuspecting consumer. The only way a trademark owner can protect the goodwill of its trademark is through regular and consistent enforcement aimed at limiting the availability of counterfeit products.

Chapter 3: Counterfeiting Is Not a Victimless Crime

Historically, counterfeiting was viewed as being limited to luxury goods- this is probably the most visible market since counterfeiters unabashedly sell them on the streets and the Internet. However, the counterfeit problem extends far beyond handbags and watches.¹⁵

¹³ See generally www.ebay.com.

¹⁴ See *Tiffany Inc. v. eBay Inc.*, 576 F. Supp. 2d 463 (S.D.N.Y. 2008).

¹⁵ Timothy Trainer, *The Fight Against Trademark Counterfeiting*, THE CHINA BUSINESS REVIEW, 2002.

A. Health Hazards

In 2007, Colgate-Palmolive faced the burden of removing counterfeit toothpaste from discount store shelves that contained an ingredient not authorized for COLGATE branded toothpaste.¹⁶ While the counterfeit versions were determined to be a low health risk (although it did contain Diethylene Glycol, an ingredient found in antifreeze), it demonstrated the vulnerability of a well-known, non-luxury product falling prey to the counterfeit market.¹⁷

Other counterfeit products include automotive parts (including brake pads), baby products, toys, pharmaceuticals, etc.¹⁸ Alarming, it is estimated that 10% of all drugs sold in the U.S. are counterfeit and 2% (over 500,000) of the airline parts installed are counterfeit.¹⁹

Further compounding the problem, it is well established that consumers of counterfeit and replica products financially support criminal activity, in most instances unknowingly. Perhaps best symbolizing the opportunity to profit at the public's expense, it was recently reported that criminal gangs are capitalizing on the H1N1 flu pandemic by selling counterfeit versions of the popular flu drugs TAMIFLU (owned by Roche Laboratories, Inc) and RELENZA (owned by GlaxoSmithKline) via online "Canadian pharmacies."²⁰

B. Counterfeiting Funds Terrorist Organizations, Gangs and Exploits Child Labor

While often overlooked or dismissed as being a victimless crime, evidence indicates that the counterfeit industry is more lucrative than the drug trade.²¹ Indeed, it has been shown that drug dealers are often lured into the counterfeit business since it involves a lower risk in terms of criminal penalties and

¹⁶ Allison Klimerman & Tom Paoella, *Update: Counterfeit Toothpaste Falsely Labeled as "Colgate,"* Colgate-Palmolive Company News, June 15, 2007.

¹⁷ *Id.*

¹⁸ See Timothy Trainer, *The Fight Against Trademark Counterfeiting*, THE CHINA BUSINESS REVIEW, 2002; see also Statement on Trademark Counterfeiting, U.S. Senate Comm. on Foreign relations, February 12, 2002.

¹⁹ The International Anticounterfeiting Coalition, *available at* <http://www.iacc.org/counterfeiting/counterfeiting.php>.

²⁰ Kate Kelland, *Online Gangs Cashing in on Swine Flu*, YAHOO NEWS, November 16, 2009, *available at* http://yahoo.com/s/nm/us_flu_antivirals_gangs.

²¹ New York/New Jersey Intellectual Property Rights Conference: IP Crimes, Victims & Cases, New York, November 5, 2009.

danger and ultimately reaps higher rewards.²² The penalties associated with selling counterfeit goods are less than selling drugs.²³ According to the International Anti-counterfeiting Coalition (“IACC”), a non-profit organization focused on combating counterfeiting, the sale of counterfeit products is more than a \$600 billion dollar annual business, representing at least 5% of world trade and costing U.S. Businesses alone over \$200 billion.²⁴ And the counterfeit market shows no signs of slowing down; it has grown over a startling 10,000 percent in the last twenty years.²⁵

Not surprisingly, New York City is a leading area in the U.S. in the counterfeiting trade, exceeding \$80 billion annually.²⁶ This level of success is highly attractive to those in illegal markets- selling counterfeit products has become a significant source of income for gangs and has been linked with terrorist activity. For example, funds from pirated CDs were traced to the terrorist group responsible for the Madrid train bombings in 2004²⁷ and it is believed that the 1993 bombing of the World Trade Center was funded by a counterfeit t-shirt ring.²⁸ Following the terrorist attacks on the United States of September 11, 2001, enforcement agencies have increased focus on locating and halting the source of the counterfeit products, thereby alleviating some of the burden traditionally carried by trademark owners.²⁹

Purchasing replica/counterfeit products have also been linked to child labor and child trafficking.³⁰ Frequently there is no oversight over manufacturing facilities given their underground and illegal operations in developing countries lacking significant child labor laws. Without any supervision, manufacturers of counterfeit goods are free to exploit socially irresponsible and otherwise prohibited resources, including child labor.³¹ A well-publicized problem, it is estimated that child workers make

²² *Id.*; see also *Counterfeit Goods: Easy Cash for Criminals and Terrorists Before the US Senate Homeland Security and Governmental Affairs Comm.* (May 25, 2005)(Statement of Kris Buckner, President, Investigative Consultants).

²³ *Id.*

²⁴ See www.iacc.org, see also Sam Cocks, *The Hoods Who Moved the Goods: An Examination of the Booming International Trade in Counterfeit Luxury Goods and an Assessment of the American Efforts to Curtail its Proliferation*, 17 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 501 (2007).

²⁵ See The International Anticounterfeiting coalition, at <http://www.iacc.org/counterfeiting/counterfeiting.php>

²⁶ *Counterfeit Goods are linked to terror groups*, NEW YORK TIMES, February 12, 2007.

²⁷ *Id.*

²⁸ *Financing Terror Profits from counterfeit goods pay for attacks*, U.S. Customs Today, November 2002. See also *Threats and Responses: The Money Trail; Fake Goods Support Terrorism, Interpol Official Is to Testify*, THE NEW YORK TIMES, July 16, 2003.

²⁹ See *id.*

³⁰ Dana Thomas, *Deluxe: How luxury lost its Luster*, Penguin Books (2007).

³¹ *Id.*; see also Dana Thomas, *The Fake Trade: Wanted for Stealing Childhoods*, Harper’s Bazaar January 1, 2007. See also Maruxa Relano *et al.*, *Girl Who Came to U.S. for School Busted at Illegal Sweatshop*, New York Daily News, October 9, 2007.

up as much as twenty percent of the workforce in China and contribute significantly to the manufacture of counterfeit products.³² This cheap and “illegal” workforce lowers the cost of manufacture and increases the profits associated with the goods, but of course fosters all of the problems discussed above.

Chapter 4: International Perspectives on Enforcement

U.S. Anti-counterfeiting Legislation and Enforcement

a) Legislation

The U.S. passed the Trademark Counterfeiting Act of 1984 which was later followed by the Anti-Counterfeiting Consumer Protection Act of 1996 and the Stop Counterfeiting in Manufacturing Goods Act (2006).³³ This legislation has evolved with the progression of the counterfeit product trade. In 1984, criminal penalties were introduced for those caught intentionally trafficking or attempting to traffic goods bearing a counterfeit mark, as well as treble damages for civil liability.³⁴ In addition, if an offender knowingly or recklessly caused bodily injury while trafficking in counterfeit products, a twenty year sentence and/or a fine could be imposed.³⁵ The statute also permitted *ex parte* seizure of counterfeit products and related pertinent documents.³⁶ However, these penalties were considered insufficient to adequately address the problem, particularly in connection with the rising trend of organized crime in the counterfeit market.³⁷

The 1996 Consumer Protection Act added statutory damages, as an alternative to actual damages, from \$500 to \$100,000 for each trademark infringed, and up to \$1,000,000 if the infringement was found to be willful.³⁸ This was necessary since the harm resulting from counterfeiting is often difficult to quantify and is more punitive. This Act also permitted U.S Customs to impose civil penalties on

³² Jan Goodwin, *The Human Cost of Fakes*, Harper’s Bazaar, January 1, 2006.

³³ See Trademark Counterfeiting Act of 1984, Pub. L. No. 98-473, §1503 (18 U.S.C. §2320); Anti-Counterfeiting Consumer Protection Act of 1996, Pub. L. No. 104-153, sec. 3. §1961(a)(3), 110 Stat. 1386, 1386 (18 U.S.C. §1961); Stop Counterfeiting in Manufactured Goods Act, Pub. L. No. 109-181, sec. 1-2, §2320, 120 Stat. 285, (18 U.S.C. §2320).

³⁴ 18 U.S.C. § 2320(a); see *Louis Vuitton S.A. v. Spencer Handbags Corp. et al.*, 765 F.2d 966, 971 (2d Cir. 1985).

³⁵ 18 U.S.C. § 2320(a)(2).

³⁶ 15 U.S.C. § 1116.

³⁷ Sam Cocks, *The Hoods Who Move the Goods: An Examination of the Booming International Trade in Counterfeit Luxury Goods and an Assessment of the American Efforts to Curtail Its Proliferation*, 17 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 501 (2007).

³⁸ *Supra* note 33.

importers of counterfeit products³⁹ and amended the Federal Racketeer Influenced and Corrupt Organizations Act (RICO) by adding trafficking in counterfeit goods or services as an offense under RICO.⁴⁰ RICO permits law enforcement to seize personal and real estate assets connected to the criminal activity, as well as the counterfeit goods.⁴¹ This is significant when trying to identify and eliminate all of the sources of the goods.

The 2006 Act amended the prior legislation, criminalized the trafficking in counterfeit marks including those placed on labels, patches, wrappers, emblems. This closed a loophole that previously permitted counterfeiters to sell counterfeit look-alike products with the labels and medallions not actually attached to goods or services.⁴² Under the prior law, counterfeiters were merely manufacturing and selling labels, containing registered trademarks, to third parties that would then affix them to generic goods.⁴³ The manufacture and sale of the labels did not constitute trademark infringement, since they were not affixed to any goods or services.⁴⁴ Criminal penalties include fines up to \$2,000,000 or 10 years imprisonment, or both and up to \$5,000,000 and/or 20 years for subsequent convictions.⁴⁵

The civil enforcement options generally available to a federally registered trademark holder include the ability to file suit in federal court, and enjoin further use of the infringing mark; conduct ex parte seizures of counterfeit goods; recover defendant's profits, plaintiff's damages (up to three times) and costs; recover statutory damages; destroy packaging/labels bearing (and the equipment/tools for producing) infringing marks; cause the forfeiture/cancellation/transfer of infringing domain names; and prevent the importation of infringing goods by recording with U.S. Customs.⁴⁶

To assist in the enforcement of its anti-counterfeiting laws, the U.S. has developed various agencies for the enforcement of the laws. In particular, cooperation between The National Intellectual Property Rights Coordination Center, Immigration and Customs Enforcement ("ICE"), U.S. Customs and Border Protection ("CBP") and law enforcement agencies has proven particularly effective in tracking importation of mass quantities of counterfeit products and seeking criminal penalties. For the fiscal year 2007, ICE and CBP conducted approximately 14,000 seizures, made 241 arrests and obtained 134

³⁹ 15 U.S.C. § 1526.

⁴⁰ 18 U.S.C. § 1961 (1)(B).

⁴¹ H.R. Rep. No. 104-556, at 7 (1996).

⁴² *see U.S. v. Giles*, 213 F.3d 1247 (10th Cir. 2000).

⁴³ *Id.*

⁴⁴ See Senate Congressional record, 109th Congress, 2nd Session, February 15, 2006, 152 Cong. Rec. s. 1367.

⁴⁵ 18 U.S.C. § 2320(a)(1).

⁴⁶ *See supra* note 33.

convictions.⁴⁷ Despite the constant efforts of law enforcement aimed at removing the products from the market, trademark owners still must use all civil remedies available to assist in the enforcement efforts.

b) Application and Enforcement

i. Direct Infringement

While sufficient civil remedies exist for a trademark owner, the enforcement problem mainly exists at the investigative level; actually locating and identifying a defendant in a federal infringement action is often the greatest challenge since identifying the sellers and sources of counterfeit goods often proves futile. Given the transient nature of the counterfeit industry, tracking the offenders is particularly difficult, especially in connection with sales over the Internet. Even if an entity uses its proper address in registering a domain name (which is rare) a trademark owner is often only successful in shutting down one domain, which is then quickly replaced by a new one – equally as damaging. Popular commercial registrars such as godaddy.com, ENOM and Network Solutions often facilitate the problem by providing efficient and cost effective ways for searching for and purchasing available domains, including those that contain federally protected trademarks.

In most instances, attempting to contact the registrants quickly proves futile as any correspondence is promptly returned to sender, addressee unknown. Registrars are unwilling to disclose any contact information they may have for the registrant, including credit card or other billing information. Letters seeking relief directly from the registrar are largely unanswered. Even when assistance can be obtained from the registrar, the trademark owner's efforts in obtaining such assistance is typically wasted as it usually results in now having to locate the new domain containing the infringing content. Cooperation between the registrars and the trademark owners is necessary for policing replica websites, and yet it is frequently absent due to the registrar's lack of liability.

The Internet Corporation for Assigned Names and Numbers ("ICANN") is a not-for-profit public-benefit corporation that manages the Internet domain name system.⁴⁸ According to ICANN's User Accreditation Agreement (Revised May 21, 2009), in order for an entity to be accredited by ICANN to act as registrar for top-level domains of the Internet domain system, it is required to obtain

⁴⁷ U.S. Immigration and Customs Enforcement, ICE Intellectual Property Rights Investigations, July 1, 2008.

⁴⁸ *see* <http://www.icann.org>.

and make available for the public the names and postal address of the registered name holders and can lose its accreditation if it fails to adhere to the accreditation agreement.⁴⁹ A registrar is required to cancel the registered name registration if the registered name holder fails to provide accurate and reliable contact information.⁵⁰

However, this recourse for a trademark owner is largely underutilized; the majority of replica websites have incorrect contact information and yet they continue to operate the domains. This is most likely the result of complacent registrars mixed with the lack of pressure from ICANN in enforcement. Many of these registrants use fictitious countries and addresses, and yet escape any scrutiny by the registrar. A minimum level of oversight could prevent some counterfeiters from registering, and in turn curtail websites that sell counterfeit products.

Unless the trademark owner can locate a physical address for the manufacture or sale of the counterfeit products, it is difficult to hold any party liable for direct infringement. The majority of counterfeit goods are manufactured abroad and smuggled into the United States. China remains a significant source of counterfeit products- approximately 80% of goods seized at U.S. borders originate from China.⁵¹ India is the second highest producer of counterfeit products.⁵²

As a way to circumvent mass importation and potential seizure, some counterfeit products are shipped directly to the buyer. For instance, with regard to replica watches, a buyer orders the watches online and they are sent via an international carrier, bearing some innocuous description, such as “toy.” The package often escapes scrutiny from customs and passes through without scrutiny. In other instances, tags and labels bearing the counterfeited trademarks are applied once they arrive in the U.S.⁵³ Capturing the generic goods at the border is extremely difficult. Limiting the prevalence of counterfeit products in the U.S. is dependent on other enforcement strategies.

⁴⁹ ICANN Registrar Accreditation Agreement, May 21, 2009, section 2.1.

⁵⁰ *Id.* at 2.1, 3.7.7.2; *See also* 3.7.7.9.

⁵¹ International Anti-counterfeiting Coalition, *available at* http://www.iacc.org/resources/IACC_2009_SPECIAL_301_Recommendations.pdf.

⁵² More Than \$270 Million in Counterfeit Goods Seized, THE ASSOCIATED PRESS, 2009.

⁵³ *U.S. v. Giles*, *supra* note 42.

ii. Contributory Infringement- Secondary Liability

Since identifying and locating the manufacturers, importers and sellers of the counterfeit products can be futile, trademark owners have sought retribution from the third parties that facilitate the sale of the counterfeit products. Because of the lucrative business of selling replica goods, third parties look to capitalize on the counterfeit market. Trademark owners are just starting the mission to hold these third parties accountable and the landscape of enforcement is evolving.

For example, during the past year, in a U.S. District Court action in the Southern District of New York, Gucci America, Inc. (“Gucci”) brought suit against a credit card processor that knowingly sought out “high risk” business, and offered its processing services to a website that openly sold replica products, including those bearing the famous GUCCI marks.⁵⁴ Gucci alleges that absent the knowing participation of these third parties, counterfeiters would be unable to sell such high volumes of replica goods.⁵⁵

This complaint was filed in August, 2009 and as of November 2009, Defendants have moved to dismiss Gucci’s claims for lack of jurisdiction, as well as on the ground that Defendants did not have sufficient involvement in the sale of the counterfeit products to be held liable.⁵⁶ Defendants are relying on precedent from the United States Court of Appeal for the Ninth Circuit in *Perfect 10, Inc. v. Visa International Services Ass’n*, where the Appellate Court held that Visa could not be vicariously liable for trademark infringement for supplying its credit card services to an infringing website since Visa had no right or ability to control the infringing activity; it merely processed credit card payments.⁵⁷ Defendants’ Motion to Dismiss remains pending.⁵⁸ The allegations made by Gucci against this third party have become necessary in enforcement of trademark rights since it is not always possible to pursue the infringer directly. However, courts must consider whether third parties can sufficiently remove themselves from liability for acts of contributory trademark infringement in the United States, even though they directly enable the infringement? In certain instances, the answer is yes.

The Internet site www.eBay.com (“eBay”) is a popular online marketplace where third parties can offer for sale a wide range of goods to a third party purchaser.⁵⁹ eBay facilitates a sale, through an online

⁵⁴ *Gucci America, Inc. v. Frontline Processing Corp, et al*, (S.D.N.Y. 09-cv-6925).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Perfect 10, Inc. v. Visa International Services Ass’n*, 494 F.3d 788, (9th Cir. 2007) cert. denied, 128 S. Ct. 2871 (2008).

⁵⁸ *Id.*

⁵⁹ See www.ebay.com.

bidding process, in exchange for a commission.⁶⁰ Because of its immense worldwide popularity eBay.com is also a tremendous source of counterfeit products. A lawsuit was filed by Tiffany Inc. and Tiffany and Company (“Tiffany”) against eBay on June 18, 2004, in the United States District Court for the Southern District of New York. Tiffany presented evidence that approximately 70% of certain Tiffany-branded products sold on eBay are counterfeit.⁶¹ This high number of counterfeit products is offered for sale by anonymous third parties despite eBay’s pro-active anti-counterfeiting efforts which include keyword searches for counterfeit products and its Verified Rights Owner Program (VeRO) which offers take down service to individually reported instances of infringement.⁶² Because eBay employed keyword searches and the take down service, it was found not liable for contributory trademark infringement despite its general knowledge of the sale of counterfeit TIFFANY products.

The District Court held that regardless of the high rate of counterfeit products sold on eBay, it remained the trademark owner’s obligation to police every sale of Tiffany- branded goods. The court based its decision on the fact that some of the Tiffany-branded products (albeit less than 30%) sold on eBay were legitimate, and eBay never took physical possession of the goods. Moreover, whenever eBay was notified by Tiffany of a particular counterfeit, it removed the listing. Of course even quick removal does not alleviate Tiffany’s problem as even with Tiffany’s best efforts it cannot reduce the percentage of counterfeit products below 70%. Notwithstanding, the court held that eBay’s efforts were sufficient; eBay was not required to take any action for what it could have reasonable anticipated.⁶³ This opinion is currently on appeal before the United States Court of Appeals for the Second Circuit.⁶⁴ Until then, the burden rests squarely with the trademark owner, despite eBay’s knowledge that a high rate of counterfeit Tiffany- branded products are sold.

Contrasting with *Tiffany v. eBay*, are the facts alleged in the recent complaint captioned *Steve Madden Ltd v. eBay Inc.*, 09-cv-6484, filed on July 21, 2009 in the Southern District of New York.⁶⁵ As alleged by Steve Madden, the manufacturer and seller of clothing and footwear bearing the STEVE MADDEN and MADDEN trademarks, it has never manufactured or authorized the sale of watches bearing its marks, and any watches sold on eBay bearing the MADDEN marks must be unlicensed and/or counterfeit watches.⁶⁶ These facts are different from the aforementioned Tiffany case and may be

⁶⁰ *Id.*

⁶¹ *Tiffany Inc. v. eBay Inc.*, 576 F. Supp. 2d 463, 485-86 (S.D.N.Y. 2008).

⁶² *Id.*

⁶³ See *Inwood Labs, Inc. v. Ives Labs, Inc.*, 456 U.S. 822, 102 S.Ct. 2182 (1982).

⁶⁴ See U.S. Court of Appeals for the Second Circuit, Appeal No. 08-3947. Oral Argument before the Appellate Court occurred on July 16, 2009 and a decision is pending.

⁶⁵ See *Madden v. eBay, Inc.*, S.D.N.Y. (Case No 1:09-cv-6484).

⁶⁶ *Id.*

sufficient to attribute liability to eBay since it has been put on notice that every watch bearing Steve Madden’s trademarks is counterfeit. eBay cannot sell any legitimate watches bearing Steve Madden’s trademarks.⁶⁷

Based on the policing efforts highlighted in the *Tiffany* case, eBay should be able to prevent the sale of any watch bearing the MADDEN marks, through its keyword search tools. Accordingly, eBay’s inability to inspect the goods should prove to be irrelevant in terms of its liability. Unfortunately, this issue will not be resolved in the immediate future since the parties settled the dispute and Plaintiff Madden withdrew the complaint in August 2009.⁶⁸

In a recent California District Court decision in *Louis Vuitton Malletier, S.A., v. Akanoc Solutions, Inc., et al.*, a jury found that Defendants’ Internet hosting business was liable for contributory trademark and copyright infringement because of its direct involvement in hosting websites that sold counterfeit Louis Vuitton goods.⁶⁹ Many of the websites hosted by Defendants overtly offered for sale “replica” goods. Absent Defendants’ participation in hosting these websites, there would be no access to the infringing content. This California ruling captures the disparities among U.S. law- arguably under this same reasoning, eBay should have been found liable.

Contributory infringement is not limited to large scale operations. Manufacturers of counterfeit products have found another way to infiltrate the marketplace. Individuals can host their own “purse party” or other similar event, and sell counterfeit products within their communities for income.⁷⁰ This further lessens the stigma associated with selling and purchasing a counterfeit product- the transaction occurs in someone’s home and typically from a friend or acquaintance. But under the Lanham Act, the host of such a party is subject to liability for selling counterfeit merchandise.⁷¹ While the potential for liability exists, trademark owners and law enforcement generally do not have the resources (and/or desire) to pursue such small scale operations. The criminal enforcement of such activity generally focuses on mass quantities of counterfeit products.⁷²

⁶⁷ *Id.*

⁶⁸ *See Madden v. eBay, Inc.*, S.D.N.Y. (Case No 1:09-cv-6484).

⁶⁹ *Louis Vuitton Malletier, S.A., v. Akanoc Solutions, Inc., et al.*, CV07-03952 JW (N.D. Cal. 2007).

⁷⁰ *See* Lauren D. Amendolara, *Knocking Out Knock-Offs: Effectuating the Criminalization of Trafficking in Counterfeit Goods*, 15 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 789, 826 (2005).

⁷¹ *Id.*

⁷² U.S. Immigration and Customs Enforcement, ICE Intellectual Property Rights Investigations, July 1, 2008.

c. Fighting Counterfeiting Through Public Awareness

Brand owners and the enforcement agencies are relying on public awareness to assist in the battle against counterfeit products.⁷³ By creating advertisements and public service announcements, they intend to increase public knowledge of the widespread nature of the counterfeit products, as well as the harm to the economy, and the supporting of illegal activity, including gangs and terrorists.⁷⁴ For some time, given the availability of counterfeit handbags and watches, and the number of people wearing them, it has become almost an acceptable trend to own a “knockoff,” particularly in the ailing economy. This poses a sharp contrast with the enforcement efforts being undertaken on the other side of the supply chain- the criminal penalties imposed on those that manufacture, import or sell the counterfeit products. It appears that in order for progress to be made, the two sides of the illegal transaction need to be harmonized. So long as the consumer continues to purchase the goods, counterfeiters will make them available.⁷⁵ U.S. Customs even permits those traveling to the U.S. to import one counterfeit good, such as a handbag or item of clothing, so long as it is intended for personal use.⁷⁶ It is difficult to persuade consumers that all counterfeiting is a crime, when we are willing to overlook minor instances of infringement.

Consumer tolerance of counterfeit luxury goods, however is quite different from other counterfeit products, particularly where consumer health and safety is at risk. Can the public be convinced that purchasing a fake handbag is just as bad as purchasing counterfeit pharmaceutical? Or should the U.S. follow the lead established by France and Italy and impose sanctions for anyone responsible for purchasing a counterfeit product?

B. France’s Anti-Counterfeiting Legislation and Enforcement

France is more progressive in implementing anti-counterfeiting penalties than the U.S. and has gone beyond the minimum standards imposed by the European Union and World Trade Organization for the protection and enforcement of Intellectual Property rights. France has maintained a tougher stance on

⁷³ Peggy E. Chaudry & Stephen A. Stumph, Getting Real About Fakes, *The Wall Street Journal*, August 17, 2009, R4.

⁷⁴ *Id.*

⁷⁵ Amanda Silverman, *Draconian or just? Adopting the Italian Model of Imposing Administrative Fines on the Purchasers of Counterfeit Goods*, *CARDOZO J. OF INT’L & COMP. L.*, 2009, 196.

⁷⁶ *Id.* Peter Quinter, *Yes, You May Legally Import Counterfeit Merchandise into the United States*, *Customs and International Trade Law Blog*, January 24, 2010, available at <http://www.customsandinternationaltradelaw.com/>.

counterfeiting, largely due to the strong presence and influence of luxury goods designers in France.⁷⁷ Imposing harsh penalties in 2005, France implemented criminal sanctions for suppliers of counterfeit products and has also imposed liability on purchasers of counterfeit goods. In what has been described as a “very efficient” relationship, trademark owners work closely with custom officials and the French police in the enforcement of their rights. This includes notification of new product lines, and identification of counterfeit products.⁷⁸ Customs officials have the authority to detain and seize counterfeit products throughout the French territory, can search individuals for counterfeit products and can file enforcement action, which the trademark owner may join.⁷⁹ This contrasts sharply with U.S. policy which allows (and limits) a person arriving into the U.S. to carry one article bearing a counterfeit mark, so long as the article is only for personal use and not for resale.⁸⁰

In 2007, France passed tougher legislation in Intellectual property enforcement, while implementing the 2004 European Union IP Rights Enforcement Directive, which requires “all Member States to apply effective, dissuasive and proportionate remedies and penalties against those engaged in counterfeiting and piracy and so creates a level playing field for rights holders in the EU.”⁸¹ The new French law offers favorable options for calculating damages, including an analysis of the counterfeiter’s profits, a minimum license fee (whereby the Court cannot award damages that are lower than hypothetical royalties owed if the sale was authorized), as well as a calculation of “the moral prejudice caused to the owner of the right because of the counterfeiting.”⁸²

In addition to tougher application by the Court, France has become one of two countries implementing laws that shift the responsibility to the consumer, by creating civil and criminal liability for those that purchase counterfeit products. The penalties include fines of up to 300,000 Euros and three years of imprisonment, if it can be proven that the consumer acted in bad faith, namely, that the consumer had

⁷⁷ Jonathan Thorpe, *French Court Orders eBay to Pay Luxury Goods Giant \$63 Million*, THE AM LAW DAILY, July 1, 2008, at 2.

⁷⁸ Caroline Casalonga and Jean-Christophe Guerrini, *France: A Guide to French Anti-Counterfeiting Law*, August 31, 2009, available at <http://www.mondaq.com/article.asp?articleid=80000&print=1>.

⁷⁹ *Id.*

⁸⁰ Commissioner of Customs, Personal Use Exemption: Unauthorized trademarks, Customs Directive, No. 2310-011A, Jan. 24, 2000, available at <http://www.cbp.gov/linkhandler/cgov/trade/legal/directives/2310-11a.ctt/2310-11a.pdf>; see also Peter Quinter, *Yes, You May Legally Import Counterfeit Merchandise into the United States*, Customs and International Trade Law Blog, January 24, 2010, available at <http://www.customsandinternationaltradelaw.com/>.

⁸¹ The Directive on the enforcement of intellectual property rights, European Commission, available at http://ec.europa.eu/internal_market/iprenforcement/directives_en.htm

⁸² Franck Soutoul and Jean-Philippe Bresson, *Country Correspondents, France Introduces Tighter anti-counterfeiting provisions*, WORLD TRADEMARK REVIEW, March/April 2008 at p. 58-60.

knowledge that the goods it purchased were counterfeit.⁸³ Purchasing a counterfeit product is considered a Customs offense.⁸⁴

In what was a very similar problem as that posed in the U.S. action, *Tiffany v. eBay*, the Tribunal de Commerce in France found eBay Inc. and eBay International liable for guilty negligence in connection with its sale of counterfeit versions of LVMH Moët Hennessy Louis Vuitton's (LVMH) products over its website.⁸⁵ The French Court was not persuaded by eBay's anti-counterfeiting measures, finding that because eBay provided the platform for the sale of the counterfeit products and profited from the sale by collecting a commission, it was liable for damage to LVMH. eBay was required to pay \$61.3 million in damages.⁸⁶ LVMH effectively argued that eBay's anti-counterfeiting measures were insufficient in the prevention of sales of the goods.⁸⁷ eBay sharply criticized the decision as hurting consumer choice and stated it would appeal the ruling.⁸⁸ A spokesperson for eBay represented that the company will take down any item that is reported as counterfeit and will suspend or block any repeat offenders.⁸⁹ In contrast to the French court, the United States court held that this level of prevention was sufficient to avoid liability.

This decision, reached just prior to the U.S. decision in the *Tiffany v. eBay* case, highlights the disparities in trademark enforcement.⁹⁰ The eBay decision also follows a 2006 French ruling against Google Inc., whereby the online search engine was found liable for trademark infringement for its sale of certain keywords in connection with the LOUIS VUITTON trademark. The Paris Court of Appeal found that the association of the terms "fake," "copies," "imitation," and "knockoff" in connection with the famous trademark constituted infringement and awarded LVMH monetary damages.⁹¹

Recently, France disclosed a charter aimed at curtailing the online sale of counterfeit products by partnering brand owners along with e-commerce websites.⁹² The charter establishes practices that

⁸³ *Silverman supra* note 75 at 201.

⁸⁴ http://www.comitecolbert.com/internet/images/stories//Synthese%20Etude/The_role_of_the_Comite_Colbert_in_combating_counterfeiting_2006.pdf at page 9.

⁸⁵ Dominique R. Shelton, *EU, US Grapple with Online Counterfeit Goods*, Portfolio Media, Inc., Law360, January 10, 2008, http://iplaw360.com/print_article/69316, available at <https://www.wildmanharrold.com/article/10022008.pdf>.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Thorpe, supra* note 77.

⁸⁹ *Id.* at page 2.

⁹⁰ *Shelton, supra* note 85.

⁹¹ *Casalonga, supra* note 78.

⁹² *France Sets Crosshairs on Counterfeit Goods Online*, THE DAILY STAR, December 17, 2009, available at http://dailystar.com.lb/article.asp?edition_id=10&categ_id=3&article_id=109849

“would help standardize cooperation between companies –including luxury labels but also pharmaceutical, cosmetics and apparel manufacturers- that are victims of counterfeiting and the e-commerce websites through which they are sold to unwitting consumers.”⁹³ The practices include reporting and policing procedures, as well as prompt removal from the Internet sites, with the focus not only on protecting intellectual property owners, but consumers.⁹⁴ However, the partnership currently does not include eBay and Amazon.com, two of the largest internet suppliers of products.⁹⁵ In light of the *LVMH v. eBay* decision, it would be prudent for these online retailers to join trademark owners in the fight against counterfeit goods.

France also focuses on decreasing “counterfeit tourism,” which is aimed at limiting the amount of counterfeit products that are brought into France by tourists, or purchased by tourists during their visit to France.⁹⁶ The penalties include fines up to \$450,000 or three years of imprisonment.⁹⁷ This shift in liability for the sale of counterfeit products promotes public awareness that the counterfeit market is indeed harmful and not a victimless crime. As discussed above, identifying the source of the goods, particularly those sold over the Internet is at times impossible. By limiting the demand for the products, perhaps the supply chain will be affected. While the impact remains to be determined, it will be interesting to follow the rates of counterfeiting and enforcement to see if consumer liability limits the prevalence of counterfeit products.

C. Italy’s Anti-Counterfeiting Legislation and Enforcement

Italy is currently dedicated to revising and amending its anti-counterfeiting laws, following a time period where it was sharply criticized for under-enforcement of even the minimum standards under the EU principles and TRIPS agreement. The Italian definition of “counterfeit” is rather broad, and includes acts of unauthorized copying as well as any act of intellectual property infringement, including infringement of a trademark, patent, or designs.⁹⁸

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *New French Crackdown on “Counterfeit Tourism,”* Secure Pharma Chain Blog, September 30, 2009, <http://securepharmachain.blogspot.com/2009/09/new-french-crackdown-on-counterfeit.html>.

⁹⁷ *Id.*

⁹⁸ Alberto Camusso, *Anti-counterfeiting in Italy shows signs of improvement*, WORLD TRADEMARK REVIEW, March/April 2008, p. 64.

Counterfeiting in Italy mirrors some of the problems faced in France, namely, the reputation for innovative fashion and design, the prestige associated with a “Made in Italy” stamp, as well the demand for products that cheaply showcase the same designs.⁹⁹ Roughly sixty percent of Italy’s counterfeit products include clothes and other fashion items.¹⁰⁰ Counterfeiting has consistently been a problem in Italy, with Italy at one point being identified as the third ranked producer of counterfeit products.¹⁰¹ This is due in part to number of skilled artisans that have the manufacturing abilities and techniques required to produce high quality counterfeit products.¹⁰² But it was also attributed to the operations of family-run Italian fashion houses, historically unwilling to acknowledge the problem of counterfeit products, and unwilling to cooperate with other brand owners.¹⁰³ This trend has largely dissipated and currently, the majority of counterfeit products are imported from South-East Asia and China.¹⁰⁴

In 2005, Italy expressly implemented civil penalties for those caught purchasing counterfeit products, including fines up to 10,000 Euros.¹⁰⁵ Prior to the 2005 law, Italy’s criminal possession law (Article 648 of the Italian Criminal Code) did not explicitly address consumer liability but was interpreted as including counterfeit goods procured for purposes of a profit.¹⁰⁶ Italy imposed criminal sanctions for purchasing property of suspect origin, but it was ambiguous whether it applied to the individual consumer, or a supplier of the goods.¹⁰⁷

Subsequently, Article 473 of the Italian Criminal Code was enacted and provides sanctions for counterfeiting or altering a trademark, including three years imprisonment and a monetary fine of up to 2,065 Euros. Article 474 criminalizes the sale and importation of counterfeit trademarks including punishment of up to two years in prison¹⁰⁸ and a monetary penalty of up to 2,065 Euros.¹⁰⁹ In 2009, Italy amended articles 473 and 474, to increase the penalties associated with selling counterfeit products, including lessening the level of intent required for prosecution; an infringer that has the “possibility to be aware” can be found guilty for infringement.¹¹⁰ Infringing conduct under these sections includes

⁹⁹ Daniela Mainini, *Criminal Law Protection of IP in Italy*, IP RISK MANAGEMENT REVIEW 2006.

¹⁰⁰ Chen, *supra* note 5.

¹⁰¹ Silverman, *supra* note 75 at 182. *See also* Mainini.

¹⁰² Silverman *supra* note 75.

¹⁰³ Chen, *supra* note 5.

¹⁰⁴ Mainini, *supra* note 99.

¹⁰⁵ Silverman, *supra* note 75.

¹⁰⁶ *Id.* at 186.

¹⁰⁷ *Id.* at 187.

¹⁰⁸ Mainini, *supra* note 99.

¹⁰⁹ Alberto Camusso, *Anti-counterfeiting in Italy shows signs of improvement*, WORLD TRADEMARK REVIEW, March/April 2008 at page 64.

¹¹⁰ Lorenzo Litta, *Catch Us If You Can, New Criminal Provisions for fighting counterfeiting and piracy*, July 13, 2009.

importation or sale of a slightly modified version of a trademark, which in the past, escaped liability since it was not an exact replica.¹¹¹ Eventually, Italian courts interpreted this conduct as infringing since the sole purpose of modifying the trademark was to escape liability.¹¹²

The 2005 Industrial Property Code (which replaced forty prior laws) explicitly provides for monetary sanctions against the consumer and allows for confiscation of the goods if the transaction does not qualify as a criminal “for profit” act.¹¹³ The administrative fine associated with purchasing counterfeit products ranges between 100 and 10,000 Euros.¹¹⁴ However, it is unclear how often fines are imposed and whether this law has deterred any consumers from purchasing counterfeit products. Indeed, Italian Police have criticized the amount of the fine and proposed a lesser fine amount.¹¹⁵

D. China’s Anti-Counterfeiting Legislation and Enforcement

Although it has agreed to the minimum intellectual property standards set forth by the WTO and the TRIPS agreement, China still remains the predominant worldwide source of counterfeit goods.¹¹⁶ In 2002, counterfeiting in China was estimated to be a \$16 billion industry.¹¹⁷ In 2008, counterfeit goods originating from China valued at \$221.8 million were seized at U.S. borders.¹¹⁸

China is not just supplying counterfeit products to other countries; the demand within China remains high, particularly due to the lower cost of counterfeit goods.¹¹⁹ Counterfeit products in China have a lower price differential than the price attributed to the same counterfeit good in the U.S.¹²⁰ Consumers in China can purchase a counterfeit product as low as one percent of the authentic brand price.¹²¹ Not

¹¹¹ Camusso, *supra* note 109 at page 65.

¹¹² *Id.* at page 64

¹¹³ Silverman *supra* note 75 at 188. *See also The Economic Impact of Counterfeiting and Piracy*, Organisation for Economic Co-operation and Development, 2008, page 238.

¹¹⁴ Silverman at 205.

¹¹⁵ Silverman at 206.

¹¹⁶ *See* Maria Nelson et al., *Counterfeit Pharmaceuticals: A Worldwide Problem*, LEXSEE 96 TRADEMARK REP. 1068, 1088-1093, 2006.

¹¹⁷ Timothy Trainer, *The Fight Against Trademark Counterfeiting*, THE CHINA BUSINESS REVIEW, 2002.

¹¹⁸ *U.S. Relations with the People’s Republic of China*, U.S. Customs and Border Protection, January 8, 2009, available at http://hongkong.usconsulate.gov/uscn_others_2009010801.html.

¹¹⁹ *See* Chun-Hsien Chen, *Explaining Different Enforcement Rates of Intellectual Property Protection in the United States, Taiwan, and the People’s Republic of China*, 10 TUL. J. TECH. & INTELL. PROP. 211, 217, 2007; Li Qian, *Consumer Demand Fuels Counterfeit Goods*, CHINA DAILY, December 2006.

¹²⁰ *Id.* at 217.

¹²¹ Li Qian, *Consumer Demand Fuels Counterfeit Goods*, CHINA DAILY, December 2006.

surprisingly, tourists travel to China with the intent of purchasing cheap counterfeit products.¹²² Public awareness of the illegality of the conduct should be a priority, and the U.S., France and Italy can play a critical role in relaying this message.

Due to increased pressure from global trading partners, China has agreed to enhance its intellectual property enforcement, and to include more stringent regulations at its borders.¹²³ In 2005, the Chinese Customs General Office passed the “Rules of Implementation of the Intellectual Property Customs Protection Act,” which detailed the procedures for recording intellectual property rights, and detaining and investigating suspect goods.¹²⁴ This same year, China passed regulations for printing trademarks, requiring proof of a trademark registration and/or license before a company could print it on any packaging, as well as new regulations in People’s Republic of China Criminal Code, which detailed trademark counterfeiting regulations.¹²⁵ Violations of the criminal code include using or selling goods containing another’s trademark without consent of the trademark owner.¹²⁶

These recent regulations follow ambiguous legislation that permitted criminal penalties which ranged from up to three years in prison if the conduct was deemed “serious” or sales “relatively large,” to seven years, if the conduct was “especially serious” or sales were “huge.”¹²⁷ Clearly, this provided little guidance for enforcement. China subsequently lowered the threshold amounts for criminal enforcement; however it is questionable whether in practice any threshold amount complies with minimum standards imposed under TRIPS.¹²⁸ Implementing threshold requirements undermines the goal of limiting counterfeits and conveys a mixed message- counterfeiting is illegal, but China will accept and overlook minimum levels of counterfeiting.

A reported lack of enforcement and coordination among the Chinese government and agencies, in addition to the transition to a market economy with a large workforce, has enabled the Chinese counterfeit market to proliferate.¹²⁹ When counterfeit proceedings are actually initiated by Chinese administrative authorities, the infringers are subject to low fines, which are considered to be routine and acceptable costs of a counterfeiting business.¹³⁰ Moreover, a lack of reported statistics on the number of

¹²² Chen at 244.

¹²³ See Maria Nelson et al., *Counterfeit Pharmaceuticals: A Worldwide Problem*, LEXSEE 96 TRADEMARK REP. 1068, 1090, 2006.

¹²⁴ See *id* at 1090-1091.

¹²⁵ See *id.* at 1091-1092.

¹²⁶ See *id* at 1091-1092.

¹²⁷ Timothy Trainer, *The Fight Against Trademark Counterfeiting*, THE CHINA BUSINESS REVIEW, 2002.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ See Maria Nelson et al., at 1088-1093.

criminal prosecutions resulting in seizures, convictions or other penalties makes it difficult to track any progress with enforcement.¹³¹

Pressure has increased on China's performance under TRIPS. Under Articles 41-61, China is required to implement effective enforcement strategies that have a deterrent effect.¹³² While the IACC has noted that there has been some progress in enforcement (the number of criminal prosecutions, raids and goods seized has reportedly increased), China remains the top source for counterfeit products. Additional measures are necessary.¹³³

But the main reason why China is the leader in counterfeit products is due to the lack of enforcement. Despite having enacted the newer intellectual property regulations and penalties in 2004, and improving compliance with TRIPS Agreement, in 2008, China was the leading source of goods seized at U.S. borders- 81% of the total domestic value seized came from China.¹³⁴ A previously underutilized option in China is the initiation of civil proceedings against infringers.¹³⁵ The number of civil actions initiated in Chinese Courts has grown over the past decade, but the majority of these actions have been initiated by Chinese companies.¹³⁶ China also needs to strengthen the regulations and oversight over its exports- presently the burden rests squarely with the customs and border patrols during importation of Chinese goods in other countries. Additionally, the increased exposure and interest in luxury brands in China will be significant to protecting these same brands- it has been predicted that China will soon surpass the U.S. as the world's second largest consumer of luxury goods.¹³⁷ As China's economy grows, a market for legitimate products will also expand- and perhaps the social stigma attached with buying counterfeit goods will deter the public from seeking them.

Chapter 5: Where Do We Go From Here?

The surest way to remove counterfeit products from the marketplace is for consumers to simply stop purchasing them. No demand, no supply. However, this is far from a simple solution. Consumers with

¹³¹ See Maria Nelson et al., at 1090.

¹³² Timothy Trainer, Testimony before U.S.-China Commission, President International AntiCounterfeiting Coalition, February 4, 2005.

¹³³ Id.

¹³⁴ *U.S. Relations with the People's Republic of China*, U.S. Customs and Border Protection, January 8, 2009, available at http://hongkong.usconsulate.gov/uscn_others_2009010801.html.

¹³⁵ Nelson et al. at 1093.

¹³⁶ Nelson et al. at 1093.

¹³⁷ Jan Goodwin, *The Human Cost of Fakes*, Harper's Bazaar, January 1, 2006.

past preferences for counterfeit products are likely to be repeat purchasers.¹³⁸ One way to discourage counterfeit purchases is to increase public awareness of the illegal nature, and consequences, of such action, including supporting criminal activity. However, there is a sharp distinction in consumer perception between counterfeit luxury goods and other products. The underlying harm remains the same (harm to brand owner, economy, etc.), but certain consumers, while willing to openly purchase counterfeit clothing and handbags, understandably do not want to purchase counterfeit pharmaceuticals or health care products. Convincing the public that they should view all counterfeit goods the same is the challenge.

France and Italy have addressed this challenge directly, by implementing penalties for purchasers of counterfeit products. These penalties will most likely target consumers of counterfeit luxury goods, since luxury goods are the predominant portion of counterfeit products. It remains to be seen whether consumers in France and Italy will continue to purchase counterfeit products when faced with the possibility of receiving a fine. Ultimately, success of these laws is contingent on enforcement. Enforcement agencies and trademark owners will need to remain diligent in pursuing any violations of the anti-counterfeiting laws.

Shifting some of the burden to the consumer is a direct result of the problems associated with limiting the supply of counterfeit products. Since counterfeiting is so transient, it is difficult to investigate and locate the source of the counterfeit products. Trademark owners must search for alternative ways to enforce their intellectual property rights, including holding third parties liable for infringement.

Respectfully submitted,

Jenny T. Slocum

¹³⁸ See Boonghee Yoo, and Seung-Hee Lee, *Buy Genuine Luxury Fashion Products or Counterfeits?* ADVANCES IN CONSUMER RESEARCH, Vol. 36, 2009.

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From Voltaire to Kissinger: Can the principle of *universal jurisdiction* survive centuries of criticism? And will the International Criminal Court provide the solution?

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Chapter 1 – What is Universal Jurisdiction?

A Roman in Egypt very unfortunately killed a consecrated cat, and the infuriated people punished this sacrilege by tearing him in pieces. If this Roman had been carried before the tribunal, and the judges had possessed common sense, he would have been condemned to ask pardon of the Egyptians and the cats, and to pay a heavy fine, either in money or mice. They would have told him that he ought to respect the follies of the people, since he was not strong enough to correct them.

*The venerable chief justice should have spoken to him in this manner: “Every country has its legal impertinences, and its offences of time and place. If in your Rome, which has become the sovereign of Europe, Africa and Asia Minor, you were to kill a sacred fowl, at the precise time that you give it grain in order to ascertain the just will of the gods, you would be severely punished. We believe that you have only killed our cat accidentally. The court admonishes you. Go in peace, and be more circumspect in future”.*¹³⁹

* * * * *

Amongst Voltaire’s satirical polemic are important, timeless words. “Every country has its legal impertinences, and its offences of time and place.” Other philosophers, politicians and judges up until the present day have supported them. However, like every other politico-legal issue, there are also distinguished opponents. Throughout this paper I hope to vigorously argue, with the support of Voltaire *et al.*, both sides of the argument for and against the principle of *universal jurisdiction*, and also to summarise and critique the formation of the International Criminal Court at The Hague.

* * * * *

All states have the right to exercise jurisdiction when a crime is committed either within their jurisdiction, or by their own nationals within another state. This is regularly exercised through the principles of *territorial jurisdiction* and *extra-territorial jurisdiction*. For both, it is expedient and appropriate for the prosecuting state to exercise such jurisdiction. The principle of universal jurisdiction (or the principle of universality)¹⁴⁰ is, however, inherently different.

¹³⁹ Voltaire, *Philosophical Dictionary Part 2, Crimes or Offences*, 1764.

¹⁴⁰ For the purpose of consistency I shall use the former name throughout.

The use of this principle is whereby states claim jurisdiction over alleged criminals irrespective of their alien status, or that the alleged crime(s) was committed outside of their own boundaries. Nevertheless, despite the lack of traditional nexus with the crime, alleged offender, or victim, the prosecuting state justifies their universal jurisdiction on the grounds that the crime is so egregious that it is a crime against all, and therefore too serious to tolerate any jurisdictional arbitrage.

What constitutes an egregious crime is manifestly subjective in nature; however, the principle is analogous to the idea that certain peremptory norms (or *jus cogens*¹⁴¹) apply to all states – *erga omnes*.¹⁴² There is no exhaustive list as to what crimes constitute *jus cogens*, but it is widely accepted that the prohibition of genocide, war crimes, crimes against humanity, crimes of aggression, apartheid, slavery and torture are included. The unique status of these norms means that no derogation is ever permitted, nor can they be impliedly or expressly modified by treaty.

The vast majority of the *jus cogens* listed above are now enshrined within the Rome Statute of the International Court, more specifically Articles 5 to 8. However, as I will examine later on, the Rome Statute has not been established *erga omnes* due to certain states, most notably the United States of America, Israel and the People’s Republic of China, choosing not to ratify it.

In order to examine the full scope of the principle, I will first consider its genesis. Some commentators have argued that the principle is relatively novel, with Henry Kissinger submitting that “the very concept...is of recent vintage”, supporting this with the absence of the term from the sixth edition of *Black’s Law Dictionary*, 1990.¹⁴³ Others argue that the principle is centuries old, emanating from the maxim *hostis humani generis*. Most will query the efficacy of questioning the age of the principle, and rather one should turn attention to the legalities of its usage. Nevertheless, as the seeds of the future lie buried in the past, I will briefly address this issue.

The prosecution of pirates on the High Sea is regarded as the oldest application of the principle. *Hostis humani generis* – enemy of mankind – derives from admiralty law and, more specifically, the status of maritime pirates. States have exercised universal jurisdiction over pirates, irrespective of their nationality, for over 500 years.¹⁴⁴ The apprehension and trial of pirates within foreign courts is now recognised as a

¹⁴¹ Latin for “compelling law”.

¹⁴² Latin for “in relation to everyone”.

¹⁴³ Henry Kissinger, “The Pitfalls of Universal Jurisdiction”, July / August 2001

¹⁴⁴ Amnesty International, “Chapter Two: The History of Universal Jurisdiction”

jus cogens, part of customary international law, as well as being codified within universal conventions.¹⁴⁵

This principle was extended to torturers, as recognised in *Filartiga v. Pena-Irala*¹⁴⁶ when the court held that “the torturer has become like the pirate before him...an enemy of all mankind”.

Scholars have argued the dangers of making comparisons between those who commit piracy and those for commit breaches of peremptory norms such as genocide.

These arguments do not lack force. Nevertheless, of greater importance are the similarities of the core philosophy behind both principles – to prosecute those who pose a threat to mankind’s existence, whether on land or by sea.

From piracy the historic development of the principle skips directly to the Nuremberg and Tokyo Trials, “usually acknowledged as the birth of the modern form”¹⁴⁷. Following this the 1961 trial of Adolf Eichman by Israel was “based on the concept of universal jurisdiction”¹⁴⁸, a decision by the Israeli Supreme Court that resulted in much debate due to what some opponents believed was a nebulous judgment.

The principle found notoriety in the late 1990s with the *cause célèbre* being the protracted legal wrangling regarding Senator Pinochet, a subject I will explore in more detail in a later chapter. Further prominence was added following the decision of the International Court of Justice in *Congo v. Belgium* (or The Arrest Warrant Case)¹⁴⁹. Alas, as with other legal principles, with prominence comes appraisal and with appraisal comes opposition.

The twenty-first century has brought about further evolution of universal jurisdiction and it is continuing to develop with “extraordinary momentum”¹⁵⁰. Inexorably, evolution will produce further debate. At the time of writing the UN Human Rights Council commissioned report into the 2008-9 Gaza Conflict reached its conclusions of potential war crimes and crimes against humanity committed by both Israel and the *de facto* administration led by Hamas. Judge Richard Goldstone, the chief inspector of the investigation, has called upon individual countries to invoke their universal jurisdiction to prosecute the perpetrators of the conflict.¹⁵¹

¹⁴⁵ Article 19 of the 1958 Geneva Convention on the High Sea and Article 105 of the 1982 Montego Bay Convention.

¹⁴⁶ (1980) 630 F.2d 876.

¹⁴⁷ Yana Shy Kraytman, ‘Universal Jurisdiction – Historical Roots and Modern Implications’, BSIS Journal of International Studies, Vol. 2, 2005, page 96.

¹⁴⁸ Kenneth Rost, “The Case for Universal Jurisdiction”, September / October 2001.

¹⁴⁹ Arrest Warrant of 11 April 2000, Democratic Republic of the Congo v. Belgium, International Court of Justice, 14 February 2002

¹⁵⁰ Geoffrey Robertson QC, ‘Fair Trials for Terrorists?’, (2005) Cambridge University Press.

¹⁵¹ Paragraph 127 of Report of the United Nations Fact Finding Mission on the Gaza Conflict, 2009; *The Guardian* Newspaper

As I will explore in a subsequent chapter, some nations have gradually reduced the statutory recognition of universal jurisdiction, whilst others have gone as far as abrogating it. Notoriously, Belgium is one country that has relaxed her laws on universal jurisdiction following the *The Arrest Warrant Case*, a case that furnishes opponents to the principle with supportive *obiter dictum*, particularly in the separate and dissenting opinions of the Court.¹⁵² These changes in national laws are, however, concomitant with the formation of the International Criminal Court. This paper will focus on the International Criminal Court, and question whether it can provide a viable and long-term solution to ensuring the indictment and prosecution of heinous criminals.

For clarification, I do not seek to endorse one school of thought over another and will provide an apolitical overview of both sides. The arguments have and will continue to be arbitrated by the courts, national and also international.

Chapter 2 - From Voltaire to Kissinger: Arguments against universal jurisdiction

*“Judges are not the avengers of humankind in general... A crime is punishable only in the country where it was committed.”*¹⁵³

* * * * *

Throughout the eighteenth century, Voltaire stood at the apex of opposition to the principle of universal jurisdiction, sequentially influencing the work of Beccaria, other Enlightenment philosophers, and the lawmakers of the Revolution. As a supporter of Voltaire, Martens unequivocally asserted that “the lawmaker’s power extends over all persons and property present in the State”, nevertheless, “the law does not extend over other States and their subjects”.

The turn of the twentieth century, and in particular the “universalisation” of warfare following the two world wars and the proliferation of nuclear weaponry, has seen an increase in the significance of ensuring that those who commit crimes contrary to international law should be brought to either national or international justice. Crimes committed during warfare, or the obliteration of large racial groups, have

(UK), 16th September 2009, page 16

¹⁵² Opinions by President Guillaume and Judge Oda respectively.

¹⁵³ Beccaria, *Traite des delits et des peines*, para. 21 (1764)

overtaken piracy as the most heinous of crimes. Securing prosecutions is therefore of the utmost importance.

In the twentieth century there has been no more vehement opponent to the principle as the former United States Secretary of State, Henry Kissinger. In July 2001 he published ‘The Pitfalls of Universal Jurisdiction’¹⁵⁴ in which he unambiguously details criticism towards the application of the principle, and speaks of his concerns for the formation of the International Criminal Court.

The arguments against the principle cannot simply be placed into an exhaustive and hierarchal list. Nevertheless, one of the key arguments against universal jurisdiction is its politicisation. Kissinger writes that nations “should not allow legal principles to be used as weapons to settle political scores”¹⁵⁵, and with even more eloquence, “universal jurisdiction risks creating universal tyranny – that of judges”.¹⁵⁶

In today’s political environment, durable foreign relations are imperative for a country’s stability, both diplomatically and economically. Opponents are concerned that attempts to prosecute foreign politicians will significantly affect fundamental foreign policy objectives, and that countries will merely enjoy a political “tit-for-tat”, the result of which will only enhance hostility. Kissinger uses the example of the Arab-Israeli conflict, and how universal jurisdiction would “permit the two sides...to project their battles into the various national courts by pursuing adversaries with extradition requests”.¹⁵⁷ Inexorably the accused will be subjected to a show trial arbitrated by quasi-judicial jurists. Of equal importance to diplomacy is the legal right of a nation to defend herself, a right which opponents contend, nations will be diffident to do with the threat of future prosecutions.

The United Nations Charter affirms that all states should be equal in sovereignty. Opponents argue that this ‘*Westphalian sovereignty*’ is breached by universal jurisdiction. States must endeavour to uphold the independence and impartiality of their own judiciary, and that for a state to claim jurisdiction over the national of a fellow sovereign state (*de jure* or *de facto*) is untenable. The appropriate solution to the problem of judicial activism is reliance upon territorial jurisdiction. The examples of wholesale criminal trials for human rights violators in post-Franco Spain and the independent inquiries in post-apartheid South Africa are cited to emphasise the value of national reconciliation, which in time leads to a more vigorous democracy.

¹⁵⁴ *Ibid.* at 5.

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

The final criticism regards rules of procedure and law. Despite the political and legal expedience of the Nuremberg Trial, commentators to this very day have disputed the rules of procedure as being imbalanced and formulated *ex post facto*. Kissinger argues that the decision of the British House of Lords in *Pinochet (No.3)*¹⁵⁸ sets a perilous precedent to enforce extradition requests designed for “ordinary” criminals, and thus raising important questions about dissimilar rules of evidence, or rights of the accused.

Chapter 3: Arguments in support of universal jurisdiction

*“Behind much of the savagery of modern history lies impunity”*¹⁵⁹

* * * * *

Support for the principle of universal jurisdiction dates back to the writings of Covarruvias and “the father of international law”¹⁶⁰, Hugo Grotius. They advocated the right for nation states to prosecute those who sought refuge in their country, irrespective of the territory where the crime was committed. For them to enjoy the fruits of their crimes in a foreign state was, they stated, intolerable.

The core argument for nation states to invoke their universal jurisdiction is for them to act in accordance with the maxim *aut dedere, aut judicare* – to either extradite or prosecute those accused. Grotius *et al.* contended that a country had a moral obligation to either extradite the accused or to prosecute them in their own courts. Current day proponents, including Amnesty International, support that it is incumbent upon the arresting state to endeavour to bring those responsible for committing egregious crimes to international justice.

In the midst of criminal expansionism, prosecutions are not merely expedient, but necessary¹⁶¹ for providing solace to victims and their families. If it is not practicable for such prosecution to take place within the country where the crime was committed, then other countries should not be inhibited from doing so. Proponents believe that opposition to the principle is inimical to the international rule of law.

In addition to the moral obligation (which can be disregarded as liberal idealism), signatories to the

¹⁵⁸ *R v. Metropolitan Stipendiary Magistrate and others, ex parte Pinochet Ugarte (No. 3)*, [1999] All ER (D) 325

¹⁵⁹ Kenneth Roth, ‘The Case for Universal Jurisdiction’, September/October 2001.

¹⁶⁰ J G Starke, *Introduction to International Law*, 9th Ed., (1984).

¹⁶¹ For an interesting semantic summary of the difference between ‘expedient’ and ‘necessary’, see the dicta of Lord Bingham of Cornhill in *R(on the application of Gillan) v. Commissioner of Police for the Metropolis and another* [2006] UKHL 12, at para. 13.

Fourth Geneva Convention of 1949 are also under a legal obligation to prosecute or extradite those accused. Article 146 of the Convention provides:

“Each High Contracting Party shall be under the obligation to search for persons alleged to have committed, or to have ordered to be committed, such grave breaches, and shall bring such persons, *regardless of their nationality, before its own courts*. It may also, if it prefers, and in accordance with the provisions of its own legislation, hand such persons over for trial to another High Contracting Party concerned, provided such High Contracting Party has made out a *prima facie* case.”

Article 146 was cited (along with Section 134 of the Criminal Justice Act 1988 – See Chapter 4, United Kingdom) in September 2005 by lawyers acting for a group of Palestinians seeking a warrant for the arrest of Israeli Major-General Oron Almog, at the time planning a visit to the United Kingdom. The warrant was duly granted by Bow Street Magistrates’ Court; however, due to certain political issues, Almog did not leave the aircraft.

Proponents argue that judicial deference to decline intervention is unthinkable when dealing with the most flagrant violations of human rights. Furthermore, arguments to avoid prosecutions due to breaches of national sovereignty are merely totalitarian, protectionist and “super-power” exceptionalism. Often, exercising universal jurisdiction is the last resort if there is no viable possibility of national investigations, or as I will explore further in Chapter 6, the country from where the accused has been naturalised is not a signatory to the Rome Statute of the International Criminal Court.

Finally, to counter the arguments of inequitable proceedings in foreign courts, proponents of the principle believe that the accused will ostensibly receive a more fair and impartial trial due to the objectivity of non-national jurists. This option finds the appropriate equilibrium between “judicial activism” and “judicial deference”. Moreover, with the independence of the judiciary in the majority of countries which have invoked the principle, the decision therefore lies not with the incumbent government, but with autonomous and learned judges.

Chapter 4: Comparative Analysis of National Laws on Universal Jurisdiction

“It does not seem...that it has been shown that there is any State practice or general consensus let alone a widely supported convention that all crimes against international law should be justiciable in National Courts on the basis of the universality of jurisdiction”.¹⁶²

* * * * *

I will now perform a comparative analysis of some of the leading Nations and the existence of legislation regarding the principle of universal jurisdiction. It will focus on the maxim aut dedere, aut judicare – whether a Nation should extradite the perpetrator, or whether they have a statutory obligation to prosecute them. Certain nations have often sought arrest warrants, and this has raised questions over whether crimes are justiciable in National Courts.

I will also précis the two ad hoc international tribunals that have been set up for specific investigations, namely the 1993 International Criminal Tribunal for the Former Yugoslavia (ICTY) and the 1994 International Criminal Tribunal for Rwanda (ICTR). Certain Nations have enshrined laws to allow for the exercise of absolute universal jurisdiction in relation to crimes committed in these two regions. Both tribunals were set up by the UN resolutions from the Security Council – 827 and 955 respectively.

1. Spain

Following the order from Baltazar Garzon for the arrest of Augusto Pinochet in October 1998 under an international arrest warrant, Spain has become infamous on a global scale. Often referred to as the ‘world’s judicial gendarme’, the Audicencia National in Madrid has been at the forefront of investigations into international conflicts for the past decade, until recently the Spanish Parliament voted through legislation to diminish the laws on absolute universal jurisdiction.

Prior to the recent changes, Spanish law contained two provisions regarding the principle of universal jurisdiction. Firstly, under Article 65 of Ley Organica del Poder Judicial (LOPJ), Spanish courts had jurisdiction to prosecute crimes committed abroad where Spain, by nature of their signatory status to certain international statutes, is obliged to exercise jurisdiction. Furthermore, Article 23.4 of the LOPJ,

¹⁶² Lord Slynn of Hadley, *ex parte Pinochet* (No. 1) [1998] UKHL 41.

enacted on 1st July 1985, specifies genocide and terrorism as crimes that may invoke the principle.

Alas, on 25th June 2009 Spain's lower house of Parliament voted unequivocally in favour¹⁶³ of narrowing the law. In a move to limit the competence of the Audencia Nacional, the new law allows Spanish courts to exercise their universal jurisdiction only if Spanish citizens have been directly affected, a move which lawyers in Spain have described as "a step backwards for democracy, a clear path towards impunity".¹⁶⁴

Despite Spain's notoriety there have been limited successful prosecutions. The Pinochet case, notwithstanding the unprecedented decision of the British House of Lords to prohibit immunity, was considered a failure by some commentators in that the ex-Chilean leader was not extradited to Spain to stand trial. Successful prosecutions are limited to the former Argentine naval officers, Adolfo Scilingo and Ricardo Miguel Cavallo.

2. France

Under French law, the only form of universal jurisdiction that has been incorporated is that based on treaty obligations in respect of certain offences: however, there has been no incorporation based on customary international law and jus cogens.

Article 689-1 of the code de procedure penale (French Code of Criminal Procedure) defines the mechanism of treaty-based universal jurisdiction:

"Perpetrators of or accomplices to offences committed outside the territory of the Republic may be prosecuted and tried by French courts either when French law is applicable under the provisions of Book 1 of the Criminal Code or any other statute, or when an international Convention gives jurisdiction to French courts to deal with the offence".¹⁶⁵

¹⁶³ 339 votes for, 8 against, 1 abstention

¹⁶⁴ A Segura and R Marillo, 'In defense of Universal Jurisdiction', May 24th 2009.

¹⁶⁵ All translations of the French Criminal Code are taken from the official site of the French Government, www.legifrance.gouv.fr. I also wish to pay thanks to Ms. B Dorfmann for her additional assistance.

Upon ratifying the UN Convention against Torture 1984, the French Government enacted Article 689-2. This ensures that crimes of torture are justiciable in French courts, however with an important caveat that the person may only be prosecuted and tried if he is “found in France”.

To date the principle of universal jurisdiction has only been applied on one occasion in France, and this was fraught with its own legal difficulties. On 1st July 2005, after numerous appeals and cross-appeals, Ely Ould Dah was sentenced by the Cour d’assises a Nîmes to ten years imprisonment for the torture of Black-African members of the Mauritanian military in 1990-1 at the Jreida death camp. Scholars believe this case represents a “significant step forward in the fight against impunity”.¹⁶⁶

The ratification of the Rome Statute of the International Criminal Court has compelled the French Government to propose legislation to incorporate Articles 5 – 8 of the Statute, the Articles that legally define genocide, crimes against humanity, war crimes and crimes of aggression. This legislation is not yet in force.

3. Belgium

Alongside Spain, Belgium is globally recognised for their unfettered deposition of suits against high-profile international politicians, including former US President, George H.W. Bush Snr., former Prime Minister of Israel, Ariel Sharon, and the late head of the Palestinian Liberation Organisation, Yasser Arafat.

Belgium has seen a relaxation of its law on universal jurisdiction since the Belgian Parliament voted in the laws of 1993 and 1999¹⁶⁷ (which was amended to include crimes against humanity and genocide). The repeal of the law included two important caveats; firstly, that the accused person be of Belgian nationality or secondly, that the accused is present in Belgium at the time of his arrest, therefore abolishing the principle of universality in absentia. The repeal of the “law of universal jurisdiction” was passed on 1st August 2003 as a consequence of political pressures following the majority decision of the International Criminal Court in The Arrest Warrant Case¹⁶⁸, the facts of which are outlined below.

¹⁶⁶ Unknown author, ‘Implementing the principle of Universal Jurisdiction in France’, (2006).

¹⁶⁷ Act Concerning the Punishment of Grave Breaches of International Humanitarian Law, February 10 1999, Article 5(3) and Article 7

¹⁶⁸ *Ibid* at 11.

On 11th April 2000 a Belgian magistrate, invoking the 1999 law on universal jurisdiction, issued an international arrest warrant in absentia against Adbulaye Yerodia Ndombasi (herein referred to as “Mr. Yerodia”), then the incumbent foreign minister of the Democratic Republic of Congo. Mr. Yerodia was accused of having made “various speeches inciting racial hatred”¹⁶⁹ contrary to the Geneva Convention of 1949. On 17th October 2000 the Congo filed an application for Belgium to annul the arrest warrant based on two separate legal issues. Firstly, that the law on universal jurisdiction violated the principle of sovereign equality. The second legal contention relates to the law of state official immunity, the true impact of which will be discussed further in Chapter 6.

Despite the severity of the change in Belgian law, some investigations that had already commenced pre-2003 continued. These residual cases include the former President of Chad, Hissene Habre, who was indicted in September 2005 for crimes against humanity, torture and war crimes. Belgium is still awaiting his extradition from Senegal, where he is currently subject to house arrest.

4. United Kingdom

Due to the absence of a codified constitution in the United Kingdom, ratified treaties are not automatically incorporated into domestic law. Two Acts of Parliament – Geneva Conventions Act 1957¹⁷⁰ and Criminal Justice Act 1988¹⁷¹ - include provisions that allow individuals to be tried in British Courts for committing breaches of certain jus cogens. Moreover, the British Parliament was prompt in legislating to enforce breaches of Articles 5, 6 and 7 (genocide, crimes against humanity and war crimes) of the Rome Statute with the implementation of the International Criminal Court Act 2001¹⁷². There is a notable absence of “crimes of aggression” from the 2001 Act, much to the frustration of the British Left who claim that the declaration of war against Iraq in 2003 was a “crime of aggression”. This argument was advanced in R v Jones and others¹⁷³ in which the British House of Lords held per curiam that the “crime of aggression” was not a crime under British law.

¹⁶⁹ *Ibid.*, para 15.

¹⁷⁰ Geneva Conventions Act 1957 (c.52)

¹⁷¹ Criminal Justice Act (c.33)

¹⁷² International Criminal Court Act 2001 (c. 17)

¹⁷³ [2006] UKHL 16.

Section 1(1) of the Geneva Conventions Act 1957 states:

“Any person, whatever his nationality, who, whether in or outside the United Kingdom, commits, or aids, abets or procures the commission by any other person of a grave breach of any of the scheduled conventions or the first protocol shall be guilty of an offence.”

Section 1(2) of the 1957 Act further enshrines the principle of universal jurisdiction into British domestic law for breaches of the Fourth Geneva Convention 1949. It provides:

“In the case of an offence under this section committed outside the United Kingdom, a person may be proceeded against, indicted, tried and punished therefore in any place in the United Kingdom as if the offence had been committed in that place... ”.

Following the United Kingdom becoming a party to the UN Convention against Torture 1984, the British Parliament enacted Sections 134 and 135 of the Criminal Justice Act 1988. Section 134 is limited to the crime of torture.

Section 134 of the Act provides:

“A public official or person acting in an official capacity, whatever his nationality, commits the offence of torture if in the United Kingdom or elsewhere he intentionally inflicts severe pain or suffering on another in the performance or purported performance of his official duties”.

Section 135 of the Act sets out that no prosecution can be brought under Section 134 without the consent of the Attorney General.

The retrospectivity of Section 134 of the Act was held not to exist by the seven-Lord Judicial Committee of the House of Lords in R v Metropolitan Stipendiary Magistrate and others, ex parte Pinochet Ugarte

(No. 3)¹⁷⁴. Thus, charges against Augusto Pinochet for torture and conspiracy to torture relating to conduct before Section 134 came into effect were not extraditable.

To date, only one person has been convicted in a British Court for crimes committed abroad. Afghani warlord, Faryadi Zardad, was convicted under Section 134 of the 1988 Act for torture committed during the 1990s in Afghanistan. Zardad was sentenced to twenty years imprisonment.

There are proposals in the offing to repeal the law regarding the issuance of arrest warrants by magistrates under the Geneva Conventions Act 1957 and International Criminal Court Act 2001. These proposals were prompted by an attempt to issue an arrest warrant for former Israeli Foreign Secretary, Tzipi Livni. The proposals include the requirement for consent by the Attorney-General, not only for decision to prosecute, but for the issuance of the arrest warrant. Many on the British Left reject these proposals as diminishing the independence of the judiciary and increasing the powers of the quasi-judicial role of the government.

5. Norway

Article 12.4 of the Norwegian General Civil Penal Code enables the prosecution of non-Norwegian nationals for murder and assault committed overseas. The law, however, states that that offender must be “resident in the realm or is staying therein”. Norway’s ruling government has been criticised for allowing Norway to become a haven for alleged war criminals who remain at liberty. In order to reduce further reproach, in September 2005 a special prosecutor and investigating unit was established to create a detailed list of cases in order to formulate guidelines for the selection of potential indictments.

The chief Norwegian prosecutor, Siri Frigaard, has recently¹⁷⁵ dismissed complaints filed accusing former Israeli Prime Minister, Ehud Olmert, of committing war crimes during the 2008/9 incursion into Gaza. Frigaard commented that Norway “must show great care”¹⁷⁶ when investigating complaints of breaches of jus cogens.

¹⁷⁴ [1999] All ER (D) 325

¹⁷⁵ 6th November 2009, ‘Norway dismisses Israel war crimes complaint’, www.ynetnews.com

¹⁷⁶ *Ibid.*

Nota Bene – *To avoid duplication I find it necessary to set out the following. All of the above nations have ratified the International Criminal Court. Therefore, their obligation under the Rome Statute to “exercise [their] criminal jurisdiction over those responsible for international crimes”¹⁷⁷ forms part of their national laws, and (technically) supersedes national law.*

6. The United States of America

The principle of universal jurisdiction is inconspicuous under United States law when compared to the European countries listed above. The only entry within the United States Code referring to the principle is the law criminalising torture under the Extraterritorial Torture Statute of 1994. This law is codified at 18 USC § 2340A. The statute prohibits torture committed by both US citizens and non-citizens who are present in the United States of America.

18 USC § 2340A(b) states:

“There is jurisdiction...if (1) the alleged offender is a national of the United States, or (2) the alleged offender is present in the United States, irrespective of the nationality of the victim or alleged offender”

To date no non-citizen has been indicted under this statute, a statistic that has disappointed the UN Committee Against Torture. The only US-citizen to be indicted is Charles “Chuckie Taylor” Jnr, son of the Liberian President Charles Taylor. On 8th January 2009 he was sentenced to ninety-seven years imprisonment.

7. International Criminal Tribunal for the Former Yugoslavia¹⁷⁸

The Tribunal was established by UN Security Council Resolution 827, passed on 25th May 1993, to prosecute serious crimes committed during the numerous wars in the Balkans. The remit of the ad hoc tribunal extended only to the trial of individuals, not of entire governments. Since its formation in 1994, the tribunal has indicted approximately 160 individuals. Indictees have included former President of the

¹⁷⁷ Preamble to Rome Statute of the International Criminal Court.

¹⁷⁸ Full title, the International Tribunal for the Prosecution of Persons Responsible for Serious Violations of International Humanitarian Law Committed in the Territory of the Former Yugoslavia since 1991.

Federal Republic of Yugoslavia, Slobodan Milosevic¹⁷⁹, Milan Babic,¹⁸⁰ Ramush Haradinaj,¹⁸¹ and most recently Radavan Karadzic. The Tribunal seeks to conclude all trials by the end of 2010.

8. International Criminal Tribunal for Rwanda

The Tribunal was established in November 1994 by UN Security Council Resolution 955 to prosecute serious crimes committed during the Rwandan genocide of Tutsis by the Hutu Government in January 1994. The Tribunal plans to complete all trials by 2012. To date, twenty-nine of the accused have been convicted, including former Rwandan Prime Minister, Jean Kambanda.

Chapter 5 – The International Criminal Court

“An International Criminal Court is hereby established. It shall be a permanent institution and shall have the power to exercise its jurisdiction over persons for the most serious of crimes of international concern...”¹⁸²

* * * * *

And finally, the pertinent and inevitable question – will the International Criminal Court, which came into being on the 1st July 2002, provide a long-term and viable solution to the criticisms listed in Chapter 2 of countries exercising their universal jurisdiction?

i. History of the Court

The ideology and raison d'être behind the formation of the Court derives from the Nuremberg and Tokyo Tribunals, set up to deal with the atrocities committed during the Second World War. The idea to establish a permanent international tribunal was revived in 1989 following the fall of the Berlin Wall and the sharp increase in the illegal drug trade in the Central and South Americas. The requirement for such a tribunal was further highlighted following the ad hoc tribunals in the Former Yugoslavia and

¹⁷⁹ Who, after a five-year trial, died in the War Criminal Prison in the Hague on 11th March 2006.

¹⁸⁰ President of the Republika Srpska Krajina

¹⁸¹ Former Prime Minister of Kosovo

¹⁸² Article 1, Rome Statute of the International Criminal Court – Part 1 Establishment of the Court

Rwanda. On the 17th July 1998 the General Assembly of the United Nations convened a conference in Rome which duly adopted the statute by a vote of 120 to 7, with 21 countries abstaining. The seven countries that voted against the treaty were People's Republic of China, Iraq, Israel, Libya, Qatar, the United States of America, and Yemen. The statute legally came into force on the 1st July 2002. At the time of writing 110 countries have ratified the court with the Czech Republic recently becoming the 110th State Party. A further eight countries¹⁸³ have acceded to the Statute and negotiations regarding the ratification are underway with their respective legislatures.

ii. The Court's Remit and Current Work

The Court is legally and functionally independent from the United Nations. Furthermore, the Court only has jurisdiction *ratione temporis*, "with respect to crimes committed after the entry into force of [the] Statute".¹⁸⁴ Article 14 of the Rome Statute provides that only a member of the court may refer a situation to the Prosecutor requesting an investigation. If the country where the accused is naturalised is not a Member State then the Prosecutor must rely on a United Nations Security Council Resolution, as in the investigation and prosecutions relating to Darfur, Sudan.

The Rome Statute unambiguously states that the primary responsibility to investigate situations and prosecute criminals is for the Member State. Article 17 of the Rome Statute provides that a case shall only be judged admissible if the Member State is "unwilling or unable genuinely to carry out the investigation or prosecution".¹⁸⁵

At the time of writing there are four ongoing investigations authorised by the Court: Uganda, Democratic Republic of the Congo, Central African Republic and Darfur (Sudan). The situation in Darfur was referred to the Prosecutor following Security Council Resolution 1593 after the USA withheld their veto to permit the investigation. Moreover, the situation in Darfur produced the indictment of Omar al-Bashir, the first acting head of state. More recently, the Prosecutor confirmed that he is closely analysing the situation in Kenya following the disputed presidential election in 2007.

¹⁸³ The accession states are Afghanistan, Cook Islands, Dominica, East Timor, Japan, St. Kitts and Nevis, Turkey and Suriname.

¹⁸⁴ Article 11 of the Rome Statute of the International Criminal Court.

¹⁸⁵ Article 17 of the Rome Statute of the International Criminal Court.

Opposition to the Court's formation

The status quo is that a number of “major” nations have not ratified the Rome Statute, most notably, the United States of America, People’s Republic of China, Russia¹⁸⁶, India and Israel. The most tempestuous relationship has been that of the USA and the Court, which has resulted in the USA taking direct action to protect its sovereignty. For completeness, I shall provide a laconic history of the relationship between the United States of America and the International Criminal Court.

Former President Bill Clinton signed the Rome Statute on 31st December 2000, nevertheless he did not submit the treaty to the Senate for ratification as is required under US law. Clinton’s successor, Former President George W. Bush took the decision to nullify the US’s signature citing a clear breach on national sovereignty, a decision supported by Henry Kissinger.¹⁸⁷ President Bush went further than the nullification to protect the sovereignty of the USA. Firstly, President Bush approached certain allies to secure bilateral immunity agreements to prohibit the surrender of government officials and military personnel. Secondly, the American Service Members’ Protection Act (ASPA) was signed into law. The provisions of ASPA authorises the President to use “all means necessary and appropriate to bring about the release of any US or allied personnel being detained or imprisoned by, on behalf of, or at the request of the International Criminal Court”.

The primary argument in opposition to the Court is its potential to diminish national sovereignty. For countries such as the US and China, their constitutions represent the supreme law for their citizens to adhere to. Further criticisms, particularly for American citizens, include the suspension of legal safeguards if they were brought before the Court enjoyed under the US Constitution.

¹⁸⁶ Russia have signed but not ratified the Statute.

¹⁸⁷ *Ibid.* at 5.

Chapter 6 – Immunity

“State immunity is the product of a conflict between two international law principles, sovereign equality and adjudicatory jurisdiction”.¹⁸⁸

* * * * *

*Scholars argue that the laws governing immunity from prosecution are yet further obstacles that stand between the prevention of impunity and breach of sovereignty. Two separate immunities are recognised by international law; immunity *ratione personae* and immunity *ratione materiae*. The scope of both immunities have been at the centre of supreme jurisprudence in the last twenty years, including the decision of the British*

House of Lords in Pinochet (No. 3)¹⁸⁹ and the judgment of the International Court of Justice in the Arrest Warrant Case¹⁹⁰. I shall also consider the effects of international treaties regarding immunity, and whether the obstacle of immunity can be easily overcome

i. State Immunity – Immunity Ratione Personae

Certain scholars argue that there has been little evolution to the law of immunity since Louis XIV’s famous retort to the Paris Parliament, “L’état c’est moi” - the principle that the Head of State, regarded as the personal embodiment of the state itself, is entitled to the same immunity.

*Immunity *ratione personae* is not only available to a country’s Head of State. It is also available to certain individuals by reasons of their function in government, including Ministers for Foreign Affairs. As Lord Millet writes in Pinochet (No. 3), there are some important caveats: “[I]t is not available to serving heads of government who are not also heads of state...It would have been available to Hitler but not to Mussolini or Tojo”. It ensures for absolute immunity from both criminal prosecution and civil liability¹⁹¹ in foreign courts. The “weak spot”¹⁹² of this type of immunity is that it ensures for his/her benefit only so long as they remain incumbent. The extension of this principle to Ministers for Foreign*

¹⁸⁸ Lee M Caplan, ‘State Immunity, Human Rights, and *Jus Cogens*: A Critique of the Normative Hierarchy Theory’, 2004

¹⁸⁹ *Ibid.* at 20.

¹⁹⁰ *Ibid.* at 11.

¹⁹¹ For civil, see *Al-Adsani v. United Kingdom* (no. 31253/96), European Court of Human Rights, Grand Chamber.

¹⁹² S Wirth, ‘Immunity for Core Crimes? The ICJ’s Judgment in the Congo v. Belgium Case, EJIL 13 (2002) 877 – 893.

Affairs is not for their personal benefit. It is, as per the majority of the International Court of Justice in The Arrest Warrant Case, “to ensure the effective performance of their functions on behalf of their respective States”.¹⁹³ The rationale of this principle is that the person who enjoys such immunity is in charge of their government’s diplomatic activities.

*The significant issue in the Arrest Warrant Case was whether immunity *ratione personae* should extend to breaches of *jus cogens* (referred to in the judgment as “core crimes”). The majority opined that it should do, a decision which has been criticised as being decided *per incuriam*.*

ii. Immunity Ratione Materiae

*In comparison, immunity *ratione materiae* is a functional, subject-matter immunity. It is available to former Heads of State who have relinquished their role in respect of their governmental or official acts. The rationale of immunity *ratione materiae* is to preserve the integrity of the activities of the state, and thus provide immunity to one’s official acts during their tenure. This principle is enunciated further in the Latin maxim *par in parem non habet imperium*, the effect of which is that one sovereign state does not adjudicate on the conduct of another.*

*The protection afforded by immunity *ratione materiae* was discussed at length by the British House of Lords in Pinochet (No.3). Referring only to the crime of torture - now a crime of humanity as defined under Article 7(f) of the Rome Statute of the International Criminal Court – the majority of the Law Lords held that this crime could not be said to be a state function. Therefore, it was held that Senator Pinochet would have been shielded from the indictment if he were still the Head of the Republic of Chile by immunity *ratione personae*, even for the crime of torture. This is very much consistent with the decision in the Arrest Warrant Case. The House of Lords did not go beyond their remit to discuss *obiter dicta* the parameters of which core crimes would or would not abolish immunity *ratione materiae*, but one would hope that all *jus cogens* would not be regarded as normal State functions.*

iii. Immunity and the International Criminal Court

*The Rome Statute of the International Criminal Court provides two separate provisions pertaining to immunity from prosecution, both under Article 27. Firstly, Article 27 (1), abolishing immunity *ratione materiae*, provides:*

¹⁹³ *Congo v Belgium*, para. 53 of majority judgment.

“This Statute shall apply equally to all persons without any distinction based on official capacity. In particular, official capacity as a Head of State of Government, a member of Government or parliament, an elective representative or a Government official shall in no case exempt a person from criminal responsibility under this Statute, nor shall it, in and of itself, constitute a ground for reduction in sentence.”

*Furthermore, Article 27 (2), abolishing *ratione personae*, provides:*

“Immunities or special procedural rules which may attach to the official capacity of a person, whether under national international law, shall not bar the Court from exercising its jurisdiction over such a person.”

Some commentators have also asserted that the latter part of Article 27(1) – the reduction in sentence – is similar to the Nuremberg Defence.¹⁹⁴

*Article 27 was first implemented following the indictment of Sudanese Head of State, Omar al-Bashir, who under customary international law would have received immunity *ratione personae*. Merely based on this example it is evident that the International Criminal Court will not allow total impunity from prosecution.*

iv. Discussion

Whilst the decision of the International Court of Justice in the Arrest Warrant Case led to the arrest warrant issued by the Belgian magistrate to be revoked, it was only binding on the two parties to the case, and therefore only obiter dictum on all other nations. The powers of the International Criminal Court are limited to those cases brought before them. Article 27 cannot be cited in national courts, and therefore the inequity of the decision in the Arrest Warrant Case will prevail.

¹⁹⁴ Cassese A, ‘The Sharon and Others Case’, (2003) ICJJ 437

Inconsistencies remain with customary international law and the Rome Statute of the International Criminal Court. As stated in Article 17, the Court must complement the national investigation, and only proceed if the State is “unwilling” to prosecute. The following example will illustrate the central predicament:

*Following the full Coalition withdrawal from Iraq, the Iraqi Government vote to accede to the Court. Thereafter, it charges the incumbent Foreign Secretary of the United Kingdom with war crimes and of committing a crime of aggression. The former Foreign Secretary is in Spain (a State Party of the Rome Statute) giving a speech. The Iraqi courts request that Spain, applying *aut dedere, aut judicare*, extradite or prosecute the Foreign Secretary. The Spanish judge cites the Arrest Warrant Case to mean that the former Prime Minister enjoys immunity *ratione personae*. Iraq refers the situation to the Prosecutor of the Court. Can he rule it admissible on the grounds that Spain was “unwilling” to carry out the prosecution?*

The answer to this query remains a moot point; however, arguably the answer would be ‘no’.

The majority judgment in the *Arrest Warrant Case* makes clear that “immunity from prosecution [*ratione personae*] ... does not mean that they enjoy impunity in respect of any crimes they might have committed”, describing ‘immunity’ and ‘impunity’ as “quite separate concepts”.¹⁹⁵ The Court then offered examples of how an incumbent member of Government enjoying immunity *ratione personae* cannot be exonerated from all criminal responsibility. These examples include domestic prosecutions by the accuser’s own courts; waiving of immunity from their own state to allow a foreign prosecution; prosecution in a foreign court when the accused ceases to hold office; and lastly, criminal proceedings before the International Criminal Court.

I am not alone in deeming these examples to be idealistic, although Judges Higgins, Kooijmans and Buergenthal of the International Court of Justice in their separate opinion in the *Arrest Warrant Case* use more politically correct language in enunciating their unease: “We feel less than sanguine about examples given by the Court”.¹⁹⁶ They proceed to put forward “the only credible alternative”¹⁹⁷ - universal jurisdiction. This alternative does, however, come with some caveats of an uncooperative

¹⁹⁵ *Ibid.* at 11, para 60.

¹⁹⁶ *Ibid.*, para 78 of separate opinion by Judges Higgins, Kooijmans and Buergenthal.

¹⁹⁷ *Ibid.*

government who opts to keep a Minister in office for an indeterminate period, or a dictator who dies in power. Both would therefore receive impunity and, despite centuries of jurisprudence, still be able to declaim “*L’état c’est moi*”.

Conclusion

“A culture of impunity continues to prevail”¹⁹⁸

* * * * *

I posed the question in my title as to whether the principle of universal jurisdiction can survive centuries of criticism. The short answer is ‘yes’, it has survived. Nevertheless, the unavoidable truth is that the momentum the principle has gathered since Pinochet (No. 3) has been rhetorical and not substantive. The unfortunate truism of international criminal law is that some people will receive impunity, largely due to the issues regarding immunity listed in Chapter 6.

In addition, the arguments against the principle are highly compelling. As I commenced my research for this paper I stood firm in my beliefs ‘for’ the principle. Ideologically, I am positive that the vast majority of us believe in the prosecution of bellicose leaders who have committed egregious crimes. Alas, realpolitik wins the day and diplomacy may have to be placed above the rule of law. This is accurately put by Sir Ian Brownlie QC, who writes:

“The overall problem remains. Political considerations, power, and patronage will continue to determine who is to be tried for international crimes and who not”.¹⁹⁹

Proceedings are fraught with difficulties, both legal and practical. Legal problems include the immunity that the accused may enjoy. Practical problems include the extradition and collating the inculpatory evidence needed for a prosecution.

The second question I posed was whether the International Criminal Court would provide a solution to the criticisms of the principle of universal jurisdiction. The short and long answer is

¹⁹⁸ Judge Richard Goldstone, Report of the United Nations Fact Finding Mission on the Gaza Conflict, 2009.

¹⁹⁹ Ian Brownlie, ‘The Principles of Public International Law’, 6th ed., (2003), pg. 575.

‘no’. Without the ratification of the United States of America, China and Russia the court does not have legitimacy. Furthermore, these three powers hold a veto in the United Nations Security Council to block any referral to the Prosecutor of the International Criminal Court for non-signatories to the court. Another unfortunate truism is that the International Criminal Court will not provide a panacea for breaches of international law.

There remains a problem. The International Criminal Court was perceived as a solution to the problems of universal jurisdiction. Yet, without the Court being ratified erga omnes, the principle of universal jurisdiction remains “the only credible alternative”.²⁰⁰

The desire for the proliferation of both the principle of universal jurisdiction and prosecutions at the International Criminal Court are, regrettably, Utopian. The law is not above us all.

Submitted by:

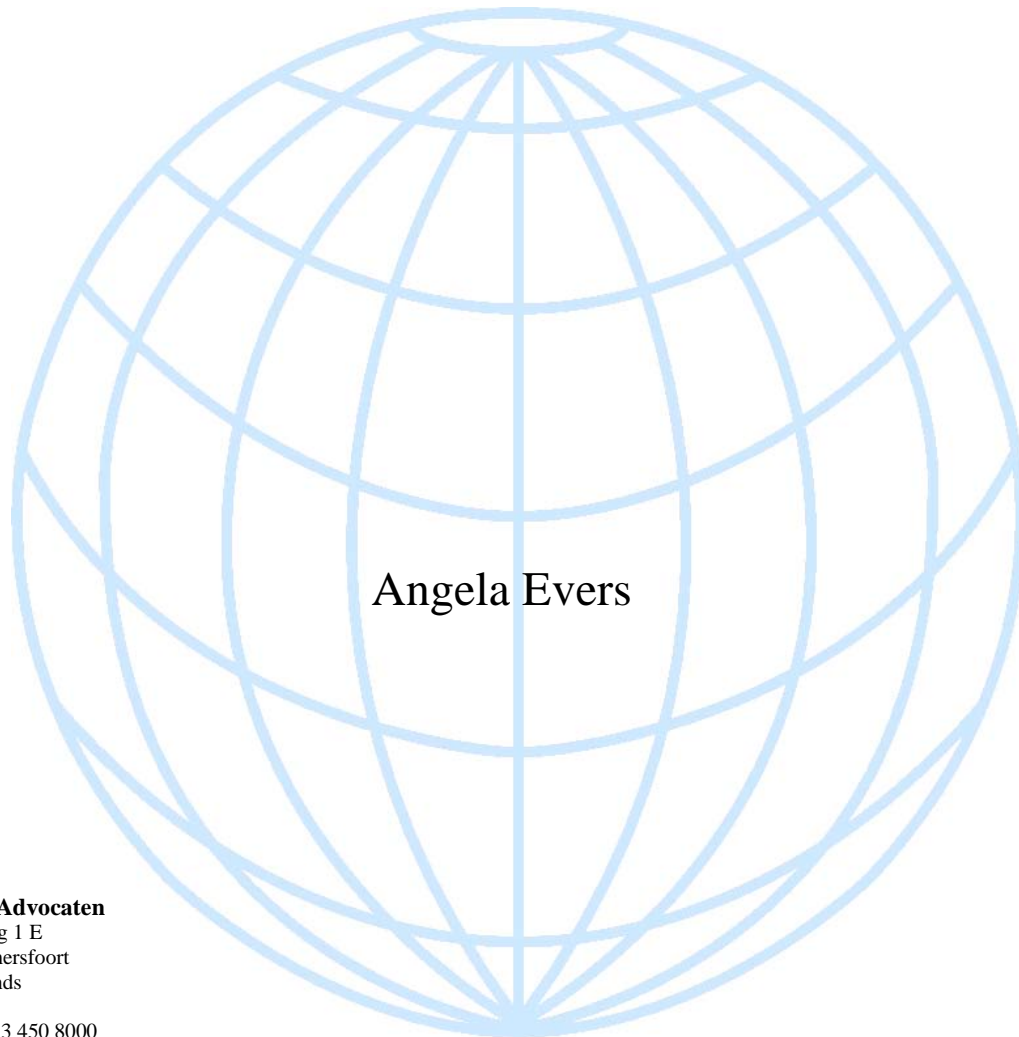
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Zak Golombeck

²⁰⁰ *Ibid.* at 59.

Companies' Freedom of Establishment after 'Sevic'

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Introduction

The freedom of establishment for the companies within the EU is of particular importance under European corporate law. The Court of Justice's judgment in *Sevic* has changed the issue of cooperation and consolidation between companies established in different Member States.

The intervention of the European Union with company law is based on the right of establishment (43 EU Treaty). In order to attain freedom of establishment as regards a particular activity, the Council, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, shall act by means of directives as described in article 44 EU Treaty. The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions. They will carry out their duties in particular by according, as a general rule, priority treatment to activities where freedom of establishment makes a particularly valuable contribution to the development of production and trade. Additionally, by ensuring close cooperation between the competent authorities in the Member States in order to ascertain the particular situation within the Community of the various activities concerned. Moreover by abolishing those administrative procedures and practices, whether resulting from national legislation or from agreements previously concluded between Member States, the maintenance of which would form an obstacle to freedom of establishment. In addition by ensuring that workers of one Member State employed in the territory of another Member State may remain in that territory for the purpose of taking up activities therein as self-employed persons, where they satisfy the conditions which they would be required to satisfy if they were entering that State at the time when they intended to take up such activities. Nevertheless, by enabling a national of one Member State to acquire and use land and buildings situated in the territory of another Member State, in so far as this does not conflict with the principles laid down in Article 33(2). Also by effecting the progressive abolition of restrictions on freedom of establishment in every branch of activity under consideration, both as regards the conditions for setting up agencies, branches or subsidiaries in the territory of a Member State and as regards the subsidiaries in the territory of a Member State and as regards the conditions governing the entry of personnel belonging to the main establishment into managerial or supervisory posts in such agencies, branches or subsidiaries; by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and other, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 with a view to making such safeguards equivalent throughout the Community and last but not least by satisfying themselves that the conditions of establishment are not distorted by aids granted by Member States.

After the process has stagnated for a long time, the last years some new directives have been adopted

and some existing directives have been modernized. What is the content and extent of these changes?

This paper will examine the above on the following question:

‘Is corporate mobility necessary and what does “Sevic” contribute to it?’

Is a Directive on Corporate Mobility still needed?’

Structure

The main question mentioned above will be explained in the following chapters. In chapter 1 the importance of corporate mobility will be discussed. Is it really an issue? In chapter 2 the content and meaning of the *Sevic* Case will be explained together with the structure of the case, the relevant articles of the EU Treaty, an explanation of the freedom of establishment and her (inherent) restrictions as well as the justification for such restriction. Finally, chapter 3 will discuss the judgment’s consequences in relation to Directive 2005/ 56/ EC of the European Parliament and of the Council of 26 October 2005 on Cross-border Mergers of limited liability companies (further on: the Directive). The conclusion will contain the answer to the central question whether or not there is a need for a future directive.

A short historical introduction

In the 1960s, the topic of corporate mobility stood high on the agenda: an ambitious treaty was negotiated among the then six member states. The attempt failed because one member state had changed from the real seat system towards the incorporation system.

Later on, the topic disappeared from the political agenda. The harmonization was used to increase the minimum level of regulation in all member states. It was proclaimed that by harmonizing the domestic company laws the economic systems would be strengthened. One effect was that some of the states that obviously had adopted a lower standard of regulation were obliged to raise their level of regulation, hence making their national company law less attractive. One of the objectives of company law harmonization may have been to stop the “unhealthy” competition from one of the member states as this lenient regulation would have made the other states’ legal regime less attractive and might have resulted in a certain emigration to the state of least regulation.

Regulatory competition played an important role from the beginning: member states used harmonization to defend their own system of law, and avoid it to be challenged by other, more attractive systems. And companies to a certain extent availed themselves of this type of competition, the more so as the more attractive regime was also attractive in terms of taxation.

During the following decennia, the issue was not explicitly discussed except as far as the possibility was concerned for German companies to re-incorporate abroad: as German codetermination would have been at stake, the issue was not considered politically mature and hence the existing armistice continued.

The stalemate lasted until the late nineties. Two developments triggered the change towards more open scenery.

1. European Company Statute

After memorable discussion a compromise was reached on workers’ codetermination, freeing the way to the adoption of the regulation on the *European Company Statute*. The Statute allows companies not only to merge cross border, but also to transfer their seat from one jurisdiction to another. The two main types of corporate mobility were thus achieved. The price remains relatively high: one first has to create a European Company, to be able to move to another jurisdiction. Now that the cross border merger directive has been adopted, the advantage of the SE is equally reduced.

2. The four cases of the ECJ

The other were the four cases of the ECJ, well known today under the name of the parties involved, i.e. Centros, Überseering, Inspire Art and, important for this paper, Sevic. They changed considerably the possibility for national law to restrict access to foreign companies to their national legal order. Mobility is hence allowed, although the conditions under which mobility can take place needs to be further clarified.

Chapter 1: Is corporate mobility a real issue?

1.1 Types and meanings of corporate mobility

Corporate mobility has many meanings and above all there are several types of corporate mobility. One could distinguish cases in which new companies are formed in one jurisdiction, doing in business in another jurisdiction. Another type is the company migrating from one state to another, whether subjecting itself – voluntarily or not – to the latter’s state company law: here the question is: what is migration? There may be several types of migration: a company could also establish a branch in another state, or a mere representative office: would these cases have to be treated similarly? And could the branch not become the head office once the business appears to be more successful than in the home state? One admits that by creating a subsidiary, the company uses its freedom of establishment, but this does not raise issues of legal mobility. Finally, companies could merge on a cross border basis, whereby the resulting entity will be subject to a different legal regime than at least one of the merged entities. This is the technique usually followed in the US for changing the legal regime applicable to the company.

The recent study by Becht, Mayer and Wagner deals with a first type: From the figures in Becht mentioned above, it clearly appears that this movement has gained momentum after the *Centros* and other cases became widely known on the European continent and once incorporation agents had seen a market in this kind of business. Most of these companies are fairly small, raising the fear that mala fide founders would use them or leading to a wave of insolvencies within a relatively short period of time. None of this has appeared up to now. There have been no cases of major companies re-incorporating abroad, although some have threatened to do so, probably to put pressure on their domestic tax authorities.

The UK is playing the role of a European Delaware, being the state offering the most attractive, in this case the cheapest incorporation service while offering a well developed and very flexible legal regime. Other states have awakened to the call of competition. The debate about the minimum capital rule has accelerated: is this the right approach to offer protection to creditors and other third parties? New avenues are being investigated and the Commission has issued a call for research in alternative creditor protection techniques. *Centros* and other relevant cases might develop as a trigger for a more fundamental change in European company law.

Other types of mobility aim at increasing the efficiency of company structures. One of the characteristics of the European business model is the widespread use of subsidiaries. Many larger groups own hundreds, even thousands subsidiaries. The need to create a subsidiary is often linked to the diversity in the legal systems in the 27 member states. This structure is cumbersome, expensive, and a threat to efficiency. Of course, in each of the subsidiaries a separate board of directors is needed, often with a separate auditor, a local accounting system applies, and so on. Groups hesitate to convert their subsidiaries into branches, which generally are cheaper to run. Even in the banking sector, where capital requirements offer a handsome premium to integrating by way of branches, the existence of subsidiaries remains widespread. Not that the subsidiaries are run as separate legal entities: subsidiaries are needed for a host of reasons and have sometimes been imposed by the banking supervisors to ensure more efficient supervision on the local entity. Within the EU, the requirement to create a subsidiary for exercising freedom of establishment would run contrary to the Treaty rules. But for non-EU banking groups, this requirement often applies.

In fact, large financial groups are often run as one integrated business, disregarding the existence of the legal entities. This may result in serious tension between the economic and financial reality, and the underlying legal structure.

Company mobility would contribute to facilitate this type of company integration, in the sense that by allowing cross border mergers, groups will be able to do away with many of these intermediate layers of command that very often only existed on paper. It would increase efficiency of running a larger group, reduce the cost of doing business and allow a better cross border integration.

In this field, the initiative of the European Union to have adopted the directive on cross border mergers was very welcome.

1.2 Seat transfers

Apart from mergers, formal seat transfers should also be allowed and that in all European states. In certain cases, a seat transfer may be the right way to streamline a group, by having all activities subject to the same legal system, or be a first step towards a full merger. A merger is a heavier and more costly technique to achieve a similar result. An adequate regime for seat transfers might stimulate regulatory competition in the market for merger regulations. One regulation would then compete with another.

The question arises: what is a “seat transfer”? Does it refer to the “registered office” or to the real seat, or to the seat as mentioned in the by-laws? It is well known that the “siège réel” that is used does not correspond to the “registered office” followed in other jurisdictions. Therefore the issue is not how to transfer the seat – these are the mechanics for which the proposal for a 14th directive offers a good starting point – but what are the consequences of transferring the seat? Does a seat transfer imply a change of the applicable legal regime, a change of what is called the “nationality” of the company?

This question deserves attention. In principle, apart from the formal aspect or the effect on other regulations – e.g. tax law - the transfer of the seat may have an effect on the legal order that is applicable to the company. Under the “siège réel” doctrine, the transfer of the seat results in the company being subject to the law of the transferee state. This effect is obviously not triggered in case the registered office is changed, as under prevailing legal analysis, the registered office cannot be transferred out of the jurisdiction of formation. And is there any legal effect to a transfer of the principal place of business, provided that is different from the real seat, or of the administrative headquarters?

This aspect also will deserve attention in a future directive. Only by allowing the registered office or the real seat to be transferred could a company effectively opt for a different legal regime. The ECJ case law has not dealt with this aspect, as the companies involved had not changed their registered office but had established themselves abroad, where the host law attempted to capture them.

1.3 A future Directive?

First of all, there must be made a clearly distinction between transferring the seat on a de facto basis, and a formal seat transfer. The first one does not necessarily trigger a change in the applicable legal system, and according to the previously mentioned case law, it rarely renders the regulation in the host state applicable. The formal seat transfer incorporates the decision of the company to adopt a different legal regime, both in the real seat and in the registered office regimes.

According to the first hypothesis, companies that establish an operation in another state are making use of their right to free establishment. Imposing burdensome requirements in the host state cannot restrict this right. Hence would it not be excessively burdensome if the host state required the company to conform itself to all rules of local company law, that the company would have to adapt its articles of incorporation and byelaws, change its governance and ownership structure or even to reincorporate?

This “renationalisation” requirement would not be compatible with the principles of free establishment and non-discrimination, as the same requirement would not apply to branches according to the decision in the *Überseering* case: local requirements should remain limited to what is allowed under the “general good” exception with a view of protecting the local interests (creditors, employees), and reviewed on the basis of the well known fourfold touchstones for the “general good” which the Court has consistently read in a rather narrow sense. Corrective measures might be allowed, but a wholesale “nationalisation” goes beyond what is proportionally needed to allow a company to effectively function in another state. Whether a company that has maintained its original legal regime would offer less protection than a domestic one depends on the interests involved: as the Court remarked in *Centros*, the protection of creditors is not to be achieved by the host state requiring legal capital, as branches could trade without any such guarantee. But the outcome will be different if employee rights are concerned: these however should be linked to the enterprise in stead of the company.

Whether that company is entitled to function in its host state without adaptation can be derived from the *Überseering* case, where, contrary to the prevailing opinion under German law, the company was entitled to bring legal proceedings according to the laws of its state of incorporation. It seems logical to extend this recognition to the legal body in general.

A company entering another state’s legal area can continue to exist under its original legal regime, it does not have to adopt specific provisions in order to conform to local company laws, except to the extent that these might be needed for purposes of the “general good”. This approach would also take care of the “creeping seat transfer”, where over time more and more functions are located in another state, without explicit decision to transfer the seat.

If this would be the right interpretation, it would mean that on our local markets, companies of different nationalities would be acting alongside domestic companies, even if they had their head office or center of administration in the host state. In fact, is this not that what we already can observe today? What about the co-existence of the foreign and domestic companies where the host market cannot determine whether the establishment is a principal office, a branch, or any other intermediate form?

A different case is that of the company formally deciding to transfer its seat, and hence opt for another legal regime.

Company mobility is more than de facto migration: companies should be allowed to voluntarily change their legal regime, and become subject to the laws of their host state. This change should not happen by surprise, by stealth, but be the consequence of a deliberate decision, and be executed in an orderly

manner. Usually this will be linked to a formal decision to transfer the seat, whereby all interests involved will be affected. There might be a need for creditors who might fear to enjoy a lower degree of protection in the transferee state, to oppose the transfer, or at least to claim additional guarantees. Minority shareholders also have a right to intervene in the procedure: should not a vote be taken in the general meeting, possibly with a qualified majority? These guarantees have been granted in case of a cross border merger: there are good reasons also to grant equivalent safeguards in case of a cross border merger. A seat transfer should also offer guarantees as to the procedures to be followed: the draft proposal for a 14th directive offers a good base for further discussion. In general one would like to see the same safeguards applicable as in case of the formation of a new company, e.g. in terms of formalities, disclosure but also of possibilities to see the decision annulled. As in this case the company opts for another legal regime, it is evident that it will have to conform to the laws of that state, and have to adapt its articles of association, its governance, et cetera. Finally, the seat transfer should be allowed for all company types, raising some delicate question of rendering the European directive applicable to all types of companies, which is not the case today.

A final thought: should one link the change of applicable company law to a change of the seat? Both elements are not necessarily related: in a European perspective, a company located in state A could opt for the company law of state B. In practice however, the organization of company law are so strongly linked to the seat, or the registered office, that it is simpler to maintain the applicable legal system linked to the seat, be it real seat or registered office.

Chapter 2: The Sevic Case

2.1 Structure

The EC Court of Justice's *Sevic* ruling of December 2005, is a judgment for companies' freedom of establishment. This freedom is guaranteed by the Articles 43 EC and 48 EC. The Court of Justice decided, briefly, as follows. The general refusal by a Member State to register a 'cross-boarder merger' in the commercial register, whereas such registration is possible for 'internal mergers', is contrary to Articles 43 EC and 48 EC.

2.2 What were the facts and the dispute in the main proceedings?

A merger contract concluded in 2002 between Sevic AG, a company established in Germany, and Security Vision Concept SA, a company established in Luxembourg, provided for the dissolution without liquidation of the latter company and the transfer of the whole of its assets to Sevic AG. The German Amtsgericht Neuwied rejected the application for registration of the merger in the commercial register, arguing that the German law on the transformation of companies provided only for mergers between legal entities established in Germany ('internal mergers') and that this law did not apply to mergers between companies established in Germany and companies established in other Member States ('cross-border mergers'). In Germany, moreover, there are no general rules, analogous to those laid down by that law, which apply to cross-border mergers. Sevic AG brought an action against the decision by the Amtsgericht before the Landgericht Koblenz. That latter court asked the Court of Justice whether provisions such as the German provisions just referred to, are compatible with Articles 43 and 48 EC.

2.3 What was determined in the Sevic case?

The Court has decided in the *Sevic* case that it constitutes an infringement on the freedom of an establishment if an internal state provision generally prohibits the registration (in the German commercial register) of a company that is the result of a merger of a company from another member state with an absorbing German company. According to this judgment, the registration of a merger may not be refused if the respective internal state provisions are met in such a way that the registration of the merger would be possible if both of the companies were established in the same member state, and provided that no imperative reasons in the public interest justify a restriction of the freedom of establishment in the particular case.

2.4 A closer look: the motivation

The preliminary reference in *Sevic* was brought by a German company which was prevented from merging with a Luxembourg company because of the fact that German legislation provided only for the inscription in the company register of mergers between German firms. The Court deals with the case through the familiar model of (a) applicability of the freedom of establishment, (b) the existence of a restriction on this freedom and (c) the possible justification for the restriction.

The Applicability of articles 43 and 48 EC

As to the applicability of articles 43 and 48, the Court notes that "cross-border mergers constitute particular methods of exercise of the freedom of establishment, important for the proper functioning of the internal market".

Article 43 EC requires the elimination of restrictions on the freedom of establishment. All measures which prohibit or impede or render less attractive the exercise of that freedom must be regarded as such restrictions. Without referring to its earlier case law, the Court rules that a difference in treatment between companies according to the internal or cross-border nature of the merger constitutes a restriction on the right of establishment within the meaning of Articles 43 EC and 48 EC.

As the Advocate General in the *Sevic* case has pointed out in point 47 of his Opinion, a merger such as that at issue in the main proceedings constitutes an effective means of transforming companies in that it makes it possible, within the framework of a single operation, to pursue a particular activity in new forms and without interruption, thereby reducing the complications, times and costs associated with other forms of company consolidation such as those which entail, for example, the dissolution of a company with liquidation of assets and the subsequent formation of a new company with the transfer of assets to the latter.

In so far as, under national rules, recourse to such a means of company transformation is not possible where one of the companies is established in a Member State other than the Federal Republic of Germany, German law establishes a difference in treatment between companies according to the internal or cross-border nature of the merger, which is likely to deter the exercise of the freedom of establishment laid down by the Treaty.

Such a difference in treatment according to internal and cross-border mergers constitutes a restriction within the meaning of Articles 43 EC and 48 EC, which is contrary to the right of establishment.

The existence of a restriction

With regard to the existence of a restriction, the Court finds sufficient the differential treatment accorded to internal and cross-border mergers as mentioned above.

The justification

Such difference in treatment can only be justified if it complies with the well known criteria of:

- (1) a legitimate objective justified by imperative reasons in the public interest;

- (2) a measure appropriate to securing this objective;
- (3) which does not go further than necessary to attain the desired result.

The Court notes that imperative reasons in the public interest could, in certain circumstances, justify a measure dealing with special problems caused by cross-border mergers. A general refusal of registration as at issue in this case, however, goes further than what is necessary to protect these legitimate interests.

2.5. Has the Court of Justice formed a general rule with the *Sevic* judgment?

Since the outcome of the ECJ case *Sevic* C-411/03 it is clear that a cross-border merger into another member state is protected by freedom of establishment (Articles 43, 48 EC Treaty). This can be indicated as a general rule. Nevertheless, there is still considerable legal uncertainty concerning whether a cross-border merger from a member state must be legally recognized by that (home) member state. The *Sevic* judgment, for instance, does not explicitly contain rulings with regard to cases where the German company is the absorbed entity and the German authorities refuse to enter the merger into the commercial register. Moreover, as of today, the internal state provisions in the various member states are not harmonized beyond the scope of the Directive 78/855/EEC of October 9, 1978. Therefore, potentially contradicting national regimes have to be applied in cases of cross-border mergers.

Chapter 3: Judgment Relations

3.1 The *Sevic* judgment in relation to the judgment of *Daily Mail*

The fact that it is the German company that claims, also brings the case close enough to the *Daily Mail* case as to merit an explicit distinction. That case also concerned restrictions on the freedom of establishment (coming from the state of origin). It's true that *Daily Mail* was different in various respects, - for example the aspect that it dealt with the transfer of the seat of a company instead of a cross-border merger.

In the *Sevic* case, the Netherlands Government, referring to *Daily Mail*, had submitted that the dissolution of a company is an issue that is governed exclusively by national legal systems and that Articles 43 EC and 48 EC should not be interpreted as granting companies the right to dissolve

themselves by taking part in cross-border mergers. Without specifically examining this submission founded on *Daily Mail*, the Court in *Sevic* dismisses the Netherlands argument. *Daily Mail*, in short, reaffirmed the “free choice of connecting factors”; Member States are free to choose the factor providing a connection to the national territory of their companies. They may choose between the registered office, central administration and principal place of business.

Daily Mail thus concerned relations between a company and the Member State under whose laws it had been incorporated in a situation where the company wished to transfer its actual centre of administration to another Member State whilst retaining its legal personality in the State of incorporation. In *Sevic* – by contrast- there is no such retention of legal personality. Moreover, in this connection, the relations between the company and the Member State under whose laws it had been incorporated are unproblematic: the Luxembourg Government raised no objection at all and proceeded to remove the Luxembourg company from the national register of companies. The *Sevic* judgment therefore does not impinge upon the Member States’ “free choice of connecting factors” under Article 48 EC as reaffirmed in *Daily Mail*.

3.2 The *Sevic* judgment in relation to the Directive on Cross-border Mergers of October 2005

Similar to *Sevic*, the Directive on Cross-border Mergers also concerns cross-border mergers and furthermore changes of legal form and demergers. Does this make the Directive superfluous?

Firstly, *Sevic* makes clear that cross-border mergers are within the scope of the Treaty provisions on freedom of establishment. Restrictions on the freedom of establishment are prohibited by Article 43 EC. Now, even though individuals may invoke Article 43 EC, as interpreted by the Court in *Sevic*, against national (and Community) authorities – the so-called “(vertical) direct effect” – and the Commission may start an infringement procedure against a Member State which has failed to fulfill its obligations under Article 43 EC, the Directive on Cross-border Mergers is to be considered as a more effective means of eliminating the restrictions concerned. While, in short “direct effect” and the infringement procedure relate to individual cases resulting from specific circumstances and measures in a particular Member State, the Directive on the other hand, by the introduction into the law of Member State of a set of similar provisions, is aimed at ensuring, in a general and systematic fashion, that restrictions are eliminated.

Secondly, the Directive on Cross-Border Mergers may be said to remove obstacles to freedom of establishment, which remain – or which are created – by virtue of the fact that the national legislature applies a justified derogation from the prohibition of Article 43 EC. As mentioned above, “restrictions” of freedom of establishment, which are prohibited by Article 43 EC, may be justified on one of the grounds set out in the Treaty itself, notably Article 46 EC, or by an overriding reason relating to the public interest. In order to set aside the justified barriers under consideration, the Community legislature is entitled to adopt measures by which it takes over from the national legislature the protection of the matter of public interest. In addition, this Recital 3 in the Preamble of the Directive goes as follows:

“ (...) None of the provisions and formalities of national law, to which reference is made in this Directive, should introduce restrictions on freedom of establishment or on the free movement of capital save where these can be justified in accordance with the case law of the Court of Justice and in particular by requirements of the general interest and are both necessary for, and proportionate to, the attainment of such overriding requirements.”

Thirdly, the Directive aims to resolve conflicts or disparities between national legal systems, by making the national rules “compatible” with one another. The directive provides for co ordinations relating to the specific problems cross-border mergers (which involve the application of several national legal systems in a single legal operation) pose.

The Merger Directive is not directly applicable and needs to be implemented into national law by December 2007. Nevertheless, based on the *Sevic* decision of the European Court of Justice, it is very likely that the member states will implement the Merger Directive prior to December 2007 in order to comply with the requirements as laid out in this decision. In addition to this the standards of the *Sevic* decision may have significant influence on any implementation and interpretation of the Merger Directive. The Merger Directive provides for simple, standardized tools to implement a cross border merger within the European Union. The timeline for the implementation of a cross border merger may be shortened significantly, since lengthy negotiations with the employees regarding their participation in the new entity can be avoided. As a consequence, any cross border merger should be structured based on the provisions of the Merger Directive. However, the statements made, and principles developed, by the European Court of Justice will remain of significant importance not only in the course of the national implementation processes of the Merger Directive, but will serve as a significant guideline for open issues and interpretation of all cross border issues, including those related to the Merger Directive.

Conclusion

The *Sevic* judgment is of essential importance to the issue of cooperation and consolidation between companies established in different Member States. Nevertheless it concerned a specific type of merger in *Sevic*, the conclusion that the Court of Justice has ruled in general terms that cross-border merger operations constitute the exercise of the freedom of establishment is justified.

Both the *Sevic* judgment and the Directive on cross-border mergers increase the possibilities for existing companies to reincorporate in other Member States. The discussion about the seat transfer is by now largely settled. The ECJ have opened the floodgates, the legislation will now have to streamline the consequences. By allowing cross border mergers, a significant part of the matter has been solved. The SE also contributes to the solution, at the same time creating other externalities.

Nevertheless, a distinction should be made between a voluntary seat changes, which is in fact the choice for another legal system: a directive should facilitate this. It should apply to changes of the real seat and of the registered office as well, and clarify that both will result in a change of applicable law. A directive should not only deal with the mechanics, but also make clear statements about the legal consequences.

A different case is the one in which a company develops activity in another state that may amount to a seat transfer under the real seat doctrine. Here the directive should make sure that this development does not subject the company to its host's laws. The directive should usefully specify which classes of provisions of general good could be considered applicable in that case. A restrictive reading would be preferred.

In conclusion, I have the conviction that a Directive on the seat transfer is indispensable.

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The United States’ GLOBAL ONLINE FREEDOM ACT 2009

Is it the Appropriate Approach to Prohibiting
Global Internet Censorship?



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Chapter 1 : Introduction - The Internet, Censorship and Freedom of Speech

The Internet has, throughout the last decade, been conceptualized as a forum for free expression with almost boundless possibilities for individuals to exchange ideas, articulate their thoughts and to freely access the expression of others. The Internet, made up of a vast public system of multiple interlinking commercial, academic, household and government networks, currently has an estimated usage of nearly two billion people worldwide. Based on non-proprietary standards, such a global medium of communication ultimately entails numerous global challenges that implicate fundamental values and policies. Internet policy affects an array of social issues; be it in intellectual property, in the ownership of key technical resources like domain names and IP addresses or in privacy and civil liberties in terms of surveillance and spy-ware. Most of all, Internet policy attempts to concentrate and harmonize the world's diverse views on freedom of expression in cyber-space.

Principles of free speech that one country reveres may be an aversion to another; and nowhere is this more prevalent than in the celebration of free speech in the United States (“US”), and the protection of local morality in China. Upholding the value of freedom of speech on the Internet has now become one of the most controversial issues in the legal vortex, especially in the wake of continuously expanding Internet regulation over cyber-censorship worldwide. The actions of American private companies and Internet Service Providers (“ISP”), by adhering to the political censorship of China in order to conduct business in China, are under scrutiny for disrespecting First Amendment rights to information. Conflict of viewpoints are clearly shown by Internet content regulation cases that constantly entail disputes involving value clashes and conflicting state authority.

With the re-introduction of the Global Online Freedom Act 2009 (“GOFA”) following the original Global Online Freedom Act 2006 as well as the less publicized Global Internet Freedom Act 2006 (“GIFA”), and with the United States spearheading the movement against political censorship of the web mainly perpetrated by listed Internet restricting countries, it begs the question whether global political Internet censorship, and indeed the Internet at large, should be administered the way it is now, by private companies, organizations and governments that assert their own agendas for the future of the Internet. As activities in cyberspace are often separate from established geographical boundaries, this raises questions as to what portion of the web any given country has a right to treat as falling under its jurisdiction; governments on their own are unable to ascertain which legal system should be applied to activities in cyberspace.

In November 2005, the United Nations Summit on the Information Society (“**WSIS**”) in Tunis attempted to solve Internet administration questions but unfortunately left ambiguities. Though a consensus for an Internet Governance Forum (“**IGF**”) was achieved during the summit, the establishment of the IGF follows the mandate that the IGF is to principally facilitate dialogue between participants and does not have any direct decision making authority. This has left the U.S. in continued control of the Internet Domain Names System (“**DNS**”) and less directly, Internet policy through the Internet Corporation for Assigned Names and Numbers (“**ICANN**”).

The first session of the IGF, conducted in October 2006, opened the opportunity for major assault from various participating countries on Internet blocking and filtering, placing immense pressure on governments named as repressive to justify their actions. The creation of Dynamic Coalitions has allowed for discussion of an Internet Bill of Rights and debates concerning the freedom of expression and freedom of the media on the Internet. The IGF was given a five year mandate due to expire in 2010; there has so far been four annual IGF sessions, the latest conducted on 15th -18th November 2009 in Egypt. Despite China’s call for the abolition of the IGF, most participants, including the US, Japan and the European Union, supported the extension of the IGF’s mandate beyond 2010, deeming the forum as a valuable venue for information sharing and international dialogue.

Furthermore, on 12th January 2010, Google announced its potential pullout from China, possibly shutting down Google.cn as a response to cyber attacks that attempted to obtain intellectual property from Google, as well as information on human rights activists through hacking into email accounts. Its refusal to continue censoring results on Google.cn, and its initiation of talks with the Chinese government to operate an unfiltered search engine, will have profound impact on the world’s response to Internet censorship. Should Google pull out from China, it will likely affect a more stringent attitude towards regulations against restrictions of free speech on the worldwide web and even propel the enactment of the GOFA in the United States.

This paper will discuss all the above highlighted issues with aims to discover, through examining previous, current and potential global Internet regulations, international approaches to jurisdiction and emphasizing on the approach to net political censorship of the U.S., China, and on the surface, France, whether the GOFA is the appropriate approach to tackle political censorship on the Web. Does the Internet require an international regulatory scheme, like the potential Internet Bill of Rights, and to what extent will the Internet Governance Forum make a difference? Just how should political censorship on the Internet be governed?

Chapter 2 : The Internet - The Development of the Internet and Internet Regulation

2.1. Development of the Internet

The Internet, put simply, is “a global pool of information and services, accessible locally through individual computer stations that are each part of a global system of interconnected computer networks”²⁰¹. The concept of the Internet began in 1969 as a U.S. military program entitled “Defense Advanced Research Projects Agency Network” or “DARPANET”. It was later renamed “ARPANET” and was designed to specifically research networking possibilities. Working by breaking information into “packets”, and specifically addressing each packet to a specific computer, it enabled computers operated by the military, defense contractors and universities conducting defense related research to communicate with one another²⁰². This was done through redundant channels that enabled effective communication even if segments of the network were damaged by war. The no longer existing “ARPANET” provided the fundamental basis of the modern day “Internet”; the product of a gradually expanding system of interlinked civilian and corporate computer networks²⁰³.

2.2. Internet Regulation

The Internet by nature is international, and is independent of physical geography. The existence of the Internet allows transmission of any types of information under complete anonymity. The Internet is currently neither owned by one single person, government nor business, nor is it subjected to any global international regulation. It is because of these two characteristics of the Internet that has made it a challenge to apply traditional understandings of jurisdiction and national governance on to cyberspace activities²⁰⁴. Legal systems in the traditional sense are tied to particular geographical areas, and jurisdiction tends to hold within the borders of a nation state. Imposing national controls on an entity that is international by definition is, therefore, almost an impossible task to fulfill.

201 E. Halpin, S. Hick and E. Hoskins, “Human Rights and the Internet” Macmillan Press Ltd. 2000, Pg 6.

202 A. Wu, “Spinning a Tighter Web: The First Amendment and Internet Regulation”, 17 N. III. U. L. Rev. 263, (1997).

203 E. Chen, “Global Internet Freedom: Can Censorship and Freedom Coexist?”, 13 DePaul-LCA J. Art & Ent. L. 229 (2003).

204 C.W. Crews Jr. and A. Thierer, “Introduction: Who rules the net?” in C.W. Crews Jr. and A. Thierer, “Who Rules the Net? Internet Governance and Jurisdiction”, Cato Institute, Washington DC (2003)

Yet, regulation of the Internet has continued to rely upon national legal controls implemented by governments attempting to regulate the Internet for their citizens²⁰⁵. From the American Bar Association to the French courts, from the International Telecommunications Union to the European Union (“EU”), and from Chinese regulators to the United Nations (“UN”), they all represent a different interest in the regulation of the Internet. The European Union’s Electronic Commerce Directive and the Hague Convention on International Jurisdiction and Foreign Judgments in Civil and Commercial Matters have set out frameworks to resolve cyber-disputes. The UN were contemplating an international Internet governance model during the WSIS, hence the establishment of the IGF. The Internet is now well on its way to becoming a heavily regulated network, housing conflicting demands from special interest groups and federal, state and international governments.²⁰⁶

In the U.S., domestically implemented legislations to impose controls on the Internet have, thus far, proved futile. A notable illustration is the decision of the Supreme Court in the case of *Reno v. ACLU*²⁰⁷, where the court struck down two statutory provisions ratified within the Communications Decency Act (“CDA”) 1996²⁰⁸, aimed to protect children from communication termed “indecent” and “patently offensive” on the Internet²⁰⁹. Subsequent legislations in the U.S. following the CDA, explained later, were equally unsuccessful.

In *ACLU v. Reno*²¹⁰, Judge Dalzell stated that “it is no exaggeration to conclude that the Internet has achieved, and continues to achieve, the most participatory marketplace of mass speech that this country – and indeed the world – has yet seen.”²¹¹ The achievement of the Internet in terms of spreading public speech has had Internet law scholars identifying the Internet as a mass public forum embodying free speech values; values that are emphasized heavily upon by Article 19 of The Universal Declaration of Human Rights 1948²¹², Article 10 of the European Convention of Human Rights²¹³ (“ECHR”) and guaranteed by the First Amendment of the United States Constitution²¹⁴. Not only is the Internet a warehouse of information, but its autonomous nature has enabled it to become a powerful tool for democratization.²¹⁵

205 E. Halpin, S. Hick and E. Hoskins, “Human Rights and the Internet” Macmillan Press Ltd. 2000, Pg 6.

206 C.W. Crews Jr. and A. Thierer, “Introduction: Who rules the net?” in C.W. Crews Jr. and A. Thierer, “Who Rules the Net? Internet Governance and Jurisdiction”, Cato Institute, Washington DC (2003).

207 *ACLU v. Reno* 929 F. Supp. 824, 831 (E.D. Pa. 1996), aff’d, *Reno v. ACLU* 521 U.S. 844 (1997).

208 47 U.S.C. § 230 (1996).

209 L. Parratt and J. Wadham “Liberating Cyberspace: Civil Liberties, Human Rights & the Internet”, edited by Liberty, Pluto Press, 1998.

210 See *ACLU v. Reno*, Supra note 7.

211 Judge Stewart Dalzell in *ACLU v. Reno*, Supra note 7.

212 “Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive and impart information and ideas through *any media* and *regardless of frontiers*.”

213 “Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas *without interference by public authority* and *regardless of frontiers*...”

214 In part provides: “Congress shall make no law...abridging the freedom of speech...”

215 D. Nunziato, “The Death of the Public Forum in Cyberspace”, 20 Berkeley Tech. L.J. 115 (2005).

Governments of all Internet using countries are faced with a predicament: they must allow the free flow of speech and expression, while at the same time protect citizens from socially unacceptable information being transmitted through the Internet²¹⁶. Within Article 10 of the ECHR, it provides for member states to place “restrictions necessary in a democratic society in the interests of...territorial integrity...” and “for the protection of morals”²¹⁷. This would allow member states like Germany and France to impose censorship on websites containing holocaust denial or sites selling Nazi memorabilia. Indeed, the German Basic Law incorporates freedom of expression as a fundamental individual right in Article 5, but provides that the German government may limit an individual’s expressive right if it conflicts with public order, criminal laws or rights of others. With that, the German Parliament approved the Information and Communications Services Act authorizing the censorship of pornography, violence and neo-Nazi propaganda on the Internet²¹⁸. The French Rights of Man provides that “Any citizen may . . . speak, write and publish freely, except what is tantamount to the abuse of this liberty in the cases determined by Law”²¹⁹ and with this, the French government was able to take a positive role in preventing hate speech, criminalizing the expression of racist ideas.²²⁰ No such equivalent restrictions can be found in the First Amendment, as in essence the First Amendment guarantees liberty for individuals to express themselves without interference or constraint by the government²²¹. The liberty of speech afforded by the Internet however has generated apparent need for governments, like the U.S., to censor sensitive information as social protection. Internet censorship laws allow states to impose restrictions on “socially intolerable” expression, publications and the dissemination of information on the web, like images of pornography or articles concerning politically sensitive material, while hardware technology and filtering software created by information technology corporations enable the blockage of undesirable information or the monitoring of individual activity through the Internet.

216 A. Staiman, “Shielding Internet Users From Undesirable Content: The Advantages of a PICS Based Rating System”, 20 Fordham Int’l L.J. 866, 889 (1997).

217 Article 10 (2), European Convention of Human Rights.

218 K. Rappaport, “In the Wake of Reno v. ACLU: the Continued Struggle in Western Constitutional Democracies with Internet Censorship and Freedom of Speech Online” 13 Am. U. Int’l L. Rev. 765, 1998.

219 Article 11, Déclaration Universelle des Droits de l’Homme et du Citoyen 1789 (Declaration of the Rights of Man and the Citizen), France

220 Article 24, Loi du 29 Juillet 1881 sur la Liberté de la Presse (Law of July 29, 1881 on the Freedom of the Press).

221 See *Smith v. Collin*, 439 U.S. 916, 916 (1978), where Skokie, Illinois refused to issue a permit for a demonstration the National Socialist Party of America intended to conduct in a Jewish neighborhood. At the core of the city’s rationale for refusing permission was the harm that such a demonstration would cause the Jewish community in general and to local Holocaust survivors in particular. The Supreme Court of Illinois held that the refusal was unconstitutional as it violated the First Amendment, and made clear that the freedom of speech was a value so integral to the democratic way of life as to withstand virtually any form of legal balancing.

“Socially intolerable” information differs for every country, and this difference affects the extent to which censorship is applied within a nation state to the Internet. In the U.S., socially intolerable information is separated into “obscene” (materials that are typically referred to as “adult”) and “indecent” (socially unacceptable information that is deemed to be devoid of any useful expression)²²². At the moment, the U.S. and EU have similar views towards intolerable material on the Internet²²³. Much of the public debate about regulating the Internet in the U.S. and EU has centered on the well-worn issues of obscenity and racial hatred, and some of the statutory provisions governing those kinds of expression may be applied fairly straight-forwardly to the Internet²²⁴. Other countries, like China, hold a stricter view on what constitutes egregious information and have moved to constrict the spread of political information like “democracy” and “human rights” to local users of the Internet. This disparity in views and laws ultimately hinders international harmonization and raises potential economic problems, resulting in uncertain liability²²⁵.

2.3. Yahoo! and the French Approach to Internet Regulation

Different national controls present varying regulations to the Internet, and determining the jurisdiction of a speech related offence or even whether an offence has been committed at all is an extremely difficult task. This can be evidently illustrated by the case of *Yahoo! Inc. v. La Ligue Contre Le Racisme Et L'Antisemitisme*²²⁶. The long running legal dispute between Yahoo and the French courts not only highlight the difficulty of imposing offline geographic borders to the net, but also the difficulties of international regulation of the Internet.

222 *Miller v. California*, 413 U.S. (1973) at 17. Three-prong test established to determine whether material can be classified as “obscene”.

223 S. Hanley, “International Internet Regulation: A Multinational Approach” 16 J. Marshall J. Computer & Info. L. 997, 1998.

224 A. Newey, “Freedom of Expression: Censorship in Private Hands”, in L. Parratt and J. Wadham “Liberating Cyberspace: Civil Liberties, Human Rights & The Internet”, edited by Liberty, Pluto Press, 1998.

225 C. Barron, “Internet: Right & Wrongs”, Eur. Dow Jones, February 1, 1997. *See also* “Illegal and Harmful Content on the Internet: Communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, COM(96) 487, April 27, 1997.

226 Case No. C-00-21275JF, 145 F. Supp. 2d 1168 (N.D. Ca., September 24, 2001).

Internet sites, in several French cases, have by definition been deemed “traditional press publications”²²⁷. The result is therefore that the Internet is subject to French law on the press²²⁸. Having determined that national law does apply to the Internet, French courts turned towards determining jurisdiction. In the case, Yahoo! Inc was brought before the court after material, namely Nazi memorabilia, was found to be sold on its auction website which violated French law, where the selling or exhibition of objects that incite racial hatred was unlawful.²²⁹

Prior to the case of Yahoo! Inc., *Faurisson*²³⁰ dealt with the question of effect. Art 113-2 of the French Criminal Code specifically deems a crime to have been committed on the Republic's territory as long as one of its elements takes place in the territory. With regards to press publications, the court held that the crime is deemed to be committed wherever writings are diffused or broadcasts are received. Territorial jurisdiction and the applicability of French law are therefore extended to the Internet, which, while hosted abroad, had been viewed within territorial limits. So, Yahoo! was required to block French citizens' access to such websites and to post warnings that browsing violates the French Criminal Code²³¹ precisely because French citizens are able to view Yahoo's websites that incite racial hatred within French territory. Though Yahoo's lawyers pointed to the Internet's borderless characteristics, that French law could not possibly hold jurisdiction on a Californian company and that it was technically impossible to block users from accessing offending websites, the Judge nevertheless issued a \$13,000 fine for every day of non compliance.

Facing a possible penalty, Yahoo! sought a declaratory judgment from a United States federal court that the French judgment violated its First Amendment protections and was therefore not enforceable²³². American case law is technically clear. ISPs have full protection against libelous or abusive messages distributed across the Internet²³³. The United States district court ruled that because of the chilling

227 For example: *T.G.I. Paris*, June 12, 1996 (aff. UEJF c/ Calvacom); *T.G.I. Paris*, April 30, 1997 (aff. ESIG c/ Groupe Express, Compuserve); Cass. Crim., March 21, 2000 (aff. Ministère Public et associations antiracistes c/ Jean-Louis C.). See also J. Mailland, “Freedom of Speech, The Internet and the Costs of Control: The French Example” 33 N.Y.U. J. Int'l L. & Pol. 1179, 2001.

228 Press publication defined as “any service using a written mode of thought-communication, available to the public in general or to categories of public.” The Law on the Press 1881, No. 86-897 of Aug. 1, 1986, J.O., Aug. 2, 1986, art. 1, available at <http://www.legifrance.gouv.fr/texteconsolide/PCEAL.htm>.

229 French Criminal Code R645-1.

230 *T.G.I. Paris*, Nov. 13, 1998, (UNADIF, FNDIR c/ Robert F.) (known as *Faurisson*, Nov. 13, 1998), available at <http://www.meldpunt.nl/juris/francejp3.html>.

231 J. Naughton ‘Yahoo! for brave French courts’, The Observer, Guardian Unlimited, Sunday November 26, 2000.

232 *Yahoo! Inc. v. La Ligue Contre Le Racisme Et L'Antisemitisme*, 169 F. Supp. 2d 1181, 1184 (N.D. Cal. 2001), appeal withdrawn to be reheard en banc, 2005 U.S. App. LEXIS 2166.

233 *Alexander G. Lunney v. Prodigy Services Company*, 94 N.Y.2d 242 (1999). See also D. Hearst, “Yahoo! enters international legal minefield”, The Guardian, July 24th 2000.

effects the court order will have on free speech, protections provided by the First Amendment outweighed any responsibility for Yahoo! to recognize the French court's demands. This decision was later reversed by the Ninth Circuit because the District Court had no personal jurisdiction over the parties²³⁴. The case has since been reheard by the Ninth Circuit Court of Appeals in early 2006, where a split decision asserted jurisdiction over the dispute but declined to provide Yahoo! with its order of protection from the First Amendment²³⁵. The Court moved to rule that the case was moot as the French Courts had not proceeded to claim the penalty.

This case has brought the “seemingly borderless net to a world with borders”, and despite the chance to create a solid standing on law, borders and the Internet, the courts failed to reconcile the problem and have instead continued to express conflicted opinions upon jurisdiction²³⁶. French judicial efforts to enforce state speech content control laws on the Internet have clearly met barriers, and could be said to be proved ineffective. The substantial differences in worldwide civil liberty norms make cross border enforcement of speech laws inconsistent, unpredictable and ineffectual.

In the struggle of determining jurisdiction over the Internet, U.S. politicians have highlighted their criticisms on regulatory overreach by foreign nations, especially during France's attempt to censor Yahoo! web material²³⁷. Yet, the United States have also been ambitious to assert the reach of their cyber-laws beyond American borders; attempting to restrict pornography, and imposing digital copyright laws²³⁸ are apt examples.

234 Yahoo! was also required to wait for foreign litigants to arrive in the US to enforce the French order before Yahoo's First Amendment claim could be heard again by the court. *See also* T. Gerlach, 'Using Internet Content Filters to Create E-Borders to Aid in International Choice of Law and Jurisdiction', 26 Whittier L. Rev. 899.

235 M. Geist, 'The law, borders and the Internet', BBC News, 24th January, 2006.

236 *Id.*

237 "U.S. Judge Says Yahoo Not Bound by French Nazi Ban," Yahoo! News, November 7, 2001.

238 In terms of digital copyright laws, the US forced Canadian iCraveTV to stop retransmitting of previously broadcasted television shows over the Internet. *See* L. Lessig, "Cyberspace Prosecutor," The Industry Standard, February 21, 2000. In another case, a Russian software programmer was prosecuted under the 1998 Digital Millennium Copyright Act for providing software that could be used to crack e-books, an action not criminal in his homeland but violates U.S. copyright law. *See* L. Bowman, "Whose Laws Rule on the Wild Wild Web," CNET News.com, May 29, 2002.

2.4. International Cases of Internet Regulation

Other countries are also engaged in extra-territorial Internet censorship. The High Court of Australia in *Dow Jones v Gutnick*²³⁹ held that in cases of Internet libel, libelous action occurs where content is downloaded. The American Dow Jones found itself liable in Australian courts for posting defamatory articles on to the web which are subsequently downloaded in Australia. As this case ascertains how publication is defined in cyberspace and determines which country or state's libel laws should apply to the published material²⁴⁰, it could have monumental effects. The Australian ruling is likely to be followed by other commonwealth countries, especially the UK, and given that UK libel laws are known to favor the claimant, an example being the allowance of Russian tycoon Berezovsky to sue U.S. business magazine Forbes at the London High Court²⁴¹, it could encourage international “forum shopping”, especially within the EU²⁴².

The Australian federal government had also recently announced their plans to implement legislation to improve safety on the Internet for Australian families. These measures force ISPs to block a blacklist of “refused classification” websites, websites which regard child sex abuse, sexual violence and instructions on crime, for all Australian Internet users.²⁴³ The possible implementation of this legislation is met with substantial criticism, with many of its critics deeming it fundamentally flawed due to the difficulty of identifying what precisely would be blocked and who will act as decision maker. Tests of the filter have shown that, though the filter does work, it has filtered far more than child porn; Wikipedia entries, euthanasia sites and certain religious sites have been found to be filtered as well.²⁴⁴

China is perhaps the most notable adversary of national restrictions on the Internet in the implementation of its Internet regulations, and most notably the functioning of its “Golden Shield” project.

239 *Dow Jones Company Inc. v Gutnick* [2002] HCA 56 (10 December 2002).

240 L. Vangelova, “Internet Libel Laws in Limbo”, USC Annenberg Online Journalism Review, September 26, 2002.

241 See *Berezovsky v. Michaels and Others, Glouchkov v. Michaels and Others (Consolidated Appeals)*, May 11, 2000, available at <http://www.publications.parliament.uk/pa/ld199900/ldjudgmt/jd000511/bere-1.htm>.

242 C. Dyer, “Ruling could be adopted by English Courts”, The Guardian, December 11, 2002.

243 Hon. S Conroy, Minister for Broadband, Communications and the Digital Economy, Deputy Leader of the Government in the Senate, “Measures to Improve Safety of the Internet for Families”, Minister Media Release, December 15, 2009 available at: http://www.minister.dbcde.gov.au/media/media_releases/2009/115

244 C. Jacobs “Net Censorship Trial Report brings more Questions than Answers” Electronic Frontiers Australia, 15 December 2009, available at <http://www.efa.org.au/2009/12/15/net-censorship-trial-report-brings-more-questions-than-answers/>

Chapter 3 : Internet Regulatory System in China - Regulations, Legislation and Controls

According to recent study conducted by the China Internet Network Information Centre (“CNNIC”), China currently has a grand number 338 million Internet users²⁴⁵, 80.2% of which access the Internet from their homes and 35.5% of which access the Internet in cyber cafes²⁴⁶. These numbers are undoubtedly constantly rising. China also currently possesses one of the most sophisticated Internet filtering and regulatory regimes in the world. Achieved by implementing a variety of laws, regulations and schemes, the primary mechanism of control, aptly named the “Golden Shield” Project (金盾工程), otherwise known as the “Great Firewall of China”, subjects each and every one of these 338 million Internet users to the extraordinarily complex and arguably unorganized system of legal regulation and filters. Authorities are legally allowed to restrict and penalize access to any information on the Internet deemed “subversive” or “critical” of the state²⁴⁷. These policies comprise of requirements and prohibitions issued by multiple bodies and administrative agencies²⁴⁸ that frequently issue regulations containing broad, sweeping definitions left intentionally vague and are repeatedly overlapping or restating prior rules²⁴⁹. Companies within its borders are subject to an array of penalties and threats to keep Internet content clean. Web pages that originate elsewhere globally are blocked by the Great Firewall if found to contain illicit content²⁵⁰.

3.1. Development of the Internet in China

The year 1987 saw the establishment of the first computer network in China, named the China Academic Network (“CANET”). Providing support for academic and scientific research in computer science, this network paved the way for multiple academic networks to be established. In 1994, the appeal for direct connection to the Internet was accepted during the Sino-American Federation of Scientific and Technological Cooperation meeting in Washington DC. Through the help of Sprint Corporation, the National Computing Facilities of China (“NCFC”) released a dedicated circuit to the Internet, creating the first network to be directly connected to the Internet.²⁵¹

245 CNNIC, “22nd Statistical Survey Report on the Internet Development in China, July 2009”, *available at* <http://www.cnnic.net.cn/uploadfiles/pdf/2009/10/13/94556.pdf>.

246 Id.

247 Web sites containing content related to Taiwanese and Tibetan independence, Falun Gong, the Dalai Lama, the Tiananmen Square incident, opposition political parties, anti-Communist movements like democracy and criticism of Chinese human rights standards are commonly blocked.

248 Entities involved in Internet regulation in China include: Central Propaganda Department; Department of Commerce; Department of Telecommunications; General Administration of Press and Publications; Ministry of Culture; Ministry of Information Industry; Ministry of Public Security; Public Security Bureau; State Administration of Radio, Film, and Television; State Council; State Council Information Agency and the State Secrets Bureau.

249 C. Thompson, “Google’s China Problem (and China’s Google Problem)”, New York Times, April 23, 2006.

250 Id.

251 L. Tsui, “Internet in China: Big Mama is Watching - Internet Control and the Chinese Government”, University of Leiden, July 2001, pg 20.

In 1995, the first commercial network, ChinaNet, was set up by the Ministry of Posts and Telecommunications (“MPT”) and China Telecom²⁵². The introduction of Internet commerce in China initiated a further nine networks in 2001 to receive approval from the State Council to offer Internet services²⁵³.

3.2. “Guarded Openness”

With the economic opportunities that the Internet presents, the linking of China to the Internet created a dichotomy in the regulation of information transferred to the Internet: how does one balance reaping economic benefits through open global information without compromising the protection of the state?

The principle of “Guarded Openness” resonates through China’s Internet regulations and legislation. The Chinese government is seeking to protect the economic interests of openness to universal information, while at the same time guarding against foreign economic dominance, and the use of the Internet by domestic or foreign groups to organize anti-party activity. Though it is easy to assume that there is a unitary, official, national Internet strategy, in practice, the regulatory system is a series of interrelated security policies and regulations pursued by the various bureaucracies.²⁵⁴

3.3. Chinese Internet Regulations and Legislation

As an overview, China's filtering regime appears to be carried out at various control points, unlike many filtering systems in other countries. No single statute specifically describes the manner in which the state will carry out its filtering regime, and a broad range of laws including media regulation, protections of “state secrets,” controls on ISPs and laws specific to cyber cafés are the basis of

252 C. Zheng, “Opening the Digital Door,” Telecommunications Policy 18 (1994), pg 236-242.

253 Hartford, “Cyberspace with Chinese Characteristics,” *available at* <http://www.pollcyber.com/ch/pubs/home.htm> pp. 13-14.

Networks that received approval are:

CERNET – China Education and Research Network, overseen by the Ministry of Education, for schools and research institutes;

CSTNET – China Science and Technology Network, overseen by Chinese Academy of Sciences, for scientific research institutes, some government enterprises and state enterprises;

ChinaNET – operated by China Telecom under MII (former MPT), for the general public;

ChinaGBN – China Golden Bridge Network operated by Jitong Co. under MII (former MEI), for the general public;

UNINet – operated by China Unicom, aimed at SME (Small Medium Enterprises);

CNCNet – operated by China Netcom, heavily involved in broadband services;

CMNet – operated by China Mobile (spin-off from China Telecom);

CGWNet – planned by China Great Wall Communications; *and*

CIETNet – China International Economics and Trade Net.

254 “Review of China’s Internet Regulations and Domestic Legislation”, Rights & Democracy, International Centre for Human Rights and Democratic Development, September 13, 2002.

overwhelming legal support for censorship and filtering by the state. No one specific organization or authority governs the security apparatus of the Internet. The Chinese Government has no definite list of censored websites, preferring to leave much of the censorship to private firms, ISPs and cyber cafés that frequently censor far more material than needed²⁵⁵. For instance, cyber cafés are required by law to track Internet usage by customers and to keep correlated information on file for 60 days²⁵⁶. Another example is that access providers must record customer account and phone numbers as well as IP addresses. Content providers that are involved in publishing, operating bulletin boards or engage in any kind of journalism must keep a copy of all content posted on the web²⁵⁷.

The Internet security apparatus essentially functions via the control of organizations that are responsible for internal or external security. Among which, the Public Security Bureau (“**PSB**”) and the Ministry of State Security (“**MSS**”), the former responsible for internal security, and the latter handling foreign civilian intelligence gathering and internal counter-intelligence against foreign threats respectively, are the most significant and influential²⁵⁸. The “Golden Shield” Project²⁵⁹, owned by another prominent organization, the Ministry of Public Security (“**MPS**”), is viewed as one of the most important projects ensuring the retention of state control. The ongoing process, beginning in November 2003 and the first part of the project passing national inspection in November 2006, is to enable the construction of a communication network and computer information system for the police to further their capabilities and effectiveness in censorship and surveillance of the Internet. The “Golden Shield” system blocks content by preventing IP addresses from being routed through and consist of standard firewall and proxy servers at the Internet gateways. The system also selectively engages in DNS poisoning when particular sites are requested.

255 “The Chinese system relies on a classic psychological truth: self-censorship is always far more comprehensive than formal censorship.” - C. Thompson, “Google’s China Problem (and China’s Google Problem)”, New York Times, 23 April 2006.

256 Regulations on the Administration of Internet Access Service Business Establishments [Internet Cafés] translated at http://www.zetronic.com.cn/news_details.asp?newsid=10015

257 Measures for the Administration of Internet Information Services, Sept. 25, 2000, translation *available at* <http://www.cecc.gov/pages/virtualAcad/exp/explaws.php>.

258 “Review of China’s Internet Regulations and Domestic Legislation”, Rights & Democracy, International Centre for Human Rights and Democratic Development, September 13, 2002.

259 The “Golden Shield” Project debatably consists of three projects, but is often grouped as one. *See* L. Tsui, “Internet in China: Big Mama is Watching - Internet Control and the Chinese Government”, University of Leiden, July 2001.

3.3.1. Internal Security: the Public Security Bureau

The physical and online scope of civilian network security is maintained and headed by the PSB. The Computer Management and Supervision Bureau, the primary PSB unit and founded as early as 1983, is charged with the maintenance of network security. Its duties are formally highlighted and codified in the “Computer Information Network and Internet Security, Protection and Management Regulations”, approved by the State Council on December 11, 1997 (the “**Regulations**”) . Under the Regulations, the PSB has the responsibility to oversee ISPs and all other commercial enterprises that have users with Internet access²⁶⁰. The PSB is given the power to demand from Internet companies monthly reports on the number of users, number of page views and user profiles of their sites. ISPs are additionally required to help the PSB in inspecting incidents that involve illegal or criminal activities in computer information networks. The duty for maintaining security ultimately lies with the ISPs, and violations by users will result in the cancellation of the ISP’s business license and its network registration, fines, and possible criminal prosecution of both the company employees and the user²⁶¹. To avoid the Internet Police or “Big Mamas”, ISPs implement multiple self-censoring policies. These “Big Mamas” are the estimated 40,000 technical experts that monitor Internet cafes and filter code in sites, emails, bulletin boards, blogs and chat rooms for unsuitable political commentary²⁶².

The acceptable uses of the Internet by the users themselves are also defined within such regulations. All users are required to register with the PSB their personal information that can be linked directly with their network account information. These accounts, under article 13 of the Regulations, cannot be lent to others and are strictly non-transferable. Furthermore, should users wish to create, replicate, retrieve or transmit information on the Internet, they must adhere to a list of ‘unsuitable’ information that must not be touched²⁶³.

260 According to Article 8, “units and individuals engaged in the Internet business must accept the security supervision, inspection, and guidance of the Public Security Bureau.”

261 As stated in articles 20 – 23 of the “Computer Information Network and Internet Security, Protection and Management Regulations”, December 1997.

262 “China’s ‘Big Mamas’ in a Quandary,” Paul Mooney, YaleGlobal, April 12, 2004, *available at* <http://yaleglobal.yale.edu/display.article?id=3676>.

263 These include: 1) inciting to resist or breaking the Constitution or laws or the implementation of administrative regulations; Inciting to overthrow the government or the socialist system; 2) inciting division of the country, harming national unification; 3) inciting hatred or discrimination among nationalities or harming the unity of nationalities; 4) making falsehoods or distorting the truth, spreading rumors, destroying the order of society; 5) promoting feudal superstitions, sexually suggestive material, gambling, violence, murder, *and/or* 6) terrorism or inciting others to criminal activity, openly insulting other people or distorting the truth to slander people; 7) injuring the reputation of state organs; 8) other activities against the Constitution, laws or administrative regulations.

The Regulations also give power to the PSB to control, certificate and set standards on information security products in China. This ability to certificate Internet security products puts the PSB in an exceptional position, unavoidably leading to close relationships with foreign and domestic companies that market information security products. These affiliations are purportedly both direct and indirect, including complete ownership, actual control, strategic alliance, or simply certification and approval oversight.²⁶⁴

3.3.2. External Security: the Ministry of State Security

Formed in 1983, the MSS is responsible for external civilian intelligence gathering and internal counter intelligence. It combines the external intelligence, counter intelligence, and internal security functions of the PSB and the “Investigation Department of the Chinese Communist Party Central Committee”. As the distinction between external and internal security is inescapably vague, the PSB and MSS are constantly locked in bureaucratic competition, particularly with regards to information security.²⁶⁵

In terms of foreign efforts at undermining Chinese information security and overseas subversion plans, the MSS has explicit mandate to govern such issues. Both of these issues however frequently intersect with the PSB’s role, for example, in domestic network security. At the same time, where the MSS believes it has sole governance on undermining overseas subversion plans, chiefly in Tibet and Xinjiang, the PSB oversees ISPs and other facilitators of contact with the outside. These inconsistencies hinder the two bureaucracies, whereby they are both in cooperation and in conflict with each other. With the constantly growing Internet legal regime, new divergences are created as new incidences or relevant technological advances spring up.

3.3.3. The Legal Regime and Framework

There are currently to date about 34 regulations and measures that govern different aspects of posting and receiving information on the Internet²⁶⁶. Among which, there are more than 10 regulations and measures that restrict and impose procedures that enable censorship and surveillance of Internet activities.

264 “Review of China’s Internet Regulations and Domestic Legislation”, Rights & Democracy, International Centre for Human Rights and Democratic Development, September 13, 2002.

265 Id.

266 See <http://www.lawinfochina.com/list.asp?page=1&ldb=1&kt=1&kf=0&keyword=Internet>.

Since 1995, the year China began allowing commercial connections to the Internet, a number of mandatory and voluntary restrictions have been issued. In 2000, the Chinese government rapidly built up a legal framework on the foundation of the Regulations, whereby four extensive laws were passed.

The first was passed on October 1st, 2000²⁶⁷, which deals with the involvement of foreign investments in the Internet sector and the control that operators have over their sites. The regulation specifically states that any foreign companies wishing to invest in the Internet sector must obtain an authorization from the Ministry of Information Industry (“**MI**”). Additionally, managers of Chinese sites are responsible for editing and censoring the content published on their sites. Failure to do so can result in fines or closings.

The enactment of the regulation also introduced a new requirement; operators are required to report any infractions to the proper authorities. They must also have readily available the addresses of Internet users who have visited their site in the past sixty days, lest the need to provide such information to the authorities. The regulation also prohibits the posting of “subversive” information on the Internet, particularly documents which incite “ethnic hatred, discrimination, feudal superstitions”, spread “rumors that could lead to social disorder or damage social stability”, promote Tibetan or Taiwanese independence, or have content containing “obscenity, pornography, violence or terrorism”²⁶⁸.

The second legislation was implemented on November 2000²⁶⁹, which concerns the content of news sites and Chinese discussion forums. It specifically states that sites are only allowed to publish information given by public media; filtered and censored content within the boundaries of official state propaganda. News originating from foreign media sources cannot be published on Chinese sites unless official authorization has been attained. Websites are also held responsible for any “subversive” information published. All of these measures apply also in discussion forums. Violation of this law can lead to administrative sanctions, fines, or prison sentences, depending on the seriousness of the wrongdoing. This measure has a profound impact; this leaves news portals like Suhu.com to be solely dependent on China’s official press and media.

267 “Telecommunications Regulations of the People’s Republic of China”, PRC Telecommunications

Regulations (中华人民共和国电信条例), October 11, 2000, issued by State Council Order No. 291, signed by Premier Zhu Rongji on September 25, 2000.

268 Id.

269 “Measures for Managing Internet Information Services”, Measures for Managing Internet Information

Services (互联网信息管理条例), Legal Daily (法律日报), issued by the State Council Order No. 292; signed by Premier Zhu Rongji on September 25, 2000.

The third law was passed on December 28, 2000²⁷⁰, affirming that “spreading rumours, defamation or publishing harmful information, inciting the overthrow of the country’s government, the socialist system or a division of the country” can be deemed as “cyber crime” and “cyber dissidence”. Prison sentences were mandated for crimes relating to the “promotion or organization of religious cults” and “leaking state secrets”²⁷¹. Additionally, the official news agency Xinhua in January 2001 announced that anyone involved in “espionage activities” such as “stealing, uncovering, purchasing or disclosing State secrets” using the Internet or by any other means risks from ten years to life in prison, with a maximum penalty of death²⁷².

On September 25, 2005²⁷³, China announced a revision and update of its implemented guidelines in 2000 for banned Internet material, expanding the scope of monitored content to include cell phone text messages, e-mail lists, blogs, and chat rooms²⁷⁴. The type of banned content includes “inciting ‘illegal’ assemblies, marches and demonstrations” and “activities on behalf of ‘illegal’ civil groups.” The other nine restrictions listed remain largely unchanged from the 2000 enforced guidelines, stating the prohibition and ban of “rumors, pornography and defamatory statements”.²⁷⁵ An additional requirement, established in March 2005, stated that “all China-based websites be formally registered with the government by the end of June or be shut down by the Internet police”²⁷⁶.

The latest addition to the set of state-wide regulations is the March 2006 measures concerning the administration of Internet e-mail services²⁷⁷. This legislation highlights procedures, safeguards, restrictions and permissions of any activities related to the provision of email services. Interestingly, article 3 explicitly safeguards a citizen's privacy of correspondence in using email services. This right, like much other freedom of expression rights afforded to citizens, is subjected to content inspection by the public security organ when there is a need to uphold national security²⁷⁸.

[illegible]

271 *Id.*

272 “Explanations on Certain Questions Concerning the Specific Application of Law in the Trial of Cases of Stealing, Making Secret Inquiries of or Buying State Secrets and Intelligence and Illegally Providing Gathered State Secrets and Intelligence for Units Outside the Country”, in “China: Supreme People’s Court on Stealing State Secrets”, BBC Monitoring, January 23, 2001, from report in Xinhua, January 21, 2001.

273 [“Provisions for the Administration of Internet News Information Services”, Provisions for the Administration of Internet News Information Services \(□□□□□□□□□□□□□□□□\)](#), September 25, 2005.

274 A. Jesdanun, "The fear of the Internet: Online rules seek to control protests in China", Associated Press, October 3, 2005, *available at* <http://www.chron.com/cs/CDA/ssistory.mpl/business/3380884>.

275 "China's New Internet Regulations", Globalization101.org, a project of the Carnegie Endowment, October 23, 2005, available at <http://www.globalization101.org/index.php?file=news1&id=8>.

276 "Microsoft Joins Hands With Yahoo!, Google To Censor China's Web," AFP Monday, June 13, 2005.

277 Measures for the Administration of Internet E-mail Services(□□□□□□□□□□), February 20,
2006.

278 Article 3 states that “Citizens’ privacy of correspondence in using Internet e-mail services shall be protected by law. Unless the public security organ or procuratorial organ makes an inspection on the contents of correspondence pursuant to the procedures prescribed in law when required by national security or investigation of crimes, no organization or individual shall infringe upon any citizen’s privacy of correspondence on any pretext.”

3.3.4. “Real Name System”

Since 2003, PRC government Internet regulators have been pushing to implement real-name registration controls where new users are required to log on under their true identities to post comments. An official proposal of the system in 2006 was met with immense opposition from the general ‘blogging’ public, evidenced by surveys conducted on sites like Sina.²⁷⁹

The Hangzhou municipal government in Zhejiang province recently tested the policy by requiring Internet portals under its administration to ask for the real identity of their users from May 1st, 2009²⁸⁰. The legislation also placed the requirement on users based in Zhejiang who comment, blog or play games on sites²⁸¹. The law is designed to protect national security, social order and the social moral system, but although the legislation has been passed, it has yet to be enforced by local Internet portals and the authorities²⁸².

3.3.5. The Green Dam Youth Escort

On 19 May 2009, the Ministry of Industry and Information Technology issued a directive²⁸³ to come into affect 1 July 2009 requiring manufacturers to pre-install the Green Dam software in all Chinese-made computers before they leave the factory. Imported computers must also contain the software before they are sold in Mainland China²⁸⁴.

The stated objective of the notice was "to build a green, healthy, and harmonious online environment, and to avoid the effects on and the poisoning of our youth's minds by harmful information on the

279 J. Ansfeld, "China Web Sites Seeking Users' Names", New York Times, September 6, 2009 *available at* http://www.nytimes.com/2009/09/06/world/asia/06chinanet.html?_r=1&hp

280 “Hanzhou Computer Information Network Security and Protection Management Regulations” “杭州市计算机信息网络安全保护管理条例” Effective May 1, 2009

281 See J. Ansfeld, “China Web Sites Seeking Users’ Names”, *supra* note 81.

282 Qian Yan Feng, "New Internet Law mere Scrap of Paper" *China Daily*, May 26, 2009, *available at* http://www.chinadaily.com.cn/cndy/2009-05/26/content_7941328.htm

283L. Chau, “Green Dam” Creator Seeks To Reassure That He’s not Out To Censor China’s Web” Wall Street Journal, June 10, 2009

284 M. Bristow, "China Defends Screening Software", BBC News, June 9, 2009 *available at*
<http://news.bbc.co.uk/2/hi/asia-pacific/8091044.stm>

Internet”²⁸⁵. Foreign ministry spokesman Qin Gang (秦刚) stated at a regular press meeting that it was in accordance with the law and that the software “is aimed at blocking and filtering some unhealthy content, including pornography and violence.”²⁸⁶

Critics however commented that while the software is apparently aimed at protecting users against pornography on the web, they fear this new software could be used by the government to enhance its Internet censorship system, namely the Great Firewall of China.

On August 13th, 2009, China's Ministry of Industry and Information Technology announced its withdrawal of requirements that the Green Dam Internet censorship software be pre-installed on all computers. China is however continuing to install the software in computers at Internet cafes and universities, and some manufacturers such as Lenovo and Asus continue to include it with computers shipped to the country.²⁸⁷

Chapter 4 : China's Limitations on Internet Speech - Expression or Inhibition?

4.1. Rights to Freedom of Expression

Rights to freedom of speech and privacy are essentially afforded in the Chinese Constitution to citizens as protection against filtering and surveillance.²⁸⁸ These rights are however unfortunately unclear, and in essence, the Chinese Constitution consists mostly of policy statements subjected to much exceptions, rather than guarantee citizens their rights and obligations. Freedom of expression and privacy on the Internet are also likely to be classified as meeting “the needs of state security or of investigation into criminal offences”. In these circumstances, as highlighted by section 40²⁸⁹, “public security or

285 “Notification regarding requirements for pre-installing green filtering software on computers” (关于计算机 □ □ □ □ □ □ □ □ □ □ □ □) Ministry of Industry and Information Technology of PRC, 19 May, 2009. available at <http://www.miit.gov.cn/n11293472/n11293832/n11293952/12398220.html>

286 Agencies, Beijing and Washington, “China defends web filter mandate despite Microsoft concerns”, June 10, 2009 Taipei Times, available at <http://www.taipeitimes.com/News/front/archives/2009/06/10/2003445809>

287 Editorial, “China's Great Firewall”, Washington Post, August 17 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/08/16/AR2009081601697.html>

288 “Article 22: The state promotes the development of literature...the press...publishing and distribution services... and other cultural undertakings that serve the people and socialism...” and “Article 35: Citizens of the People's Republic of China enjoy freedom of speech, of the press...”, Constitution of the People's Republic of China, available at <http://english.people.com.cn/constitution/constitution.html>.

289 “Article 40: The freedom and privacy of correspondence of citizens of the People's Republic of China are protected by law. No organization or individual may, on any ground, infringe upon the freedom and privacy of

procuratorial organs are permitted to censor correspondence in accordance with procedures prescribed by law.” Hence, though China apparently provides certain protection to users in the form of legally guaranteed rights, these safeguards rarely function in practice, and are likely to be deemed inapplicable in the Internet context.²⁹⁰

4.2. “The Internet in China: A Tool for Freedom or Suppression?”

As mentioned in the previous chapter, all ISPs operating within China’s borders are legally responsible for the content they display²⁹¹, and ISPs that fail to adhere to the law face revocation of their business license, and possible arrest of company staff²⁹². In addition to using legislative means of repression, the Chinese authorities have been outsourcing censorship and monitoring tasks to private companies. As stated by scholar Rebecca Mackinnon, “the process of website censorship by which domestically hosted content [in China] is deleted completely or prevented from being published in the first place...is carried out almost entirely by Internet company employees, not by ‘Internet police’ or other government officials.”²⁹³

What this means for foreign net based companies setting up in China is that they must follow China’s tight censoring regime. For American ISPs and technology companies, mainly Yahoo, Google, Microsoft and Cisco Systems, they have had to ensure that their local country sites and products operate within the laws, regulations and customs of China²⁹⁴. Each of these American corporations have, because of their observance, come face to face with a barrage of criticisms, highlighting their co-operation with the “world’s most rigorous system of Internet censorship”²⁹⁵, their disrespect for free speech on the Internet²⁹⁶ and pressed for fuller answers about their business practices in China and the

citizens' correspondence except in cases where, to meet the needs of state security or of investigation into criminal offences, public security or procuratorial organs are permitted to censor correspondence in accordance with procedures prescribed by law.” Refer to Constitution of the People’s Republic of China. Id.

290 “Internet Filtering in China in 2004 – 2005: A Country Study”, April 14th 2005, *available at* http://www.opennetinitiative.net/studies/china/ONI_China_Country_Study.pdf.

291 Human Rights Watch, “Freedom of Expression and the Internet in China” (citing Measures For Managing the Internet Information Services, *supra* note 69).

292 International Centre for Human Rights and Democratic Development, “Review of China’s Internet Regulations and Domestic Legislation”, *available at* <http://www.ichrdd.ca/english/commdoc/publications/globalization/legislationInternetChinaEng.pdf>.

293 C. Walker and S. Cook, “China’s Commercialization of Censorship”, *Far Eastern Economic Review*, May 2, 2009

294 M. Osako, Yahoo Spokesperson in the article by J. Wakefield, “Firms Face Moral Dilemma in China”, *BBC News*, September 7th 2005.

295 D. Bambauer, “Cool Tools for Tyrants”, January – February 2006 *Legal Affairs*.

296 A. Donoghue, “Internet companies ‘must respect free speech’”, *ZDNet UK*, January 10th, 2006

implications for human rights²⁹⁷. On February 15th, 2006, each company was subject to scrutiny by the House Subcommittee on Africa, Global Human Rights and International Operations and other witnesses that were critical of their activities²⁹⁸.

On the one hand, these criticisms are technically correct, and the activities of these corporations have a profound impact on civil liberties. For example, Cisco Systems Inc. supplies Internet infrastructure equipment to digital systems across the globe. It has also provided the Chinese government with technology necessary to filter Internet content through its creation of “Policenet”, and it currently holds 60 percent of the Chinese market for routers, switches and other complex networking gears that sustain China’s repressive regime²⁹⁹. Microsoft was found to censor the content of its blog service in its MSN Space, and also shutting down the blog of a Zhao Jing from its entire service under the informal request of the Chinese government. Yahoo’s cooperation and transfer of information with the Chinese secret police allegedly led to the imprisonment of deemed “cyber-dissident” Shi Tao, and the eight-year imprisonment of another user Li Zhi³⁰⁰, sentenced for “inciting subversion”. Both users criticized the corruption of local officials on online discussion groups. Yahoo is also co-owner of China’s largest e-commerce firm, Alibaba. Until recently, Google had willingly censored itself for China, restricting access to thousands of sensitive terms to launch its new “Google.cn” that complies with China’s censorship laws. Slated the most from the bout of blame, Google’s ironic motto “Don’t be evil” became the focus of critic’s arguments against the company’s controversial move into China³⁰¹.

297 T. Zeller, “Online Firms Facing Questions About Censoring Internet Searches in China”, New York Times, February 15th, 2006.

298 House of Representatives, Committee on International Relations Joint Hearing of the *Subcommittee on Africa, Global Human Rights & International Operations* and the *Subcommittee on Asia and the Pacific* “The Internet in China: A Tool for Freedom or Suppression?”, Washington D.C. 205150128, February 15th, 2006. (hereinafter known as the “**Hearing**”)

299 See Congressman Christopher Smith Statement for Hearing. Ibid. See also “Cool Tools for Tyrants” supra note 95.

300 Reporters Without Borders, “Chinese man ‘jailed due to Yahoo’” BBC News, February 9th 2006

301 See “Here Be Dragons”, the Economist, January 26th 2006. See also C. Thompson, “Google’s China Problem (and China’s Google Problem)”, New York Times, 23 April 2006 and J. Kuznicki, “Free Speech in China: A Roundup of Recent Events”, Positive Liberty, February 1st 2006, available at <http://positiveliberty.com/2006/02/free-speech-in-china-a-roundup-of-recent-events.html/trackback/>.

4.3. The Global Online Freedom Act 2006, 2007 and 2009

The progression of the Hearing gave way to the swift introduction of a bill, titled the Global Online Freedom Act³⁰². This Act, introduced with aims to “promote freedom of expression on the Internet, to protect United States businesses from coercion to participate in repression by authoritarian foreign governments, and for other purposes”³⁰³ would restrict an Internet company’s ability to censor or filter basic political or religious terms, even if this means putting them at odds with local laws of the countries they operate in³⁰⁴. This would ultimately render much of what the Internet companies are currently doing in China illegal. It will become the policy of the U.S. to firstly, “promote the ability of everyone to access and contribute information, ideas, and knowledge via the Internet”, to secondly “use all instruments of U.S. influence, which include diplomacy, trade policy, and export controls, to support, promote, and strengthen the free flow of information”, and to thirdly “proscribe any U.S. businesses from collaborating with officials of Internet-restricting countries in effecting potential censorship of online content”³⁰⁵.

The GOFA requires the State Department to annually designate “Internet restricting countries” and prohibits U.S. Internet companies from locating personal identifiable information of Internet services accounts within the restricting countries, and user data would have to be stored outside China and other repressive countries. Furthermore, U.S. Internet companies will have to report the terms a repressive government requires them to censor or filter, and the State Department could make them public. These companies would then have to notify the State Department and the U.S. attorney general before responding to a disclosure request, with the U.S. attorney general being granted the authority to proscribe the company from compliance of the request. The GOFA also prohibits the companies from blocking U.S. government websites. Finally, the provisions of the Act provides for the launch of an Office of Global Internet Freedom within the State Department which establishes standards for Internet companies to operate overseas³⁰⁶.

302 Introduced by Subcommittee Chairman, Representative Christopher H. Smith, Republican of New Jersey. of Representatives, Committee on International Relations Joint Hearing of the *Subcommittee on Africa, Global Human Rights & International Operations* and the *Subcommittee on Asia and the Pacific* “The Internet in China: A Tool for Freedom or Suppression?”, Washington D.C. 205150128, February 15th, 2006.

303 The Global Online Freedom Act 2006.

304 See D. Bambauer, “Cool Tools for Tyrants”, *supra* note 95

305 GovTrack.us, Tracking the United States Congress, 109th U.S. Congress (2005-2006) H.R. 4780: Global Online Freedom Act of 2006 available at: <http://www.govtrack.us/congress/bill.xpd?bill=h109-4780>

306 On February 14, 2006, the State Department also announced the formation of a new Global Internet Freedom Task Force to examine efforts by foreign governments to restrict access to political content and the impact of such censorship efforts on U.S. companies.

The GOFA 2006 was approved by the U.S. House subcommittee that had jurisdiction of human rights during the 109th Congress, but the session finalized before the bill could be conveyed in front of the full house for a vote³⁰⁷. The Act was reintroduced as the “Global Online Freedom Act 2007”³⁰⁸ for Congressional approval in the 110th Congress in January 2007, in view of efforts by shareholders to pressure companies to modify their business practices with repressive countries³⁰⁹. On February 22, 2008, it was placed on the Union Calendar No. 320 and passed three House committees, but heavy lobbying against the GOFA, due to concerns about putting companies in the middle of disputes between countries³¹⁰, prevented the bill from securing a House of Representatives floor vote before the session ended³¹¹. On May 6th, 2009, the Act was amended and once again reintroduced as the “Global Online Freedom Act 2009”³¹².

The Act is in its first stages of the legislative process and has yet to go into general debate; however Google’s recent threat to pullout of China over intellectual property and censorship concerns has reignited interest in the GOFA which may propel its enactment.

4.4. Google: In and Out of China

As mentioned above, Google's launch of the self-censored “Google.cn” search engine in China was heralded as a “black day” for freedom of expression³¹³. From Google.cn’s inception to date, Google has faced immense criticism for its continued, admitted adherence to the Chinese government and their censorship regulations. Despite global pressure from human rights groups, the US House of Representatives and international organizations, Google successfully garnered approximately 43% of China’s search engine market share by the end of 2009, while its rival Baidu held 56% according to web analytics firm StatCounter³¹⁴.

307 P. Creamer from the Office of U.S. Rep. C. Smith, “Smith Reintroduces the Global Online Freedom Act”, PRNewswire / USNewswire, Washington, January 8th 2007.

308 GovTrack.us, Tracking the United States Congress, 110th U.S. Congress (2007-2008) H.R. 275: Global Online Freedom Act of 2007 available at: <http://www.govtrack.us/congress/bill.xpd?bill=h110-275>

309 Id. As an additional note and example, 29% of Cisco Systems shareholders forced the company to account for and record its activities in countries with repressive regimes.

310 R. Mark “Google, China Dispute Revives Global Online Freedom Act” eWeek, January 17, 2010 available: <http://www.eweek.com/c/a/Government-IT/Google-China-Dispute-Revives-Global-Online-Freedom-Act-493296/>

311 “Smith Reintroduces Web Freedom Bill” Tech Daily Dose, Congress Daily, National Journal, May 6, 2009

312 GovTrack.us, Tracking the United States Congress, 111th U.S. Congress (2009-2010) H.R. 2271: Global Online Freedom Act of 2006 available at: <http://www.govtrack.us/congress/bill.xpd?bill=h111-2271>

313 “Google move “black day” for China” BBC news, January 25, 2006 available at: <http://news.bbc.co.uk/go/pr/fr/-/2/hi/technology/4647398.stm>

314 StatCounter, “Top 5 Search Engines in China from June to December 2009”, available at: http://gs.statcounter.com/#search_engine-CN-monthly-200906-200912

In Google's testimony before the Hearing in 2006, the vice president for global communications and public affairs at Google testified this:

"The requirements of doing business in China include self censorship – something that runs counter to Google's most basic values and commitments as a company. Despite that, we made a decision to launch...Google.cn – that respects the content restrictions imposed by Chinese laws and regulations... our decision was based on a judgment that Google.cn will make a meaningful – though imperfect – contribution to the overall expansion of access to information in China."³¹⁵

In a shocking turn, Google announced in a statement posted on January 12th, 2010 its intentions to potentially pullout from China as a response to "highly sophisticated and targeted attacks" originating from China that occurred in mid-December 2009 against Google and 20 other businesses. Such attacks attempted to obtain intellectual property and gain access to the e-mail accounts of Chinese human rights activists³¹⁶. If talks between Google and the Chinese government fail to permit the running of an uncensored search engine within the law, Google is prepared to withdraw its businesses from China in protest. As written by David Drummond, senior vice president of corporate development and chief legal officer for Google:

"We have taken the unusual step of sharing information about these attacks with a broad audience not just because of the security and human rights implications of what we have unearthed, but also because this information goes to the heart of a much bigger global debate of freedom of speech... These attacks and the surveillance they have uncovered – combined with the attempts over the past year to further limit free speech in the web – have led us to conclude that we should review the feasibility of our business operations in China. We have decided we are no longer willing to continue censoring our results on Google.cn... We recognize that this may well mean having to shut down Google.cn, and potentially our offices in China."³¹⁷

Google's refusal to continue censoring results on Google.cn and its initiation of talks with the Chinese government to operate an unfiltered search engine has already had a profound impact on the world's response to Internet censorship. During the U.S. President Obama's visit to China in November 2009,

315 Elliot Schrage, "Testimony: the Internet in China", posted by Karen Wickre, Google Blog team, February 15 2006, available from the Official Google Blog.

316 J. Meserve and M. Ahlers, "Google reports China-based attack, says pullout possible" Washington CNN, January 12 2010, available at: <http://edition.cnn.com/2010/TECH/01/12/google.china/index.html>

317 D. Drummond, SVP, Corporate Development and Chief Legal Officer of Google Inc. "A new approach to China", January 12, 2010, available from the Official Google Blog.

U.S. President Barack Obama pushed for an unshackled Internet and expanded political freedoms, saying he was a “strong supporter of open Internet use” and a “big supporter of non-censorship”³¹⁸. Following Google’s statement, President Obama’s views were strongly propelled, and resonated in the US Secretary of State Hilary Clinton’s statement before the Newseum in Washington D.C. on January 21st, 2009, who spoke about advancing the U.S. agenda in combating Internet censorship and urged China to investigate not only the cyber intrusions but also openly publish its findings³¹⁹.

The Secretary’s statement was not met with a welcome response from the Chinese government. Foreign Ministry spokesman Ma Zhaoxu defended China’s Internet policies, saying that China’s Internet regulations were in line with Chinese law and did not hamper the cyber activities of the world’s largest and fastest developing online population. Mr. Ma further stated that the U.S. is damaging relations between the two countries by imposing its “information imperialism” on China, and denied any state involvement in the cyber attacks on Google.

In light of the above, much interest in the GOFA has been revived, with the GOFA being viewed as the official support to the turning point created by Google in preventing Internet companies from censoring information overseas³²⁰. The Secretary’s statement had highlighted almost all of the countries that the GOFA identifies as “Internet Restricting Countries”³²¹. As said by the GOFA’s chief sponsor, Representative Christopher Smith, “Google sent a thrill of encouragement through the hearts of millions of Chinese... but IT Companies are not powerful enough to stand up to a repressive government like China. Without US government support, they are inevitably forced to be ever more complicit in the repressive governments’ censorship and surveillance.”³²² Aside from having already secured endorsements from Google, Reporters without Borders and Amnesty International, the GOFA has gained the endorsement of House Speaker Nancy Pelosi, stating that “it’s time for action: Let’s move this bill. It is essential that technology companies not assist in efforts that violate human rights or prohibit the exchange of free ideas.”³²³

318 T. Branigan “Barack Obama criticizes internet censorship at meeting in China” Guardian.co.uk, November 16, 2009 *available at*:

<http://www.guardian.co.uk/world/2009/nov/16/barack-obama-criticises-internet-censorship-china>

319 Secretary of State Hilary Rodham Clinton, “Remarks on Internet Freedom” The Newseum, U.S. Department of State, Washington D.C., January 21, 2010, *available at*:

<http://www.state.gov/secretary/rm/2010/01/135519.htm>

320 See R. Mark “Google, China Dispute Revives Global Online Freedom Act”, *supra* note 110.

321 See Secretary of State Hilary Rodham Clinton, “Remarks on Internet Freedom”. *Supra* note 119.

322 “Hailing Google, US Lawmakers seek Internet Law” Agence France- Presse (AFP), January 14 2010 *available at*: http://news.yahoo.com/s/afp/20100114/pl_afp/uschinaitinternetgooglecongress

323 See R. Mark “Google, China Dispute Revives Global Online Freedom Act”, *supra* note 110.

The effects of the GOFA will be further discussed below, but on the outset, the passing of the GOFA would escalate the U.S.'s influential control over the Internet by controlling the actions of American ISPs that dominate the worldwide Internet technology market. The legislation will make the United States the international 'police force' of free speech violations throughout the Internet should it be enacted. Though the United States strongly provides for human rights protection and upholds such rights to a great degree, the United State's history of Internet censorship regulation is unfortunately far from flawless.

Chapter 5 : U.S. Internet Regulation and Censorship - U.S. Role in Running the Internet

5.1. The First Amendment of the United States Bill of Rights

The First Amendment prevents governmental infringement of an individual's right to freedom of speech³²⁴. Any state law that implements the restriction of expression based on content or message is unenforceable and presumed void³²⁵. This right is however subject to certain criteria and certain topics are excluded from the protection of the First Amendment. The government has the right to control speech containing obscenity³²⁶, defamation³²⁷, and "fighting speech" or hate speech³²⁸, all deemed as speech of "low value", and are given the liberty to limit free speech by the least restrictive means at federal, state or local levels³²⁹.

The U.S. courts are however highly suspicious of any limitations on First Amendment rights. Legally speaking, the U.S. has had numerous attempts in regulating content on the Internet. Hundreds of bills have been introduced in recent sessions of the U.S. Congress, with prominent policy battles including bills addressing privacy, cyber security, the "digital divide", domain names, digital copyright and

324 While the express language of the First Amendment only restricts Congress, the amendment is binding on all branches of the federal government and the individual state governments. *See Gitlow v. New York*, 268 U.S. 652 (1925) (assuming that the First Amendment freedoms of expression are among the liberties protected by the due process clause of the Fourteenth Amendment).

325 *R.A.V. v. City of St. Paul*, 505 U.S. 377, 382-88 (1992), setting standard that content-based speech restrictions are presumed invalid. *See also* L.H. Tribe, *American Constitutional Law* 580-83 (1988).

326 *Roth v. United States*, 354 U.S. 476, 484 (1957), obscenity is "utterly without redeeming social importance". *See also Miller v. California*, 413 U.S. (1973) at 17.

327 *New York Times Co. v. Sullivan*, 376 U.S. 254, 283 (1964).

328 *Chaplinsky v. New Hampshire*, 315 U.S. 568, 572 (1942), "Fighting words" are "those by which their very utterance inflict injury or tend to incite an immediate breach of the peace". *See also Rice v. Paladin Enterprise*, 128 F.3d 233 (4th Cir. 1997).

329 *Burson v. Freeman*, 504 U.S. 191, 198 (1992). *See also Austin v. Michigan State Chamber of Com.*, 494 U.S. 652 (1990).

taxation, and most prominently, the restriction of obscene content on the Internet³³⁰. Most marked of such attempts, as mentioned before, is the Communications Decency Act (“CDA”)³³¹. Though the First Amendment affords the government leeway to confine certain speech on the Internet, prominent acts of congress were struck down by the Supreme Court as unconstitutional and contrary to the First Amendment, as in *Reno v. ACLU*³³². Subsequent legislation after the CDA concerning pornography were also found to be unconstitutional and held to be overly vague; the Child Pornography Prevention Act (“CPPA”)³³³ was struck down by *Ashcroft v. Free Speech Coalition*³³⁴ as being vague and far-reaching, the Child Online Protection Act (“COPA”)³³⁵ was taken in *Ashcroft v. ACLU*³³⁶ as an example of overly broad legislation and is likely to be eventually invalidated by the Court, and the Children’s Internet Protection Act (“CIPA”)³³⁷ was also held as being overbroad and unconstitutional by *American Library Association v. United States*³³⁸.

5.2. Reno v. ACLU

The first Internet speech regulation invalidated by the Supreme Court was the CDA in the case of *Reno v. ACLU*³³⁹. In the case, several litigants challenged the constitutionality of two provisions within the CDA that intended to protect minors from unsuitable, explicit Internet material. The CDA criminalized the intentional transmission of "obscene or indecent" messages as well as the transmission of information "that, in context, depicts or describes, in terms patently offensive as measured by contemporary community standards, sexual or excretory activities or organs." After being enjoined by a District Court from enforcing the above provisions, Attorney General Reno appealed directly to the Supreme Court. The question presented before the Court was whether certain provisions of the CDA violated the First Amendment by being overly broad and vague in their definitions of the types of Internet communications which they criminalized.

330 For an overview of such proposed and existing programs and regulations, see C.W. Crews Jr. and A. Thierer, “The Digital Dirty Dozen: The Most Destructive High-Tech Legislative Measures of the 107th Congress,” Cato Institute Policy Analysis no. 423, February 4, 2002, [available at http://www.cato.org/pubs/pas/pa-423es.html](http://www.cato.org/pubs/pas/pa-423es.html); and Thierer, Crews, and T. Pearson, “Birth of the Digital New Deal: An Inventory of High-Tech Pork-Barrel Spending,” Cato Institute Policy Analysis no. 457, October 28, 2002, [available at http://www.cato.org/pubs/pas/pa-457es.html](http://www.cato.org/pubs/pas/pa-457es.html).

331 47 U.S.C. § 230 (1996).

332 521 U.S. 844 (1997).

333 18 U.S.C. § 2252 (1996).

334 535 U.S. 234 (2002).

335 14 U.S.C. § 1401 (1998).

336 535 U.S. 564 (2002).

337 17 U.S.C. § 1701: The Children's Internet Protection Act (CIPA) conditions federal E-rate funding on installation of filtering technologies in public schools and libraries.

338 201 F.Supp. 2d 401 (E.D.Pa. 2002).

339 521 U.S. 844 (1997).

The Court held, affirming the district court decision with a 7-2 majority, that the Act violated the First Amendment because its regulations amounted to a content-based blanket restriction of free speech. On the out set, there was little debate about the government's reason for regulating the Internet, as the protection of children is a national and international concern. The chief debate however focused on whether the legislation was narrowly adopted to reach the target without infringing on the rights of adult speech on the Internet. The Court found that the Act did not define its offences adequately; there was no clear definition of “indecent” communications, noting clearly that the First Amendment distinctly distinguishes between “obscene” and “indecent” sexual exhibition, and it protects only the latter. Criminalizing “indecent” communications goes explicitly against the First Amendment. The CDA failed to provide supportive statements from an authority on the unique nature of Internet communications and also cannot conclusively demonstrate that the transmission of "offensive" communication had no socially redeeming value. The CDA failed to limit its restrictions to particular times or individuals by showing such an act would not impact on adults; the legislation was worded sufficiently broadly to “chill the expression of adults” and was more restrictive than necessary to achieve its legitimate aims.³⁴⁰

In *Reno*, the Supreme Court recognized that when comparing regulation of terrestrial forms of media to the Internet, different considerations apply. “Communications over the Internet do not invade an individual’s home or appear on one’s computer unbidden”³⁴¹, so the potential of accidentally stumbling upon indecent material on the Internet is small. At the same time, most sexually explicit images displayed on the web are preceded by content warnings, so to enter an indecent website takes positive action. The Supreme Court upheld the District Court’s conclusion that “the CDA places an unacceptably heavy burden on protected speech”. The speech restriction at issue amounted to “burning the house to roast the pig”. To this extent, this decision is a landmark judgment in relation to free speech³⁴².

The *Reno v. ACLU* judgment firmly sculpted the outcome of succeeding legislation concerned with the regulation of speech on the Internet. While there may be a legitimate need to ensure that individuals (children, teenagers and adults alike) are not exposed to offensive or potentially damaging material, censoring human sexual expression on the Internet is not a proportional response to the actions of a minority that distribute offensive material within that category. Any disproportionate speech restriction imposed on the modern-day epitome of democracy should not be adhered to, especially under the

340 T. Cabe, “Regulation of Speech on the Internet: Fourth Times the Charm?”, 11-FALL Media L. & Pol’y 50, Fall 2002.

341 Judge Stevens at District Court, *ACLU v. Reno*, Supp. 824, 831 (E.D. Pa. 1996).

342 K. Rappaport, “In the Wake of *Reno v. ACLU*: the Continued Struggle in Western Constitutional Democracies with Internet Censorship and Freedom of Speech Online” 13 Am. U. Int’l L. Rev. 765, 1998

protection of the First Amendment.

In light of free speech traditions embedded within the American Constitution, and the Supreme Court's clear answer to the restriction of free speech, the adherence of technological corporations to censorship laws in China are indeed curbing both free expression and the right to information. It is seemingly so that by enacting the GOFA, it is able to restrain the likes of Yahoo, Cisco and Microsoft in their trespass against free speech rights of individuals. It may also achieve the continued U.S. influence over the governance of the web as general consensus start to move towards an international regulatory scheme.

5.3. The U.S. Influence over the Internet

As the "ARPANET" spread to encompass a global user crowd, the U.S. government and Congress, under the Clinton Administration, undertook measures to turn over many aspects of government control of the Internet to private entities³⁴³. Essentially, Internet governance is the making and enforcement of collective policies for the global net community, ranging from the technical aspects like domain names and Internet addresses to the social and political; determining who is to run the Internet system³⁴⁴. On September 18th, 1998, the government established an innovative approach to running the Internet by subcontracting Internet governance functions to a private, non-profit corporation with international participation, namely the Internet Corporation for Assigned Names and Numbers ("ICANN"). ICANN was originally created in order to oversee a number of Internet related tasks previously performed directly on behalf of the U.S. Government by other organizations like the IANA³⁴⁵, and has since administered the domain name system, managed IP addresses, introduced new generic top-level domains hence initiating competition among domain name registrars, and finally created a dispute resolution process for trademark conflicts³⁴⁶. Despite such successes, ICANN has come under pressure for reform. Though ICANN operates under international status, it is currently contractually linked to the U.S. Government and the U.S. Department of Commerce, with this authority stemming from the historical role of the United States in creating the Internet. In turn, the U.S. has almost unilateral oversight of the Internet's domain name system³⁴⁷.

343 D. Nunziato, "The Death of the Public Forum in Cyberspace", 20 Berkeley Tech. L.J. 115 (2005)

344 M. Geist, "Unease over how the net is run", BBC News, April 3rd, 2006.

345 Internet Assigned Numbers Authority: an organization that oversees IP address allocation, DNS root zone management and other Internet protocol assignments. IANA is now operated by ICANN. *See also* <http://www.iana.org/>

346 D. Cogburn, "The US role in running the net", BBC News, November 14th, 2005

347 Id.

Owing to the history of the Internet's establishment, and the most prominent of organizations running the net being American, the U.S. has technically assumed majority control over the Internet, especially through the government's influence on ICANN. Many critics have called for the further internationalization of ICANN, where it will be reconstituted as a public sector entity under international law that is free from contractual links to the U.S. Government. According to Jonathan Zittrain, Chair in Internet Governance and Regulation at Oxford University, "there's one set of countries, anchored by Iran, Cuba and China, that would like to see some process by which governments of the world have a much larger hand in controlling the shape of the net". In light of such criticisms, the U.S. administration issued a statement, titled "U.S. Principles on the Internet's Domain Name and Addressing System" which reasserts the U.S. Government's continual intentions to "preserve the security and stability of the Internet's Domain Name and Addressing System ("DNS")"³⁴⁸. Rightly stated by Cogburn, stability of the Internet cannot simply be "we're happy with the way things are now, so don't rock the boat"³⁴⁹.

On September 14th, 2005, proposal for changes, headed by the EU, were submitted at the second phase of the UN World Summit on the Information Society ("WSIS") in Tunisia, lobbying for a new multilateral approach that limits the influence of any one country over the Internet. Billed as a "summit of solutions", the WSIS became the turning point of debate over global Internet governance³⁵⁰.

Chapter 6 : International Internet Governance - the WSIS and the IGF

6.1. WSIS Tunisia and Working Group on Internet Governance

As defined by the Working Group on Internet Governance ("WGIG") (established by the United Nations Secretary-General after the first phase of the Summit to further develop the second phase), Internet governance is the development and application by Governments, the private sector and civil society in their respective roles, of shared principles, norms, rules, decision making procedures and programs that shape the evolution and use of the Internet³⁵¹. Much of the second phase of the Summit

348 National Telecommunications and Information Administration (NTIA), "Domain Names: U.S. Principles on the Internet's Domain Names and Addressing System", *available at* http://www.ntia.doc.gov/ntiahome/domainname/USDNSprinciples_06302005.htm

349 Id.

350 UN General Assembly, 2005 World Summit, September 14-16, 2006, *available at* http://www.un.org/ga/59/hl60_plenarymeeting.html

351 WGIG Final Report, *available at* <http://www.wgig.org/>.

was marked by the stark differences of opinion over freedom of speech³⁵², and was mainly dominated by questions about whether the U.S. should keep technical control and freedom of speech on the Internet³⁵³. By ICANN emerging as the sole control over the Internet's technical functions, the U.S. is isolating other countries from the governance of the Internet, at least in terms of the Domain Name System. Despite continuous controversial debate and divergent views over regulation of the DNS, and indeed the Internet, the second phase of the WSIS ended with an agreement to retain ICANN's role as manager.

6.2. Internet Governance Forum

One significant outcome of the WSIS Tunisia was the creation of a new Internet Governance Forum ("IGF")³⁵⁴, marking the first step into the global regulation of the Internet, and the "recognition that all governments have equal responsibility for Internet governance"³⁵⁵. The mandate of the IGF is chiefly that of a discussion forum, enabling dialogue between participants and for it to become the venue for countries to "raise grievances" and "pursue continued reform" of the Internet³⁵⁶. The IGF may "identify emerging issues, bring them to the attention of the relevant bodies and the general public, and, where appropriate, make recommendations," but does not have the authority to directly impose decisions³⁵⁷.

On October 31st, 2006, the Greek government hosted the first meeting of the IGF. Spanning four days, the "multilateral, multi-stakeholder, democratic and transparent" forum discussed a wide range of issues related to Internet Governance and made recommendations regarding the regulation of the Internet to the International community. At the main plenary session, China received an onslaught of criticism for their tight controls on the Internet, to a point "where that country might have gained some sympathy"³⁵⁸, but shocking denial of any blocking or filtering occurring in China from a Chinese delegate from Geneva rendered any consideration for the regulatory regime unrecoverable. The forum paved the way to a unanimous dissent among the stakeholders on overbearing state control of Internet content, and the Internet itself³⁵⁹. The first meeting of the IGF also created the Dynamic Coalitions, providing open

352 J. Twist, "Controversy Blights UN net summit", BBC News, November 18th, 2005.

353 J. Twist, "Essential test for UN net summit", BBC News, November 19th, 2005.

354 See <http://www.intgovforum.org/>.

355 Yoshio Utsumi, Secretary General of the International Telecommunications Union in J. Twist, "Controversy Blights UN net summit", BBC News, November 18th, 2005.

356 M. Geist, "Analysis: Net control debate rumbles on", BBC News, November 17th, 2005.

357 Paragraph 72 of the Tunis Agenda, The Mandate of the IGF, available at <http://www.intgovforum.org/mandate.htm>

358 M. Mueller, "Internet Governance: UN Approach Questionable", Syracuse University, School of Information Studies, October 31, 2006 available at <http://www.circleid.com/rss/members/1121>.

359 Id.

platforms to exchange information and advance initiatives more specific to certain fields, such as an Internet Bill of Rights and the freedom of expression and freedom of the media on the Internet³⁶⁰.

At its inception, the IGF was given a five year mandate due to expire in 2010. There has so far been four annual IGF sessions; the 2nd IGF held in Brazil on 12 – 15 November 2007 with a focus on development and bridging the digital divide, the 3rd IGF held in Hyderabad with a focus on accessibility, privacy, cyber security and managing Internet resources, and the latest IGF meeting, conducted on 15th -18th November 2009 in Egypt, revisited previously discussed issues with an increased recognition of the importance of human rights.

The IGF has just met its fifth year of establishment, and so far, yearly meetings have served only as warnings to imperious state control over the Internet, without any greatly influential steps towards settling the different national views on Internet censorship. Marring the spirit of the fourth IGF meeting was the ONI poster incident, where Chinese government officials used UN protocols to order the forceful removal of a promotional poster for a book titled “Access controlled”, which bore the sentence *“The first generation of internet controls consisted largely of building firewalls at key Internet gateways; China’s famous “Great Firewall of China” is one of the first national Internet filtering systems”*³⁶¹.

There have also been calls to disassemble the IGF after its five year mandate due to the forum’s tendencies to favor agendas of IT “heavyweight” countries. During the fourth IGF meeting, Chen Yin, head of the Chinese delegation, called for the abolition of the IGF, painting the forum as a powerless gathering and stated that “without reforms to the IGF, it is not necessary to give it a five year extension”. Most participants however, including the US, Japan and the European Union, supported the extension of the IGF’s mandate beyond 2010, deeming the forum as a valuable venue for information sharing and international dialogue³⁶². Reflecting upon comments made by the Chinese delegation, the establishment of IGF may have loosened the U.S. grip over the Internet, but it continues to be heavily influenced by U.S. policies, not only because of ICANN, but also because of the huge technological gap between the digitally developed and dispossessed nations of the world. This has made the U.S. government, the founder of the original ARPANET and experienced in aspects of digital advancement, the dominating regulator.

Chapter 7 : Analysis - Towards an International Regulatory System

360 For a comprehensive list of the Dynamic Coalitions, please see:

<http://www.intgovforum.org/Dynamic%20Coalitions.php>

361 The Association for Progressive Communication’s Statement on the Fourth Internet Governance Forum (2009), November 26, 2009, Johannesburg, South Africa

362 Agence France-Presse, “China says scrap UN Internet Governance Form”, November 19, 2009

7.1. A Unified International Regulatory System?

Much of the cyberspace regulatory and legislative disputes arose because of the contest to regulate a system that has a common property status; that is, no single entity specifically owns the Internet. Owing to its legacy as originally being a U.S. government-sponsored network, the setting of Internet policy is subject to politicized, public battles between the U.S. and other nation states. Though the Internet is made up of networks containing both public and privately owned infrastructure, governance of public Internet policy still emerges mainly from ICANN, the U.S. Commerce Department, U.S. Congress, sometimes with various other governments and treaties, and never via private entities and system operators, whose ownership is contained to hardware like routers, servers and fibers.

The quandary of Internet legislation lies in the hybrid nature of the Internet; it is both private and public at the same time, and there is currently no middle ground nor consensus as to balancing the control of the Internet.³⁶³ As with most common properties, the approach would usually be either governmentally regulate, or completely privatize; the window of opportunity the Internet presents to absolute free speech causes many to advocate complete privatization to allow self censorship instead of governmental³⁶⁴. In this light, there have been suggestions and discussions between U.S. companies to implement a “code of conduct”, setting out minimum corporate standards related to Internet freedom. Others, like Gerlach³⁶⁵, propose to project geographical borders on to the Internet by creating e-borders, limiting possibilities of extra-territorial Internet censorship like in *Dow Jones*³⁶⁶ or *Yahoo!*³⁶⁷, and containing the cyber-laws of each individual nation within its own borders.

Yet, this proposal provides no solution to jurisdiction or enforcement, and will be incredibly difficult to facilitate. It will simply be mapping out current problems with geographical jurisdiction on to cyberspace. At the same time, to section off “speech” or “no speech” areas does nothing to uphold free speech. Censorship of speech in general will lead to balkanization, and as Sunstein states, a well functioning system of free expression is one where people are exposed to a variety of ideas so as to examine their own views and to comprehend other perspectives, even though they may be disagreeable,

363 C.W. Crews Jr. and A. Thierer, “Introduction: Who rules the net?” in C.W. Crews Jr. and A. Thierer, “Who Rules the Net? Internet Governance and Jurisdiction”, Cato Institute, Washington DC (2003).

364 See T. Cabe, whereupon analysis of American attempts at legislation has led to the conclusion that the US should promote self-regulation and encourage technology industry to provide filtering tools. Supra note 140. See also A. Wu, proposing alternative methods to government legislation on the Internet. Supra note 2.

365 T. Gerlach, ‘Using Internet Content Filters to Create E-Borders to Aid in International Choice of Law and Jurisdiction’, 26 Whittier L. Rev. 899.

366 *Dow Jones Company Inc. v Gutnick* [2002] HCA 56 (10 December 2002).

367 *Yahoo! Inc. v. La Ligue Contre Le Racisme Et L'Antisemitisme*, 169 F. Supp. 2d 1181, 1184 (N.D. Cal. 2001), appeal withdrawn to be reheard en banc, 2005 U.S. App. LEXIS 2166.

and should not consist of closed groups with little communication among each other³⁶⁸. The present situation of the Internet is just that: systems of differing censorship that hinder harmonization and freedom of expression.

The international approach may be the only current solution to properly configure jurisdiction on the international Internet. During the WSIS however, U.S. officials denounced, with no alternative vision, ITU General Secretary Yoshio Utsumi's call to devise a global regulatory framework for cyberspace. Secretary of State Hilary Clinton's recent address at the Newseum following Google's statement strongly stressed the U.S. agenda for fighting Internet censorship by "reinvigorating the Global Internet Freedom Task Force as a forum for addressing threats to internet freedom around the world, and urging U.S. media companies to take a proactive role in challenging foreign governments' demands for censorship and surveillance"³⁶⁹. This statement has centered the U.S. as the prominent advocate of free speech on the Internet and has kept decision making bodies of the Internet, like ICANN, firmly in its place, which possibly continues the U.S. domination over Internet regulatory decisions. Now, in light of Google's possible pullout, with GOFA gaining momentum through Congress, enforcement and jurisdiction issues will once again arise with regards to the powers of this Act (if it does become one), especially in relation to the U.S. extending its powers of diplomacy to attempt to restrict the ten named countries, China being the forefront, from violating free speech values.

7.2. Is the GOFA the Correct Approach?

On the outset, the aim of the Global Online Freedom Act indeed upholds democracy and the right to freedom of speech. It adheres to human rights standards and is a positive move towards one way of tackling repressive regimes. It will initiate global awareness to the current political censorship situation on hand, and prevents companies from profiting from denying free speech of citizens within repressive countries.

The powers contained within this bill are however, unfortunately broadly defined and worryingly imprecise. One portion of the bill prohibits censorship as dictated by an "Internet restricting country", listing ten repressive governments, among which is China. Unfortunately, it continues to allow

368 C. Sunstein, "The First Amendment in Cyberspace", Yale Law Journal, Volume 104, Issue 7, 1995.

369 See Secretary of State Hilary Rodham Clinton, "Remarks on Internet Freedom" The Newseum, *supra* note 119.

censorship as dictated by the U.S. and its friends.

Yet, the GOFA is extremely in line with the U.S.'s steadfast commitment to First Amendment rights. It will make the actions of companies that conform to repressive policies illegal, which is a sound way of refusing to assist other nations with regulation that restrict what U.S. history and heritage regards as an inalienable right. The effects of the possible enactment of GOFA can already be seen; U.S. corporations under scrutiny have been shown to react, taking for example Cisco's shareholders demanding the company's activities in repressive countries be answerable to the board³⁷⁰ and most recently, from Google's open statement of their refusal to continue to censor their search engine in compliance with Chinese laws. The U.S. disagreement with an international scheme may just be a reflection of this: aside from arguments of instability, a global Internet regulatory system may end up taking a lowest-common-denominator standard of regulation, which, in terms of free speech rights, may leave repressive regimes with a compromise. The U.S. Supreme Court has stated fervently that there should be no compromises in terms of First Amendment Rights.³⁷¹

But, taking into account that the GOFA directly affects China, enacting the GOFA will have substantial economic repercussions, especially when the GOFA directly affects American technological businesses seeking to do business here. In terms of free speech, enacting this Bill will deny Chinese citizens access to any information provided by American ISPs, censored or uncensored, should they be found to comply with Chinese authorities, because these ISPs will be forced to withdraw from the market. Taking the view of Clive Thompson "For most Americans...there are no half-measures in democracy or free speech. A country either fully embraces these principles, or...totalitarianism. But for Chinese bloggers...the Internet, as filtered as it is, has already changed Chinese society profoundly. For the younger generation, especially, it has turned public speech into a daily act."³⁷² The restriction of American firms to cooperate with repressive regimes will only further widen the technology gap.

Furthermore, it is one thing that Google has, out of its own initiative, chosen to respond to cyber attacks and initiate negotiation with the Chinese government by threatening to pull out of China. Google has instigated global awareness in the issues surrounding Internet censorship, and should be applauded for

370 P. Creamer from the Office of U.S. Rep. C. Smith, "Smith Reintroduces the Global Online Freedom Act", PRNewswire / USNewswire, Washington, January 8th 2007.

371 See D. Loundy, "Internet Speech Cases Cinch Broad Freedom", Chicago Daily Law Bulletin, July 10, 1997 available at http://www.loundy.com/CDLB/Free_Speech.html.

372 C. Thompson, "Google's China Problem (and China's Google Problem)", New York Times, 23 April 2006.

its actions. Although it was originally savaged for “selling out” when it first announced its decision to censor for China, Google’s public threat now, when it controls almost 40% of the market share, has put far more pressure on the Chinese government to relax its policies than a boycott of the country five years ago.

It is however quite another matter to make co-operation with Internet censoring countries illegal. As stated by EU Telecoms Commissioner Viviane Reding in a meeting of the European Parliament, “...I am not convinced so far that hard law is the best way to deal with the challenge. I believe that we should not put European companies in an invidious position where their choice appears to be to break the law or leave the market to more unscrupulous operators. Rather, our goal should be to find ways to allow operators and service providers to respect human rights without doing either.”³⁷³ The Bill will certainly keep servers out of China, but individuals that reside within such countries are at the same time deprived of locally uncensored information. China does not need a technology blockade; this will only ensure China’s closed society, and is undesirable if the Internet seeks democratization³⁷⁴.

Practically speaking, Chinese users have already found ways of getting around the Shield³⁷⁵. Other times, enforcement of Internet regulation have been found to be sporadic, and there are many instances when filters on blocked sites are lifted³⁷⁶. Candidly spoken by Bill Thompson, “if we in the West, with our liberal political culture and our attempts to build open societies, do not engage with China then we lose the opportunity to influence them and convince them of the benefits that this brings.”³⁷⁷ He continues, “If the Chinese government fears instability then we should offer help and advice and support, not closed borders and locked doors.”

China is extremely aware of the benefits that the Internet brings. As said by Jiang Zemin, “we should recognize the tremendous power of information technology and vigorously promote its development. The melding of the traditional economy and information technology will provide the engine for the development of the economy and society in the 21st century.”³⁷⁸ At the moment however, China is still slightly reluctant to loosen its grip on control, and the U.S.’s fervent passion for freedom of speech is

373 H. Jones, “EU media chief rules out Internet freedom law”, Reuters, February 3, 2009

374 C. Sunstein, “The First Amendment in Cyberspace”, Yale Law Journal, Volume 104, Issue 7, 1995.

375 C. Thompson, “Google’s China Problem (and China’s Google Problem)”, New York Times, 23 April 2006.

376 L. Tsui, “Internet in China: Big Mama is Watching - Internet Control and the Chinese Government”, University of Leiden, July 2001.

377 B. Thompson, “Why Google in China makes sense”, BBC News, January 27th, 2006

378 Jiang Zemin in a speech at the World Computer Congress 2000 in Beijing, quoted after A. Lin Neumann, “The Great Firewall,” Committee to Protect Journalists, January 2001, available at http://www.cpj.org/Briefings/2001/China_jan01/China_jan01.html.

not equally mirrored in China. In essence, most Chinese citizens feel that they have already been launched into the age of technology, rights and freedoms; most things are readily available, technically at the click of a mouse. The Chinese government has been forced by Google to consider their restrictive attitudes towards Internet censorship, but it remains to be seen how the negotiations between the Internet giant and the Chinese government pan out. Ultimately, bringing Chinese government restrictive attitudes to a turnaround may need a slower, gentler coaxing. The GOFA will be too blunt a tool that may encumber, not encourage, freedom of and rights to expression.

Furthermore, U.S. interventionist attitudes and current domination of the Internet governing sphere is causing political discomfort³⁷⁹, evidenced by criticisms of ICANN during the run up to the WSIS, pressure placed on ICANN's policies and its inefficiency in developing much needed country code domains³⁸⁰, and now the Chinese government's negative reaction to the U.S.'s targeted statements against China's censorship regime. At this time, the U.S. government should take a co-operative role in Internet governance so that the Internet retains its natural, international, characteristic. In essence, as the Internet continues to grow, it needs international oversight to keep to its international roots.

The Bill is yet to be implemented and may still change; perhaps the installation of the office of Global Internet Freedom envisaged within the Bill can change its apparent American outlook to a further "global" perspective. Perhaps the problems lie not in whether we restrict companies from cooperating with censorship laws. Rather, there should be change in the current shape and form of the Internet (a mixture of private and governmental forums³⁸¹) to an internationally regulated "public" forum open to all sorts of contributions from different countries, companies and individuals.

379 See E. Chen, "Global Internet Freedom: Can Censorship and Freedom Co-exist?", 13 DePaul-LCA J. Art & Ent. L. 229 (2003).

380 M. Geist, "Unease over how the net is run", BBC News, April 3rd, 2006.

381 See D. Nunziato, "The Death of the Public Forum in Cyberspace", 20 Berkeley Tech. L.J. 115 (2005).

Chapter 8 : Conclusion - An International Regulatory Scheme

All nations agree that some form of Internet regulation is necessary, but naturally, the degree of legislation and protection imposed upon each nation varies from country to country. On the one end of the spectrum is individual government censorship where all information passes through government filters and interception. Self regulation lies on the other end of the spectrum, advocating the job of censorship to individuals to govern what should or should not be seen. Until the establishment of an international regulatory scheme, both these ends will remain unchallenged without compromise, and Internet regulation will remain as it is at present; split between two ends of the spectrum. Sarah Hogg, former advisor to the last Conservative Prime minister and a member of the U.K. House of Lord's committee on science and technology, has commented, "The Internet has thrived on creative anarchy...racial and subversive material finds its way on to the information superhighways, and new ways will have to be found of dealing with it...the protection of intellectual property and privacy; sanctions on libel and obscenity – such issues can only be dealt with governments acting together."³⁸²

Just as the Internet is an international entity, human rights are also a global issue that should not be left to one nation to regulate. With that said, the creation of the Internet Governance Forum is a welcome step towards creating the power the United Nations, an international body, needs to sanction countries in violation of human rights norms as well as pressure countries that aid in the process. The U.S. should still continue to publicly condemn violations committed in China, as this would raise constant awareness to the issue, but should leave the enforcement of internationally based legislation like the GOFA to global organizations to create and promote.

The IGF is nearing the end of its mandate but is likely to be renewed. It has not yet been charged with the issue of governing freedom of speech over the Internet³⁸³, but in light of current issues, broad principles concerning international electronic freedom of expression³⁸⁴ needs to be defined and perhaps an international covenant should be established by the UN, or another international body.

382 "Relaxed Hand on the Wheel", Financial Times, July 31st, 1996. *See also* C. Foley, "Human Rights and the Internet", in L. Parratt and J. Wadham "Liberating Cyberspace: Civil Liberties, Human Rights & The Internet", edited by Liberty, Pluto Press, 1998.

383 See <http://www.intgovforum.org/>.

384 Expressed in Article 19 of the International Covenant of Civil and Political Rights (ICCPR) but no further jurisprudence has been developed.

Establishing an international covenant is not without its challenges. Nations are currently split between extreme differences in points of view towards freedom of speech and right to information. As suggested by Hanley³⁸⁵, there are two basic problems inherent in an international approach. Firstly, every country has a different standard of tolerance to indecent information, making consensus to an overall regulatory agreement difficult. Secondly, because of the Internet's international scope, it does not lend itself to identifying or complying with conventional methods of jurisdiction.

At this stage, the sole establishment of one international Internet regulatory scheme, especially in terms of human rights, will not solve all existing problems, and not all countries can be expected to concur. The world is not yet ready for an international solution, but what are needed are inter-governmental agreements and discussions that would lead to harmonization of existing rules; a general consensus of the types of information that do need to be governed like domain names and child porn, and an overall greater transparency of Internet governance³⁸⁶. Perhaps a code of conduct setting out minimum corporate standards related to Internet freedom should be agreed upon between U.S. companies³⁸⁷. Perhaps more research should be put in place to develop anti-censorship software³⁸⁸.

Nevertheless, continuous pressure should be placed on countries that violate human rights, and the advocating of free speech in the U.S. is to be commended, and should be extended to other countries across the globe. Discussion of implicating any specific human rights code for the Internet should however be kept on a global level, overseen by an international organization, be it a specifically created organization for such purpose, or even a body belonging to the UN to ensure adherence from all countries. Rightly stated by Foley, "an inevitable result of the globalization of society is the globalization of government, just as the internationalization of crime has led to the internationalization of policing. The democratic deficit here is enormous and, in this sense, human rights in cyberspace concern all." It is indeed because of the international nature of both the Internet and human rights that an international direction in Internet governance, and directly the governance of global Internet censorship, should be found.

385 S. Hanley, "International Internet Regulation: A Multinational Approach" 16 J. Marshall J. Computer & Info. L. 997, 1998.

386 Y. Timofeeva, "Worldwide Prescriptive Jurisdiction in Internet Content Controversies: A Comparative Analysis", 20 Conn. J. Int'l L. 199, Summer 2005.

387 H. Jones, "EU media chief rules out Internet freedom law", Reuters, February 3, 2009

388 Id.

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Challenges of awards *vis-à-vis* the finality of international arbitration

A large, light blue wireframe globe centered on the page, with latitude and longitude lines.

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‘(...) the review on the merits (...)

Such review is, whatever euphemistic phraseology is used, in reality an appeal from the decision of the arbitrator or arbitration tribunal. This raises a general question of principle: has a person involved in a legal dispute a fundamental right to a second shot if the first shot has misfired? (...)

by Clive M Schmitthoff, ‘Finality of arbitral awards and judicial review’, in *Contemporary Problems in International Arbitration*, edited by J. DM Lew, Queen Mary College University of London, Centre for Commercial Law Studies, , Martinus Nijhoff Publishers, 230.

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Chapter I Introduction

International arbitration is, nowadays, one of the most common dispute resolution methods used in international commercial and international investment matters.

The reason lies on the advantages commonly adherent with international arbitration, notably swiftness and flexibility of proceedings, freedom to choose the applicable rules, the place of arbitration (neutral forum) and the decision maker(s), confidentiality, lack of appeal¹ and the possibility of reaching a binding and enforceable decision (award).

The fact that an award is binding in the same terms as a judicial decision requires, thus, a certain degree of control of its legality or enforceability.

Such control is due by judicial courts, either at a declarative stage, when it analyses the invoked grounds for annulment of the award², or in an enforcement stage, when courts appreciate whether there are grounds to refuse its enforceability.

The present paper focuses on the nature of judicial control when faced with a request for annulment of an international award.

Chapter II: The controversy

When a party loses a battle in litigation, the war is usually far from being lost.

An unhappy party in Court may, as a rule, appeal an unfavourable decision in more than one instance. In many countries, such a party may continue appealing on certain grounds and even request the appreciation of higher (specialized) judicial instances, notably the Constitutional Court or even the European Court of Justice. Before a judicial decision has *res judicata*³ effect, a party may well litigate for several years, alleging or counter alleging until reaching potential voluntary compliance or the enforcement stage.

¹ Unless parties decide otherwise.

² However, it remains possible, in England, to appeal on a point of law if certain conditions are met (Arbitration Act 1996, Section 69).

³ Or '*Estoppel by record* (or *per rem judicatem*)' (*Oxford Dictionary of Law*, Oxford University Press, Sixth Edition, Edited by Elisabeth A. Martin and Jonathan Law, 463, 199-200, 291-292)

When a party loses a battle in arbitration, the scenario is not quite the same.

In international arbitration, there is, as a rule, no appeal on the merits⁴. The *ratio legis* is simple to understand: arbitration has a contractual nature as it relies on the consent of the parties. It is supposed to be a previously agreed forum for dispute resolution in a swift and fast way, guided by the laws and rules expressly chosen by both parties, which are usually referred to in the arbitration agreement. Judicial review of the merits of an international award would clash with the voluntary construed neutral forum set up to decide in accordance with the parties' chosen rules and law(s).

Unfortunately, practice has shown that those who frankly look for the benefits of international arbitration have been confronted with a demoralizing use of the challenge of arbitral awards.

Despite the fact that parties in international arbitration are aware that there is no appeal on the merits, parties do use - and abuse – frequently the narrow solution put at their hands by the legislator as a means to avoid the immediate consequences of an unfavourable award: requesting its annulment.⁵

The fact is that parties, in most cases, are either trying to resist an unfavourable decision by means of a revision on the merits of the award in Court or just delaying its effects as a dilatory technique. Allegations of breach of due process - such as the right to be heard and to present one's case - and allegations based on violation of international public policy⁶, *inter alia*⁷, have invariably become standard practice as means to seek the annulment of an award by a frustrated party.

A disguised appeal envisaging the review on the merits of a final decision has assumed to be, in current times, a disturbing reality. The disproportionate use of mechanism of challenge of the awards leads to nullifying the advantages thought to be achieved when resorting to arbitration. A distortive practice leads to an asphyxiation of international arbitration players and international arbitration itself.

⁴ '(...) Modern arbitration statutes exclude, or permit exclusion of, review of the merits of a dispute, while granting a review to ensure procedural fairness (...)’ (W.W. Park, Judicial Controls in the Arbitral Process, in *Arbitration of International Business Disputes – Studies in Law and Practice* (Oxford University Press, 2006), 234.

⁵ Request for annulment, application for setting aside and challenge of an award are synonyms.

⁶ Or ‘*ordre public international*’. Public policy ‘(...) covers those principles and standards which are so sacrosanct as to require their maintenance at all costs and without exception’ (part of the definition of The International Law Association Committee on International Arbitration (J.D.M. Lew, L. Mistelis, S. M. Kroll, *Comparative International Commercial Arbitration* (Kluwer Law International, 2003), 422.

⁷ Notably the inexistence of consent to arbitrate.

In this sense, Courts do play a crucial role in this area. They tend to apply a cautious and narrow approach when appreciating a request for annulment of an award. That explains why successful challenges of awards are rare. However, the simple act of challenging already implies a delay and postponing the immediate effects of an award.

The purpose of the present paper is to point out the generalized lenient use of the instrument of challenge of awards, the reasons behind it and its impact on international arbitration. As such, one shall make a reflection on the reasons behind such lenient use of challenges on awards, questioning whether an excessive judicialization in international arbitration exists and what could potentially be a solution.

Chapter III: Is the request for annulment of an international award used as a veiled appeal on the merits?

It is well-known that the purpose of the request for annulment in international arbitration is not to permit a second instance reviewing the merits of an arbitral award. It is supposed to merely allow a minimum degree of judicial control, notably for the protection of natural justice (or due process)⁸ and international public policy in general.

The principle of finality of the award is reflected in most arbitration statutes⁹, clearly reflecting the spirit of international arbitration which is to reach an award in a neutral forum that solves a dispute in one shot, this is, without the possibility of appealing from it.

Nevertheless, it is also common ground that a losing party, as a rule, will try to find every possible way to alter the effects of an unfavourable award. Such party will explore any legal means and argumentation to have the award annulled, or at least to have its effects delayed as much as it can, even if conscious that it is doubtful whether any challenge grounds deserve any credibility in one's case.

However disturbing as it may sound, the truth is that challenging an award based, for instance, on biased arbitrators not rarely follows the above mentioned purpose. Either because the arbitrator did not disclose (irrelevant) facts, such as, for instance, that a party-appointed arbitrator and the Counsellor for the counter-party were in the same College at the same year, or that the arbitrator and one of the lawyer's for

⁸ As it is referred to in U.S. (Tweeddale and K. Tweeddale, *Arbitration of Commercial Disputes – International and English Law and Practice* (Oxford University Press, 2005), 386.

⁹ E.g.: German Arbitration Law, Section 1055; Swiss Law (Swiss Private International Law Statute (1990)), Article 190; (English) Arbitration Act 1996, Section 58.

a party belong to the same Chamber, being therefore, allegedly unable to be impartial, or when a party suddenly discovers that an arbitrator was a (minor) shareholder for one of the companies, making such party believe (or pretending to believe) that the arbitrator lacks, therefore, independency. There is no doubt, however, that real situations of biased arbitrators do occur from time to time. In fact, jurisprudence shows such reality.¹⁰

One last shot in the dark also reflects a parties' attempt to comfortably delay the effects of an award. The use of such dilatory techniques undermines international arbitration. It implies that while a losing party gains time and postpones a financial (or other) negative immediate impact resulting from the award, the winning party is stuck to the judicial Court review, a situation which may well take the same time (or even more) than arbitration proceedings.

This is a reality that is, unfortunately, widespread in international arbitration.

The point that we intend to make is that a request for annulment of an international award is commonly used by parties as a veiled appeal on the merits.

Such disguised appeal may have, in reality, two purposes. The first one is to effectively try to reach a second opinion by a judicial Court and turn the award in the claimant's favour, convincing the Court of procedural unfairness, or by relying on an undercover revision on the merits of such an award, this is, hoping for a new appreciation of facts and law at stake (situation that although difficult to apply, due to

¹⁰ E.g.: *Commonwealth Coatings Corp v Continental Casualty Co.* (393 US 145 (1968): a Court set aside an award based on the fact that an arbitrator had not disclosed business connections with one of the parties, even if no actual bias was found; *Liverpool Roman Catholic Archdiocesan Trust v. Goldberg* [2002] 4 All ER 950, In this case, the defendant (a barrister) appointed, as an expert, another barrister that was a good friend of him and belong to the same chamber as the defendant. Although the Court did not consider that the conclusions of the expert were biased, it considered that a reasonable observer would consider that such a relationship between both is sufficient to affect the views of the expert . In short, despite no proof of bias, if the Court had decided otherwise, perhaps a dangerous precedent would have emerged; *Hrvatska Elektroprivreda v Slovenia [ISCID Case No ARB/05/24]* (6 May 2008): In this bilateral investment dispute relating to a power plant, a week before a substantive hearing, Slovenia's lawyers informed the tribunal of the list of persons attending, which included a QC (the QC) from the same chambers as the chairman of the tribunal (the chairman). The tribunal noted that barristers are sole practitioners, and that chambers are not law firms. However, the Tribunal also observed that chambers have evolved and often market themselves with a collective connotation. Within that context, the Tribunal observed that para 4.5 of the Background Information on the IBA Guidelines on Conflict of Interest in International Arbitration referred to "*an understandable perception that barristers' chambers should be treated in the same way as law firms*". The Tribunal considered that continued participation in the proceedings could lead a reasonable observer to form justifiable doubts as to the impartiality or independence of the chairman. It ruled, thus, that the QC was excluded from the hearing. ("*A double Act - Should we be concerned if arbitrator & Counsel are from the same chambers?*") Kwawar Qureshi QC Report. (<http://www.mcnairchambers.com/media/documents/200908/NLJARBITRATORCONFLICTOFINTERESTMAY2009.pdf>, last visited 12 February, 2010).

Courts' narrow approach in reviewing, is possible to occur). The second purpose of a veiled appeal is to be a way to delay the effects of an unfavourable decision as much as possible. This is where we believe that the main concern should be.

Requesting judicial review may well achieve a claimant's goals: If not a review on the work of the arbitrators, at least it will surely achieve the second goal: delay. In some countries, Courts may take the same time, or more, to decide on a challenge of an award than the arbitration proceedings itself.

The misuse by losing parties of the challenging mechanism leads us to inevitably reflect on the level of control Courts have, in general, in international arbitration.

Chapter IV: The interaction between Courts and Tribunals – Excessive interference or necessary intervention?

Drawing the line between (minimum) judicial intervention and (excessive) judicial interference is a controversial issue. The challenge basically lies on balancing legality and finality.

Although the trend in international arbitration has been to reduce Courts' intervention in arbitral awards, one could say that a too wider judicial review on international awards still exists, notably in England, Germany and France¹¹.

¹¹ Despite the demanding standards for challenge of awards applied by English Courts (*substantive jurisdiction* and *serious irregularity*, Section 67 and 68 of (English) Arbitration Act 1996, respectively), one could say that the other side of the coin is the existence of (a certain type) of appeal: an appeal on point of law. In fact, Arbitration Act 1996 is unique in the sense that it admits an appeal of an international award, even if only on a point of law. Although not expressly admitting any judicial revision on the merits of an international award, this is, a review to the Tribunal's factual findings, it does admit a judicial review on 'substantive errors of law' (G. B. Born, *International Commercial Arbitration*, Volume II, Kluwer Law International, Third Edition, 2009). Additionally, the concept of serious irregularity does not entail the degree of transparency that is desired to exist in a Statute, especially when one is dealing with a matter that involves a narrow approach from the Courts. Such concept is 'excessively vague according to continental standards.' (Fouchard, Gaillard, Goldman on International Commercial Arbitration, E. Gaillard and J. Savage (eds.), (1999) 887-962, Wolters Kluwer, Law & Business, Kluwer Law International, 10). Relying on Courts to define and apply a concept whose meaning is not precise and sufficiently defined in Arbitration Act 1996, may involve abuses by a frustrated party relying on a broader approach for challenge.

In Germany, Section 1059 ZPO establishes six exhaustive grounds for challenging an award: (i) lack of a valid arbitration agreement; (ii) breach of the right to be heard; (iii) excess of authority; (iv) flaws in the composition of the Tribunal or in the procedure; (v) non arbitrability and (vi) conflict with public policy (*ordre public*). K.H Bockstiegel, S.M Kroll and P. Nacimiento, *Arbitration in Germany – The Model Law in Practice* (Wolters Kluwer, Law & Business, Kluwer Law International, 2007). These grounds are summarized, not quoted literally.

Regarding France, a frustrated party may find five grounds for challenging an international arbitration award made in France: (i) absence, void or expired arbitration agreement; (ii) irregular composition of the arbitral tribunal; (iii) failure of the arbitrators to comply with their brief (*infra petita* and *ultra petita*); (iv) breach of due process and, finally (iv) when recognition and enforcement would breach international public policy. (Article 1502, French Code of Civil Procedure –Book IV). These grounds are the same as the ones one can rely on when appealing against recognition and enforcement of an award made outside France.

It is usually pointed out that Courts have two different tasks towards arbitration: the task to assist and the task to control.¹² Assistance stands for the intervention of the Court while arbitral proceedings are taking place. Control implies interference of the Court once the award is rendered. Judicial review of an award is, therefore, a major manifestation of the task of control of a Court in arbitration. Such judicial control implies a real interference with arbitration. It is the level of interference of the Court that we shall discuss below.

In international arbitration, two panoramas for judicial review of arbitral awards are usually foreseen. One is to simply allow a judicial review on the merits of the award. A second one is to allow a limited review to control non compliance with basic procedural fairness (fraud and excess of authority of arbitrators included) or natural justice. Additionally, a more recent (third) model excludes the possibility of setting aside an international award, even if fraud or excess of authority are at stake (case of Belgian law).¹³

The issue raised is to ascertain to what extent it is justifiable to allow Court's interference with an international award to which they were fully absent, to which international rules and foreign law(s) they are not acquainted of and, finally, to which spirit and environment (which characterizes international arbitration) they were not aware of?¹⁴

It is unanimous that it is not possible to leave Courts apart from some degree of control in international arbitration. The fact is that, despite its contractual nature, the purpose of Tribunals is the same as Courts: to serve justice.¹⁵ Controlling an award's compliance with international public policy justifies by itself the need for some degree of Court Control.

Review on the merits of an award is commonly excluded nowadays (unless otherwise agreed, exceptionally), as it jeopardizes the principle of finality in international arbitration. Several arguments can be referred in that sense:

¹² P. Sanders, *Quo Vadis Arbitration, Sixty Years of Arbitration Practice* (Kluwer Law International, 1999), 18.

¹³ W.W. Park, Judicial Controls in the Arbitral Process, in *Arbitration of International Business Disputes – Studies in Law and Practice* (Oxford University Press, 2006)), 266; C. M. Schmitthoff, 'Finality of Arbitral awards and judicial review', in *Contemporary Problems in International Arbitration*, Edited by J. DM Lew, Queen Mary College University of London, Centre for Commercial Law Studies, Martinus Nijhoff Publishers, 230.

¹⁴ In short, with an award that was not the product of any particular legal system (S. Brekoulakis, 'The Effect of an Arbitral Award and Third Parties in International Arbitration: *Res Judicata* Revisited', (*The American Review of International Arbitration*, vol.16, 2005), 29.

¹⁵ Although a different kind of justice, due to arbitrator's discretion within the applicable law.

Firstly, parties who resort to international arbitration are aware that the type of justice applied by Tribunal is different (if not only in its spirit) from the one applied by a national Court. Thus, a losing party that chose arbitration can not rely afterwards in a Court for a second chance of winning. It would make no sense to consider that parties wanted to allow a subsequent intervention of a national Court in issues of law and contract interpretation, when the purpose for choosing arbitration was exactly for arbitrators to exclusively decide on such matters.¹⁶

Secondly, the choice for arbitration is to achieve a decision by relying on deep technical knowledge of the arbitrators in the matters at stake, on confidentiality and on a timeframe. It is senseless to destroy such goals with an appeal to be decided by someone without such expertise specialist, with costs and delays involved, and which decision would be public at the end.¹⁷

Thirdly, parties do wish to have their dispute solved by a neutral forum and not in any of the parties' national Courts. Such choice is a main frame in international arbitration and it mirrors the discomfort felt by one party relying on the other parties' judicial Courts to solve their dispute, and vice-versa. Allowing the subsequent intervention of a national Court to review the merits of an award could affect such neutrality.¹⁸

In this respect, unhappy parties do tend to conveniently ignore that it was their choice to have a dispute finally solved in a 'a geographic half-way house'.¹⁹ Asking an initially-excluded Court to interfere after an award was rendered as a means to have such award set aside is commonly a litigious strategy stretching the purpose of challenge mechanisms to the limit, being at the end a pure attack on the autonomy of the arbitration process.

Some authors, nevertheless, defend that Courts should review the merits of an award.²⁰ Duncan Wallace develops such idea:

'Judicial control, in the form of the correction of mistakes of law of interpretation where it is desired and possible, is an aid, not an hindrance, to that end (...) If judges of first instance, with a life-time of experience and training, and under the full glare of publicity, are subject to appellate control and review in this area,

¹⁶ P. Mayer, 'Seeking the Middle Ground of Court Control: A Reply to I. N. Duncan Wallace', *Arbitration International*, Vol. 7 No. 4 (1991), 311 – 318.

¹⁷ *Idem.*

¹⁸ *Idem.*

¹⁹ S. D. Franck, 'The Role of International Arbitrators', *ILSA Journal of International and Comparative Commercial Law*, 2006, 3.

²⁰ D. Wallace. Although focusing on the construction field, his thoughts seem to apply to international arbitration in general.

there must be a strong if not overwhelming case for arbitrators' institutions, in their own enlightened self-interest, to welcome, and not to seek to exclude, control in this area as well as in the area of mistakes of law (...).'²¹

Others, such as Pierre Mayer, totally disagree with such a view, as follows:

‘(...) Recourse to the courts should be available to carry out control functions (...) But to conduct a review of the merits, even if it were limited to issues of law and contract interpretation, as the author suggests, would transform the controlling court into an appellate level of jurisdiction.²² In short, ‘Judicial review on the merits is a manifestation of distrust of arbitral justice, suspected of incompetence and partiality’.²³

Be as it may, the trend nowadays in modern arbitration statutes is to allow a limited review based on the breach of basic procedural fairness or natural justice.

According to Park, Courts are crucial to avoid ‘aberrant arbitral behaviour, promoting confidence within the commercial community that arbitration will not be a lottery of erratic results’,²⁴ leading to more efficient arbitration as it avoids parties’ victims of injustice to challenge enforcement proceedings every time that enforcement is filed against them, in several countries.

Moreover, it implies a control of the quality of the awards (and arbitrator’s misconduct), thus ensuring that arbitrators have not rewritten the contract or ignored imperative norms of international public policy, even when the parties have authorized the arbitrator to act as amiable compositors.²⁵

In short, Park believes judicial review can not be excluded at all, as long as it does not imply a revision on the merits of the award, fraud, partiality or excess of authority, this is, those which implicate national or third party interests.²⁶

²¹ D. Wallace ‘Control by the Courts: A Plea for More, Not Less’, *Arbitration International*, Vol. 6 No. 3 (1990), 253 – 267.

²² P. Mayer, ‘Seeking the Middle Ground of Court Control: A Reply to I. N. Duncan Wallace’, *Arbitration International*, Vol. 7 No. 4 (1991), 311.

²³ *Idem*, 317.

²⁴ *Vide* note 13, first part, 151.

²⁵ *Idem*, 232.

²⁶ *Idem*, 164.

We share the opinion of those who believe it is impossible to eliminate some degree of control from a Court. However, we believe such judicial control should be reduced for international arbitration to operate with more autonomy.

One does not have, nevertheless, an extreme position in the sense that Courts should be totally excluded from any kind of intervention in arbitration. In fact, one agrees that Courts should not be excluded in full, as that could turn international arbitration into a dangerous area, potentially resulting in some degree of abuse and disrespect for major principles of justice, and in the extreme, to potential situations of corruption or fraud.²⁷

However, Court's intervention in arbitration after an award is rendered should be even more reduced and only be allowed in cases where criminality may be involved, such as fraud, corruption, or other situations where illegality may be at stake,²⁸ this is, for purposes of controlling respect for international public order. Other grounds which deal with the sphere of the arbitration itself, notably in compliance with major procedural rules, could be resolved fully within the sphere of arbitration.

We do not intend to ignore the importance of compliance of a Tribunal with rules of due process, such as the right to be heard or to present one's case. When we say that the control of such matters should stay within the sphere of arbitration, we are merely defending the exclusion of an outsider judicial body (except for matters of illegality/criminality) either by relying on the action of the proper Tribunal or, by permitting a second instance (arbitral) Tribunal to deal with such issues. One does not defend, as such, a total exclusion of any kind of control on an award, but merely a stronger limitation on judicial review, as we shall develop below.

²⁷ In the sense of turning international arbitration into a blank check for contracts with illegal purposes, or leading to corruption or fraud with the arbitral process.

²⁸ Despite the fact that 'Arbitrators are naturally sensitive to the need for morality in international business. States should, on their side, acknowledge the autonomy of arbitration and the difference between arbitrators and judges.(...)' (A. Mourre, in *Arbitrability (Mistelis, Brekoulakis)* - Part II, Chapter 11: Arbitration and Criminal Law: Jurisdiction, Arbitrability and Duties of the Arbitral Tribunal, 209, www.kluwerarbitration.com, last visited 9 February, 2010).

Chapter V: Is it time to change the rules of the game?

The misuse of the challenge of awards mechanisms, despite Court's narrow approach in appreciating such challenges, has a truly negative impact on international arbitration. It not only implies the risk of interference with (the merits of) an award or with the way the Tribunal conducted the proceedings, but it mainly implies a strong delay in settling a dispute by arbitration.

This situation is even more dramatic when one realizes that delay in challenges may be higher than in (judicial) appeals. If it is found that an award is irregular, new procedures must take place and, at the end, there will be three examinations on the same matters: by the initial Tribunal, by judicial Court and by a new Tribunal. And to make things worse, the losing party could even challenge the (second) award once again, claiming the existence of a new irregularity.²⁹

Resorting to arbitration implies that parties create their own forum, their own rules; they appoint the arbitrators who believe to have clear technical knowledge, experience, competence and reputation enough to decide their dispute. Such party-appointed arbitrators appoint the Chairman. In this general scenario, parties do create in fact the environment and choose the law and rules they want to apply to their own dispute. Thus, opening the door to judicial interference that may carry the risk of destroying the effects of an arbitration, or at least, allowing the opportunity to challenge an award (even if not successfully), based on grounds that could be appreciated by a Tribunal, is perhaps a step back from swiftness and autonomy of international arbitration.

For instance, if a party suspects that one of the arbitrators is biased in a tripartite Tribunal, its majority could well react, notably by accepting the (party requested) removal of such arbitrator or simply not considering such biased arbitrator for the purposes of the final decision, as the dispute is decided by the majority of arbitrators.³⁰ They may also consider that such allegations are unfounded. If the majority of the Tribunal does not react to the party's claims, the latter could appeal to an arbitral second instance, idea that we develop below. But there is no need, in our view, to have the opinion of a judge that was not present in the arbitration proceedings, who is not truly aware of the mechanisms of arbitration and who, at the end, may well interfere with the result achieved in an award, as well as cause an extra delay, when it was really not necessary.

²⁹ P. Mayer, 'Seeking the Middle Ground of Court Control: A Reply to I. N. Duncan Wallace', *Arbitration International*, Vol. 7 No. 4 (1991), 312.

³⁰ Born points out the right of the parties to independence/impartiality of all arbitrators, even if the majority of arbitrators is to decide (G. B. Born, *International Commercial Arbitration*, Volume II, Kluwer Law International, Third Edition, 2009, 2646)

Moreover, although not relying on an idea of absolute enlightenment of arbitrators, as if they were not subject to make mistakes (naturally that they are), it is a fact that arbitrators are, as a rule, most commonly high reputable teachers, sometimes ex-judges and lawyers, people of high intellectual and moral standards, aware of their ethical duties and of the way they should conduct the proceedings, comparable in that sense to Judges. Trusting the arbitrators and relying on them to decide by applying the rules chosen by the parties in a final way is implicit when resorting to arbitration. In case of error by an arbitrator, then such error should be pointed out and dealt with, if necessary, by another different board of arbitrators, in a second instance tribunal.³¹ Thus, resorting to arbitration does not have to be a *‘trade-off between impartiality and expertise’*.³²

Autonomy and efficiency of arbitration are not fully achieved with today’s general grounds for challenge. Judicial review bears some criticism:

Firstly, it has a negative impact on the claimant. It implies postponing the effect of an arbitral award meant to be obtained in a swift way through a neutral forum, implying losing time and money for the winner party, as there is a risk of dissipation of assets of the debtor, judicial costs to be paid and eventually witnesses to be heard.

Secondly, it has a negative impact on the arbitrator, as judicial review may condition his adjudicatory functions, despite the fact that errors of law of the arbitrator are no ground for challenge,³³ as per *Lesotho*.³⁴

Thirdly, it has a negative impact on arbitration itself. Control by Courts ‘should be limited to ensuring respect for traditional standard of fairness, the limits of the arbitral mission, and the rights of third parties’.³⁵ In other words, Courts should not examine the award according to the same standards applied to domestic controversies.

Therefore, we do believe that the present panorama, although limiting judicial review, should nonetheless suffer a change towards an even less interventionism:

³¹ This idea is developed below.

³² Judge Posner, in *Merit Ins. Co. v. Leatherby Ins. Co.* (1983) 714 F. 2d 673, 679 (7th Cir.).

³³ W.W. Park, ‘The Arbitral Situs and the Lex Loci Arbitri’, 164.

³⁴ *Lesotho Highlands Development Authority v. Impregilo SpA*, [2005] 2 Lloyd’s Rep 310 distinguished clearly procedural error and substantive error: there is no challenge under serious irregularity on the conclusions reached by their arbitrators in the award.

³⁵ See note 33, 178.

Firstly, we believe that arbitration's autonomy would be reinforced if Courts would be solely entitled to appreciate challenges of awards based on illegality claims, notably fraud and corruption. Such matters should not be excluded from judicial Courts in order to control arbitration from being a forum that would allow illegality enter and contaminate its judicial functions and purposes.

Nevertheless, all other typically recognized challenge grounds, such as breach of the due process rules and excess of powers of the arbitrators, bias of the arbitrators, matters of (non) arbitrability (except if an illegal matter is at stake, where a Court should be entitled to intervene), should be appreciated exclusively within the arbitral atmosphere.

In a first moment, by the own Tribunal conducting the proceedings, either while these are taking course or after the award is rendered. In a second moment (and when necessary), by an arbitral second instance³⁶: a new Tribunal composed of different arbitrators that are not chosen by the parties but belong to an independent board created for such purpose. This second instance Tribunal would be necessary to establish a certain degree of arbitral awards, but would have the advantage of being swifter, confidential, composed by different arbitrators than the ones that rendered the award, something Judicial Courts usually do not offer.

Perhaps, one could apply a similar solution already existing for settlement of investment disputes under the ICSID Convention³⁷ (article 52) – this is, the creation of an *ad hoc committee* (a second independent arbitral instance) composed of three persons, none of them belonging to the Tribunal which rendered the award. With such a solution, a party would gain time (saving therefore, money) when relying on the appreciation of such claims by other independent arbitrators who have experience and knowledge in international arbitration.

³⁶ Pierre Mayer refers to the possibility of organizing 'a system of arbitral appeals' which would provide the 'same additional assurance of quality that is sought by creating appellate jurisdictions'. However, the same author refers that such an idea is not followed by most modern rules due to the fact that parties usually chose arbitration for its rapidity (*Vide* note 22).

³⁷ Convention on the Settlement of Investment Disputes between States and National of other States (Washington Convention). Article 52: '(1) Either party may request annulment of the award by an application in writing addressed to the Secretary-General on one or more of the following grounds: (a) that the Tribunal was not properly constituted; (b) that the Tribunal has manifestly exceeded its powers; (c) that there was corruption on the part of a member of the Tribunal; (d) that there has been a serious departure from a fundamental rule of procedure; or (e) that the award has failed to state the reasons on which it is based. (...) (3) On receipt of the request the Chairman shall forthwith appoint from the Panel of Arbitrators an *ad hoc* Committee of three persons. None of the members of the Committee shall have been a member of the Tribunal which rendered the award, shall be of the same nationality as any such member, shall be a national of the State party to the dispute or of the State whose national is a party to the dispute, shall have been designated to the Panel of Arbitrators by either of those States, or shall have acted as a conciliator in the same dispute. The Committee shall have the authority to annul the award or any part thereof on any of the grounds set forth in paragraph (1). (...) (5) The Committee may, if it considers that the circumstances so require, stay enforcement of the award pending its decision. If the applicant requests a stay of enforcement of the award in his application, enforcement shall be stayed provisionally until the Committee rules on such request. (6) If the award is annulled the dispute shall, at the request of either party, be submitted to a new Tribunal constituted in accordance with Section 2 of this Chapter.'

One is not unaware that ICSID's *ad hoc committee* is a solution that relies on a massive ratification of an International Convention by many countries, which was intended for the settlement of investment disputes, not for international commercial disputes.

A potential solution to safeguard the autonomy of arbitration would be exactly by drafting an international instrument (Convention) that would create a similar international appeal board. That would reduce the scope of judicial review, either on the merits or not (except for issues where illegality/criminality was raised, as referred), notably by establishing also common grounds for challenge in international arbitration in every national law.

Despite the harmonization achieved with the application of the Model Law³⁸ in many countries in the world, the fact is that jurisdictions still differ from each other when it comes to reviewing an award, differences that goes against the trend in international arbitration. Perhaps an international treaty would be a reasonable solution to harmonize for good challenges in international arbitration. In such a treaty, few exhaustive grounds for challenge of awards would be established, previewing for instance the above mentioned Committee for appreciation of cases other than issues of illegality. Moreover, the possibility of any appeal on a question of fact or on a question on law would be expressly excluded. This would be a way to limit Court intervention and eliminate vague concepts in certain jurisdictions, such as serious irregularity in English law as well as any attempt to appeal, even if on a point of law.

At the end, less judicial interference combined with harmonized grounds for challenge would strengthen finality and autonomy of international arbitration.

*

Chapter VI: Conclusion

The standard practice of challenging unfavourable awards as if it were an appeal on the merits goes beyond the spirit that was intended for international arbitration, this is, to create a neutral forum that applies parties' chosen rules in order to decide a dispute in a final and binding way.

But challenges are not appeals. Their purpose is simply to control serious breaches in arbitral proceedings related to major principles of due process and international public order, not to review the decision of arbitrators on the merits, which is not admissible in international arbitration.

³⁸ *UNCITRAL Model Law on International Commercial Arbitration (1985)*, adopted by the UN Commission on International Trade, amended on 7 July 2006.

Nevertheless, one might say that the misuse of challenges to awards is leading international arbitration into a two instances mechanism. For instance, alleging lack of independence and impartiality of an arbitrator is amongst the grounds a losing party will use to have an award reviewed and set aside, which is usually a premeditated technique either to try a second opinion by a different forum, or simply a dilatory procedure. The number of unsuccessful challenges, contrasted to successful ones, shows such reality. However, the fact is that delay of *res judicata* effect is always achieved by a challenge on the award, which, at the very least, interferes with finality and swiftness.

In general, we believe that judicial review of an award could be more limited as to preserve finality and autonomy in international arbitration in a more intensive way. It is naturally undeniable that judicial control, as to maintain international public order, is crucial. Courts must avoid that arbitration turns into a mechanism for reaching illegal purposes. However, it could be limited to matters of illegality and criminality. Other existing grounds should be maintained but dealt within the arbitration environment, this is, first by the proper Tribunal, and secondly, by a second arbitral instance, preserving therefore swiftness, expertise, confidentiality, neutrality and, at the end, entitling a degree of control for arbitrators' errors or bias.

The suggested solution of a Convention expressly excluding the appeal on international awards, harmonizing minimum grounds for challenge and creating a second arbitral instance for international commercial disputes, following ICSID's idea of an *ad hoc committee*, could be a way to change the described reality, avoiding not only the immediate impact of challenges (delay) but reducing the risks of judicial interference on the merits of an award.

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The Sub-Permanent Establishment (“Sub-PE”) and the OECD Model Convention

A large, light blue wireframe globe centered on the page, with latitude and longitude lines.

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PERSONAL STATEMENT

This article is based on the Adv LLM paper the author submitted in fulfilment of the requirements of the 'Master of Advanced Studies in International Tax Law' degree at the International Tax Center Leiden (Leiden University), under the supervision of Prof. Kees van Raad, to whom the author thanks for.

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Overview of Main Findings

Throughout the paper the author reaches a number of solutions, and takes position on several issues.

Firstly, the author presents a definition of Sub-PE, describing the scenario that shall be borne in mind by the readers when thinking about such expression. Based on the term brought up, to the best of the author's knowledge, by Prof. Kees van Raad,¹ "Sub-PE", the author builds up the concept by setting up its core elements. Furthermore, the author disassociates those elements from other features that, despite being frequently put together with the term, are merely accessory to the notion of Sub-PE, corresponding, sometimes, even to misapprehensions of the reality under study.

Moreover, the author describes several examples of Sub-PEs that may be observed in real live practice. Many of the cases portrayed represent commonly used ways to structure multinational enterprises, although in the great majority of the cases the term Sub-PE is not invoked along the lines with such structures. Thus, through such set of examples the author wishes to increase the awareness of the tax community to scenarios in which the described reality may appear.

In addition, the author draws attention to the fact that the layers of Sub-PE may even add to one another, creating a Sub-Sub-PE.

Secondly, the author examines the issues surrounding the Sub-PE from the viewpoint of all States involved in the triangulation, the State of Residence, the State hosting the PE, and the State hosting the Sub-PE.

Among the steps of such analysis, the author deals with the discussion surrounding the taxation by the State hosting the PE of foreign-source active business income allocable to a PE therein. The issue is also analyzed under the perspective of such income being simultaneously allocable to two different PEs (PE and Sub-PE).

In this regard, the author brings new arguments to the table, and takes position on the discussion.

Additionally, the author takes a new approach on the discussion regarding the hierarchy between the PE, and the Sub-PE distinguishing a legal, or formal hierarchy, from a practical (organizational, economical, and functional) pecking order between the two PEs. The author suggests a moderate approach, half way from those that believe in the hierarchy, and those that do not defend this position.

From the perspective of the State of Residence, the author tackles the obligation of such State to provide

¹ See Prof. Kees van Raad, 'Triangular cases, The 1992 OECD Model Treaty', in 33 European Taxation 9 (September 1993), pp. 298 to 301, at p. 298.

reliefs under two treaties (R-PE, and R-SPE), and analyzes the interaction between such reliefs. Although this discussion is not new, the fact that the triangulation under study refers to active business income, brings fresh elements to the debate, as the exemption method may become more of an elected choice. Thus, the author pays special attention to situations where both treaties entered by the State of Residence apply the exemption method. In this regard, the author believes that the interaction among reliefs and the allocation of taxing rights between the three States involved will result differently if the State of Residence applies a country-by-country, or an overall limitation.

Finally, and still on the topic of the interaction of reliefs, the author suggests a new interpretation of art. 23 A (4) OECD Model 2000, and the addition of a new section to the commentaries on such article, as a way to solve situations of potential double, or triple taxation, or less than single taxation.

“I am a citizen, not of Athens or Greece, but of the world”

Socrates

1. Introduction

1.1. Preliminary notes

Due to the practical effects of the globalization, the proliferation of structures in which foreign enterprises operate through permanent establishments² (“PEs”) have become quite widespread.

As it is eloquently described by the Report on the Attribution of Profits to Permanent Establishments, *“[I]n many cases, business operate through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilization, risk diversification, economies of scale, etc., making the structure more profitable.”*³

To this regard, the OECD Model Convention⁴ lays down, as a general rule, that business profits shall be taxable only by the Residence State (“State R”). However, the state hosting a PE of a foreign enterprise (“State PE”) may tax inasmuch income as it is attributable to the PE therein. Yet, this seemingly straightforward principle is less than clear in what concerns the taxing powers of State PE over foreign-source income.

To the extent that such income is of a passive nature (dividends, interest, or royalties) the situation has been written extensively, and has even been addressed by the OECD,⁵ being at this point largely settled. Conversely, where the foreign-source income derived by the PE comprises active business income, the issue has not been tackled with the same magnitude, and leaves room for further discussion.

The subject gets even juicier if foreign-source active business income can be simultaneously allocable to another PE in a third State.

² For the notion, and requirements of permanent establishment see art. 5 OECD Model, and respective commentaries.

³ See, Part I, section 84 of Report on the attribution of profits to permanent establishments – Parts I – IV, (17 July 2008).

⁴ See art. 7 OECD Model.

⁵ OECD Committee on Fiscal Affairs, Model tax Convention: *Four Related Studies* (Paris: OECD, 1992), pp. 27-41, pp. 27-41 (hereinafter “Triangular Cases Report”).

The abovementioned scenario, in which a non-resident enterprise operating through a PE in State PE is carrying on business in a third State, (“State SPE”) through another PE (Sub-PE)⁶ therein, will constitute the primary scope of the present study.

1.2. Notion of Sub-PE

In the opinion of the author, a Sub-PE refers to a scenario where, plain simply, *a non-resident enterprise operating through a PE is carrying on business through another PE, the latter being the Sub-PE.*

It is important, however, to make a preliminary analysis of some features that usually walk hand-in-hand with the notion of Sub-PE, and highlight which elements are essential to the definition, and which are merely accessory. Furthermore, it is essential to clear out some misapprehensions that surround the subject, and discuss some of the requirements upon which the notion builds up:

- (i) To begin with, queries arise as to the possibility of *attributing active business income derived outside State PE to a PE therein* (as it was already mentioned above, and will be further developed below, this issue is particularly acute where active business income is also allocable to another PE (Sub-PE) in a third State). At this point, there is generally a misapprehension that there is a Sub-PE whenever a PE is *deriving active business income from a third state*.

This feature, in the opinion of the author, is not essential, as the fact that a PE is deriving business income from another state does not create, *per se*, a Sub-PE. The Sub-PE will only be deemed to exist, in such situation, when the business carried on in the third state meets the requirements of art. 5 OECD Model, and achieves the PE threshold therein.

- (ii) Another feature commonly put together with the idea of Sub-PE is *treaty entitlement of the PE*.

In the opinion of the author, however, this understanding is mistaken. The notion of Sub-PE does not require treaty entitlement by the PE. In fact, it is clear that the PE-SPE treaty does not apply by itself⁷ (although it may be applicable due to the non-discrimination clause of art. 24 (3) OECD Model included in the R-PE treaty).

⁶ As it was mentioned above, this denomination, was used by the first time, to the best of the author’s knowledge, by Prof. Kees van Raad, addressing the fact that “(...) *assets attributable to a foreign branch increasingly include real property and business establishments («Sub-PE» in a third country*”. (see van Raad, note 1).

⁷ The author refrains, for the time being, from commenting on the recent approaches to the case-law of the European Court of Justice that the author will leave aside for the time being.

Nevertheless, that fact does not preclude a non-resident enterprise operating through a PE, to carry on business through another PE, nor does it prevents State PE to tax business income arising in a third State, and to grant a correspondent relief, as it will be better described in Chapter 3.

- (iii) Further to the above, there is a frequent misunderstanding concerning the idea that, at some point, the PE will *derive income from another PE*.

Also in this case the belief may be proven wrong. One can easily picture a situation in which the Sub-PE produces a single component of an item that is manufactured through the PE. Thus, disregarding any transfer pricing remuneration of such activity, from State PE's perspective there will be no foreign-source business income arising in State SPE, and still, in the opinion of the author, a Sub-PE will be deemed to exist (see sub-chapter 2.2., example 3 below).

- (iv) In addition, there is also a misapprehension that there has to be an identity between *the business activity carried through the PE, and through the Sub-PE, and, conversely, a lack of identity between the enterprise in State R, and the activity carried through the Sub-PE*. In the opinion of the author, such feature is not crucial.

To this regard it is important to begin by stressing that neither the PE, nor the Sub-PE are legal entities, and, therefore neither one can carry on an activity by itself. Thus, whenever referring to the activity of each of the two PEs one should always bear in mind that the activity is being carried out by a person, (either an individual, or a company) through the PE. In the case of the Sub-PE, as it was explained above, the resident of State R, is operating the Sub-PE through a PE in State PE.

Furthermore, the critical feature is that the non-resident enterprise, operating through the PE, is also carrying on business through the Sub-PE. The resemblance of activities carried through both PEs, *per se*, does not have legal significance. Nevertheless, in order to consider that the Sub-PE is being operated through the PE, it is necessary to substantiate a link between the activities carried through both PEs.

The previous requirement may, in some cases, be difficult to verify.

In theory it is even possible to picture a scenario in which the activity of the enterprise in State R, and the activity carried on through the Sub-PE in State SPE are the same. For instance the manufacture of caps, being, nevertheless, notorious that the production in State SPE corresponds to a business carried on through the PE, notably because the caps produced in State SPE use a technology developed in State PE.

In the opinion of the author, the compliance with such link requires a comprehensive case-by-case scrutiny in which the business relationship between the PE and the Sub-PE shall be analyzed according to several features. Such features shall be, although not exclusively, the characteristics of the:

- (a) *Activity*: by comparing the core of the business carried through the Sub-PE with the activity operated through the PE;
- (b) *Products*: comprehending the materials used, as well as the models, the style, the price etc. as this features may also indicate a definite influence of the PE over the Sub-PE;
- (c) *Production*: regarding which technology is applied, the techniques used etc., in order to compare such traits with the PE;
- (d) *Investment*: which comprises an analysis of the accounting of the PE with the purpose of tracing the origin of the funds invested in the Sub-PE to resources accounted for in the PE's books (for instance regarding the wages paid to a Sub-agent, the acquisition of goods, the acquisition, or rental fee of the infra structures, etc.); and
- (e) *Management*: to establish which part of the enterprise is managing *de facto* the Sub-PE, giving production orders, supervision, etc..

Although legally both PEs are a part of the same enterprise, like the yolk and egg white belong to the same egg,⁸ the executive orders of the Sub-PE may, in practice, be given by one part of the enterprise rather than by the other.

- (v) Furthermore, *the existence of a fixed business establishment (i.e. a physical PE)*⁹ is also not essential, once a Sub-PE, as it will be demonstrated below, may exist by means of an agent, or a certain threshold of services (see sub-chapter 2.4. examples 7, and 8, and sub-chapter 2.6. example 10).

⁸ This example was mentioned by Prof. Kees van Raad in some of his classes.

⁹ See art. 5 (1) OECD Model Convention.

- (vi) Finally, the misconception that *the Sub-PE has to be located in a third state* also seems to be quite widespread. However, the fact that a Sub-PE can exist in the State R, proves that the referred element is also not vital to the concept.

Regarding the last indent, the author recognizes, however, that the aforesaid concept of Sub-PE derives a great deal of importance from its application to triangular situations. Thus, the analysis below will be mainly based on a scenario where the Sub-PE is deemed to exist in a third State.

1.3. Relevant issues

At this point, before attempting a deeper analysis, it is important to be aware that it is not only the definition of Sub-PE which is surrounded by uncertainty. Also, the bare existence of such figure, and the way to apply the relevant treaty network by all three countries concerned (State R, PE, and SPE) in a scenario involving a Sub-PE is largely debated by treaty interpreters, and the tax community in general. Such issues are far from being peaceful and do not go without a number of unsettled queries that are important to discuss.

The issues surrounding the existence of a Sub-PE start with its *volatile trait*. As not all States involved will identify the same reality in State SPE, the notion of Sub-PE is of a relative nature:

- (i) State R will be able to identify a Sub-PE, and, at the same time a regular PE in State SPE. As it will be developed *infra*, State R is bound by two treaties, R-PE and R-SPE. Thus, by looking at the business which is being carried on in State SPE, State R perceives the reality with two different sets of eyes. On the one hand, by applying the R-SPE treaty, it sees a regular PE in State SPE. But on the other hand, when applying the R-PE treaty, it distinguishes that the PE in State SPE is integrated in the business carried on in State PE. Thus, State R is also able to identify the features of a Sub-PE;
- (ii) From State PE's viewpoint, there will be a Sub-PE in State SPE. Although the treaty PE-SPE does not apply by itself (due to the lack of treaty entitlement), there is a business in State SPE which is being carried through a PE of a non-resident enterprise hosted by State PE. Once more, as it will be further extended below, this set of facts will generate legal obligations to State PE – obligation to grant relief - due to the application of art. 24(3) of the R-PE treaty. Thus, State PE will also perceive a Sub-PE in State SPE;

(iii) Finally, from State SPE standpoint, there will be no Sub-PE. Due to the fact that the only treaty applicable is the R-SPE, there are neither obligations towards State PE, nor other reasons why the PE hosted by the latter state would deserve any special attention. In conclusion, State SPE only identifies a regular PE with no special features.

Although it was referred that the Sub-PE is more of functional concept than a legal one and that there are several criteria to determine the existence of a link between PE and Sub-PE, preliminary to the verification of such link there as to be a legal obligation mandating a direct relation between the two parts of the enterprise (PE-Sub-PE) and the search for the relationship in another jurisdiction, *i.e.*, there has to be a legal reason to look for a relation in the other jurisdiction.

Furthermore, as it was implied above, one of the most debatable issues regarding the existence of a Sub-PE is whether *active business income allocable to the Sub-PE can simultaneously be attributable to the PE in State PE, and taxed therein*. As it will be better analyzed below, some defend that active business income shall be treated differently from passive income, and, consequently, State PE's taxing rights should be restricted. On the other hand, other commentators see no difference between the allocation of active business income and passive income, even if the income arising in a third State is simultaneously allocable to a PE therein.

Another matter worth mentioning is the ascertainment of a *hierarchy between the PE and the Sub-PE*. A number of commentators argue that in some cases a PE has to be seen as a fictitious HO of the Sub-PE, while others defend that there is no recognition of the concept of Sub-PE by the OECD Model, and, consequently, both PEs should be excluded from any form of hierarchy.

Moreover, another affair involving the Sub-PE, which is already a classic debate in triangular situations, concerns the *interaction of the reliefs available by the treaties entered by the three States* involved in the triangulation.

Once three States will claim taxing rights over the income arising in State SPE, this situation can potentially result in double or even triple taxation, or, conversely, in less than single taxation.

Although it is not a new issue, the discussion may involve new features when concerning a Sub-PE. Foremost, in the great majority of triangular cases with passive income, double taxation is relieved by means of the credit method. Nevertheless, when dealing with active business income, the exemption method may become more of an elected choice. Thus, the combinations of reliefs granted by State R, PE and SPE may vary in a higher range when compared with a typical triangular case, bringing additional considerations to the debate.

Finally, the most important concern regarding the topic under analysis is to determine, in practice, in which situations one may contemplate a Sub-PE. This will be the focus of the first Chapter of this study.

Please note that this paper does not intend to be exhaustive, but, instead, to provide a fair pool of arguments in selected issues regarding the subject matter, allowing some discussion over the topic.

Additionally, the author believes that some of the issues described below would find a more accurate, or equitable solution in a multilateral treaty, or even through the addition of new provisions to the OECD Model. Nevertheless, those solutions would involve the negotiation of a new treaty network, and, most likely, could not be effective in the short run. Nevertheless, from the perspective of the taxpayer, the tax authorities or even from the perspective of the practitioner, it is necessary to find a solution among the tools available that can be implemented in the shortest period possible.

Considering the above, the author will focus his attention on the current wording of the OECD Model to solve the above-described issues.

*“Some men see things as they are and say «Why»?
I dream of things that never were and say «Why not?»”*

George Bernard Shaw

2. Examples of Sub-PEs

2.1. General remarks

The far most important issue surrounding the topic hereby analyzed is to determine in which structures and situations one can run across a Sub-PE.

In the opinion of the author, this first step will set the grounds for further discussion on the subject matter, and place this debate outside the range of a merely theoretical exercise.

The author does not wish to be far-reaching in the identification of Sub-PEs, but only to describe examples that are, in its underlying principles, close to real life situations.

The factual scenarios portrayed resemble in many aspects cases presented before courts in several countries. Thus, regarding each of the examples the author typically provides a selected list of case-law which intends to support the real life existence of the facts described.

Please note, however, that the requirements for the existence of a PE in State SPE (*i.e.* of a Sub-PE) are intentionally easy to meet in each case. Although conscientious that the reality is hardly ever as blunt, the author believes that the day-to-day grey areas, in which the compliance with the requirements for the existence of a Sub-PE¹⁰ are doubtful, should be handled in the same way as with any other PE (and, therefore do not deserve any special attention at this point).

Furthermore, the author starts from the assumption that the requirements for the existence of a PE in State PE are met in all cases, and, also, that the connection between the PE in State PE and the PE in State SPE (Sub-PE) is not rebuttable.¹¹

¹⁰ Requirements of Art. 5 OECD Model.

¹¹ In order to present its examples, the author used a structure similar to the one used by Prof. Kees van Raad (See Prof. Kees van Raad, *supra* note 1, at p. 300).

2.2. Physical Sub-PE

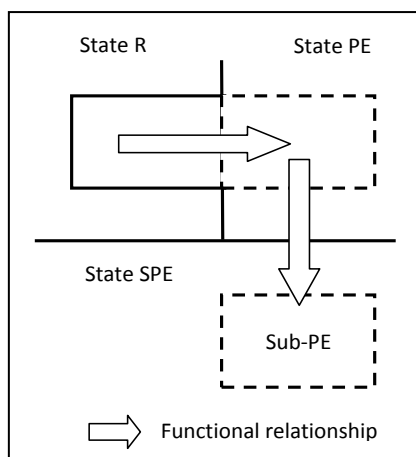
Example 1

Corporation A, a resident of State R, is in the Hotel industry. Since Corporation A's business is spread around the world, A decided to operate each market through local branches (which qualify as physical PEs according to art. 5 (1), and (2) OECD Model).

In each market, which includes a country, or a group of countries with similar market conditions, the business will be carried through a different hotel brand (*i.e.* in one market Corporation A will operate under the name *x*, in another market under the name *y* etc.).

As a result of the described choice of business structure, Corporation A is operating a market which comprises State PE and State SPE through a branch hosted by State PE. Moreover, both States use the same brand name.

Furthermore, although Corporation A owns Hotels in both States, all the employees (working in the two States) are given orders by the branch in State PE, and are paid by the same branch.



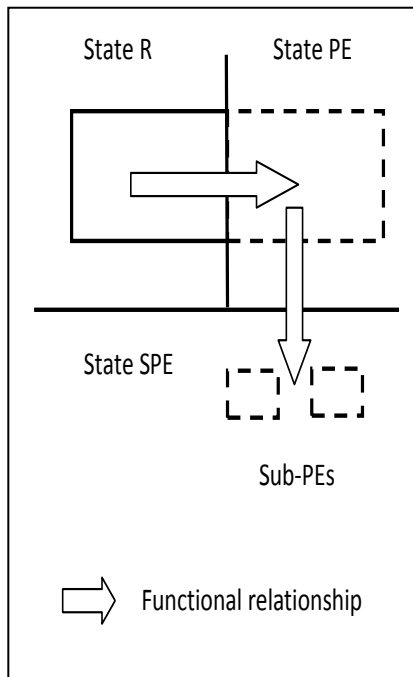
Assuming that the hotel in State SPE also qualifies as a PE according to art. 5 (1) OECD Model, Corporation A is operating such PE through the Branch in State PE.

In other words, the PE in State SPE shall be considered a Sub-PE.¹²

¹² Please see the following list of case-law which point out that the factual examples are close to real life situations: In Bundesfinanzhof (Federal Tax Court), Germany, 3 February 1993, I R 80-81/91, available at www.ibfd.org. Also Bundesfinanzhof, Germany, 23 September 1983, III R 76/81, available at www.ibfd.org, although the PE requirements were not met, a mere circumstantial event, the fact remains that it would be easy to build on the facts a situation where the German agent of an American corporation could execute its functions outside Germany; In Bundesfinanzhof, Germany, 5 June 2002, I R 86/01 available at www.ibfd.org, the only crucial difference is the lack of a triangular situation. Nonetheless, it would be easy to picture a case in which the Swiss company making the transfer of the information and computer programs to a third country extended its functions by providing technical aid in a way that might be deemed to be a PE.

Example 2¹³

Corporation A, a resident of State R, is a wholesaler of food products which also operates in State PE through a branch therein. The branch qualifies as a physical PE according to art. 5 (1), and (2) OECD Model.



The referred branch, under a different brand name, sells products to the general public in State PE as a retailer (*i.e.* Corporation A operates in State R under the brand x, and in State PE under the brand y).

Furthermore, Corporation A using the branch in State PE sets vending machines in State SPE, which are also operated and maintained through the branch. Moreover, the vending machines sell products under the same brand name as the branch.

Assuming that the vending machines may be considered a PE¹⁴ according to art. 5 (1) OECD Model, it is clear that, in this case, Corporation A, through the PE (in State PE) is carrying on business through another PE, or PEs (the vending machines) in State SPE.

Thus, the vending machines in State SPE shall be deemed to be Sub-PEs.

Example 3

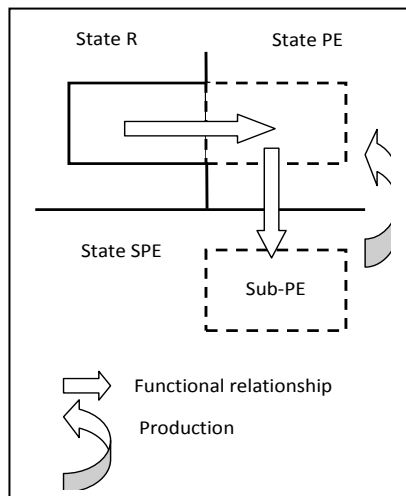
Corporation A, resident in State R, manufactures, and sells tobacco products.

Inside State R there is a high demand for cigars, reason for which Corporation A does not produce any other product inside State R.

Corporation A operates in State PE through a plant therein, which specializes in the manufacture, and sale of cigarettes, not producing, nor selling anything else. The plant qualifies as a PE according to art. 5 (1) and (2) of the OECD Model.

¹³ The facts described in example 2 was based on Sec. 10 of OECD Comm. on Art. 5.

¹⁴ According to section 10 of OECD Comm. on Art. 5.



Country SPE is rich in cotton, which is used to manufacture cigarette filters. Thus, using cash accounted for in the books of the PE, Corporation A acquired another plant in State SPE to manufacture the necessary cigarette filters (which due to the proximity of the cotton fields will allow a significant reduction of costs). The plant in State SPE qualifies as a PE according to art. 5 (1), and (2) OECD Model.

The entire production of filters manufactured through the plant in State SPE is absorbed by the production of cigarettes manufactured in State PE.¹⁵

According to the afore-described facts, the plant in State SPE is a Sub-PE.¹⁶

Please note that in this scenario, disregarding any transfer pricing remuneration regarding the production of the filters, from State PE's perspective there will be no foreign-source business income arising in State SPE.¹⁷

Example 4

Corporation A, a manufacturer and seller of luxury cars resident in State R, carries on the same business in State PE through another factory/dealership therein. The factory qualifies as a PE according to art. 5 (1), and (2) of the OECD Model.

Thus, Corporation A serves the market of State R with the factory and dealerships therein, and the market of State PE with another factory/dealership in State PE.

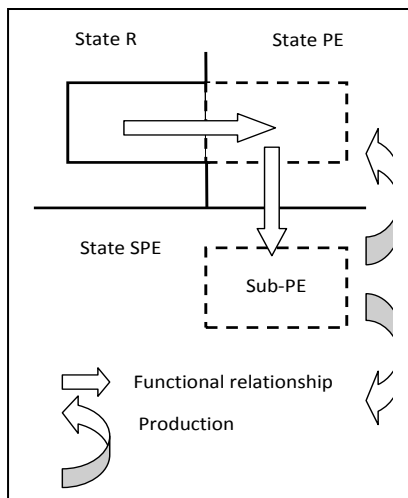
Due to the absence of paved roads in State PE, the cars manufactured therein need to incorporate a carter protection which is not available for models manufactured in State R. The carters assembled in the cars are produced by a small factory in State SPE which also belongs to Corporation A.

¹⁵ The factual situation described is based on an example mentioned by Prof. Kees van Raad in one of its classes.

¹⁶ According to section 7 of OECD Comm. on art. 5, the activity carried on (by the PE) does not need to have a productive character, thus, the filters plant may be deemed to be a PE, in this case, a Sub-PE, assuming that the remaining requirements of art. 5 (1) are met, notably regarding the permanence.

¹⁷ At this point, the author does not wish to address the issue regarding the application of the principle of deemed independence between two PEs. Thus, for further analysis on the subject please see Franz Philipp Sutter *et al.*, *Triangular Tax Cases. The Sub-Permanent Establishment in a Third State*, (Vienna: Linde Verlag, 2004), p. 102.

Furthermore, the factory in State SPE was acquired with money accounted for in the books of the PE (hosted by State PE), and uses technology formerly developed in State PE.

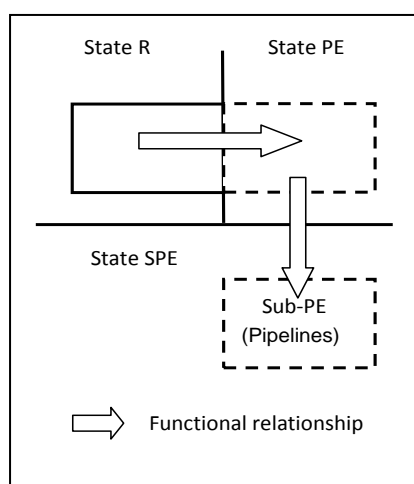


Once more, the plant in State SPE shall be considered a Sub-PE.

2.3. Project Sub-PE

Example 5

Corporation A, a resident of State R, is a multinational enterprise operating in State PE through a branch therein (which qualifies as a PE according to art. 5 (1), and (2) OECD Model).



Through the referred branch, Corporation A started to execute projects in connection with the oil industry, notably the laying of pipelines, excavating and dredging in State SPE.¹⁸

The activities conducted in State SPE are included in the term “building site or construction”, and, therefore qualify as a project PE in State SPE according to art. 5 (3) OECD Model.¹⁹

Thus, in this case, the project PE carried on in State SPE may be deemed to be a Sub-PE.

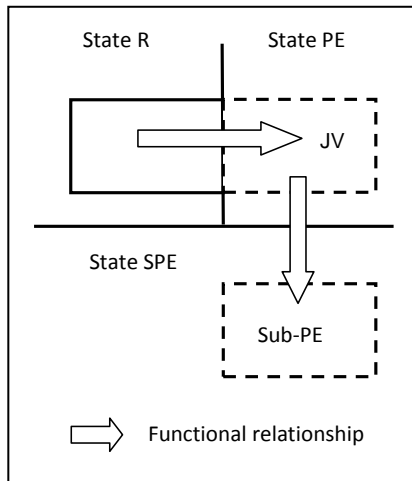
¹⁸ The facts of this example are in all aspects similar to the case decided by Stavanger byrett (Stavanger County Court), Norway, 18 September 1980, 00-260 A, available at www.ibfd.org.

¹⁹ See section 17 of OECD Comm. on art. 5.

Example 6

Corporation A, a real estate developer resident in State R, entered into a joint venture with another corporation in order to build a bridge in State PE.

The joint venture is carried through a fixed place in State PE which qualifies as a physical PE according to art. 5 (1) OECD Model.



The construction of the bridge is continued across the border of State PE, into State SPE.

Furthermore, the construction works in State SPE take more than twelve months qualifying as a project according to art. 5 (3) OECD Model.²⁰

In this case, the integration of the PE hosted by State SPE in the joint venture (*i.e.* in another PE) will deem the existence of a Sub-PE.^{21 22}

²⁰ According to art. 5 (3) OECD Model, and section 16 to 20 of OECD Comm. on Art. 5, the mentioned construction may be deemed to be a project PE.

²¹ Although section 20 of OECD Comm. on art. 5 mentions situations in which the activity has to be relocated continuously, taking the position that the lack of permanency of the work force in one particular place is immaterial, being the entire activities considered a single project, the commentary does not seem to cover situations where the project extends across the border. This is well demonstrated in the third sentence of section 20 of OECD Comm. on art. 20, where it is explained that the relocations have to take place within a country.

²² Please see selected case-law with resembling facts: In Hof van Beroep/Cour d'Appel (Court of Appeals) Antwerpen/Anvers, Belgium, 12 April 1984, available at www.ibfd.org, a Dutch building company which was performing projects through a company in Belgium was considered, by the Belgium Tax Authorities, to be operating through a PE therein. Easily, being the PE requirements met by the Belgium company [which *in casum* were not] could the constructions be carried across the border, for instance in Luxemburg); Also, in Conseil d'Etat (Supreme Administrative Court), France, 30 April 1980, case number 5,761, available at www.ibfd.org, the facts are almost the same as the example described with the exception that the building corporation was resident in the same State where the activities were carried.

2.4. Agency Sub-PE, and the Sub-Agent

Example 7

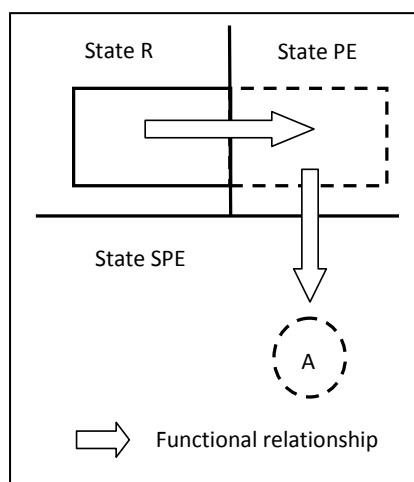
Corporation A, a pharmaceutical resident in State R, operates in State PE through a branch therein (which qualifies as a physical PE according to art. 5 (1), and (2) OECD Model).

The branch is responsible for the sales, and distribution of medicine manufactured by Corporation A.

In order to increase the sales in certain strategic markets, the branch engaged an agent in State SPE (which qualifies as an agent PE according to art. 5 (5), and (6) OECD Model).²³

The agent is subject to detailed instructions through the PE regarding the way to approach potential buyers, is provided with lists of target costumers, and receives extensive training at the branch facilities regarding the characteristics of the products.

Furthermore, the agent is submitted to a high level of control by the branch having, among other things, to report the amount of medicine sold.



The agent is on the branch's payroll, and is guaranteed a fixed wage. Moreover, the agent does not bear any risk (stock, credit etc.) in case the medicine is not sold.²⁴

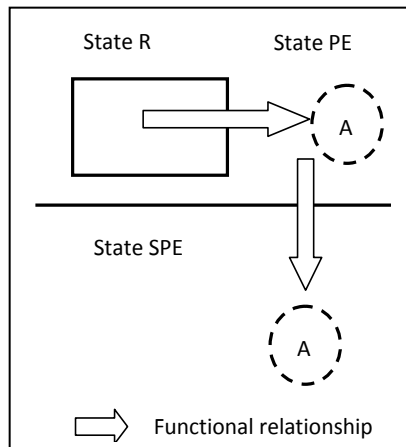
In the described circumstances, the agency PE in State SPE may be deemed to be a Sub-PE.

²³ In this case the activities carried by the agent are not limited to those mentioned in article 5 (4) OECD Model.

²⁴ On a factual situation somewhere between this example and the example regarding the Company Sub-PE, mentioned below, in the case decided by the Finanzgericht Bremen, Germany, 13 May 2004, case number 1 K 224/03, available at www.ibfd.org the German partners of a partnership put a Liberian resident company in charge of the management of the partnership. Such company engaged a Swiss company to act in the name, and for the account of the partnership; on the same subject see also Tax Court of Canada, Canada, 16 May 2008, 2007-2033(IT)G, 2007-3490(IT)G, available at www.ibfd.org; and Tax Court of Canada, Canada, 16 May 2008, 2005-170(IT)G, available at www.ibfd.org.

Example 8²⁵

Corporation A, a coffee distributor resident in State R, operates in State PE through a dependent agent therein (which qualifies as an agent PE according to art. 5 (5), and (6) OECD Model).



The agent takes on another agent (*i.e.* the first agent has authority over the second agent) with whom he splits half of his clients. The latter agent also qualifies as an agent PE according to art. 5 (5), and (6) OECD Model.

The newly hired agent carries his activities mainly in State SPE.

Once again, the agent in State SPE shall be deemed to be a Sub-PE (Sub-Agent).

2.5. Company Sub-PE

Example 9

Corporation P, a resident of State R, is a neck-tie manufacturer, and wholesaler.

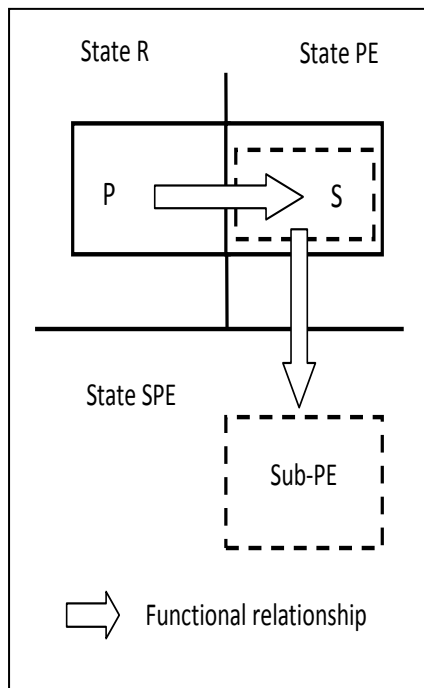
Corporation S is a fully fledged subsidiary of Corporation P in charge of sales, and distribution of ties in State PE, where it is resident.

Furthermore, Corporation S also operates in State SPE through a branch therein (which qualifies as a PE according to art. 5 (1) and (2) of the OECD Model).

Due to a restructuring of the group, Corporation S is stripped of all its risks (stock, advertising, losses, etc.), which will now be borne by Corporation P. Furthermore, the new “job description” of Corporation S only includes the conclusion of contracts in the name of Corporation P²⁶ (never taking title to the goods), for what it is entitled to a fixed commission.

²⁵ This example was based on the situation discussed by Arthur Pleijsier, *The Agency Permanent Establishment*, Maastricht 2000, Datawyse, Universitaire pers Maartricht, p. 176.

²⁶ Not limited to those described in Art. 5 (4) OECD Model.



Corporation P provides its subsidiary with strict instructions on how to perform its functions, and requires regular reports on the business conducted being that, sometimes, Corporation S has to seek for the approval of its parent in order to perform some of its functions.²⁷

Corporation S's branch remains operating the market of State SPE, under the same structure, and limitations as the rest of the enterprise in State PE.²⁸

Assuming that upon the restructuring Corporation S becomes an agent PE (according to art. 5 (5), (6) and (7) OECD Model), all parts of the enterprise are affected by such change, and become part of the same agency PE. Thus, the agency PE extends itself over two States (PE, and SPE).

In this situation, as long as Corporation S is deemed to be a PE²⁹ (company PE), due to the integration of the fixed place of business in State SPE in the PE, such place may be considered a Sub-PE.

Please note that the PE-SPE treaty will not apply to the income allocable to the agency PE. Although, this fact is commonly misunderstood, one shall not confuse the treaty entitlement of the agent itself (Corporation S) with the entitlement of the agency PE. For instance, in the case of the agent's commission the PE-SPE treaty may apply. However, in the case of the agency PE there will be no treaty entitlement, as generally no PE will be considered a resident of a contracting state.

Even though the above scenario may require a higher degree of abstraction, the fact that the agent is a Corporation, and not an individual is of no relevance to the application of the relevant treaty network.

²⁷ Regarding the existence of a "company PE" it is significant to highlight the opinion of Willard B. Taylor, Virginia L. Davies, and Janice McCart, referring that "[I]n the real world, where subsidiaries do not in fact operate with complete independence from their corporate parents, the risk of finding that a subsidiary is an agent of its parent in such a case is not to be dismissed." (see Willard B. Taylor, Virginia L. Davies, and Janice McCart 'Policy Forum: A Subsidiary as a Permanent Establishment of Its Parent', 55, Canadian Tax Journal, Revue Fiscale Canadienne, 2 (2007), pp. 333 to 345, at p. 336.

²⁸ The circumstances of this case resemble the case discussed by the Income Tax Appellate Tribunal (ITAT), India, 5 December 2008, IT Appeal No. 7576 (MUM.) of 2004 available at www.ibfd.org, in which a Dutch corporation subcontracted a project in India to its Malaysian subsidiary, after setting a project office in Mumbai, and a site office in Haldia. The project involved the design and construction of oil and gas products, and the personnel executing the project was on the payroll of the subsidiary.

²⁹ As a side comment, it is interesting to see that affiliated companies were listed in the first draft of the League of Nations as an example of PE. See Matias Milet, 'Permanent Establishments Through Related Corporations Under the OECD Model Treaty', 2 Canadian Tax Journal, Revue Fiscal Canadienne 55 (2007) pp. 289 to 330, at p. 296.

2.6. Service Sub-PE

Example 10

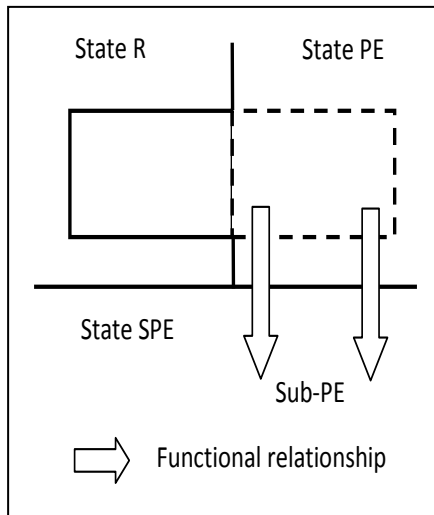
The 2008 update to the OECD Model Commentary opens the possibility to add up a new provision to art. 5 which comprises a new sort of PE, a service PE.

The text of the alternative provision, dealt with in section 42.23 of OECD Comm. on art. 5, provides that
“[N]otwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

- a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual,*
- b) or b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.”*

If there would be such a provision in the relevant treaty network (R-PE, R-SPE, and PE-SPE) one could picture an example as the following:

Corporation A, an accounting firm resident in State R, also operates through a branch in State PE (which qualifies as a PE according to art. 5 (1) and (2) of the OECD Model.



Moreover, a client of Corporation A in State SPE required the presence of one chartered accountant to conduct a due diligence therein. Due to the geographical proximity to State PE, the professional sent to conduct the due diligence usually works at the branch site in State PE (and is on the payroll of the branch), and is using the branch as a back office to conduct the work.³⁰

Although always inside State SPE, the due diligence was conducted out of different locations and, therefore, none of the physical places where it was conducted qualified as a PE according to art. 5 (1) OECD Model.

Furthermore, the work took 185 days, and was responsible for 70% of the gross revenue attributable to active business activities of the enterprise during that period.

In this situation, the requirements for a Service PE would be met in State SPE. Thus, there would be a Sub-PE in State SPE.

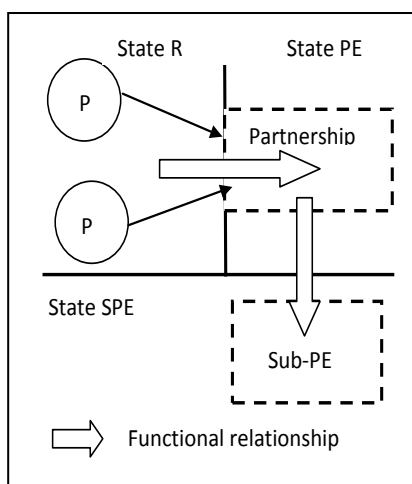
³⁰ See a similar example at section 42.25 OECD Comm. on art. 5.

2.7. Partnership Sub-PE

Example 11

P is a partnership incorporated in State PE.

Although State PE considers P a transparent entity, it qualifies as a PE therein (according to art. 5 (1) OECD Model).



The partners of the partnership are residents of State R.

The partnership operates a construction project in State SPE which lasts more than 12 months.³¹ Such project qualifies as a project PE according to art. 5 (3) OECD Model.

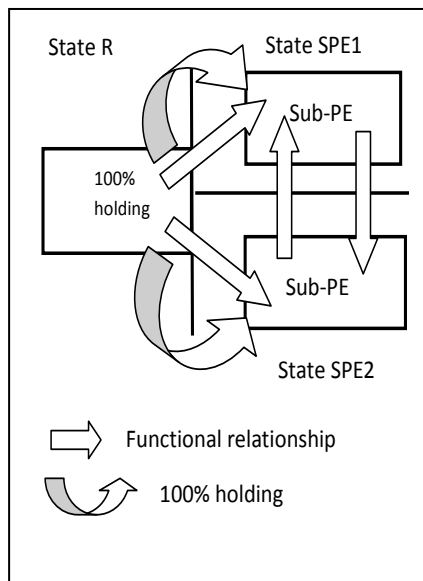
In this example, the project PE shall be considered a Sub-PE.

2.8. Cross-reverse Sub-PE

Example 12

Corporation P is a wholesaler of tobacco products resident in State R.

³¹This example is based on Michael Lang et al., 'Triangular Situation: Partnership with Sub-Permanent Establishment in Third Countries', *Steuer und Wirtschaft International* [2004] pp. 14 to 16, at pp. 15 and 16.



Corporation P has two subsidiaries, Corporation S1 resident in State SPE1, which produces and sells cigars, and Corporation S2, resident in State SPE2, which produces and sells cigarettes.

Due to a restructuring of the group, neither Corporation S1, nor S2 bear any risks of the activity (which are now borne by Corporation P), and both of them are paid a commission by Corporation P according to the volume of sales reached each month.

Thus, assuming that both subsidiaries act as agents of Corporation P, and meet the requirements of art. 5 (5), and (6) OECD Model, each of the subsidiaries may qualify as an agent PE of Corporation P (Company PE).

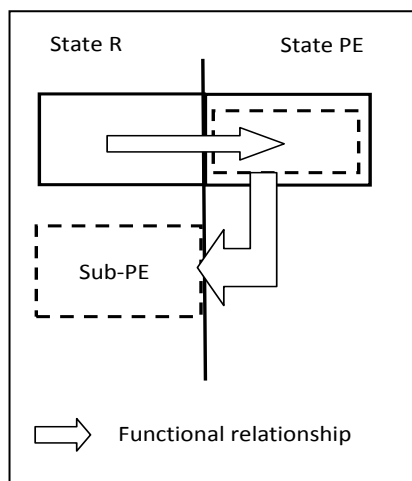
Furthermore, let us assume that due to changes in the market of both countries there is a growing demand for cigars in State SPE2, and for cigarettes in State SPE1. Moreover, in order to face the new market conditions Corporation S1 makes a room available in its facilities in order for Corporation S2 to carry on its business (sell cigarettes), and vice-versa. If the spaces made available by the two subsidiaries meet the requirements of art. 5 (1) OECD Model, each of them may be considered a physical PE of the other.

In this case, as both affiliates are deemed to be simultaneously a PE, and a Sub-PE.

2.9. Sub-PE in State R

Example 13

As it was mentioned above, the location of the Sub-PE in a third State does not appear to be crucial to its concept. Thus, in the majority of the examples above, it is also possible to picture a situation in which the Sub-PE is located in State R.



2.10. Examples of Sub-Sub-PE

Example 14

Based on the above described scenarios it is easy to picture a situation where the layers of Sub-PE add to one another creating a Sub-Sub-PE.

Let us take the following example:

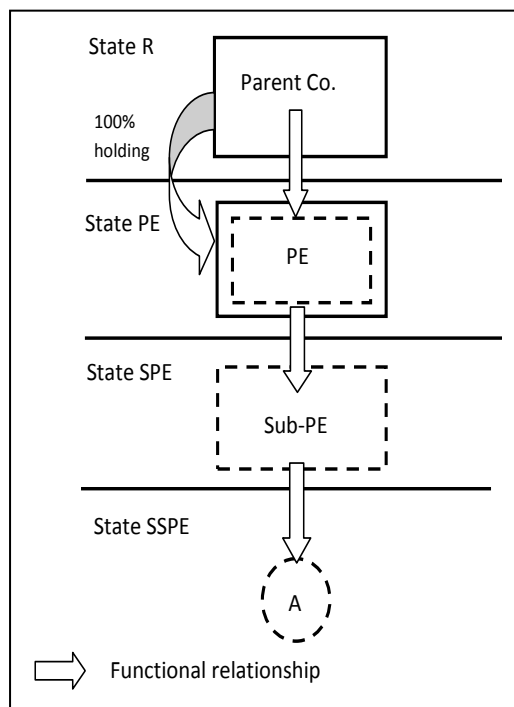
Corporation P, resident in State R, incorporates a subsidiary in State PE (Corporation S).

Corporation S operates in State SPE through a branch therein, which qualifies as a physical PE according to art. 5 (1) and (2) OECD Model.

Assuming that the requirements of art. 5 (5) and (6) are met by Corporation S, due to a restructuring of group (resembling the facts of example 9, above), S may be deemed to be a PE of Corporation P.

Under this scenario, Corporation S's branch in State SPE shall be considered a Sub-PE.

At this point, the layers of Sub-PE may add up, as the branch in State SPE may combine the features of any of the examples above, and, for instance, engage an agent in State SSPE.



Moreover, in this case, the agent may be seen as a Sub-Sub-PE ("Baby Sub-PE").

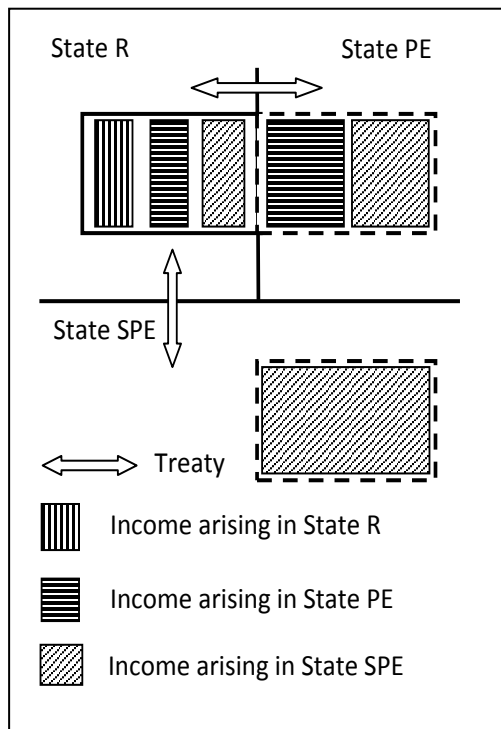
"There is never a dull moment in the world of an international tax lawyer"

Prof. Kees van Raad

3. Triangular cases with active business income

3.1. State of the art on triangular cases

Due to the demands of an increasingly multilateral market, enterprises tend to carry on business simultaneously in more than one State, giving birth to what is commonly designated by triangular cases.³² Notably, a “*typical triangular case*”³³ may be deemed to exist where an enterprise of State R is operating in State PE through a PE therein, and deriving passive income from a source in State SPE.³⁴



Still, the fact that double taxation treaties are generally bilateral,³⁵ presents in such cases severe difficulties to the avoidance of double taxation, a problem which has been stressed over and over again by commentators, and even by the OECD.³⁶

In the afore-described situation of a typical triangular case, from the perspective of State SPE, the income is derived by a resident of State R, and therefore, the only treaty applicable is R-SPE. State PE however, will consider the income allocable to its PE, and in the great majority of cases will want to impose tax on such income, even though a lack of treaty entitlement will prevent the application of PE-SPE treaty. In this situation, State PE will only be able to apply R-PE treaty.

According to the above described steps, the application of the relevant treaty network could lead either to double taxation (of the income derived in State SPE and allocable to the PE), or to a

³² *I.e.* cases involving three States (for further analysis on the notion of triangular cases see Prof. Kees van Raad, ‘Triangular cases, The 1992 OECD Model Treaty’, note 1 *supra* p. 298).

Prof. Klaus Vogel defends that more realistically this scenario should be referred as “polyangular” cases (see Prof. Dr h.c. Klaus Vogel, ‘“State of Residence” may as well be “State of Source” – There is no Contradiction’, Bulletin – Tax Treaty Monitor, (October 2005), pp. 420 to 423, p. 422.

³³ This expression was used by the Triangular Case Report p. 27 (see note 5 *supra*).

³⁴ For further information on the definition of typical triangular cases and related issues please see Triangular Case Report p. 27 (note 5 *supra*).

³⁵ There are however, some examples of multilateral tax treaties, such as the Nordic convention entered by Denmark, Finland, Iceland, Norway and Sweden.

³⁶ For further analysis on the limitation of the OECD Model to solve triangular cases see Prof. Kees van Raad, ‘Triangular cases, The 1992 OECD Model Treaty’, p. 298 (see note 1 *supra*); John Avery Jones, and Catherine Bobbett, ‘IFA, Triangular Treaty Problems: A summary of the Discussion in Seminar E at the IFA Congress in London’, Bulletin, (January 1999), pp. 16 to 20, pp. 16 to 20; Dr Martín Jiménez, Dr García Prats and Dr Calderón Carrero, ‘Triangular Cases, Tax Treaties and EC Law: The *Saint-Gobain* Decision of the ECJ’, Bulletin (June 2001) pp. 241 to 253, pp. 241 and 242; Michele Gusmeroli, ‘Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1’, European Taxation, (January 2005), pp. 2 to 13, pp. 2 to 5; Gang Zhai, ‘Triangular Cases Involving Income Attributable to PEs’, Special Reports: Tax Notes International, (March 23, 2009), pp. 1105 to 1123, pp. 1105 to 1123; and Triangular Case Report pp. 27-41 (see note 5 *supra*).

higher burden of State R, which would be obliged to relief two levels of taxation³⁷ instead of just one (as it happens in bilateral situations).

Nevertheless, the extensive literature on typical triangular cases, notably the “*Triangular Case Report*”,³⁸ has had the virtue of setting out some principles to this regard. To begin with, if the domestic tax law of State PE provides for unilateral reliefs to its residents regarding income derived from (and taxed by) State SPE, such relief should also be granted to non-resident PEs.³⁹ Then again, if it is not possible to apply unilateral reliefs, State PE is encouraged to extend its treaty relief to the hosted PEs of non-resident enterprises⁴⁰ applying, to that end, art. 24 (3) of the R-PE treaty.

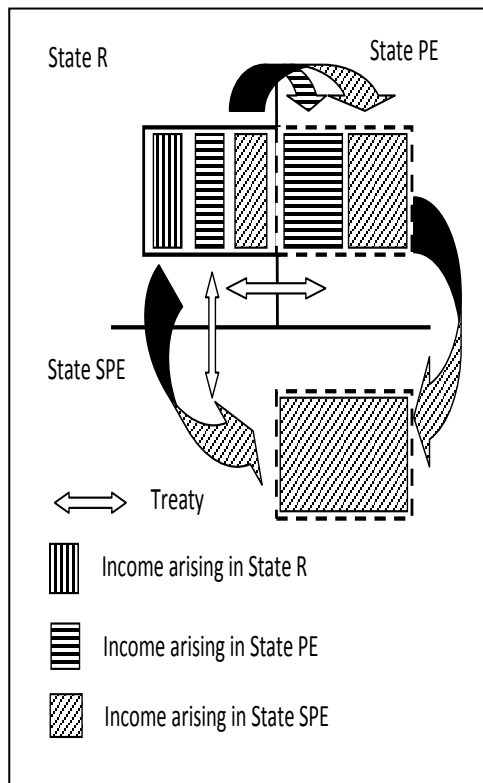
Based on the preceding principles, and assuming that: (i) the three countries entered into tax treaties identical to the OECD Model; (ii) the total passive income (dividends, interest, royalties etc.) of the enterprise (amounting to 100) was entirely derived from State SPE; (iii) all the States have a 25% domestic tax rate; and (iv) all of them apply the ordinary credit method to relieve the double taxation, the taxing rights should be allocated as follows:

³⁷ Tax levied by State SPE, and by State PE.

³⁸ *Triangular Case Report* (see note 5 *supra*).

³⁹ This principle is stated by section 67 of OECD Comm. on art. 24. Although the wording of the comm. only mentions credit, it is well accepted among commentators that the same should apply where double taxation is relieved by means of an exemption (see Prof. Kees van Raad, ‘Triangular cases, The 1992 OECD Model Treaty, European Taxation’ p. 299, note 1 *supra*). To this regard, the author believes that the Comm. only mentions credit due to the fact that this is generally the method adopted to relief double taxation in case of passive income.

⁴⁰ This principle is stated by section 70 of OECD Comm. on art. 24, nevertheless there seems to be some debate to the exact way to grant such relief. Notably there are some States that do not accept that the obligation to grant the credit derives directly from art. 24 (3) OECD Model. Those States are recommended to negotiate an *ad hoc* provision to be added to their treaties. Furthermore, there seems to be some confusion regarding the attribution of the credit to be granted (if the amount foreseen by R-S treaty or PE-S treaty, the minimum common denominator) and even if such credit does not jeopardize the bilateral effect of treaties (for such discussions please see Prof. Kees van Raad, ‘Triangular cases, The 1992 OECD Model Treaty’ p. 299, note 1 *supra*, and Gang Zhai, p. 1108, note 36 *supra*).



State SPE should only be restricted by SPE-R treaty, and would be able to withhold tax at source (the tax rate will depend on the item of income, let us assume 10%):
 $100 @ 10\% = 10$;

State PE would also attribute the income to the PE therein, and tax (net) at its domestic tax rate of 25%. Furthermore, State PE would have to grant a relief of 10, either according to its own domestic tax law (unilateral relief), or to its treaty with State R (non-discrimination clause):
 $100 @ 25\% = 25 - 10 = 15$;

State R, bound by both treaties, R-PE and R-SPE, would be able to tax (net) according to its domestic tax rate of 25% and grant relief for the taxes levied abroad: $100 @ 25\% = 25 - 15$ (State PE) – 10 (State S) = 0

The overall tax burden will be 25.

According to the abovementioned example everything seems to work out perfectly, both regarding the elimination of double taxation, and the allocation of taxing rights among the three States. And only if reality was that simple, the issue could be fully settled. But it is not!

For one, as it was demonstrated in Chapter 2 above, in some triangular cases the income derived by a PE has an active nature (active business income), being that, in some cases, such income is even simultaneously allocable to two PEs at the same time. These situations, which remain largely unregulated, will be addressed in the following Sub-headings of this chapter.⁴¹

⁴¹ The author acknowledges that there are several classical issues regarding triangular cases, and specifically surrounding the application of Article 24 (3) OECD Model 1992. Nevertheless, those issues seem to be outside the scope of the present analysis. The author however, recommends the following literature on the subject: Triangular Case Report (see note 5 *supra*); Prof. Kees van Raad, 'Triangular cases, The 1992 OECD Model Treaty' (see note 1 *supra*); Kees van Raad, 'International: Dual Residence', European Taxation, (August 1988), pp. 241 to 246; John Avery Jones and Catherine Bobbett, (see note 36 *supra*); Dr Martín Jiménez, Dr García Prats and Dr Calderón Carrero, (see note 36 *supra*); Michele Gusmeroli, (see note 36 *supra*); and Gang Zhai (see note 36 *supra*).

3.2. Taxing rights of State SPE

In the great majority of the examples described in Chapter 2, the PE is deriving foreign-source active business income which is arising in State SPE. Thus, in principle, discounting an occasional tax holiday, State SPE will tax the income.

Moreover, State SPE is only bound by the R-SPE treaty, once PE-SPE treaty does not apply due to the lack of treaty entitlement.⁴² Thus, assuming that the Sub-PE qualifies as a PE under the former treaty, State SPE will be able to tax the income attributable to the PE therein according to art. 7 OECD Model.

3.3. Taxing rights of State PE

3.3.1. Taxation of foreign-source active business income

One of the far most controversial aspects surrounding the figure, and concept of Sub-PE is the possibility of State PE to tax foreign-source active business income, where such income is allocable to a PE of a foreign enterprise hosted by that state. The issue becomes even trickier where the income is simultaneously allocable to another PE in State SPE *i.e.* to a Sub-PE.⁴³

In the opinion of the author, the *first step* to this analysis should be to check whether the provisions of the domestic law of State PE allows the taxation of active business income derived outside its borders. As a general principle, once a treaty cannot create a new claim,⁴⁴ ⁴⁵ if the domestic law of State PE does not

⁴² According to art. 1 OECD Model a treaty may apply “(...) to persons who are residents of one or both of the Contracting States.”, thus, once neither one of the PEs (PE in State PE and Sub-PE in State SPE) qualify as a resident (according to art. 4 OECD Model) the treaty between the two States (PE-SPE) cannot apply.

⁴³ Even paragraph 2 of the OECD Report on the attribution of profits to permanent establishments (see note 3 *supra*) recognizes that “[T]o the date, there has been considerable variation in the domestic laws of OECD member countries regarding the taxation of PEs.”.

⁴⁴ “As a general rule, tax is imposed by domestic law; treaties do not impose tax. If a country is not entitled under its domestic law to tax an amount, the amount is not taxable, even if an applicable tax treaty gives the country the right to tax the income”. See Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, *The Taxation of Business Profits Under Tax Treaties* Canadian Tax Foundation/L’Association canadienne d’études fiscales, Chapter 4, Brian J. Arnold and Jacques Sasseville, *Source Rules for Taxing Business Profits Under Tax Treaties*, pp. 109 to 131, p. 118 and 119.

In the opinion of the author, to some extent, tax treaties work the same way as will. Even though at the moment the will is prepared the deceased attributes a certain estate to one of its inheritors, if at the moment the will is executed the referred estate is not anymore among the property of the deceased, the inheritor will not be attributed such estate. The will only distributes the existing estate among the inheritors, and cannot transmit on its own a property that does not belong to the deceased. Tax treaties perform a similar function, only regarding taxing rights.

⁴⁵ As an exception to this rule, Brian J. Arnold and Jacques Sasseville mention that “In a few countries such as Australia, France, and Japan, tax is imposed under the domestic law by reference to taxing rights given by the treaty.” See Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, p. 118 note 44 *supra*, and also Avery Jones et al. ‘Tax Treaty Problems Relating to Source’, n.º 3, (1998) *British Tax Review*, pp. 222 to 250, pp. 223 to 224.

consent to the taxation of income derived by a PE off-borders, the issue raised above becomes more of an analytical exercise than a practical subject.

It happens that States are sovereign to establish their own taxing criteria. Thus, sourcing rules may differ greatly from one State to the other (and even from the OECD Model), mandating a case-to-case analysis of the domestic law provisions in each State. In short:

- (i) A large number of States do not call jurisdiction over foreign-source active business income allocable to a PE of a non-resident enterprise hosted by that state;
- (ii) In a number of other cases, however, the domestic law will allow the taxation such income;^{46 47}
- (iii) Nevertheless, in many States, the domestic law will not be of much help, once there will simply be no provision regulating the taxing rights of the State regarding foreign-source active business income allocable to a PE therein⁴⁸.

Given the fact that in a fair number of States the domestic law will not prevent State PE to tax foreign-source active business income, the answer to the query under analysis is shifted to the tier of the treaty. Thus, the *next step* to this analysis should be to investigate how the OECD Model governs this situation.

According to art. 7 (1) OECD Model the profits of the enterprise may be taxed in State PE inasmuch as they are attributable to a permanent establishment hosted by that state. From the interpretation of such provision (which is in no way contradicted by the OECD Comm.), results that there is no restriction regarding the taxation, by State PE, of active business income derived off-borders.⁴⁹

Although the following may sometimes be misapprehended, the fact is that art. 7 OECD Model seems to replace a “source” criterion by a criterion of “attribution”. Thus, State PE is not restricted in its taxing

⁴⁶ For instance Spain.

⁴⁷ “One situation in which national treatment problems clearly arise concerns the effectively-connected income of a foreign source attributed to PEs (i.e. income originating outside the country in which the PE is situated). As mentioned before, countries tend to consider – in a fictitious way – that such foreign income attributed to PEs located in their territory is derived in their own territory and the country thus has no obligation to mitigate international double taxation.” See Dr Martín Jiménez, Dr García Prats and Dr Calderón Carrero, p. 243 note 36 *supra*.

⁴⁸ This conclusion was reached through a conversation with Prof. Kees van Raad.

⁴⁹ In this regard, some may even defend that the PE taxation is territorial, arguing that art. 7 (1) and (2) OECD Model introduce an exception, allowing source countries to tax income when, above a certain level of connection with the territory, a PE is deemed to exist therein. Thus, being this situation exceptional, it only comprises income derived inside the borders of State PE. In the opinion of the author however, there seems to be no basis for such reasoning, specially considering the underlying principles to the OECD report on triangular cases.

rights (wherever the income arises), as long as the income is attributable to the PE.⁵⁰ This interpretation is further supported by arts. 21 (2), and 23 OECD Model 2000 (“art. 21, and 23 OECD Model”).

In a nutshell, art. 21 states that if a PE derives income from third States, such income shall be dealt with by art. 7 OECD Model. Furthermore, under art. 23 OECD Model, State R shall grant a relief for the taxes levied by a third state on income derived by a PE.^{51 52}

In the opinion of the author, the wording of the articles mentioned in the previous paragraph does not leave room for doubts regarding the position of the OECD on this matter. Art. 7 does not restrict the taxing rights of State PE on active business income arising in third States.⁵³

3.3.2. Taxation of foreign-source active business income allocable to the Sub-PE

As it was defended above, State PE is not restricted to tax foreign-source income attributable to a PE of a foreign enterprise. Thus, at this point of the discussion, it is important to further determine if the fact that such income is allocable to another PE in a third state (Sub-PE in State SPE) will somehow change the abovementioned conclusion.

Regarding this topic there seems to be a lack of unanimity, and an even greater diversity of reasoning.

As a general argument in favor of the foreign-source taxation of business income simultaneously allocable to both PEs, it can be argued that due to the PEs lack of treaty entitlement, the treaty PE-SPE does not apply and, therefore, the deemed independence principle does not apply to the situation.⁵⁴

⁵⁰ Regarding this issue Brian J. Arnold and Jacques Sasseville mention that “ (...) article 7 does not refer explicitly to the source of business profits. Instead, it identifies the income that may be taxed by the country in which a PE is situated (namely, the profits attributable to the PE). This rule eliminates the need for source rules concerning sales or services but performs the same function. In terms of the source of income, article 7 provides, in effect, that any income attributable to a PE in a country is considered to be sourced in that country.”(emphasis added). See Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, p. 119 note 45 *supra*.

Also, Dr Martín Jiménez, Dr García Prats and Dr Calderón Carrero p. 241 (see note 36 *supra*) in a similar position, defend that “Permanent establishments (PEs), however, are taxed not only on a territorial basis (i.e. on the income derived in the country in which they are situated), but also on the basis of effectively-connected income, which means attributing to a PE the income derived by a non-resident individual or entity through that PE.”

⁵¹ See Section 10 of OECD Comm. on art. 23.

⁵² “It could be argued that if there is no treaty between the third country and the country in which the PE is located, the treaty between the residence country and the PE country is simply silent about any profits attributable to a PE in a third country”. See Brian J. Arnold, Jacques Sasseville and Eric M. Zolt p. 118 note 45 *supra*.

⁵³ Another issue that, in the opinion of the author supersedes the scope of the present paper is which criteria should be used to determine where the income is geographically sourced. Even though there is extensive literature and even some regulation (OECD Report: attribution of profits to permanent establishments) about the attribution of profits to permanent establishments, the truth is that it is extremely difficult to locate an income-generating transaction to a geographical place. Regarding this issue please see Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, pp. 119, and 120 note 45 *supra*.

⁵⁴ Following a similar line of reasoning see Ulrich Wolff (Michael Lang et al. pp. 15 and 16 see note 31 *supra*).

According to the deemed independence principle (stated on art. 7 (2) and (3) of the OECD Model), the profits of a PE must be determined as if the PE were an independent entity dealing at arm's length with other parts of the same enterprise. Thus, in short, if the profits are deemed to be attributable to a PE (Sub-PE) they cannot be simultaneously attributable to another PE.

However, in the view of those that defend this argument, hence the PE-SPE treaty does not apply by itself (due to the lack of treaty entitlement by the PEs) such principle could not be enforced. Therefore, the income can be simultaneously attributable to two PEs and taxed by the states hosting such PEs.

Furthermore, the binding effect of treaties, and the fact that the obligation under one treaty shall not affect the obligations under another treaty (*pacta sunt servanda*), as prescribed by art. 26 of the Vienna Convention,^{55 56} is another argument in favor of this sort of “*taxation off-borders*”.

On the opposite side, the stronger argument seems to lie on a different understanding and the application of the separate-entity principle in what regards active business income, and on the fact that income allocable to one PE cannot be simultaneous linked to another.⁵⁷ It is defended that a business is autonomous, exists and stands by itself therefore income allocable to one PE cannot be integrated in another PE. According to such view there is a difference between passive and active business income in the sense that passive income does not exist by itself, and, consequently shall be linked to a place of investment, either the PE, or the HO. Contrarily, active business income whenever achieving the PE threshold is a business by itself, and it does not need a link to any other place (with the exception of the person in which it is integrated).⁵⁸

Still defending that income allocable to a PE cannot be simultaneously allocable to another PE (and denying the existence of a Sub-PE), some even believe that if the income could be simultaneously allocable to both PEs (PE and Sub-PE), it would not be possible to determine which of the two PEs is the Sub-PE.

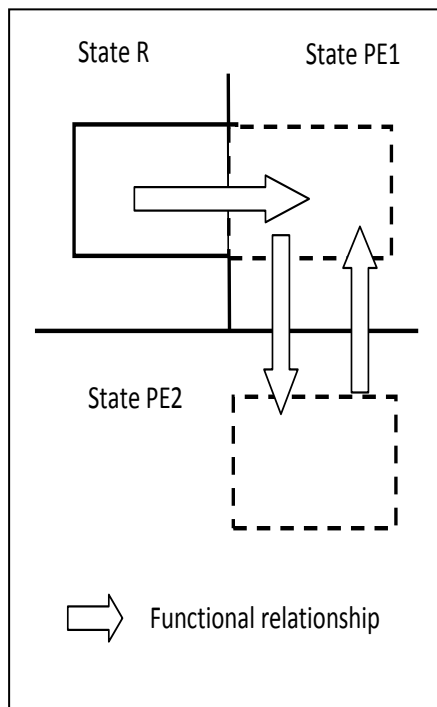
⁵⁵ Reference is made to the Vienna Convention on the Law of Treaties, concluded in Vienna, 23 May 1969.

⁵⁶Defending this view Gang Zhai pp. 1119, and 1120 (see note 36 *supra*).

⁵⁷ Representative of this view is Helmut Loukota pp. 14, to 16 (see Michael Lang et al. note 31 *supra*), and Alexander Stieglitz p. 110 and 111 (see Franz Philipp Sutter et al. note 17 *supra*).

⁵⁸ At this point the author wishes to thank Mr. Jeroen Smits for an exchange of arguments over this subject matter.

To further demonstrate this argument, let us take the following example:



Corporation A, resident in State R, is a car manufacturer and seller.

Part of the production of vehicles is manufactured in State PE1 through a factory therein. The factory also sells part the vehicles produced on the local market.

Due to the low cost of labor in State PE2, a part of the production of State PE1 is demobilized to State PE2 where, approximately, half of the components of the vehicles will be manufactured and assembled.

In this situation, according to those who defend this argument, the PE in State PE2 could also claim taxing rights over the vehicles sold in State PE, being, therefore, difficult to determine which of both PEs is the Sub-PE.

Almost summing up both lines of reasoning above, Brian J. Arnold, and Jacques Sasseville, stress that “[I]f the foreign-source profits are attributable to a second PE that the taxpayer has in a third country, it seems clear that the profits are not attributable to the first PE. This result flows from the separate-entity principle of article 7(2): see paragraph 11 of the commentary on article 7 of the OECD model convention. It could be argued that if there is no treaty between the third country and the country in which the PE is located, the treaty between the residence country and the PE country is simply silent about any profits attributable to a PE in a third country. As a result, it is conceivable, but unlikely, that profits are attributable to the PE under the treaty even though they are also attributable to a PE in a third country.”.⁵⁹

3.3.3. Position adopted

In the opinion of the author, the debate should start by a reflection on how to apply the law, *i.e.* the provisions in force to the facts, and not by looking for the most equitable solution. Only after this gateway it is possible to reflect on the fairness of the provisions, and discuss, out of principle, what would be the best solution.

⁵⁹ See Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, p. 118 note 45 *supra*.

Bearing that in mind, it is necessary to start by interpreting art. 7 OECD Model, running all the interpretative steps foreseen by the Vienna Convention,⁶⁰ which prescribes that “[A] *treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*”.

By segmenting the paragraph from the Vienna Convention, one can distinguish three principles: (i) *a treaty shall be interpreted in good faith*; (ii) *the parties are to be presumed to have the intention that appears from the ordinary meaning of the terms used by them*; (iii) *the ordinary meaning of a term has to be determined in the context of the treaty and in the light of its object and purpose.*⁶¹

Leaving aside the first the indent, which does not seem to be of much relevance for the present discussion, the second indent, known as the “*textual approach*” seems to support the argument that, as art. 7 OECD Model does not differentiate active business income from passive income (allocable or not to another PE), the intention of the States entering the treaty was also to maintain a similar treatment between active, and passive income.

In the opinion of the author the latter should be the leading argument. The interpretation of a treaty is a technical work, which should begin, and end with the actual wording of the provisions. As a general rule of interpretation, where the law does not distinguish we ought not to distinguish either (“*ubi lex non distinguit, nec nos distinguere debemus*”). According to such argument, State PE should not be restricted to tax foreign-source active business income, even if allocable to a PE in a third State.

Furthermore, it is necessary to determine the ordinary meaning of the provision in the context of the treaty (R-PE) and in the light of its object and purpose:

To begin with, the OECD model does not provide with any elements that could lead to an interpretation other than the one that textually results from the wording of art. 7 OECD Model, *i.e. the* taxation of income allocable to the PE (even when such income is simultaneously attributable the Sub-PE). Therefore, that shall be the ordinary meaning in the context of the treaty.

Moreover, as it was already mentioned, a treaty is generally entered in a bilateral context, applying only between the signatory parties. Thus, R-PE treaty is not able to enforce the deemed independence

⁶⁰ Reference is made to the Vienna Convention on the Law of Treaties, concluded in Vienna, 23 May 1969.

⁶¹ Based on the outline on Tax Treaty Interpretation prepared by Raffaele Russo, International Tax Center Leiden, Tax Treaties, Tax treaty interpretation, Course Section 3, version of October 2004.

principle⁶² between States PE-SPE. As such, one cannot accept that the ordinary meaning of art. 7 OECD, in the context of the treaty, and in light of its object and purpose, could lead to an interpretation which would result in the application of the deemed independence principle between such States.

In conclusion, as the R-PE treaty does not distinguish if the income is of a passive or active nature, nor if it is allocable or not to another PE, there is no reason to treat both sorts of income differently.

Without a binding treaty, State PE does not have to look across its borders to see if there is a PE in State SPE, nor it has the means to make its taxing rights dependent of such fact.

In the absence of a binding treaty, and, consequently of an exchange of information clause, State PE cannot tell accurately if the PE requirements are met in the other state.⁶³

Although those who defend that income allocable to a Sub-PE in a third state cannot be taxed by State PE do not go without valid reasons, as it was pointed out before, art. 7 OECD Model replaced a “sourcing principle” for an “allocation principle” which mandates the defended interpretation from a strictly legal perspective.⁶⁴

Some additional arguments can nevertheless be presented:

Firstly, as it has been said before, the allocation of active business profits even if linked to a PE in a third state, is comprehended in the wording of art. 7 OECD Model. Thus, should by some reason the OECD did not agree with such result, the interpretation defended should have been especially carved out by the OECD Comm., which, up to this point, was not.

Furthermore, considering that the new draft of art. 7⁶⁵ OECD dealt extensively with the attribution of profits to the PE, one would expect that the issue had been addressed should the OECD did not agree with the defended interpretation. Nevertheless, once again, there is no mention to an interpretation contradicting, or limiting the wording of the provision.

⁶² Principle stated on art. 7 (2) and (3) of the OECD Model, under which the profits of a PE must be determined as if the PE were an independent entity dealing at arm’s length with other parts of the same enterprise.

⁶³ There are some instruments that could help State PE to obtain the information needed, notably the Convention on Mutual Administrative Assistance in Tax Matters, concluded in Strasbourg on 25 January 1988. Nonetheless, this would not be a “treaty solution” *per se*. Moreover, the number of signatory States to this convention is extremely limited, especially when compared with the number of States that have already entered into a double taxation treaty (based on the OECD Model).

⁶⁴ *The approach adopted in article 7 seems to be an exception to the internationally agreed-upon principle that a country is entitled to tax non-residents only on income derived from sources in the country.*” (See Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, p. 124 note 45 *supra*).

⁶⁵ Draft alternative Article 7 of the OECD Model Tax Convention and related Commentary (July 2008) (E).

Secondly, “business income” may have a very comprehensive meaning, hence the business of an enterprise may be to manage a portfolio of shares, deriving dividends from such investment, as well as to manufacture and sell goods.⁶⁶ In both examples the income constitutes business income to the eyes of the enterprise. Therefore, there is no reason why they should be subjected to a different treatment.

Still, following the same line of reasoning, it would be *prima facie* more difficult to fit passive income in the wording of the provision (art. 7 OECD Model), as the article mentions *profits*, than active business income, since in some countries passive income is not even considered a business profit.⁶⁷ Nevertheless, it seems to be settled, notably by the Triangular Case Report, that passive income can be allocable to a PE. Thus, if the law does not restrict the allocation of passive income which, in some situations may not even be considered business income, why should the allocation of business profits be restricted?!

Considering the above, it seems that the Triangular Case Report did not approach this situation (triangulations with active business income / triangulations with active business income allocable to a Sub-PE) due to the fact that it appears to be more common to find a typical triangular case than a triangular case with active business income allocable to another PE, and perhaps at the time, the OECD did not find the issue relevant enough.

In conclusion, the author believes that according to the OECD Model, State PE is not restricted to tax foreign-source income, even if such income is simultaneously attributable to another PE in a third State, *i.e.* to a Sub-PE.

3.3.4. Issue for Sub-PE non believers: Mismatch between State R, and State PE regarding the requirements for the existence of a PE

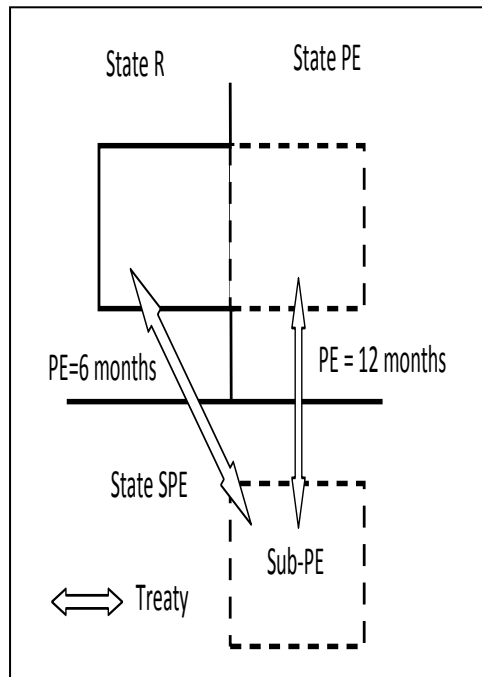
As it was mentioned above, some commentators defend that active business income cannot be allocable simultaneously to two PEs. Thus, even though a non-resident enterprise operating through a PE (in State PE) is carrying on business in another state (State SPE) through a PE therein, in the opinion of such commentators, the income cannot be taxed in State PE if the PE threshold is reached in State SPE.

⁶⁶ Netherlands, and Germany are examples of States that treat any income derived by a company as business profits.

⁶⁷ To give an example, UK does not consider passive investment income as business income.

For them, it is therefore crucial to determine if there is a PE in State SPE, once the taxing rights of State PE will greatly depend of the fulfillment of such threshold.⁶⁸

As such, for them, an additional query must be posed: if R-SPE, and PE-SPE treaties have different PE requirements, notably time wise, *i.e.* one treaty may deem the existence of a PE after 6 months of permanency of a fixed place of business, and the other only after 12, which PE requirements shall apply to the case?



Although the issue regains some additional importance with the Service PE, once the chances of a mismatch in such cases are even greater,⁶⁹ in the view of the author, however, this topic is highly theoretical, and in practice, a non-issue.

As it was defended in 3.3.3. above, State PE will not be restricted to tax foreign-source business income, even if such income is allocable to another PE in a third State.

Thus, as the taxing rights of State PE are not altered whether the foreign-source income is allocable to another PE or not, it becomes irrelevant if the PE threshold in State SPE is reached. Moreover, the fact that the income is allocable to another PE in State SPE will not interfere with the relief policy of State PE.

Furthermore, the existence of a Sub-PE, as it was already referred in Chapter 1.3. above, is *volatile*, as not all States involved will identify the same reality in State SPE. Thus, should the PE requirements are not met according to PE-SPE treaty State PE will not see a PE in State SPE, even though the perspective of State R, resulting from the R-SPE treaty, may be different. The international tax consequences of this scenario will, however, be extremely limited, as State PE will tax the income arising in State SPE either way, and, most likely, will also grant the corresponding relief either way.

⁶⁸ For further in depth regarding this issue see Michael Lang et al. pp. 15, and 16 see note 31 *supra*.

⁶⁹ Considering that the Service PE is not even in the main body of art. 5 OECD Model, and corresponds to a new section introduced by the July 2008 Update.

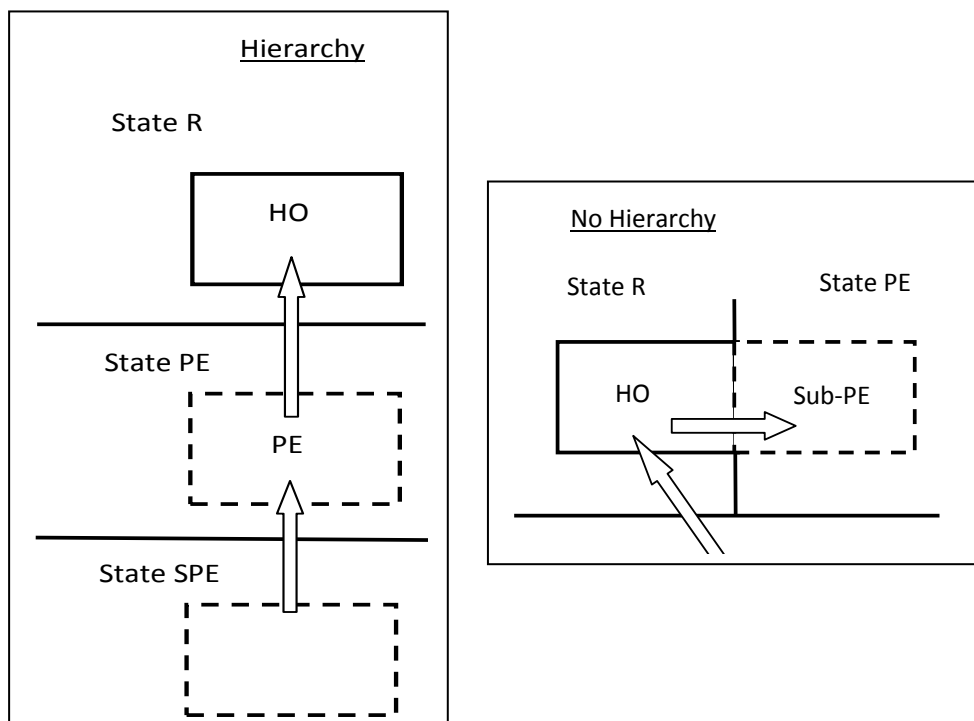
3.3.5. Hierarchy between PE and Sub-PE

Up until this point the Sub-PE has been implicitly described as being dependent and structurally organized below the PE. It is important, however, to seek for the true relationship between the two PEs, and determine if there is any hierarchy between them.

Some defend that the PE should be seen as a fictitious HO of the Sub-PE, a sort of “superordinated head-PE”⁷⁰ in its relation with the Sub-PE, *i.e.* the income attributed to the Sub-PE should be automatically derived by the PE, instead of being allocated to the HO (enterprise of a resident of State R).⁷¹

On the other end of the rope, some defend⁷² that, hence there is no express recognition of the concept of Sub-PE neither by the double taxation treaties, nor by domestic laws, such reality qualifies as a regular PE.

The diagrams below demonstrate the two viewpoints:



⁷⁰ This expression was used by Alexander Stieglitz (see Franz Philipp Sutter *et al.* pp. 102 and 103 note 18 *supra*).

⁷¹ To this respect, Alexander Stieglitz highlights Juch, CDFI LXVIIb (181), pp. 80, 95 and Jacobs, Internationale Unternehmensbesteuerung (1991), pp. 246 and 247 (see Franz Philipp Sutter *et al.*, pp. 102, and 103 note 18 *supra*).

⁷² To this respect, Alexander Stieglitz mentions Gassner and Hofbauer, in: Gassner et al (eds), Beschränkte Steuerpflicht p. 85. (see Franz Philipp Sutter *et al.*, pp. 102 and 103 note 18 *supra*).

In the opinion of the author, the answer to the query posed will be different from perspective of the three States involved:

- (i) From the viewpoint of State SPE, R-SPE treaty is the only treaty in force. Thus, legally, the interaction with the PE in State PE shall occur exactly in the same manner as with any another PE belonging to the enterprise.

Even if the business carried in State SPE is curtailed by the needs of the PE in State PE, or for instance if there are funds being transferred to State SPE which were accounted for in the PE's accounts, from the perspective of the State SPE there will be no difference from this scenario towards a situation involving a "regular" PE.

- (ii) From the perspective of State PE however, the reality will be different. Furthermore, in the opinion of the author, from the viewpoint of State PE the analysis of the relationship between both PEs (PE, and Sub-PE) has to be done on double ends: legally and functionally (or business wise).

Legally, as it was mentioned above, the PE-SPE treaty does not apply. Thus, there is no legal hierarchy between the two PEs. Thus, from a purely legal or formal standpoint, both PEs shall relate among themselves like any other PEs included in the same enterprise.

Functionally, however, the Sub-PE will be effectively integrated in the PE.

Working on the abovementioned definition of Sub-PE, *i.e. a non-resident enterprise operating the Sub-PE through the PE*, the main assumption is that there is a strong linkage between PEs. Thus, in the business relationship between PE, and Sub-PE, the latter will be a subset of the former regarding the functions which is it performing (functional dependency), the structure according to which the business is organized (organizational dependency), or even regarding the route of the money flow (economic dependency).

The role of the Sub-PE in the enterprise *i.e. the business operated through the Sub-PE* will be dictated by the needs of the PE: the goals and functions of the Sub-PE will be set through the PE, the production orders of the Sub-PE will be placed in order to fit the needs of the PE etc..⁷³

⁷³ See sub-chapter 1.2. above.

Moreover, in a higher or lower level, the Sub-PE may be effectively managed through the PE, given the fact that, to some extent, the former is only an extension or a complement of the activity of the latter (“a *longa manus*”).

Finally, from an economic point of view, there may also be an idea of dependency, that can be supported, for instance, by the origin of the funds invested in State SPE being traced to funds accounted for in the PE’s books. To provide with an example, by the fact that the wages of the employees of the Sub-PE, or of the Sub-agent may be disbursed by the PE.

Even though both PEs are a part of the same enterprise, two “arms” or “hands” of the same body, in the case of the Sub-PE, one hand appears to be commanding the other. To further develop this image, the idea of a Sub-PE is the same as one hand holding the other hand, where the second hand grabs a heavy bag. Although both arms/hands are equal parts of the same body, if the first hand drops the second, the latter will not be able to hold the bag. Thus, the second hand appears, in practice as dependent on the first.

In conclusion, although from a strictly legal stand point there is no pecking order, the business structure of the corporation will place the PE at a top position, acting as a fictitious “Head-PE”.⁷⁴

As a result of the abovementioned functional supremacy of the PE towards the Sub-PE, the income arising in State SPE will be allocable to the PE. As such, even though legally PE and Sub-PE should be considered “brothers”, and placed in parallel to one another, there are some legal consequences to be derived from their functional relationship, which highlight the upper position of the PE. Firstly State PE will in a great deal of situations be able to tax the income arising in State SPE (as it is allocable to the PE), and secondly, as it will be better analyzed in 3.3.7. and 3.3.8. below, the taxation by State PE may generate an obligation to grant a correspondent relief.

(iii) Also, from the perspective of State R, the reality can be perceived with two different sets of eyes. On the one hand, by applying the R-SPE treaty, State R sees a regular PE in State SPE. But on the other hand, when applying the R-PE treaty, it distinguishes that the PE in State SPE is integrated in the business carried on in State PE. Thus, State R is also able to identify the features of a Sub-PE in State SPE.

⁷⁴ References to a functional and organizational PE, as well as to a “superordinated head-PE” were made by Alexander Stieglitz (see Franz Philipp Sutter et al., *supra* note 18, p. 102).

In the opinion of the author, the Sub-PE is not a *tertium genus* or, in other words, an entity with a different nature from any other PE. It is, however, a special sort of PE that, for its peculiar characteristics, which are the integration, and its practical dependency from the PE, deserves some special attention.

Generally, due to the bilateral reach of tax treaties, the provisions of such treaties generate rights and obligations for both parties involved. Nevertheless, in a triangular case scenario, sometimes the mirror reflects a different image. Cases involving Sub-PEs are a clear example of this deflected reflection. Although R-PE treaty does not restrict State PE to tax income derived in State SPE, and binds it to the correspondent obligations (grant relief), given the fact that the PE-SPE treaty is not in force in this case, the same set of rules does not apply to State SPE.

Considering the above, as a concluding remark, in the opinion of the author, it is necessary to distinguish a formal/legal hierarchy from a practical (organizational, functional, and economical) pecking order. Although formally there is no hierarchy between PE and Sub-PE, being both equal parts of the same enterprise, from the perspective of State PE (and to some extent, in the perspective of State R), the PE will appear on top of the Sub-PE, being the latter in practice dependent on the first.

3.3.6. Standpoint

Reached this point, it is important to sum-up the results achieved so far.

In the opinion of the author, up to now this paper was able to determine that, according to the OECD Model, State PE is not restricted to tax foreign-source income, even if allocable to another PE (Sub-PE).

Furthermore, it was observed that the trend followed by the great majority of States in their domestic law, seems to be contrary to the OECD Model, either by not allowing taxation of active business income off-borders, or simply by not having a provision regulating such matter.

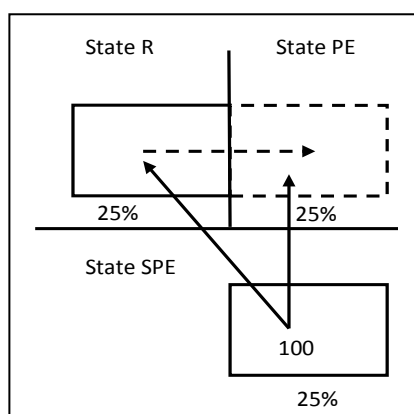
Also, as it was mentioned, in the opinion of the author a Sub-PE is deemed to exist whenever *a non-resident enterprise operating through a PE is carrying on business through another PE, the latter being the Sub-PE*. Thus, even if State PE would be restricted to tax active business income arising in State SPE, the reality in State SPE could still qualify as a Sub-PE from a purely abstract and theoretical standpoint (as there would still be a strong business link between the two PEs). Nevertheless, in such case, from an international tax perspective, the Sub-PE becomes almost irrelevant.

Some States, however, allow in their domestic law provisions, the taxation of foreign-source active business income, or simply do not take a position to this regard. In those cases, the Sub-PE is brought to the spotlight, as there are a number of issues surrounding such a scenario.

In this situation, the three States involved in the triangulation, State R, PE, and SPE will claim taxing rights over the income, resulting, potentially, in triple taxation. Thus, from this point on it is important to determine how the triple taxation may be mitigated, and how will the reliefs available, either by the domestic law, or by the treaties in force, interact.

3.3.7. Unilateral Reliefs

Based on the abovementioned conclusions, according to the OECD Model State PE is not restricted to tax income derived from State SPE. Thus, in such a scenario, the income could *prima facie* be taxed three times.⁷⁵



However, if State PE avails the PE with unilateral reliefs for the taxes levied outside its borders, and considering that, in principle, State R, as the State of residence, should also be under the obligation of providing relief, theoretically the issue (double/triple taxation) could be solved.⁷⁶ Thus, the granting of a relief by State PE assumes a crucial importance in the mitigation of double / triple taxation.

Nevertheless, to begin with, there is a large number of countries that do not provide for unilateral means of relieving double taxation, such as Angola, Czech Republic, Saudi Arabia, just to name a few. In some other cases, even though such relief is provided by the domestic law, it is only applied to some extent. To give a few examples, France's unilateral relief is only available for business income derived from PEs abroad, in Monaco it is not available for individuals, or in Tunisia is not available for companies (reference is made to an extensive list of States that do not provide unilateral reliefs).⁷⁷

⁷⁵ In the example above, the assumption is that entire income of the enterprise is 100, being wholly derived in State SPE. In a scenario where no reliefs were available, considering that each of the States would apply a 25% tax rate over the income, the overall tax burden would be 75. That would mean an effective tax rate of 75% over the income.

⁷⁶ Following the data of the diagram above, State SPE would tax 25. State PE would tax 25 and grant a relief of 25, and, finally, State R would tax an additional 25 and grant a relief in the same amount. The overall tax burden would be 25, and the effective tax rate of such income would equally be 25%.

⁷⁷ The following list refers to States in which there are no unilateral reliefs available: Algeria (for companies), Angola, Bahrain,

Furthermore, even among the States that do provide unilateral reliefs, some of them do not consider necessary to avail such benefit to a PE of a foreign enterprise.⁷⁸

In conclusion, in a great deal of situations, the granting of a relief by State PE, is shifted to the tier of the treaty.

3.3.8. Application of the non-discrimination clause (art. 24 (3) OECD Model 1992)

As it has been implied so far, in the opinion of the author, the rules used to solve typical triangular cases (notably the rules put forward by the Triangular Case Report),⁷⁹ in its underlying principles, should also apply to triangular cases with active business income. Thus, it is necessary to bring art. 24 (3) OECD Model to the equation.

When approaching the topic of the application of the non-discrimination clause included of the R-PE treaty (art. 24(3) OECD Model) the issue gets even trickier than regarding the application of unilateral reliefs.

This provision may be applied to a double end, the first is to extend the application of unilateral reliefs, *prima facie* only applicable to residents, to non-residents. The second consists, in the absence of unilateral reliefs, to entitle the hosted PE to treaty reliefs.⁸⁰

The *first* goal is stressed by section 49 Comm. OECD Model on art. 24, which mentions that “(...) *it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprise under domestic law*”.

Nevertheless, due to a number of reasons, however, not all States are willing to follow such principle.

Belarus, Benin, Bhutan, Bolivia, Brunei (for individuals), Cayman Islands, Costa Rica, Czech Republic, Ecuador (for companies), Egypt (for individuals), El Salvador, France (except for business income derived from PEs abroad) Gabon, Guatemala, Honduras, Kyrgyzstan, Lebanon (for individuals), Libya (for companies), Madagascar (for companies), Maldives, Mali, Monaco (for individuals), Myanmar, Nauru, Netherlands, (except for individuals and PE income [exemption method]), Nicaragua, Palau, Panama, Paraguay, Qatar, Russia (for individuals), Saudi Arabia, Slovak Republic, Swaziland, Tunisia (for companies), Ukraine, Uruguay, Uzbekistan, Vanuatu. The referred information is available at www.ibfd.org.

⁷⁸ See Triangular Case Report p. 33 (note 5 *supra*).

⁷⁹ See Triangular Case Report p. 33 (note 5 *supra*).

⁸⁰ At this point, the author would like to highlight another issue that may be brought up, which is the influence of the European Court of Justice (“ECJ”) in the comparability factor necessary to apply art. 24 (3) OECD Model. The mentioned article refers that “[T]he taxation on a permanent establishment which an enterprise of Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.”. The application of the provision requires, to a certain extent, the comparison of a PE with a resident enterprise. Nevertheless, for one, the meaning of the term enterprise is far from clear, and secondly the ECJ has decided on several cases, in which it is addressed the issue of the comparability of a PE with a subsidiary (for instance Avoir Fiscal, or Saint Gobain). This fact may, in the future, curtail the application of art. 24 (3) OECD, and *in limine* give a different extension to the provision inside and outside Europe.

Furthermore, as it was seen in the analysis of the previous topic, not all States have unilateral reliefs, and some have limitations to its usage, shifting the relief to the tier of the treaty.

In the *second* situation, the non-discrimination clause becomes even more of a topic of discussion as some defend that there is no ground for such obligation, given the bilateral effect of tax treaties. In the opinion of some the lack of treaty entitlement by the PE, disallows the extension of treaty reliefs to non-residents of State PE.

In the opinion of the author, however, this argument does not hold true once State PE will not be applying the PE-SPE treaty, but only enforcing the non-discrimination provision included in the R-PE treaty.⁸¹ Furthermore, such action will not affect in any way State SPE. Therefore, there will be no breach of the bilateral effect of tax treaties.

Nevertheless, the opinion of the author and several other commentators becomes irrelevant as the practice in some States is not to grant the relief,⁸² as the OECD well anticipated.⁸³

Thus, the issue of reliefs granted by State PE and the possibility of more than one tier of taxation, which is in theory solved to a large extent, may still be pretty much alive in practice.⁸⁴

In conclusion, from State PE's viewpoint, the issue concerning reliefs available regarding income derived from State SPE, shall be dealt with in the same way as in a typical triangular case. Nevertheless, the author highlights that in many situations this seemingly solved topic is still a source of major concerns, as the principles put forward by the OECD, notably through the Triangular Case Report, are not effectively followed by some States.

⁸¹ Defending the same please see Gang Zhai, p. 1108 note 35 *supra*.

⁸² An important exception is art. 24 (2) of the French - Italy treaty.

⁸³ See Section 70 of OECD Comm. on art. 24.

⁸⁴ Some authors defend that recent decisions by the European Court of Justice, such as the *Avoir Fiscal* or the *Saint Gobain* may present with an alternative way to solve triangular cases, defending that the treaty network of State PE should be available for the PEs hosted (by State PE), being even discussed if the PE should also avail himself of the treaty network with third States. Nevertheless, a solution such as that, even if possible, would not represent an *erga omnes* solution once it would be hardly applicable to triangular cases with no link to Europe, reason why the author does not wish to further analyze this issue. For a deeper discussion on the subject please see Dr Adolfo J. Martín Jiménez, Dr F. Alfredo García Prats and Dr José M. Calderón Carrero note 36 *supra*.

3.4. Taxation by the Residence State

3.4.1. Standpoint

As it was already mentioned, the author defends that triangular cases with active business income shall be solved in the same manner as typical triangular cases.

Moreover, the author highlighted that in a triangulation with active business income (as in any other) three states may claim taxing powers over income arising in State SPE (States SPE, PE and R). Such fact may raise issues of double or triple taxation, unless the consecutive layers of taxation are mitigated by the States involved.

Furthermore, the author stressed that even though the OECD (notably through the Triangular Case Report) has greatly settled the issue of double/triple taxation, underlining the role of State PE to this matter, in practice the topic remains, to some extent, unresolved.

Many States do not have unilateral reliefs (or do not make them available to PEs of foreign enterprises). And in some other cases, states simply do not follow the directives of the OECD regarding the granting of reliefs by State PE.

As a result of the afore-mentioned, in a number of situations, the mitigation of double/triple taxation lays entirely in State R.

The following sub-headings will further develop this issue.

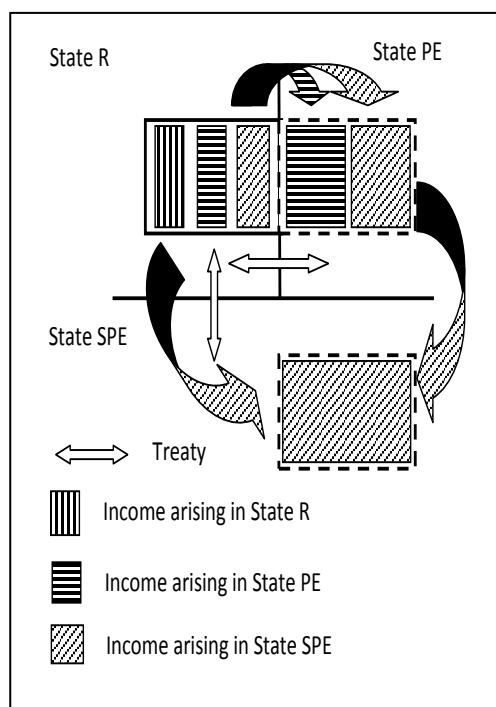
3.4.2. Treaty Reliefs

Following the principles defended above, both State SPE, and State PE will claim taxing rights over the income derived from State SPE (and allocable to the Sub-PE). Additionally, State R will also want to tax such income as the State of Residence (worldwide income principle).

As pointed out, hence such situation could potentially result in double or triple taxation, it is further necessary to analyze the treaty network available, in this case from the perspective of State R, and apply the necessary relief mechanisms.

Assuming that all three States (R, PE, and SPE) have concluded treaties based on the OECD Model, State R will be able to apply its treaty with State PE, and, simultaneously, the treaty with State SPE. Thus, State R is bound to provide reliefs under two treaties.

Nevertheless, the income derived from State PE already includes revenues arising in State SPE, which will imply that the same amount of income is subject to a double relief by State R.



The diagram below represents the mechanism of reliefs described:

3.4.3. Relief methods (brief approach)

According to the OECD Model Comm. the existing conventions adopt two leading principles for the elimination of double taxation,⁸⁵ the credit principle, and the exemption principle.

Both principles may be applied by two main methods. Thus, the credit principle may follow the ordinary credit or the full credit method,⁸⁶ and the exemption principle the income exemption or the tax exemption method.

⁸⁵ See section 12 OECD Comm. on art. 23.

⁸⁶ Considering the limited relevance of this method of relieving double taxation to the subject matter, there will be no further references to it. Nonetheless, for further developments please see section 15 to 17 OECD Comm. art. 23.

The OECD Model, however, has only left to the States the choice between the tax exemption, included in art. 23 A OECD Model (or exemption with progression according to the wording of the OECD Comm.)⁸⁷ and the ordinary credit method, included in article 23 B OECD Model.

In what regards triangular cases with passive income, in the majority of situations states adopt the ordinary credit method,⁸⁸ as in such situations (in which typically the source State applies a withholding) the application of the exemption principle would over reduce the tax burden of an enterprise. Nonetheless, when active business income is involved, the exemption principle becomes more of an elected choice. The application of the exemption principle to triangular cases with active business income will, therefore, be further developed bellow.

Under the ordinary credit method, State R (which according to the worldwide income principle, will tax the entire income of the enterprise, including income derived from foreign sources) will be bound to grant a deduction from its own tax on the lesser of the: (i) tax levied by the foreign state; and (ii) tax computed according to the domestic rules of State R, on the income derived from foreign sources.

According to the income exemption method, State R will not take foreign-source income into account for the purposes of computing its tax. Thus, State R will only consider income arising in State R.

Finally, according to the tax exemption method, State R retains the right to take the foreign-source income into consideration when determining the tax to be imposed on the rest of the income. Consequently, the exemption granted by State R will be determined by excluding from the taxes computed according to State R's domestic provisions, a portion of the tax proportional to the income derived from foreign sources.

Further to the above, Countries generally apply either a *country-by-country limitation*, or an *overall limitation*. According to the second method whenever an enterprise derives income from two different sources, the income arising in one source shall be put together with the income arising in the other source. Conversely, with a country-by-country limitation the relief is computed individually regarding each state.

The table below represents the abovementioned principles from a numerical standpoint. In the far left column are indicated the treaties with relevance to the situation, and the respective method of relieving double taxation, in which "C" stands for ordinary credit, "IE" for income exemption, and "TE" for tax

⁸⁷ See section 29 OECD Comm. on art. 23.

⁸⁸ Even where the exemption principle is applied in a treaty to other sorts of income. See art. 23 A (2).

exemption. In the case presented the overall income of the enterprise is 300, being that each of the countries generated 100 inside its borders.

(Please note that, as the following sub-headings will devote special attention to the interaction between treaties using the exemption method, the following table will also reflect such preference).

Double Taxation Relief	WWI	State R		State PE		State SPE		OTB
		Double Relief		Relief under 24 (3)				
		Taxable Income	Tax Payable (25%)	Taxable Income	Tax Payable (25%)	Taxable Income	Tax Payable (25%)	
No Reliefs	300	100+100+100 = 300	75	100+100 = 200	50	100	25	150
R/PE – C R/SPE – C PE/SPE – C	300	100+100+100 = 300	75-25-25 = 25	100+100 = 200	50-25 =25	100	25	75
R/PE – TE R/SPE – C PE/SPE – C	300	100	75-50-25 =0	100+100 = 200	50-25 =25	100	25	50
R/PE – IE R/SPE – IE PE/SPE – IE	300	100	25	100	25	100	25	75
R/PE – TE R/SPE – TE PE/SPE – TE	300 ⁸⁹ 300 ⁹⁰	0 100	0 25	100 100	25 25	100 100	25 25	50 75

From the analysis of the chart above, it is clear that when the method of relieving double taxation provided by both treaties entered by State R is the credit, the end result seems to be acceptable. Once the relief granted by State PE will reduce the burden of the PE, and consequently curtail the relief granted by State R under the R-PE treaty, the taxing rights of the three States involved seem to be equitably allocated, with no additional burden borne by any of those.

⁸⁹ The example was computed under a country-by-country limitation.

⁹⁰ The example was computed under an overall limitation.

However, if there is a mismatch between the method of relief used under both treaties, or if both treaties apply the tax exemption method, the end result described above does not appear to be acceptable, as there will be an additional burden for State R, and, on the other hand, there seems to be less than single taxation over the income derived from State SPE.

In the fifth band above, it becomes quite clear that, in some cases, the interaction of two treaties applying the income exemption method does not go without problems as the computation of the exemption regarding the income derived from State PE (according to R-PE treaty) already comprises the income derived from State SPE. However, State R will also be bound to grant a relief according to the R-SPE treaty, which means that, in practice, the same income may be relieved twice.

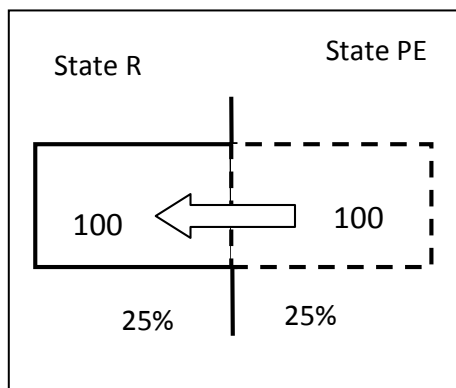
In such cases, although the income is taxed by State SPE, the truth is that State R will grant a double relief for such income, thus the tax paid in State SPE is recovered in State R (for the enterprise is the same as transferring money from its left pocket to the right pocket). Nevertheless, even though the situation is not satisfactory, the right path to solve the case seems to be quite controversial.

The interaction between credit and exemption has been dealt with extensively in the context of typical triangular cases. Nonetheless, the interface between two treaties applying the exemption method is more of a virgin ground, due to the fact that such method is generally not elected to mitigate double taxation in a typical triangular case (where in the great majority of scenarios the source state will apply a withholding over the income generated therein). Being this situation common to all sorts of triangular cases, the author believes that it supersedes the scope of the present paper.

Conversely, the application of the exemption method by both treaties entered by State R appears to be almost a specific feature of triangular cases involving a Sub-PE. Thus, this issue will then be further developed below.

3.4.4. Interaction between R-PE, and R-SPE treaties when both treaties apply the tax exemption: overall Vs country-by-country⁹¹

As mentioned above the computation of a relief under the tax exemption method, results from the application of the domestic tax rate of State R over the worldwide income of the enterprise, which is then reduced proportionally to the income derived from foreign sources:



Example:

- Worldwide tax burden according to State R:
 $200 @ 25\% = 50$
- Relief: $100/200 * 50 = 25$
- State R's tax burden: $50 - 25 = 25$

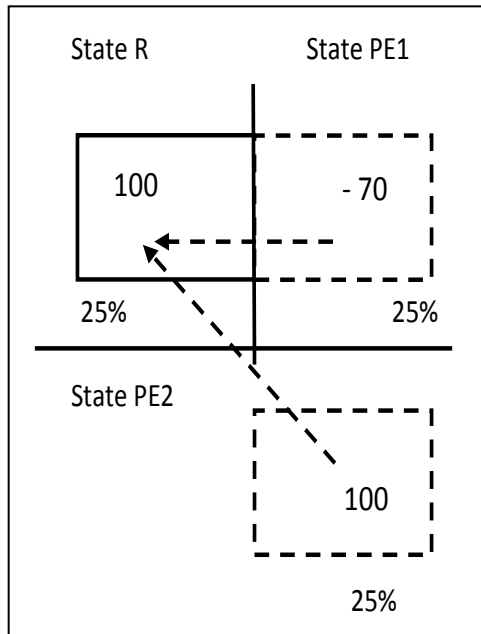
Nevertheless, as it was mentioned above, countries that employ the (tax) exemption method generally apply either a *country-by-country limitation*, or an *overall limitation*.

According to the first method, whenever an enterprise derives income from two different sources, the income arising in one source shall be put together with the income arising in the other source.

⁹¹ Section 13 OECD Model Commentary on art. 23, mentions that the exemption principle may be applied by two different methods, the “*full exemption*” and the “*exemption with progression*”. The first applies when income derived outside the state of residence is not at all considered in the computation of the tax by the residence state, not even to determine an eventual progressive rate. The latter will apply when the income from foreign sources is not taxed by the residence country but such amount is, however considered when determining the tax to be applied by the residence country. It is important, however to distinguish “*exemption with progression*” from “*proportional tax exemption*” whereas the latter concept includes foreign losses and a reduction of the tax due on that income for the fraction thereof that proportionally refers to the foreign income, “*exemption with progression*” does not involve the taking into account of foreign losses.

Conversely, with a country-by-country limitation the relief is computed individually regarding each state.

The examples below provide with a brief explanation on how to apply both methods:



Examples

Overall limitation:

- Worldwide Income/taxation:
 $100 - 70 + 100 = 130 \times 25\% = 32,5$
- Relief: $30 / 130 \times 32,5 = 7,5$
- State R's tax burden: $32,5 - 7,5 = 25$

Country-by-country:

- Worldwide Income/taxation:
 $100 - 70 + 100 = 130 \times 25\% = 32,5$
- Relief State PE1: $-70 / 130 \times 32,5 = -17,5$ (0)
- Relief State PE2: $100 / 130 \times 32,5 = 25$
- State R's: $32,5 - 25 = 7,5$

Generally, the effects of the two methods are only relevant if the residence country applies a tax exemption at the top, or at the bottom,⁹² or if one of the sources is generating negative income.

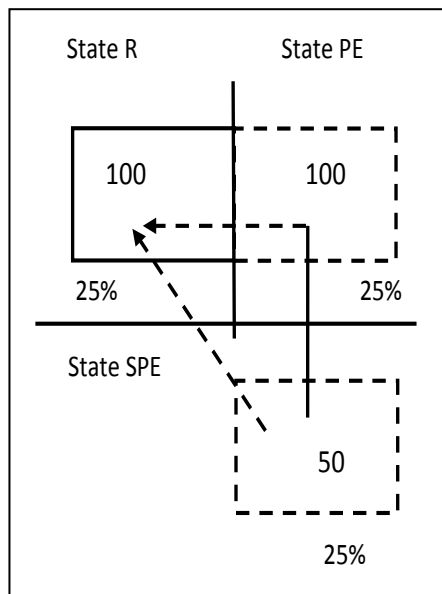
Nevertheless, the usage of one method detrimental of the other will, in the opinion of the author, also work a few differences in a triangular case scenario with a Sub-PE in a third state:

- (i) In an overall computation, the numerator will comprehend the full amount of the foreign-source income which, nevertheless, only comprises the income sourced in each of the foreign States. Hence the income sourced in State PE does not comprise the income which arises in State SPE the relief granted is effectively proportional to the foreign source income;
- (ii) Conversely, where a country-by-country limitation is used, once the relief is figured out regarding each country, individually, in the computation of State SPE's relief, the numerator will be composed by the income sourced therein, but, regarding the relief to be granted to State PE, the numerator will be determined by the income allocated to the PE, which, on its

⁹² The application of the tax exemption results in exclusion from taxation of the part of the income that is attributable to a foreign source. However, when the State of Residence applies progressive tax rates, it is necessary to determine which layer of the income is going to be excluded, whether the bottom end, subject to lower tax rates, or the top end, subject to higher tax rates. The former case is called exemption at the bottom, and the latter exemption at the top.

hand, comprises the income derived from State SPE. In this latter situation, the income derived in State SPE will be subject to two reliefs by State R, which will effectively reduce the domestic-source income of State R.

The examples below provide with a more practical explanation on the position defended:



Examples:

Overall limitation:

- Worldwide Income/taxation: $100+100+50=250 \times 25\%=62,5$
- Relief: $50/250 \times 62,5=37,5$
- Tax burden State R: $62,5-37,5=25$

Country-by-country:

- Worldwide Income/taxation: $100+100+50=250 \times 25\%=62,5$
- Relief State PE: $150/250 \times 62,5=37,5$
- Relief State SPE: $50/250 \times 62,5=12,5$
- Tax burden State R: $62,5-32,5-12,5=17,5$

To conclude this point, in the opinion of the author the usage of the tax exemption method by the two treaties entered by State R, in cases of country-by-country limitation, may result in an problem for State R, which will have to bear a higher burden. In some cases, the issue is especially acute, as the tax on domestic-source income of State R will be reduced due to the obligation to provide reliefs under two treaties.

In the situation described there will be a switch from a scenario of triple taxation, to a scenario of less than single taxation.

3.4.5. Entitlement to double relief

Although the usage of the tax exemption method in R-PE treaty has been mostly discussed under the assumption that R-SPE uses the credit method, in the opinion of the author some of the underlying arguments can still apply to the case. Thus, regarding the possibility of a resident enterprise to claim a double relief, in the present case a double exemption (based on the two treaties entered by State R), it appears to be no agreement upon the matter.

Some argue that by applying the exemption method State R is choosing a territorial system. Consequently, by relinquishing its taxing rights, State R shall not be bound to provide further reliefs.⁹³ which in any case would prevent domestic-source taxation.

Others say that State R is bound by two treaties, and as a result of the known principle of *pacta sunt servanda* it has to grant relief over those two treaties.⁹⁴ For those, to be bound by two treaties is the only technically correct position.⁹⁵ Moreover once a treaty cannot influence another treaty, there is no conflict of obligations between the two treaties.⁹⁶

Called upon cases in which a double/triple relief was under discussion the Courts tend to deny the double benefit.⁹⁷ Nevertheless, the decisions of the Courts, although equitable seem not be based upon solid arguments. Some authors have even spotted the issue and tried to provide for alternative interpretations of the law, or even suggested new provisions which could in fact lead to the same result as the Courts, but based on suitable pools of legal arguments. Not looking to be exhaustive, the author provides with the following opinions:

As Prof. Kees van Raad mentions, “[I]f State R employs the exemption method to avoid double taxation, but restricts the exemption to the permanent establishment income from State PE, no extra relief is received (...)”⁹⁸ The non-desirable result of less than single taxation only happens, following Prof. van Raad, due to the “non-specific way State R provides double taxation relief”. The author could not agree more with this position.

Also based on such principle, Michele Gusmeroli⁹⁹ proposed a new interpretation of art. 23 OECD Model, according to which, State R is only bound to provide relief for items of income that may be effectively taxed in State PE. Nevertheless, according to Gusmeroli, once State PE is bound by art. 24 (3) OECD Model to provide relief for the income derived from the third state, such income cannot be

⁹³ See Michele Gusmeroli p. 5 note 35 *supra*.

⁹⁴ See art. 26 of the Vienna Convention on the Law of Treaties, concluded in Vienna, 23 May 1969.

⁹⁵ See Michele Gusmeroli p. 5, note 35 *supra*.

⁹⁶ See Gang Zhai p. 1114, note 35 *supra*.

⁹⁷ See for instance Hoge Raad, February 8, 2002, 36.155, available at www.ibfd.org.

⁹⁸ See Kees van Raad *Non-discrimination in International Tax Law*, series on international taxation, No. 6 (Deventer: Kluwer, 1986), p. 152, para 11.7.1..

⁹⁹ Gusmeroli starts by interpreting the expressions “in accordance with the provisions of this Convention”, defending that such expression include art. 24 OECD. Furthermore, the author interprets the words “may be taxed” giving them the meaning that it should not be applied only when the actual wording “may be taxed” is used, but also whenever the provisions of the convention do not restrict the other contracting state in its taxing rights. Thus, the income should not be considered (according to such test) to be taxed by the other contracting state, when such state is obliged to grant a relief according to the non-discrimination clause (see Gusmeroli p. 5 note 35 *supra*).

considered to be fully taxable in State PE under the R-PE treaty. Thus, State R should not be bound to grant relief for such income to the extent that State PE has already provided relief to the same income.¹⁰⁰

Although this solution conducts to a satisfactory end-result, representing, in the opinion of the author, a step in the right direction, even due to the fact that it can still be fit in the wording of the OECD Model, as it was already a stated by Gang Zhai,¹⁰¹ this interpretation seems to be carved out by the OECD Comm.¹⁰². Furthermore, in the opinion of the author, the expression “may be taxed” is used in a technical sense, with meaning of section 22 to 25 of introduction to the OECD Model Comm., and section 7 of OECD Model Comm. on art. 23. Therefore, in the opinion of the author, and with all its merits, this interpretation should be dropped.

Following another path, Gang Zhai proposed the addition of a new provision to the R-S(PE) treaty that would allow State S to treat income of a PE in State PE, as if it were derived by a resident of State PE. Neither arguing over the actual provision, nor even over the idea, which in general seems to lead to a good result, in the opinion of the author, already expressed above, it seems that renegotiate an entire treaty network will take quite a few time. Therefore, even though it may be a good path to follow, in the nearest future is necessary to solve the issue raised above with the tools at our disposal.

3.4.6. Suggested solution

3.4.6.1. General approach

In the opinion of the author, from a strictly legal standpoint, being State R bound by two treaties, the only accurate position is to accept that such State is bound to provide two reliefs,¹⁰³ although clearly this situation is not the most righteous.

Furthermore, even though it is clear that no State wishes to waive its taxing rights, the issue of the double relief is, in the opinion of the author, a false question. The true problem underlying this situation is the non-taxation of the income. Should State R exempts the foreign-source income allocable to the PE in State PE, once the taxes over this income are simultaneously relieved by State PE, there will be less than single taxation, which is notoriously a non-desirable effect.

¹⁰⁰ See Gusmeroli p. 5, note 35 *supra*.

¹⁰¹ See Gang p. 1116, note 35 *supra*.

¹⁰² See section 34 Comm. or art. 23 (A) of the OECD.

¹⁰³ To present with a visual analogy, to grant a double relief could be comparable to paying alimony to two ex-spouses without the benefits of marriage. Nevertheless, the state is bound by two treaties, as well as the ex spouse is bound by two pre-nuptial agreements.

According to section 2, and 3 of the introduction of the OECD Model, the main purpose of the Model Convention is to clarify standardize, and confirm the fiscal situation of taxpayers, and to provide means of settling, on an uniform basis, the most common problems that arise in the field of international juridical double taxation.

The purpose of the OECD Model is then to find solutions, and apply the same answer to every taxpayer. In other words, to grant legal certainty to recurrent tax issues in international tax law providing for a common playing field.

Furthermore, the OECD, while admitting that the Model does not provide with consistent solutions to some of the problems raised by triangular cases, following the above goals, tries to find solutions to such issues, and to settle the arising problems by adopting new interpretations to the provisions of the OECD model that, in some situations, may even be borderline with their actual wording. This route, which generally conducts to changes and updates to the existing Commentary, is preferred over new introductions to the body of the Model Convention itself.

Aside from double taxation, non-taxation has also been a concern of the OECD. That preoccupation has even been shown in the partnership report, which concludes that in some situations the contracting States are not required to interpret a tax treaty in a way that gives rise to double non-taxation. Thus, the objective to achieve a single taxation is so defining that the OECD accepts, in extreme situations, a waiver on an interpretation if there is risk of non-taxation. This goal interacts with the purposes of legal certainty of the convention, and the aim to standardize solutions for all the taxpayers.

Thus, in the opinion of the author, the above-described problem shall also be subject to an interpretative resolution, in order to be automatically applicable.

Moreover, the author believes, as Prof. van Raad, that the true issue lays on the relief granted by State R regarding the income derived from State PE, which comprises the income arising from State SPE. Thus, the solution should be found in the R-PE treaty.

3.4.6.2. *Main approach*

According to art. 23 A (4) OECD Model 2000, “[T]he provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.”

The aforementioned provision, added to the OECD Model in 2000, provides that State R is not bound to grant relief should: (i) the other contracting state; (ii) applies the provisions of the convention; (iii) to exempt such income or capital from tax.

Considering that the treaty under analysis is the R-PE treaty, by the “other contracting state”, the provision refers to State PE.

In what regards the second indent, although it is clear that the convention is R-PE treaty, it is not clear to which provisions art. 23 A (4) refers to. As it is defended by Michele Gusmeroli, with an open reference to “*the provisions of this convention*” one can only assume that all provisions of the OECD Model are included. Otherwise, should the expression would only comprise distributive rules it would make sense to use a more rigorous wording, such as “the provisions of the Chapter III”.

Thus, in the opinion of the author, the expression “*applies the provisions of this Convention*” shall include all the provisions of the OECD Model, including art. 24 (3) OECD Model.

Regarding the third indent, section 56.1 of OECD Comm. on art. 23, mentions that art. 23 A (4) OECD Model refers to two situations, the first being when a provision of the Convention eliminates the right to tax, and the second when State R considers that the item of income may be taxed in the state of source. As it can be observed, the term “exempt” is used in an ample meaning, comprehending situations in which the interpretation of the provisions of the convention prevent State PE to tax an item of income.

The author then suggests that such provision, art. 23 A (4) OECD Model, should be applied by State R in order to curtail its obligation to exempt the income deriving from State PE. In other words, State R should use the aforesaid provision, not to grant an exemption to the income which, although attributable to the PE in State PE, was derived from State SPE, inasmuch as such income was already granted a relief by State PE (notably based on art. 24 (3) OECD Model).

Matching the requirements of the provision (art. 23 A (4) OECD Model) to the case under analysis, State PE is applying the provisions of the convention, notably art. 24 (3) of the R-PE treaty, to prevent its taxing rights to apply over the income derived from State SPE, which are allocable to the PE hosted by the former state, *i.e.* is exempting such income from taxation.

In the opinion of the author, this interpretation is still comprehended in the wording of the OECD Model, and would prevent the income arising in State SPE to be subject to less than single taxation, as it can be demonstrated by the table below.

Double Taxation Relief	W WI	State R		State PE		State SPE		OT B
		Suggested Solution		Relief under 24 (3)				
		Taxable Income	Tax Payable (25%)	Taxable Income	Tax Payable (25%)	Taxable Income	Tax Payable (25%)	
No Reliefs	300	100+100+100 = 300	75	100+100 = 200	50	100	25	150
R/PE – TE R/SPE – TE PE/SPE – TE	300	100	25	100	50-25 =25	100	25	100

The reliefs should, therefore, be computed as follows:

- Worldwide Income/taxation: $100+100+100=300@25\%=75$
- Relief State PE: $200-100$ (curtailed due to the application of art. 23 A (4) OECD Model) $=100/300*75=25$
- Relief State SPE: $100/300*75=25$
- Tax burden State R: $75-25-25=25$

This interpretation, may however face a restriction, as it does not seems to be comprehended in the wording of the OECD Comm..

According to sections 56.1 to 3 OECD Comm. on art. 23, the mentioned provision applies to avoid double-non taxation as a result of disagreements between the State of residence, and the State of source on the facts of a case, or on the interpretation of the provisions of the Convention.

Nevertheless, for once, the purpose of the provision, which is to avoid double non-taxation, seems to be fully achieved with the proposed suggestion, secondly, not being carved out by the Comm., the suggested interpretation is still a viable way out. This point deserves further explanation.

The fact that the interpretation is not carved out by the OECD Comm. allows its application by two orders of reasons. *Firstly*, as section 29.3 of the Introduction to the OECD Comm. mentions, the Commentaries are “(...) *an important interpretative reference.*” Thus, the treaty applicant shall not hold back on an interpretation just because a scenario is not expressly described therein. *Secondly*, section 36 of the Introduction to the OECD Comm. States that *a contrario* interpretations of the commentaries shall be avoided. This would allow an immediate use of the suggested interpretation, as the fact that such scenario is not contemplated by the OECD Comm. shall not mean that it is excluded from application.

Most importantly, once the OECD defends that “(...) *conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries* (...)”¹⁰⁴, and considering that non-taxation is one of the aimed goals of the OECD, the adoption of the suggested solution by the commentaries to art. 23 OECD Model would allow to achieve an end result which is by all considered desirable.

Thus, as a final suggestion, the author believes that the OECD Model should include in the Comm. on art. 23 (4) the abovementioned situation.

As it is known, double taxation treaties regulate the allocation of taxing rights between two countries, having, therefore, a bilateral reach. As a consequence, provisions that deal with triangular cases are of a somehow exceptional nature (10 (5) and 11 (5) OECD Model 2000). Thus, finding a perfect solution for some of the issues raised by a triangular case in a bilateral convention is, in the opinion of the author, like searching for the pot of gold at the end of the rainbow, it is not possible.

Bearing that in mind, and although the author recognizes that the proposed solution does not go without some setbacks, it appears to be the best solution according to the wording of the provisions of the OECD Model.

“In this world nothing is certain but death and taxes.”

Benjamin Franklin

¹⁰⁴ Section 33 of the Introduction to the OECD Comm.

4. Conclusions

Over the last decades, cross-border transactions became a reality and a goal between corporations worldwide. As a natural consequence of such evolution, profits that would be exclusively taxed inside one jurisdiction are now spread between countries.

The growing concern with the mitigation of double taxation, and with the elimination of measures hindering bilateral trade, brought the concept of PE to the spotlight as, generally, business profits will be allocated between the residence, and the source state depending on the existence of such threshold.

The conventional idea that business transactions across the border are concluded between two states is somehow outdated, and multilateral trade has to be seen with different eyes. However, the known limitation of double taxation treaties, aimed at bilateral situations, shall neither hinder multi-jurisdictional trade, nor deviate from its purpose, the mitigation of double taxation.

New concepts and realities, such as a permanent establishment economically dependent of another permanent establishment, a Sub-PE, have to be discussed, and its practical application (in triangular situations) tested against the wording of the OECD model convention (as well as its commentary), and updated according to the new trends of commerce. Furthermore, even the conceptual idea of triangular cases resulting from passive investments connected to the PE state may be increasingly obsolete, and the concept of Sub-PE, and even Sub-Sub-PE has to be brought to the surface and considered a reality.

For all of the abovementioned considerations, the topic of this paper appeals as being of great interest.

The focal interest of the analysis of tax triangulations involving Sub-PEs resides in determination of a balanced distribution of taxing powers between the three States involved, bearing in mind the need to eliminate double / triple taxation, on the one hand, and less than single taxation, on the other.

Given the aforesaid, and taking into consideration the conclusions reached along the paper, regarding which the author refers back to the “Overview of Main Findings”¹⁰⁵ above, with this work the author expects to have contributed to clarify the idea of what is a Sub-PE, building up the concept, and describing situations in which this threshold may exist, and also to have settled the issue of the allocation

¹⁰⁵ Please see V above.

of taxing rights between the States involved, in a way that mitigates both double taxation, and less than single taxation.

As a final point, although the author strongly believes that the concept of Sub-PE exists along the lines of the OECD Model's provisions, it would be important to have a clear statement regarding this subject matter at the OECD Commentaries. Notably, if the OECD would take a clear position on the issue of foreign-source taxation of active business income by State PE, where such income is simultaneously allocable to another PE, the uncertainty surrounding the implementation of structures with a PE functionally dependent of another PE (Sub-PE) would become unambiguous.

It is the opinion of the author that in international tax law, legal certainty is a value that supersedes right or wrong.

Bibliography

Arnold, Brian J., 'Threshold Requirements for Taxing Business Profits under Tax Treaties', Bulletin – Tax Treaty Monitor, (October 2003), pp. 16 to 32

The author elaborates on the existing thresholds for taxing profits, notably the PE, fixed place of business, physical presence, nature and level of activity, or the amount of revenue. The analysis is conducted from the perspective of domestic law, and the OECD and UN Models. The author further highlights some of the deficiencies of such thresholds, and points out several suggestions, defending, notably, a physical presence threshold for residents of one country performing services in another country. The author questions the need for threshold requirements, defending that in some cases minimum threshold requirements for source taxation are desirable in order to stimulate cross-border activities.

Arnold, Brian J.; Sasseville, Jacques; Zold, Eric M. *The Taxation of Business Profits Under Tax Treaties* Canadian Tax Foundation/L'Association canadienne d'études fiscales: Chapter 4 (art.7), 'Source Rules for Taxing Business Profits Under Tax Treaties', Arnold, Brian J. and Sasseville, Jacques pp. 109 to 131

The authors discuss if a State hosting the PE of a non-resident corporation is allowed to tax business income sourced outside such country. The analysis stresses some of article 7 limitations notably the few guidance provided regarding the geographical source of income derived by a PE, and how the countries should determine the profits attributable to a PE.

Avery Jones, John F. *et. al.* 'The origins of concepts and expressions used in the OECD model and their adoption by States' (chapter 2.9)., Bulletin – Tax Treaty Monitor, (June 2006), pp. 220 to 254.

The chapter traces the origin of the concept of permanent establishment in domestic laws, its first use in treaties, and in a model convention, and its influences on the internal law of several countries. After this first approach, the article deals with the origins of the inclusion of building sites in the concept of PE, and with some of the exclusions from the PE threshold, notably the exclusion of a purchasing office. The chapter continues with an analysis of the agency provisions, and its origins as well as its first use in treaties, and ends with analysis of Controlled companies resulting in a PE.

Avery Jones, John; Bobbet, Catherine 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' Bulletin, (January 1999), pp. 16 to 20

The Panel discusses issues regarding triangular cases with special concern to double resident companies, both in a paying, and receiving situation (payments and receipts), and situations where a PE receives income from a third state (source state).

Jiménez, Martín; Prats, García; Carrero; Calderón, 'Triangular Cases, Tax Treaties and EC Law: The *Saint-Gobain* Decision of the ECJ', Bulletin (June 2001) pp. 241 to 253

This article tackles the impact of the Saint Gobain decision on international tax law and, in particular, on the OECD Model Convention. The authors start by describing issues regarding triangular situations arising when a PE is involved, and run a small comparison between the non-discrimination principle of art. 24 (3) OECD Model, and the non discrimination principles resulting from European Law. Furthermore, the authors analyze the extension of treaty entitlement to PEs, discussing if such

extension, according to European Law should be total or partial, and if the benefit should also extend to treaties with non-member-States. Finally, the authors provide with some suggestions on how to bring national tax systems more in line with European Tax Law.

Lang, Michael et al., 'Triangular Situation: Partnership with Sub-Permanent Establishment in Third Countries', *Steuer und Wirtschaft International* (2004) pp. 14 to 16

Based on a case-study in which a transparent German partnership, treated as PE in Germany, carries on construction works in Switzerland, and in the UK, the authors elaborate on the allocation of taxing rights between the States involved. The commentators do not agree on the treatment to be given to income attributable to the PE, notably when such income arises in a third State, and is simultaneously allocable to another PE in the latter State. Two positions are defended to this regard. According to one, the State hosting the PE is allowed to tax, being this position argued by those who defend that income cannot be simultaneously attributable to two PEs.

Milet, Matias 'Permanent Establishments Through Related Corporations Under the OECD Model Treaty', 2, *Canadian Tax Journal, Revue Fiscale Canadienne*, 55, (2007) pp. 289 to 330

The author starts with a brief description of what is a permanent establishment according to the OECD Model Convention, and of what are its purposes in International Tax Law. Moreover, the author describes the historical evolution of the treaty provisions relevant to the affiliated Corporation PE Concept, beginning with the first draft of the league-of-nations. Furthermore, representing the core of the article, the author builds up the concept of permanent establishments through related corporations, describing, and commenting on several UK, and Canadian case-law regarding the subject matter.

Raad, Kees van, 'International: Dual Residence', *European Taxation*, August 1988, pp 241 to 246

The author tackles the application of double taxation treaties to dual resident corporations, especially in view of passive income, and describes cases in which the double resident corporation is both in a receiving, and paying situation. Furthermore, it is provided with an analysis of the effects that the tie-breaker rule, included in the treaty entered between both residence countries, may have over the rest of the treaty network, notably with regard to sources in third countries. The main conclusion of the author is that the tie-breaker rule only produces effects in the treaty between both residence countries.

Raad, Kees van, 'The 1992 OECD Model Treaty: Triangular cases', 33 *European Taxation* 9 (September 1993, pp. 298 to 301.

The author starts by tackling the limitations of double taxation treaties in triangular situations. Furthermore, the author describes a triangular case study, and discusses the interaction of reliefs available by the PE country, and the residence country. To this matter the author highlights the importance of art. 23(4) of the R-PE treaty to mitigate the effects of double / triple taxation, and discusses the issue of the double relief to which Country R is bound (due to the R-S, and R-PE treaties). Finally, the author provides with a table in which the latter issue is analyzed, foreseeing several combinations of relieves by all three countries involved.

Sutter, Franz Philipp, *et al.*, *Triangular Tax Cases. The Sub-Permanent Establishment in a Third State*, (Vienna: Linde Verlag, 2004):

Langoth, Bernd, ‘Treaty Entitlement of Permanent Establishments’, pp. 19 to 48’

The author begins with the description of several issues regarding the resolution of triangular cases, and the limitation of tax treaties to deal with them. Moreover, he further describes situations of double, and triple taxation, and through a step-per-step approach provides solutions, notably by means of application of art. 24 (3) OECD. In the opinion of the author however, the only manner to fully solve triangular cases is through treaty entitlement of the PE. Thus, the author analysis the requirements for treaty entitlement, and the effects of ECJ case law to that matter.

Stieglitz, Alexander, ‘The Sub-Permanent Establishment in a Third State’, pp. 99 to 125

The author elaborates on the concept of Sub PE both under the OECD Model, and Community Law. Notably, the author discusses the treaty entitlement of PEs, and the allocation of profits between the three States involved, under both sets of laws. The author ends up defending that neither domestic law, nor the OECD Model, nor even Community law recognize any differences on treatment in a PE integrated in another PE, reason for which, in his opinion, a Sub-PE shall be treated like any other PE.

Gomes Behrndt, Marco Antônio, ‘Passive Income (dividends, interests or royalties) Received by a Permanent Establishment from a Third State’, pp. 49 to 76

The author describes several issues regarding the taxation of passive income when received by a PE, notably the application of art. 24 (3) OECD to unilateral and treaty reliefs, and the situation where State R is bound by two treaties, which relieve double taxation by different methods, describing several views on the issues addressed. The author further addresses the issues from an EC tax law perspective, notably by means of the application of art. 43, and 48 of the EC treaty, and the European directives. Finally, the author defends that the Source State should be able to tax income derived inside its territory, State PE should, according to EC tax law, and art. 24 (3) of OECD Model, grant relief for the income allocable to the PE, and the State R should be bound by the two treaties, and grant the required reliefs, independently of the fact that they are exemption or credit.

Taylor, Willard B.; Davies, Virgínia L.; McCart, Janice ‘Policy Forum: A Subsidiary as a Permanent Establishment of Its Parent’, 55, Canadian Tax Journal, *Revue Fiscale Canadienne*, 2 (2007), pp. 333 to 345

The article discusses the existence of a permanent establishment in a subsidiary. The authors discuss the problem in abstract, posing some queries that relate to the issue, referring to the US-Canadian Treaty as well as to the OECD model conventions (with some remissions to Canadian and US domestic provisions). Then, the authors debate over some case law in which the issue was raised regarding subsidiaries in the United States and in Canada.

Vogel, Klaus ‘“State of Residence” may as well be “State of Source” – There is no Contradiction’, *Tax Treaty Monitor*, (October 2005), pp. 420 to 423

The author starts by stressing the importance of the term “source” in the application of a treaty, notably in its use by distributive rules. At this point, the author arrives to the conclusion that “state of source” and “state of residence” are not opposites, and that, in fact, in the context of distributive rules, they may be the same. Furthermore, the article continues with an analysis of the concept of “source” in triangular cases (“polyangular” situations), involving the PEs, dual source situations, dual residence.

Zapata, Sonia, 'The Latin American Approach to the Concept of the Permanent Establishment in Tax Treaties with Developed Countries', Bulletin (June 1998), pp. 253 to 261.

The author makes an overview of the way developing countries in Latin America have dealt with the notion of PE, comparing the path followed by such countries with the approach of the UN, and OECD model. The analysis starts with a quick historical overview of the appearance of the UN, and OECD Model conventions, and continues with a look at the history of Latin American Tax Treaties. The core issue of the article is the impact of the UN model convention in Latin America, which is addressed, notably, by comparing the resolution of some selected examples from the perspective of the Model conventions, and of some selected treaties. Furthermore, the typical PE fictions, and the limited force of attraction principle is also analyzed under the perspectives above. The author concludes that there has been an increasing influence of the UN, and the US Model in Latin America's tax treaties.

Zhai, Gang 'Triangular cases involving Income attributable to PEs', Tax Notes International, (March 23, 2009), pp. 1105 to 1123

The author starts by reflecting on the issues involving typical triangular cases from the perspective of the three States involved, highlighting, in special, the interaction of the reliefs available by domestic law provisions, and by the treaties in force. Furthermore, the author proposes a solution based on the R-S treaty, consisting in the adding a provision to such treaty which allows the a third State (source State) to treat the PE as a resident on state PE. In the author's opinion such solution would resolve most of the issues surrounding triangular cases, including triangular cases with active business income derived by a Sub-PE in a third State.