Volume 4 Spring 2017 Issue 1

UNIVERSITY OF WARSAW JOURNAL OF COMPARATIVE LAW

ARTICLES

SHORT ARTICLES

UNIVERSITY OF WARSAW JOURNAL OF COMPARATIVE LAW

THE JOURNAL –

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COVER DESIGN –

CITATION –

The online version of the Journal is its primary version. This issue should be cited as (2017) 4(1) University of Warsaw Journal of Comparative Law.

ISSN 2353-3358 (Print)
ISSN 2353-642 X (Online)

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Volume 4 Spring 2017 Issue 1

TABLE OF CONTENTS

ARTICLES

SHORT ARTICLES

The role of public prosecutor and parties in criminal cases – an insight into Polish and American regulations

*Judyta Banaszyńska**

Abstract

The role of public prosecutor and parties in criminal cases is determined by the criminal law regulations, which in Polish and American law are mostly conditioned on the bases of common law and continental legal systems. Several differences and various approaches with reference to the special rights and obligations of the entities each time need to be considered in regard with the whole domestic legal system. In the paper the main distinctions and similarities between the roles in Polish and American regulation will be presented, as well as the short historical outline and laws in force in both countries.

I. INTRODUCTION – HISTORICAL BACKGROUND

Despite of the latest reforms, conducted in relevance to Polish acts: Penal Code[1] from 1997 (hereinafter referred as "p.c.") and the Code of Criminal Procedure[2] from 1997 (hereinafter referred as "c.c.p."), the role of public prosecutor and parties in the criminal procedure remains connected with the system of proceedings which has been evolving in Polish law over past centuries.

The first modern own Polish criminal act was *Kodeks Karzący Królewstwa Polskiego* (Penal Code of the Kingdom of Poland) from 1818, based on the Austrian, French and Bavarian law[3], later replaced by the Russian *Kodeks Kar Głównych i Poprawczych* (The Code of Main and Correctional Punishments) numbering 1221 articles.[4]

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[1] Penal Code - Ustawa z dnia 6 czerwca 1997 r. – Kodeks karny, Dz.U. 1997 nr 88 poz. 553

[2] Code of Criminal Procedure - Ustawa z dnia 6 czerwca 1997 r. - Kodeks postępowania karnego, Dz.U. 1997 nr 89 poz. 555

[3] B. Sygit, Historia prawa kryminalnego (Toruń 2007) 404

[4] Ibid 419

On the beginning of the independent Poland's history there were different criminal procedural laws being in force: Russian (1864), Austrian (1873), German (1877) and Hungarian (1896) acts. In 1919 the Codification Commission (*Komisja Kodyfikacyjna*) was launched in order to prepare the proper unified Polish procedural code, which was finally enacted in 1926 as the Regulation of the President.[5]

During the XX century many reforms - connected with Polish political systems - were conducted: communistic changes in the 50s, and also the Code of Criminal Procedure from 1969 (prepared by the Codification Commission), which was modifying the obligatory system in the framework of socialism. Finally, after almost two years of the Codification Commission's work, the new Code of Criminal Procedure was voted on the 6th of June 1997.[6]

II. PUBLIC PROSECUTOR IN POLISH PROCEDURAL REGULATIONS

Polish word "*prokurator*" (public prosecutor) comes from Latin "*procurator*" which can be translated as "legal representative". The term was known in ancient Rome, but legal institution and its role in the present form of Continental law was being formed in the XIV and XV centuries in France - in order to protect fiscal issues and the nobility's interests in the courts.[7] Currently, the role of independent public prosecutor (as a part of the dimension of administration in democratic state of law) is an essential element, even though Polish constitution is mute when it comes to determining its role.

Nowadays public prosecutor's role is mostly defined by the Penal Code, the Code of Criminal Procedure and as well Prosecutor's Office Act (*Prawo o prokuraturze*) from January 2016.

Public prosecutor in Polish procedure is often being called the "host of the process"[8] (*dominus litis*) in the pretrial period. According to the article 45 of c.c.p. public prosecutor acts before all courts in the capacity of a public accuser. He is

[5] S. Waltoś, Proces karny. Zarys systemu (Warszawa 2009) 124-125
[6] Ibid 134-135
[7] H. Zięba-Załucka, Instytucja prokuratury w Polsce (Warszawa 2003) 7-8
[8] T. Grzegorczyk, J. Tylman, Polskie postępowanie karne, (9th edn, Warszawa 2014) 281

entitled (in his own name) to bring and maintain an accusation in the cases of crimes being prosecuted upon public accusation and crimes prosecuted upon private accusation when it is sufficient with regard to the public interest.[9] The acting of public prosecutor in the criminal procedure before all kinds of the courts can be consider as a general rule.

The role of public prosecutor is significant, as it is the only figure statutory empowered to proceed in all the cases. The entitlements of other public accusers need to be treated as special procedures justified by c.c.p. legal norms or other norms of competence. What needs an underlining, is the fact that even with the presence of a different accuser, public prosecutor is not limited in his acting. Sometimes other accusers are described as "subsidiary"[10], while the superiority of public prosecutor is visible in the legal norms.

Polish doctrine of criminal procedural law has developed a number of positions and theories based on the characteristic and classification of the parties in criminal proceedings. One of the suggested categorization is generally dividing parties into offensive (the aggrieved person and accusers: public accuser, private prosecutor, subsidiary prosecutor) and defensive (the accused).[11] The continuation of the research (according to the roles in the criminal procedure) will be based on that classification.

It is worth mentioning, that the view, stating the role of the public accuser (usually public prosecutor) as the party of the criminal procedure, was frequently denied in the doctrine of criminal law. Over the years very common view was represented by *inter alia* Stanisław Śliwiński, who claimed that it is not public accuser who is party, but the state - as it is the only entity entitled to punish the accused.[12]

On the other hand, taking into consideration wide rights of public prosecutor in Polish criminal procedure, it seems fair to state that this position can be regarded

[9] P. Kruszyński (eds.), Wykład prawa karnego procesowego, (4th edn, Białystok 2012) 144
[10] W. Daszkiewicz, Oskarżyciel w polskim procesie karnym (Warszawa 1960) 12
[11] S. Waltoś, P. Hofmański, Proces karny. Zarys systemu, (11th edn, Warszawa 2013) 181-182
[12] S. Śliwiński, Polski proces karny przed sądem powszechnym: zasady ogólne (Warszawa 1959); later the view was continued by the students of S. Śliwiński: S. Kalinowski and M. Siewierski; also: W. Daszkiewicz, Oskarżyciel w polskim procesie karnym (Warszawa 1960) 25-35

not as a party in the formal sense, but like a commissioner of the public interest, who is empowered to use the rights of the accusing party.[13]

The official is definitely not bound by his own private interest, so as a result it is not possible for him to act in the case which is directly affected by his own or his relatives and relates' interest. Public prosecutor is required to be objective and independent in his acting,[14] what is assured by possessing a number of outside-the-code guarantees, which provide his non-removability, non-negotiability and immunity of the profession.[15]

During criminal proceeding public prosecutor is preparing for the hearing, appearing in the court with submitting formal motions and giving closing arguments. His presence is generally obligatory when it comes to main trial and appellate trial (art. 46, 450 § 1 c.c.p.) – with some exceptions regulated in the code. He is also able to appeal and submit extraordinary measures of appeal. What is more, he is the only party able to submit the measures for the benefit of the accused.

The significant role of public prosecutor is determined by the character of the preparatory proceedings. In the pre-trial period of the procedure, public prosecutor is conducting or supervising as the general rule, while the aggrieved person and the suspect are the parties. In judicial procedures, undertaken in preparatory proceedings, public prosecutor has the rights of a party. In the particular cases the investigation is being held – again by the public prosecutor as general rule (art. 311 c.c.p.). He is the one to prepare an indictment or approve the one created by the Police officers.

What is being emphasized in the doctrine, is the fact that public prosecutor should be accusing only when is convinced of the act of committing a crime and the guilt of a particular person in accordance to a specific crime.[16] As the public accusation is brought in order to protect public interest, public prosecutor is not able to effectively annihilate judicial procedure because of his acts. On the bases of c.c.p. regulations he is able to withdraw from the accusation (art. 14 § 2 c.c.p.).

[13] P. Kruszyński (eds.) (n 9) 145.
[14] T. Grzegorczyk, J. Tylman (n 8) 278
[15] Most significant regulations can be found in the Prosecutor's Office Act (Prawo o prokuraturze)
[16] T. Grzegorczyk, J. Tylman (n 8) 281

III. PARTIES IN POLISH CRIMINAL PROCEDURE

As it was already mentioned, public prosecutor and the accused are not the only parties which take part in criminal procedure.

A significant figure is an aggrieved party who, according to the legal definition, is either a natural or a legal person, whose legal interest was infringed or threatened by an offence (art. 49 § 1 c.c.p.). The fact of infringing or threatening legal interest needs to be determined by the norms of the substantive criminal law. The aggrieved party is a party in the preparations proceeding what is *expressis verbis* stated in art. 299 § 1 c.c.p. Later, in the main trial, it cannot be concerned as a party in that role. It is needed for the aggrieved party to appear as a private prosecutor or a subsidiary prosecutor.

Private prosecutor's role is strictly connected with the regulations from c.c.p., concerning offences prosecuted upon a private accusation (for example a slander or an insult) - mainly based upon the aggrieved party's subjective will of prosecuting the crime. According to art. 59 § 1 c.c.p. the aggrieved party may submit and support an indictment in the capacity of a private prosecutor. In case of aggrieved party's death his next of kin may assume the rights of the deceased.

Subsidiary prosecutor may be fulfilling his rights in two possible ways: alongside the public prosecutor or in his place. Worth mentioning is fact that he is always an independent party, even if he acts alongside the public accuser.[17] The death of the subsidiary prosecutor does not stop the proceedings; his next of kin may join the proceedings in the capacity of the subsidiary prosecutor at any stage (art. 58 § 1 c.c.p.). The institution protecting the rights of the aggrieved party is a subsidiary indictment which can be submitted if the public prosecutor reissues a decision refusing to initiate the proceedings or discontinuing the proceedings (art. 55 § 1 c.c.p.). The document needs to be drawn up and signed by an attorney.

Even though, he would not take an opportunity to act in one of these roles, the position of aggrieved party is still privileges, what is visible in two rights: a right to submit a request upon art. 46 p.c. and the right to take part in the main trial, even if he was supposed to be in a role of a witness (art. 384 § 2 c.c.p.).

[17] Ibid 705

Finally, it is needed to describe the other party of the procedure who is the accused. According to art. 71 c.c.p. a suspect is a person, with regard to whom a decision presenting charges was issued, or who, without the issuance of such a decision, was informed about the charges in connection with his interrogation in the capacity of a suspect, while an accused is a person, against whom an indictment was submitted to a court, and also a person, with regard to whom a public prosecutor has filed a request for a conditional discontinuation of proceedings or a request from art. 335 § 1 c.c.p.

The term "accused" related to the "suspect" upon the regulations of the c.c.p. The accused is widely entitled to a number of procedural rights and duties which are determined by the c.c.p. norms.

IV. CONTRADICTORINESS AND INQUISITION IN POLISH PROCEDURE

There is a mixed structure of combining the rules of contradictoriness and inquisition of the Polish criminal procedure – nevertheless both of them are modified comparing to original abstract understanding of the rules.[18] Contradictoriness is usually defined as a directive of conducting the criminal procedure as a litigation of two equally entitled parties before the impartial court.[19]

The general rule of the preparing proceedings is the inquisitorial character of the procedure. According to art. 297 § 1 c.c.p. the body conducting the proceeding is obligated to initiate all the legal actions, which are necessary to fulfill the aims of the procedure. Despite of that, it is needed to mention that c.c.p. directly indicates that in the preparatory proceeding the aggrieved person and the suspect are the parties (299 § 1 c.c.p.), what clearly means that public prosecutor remains an independent and objective figure with special rights. A suspect and his defense counsel, as well as the aggrieved party and his attorney may submit requests that certain procedures of the investigation be conducted (art. 315 c.c.p.). In judicial procedures undertaken in

[18] S. Waltoś, P. Hofmański, Proces karny. Zarys systemu, (11th edn, Warszawa 2013) 278
[19] A. Murzynowski, Istota i zasady procesu karnego, (3rd edn, 1994) 171

preparatory proceedings, public prosecutor has the rights of a party (art. 299 § 3 c.c.p.).

Legislator does not abandon the idea of the contradictoriness, as he leaves a number of exceptions to the general rule of inquisition - just to mention a few of them, such as: a request to conduct certain procedures of the investigation (which can be submitted by a suspect and his defense counsel, as well as the aggrieved party and his attorney) regulated in art. 315 § 1 c.c.p.; participation of the parties and their defense counsels or attorneys (if appointed, upon their demand) in the procedures of the investigation – art. 317 § 1 c.c.p.; a possibility to review the material of investigation at the request of the suspect, aggrieved party, defense counsel or attorney to be allowed – art. 321 § 1 c.c.p.

The main trial and appeal proceedings differently are dominated by the rule of contradictoriness, which is in certain circumstances limited by the rule of inquisition. The equality of the parties is visible already on the stage of the temporary proceeding which take place between the submitting the indictment and the beginning of the main trial,[20] when it is possible for the suspect to submit a written response to the indictment within seven days of the service of the indictment. What is being emphasized, is the fact that the main trial is completely contradictory, as well as the appeal and cassation.[21] General regulations which are implementing the rule are for example: the special role of the presiding judge who presides over the trial and ensures its proper course – art. 366 § 1 c.c.p.; the order of asking the questions – art. 171 c.c.p. or the right of expression of the parties – art. 367 § 1 c.c.p., as well as the order of evidence – art. 369 c.c.p.

One of the indications of the contradictoriness is the principle of openness of the trial, which can be excluded only in certain circumstances stated in the c.c.p. Secrecy as an exception is regulated in particular c.c.p. norms (i.e. art. 108 c.c.p.). The openness of the trial is usually separated by the authorities as one of the general principles of the criminal procedure.[22]

[20] S. Waltoś, P. Hofmański (n 18) 281, 499
[21] P. Kruszyński (eds.) (n 9) 70; upon articles: 450, 451, 453, 535 c.c.p
[22] e.g. J. Tylman, P. Kruszyński, K.T. Boratyńska.

Even though all the parties are entitled to submit an evidence motion,[23] it is needed to remember that the authorities in charge are obligated to fulfill the principle of free appraisal of evidence. The rule states that the convictions are based on the evidence gathered and appraised at their own discretion, with due consideration given to the principles of sound reasoning and life experience. The principle is widely used in the continental legal systems, while in the common law countries criminal procedure is usually based on the "law of evidence".[24] The final decision of admitting the evidence is made by the judge – each time it is needed to take into account special conditions from art. 170 c.c.p. What is more, the judge is entitled to submit an evidence motion by himself,[25] what is not characteristic for the contradictory procedure.

It is worth mentioning that in Polish regulations there is no "private evidence", as it is the creation of legal language.[26] The only indication of a private proving in the terminology is the "private document" mentioned in the art. 393 § 1 c.c.p., which prepared outside of the criminal proceedings and not for its purposes, including statements, publications, letters and notes, may be read out loud at the trial.

V. THE CURRENT CHANGES IN THE PROSECUTION GENERAL OF THE REPUBLIC OF POLAND

As it was already mentioned before, in January 2016 the new Prosecutor's Office Act (*Prawo o prokuraturze*) was amended. On the basis of the regulation the function of the General Prosecutor and Minister of Justice were joint. As it is stated in the § 2 of the article 1: the function of the General Prosecutor is held by the Minister of Justice ("*Urząd Prokuratora Generalnego sprawuje Minister Sprawiedliwości*"). The history of these two functions should be regarded jointly as the bodies were already combined together in the past - from 31st March 1990 to 30th March 2010.

[23] P. Kruszyński (eds.) (n 9) 244-245
[24] e.g. P. McKeown, A. Keane, J. Griffiths, Modern law of evidence
[25] T. Grzegorczyk, J. Tylman (n 8) 115
[26] R. Broniecka, Dowód prywatny w procesie karnym – uwagi natury ogólnej [in:] P. Hofmański (eds.), P. Czarnecki (eds.), D. Szumilo-Kulczycka (eds.), Pozaprocesowe pozyskiwanie dowodów i ich wykorzystanie w procesie karnym, 2015

The six-year old separation of the functions, till the 4th of March 2016, was connected with the General Prosecutor completely distinct for the Ministry of Justice and the government administration.

The change and returning to the old system was widely discussed by the public opinion and the legal doctrine, as the act significantly changed the rights of the General Prosecutor as well as the organization and terminology connected with the public prosecutors' offices.

This change is said to guarantee the control and proper functioning of the public prosecutors' offices on all the levels and also improve the safety and state-trust of the citizens.[27]

The General Prosecutor (and Minister of Justice on the same time) now has more significant measures to directly manage the public prosecutor's office, which are connected for example with the disciplinary procedure.

Modification of the act was criticized in some points – the National Council of the Judiciary of Poland stated that the joint of the functions would be dangerous for the independence of the public prosecutors who conduct the preparatory proceedings[28]. Some doubts were also presented in the legal opinion of A. Sakowicz – an expert in the Bureau of Research in the Chancellery of the Sejm from 8th of February 2016.[29]

VI. THE SOURCES OF AMERICAN LAW IN CRIMINAL CASES

Talking about American criminal cases jurisdiction, it is needed to mention the sources of law which are sufficient. The most significant regulations connected with criminal law are primarily stated by the state law, which causes in the wide dissimilarities in different states.

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[27] https://www.ms.gov.pl/pl/informacje/news,8044,od-dzis-minister-sprawiedliwosci-prokuratorem.html [30.06.2016]

[28] http://www.krs.pl/pl/dzialalnosc/posiedzenia-rady/f,177,posiedzenia-w-2016-r/521,11-15-stycznia-2016-roku/3903,opinia-krajowej-rady-sadownictwa-z-dnia-13-stycznia-2016-r-nr-wo-020-216-druki-sejmowe-nr-163-i-162 [30.06.2016]

[29] http://webcache.googleusercontent.com/search?q=cache:yfsEWb2WG6oJ:orka.sejm.gov.pl/RexDomk8.nsf/0/45F2FE81047A0F3CC1257F3B0050B8BA/%24file/i97_16.rtf+&cd=1&hl=pl&ct=clnk&gl=pl [30.06.2016]

While prosecuting, the sources of law – on the U.S. state level – are: statutes, case law, federal constitutional law. If it is pertinent to the case, the treaties and customary international law would also be a source of law in the state prosecution. Under the U.S. constitution it is not possible for the customary international law to be a source of law – firstly, the rule needs to be incorporated by the statute.[30]

The written law is much more detailed and precise, what makes it the basic sources of American criminal law in form of Federal Rules of Criminal Procedure and Federal Rules of Evidence.[31]

It is worth mentioning that, in opposition to Polish criminal procedure, a big role is the informal justice – routine everyday procedures, which contains the rule of "discretion" – the possibility of free decision making by the organs, without any written rules.[32]

VII. PUBLIC PROSECUTOR IN THE US LAW REGULATIONS

Public prosecutors in the United States of America can be regarded as the Guardians of Justice, as they are representing the government in pursuing the criminal charges,[33] what makes them the represents of the whole society on the same time.[34] They are independent and powerful public officials, who are making significant decisions: making charges, pursuing criminal charges and recommending sentences.

One of the main differences between Polish and American legal systems, when it comes to public prosecutors, is the fact that in the US (except a few states) the officials are being elected, usually for a four-year term.[35] United States Attorneys prosecute the cases involving violation of federal criminal cases, they are appointed by the President and confirmed by the Senate, later working under the direction of

[30] L. Carter, C. Blakesley, P. Henning, Global Issues in Criminal Law (2007) 116
[31] T. Tomaszewski, Proces amerykański. Problematyka śledcza, (1st edn, 1996) 23-24
[32] Ibid 30
[33] G.F. Cole, C.E. Smith, The American system of criminal justice (12th edn, Belmont, Ca 2010) 355.
[34] Ibid 359
[35] Ibid 356

the Attorney General.[36] Furthermore, each state has an elected state attorney general and over two thousands of prosecuting attorneys (known as district attorneys, state's attorneys, country attorneys), who prosecute the cases from state law. In many places the profession is associated with the prestige and well-paid, while in the other areas it can even be a part-time job or even a private practice.[37]

Legal aspects, concerned on public prosecutors, are also described in the ABA Model Rules of Professional Conduct,[38] which was created by the American Bar Association. The ABA rules, promulgated in 1983, are concerned on the legal ethics and professional responsibility for lawyers of various professions. When it comes to the public prosecutors, the regulations are mostly connected with the evidence proceedings.

In the 3.8 rule the Special Responsibilities of a Prosecutor one of the norms can be found, for example: "(b) make reasonable efforts to assure that the accused has been advised of the right to, and the procedure for obtaining, counsel and has been given reasonable opportunity to obtain counsel."[39]

Evidence, documents and many other regulations being the interests of the legislator in connection with the public prosecutor can be found in the statute law, for example Federal Rule of Criminal Procedure 16.

Furthermore, it is also important to remember about the case law – such as Under Brady v. Maryland 373 U.S. 83 (1963) from Supreme Court of United States,[40] in which the evidence was withheld by the prosecution from a criminal defendant. According to this case, the accused's rights is infringed when the public prosecutor is hiding the evidence profitable for the accused.[41]

The liberal position of the Supreme Court was easily visible, as a result of the Brady case the prosecution is obliged to disclose the information of evidence, that

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[36] P.Heymann, C. Petrie, What's changing in Prosecution?: Report of a workshop (Washington 2001) 7

[37] C. Roberson, D.K. Das, An introduction to comparative legal models of criminal justice (Boca Raton, FL 2008) 36-37

[38]http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html [30.06.2016]

[39]http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_3_8_special_responsibilities_of_a_prosecutor.html

[40] https://supreme.justia.com/cases/federal/us/373/83/case.html

[41] T. Tomaszewski (n 31) 59

would be proving the innocence of the defendant or would enable the defense or effectively impeach the credibility of the government witness.

The important thing in American process is the rule of contradictoriness, which is entitling the parties to seek the justice – "the adversarial nature of the U.S. criminal process, which validates convictions as the outcome of a contest between the parties rather than the search for truth by an actively inquiring (and at least nominally neutral) judiciary."[42]

The main difference, not known in Polish procedure, is the jury - a significant participator of criminal procedure. In criminal cases the suspected is judged by the jury only when the person is not confessing the guilt and is not using the right of a contradictory process. This – petit jury or trail jury - should be distinguished between the grand jury (consisting of the citizens in the Federal law cases), which is deciding about the charges against the person.[43]

Public prosecutor is often regarded as the only who can make significant decisions through the whole process. The pre-trial stage of the proceeding is mostly dominated by the police[44] (with some exceptions, such as an investigation of the grand jury, described as "inquisitorial element" in American justice system[45]). Also when the investigation is being conducted by the Police, it is possible for the public prosecutor to have influence in two different ways: to provide advisory assistance for the Police in term to control the procedures, as well as assuming the responsibility for the lawfulness of the investigative actions.[46]

The public prosecutor can present the charge to the jury in order to prosecutive actions be decided or whether the secret indictment should be sent in the

[42] J.E. Ross, The Entrenched Position of Plea Bargaining in United States Legal Practice, The American Journal of Comparative Law, Vol. 54 (Fall 2006) 717
[43] T. Tomaszewski (n 31) 43
[44] G.O.W Mueller, F. Le Poole-Griffiths, Comparative Criminal Procedure, New York, London, 1969, 14
[45] Y. Kamisar, W.R. LaFave, J.H. Israel, N.J. King, Basic criminal procedure: cases, comments and questions (10 th edn, St. Paul 2002) 659
[46] P. Heymann, C. Petrie, What's changing in Prosecution?: Report of a workshop, Washington 2001, 8

case.[47] The official is also able to decide whether the process should be divided into a few trials.

Later in the proceedings, the prosecutor is a party and he is entitled to manage the case being debated by the grand jury,[48] as well as deciding alone about the accusation (known as "information"), in the states where the institution of grand jury is not known.[49] In the trial public prosecutor can present the evidence and summon someone to be a witness, he also gives opening statements and facultative closing statements for the jury.

VIII. THE DANGERS IN AMERICAN PROCEDURE

Already mentioned rule of discretion can be dangerous when it comes to public prosecutors, as being elected and independent, they can act in favor to fit various interests, such as impressing voters or local authorities and judges, as usually there is no higher authority who can control their job.[50] The risk is also connected with the decisions on the prosecuting particular cases. Their freedom in that matter is easily visible, because of the lack of legality principle - so important in Polish criminal procedure.

The American process is dominated by the rule of plea bargaining[51] - a kind of contract between a public prosecutor and an accused person, which is said to be marginalizing the role of the judges and eliminate the victim from the process, in order to realize the economic goals. This principle was significant in describing the role of the public prosecutors in American procedure, as it was emphasizing the discretion and the possibility of the choice of proper procedural measures.[52]

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[47] C. Roberson, D.K. Das, An introduction to comparative legal models of criminal justice (Boca Raton, FL 2008) 38
[48] Ibid 55
[49] Ibid 56
[50] G.F. Cole, C.E. Smith, The American system of criminal justice, (12th edn, Belmont, Ca 2010) 360-361
[51] M. Rogacka-Rzewnicka, Oportunizm i legalizm ścigania przestępstw w świetle współczesnych przeobrażeń procesu karnego (Warszawa, Kraków 2007) 197
[52] Ibid 199

On the other side, the rule causes an inability of the victims to mount private prosecutions[53], what is even more empowering the public prosecutor.

Even though the American public prosecutor can be regarded as more flexible and decision-making figure than in the Polish procedure, the non-superiority rule should be considered, as another warning in the guarantees of the proper procedural conducting and fulfilling the main aims of the criminal law.

IX. CONCLUSION

The role of public prosecutor and parties in criminal cases is mostly connected with the regulations of criminal procedure which are the effect of the long-lasting legal and historical formation of a particular legal system.

The origins of Polish and American criminal procedure are connected with the development of the common law (US) and continental (Poland) legal systems, so the role of public prosecutor and parties in these particular procedures should be considered in accordance with the proper models of the systems.

Each of the legal systems represents different approach – comparing the similarities and differences in relation to participants of the criminal procedure should be regarded in order to all the individual aspects of these particular legal systems.

All the significant and even less important changes and modifications should be conducted taking into consideration the different rules and aims of the systems, regarding the dissimilarities of the social, economic and legal possibilities and limitations. Probably that would be the only effective way to construct the criminal procedure in accordance to the whole legal system of the country.

[53] J.E. Ross, The Entrenched Position of Plea Bargaining in United States Legal Practice, The American Journal of Comparative Law, Vol. 54 (Fall 2006) 717

The meaning of bad faith in European trademark law

Should the concept of bad faith, as a ground for refusal or invalidity of a community trademark, be given a uniform interpretation throughout the European Union?

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Abstract

The purpose of this article is to provide assessment of the meaning of the term 'bad faith' as a ground for refusal or cancellation of a community trade mark application. Delineating between good and bad is no easy task, the subject is widely discussed by various author in long-standing doctrine, by courts and lawyers. Despite long-standing doctrine and case law, there are still disagreements on what the concept of 'bad faith' really means. The focus of this article will be on European trademark law and therefore the relevant provisions regarding bad faith as a ground for refusal or cancellation of a community trademark application are found in article 52(1)(b) of the Community Trademark Regulation and articles 3(2)(d) and 4(4)(d) of the Trademark Directive. The relevant provisions of the two aforementioned legal instruments shall be elucidated further, and furthermore the interpretation and implementation thereof in some of the member states shall be discussed. The concept of 'bad faith', in the meaning of an absolute ground for refusal or cancellation of a community trademark application, filed in bad faith, shall be further clarified during the assessment of two milestone cases before the European Court of Justice, namely Goldhase and Malaysia Dairy, in order to assess whether it can be concluded that there is a European autonomous concept of 'bad faith'. The first national court who actually requested a preliminary ruling on the community concept of bad faith was the Austrian Court in the case Goldhase, the leading case in bad faith, this

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preliminary ruling of Goldhase was confirmed in Malaysia Dairy. The European Court of Justice upholds a uniform interpretation and application of the concept of bad faith within the European Union in its recent case law and all member states need to ensure full compliance with all EU legislation and case law. The Directive needs to be transposed into national legislation in such a way that it ensures the full effect of the Directive and the goal thereof and the harmonization within the EU. This means that all member states must, when necessary, amend their national legislation in order to comply fully to the above. This concept of bad faith is not a carte blanche for the member states to include their traditions into the national trademark legislation, on a contrary, a uniform and harmonized approach for bad faith is the goal.

I. INTRODUCTION

The purpose of this article is to provide assessment of the meaning of the term 'bad faith' as a ground for refusal or cancellation of a community trade mark application.

Trademarks are business identifiers; they identify goods or services of a particular source from those of others and have become increasingly important. The registration of a trademark gives the proprietor certain rights against unauthorized use of the trademarks; brand piracy (production and trade of counterfeit consumer goods) and trademark grabbing, namely trademark registrations in bad faith. This article focusses on the latter; the focus will be on European trademark law and therefore the relevant provisions regarding bad faith as a ground for refusal or cancellation of a community trademark application are found in article 52(1)(b) of the Community Trademark Regulation and articles 3(2)(d) and 4(4)(d) of the Trademark Directive.

The relevant provisions of the two aforementioned legal instruments shall be elucidated further, and furthermore the interpretation and implementation thereof in some of the member states shall be discussed. The concept of 'bad faith', in the meaning of an absolute ground for refusal or cancellation of a community trademark application, filed in bad faith, shall be further clarified during the assessment of two milestone cases before the European Court of Justice, namely Goldhase and Malaysia Dairy, in order to assess whether it can be concluded that there is a European

autonomous concept of 'bad faith'.

Delineating between good and bad is no easy task, the subject is widely discussed by various author in long-standing doctrine, by courts and lawyers. Despite long-standing doctrine and case law, there are still disagreements on what the concept of 'bad faith' really means. Even the European Court of Justice struggled to get a grip on this ambiguous concept of bad faith; the first national court who actually requested a preliminary ruling on the community concept of bad faith was the Austrian Court in the case Goldhase, the leading case in bad faith, this preliminary ruling of Goldhase was confirmed in Malaysia Dairy.

II. BAD FAITH IN THE EUROPEAN LEGAL FRAMEWORK

A. Introduction

In this article the focus will be on European trademark legislation. The main goal of the European Community was to create one common internal market in which the attention is drawn to intellectual property since the territoriality of national intellectual property rights impedes the free movement of goods between the member states.[1] The European Commission initiated the unification of intellectual property law which resulted in two-road strategy for trademarks which aimed for unification through the creation of a community trademark and for harmonization of the domestic trademark legislation in member states.[2] Under this approach both the community trademark system (regulated by the Community Trademark Regulation) and the domestic trademark (regulated by the Trademark Directive) shall coexist and complement each other.[3] Unfortunately neither the Directive nor the Regulation specify what the notion bad faith really means.

[1] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 47
[2] Ibid, 48-49
[3] Ibid, 49

B. The Community Trademark Regulation (CTMR)[4]

1. Introduction

The Community Trademark is a supranational legal system which exists parallel to the national systems of member states. According to recital 6 CTMR[5] the principle of coexistence states that the community trademark legislation does not replace the national laws of the member states on trademarks and that national trademarks continue to be necessary for those who do not seek the protection in the community scope. This Community Trademark Regulation is binding and directly applicable in all member states (and can be directly invoked by citizens) as opposed to the Trademark Directive.[6]

2. Article 52(1)(b) CTMR

The Community Trademark Regulation contains a provision against bad faith trademark applications; as an absolute ground of invalidity article 52 (1) (b) CTMR states that "*A Community Trademark shall be declared invalid on applications to the Office or on the basis of a Counterclaim in infringement proceedings: (…) (b) where the applicant was acting in bad faith when he filed the application for the trademark.*"

Bad faith is not included in the absolute grounds for refusal listed in article 7(1) CTMR but is listed in a separate article as an additional ground for invalidation of a community trademark.[7] Article 52(1)(b) CTMR resembles article 3(2)(d) TMD. The absolute ground of invalidity in CTMR entails that everyone (natural person, legal person) can request the cancellation of a community trademark on the grounds of bad faith.[8] Article 52(1)(b) CTMR results in the cancellation of the community trademark, limited to the goods and services for which the ground for cancellation exists; goods and services similar to the goods and services cited by the prior user.[9]

Should this article be bound to territorial boundaries of the European

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[4] Council regulation (EC) Nr. 207/2009 of 26 February 2009
[5] Article 6 Community Trademark Regulation
[6] Article 288 Treaty on the Functioning of the European Union; recital 4 CTMR
[7] *Study on the overall functioning of the European Trademark System*, Max Planck Institute for Intellectual property and competition law, Munch, 15 February 2011, 153
[8] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 115; article 56(1)(a) CTMR
[9] Ibid, 115; article 57(5) CTMR

Community, this would mean that a third party outside the EU who already used or filed a trademark application, would not be taken into account when assessing the concept of bad faith under article 52(1)(b) CTMR.[10] Article 51(1)(b) CTMR like article 3(2)(d) TMD doesn't include extraterritorial protection; the fact that there is knowledge of prior use which takes place outside of the European Union shall not constitute bad faith.[11]

The acceptance to include it in article 4(4)(g) TMD and to reject it in this article, confirms the explicit choice not to provide extra-territorial bad faith in the CTMR provision; therefore there is no protection against bad faith trademark applications which are similar or identical to an earlier sign used outside of the EU.[12] However there are several other provisions which provide effective measures against cross-border trademark, grabbing for example well-known trademarks, pre-contractual relationships, unauthorized agents.[13]

3. Article 8(3)(b) CTMR

The new bad faith opposition ground can be found in article 8(3)(b) CTMR, which introduces an additional ground for protection for non-EU marks even when the latter are not 'well-known'.[14] Article 8(3) CTMR states that bad faith can be invoked as a basis for opposing a community trademark application when the application has been filed by an "unfaithful agent"; meaning that local agents, representative, or business partners tend to register the mark for their boss or partner in their own name, without consent, which is harmful to the commercial interests of the mark.[15] The protection is cross-border and extraterritorial and while implicitly

[10] Ibid, 120
[11] Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, 499
[12] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 121
[13] Ibid, p. 121
[14] ECTA, Reform on the European Trademark System – ECTA's Preliminary comments on the Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) no 207/2009 on the Community Trademark and on the Proposal for amending the Directive 2008/95/EC to approximate the laws of the member states relating to trademarks, Brussels, 24 June 2013, p 8; Guidelines for examination in the office for harmonization in the internal market: (Trademarks and designs) on community trademarks, February 1st, 2015, part C, opposition, section 3, trademark filed by an agent, 3
[15] Ibid, 129; article 6 septies Paris Convention (extra-territorial trademark grabbing)

included in CTMR, was not in TMD. [16]

Article 8(3) CTMR finds its origin in article 6 septies of the Paris Convention (infra) and protects the rightful owner of the trademark with a right to prevent, cancel or claim as their own the unauthorized registration of their marks by their agents and representatives and to prohibit use thereof where the agent or representative cannot justify its acts.[17] The purpose of this provision is to safeguard the legitimate interest of the proprietor against unauthorized actions by an agent and safeguards the principle that commercial transactions should be conducted in good faith.[18]

C. The Trademark Directive (TMD) 19

1. Introduction

In 1980, the Commission presented to the Council its proposal for a first Council Directive to approximate the laws of the member states relating to trademarks. The European Parliament discussed the proposal in detail and adopted its opinion in 1983. The amended proposal of 1985 takes into account the opinions and the provisions have been brought into line with the amended proposal for the Council Regulation on the Community Trademark.[20]

The Trademark Directive has to be transposed into national legislation of each member state, leaving the latter the discretionary power regarding the form and methods of transposing the provisions as long as the goal of the Directive is achieved, verbatim implementation, is not always necessary.[21] However the former does not mean that the member states have margin in terms of policy making.[22] It

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[16] Ibid, 130

[17] Guidelines for examination in the office for harmonization in the internal market: (Trademarks and designs) on community trademarks, February 1st, 2015, part C, opposition, section 3, unauthorized filing by agents of the Tm proprietor (article 8(3) CTMR), 3

[18] Guidelines for examination in the office for harmonization in the internal market: (Trademarks and designs) on community trademarks, February 1st, 2015, part C, opposition, section 3, trademark filed by an agent, 4

[19] Directive 2008/95/ EC of the European Parliament and the Council of 22 October 2008

[20] Proposal for a first council directive to approximate the laws of the member states relating to trademarks, COM (85) 793 final, 17 December 1985

[21] Article 288 Treaty on the functioning of the European Union; Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 333; Article 4 Treaty on the functioning of the European Union; recital 6 TMD

[22] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 333

means that the national implementation of the Directive provisions needs to correspond with the internal substance of the directive concerned.[23]

The Trademark Directive's aim is to harmonize the domestic trademark legislation in the member states, including the ground for bad faith set out in article 3(2)(d) and 4(4)(g) of the Directive.[24] The two provisions are optional which entails that the member states can choose whether to transpose the provisions into national legislation, however should a member state decide to do so, it must do so in its entirety, adequately and accurately (verbatim implementation).[25]

2. Article 4(4)(g) TMD

Optional Article 4.4.g TMD states that *'Any member state may, in addition, provide that a trademark shall not be registered or, if registered, shall be liable to be declared invalid, where and to the extent that (…) (g) where the trademark is liable to be confused with a mark which was in use abroad on the filing date of the application and which is still in use there, provided that at the date of the application the applicant was acting in bad faith'*. Consequently, the subjective intention at the time of filing of the applicant should be taken into account.

There is a difference in regard to article 51(1)(b) CTMR, as article 4(4)(g) TMD offers member states the opportunity to provide optional additional protection for cross-border cases of bad faith.[26]

3. Article 3(2)(d) TMD

Article 3(2)(d) TMD has similarities with article 52(1)(b) CTMR: '*Any member state may provide that a trademark shall not be registered or, if registered, shall be liable to be declared invalid where and to the extent that … (d) the application for registration of the trademark was made in bad faith by the applicant*.' One difference is that article 3(2)(d) TMD allows member states to opt for refusal or opposition on the basis of bad faith.[27] Article 3(2)(d) TMD like article 51(1)(b) CTMR doesn't include extraterritorial protection;

[23] Ibid, 333
[24] Ibid, p. 334
[25] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 334
[26] Ibid, p 121
[27] Ibid, p. 115

the fact that there is knowledge of prior use which takes place outside of the European Union shall not constitute bad faith.[28]

D. OHIM

Office for the Harmonization of the Internal Market (OHIM), in particular the Cancellation Division and Board of Appeal have rendered several decisions on article 52(1)(b) CTMR.29 The conclusion is that there is no common OHIM definition on bad faith until the Goldhase case.

E. Conclusion

The meaning of bad faith in the European legal framework on trademarks (namely CTMR and TMD) is not clearly defined.

III. IMPLEMENTATION AND INTERPRETATION OF THE EUROPEAN LEGAL FRAMEWORK IN MEMBER STATES

A. Introduction

While the Community Trademark Regulation is binding and directly applicable in all member states, the Trademark Directive has to be transposed into national legislation of each member state (by December 31st, 1992).[30] Consequently, each member state has the discretion to choose the form and method to transpose the directive into national legislation in a clear and accurate manner.[31] Transposing directives in national law is not about putting national interests first but it's both top-down and bottom-up, achieving harmonization.[32]

Three national/regional legislations to assess have randomly been selected, namely the ones from Denmark, Germany and the Benelux.

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[28] Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, p 499
[29] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 131
[30] Article 288 treaty on the functioning of the European Union
[31] Ibid, 333
[32] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 123

B. Denmark

Denmark has been a member of the EU since 1973. The Danish Trademark Act was reformed in 1991 and 1996 in order to implement the Trademark Directive in the national legislation, in the form of provision 15(3)(3) of the Danish Trademark Act (*Varemaerkelov*)[33]:

*'**§ 15.** Et varemærke er udelukket fra registrering, hvis (...)*

Stk. 3. Et varemærke er også udelukket fra registrering, hvis (...)

(iii) det er identisk med eller kun adskiller sig uvæsentligt fra et varemærke, som på tidspunktet for ansøgningen, eventuelt tidspunktet for den fortrinsret, der gøres gældende til støtte for ansøgningen, er taget i brug i udl andet og stadig anvendes dér for varer eller tjenesteydelser af samme eller lignende art som dem, det yngre mærke søges registrere t for, og ansøgeren på ansøgningstidspunktet havde eller burde have haft kendskab til det udenlandske mærke.'

The above article in English states as follows:

'(3) A trademark shall, furthermore, not be registered if:

(iii) it is identical with or only insignificantly distinct from a trademark which, on the date of filing of the application or, where appropriate, the date of the priority claimed in respect of the application, has commenced to be used abroad and is still in use there for goods or services which are identical with or similar to those in respect of which registration of the later trademark is applied for, and the applicant on the date of the filing of the application had, or should have had, a knowledge of the foreign trademark.'

The relevant Danish provision doesn't mention the term 'bad faith' yet the legislator sees this article 15(3)(3) as the implementation of the extraterritorial bad faith provision of article 4(4)(g) TMD and claims that the national provision 'matches the optional provision article 4(4)(g) TMD but has a more narrow scope; the Danish provision is applicable if the applied trademark is identical or almost identical to the

[33] Consolidated act no 109, 24 januari 2012; Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, 403

senior trademark; and therefore not when the trademarks are merely confusingly similar'.[34] Article 3(2) TMD has not been implemented by the Danish Trademark Act.[35]

As the Malaysia Dairy[36] case shows (infra), this bad faith provision 15(3)(3) of the Danish Trademark Act differs from article 4(4)(g) TMD and 52(1)(b) CTMR according to which any member state may provide '*that a trademark shall not be registered where the trademark is liable to be confused with a mark which is in use abroad on the filing date of the application and which is still in use there, provided that at the date of the application the applicant was acting in bad faith*.' The Directive, unlike the Danish provision which equated bad faith with knowledge, requires that the registration of the younger mark is filed in bad faith and the applicant's subjective intention should be taken into account at the time of the filing.[37] Therefore in Danish legislation, the fact that the applicant 'has knowledge or should have knowledge of prior use' is determining for the applicant to act in bad faith.

How this 'knowledge of prior use' should be proven, the following elements are considered, for example:

1. The greater the extent of the prior use, the greater its exposure, awareness, reputation, renown within the industry, the more plausible that the applicant should have known of the prior use;
2. The fact that both parties trade in the same sector and are competitors;
3. (pre-) contractual relations between the parties.[38]

Even though the Danish legislator stipulates that article 4(4)(g) TMD is implemented in provision 15(3)(3) of the Danish Trademark Act, there are big differences between both provisions.[39] The only similarity is the fact that 'knowledge of prior use' is a factor in the assessment of bad faith.[40] The differences are enumerated hereunder:

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[34] Ibid, 405
[35] Ibid, 405
[36] C-320/12 *Malaysia Dairy Industries Pte Ltd v Ankenoevnet for Patenter og Varemoerker, 27 June 2013*
[37] Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, 405-406
[38] Ibid, 406
[39] Ibid, 405
[40] Ibid, 407

1. The limitation 'to identical or near identical signs' in the Danish provisions, as opposed to 'identical or similar signs which are confusingly similar' in TMD.
2. The Danish provision doesn't use the term 'bad faith' but uses 'having knowledge or should have had knowledge of prior use' as opposed to TMD in which the knowledge is a factor to determine bad faith. In Denmark, bad faith equated 'having knowledge or should have had knowledge of prior use.'

Bad faith in national trademark laws must be interpreted with the guidance by the case law of the European Court of Justice and provisions which are different to the EU trademark legislation need to be changed. [41]

C. Benelux

Benelux' story is similar to Denmark; Benelux law contains provisions equating bad faith to 'knowledge of prior use' and Benelux refuses, just like Denmark, to align their existing provisions with the TMD.[42]

The wording of articles 2.4 (F)(1) and (2) of the Benelux Convention on Intellectual Property [43] is clearly different from the wording in articles 3(2)(d) and 4(4)(g) TMD.

The Benelux provision states as follows:

' *2.4 Restrictions*

No right in a trademark shall be acquired by the following:(…)

(a) the registration of a trademark which was filed in bad faith, in particular:

1°. a filing in the knowledge or in inexcusable ignorance of normal use in good faith of a similar trademark for similar goods or services by a non-consenting third party on Benelux territory during the last three years;

[41] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 333-334
[42] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, p122; Directive 2008/95/ EC of the European Parliament and the Council of 22 October 2008
[43] Benelux Convention on Intellectual Property (BCIP) of February 25, 2005

2°. a filing in the knowledge, resulting from direct relationships, of the normal use in good faith of a similar trademark for similar goods or services by a third party outside Benelux territory during the last three years, unless a third party consents or the said knowledge was acquired only subsequent to the start of the use which the applicant has made of the trademark on Benelux territory.'

Ever since the first Benelux Proposal in 1953 a provision regarding anti-abuse in cases of bad faith acquiescence was included. There is no definition of bad faith but in Benelux case law the above provision is applied and interpreted as abuse of knowledge of prior use which needs to be interpreted according to the relevant factors in every case.[44] The amendments to the Benelux Convention don't change anything in this regard.[45]

Aforementioned Benelux article fails to comply with the Goldhase test[46]: knowledge alone is insufficient, also intention is relevant to assess whether bad faith has been established.[47] It is time that the Benelux straightens out their provisions and ensures full compliance by opting for a verbatim implementation of the relevant directive provisions.[48]

D. Germany

On January 1st, 1995, Germany implemented the Trademark Directive in their national legislation and introduced the optional bad faith provision from article 3(2)(d) TMD explicitly into article 50 (1)(4) MarkenGesetz[49] which replaced the old *Warenzeichengeset*, as an absolute ground for invalidation. From then on mark proprietors could request invalidation of a mark if an applicant was considered to have acted in bad faith.[50] This article however did not entail article 4(4)(g) TMD namely cancellation for cross-border trademark grabbing.[51]

Article 50 *MarkenGesetz* sounds as follows:

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[44] Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, 78-80
[45] Ibid, 79
[46] Three step test in Goldhase (infra)
[47] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 122
[48] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 124
[49] Act on the Protection of Trademarks and other Symbols of 25 October 1994, (Federal Law Gazette [BGBl.])
[50] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 185
[51] Ibid, 186

'*§ 50 Nichtigkeit wegen absoluter Schutzhindernisse*

(1) Die Eintragung einer Marke wird auf Antrag wegen Nichtigkeit gelöscht, wenn sie entgegen §§ 3, 7 oder 8 eingetragen worden ist. (...)

(4) Liegt ein Nichtigkeitsgrund nur für einen Teil der Waren oder Dienstleistungen vor, für die die Marke eingetragen ist, so wird die Eintragung nur für diese Waren oder Dienstleistungen gelöscht.'

And article 50 *Markengesetz* in English:

'*Invalidity because of absolute obstacles to protection*

(1) The registration of a trademark shall be cancelled on request because of invalidity if it has been registered in contravention of sections 3, 7 or 8. (…)

(4) If there is a ground for invalidity only for a part of the goods or services for which the trademark has been registered, the registration shall only be cancelled for these goods or services.'

In 2004 article 8(2)(10) was added as an ex officio ground for refusal of a trademark application during the registration phase.[52]

The German provision 8(2)(10) of the *Markengesetz* states as follows:

'***Gesetz über den Schutz von Marken und sonstigen Kennzeichen (Markengesetz - MarkenG) § 8 Absolute Schutzhindernisse*** *(...)*

(2) Von der Eintragung ausgeschlossen sind Marken,(...)

10. die bösgläubig angemeldet worden sind.'

The above article 8(2)(10) in English is the following:

'*Section 8 Absolute obstacles to protection*

(1) Signs eligible for protection as a trademark within the meaning of section 3 which cannot be depicted graphically shall be excluded from registration.

[52] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 185

(2) The following trademarks shall be excluded from registration:(…)

10. which have been applied for in bad faith.'

Before 1995, claims against trademark applications done in bad faith, could only be filed based on unfair competition provisions or civil right provisions.[53] Furthermore the German legislator opted for the term 'bad faith' as opposed to other traditional terms. The explanatory memorandum of the *Markengesetz* shows the importance of the autonomous interpretation in accordance with TMD[54] and calls for a new start, without relying on traditional German notions (such as '*Rechtsmisbrauch'*/abuse or '*Sittenwidrigkeit'*/ violation of honest business practices).[55] Yet, the German courts rely on these established traditional notions *Rechtsmisbrauch* and *Sittensidrigkeit* to interpret the notion 'bad faith'.[56] The central notion is *Rechtsmisbrauch* (the intent to obstruct a prior use and prevention of registration of the sign).[57] German case law distinguishes between interference of the prior use and the blocking effect to gain an edge over the competition.[58]

There is no definition of the concept of bad faith to be found in the German Trademark Act, just like there is none to be found in TMD and CTMR.

Bad faith within the meaning of Section 8(2)10 of the German Trademark Act (the current act), is subject to an overall assessment which include taking into account the following relevant factors:

1. the applicant of the younger sign knows or must know that a third party is using an identical or similar sign for identical or similar goods or services and has acquired a degree of legal protection through use.
2. In Germany, it is required that the earlier sign has required a certain degree of renown in Germany (to be determined through general knowledge in the sector concerned or duration of such use, extent of use, annual turnover).

[53] Tsoutsanis, A, Het merkdepot te kwader trouw, Leiden, 2005, 317
[54] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 187
[55] Ibid, 189
[56] Ibid, 201
[57] Ibid, 201
[58] Ibid, 202

3. The fact that the applicant of the younger sign knows or should have knowledge of the use is not sufficient for bad faith to be applicable.[59] As several authors of the German doctrine pointed out the mere ignorance or 'lack of good faith' would be incompatible with the concept bad faith from the CTMR and TMD.[60]

   There must also be the intention at the time of the application for registration; for example the sole intention of the application is to prevent a third party from continuing to use such sign or application without any intention to sue the sign. [61] This is the concept of '*Behinderungsabsicht*'; the wrongful intent of the applicant to pre-empt prior users from continuing such use.[62] In order to claim the claim the wrongful intent of the applicant to hinder prior use, the applicant should have had knowledge of prior use.[63] This German concept is confirmed in the Goldhase case by the European Court of Justice.[64] Another example is the blocking effect to gain an edge over the competition. This blocking effect of can also be dealt with in competition law (in this case, the prior use does not have to have use worthy of protection).[65]

The three abovementioned requirements are necessary to prove bad faith. This strict requirement of bad faith makes the cases with a bad-faith plea only successful in rare cases before court. In order to justify possession worthy of protection, the duration of prior use is determining and the fact that the sign has been used intensively in marketing and whether considerable turnover has been

[59] Ibid, 193-194
[60] Ibid, 194
[61] Ring, M. *Protection and modes of defense against bad-faith trademark filings*, lawyer monthly IP guide, Hoffmann & Eitle, 2014, p1; Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 191
[62] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119
[63] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 191
[64] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119
[65] Ring, M. *Protection and modes of defense against bad-faith trademark filings*, lawyer monthly IP guide, Hoffmann & Eitle, 2014, 1

earned.[66] The intent to obstruct is most often denied without any further examination during infringement procedures before German courts.[67] The intent to obstruct can be assumed if the behavior targets the obstruction of the competitor's business more than it does the promotion of the own business.[68] All relevant factors in each specific case must be weighed and considered, there is not one uniform answer.

The applicant can furthermore invoke legal action based on Sec. 3,4 no 10,8(1) sentence 1 Unfair Competition Act[69] requesting the cancellation of the younger sign filed in bad faith, this is a good additional defense for the prior user since this legal action can be lodged as a counterclaim in trademark infringement proceedings.[70]

Furthermore, there is no requirement for an applicant to have the intention to use the trademark when applying in Germany.[71] Thus, the absence of intention to use is not a ground for finding bad faith. Therefore, the argument that an opposition is based on a repeatedly filed trademark is not taken into account, the former is not sufficient to be considered bad faith in Germany.[72]

The Office may on its own initiative within the application proceedings reject a trademark application on absolute grounds due to bad faith (article 8(2) no 10 German Trade Act or request cancellation of the registration before the Office (section 50 (3) of the German Trade Act) due to absolute grounds of non-validity. The criterion for the above initiatives is an obvious case of bad faith.[73] Trademarks that have been filed in bad faith are void.[74]

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[66] Ibid, p2; Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, 50
[67] Ibid, 2
[68] Ibid p2; Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, 50
[69] Ibid p2; Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, 49
[70] Ring, M. *Protection and modes of defense against bad-faith trademark filings*, lawyer monthly IP guide, Hoffmann & Eitle, 2014, p2; Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, 50-51
[71] Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, 49
[72] Stumpf, K. *Repeated filing of a European Community trademark*, Journal of intellectual property law & practice, 2014, Volume 9, no 3, p 229
[73] Houlihan, E., *Bad Faith Trademark Filing- an international perspective*, 2013, Intellection Property Owners Association, p 51-52
[74] Ibid, p 51

E. Conclusion

The interpretation of the concept of 'bad faith' is fragmented due to the different application among member states.

There is no clear definition of bad faith in the national legislation of most member states. Furthermore, the national legislation in some member states fails to comply with the ruling of the European Court of Justice, in particular with the Goldhase test (infra) and these member states need to change their legislation in order to ensure full compliance with the EU legislation.

IV. THE UNIFORM APPROACH FOR BAD FAITH

A. Introduction

The interpretation of the concept of 'bad faith' is fragmented due to the different application among member states. The first national court which requested a preliminary ruling from the European Court of Justice on the community concept of bad faith, was the Austrian Court in the case Goldhase in 2009. This preliminary ruling was upheld in the case Malaysia Dairy. We can conclude that the European Court of Justice upholds a uniform interpretation and application of the concept bad faith within the European Union in its recent case law (infra) and all member states need to ensure full compliance with all EU legislation and case law.[75]

1. GOLDHASE

C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009)

[75] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, p121

THIS CASE IS THE LEADING AUTHORITY ON BAD FAITH AND IS THE FIRST CASE IN WHICH THE CONCEPT OF BAD FAITH WAS CLARIFIED BY THE EUROPEAN COURT OF JUSTICE BY THE REQUEST OF A NATIONAL (AUSTRIAN) COURT REQUESTING A PRELIMINARY RULING.

Facts of the case

Two chocolate manufacturers Lindt and Sprüngli had a legal dispute in Austria regarding the trademark protection of the shape of a chocolate foil-wrapped Easter bunny. The Swiss manufacturer Lindt claimed exclusivity of the shape of the chocolate Easter bunny in a community trademark, but Sprüngli, an Austrian manufacturer, countered with an invalidity claiming that the registration of the shape mark was done in bad faith, due to Lindt's knowledge of Sprüngli's (and other competitors') prior use of a similar gold foil-wrapped Easter bunny and therefore only seeking protection of the shape to prevent its competitors from continuing to use the shape in the future.

The dispute reached the Austrian Supreme Court. The Austrian Courts primarily relied on the traditional doctrine of bad faith as used in article 34 *MutterSchutzGesetz* (MSchG).[76] Bad faith was accepted in first instance, the court of Appeal struggled with the particular factors of the case namely the fact that the applicant relied on its established use abroad in Germany for the past 50 years which preceded the prior use of the defendant (Sprüngli).[77] The case was referred to the Austrian Supreme Court for clarification, the latter which referred the case to the European Court of Justice for a preliminary ruling:

1. *' 1. Is article 51(1)(b) CTMR to be interpreted as meaning that an applicant for a Community Trademark is to be regarded as acting in bad faith where he knows at the time of his application that a competitor in (at least) one member state is using the same sign or one so similar as to be capable of being confused with it, for the same or similar goods or services, and he applies for the trademark in order to be able to prevent that competitor from continuing to use the sign?*

[76] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 302
[77] Ibid, 303

2. *If the first question is answered negative: is the applicant to be regarded as acting in bad faith if he applies for the trademark in order to be able to prevent a competitor from continuing to use the sign, where, at the time he files his application, he knows or ought to know that by using an identical or similar sign for the same goods or services, or goods or services which are so similar as to be capable of being confused, the competitor has already acquired 'valuable property rights'?*
3. *If either the first or the second question is answered in the affirmative: is bad faith excluded if the applicant's sign has already obtained a reputation with the public and is therefore protected under competition law?'*

In C-529/07 (Goldhase) the European Court of Justice[78] considers all questions referring to article 51(1)(b) CTMR [now article 52(1)(b)] together instead of referring to each question separately [79] and stated:

> '*in order to determine whether an applicant was acting in bad faith within the meaning of article 51(1)(b) of Council regulation (EC) no 40/94 of 20 December 1993 on the community trademark [now article 52(1)(b) of Council Regulation 207/2009], the national court must take into consideration all relevant factors specific to the particular case[80] which pertained at the time of filing the application[81] for registration of the sign as a community trademark. In particular:*
>
> 1. *The fact that the applicant knows or must know that the third party is using in at least one member state an identical or similar sign for an identical or similar products capable of being confused with the sign for which the registration is sought;*
> 2. *The applicant's intention to prevent the third party from continuing to use such sign;*
> 3. *The degree of legal protection enjoyed by the third party's sign and by the sign which registration is sought.*'[82]

[78] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 34-53
[79] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 22; Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 304
[80] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 37
[81] Ibid, para 35
[82] Ibid, para 53

The reasons for this preliminary ruling by the European Court of Justice are elucidated below:

The preliminary questions refer to article 51(1)(b) CTMR [current 52(1)(b) CTMR], the ruling is relevant for the revised Community Trademark Regulation.[83]

Both the subjective intentions of the applicant and the objective circumstances of the case have to be taken into consideration.[84] All circumstances and relevant factors of the specific case need to be taken into account in order to establish whether the applicant was acting in bad faith, an overall assessment is required. The Court however places more importance on some factors than others, namely knowledge, intent and the degree of legal protection, which local courts and cancellation divisions need to take into account for their assessment of the term bad faith in order to act in conformity with 'Goldhase'.[85] These three factors shall be further clarified hereafter:

Factor 1: 'Knowledge of prior use'

'The fact that the applicant knows or must know that the third party is using in at least one member state an identical or similar sign for an identical or similar products capable of being confused with the sign for which the registration is sought.' [86]

The mere knowledge of another mark is insufficient[87], albeit a very important and determining element for bad faith. The motivation behind 'knowing of prior use' as a key element is not provided by the court.[88]

Knowledge does not entail actual knowledge, the fact that the applicant should have had knowledge is sufficient.[89] Furthermore, knowledge is very hard to prove, therefore the European Court of Justice allows a presumption of the

[83] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 305
[84] Stumpf, K. *Repeated filing of a European Community trademark*, Journal of intellectual property law & practice, 2014, Volume 9, Nr 3, 227; T-136/11 Pelicantravel.com v OHIM, 13 December 2012
[85] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119
[86] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 38, 53
[87] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 40
[88]Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 306
[89] Ibid, 307

knowledge of prior use: namely a few factors to indicate whether the applicant knew or should have known about prior use are: [90]

- *'The more the use is long-standing, the more probable that the applicant will have knowledge of it.'* [91] The greater the extent of the prior use, the greater its exposure, awareness, reputation, renown within the industry, the more plausible that the applicant should have known of the prior use. [92] Similar suggestions can be found in national and/or regional Trademark Legislation for example in the Explanatory Memorandum of the Benelux Trademark Act, in Germany and in Denmark.[93]
- 'The general knowledge in the economic sector concerned of such use' is a factor which indicated the knowledge of prior use and can be determined, for example by the duration of such use.[94]
- (Pre-)Contractual relations between the applicant and the prior users are also often an indication of knowledge of prior use which should be considered in conjunction with all other relevant factors in the specific case.[95] The former is consistently upheld in regard to article 52(1)(b) CTMR in many decisions of the OHIM cancellation division[96] and is recognized in for example Benelux.
- The level of similarity between the signs could indicate knowledge on the part of the applicant; for example, for complicated and/or particularly designed logos and/or figurative marks where deliberate copying is likely than spontaneous inspiration.[97]
- Level of similarity between the goods or services could also indicate knowledge on the part of the applicant (in Goldhase case). All relevant

[90] Ibid, 307
[91] Ibid, 306; C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 39
[92] Ibid, 308
[93] Ibid, 308
[94] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 308
[95] Ibid, 308
[96] Ibid, 308
[97] Ibid, 310-311

factors have to be taken into account for this assessment.[98] The Community Trademark Regulation provides for partial invalidation for the goods or services for which the ground of invalidity exists (see article 52(3) CTMR).

A limitation that should be taken into account for the ability of right holders to invalidate a mark for bad faith is for the application of article 52(1)(b) CTMR is the fact that knowledge of prior use in should take place in 'at least one member state'. What about prior use outside the EU? Extra-territorial prior use is not dealt with by the European Court of Justice.[99]

Another limitation that should be taken into account is the similar or identical signs; which is assessed as a sign for which the 'average consumer who is reasonably well informed and observant and circumspect' is 'capable of being confused with the sign for which the registration is sought', namely by the concept of likelihood of confusion which should be assessed globally; visually, phonetic and conceptual.[100] The more similar the sign, the more likely the courts shall rule that the applicant knew or should have known about the earlier sign.[101] And a third limitation is the identical or confusingly similar goods or services.

Factor 2: Intent

Only determining and proving prior knowledge is insufficient. The European Court of Justice requires proof that the applicant had the intention to prevent the third party from continuing to use the sign.[102] The Court confirmed that the relevant date for assessing bad faith is the time of filing the application and that whether an applicant is acting in bad faith depends on the applicant's intention at the time of filing.[103] The Court of Justice states this in paragraphs 40-41 of the Goldhase case:

'para 40:

[98] Ibid, 313
[99] Ibid, 314
[100] Ibid, 312
[101] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 311-312
[102] Ibid, 314
[103] Stumpf, K. Repeated filing of a European Community trademark, Journal of intellectual property law & practice, 2014, Volume 9, no 3, 227

However, the fact that the applicant knows or must know that a third party has long been using, in at least one member state, an identical or similar sign for an identical or similar products, capable of being confused with the sign for which registration is sought is not sufficient, in itself, to permit the conclusion that the applicant was acting in bad faith.

Para 41:

Consequently, in order to determine whether there was bad faith, consideration must also be given to the applicant's intention at the time when he files the application for registration.'

The factor intent is important for (for example) the following situation: when there is a lack of intent-to-use and the applicant's objective is to prevent a third party from entering the market.[104]

There is disagreement in Europe on this point; the Court hereby confirms the German and Austrian doctrine of '*Behinderungsabsicht*'; the wrongful intent of the applicant to pre-empt prior users from continuing such use (supra) and takes a different direction than some other member states which equate bad faith with 'knowledge'. [105] And the Court hereby goes against the doctrine in for example Benelux where knowledge equates bad faith. (supra)

Factor 3: The degree of legal protection

The third factor which is determining for bad faith according to the European Court of Justice is *'the degree of protection enjoyed by the third party's sign and by the sign for which registration was sought.*'[106] The new element here is that the applicant may rebut the accusation of bad faith by pointing out that the younger sign enjoys considerable reputation.[107] In casu, both the applicant (Lindt) and the alleged infringer were using the shape mark for decades, so which prior use prevails? And to

[104] Ibid, 317
[105] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119; other member states like Benelux, Austria
[106] C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 62; Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 325
[107] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 325; C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009), para 51-52

what extent was the use?[108] The European Court of justice does not give a clear-cut answer. In Goldhase it's not so much a question of when the signs have been used, but rather to what degree.[109]

On the other hand, the national courts of Germany and the regional court of Benelux for example tend to deny bad faith when the applicant can prove that its prior use preceded the use of the third party; earlier prior use prevails.[110]

A last point which needs to be discussed is the context of bad faith, which was addressed in the context of invalidation of community trademarks on the grounds of article 52(1)(b) CTMR and when involving prior use within a member state of the European Union.[111] The context did not include prior use in a non-member state. CTMR does not include an explicit provision regarding extraterritorial protection, while article 4(4)(g) TMD does.[112] The European court of Justice also didn't mention the Trademark Directive in the Goldhase case, yet similar provisions prevent bad faith in articles 4(4)(g) and 3(2)(d) TMD.[113] The European Court of Justice has repeatedly indicated that it favors a unified approach for the interpretation of the identical provisions in both the Trademark Directive and the Community Trademark Regulation, in casu applying the same legal standard of bad faith to the community trademarks (CTMR) and the national marks (TMD).[114] Hence member states should apply the Goldhase test to their own bad faith provisions in national legislation (based on TMD).[115] However we have to keep in mind the fact that the European Court of Justice did not mention the trademark directive in the Goldhase case.

Conclusion

[108] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 326
[109] Ibid, 326
[110] Ibid, 326
[111] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119
[112] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119
[113] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 119; Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 305
[114] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, p. 330
[115] Ibid, 331

In the Goldhase case,[116] the European Court of Justice points out that bad faith requires an overall assessment taking into account all relevant factors in a specific case. The Goldhase three-step test applies to the bad faith provision 52(1) (b) CTMR and entail the following three steps; (1) knowledge of prior use, (2) intent of the applicant to prevent other from using the sign (3) the degree of legal protection. Whether the applicant is acting in bad faith and whether the application should be refused or cancelled based on bad faith, depends on the three factors above.

The European Court of Justice didn't mention the Trademark Directive in the case Goldhase, yet the court has indicated that it favors a unified approach for the interpretation of the provisions in the Trademark Directive and the Community Trademark Regulation. The Community Trademark Regulation is binding and directly applicable on the member states while the Trademark Directive needs to be transposed in the member states, yet the discretionary power of the member states to choose the form of transposing the provisions in their national legislation, does not mean that the member states have a margin in terms of policy making.[117] The member states must all ensure that the Directive is transposed in a clear, accurate way which safeguards the function and the goal of the directive.[118] Verbatim implementation is not necessary but is a full transposition is encouraged.[119]

2. Malaisia Dairy

C-320/12 *Malaysia Dairy Industries Pte Ltd v Ankenoevnet for Patenter og Varemoerker, 27 June 2013*

The Japanese company Kabushiki Kaisha Yakult Honsha has been marketing its milk-based drink Yakult since 1965 in distinctive bottles, which are protected as 3D trademark in many countries. Malaysia Diary Industries (Malaysia Dairy) has been marketing a similar product in a similar bottle which have been registered as trademarks since 1980 (in for example Malaysia). In 1995, Malaysia Diary applied for

[116] *C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009)*

[117] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 333
[118] Tsoutsanis, A., *Trademark Registrations in Bad Faith,* Oxford University Press: 2010, 333
[119] Ibid, 333-334

the registration of its bottle in Denmark. Yakult opposed by invoking Danish trademark law; relative ground of refusal which includes the existence of the mark abroad and the filing of an identical or similar trademark with knowledge of the mark abroad. Malaysia Diary knew or should have known the existence of the Yakult trademark abroad. This dispute is fought in Denmark.

Yakult's argument is based on the infringement of Section 15(3)(3) Danish Trademark Act: '*A trademark is also excluded from registration if (…) it is identical to or differs only insubstantially from a trademark which at the time of the application, or as the case may be the time of priority claimed in support of the application, has been brought unto use abroad and is still used there for goods or services of the same or similar kind as those for which the later mark is sought to be registered, and at the time of the application the applicant knew or should have known of the foreign mark*.' Malaysia Dairy knew or should have known of the existence abroad, of identical earlier marks of which Yakult is the proprietor at the time the application was filed.

This Danish provision differs from article 4(4)(g) TMD according to which any member state may provide '*that a trademark shall not be registered where the trademark is liable to be confused with a mark which is in use abroad on the filing date of the application and which is still in use there, provided that at the date of the application the applicant was acting in bad faith*.' The Directive, unlike the Danish provision which equates bad faith with knowledge, requires that the registration of the younger mark is filed in bad faith and the applicant's subjective intention should be taken into account at the time of the filing. There is no reference to bad faith as such in the Danish Provision.[120]

Yakult lost before the Court of first Instance as the Danish Trademark Office rejected the grounds of opposition since Malaysia Dairy had a registered trademark in Malaysia and subsequently applied for the registration of the sign in Denmark, therefore bad faith could not be demonstrated by the mere fact that at the time Malaysia Dairy filed the application for the registration of the sign, it knew of the foreign sign of which Yakult was proprietor[121]. This confirms the decision of the

[120] Heath, G., (ed) *Annual Review of EU Trademark Law*, The Law Journal of the International Trademark Association, March –April 2014, Vol 104, no 2, 578

[121] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, p120; C-320/12 *Malaysia Dairy Industries Pte Ltd v Ankenoevnet for Patenter og Varemoerker, 27 June 2013, paragraph 12*

European Court of Justice in Goldhase; the mere knowledge of the earlier mark is insufficient to constitute bad faith.[122]

Yakult's application was granted by the Appeal Board which cancelled the registration of the Malaysian trademark because Malaysia Dairy knew or should have known about the Yakult mark in use abroad and this was sufficient according to article 15(3)(3) Danish Trademark Act to establish that the applicant was acting in bad faith, even when the applicant had acquired a registration of the mark in another country at an earlier point in time (in casu Malaysia), as opposed to the European Court of Justice in Goldhase and as opposed to the Court of First Instance. [123] Malaysia Dairy appealed before the Maritime Court which confirmed the position of the Appeal Board. Afterwards Malaysia Dairy appealed before the Danish Supreme Court, the latter which referred three preliminary questions to the European Court of Justice:

1. *is the concept of bad faith in article 4(4)(g) TMD an expression of legal standard which may be filled out in accordance with national law or is it a concept of European Union law which must be given a uniform interpretation throughout the European Union?*
2. *If the concept of bad faith in article 4(4)(g) TMD is a concept of European Union law, must the concept be understood as meaning that it may suffice that the applicant knew of should have known of the foreign mark at the time of application or is there a further requirement concerning the applicant's subjective position in order for registration to be denied?*
3. *Can a member state choose to introduce a specific protection of foreign marks which, in relation to the requirement of bad faith, differs from article 4(4)(g) TMD for example by laying down a special requirement that the applicant knew or should have known the foreign mark?*

The preliminary ruling of the CJEU stated as follows:

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[122] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, p120; C-529/07 Chocoladefabriken Lindt & Sprüngli AG v. Franz Hauswirth GmbH (2009)

[123] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 120

1. All the terms in the European Union legislation (*in casu* the concept of bad faith from article 4(4)(g) TMD) are interpreted 'autonomously' (they must be given a uniform interpretation) within the European Union.
2. Knowledge does not *per se* suffice to establish bad faith (see June 11, 2009 C-529/07, Chocolade-fabriken Lindt & Sprüngli) Article 4(4)(g) TMD must be interpreted as meaning that in order to permit the conclusion that a person making the application for registration of a trademark is acting in bad faith within the meaning of the provision , it is necessary to take into account all relevant factors pertaining specific to the particular case, which pertained at the time of the filing the application for registration. The fact that applicant knows or should know that a third party is using the mark abroad at the time of filing, is in itself not sufficient to permit the conclusion that the applicant is acting in bad faith within the meaning of that provision.
3. CJEU upholds its case law which does not allow a margin for member states to introduce specific protection of foreign marks in their national legislation when specific options are included in Directives as a general rule and therefore the former differs from the system established in the EU. Member states cannot operate their own rules of national law and dismiss the European legislation. The member states cannot operate a 'light' version of the system under which an application of a Community Trademark can be invalidated or refused if filed in bad faith.[124]

Prior to this decision, in Denmark the position under their national legislation was that actual or presumed knowledge of trademark use abroad was sufficient to establish that an applicant was acting in bad faith. But Denmark cannot stick to its own traditional doctrine of bad faith but needs to change and comply with the decisions of the European Court of Justice; all member states need to ensure full compliance with EU legislation and case law. [125]

[124] Heath, G., (ed) *Annual Review of EU Trademark Law*, The Law Journal of the International Trademark Association, March –April 2014, Vol 104, no 2, 579

[125] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 121

The ruling confirmed the alignment of the bad faith test under the TMD and the CTMR. The member states must then apply the uniform EU law interpretation without creating their own version of the rule.[126]

3. Conclusion

The European Court of Justice upholds a uniform interpretation and application of the concept of bad faith within the European Union in its recent case law (supra) and all member states need to ensure full compliance with all EU legislation and case law.[127]

The European Court of Justice states that 'bad faith' is an autonomous concept of EU law which must be uniformly interpreted in the EU.[128] Case law on bad faith within the meaning of regulation[129] equally applies for the interpretation of bad faith within the Directive[130] and vice versa. The precedent in Goldhase for article 52(1)(b) CTMR regarding the uniform standard of bad faith applies to both the Regulation and the Directive, and applies for both the invalidation of the Community trademarks and national marks.[131] The European Court of Justice subsequently applies the Goldhase standard to article 4(4)(g) TMD; the mere knowledge of another mark is not sufficient but case by case all circumstances need to be taken into account in order to assess whether the applicant was acting in bad faith or not such as the applicant's intention at the time of filing the application for the registration of the trademark.[132]

In the Goldhase case the European Court of Justice stated that in order to determine whether an applicant was acting in bad faith, the national court must take into consideration all relevant factors specific to the particular case which pertained

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[126] Heath, G., (ed) *Annual Review of EU Trademark Law*, The Law Journal of the International Trademark Association, March –April 2014, Vol 104, no 2, 579
[127] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 121
[128] C-320/12 *Malaysia Dairy Industries Pte Ltd v Ankenoevnet for Patenter og Varemoerker, 27 June 2013; C-529/07 Chocoladefabriken Lindt & Sprüngli vs Franz Hauswirth*
[129] C-320/12 *Malaysia Dairy Industries Pte Ltd v Ankenoevnet for Patenter og Varemoerker, 27 June 2013*
[130] *C-529/07 Chocoladefabriken Lindt & Sprüngli vs Franz Hauswirth, 2009*
[131] Tsoutsanis A., *Trademark applications in bad faith: righting wrong in Denmark and why Benelux is next*, Journal of intellectual property law & practice, 2014, Vol 9, no 2, 121
[132] Ibid, p121; *C-529/07 Chocoladefabriken Lindt & Sprüngli vs Franz Hauswirth (2009)*

at the time of filing the application for registration of the sign as a community trademark, in particular the intention of the applicant at the time of the filing of the application for the registration of the trademark. Therefore, bad faith is a term of subjective nature. This was also upheld in the Malaysia Diary case. Bad faith in national trademark laws must be interpreted with the guidance by the case law of the European Court of Justice and provisions which are different to the EU trademark legislation need to be changed. There are several differences between the implementing provisions and its counterpart in the directive throughout the EU, not only in Denmark.[133]

Bad faith is an absolute ground of invalidation in Community Trademark law, developed on a case-by-case basis, the most important cases being Goldhase and Malaysia Dairy.

V. CONCLUSION

This article's aim is not to provide a general meaning of bad faith but first of all addressed the concept of bad faith in the context of trademark grabbing, as a ground for refusal or invalidity of a community trademark of a trademark application and furthermore assessed whether the concept of bad faith should be given a uniform interpretation throughout the European Union.

Through the analysis of the meaning of the concept in European trademark law, namely the provisions 52(1)(b) of the Community Trademark Regulation and articles 3(2)(d) and 4(4)(g) of the Trademark Directive, furthermore the OHIM manual on trademarks and thirdly through the short comparative study between the national provisions of three member states who implemented the articles of the Directive, it was clear that there was no clear definition, let alone a uniform interpretation throughout the European Union for bad faith.

The case law of the European Court of Justice however provided solace in its first preliminary ruling on bad faith in the case Goldhase in 2009, which refers to article 52(1)(b) of the Regulation; 'bad faith must be determined on a basis of an overall assessment taking into account all the relevant factors relevant to the

[133] Ibid, p121

particular case.':

The first factor for determining whether there is bad faith is that there must be knowledge of prior use by the applicant at the time of filing. A presumption of knowledge can be made for example when there is long-standing use or when there is general awareness of prior use within the relevant industry of when there are (pre-) contractual relations between the applicant and the prior user. The signs involved must be identical or confusingly similar, as must be the goods or services. The principle of territoriality is the third limitation of the first factor; the first use must have taken place in a EU member state. The second factor is the intention of the applicant. There is some disagreement in the member states in this regard as some member states state that knowledge of prior use is sufficient such as Denmark and Benelux, while in Germany malicious intent to prevent a competitor from securing protection for the first sign is necessary on top of the first factor knowledge. The European Court of Justice had a few cases in mind which include lack of intent-to-use, prior use enjoys legal protection, intent to restrict the competition. The third factor is the degree of legal protection enjoyed by the first sign and by the sign for which protection is sought. This three-step test in Goldhase means that the European Court of Justice hereby rejects other standards such as OHIM definitions, national interpretations.

In Malaysia Dairy in 2013 the Danish court referred three preliminary questions to the European Court of Justice, which subsequently applies the Goldhase standard to article 4(4)(g) TMD; the mere knowledge of another mark is not sufficient but case by case all circumstances need to be taken into account in order to assess whether the applicant was acting in bad faith or not such as the applicant's intention at the time of filing the application for the registration of the trademark. The European Court of Justice upholds its own case law; a uniform standard is proposed for bad faith, which allows for refusal or invalidity of a community trademark law (three step).

Article 52(1)(b) CTMR is directly applicable and binding on all member states, however the provisions 3(2)(d) and 4(4)(g) of the Directive needs to be

transposed into national legislation and the member states can choose the form and methods used for the implementation. Verbatim transposition is not necessary but would show that the member states ensure full effect to the self-imposed provisions of the Directive and ensuring that the goal of the Directive is ensured and harmonization within the EU is achieved. The member states have absolutely no margin regarding policy making.

In my view this Court rulings are beneficial to the legal certainty regarding community trademarks and also for the harmonization sought within the European Union.

First of all, the uniform interpretation of the notion bad faith entailed in the Court rulings, in which the European Court of Justice takes into account all the aspects of this legal concept, and all relevant factors specific to the particular case. The Court sets up standards, namely the three-step test in order to determine whether an application for the registration of a trademark is filed in bad faith and can lead to the refusal or invalidity of the community trademark. This consequently means that all other standards (OHIM, national courts/legislation…) are hereby rejected.

Furthermore, by applying the three-step standard from Goldhase, in which article 52(1)(b) CTM Regulation was referred, to article 4(4)(g) of the Trademark Directive, it is clear that this consequently means that this Directive needs to be transposed into national legislation in such a way that it ensures the full effect of the Directive and the goal thereof and the harmonization within the EU. This means that all member states have to adapt, when necessary, their national legislation in order to comply fully to the above. This concept of bad faith is not a *carte blanche* for the member states to include their traditions into the national trademark legislation, on a contrary, a uniform and harmonized approach for bad faith is the goal.

Methods of lifting the veil of incorporation in the company law of the United Kingdom and its judicial difficulties

Patryk Polek[*]

Abstract

The paper intends to explain two methods of overcoming the difficulties associated with the separate corporate personality of the companies in the United Kingdom. The concept of the veil of incorporation, which is incessantly connected with the principle of limited liability, shields the members of the company from exposure to litigation and the possibility of being held accountable with their personal assets for liabilities incurred by the management of the company. In order to overcome these far-reaching legal effects of the aforementioned doctrine, both statutory and judicial devices were implemented. This article will present and explain these methods.

I. INTRODUCTION

The purpose of this article is to present both judicial and statutory methods of lifting the veil of incorporation in the company law of the United Kingdom. For the clarity of presentation, the article will be divided into three main parts. In the first part, fundamental principles of the English company law, such as a separate corporate personality, the principle of limited liability and the concept of the veil of incorporation will be explained. Then, the article will focus on the brief presentation of the statutory veil lifting devices created by the British legislator. The third part of this article will be devoted to a detailed description of the judicial veil lifting attempts and the difficulty concerned with that manner.

The biggest emphasis will be placed on the last part of the article, due to the fact that the judicial veil lifting doctrine causes the greatest uncertainty, and as Professor Dan Prentice submits, "*the overall problem with veil-piercing jurisprudence is that it*

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is a wilderness of isolated precedents".[1] This layout shall lead to the conclusion that this branch of English company law had been completely tangled from the early 19th century to the late 20th century and was based on many precedents and frequently inconsistent case lines, without any clear or decisive rules which could tie together that part of company law. Nevertheless, even after the landmark decision in *Adams*,[2] in which the court tried to set some rules to the veil lifting doctrine, recent Supreme Court judgment still indicate uncertain approach to these issues.

Before moving on to the details of the subject, it is crucial to start with the explanation of the essential principles of the company law of the United Kingdom.

II. FUNDAMENTAL PRINCIPLES OF UK COMPANY LAW

The fundamental case on the doctrine of the separate corporate personality is the landmark decision of *Salomon v Salomon*.[3] In this case, the court established a legal fiction by adjudicating that after the valid incorporation of the company, such artificial entity is equipped with a legal personality completely distinct from the people who compose it.[4] It is a fiction which grants certain rights and liabilities[5] – quoting Lords Halsbury "*(…) once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself*".[6] These rights relate to, *inter alia*, that the company's property is owned by the company as a separate person, not by its members; a company can enter into contracts and legal proceedings on its own; a company can sue and can be sued; and theoretically it can run infinitely even when the people running the company are changing.[7]

However, the crucial element in this doctrine is the principle of limited

1Dan D Prentice, 'Veil Piercing and Successor Liability in the United Kingdom' (1996) 10 Florida Journal of International Law 469

[2] See n 66

[3] *Salomon v Salomon and Co Ltd* [1897] AC 22

[4] Geoffrey Morse, *Charlesworth's Company Law* (17th edn, Sweet & Maxwell 2005) 25-26

[5] Or as Viscount Haldane LC in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705 submitted: "*juristic figment of the imagination, lacking both a body to be kicked and a soul to be damned*"

[6] *Salomon v Salomon and Co Ltd* [1897] AC 22 [30] (Lord Halsbury LC)

[7] Derek French, Stephen Mayson, Christopher Ryan, *Mayson, French & Ryan on Company Law* (33rd edn, Oxford University Press 2015) 126-131

liability,[8] which connotes that the assets owned and debts incurred by the company – due to the separate legal entity doctrine – are entirely distinct from the assets and debts owned by the people running the company.[9] In practice this means that the members of a company cannot be held liable for the debts incurred by the company as a separate legal entity in running its day-to-day business.[10] Members' liability of a company limited by shares will be confined to the nominal value of the shares that they have contributed in subscribing to the shares (with few exceptions irrelevant to the topic of this article).[11]

The advantage explained above is referred to by legal scholars as the veil of the separate corporate personality[12] which defends members of the company from exposure to litigation and the possibility of being held accountable with their private, personal assets for liabilities incurred by the company.[13]

Principles established in *Salomon* undoubtedly influenced the British company law and enabled rapid development of businesses.[14] However, soon after the decision, the question emerged whether the Parliament or the court has the ability to lift the veil of incorporation, ignore the principle of corporate legal personality, and is able to treat company's liabilities as belonging to members of this company.[15] In relation to the Parliament, the affirmative answer was obvious due to the principle of parliamentary sovereignty. As to the judicial veil lifting, both scholars and judges responded positively and argued that "*as early as Salomon, judgments have indicated possible exceptions to the separate entity concept*".[16] As Lord Sumption identifies, those are the situations when "*a person who owns and controls a company is said in certain circumstances to be identified with it in law by virtue of that ownership and control*".[17]

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[8] Principle of limited liability is broadly discussed in Lynn Gallagher, Peter Ziegler, 'Lifting the corporate veil in the pursuit of justice' (1990) Journal of Business Law 292
[9] John Birds, A J Boyle, *Boyle & Birds' Company Law* (10th edn, Bristol 2007) 60-62
[10] B. Pettet, 'Limited Liability – A Principle For The 21st Century?' (1995) Current Legal Problems 48 125, 126
[11] Morse (n 4) 26-27
[12] Pettet (n 10) 136
[13] Charles Wild, Stuart Weinstein, *Smith & Keenan's Company Law* (13th edn, Harlow 2005) 27
[14] Phillip Lipton, 'The Mythology of Salomon's Case and the Law Dealing with the Tort Liabilities of Corporate Groups: An Historical Perspective' 2014 Monash University Law Review 40 452, 453; see also Birds, A J Boyle (n 9) 59-60
[15] Alan Dignam, John Lowry, *Company Law* (8th edn, Oxford University Press 2014) 33
[16] Gallagher, Ziegler (n 8) 295
[17] *Prest v Petrodel Resources Ltd* [2013] UKSC 34, [2013] 2 AC 415 [16] (Lord Sumption)

Having presented the fundamental principles of the company law of the United Kingdom, the article will now move on to the explanation of statutory veil lifting devices established by the British Parliament.

III. STATUTORY VEIL LIFTING DEVICES

In certain circumstances, the veil of incorporation may be lifted if the conditions provided in the statutory provisions have been met; this situation is referred to by legal scholars as statutory veil lifting. The British Parliament has recognised that the corporate form could be used for fraudulent purposes in order to escape liability, obligation to pay taxes, or other claims. In order to prevent such possibility, two acts of parliament have been enacted – the Insolvency Act 1986 and the Companies Act 2006.

Sections 399 and 409 of the Companies Act 2006 provide that the parent company is obliged to produce group accounts which include details of the subisidiaries' names, country of activity and the number of shares it holds in the subsidiary.[18] These provisions were enacted in order to limit the possibility of avoiding taxation by moving the assets and liabilities around the companies in a group.

Another statutory possibility to lift the veil of incorporation is provided by sections 213 - 215 of the Insolvency Act 1986. Section 213 states:

"*(1) If in the course of winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.*

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner abovementioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."

The aforementioned section refers to the situation in which the people in charge of the company intend to defraud its creditors. As subsection (2) provides,

[18] Dignam, Lowry (n 15) 31

the court has the ability to impose civil sanctions and declare any person, even beyond the group of directors of the company, to be held personally liable for the fraud committed. Furthermore, except civil sanctions provided in the above mentioned section, section 993 of the Companies Act 2006 provides criminal offence of f r a u d u l e n t t r a d i n g:

"(1) If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence (…)

(3) A person guilty of an offence under this section is liable —

(a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both);"

However, in *Re Patrick and Lyon Ltd*[19] case, the court defined the standard for intent as "*actual dishonesty, involving, according to current notions of fair trading among commercial men, real moral blame*"[20], consequently submitting that the Parliament set this standard too high and therefore it is too difficult to reach it in practice. As a result, a new provision was introduced in section 214 of the Insolvency Act 1986 to deal with what is known as w r o n g f u l t r a d i n g.[21] Section 214 provides:

"*(1) ... if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.*

(2) This subsection applies in relation to a person if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

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[19] [1933] Ch 786
[20] ibid
[21] Dignam, Lowry (n 15) 32

(c) that person was a director of the company at that time;"

The purpose of wrongful trading offence is to deal with situations where negligence (rather than fraud) is combined with a misuse of corporate personality and principles of limited liability. This section is aimed only at the directors of the company and does not require dishonesty or fraudulent intent to be applied. The court, in order to resolve such issues, will look at the acts of the director in relation to company trading and will try to assess whether the director crossed the point of no return – the point where "*the things are so bad that the company can no longer trade out of the situation*".[22] If a director continues to trade after this point, he will risk having to contribute to the debts of the company with his private assets.[23]

As it can be seen by looking at the statutory veil lifting devices established by the Parliament of the United Kingdom, their main aim is to prevent the avoidance of taxation, creditors' infringement, and negligent or fraudulent acts of the directors. In such circumstances, when the conditions provided in particular sections are met, the court will have the possibility to lift the veil of incorporation and find directors or people in charge of the company liable to civil sanctions and order them to contribute to the debts of the company or – in limited circumstances – issue criminal offences against them.

Having examined statutory veil lifting devices, the article will focus on a decidedly more complicated matter – judicial veil lifting attempts.

IV. JUDICIAL VEIL LIFTING DOCTRINE

As it was noted in the introduction, the landmark decision of *Salomon* set the basis for the fundamental principle of English company law – that every validly incorporated company is a separate legal entity completely distinct from its members. However, throughout the years, judges, in some circumstances, decided to depart from the approach presented in *Salomon*, lift the veil of incorporation and expose

[22] ibid
[23] see *Re Produce Marekting Consortium Ltd (No 2)* (1989) 5 BCC 569; *Re Rod Gunner Organisation Ltd* (2004) EWHC 316 (Ch)

members of the company to litigation.[24] These exceptions to the *Salomon* rule should now be examined.

While analysing the earliest cases concerning judicial veil lifting, it can be seen that the first exception to the *Salomon* principle was established in cases where the company had been incorporated as a *sham* or *façade*,[25] which was taken by judges as a legitimate reason to lift the veil and omit the separate corporate personality principle.[26] Slade LJ explained the meaning of the *façade company* by saying that the company is a sham when an "*existing incorporated or unincorporated trader uses a company as nothing more than an artificial device for the purpose of shielding themselves from their pre-existing liabilities under contract, tort or statute*".[27]

In *Gilford Motor Company Limited v Horne*,[28] the defendant established a company whose main purpose was to compete in the market with his former employers, with whom he personally signed a restrictive non-competition agreement.[29] The court unanimously decided to pierce the veil of incorporation and gave the plaintiff an injunction against both the defendant and the company.[30] Lord Hanwoth held that "*the company was incorporated as 'a mere cloak or sham*"[31] and its only purpose was to enable the defendant to breach the non-competition agreement and it was a *mere device*[32] created to compete in a market with previous employers which "*enabled him, for his own benefit, to obtain the advantage of the customers of the plaintiff company*".[33]

In *Jones v Lipman*,[34] the defendant entered into a contractual agreement with a plaintiff, under which he promised to transfer the ownership of the land to the plaintiff. Then the defendant changed his mind, set up a company, and transferred

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[24] L S Sealy, Sarah Worthington, *Sealy and Worthington's Cases and Materials in Company Law* (10th edn, Oxford University Press 2013) 52
[25] Lisa Linklater, 'Piercing the corporate veil - the never ending story?' (2006) Company Lawyer 27(3) 65
[26] Janet Dine, Marios Koutsias, *Company Law* (8th edn, Palgrave 2014) 15
[27] *Adams v Cape Industries plc* [1991] 1 All E.R. 929 [1022]-[1026] (Slade LJ)
[28] [1933] Ch. 935
[29] S Ottolenghi, 'From peeping behind the corporate veil to ignoring it completely' (1990) Modern Law Review 53 338, 347-348
[30] Birds, A J Boyle (n 9) 65
[31] *Gilford Motor Company Limited v Horne* [1933] Ch. 935 [961] – [962] (Lord Hanwoth MR)
[32] ibid
[33] ibid [965] (Lawrence LJ), see also *Re Bugle Press* Ltd [1961] Ch 270
[34] [1962] 1 All E.R. 442

ownership of the property to this company in order to cover himself under the veil of incorporation and avoid his personal contractual obligations.[35] Russell J, for the same reasons as in *Gilford,* decided to pierce the veil of incorporation under these circumstances and made an order for specific performance against both the defendant and the company, by which the company was obliged to return the property and the defendant was forced to fulfil his contractual obligations.[36]

In more recent cases, the judicial approach to prevent the formation of sham companies with fraudulent purposes still can be found. In a 2001 case *Trustor AB v Smallbone*[37] the defendant, director of Trustor AB, was found liable for fraudulent, unauthorised transfer of money from one company to the wholly owned subsidiary incorporated for this purpose. The court decided to lift the veil because that newly incorporated company functioned as a *façade.* As Dine explains "*he tried to hide behind the corporate veil to escape his obligation to return the misappropriated funds*".[38]

As it can be seen by looking at the examples presented, the real purpose of the incorporation of the company was a crucial factor for the courts at that time.[39] The cases presented above had one thing in common - the court decided to abstain from *Salomon* principle and lift the veil in situations when the purpose of the company was to act as a sham or *façade* and had been established in order to avoid existing obligations or cover fraudulent acts. This line of cases established first precedent in veil piercing jurisprudence.[40]

Another successful veil piercing attempt was done in the late 1930s in *Smith, Stone and Knight v Birmingham Corporation*.[41] In this case, the court had to decide on the possibility of lifting the veil in the agency and parent-subsidiary relationship. A 'subsidiary', in these circumstances, is a company that is "*totally and utterly under the control of its parent to the extent that the subsidiary cannot be said to be carrying on its own*

[35] M T Moore, "'A temple built on faulty foundations": piercing the corporate veil and the legacy of Salomon v Salomon' (2006) Journal of Business Law 180, 183
[36] David Kershaw, *Company Law in Context, Text and Materials* (2nd edn, Oxford University Press 2012) 55-56
[37] [2001] 1 WLR 1177
[38] Dine, Koutsias (n 26) 16
[39] Birds, A J Boyle (n 9) 65
[40] Dignam, Lowry (n 15) 34
[41] [1939] 4 All ER 116

business in distinction from its parent".[42]

In *Smith, Stone and Knight,* the parent company carried a manufacturing paper business, later it incorporated a wholly owned subsidiary, which nominally operated the waste-paper business. The parent company allowed the subsidiary to occupy its premises without consideration while retaining ownership of these premises.[43] The question before the court was whether the waste-paper business was carried by Smith or its subsidiary. This issue was crucial because only the owner of the premises could receive compensation. Atkinson J decided that the waste-paper business was the business of the parent company and that it was operated by the subsidiary as an agent of the parent company.[44] Unlike the position in *Salomon*, the subsidiary in *Smith* was found to be carrying on business as an agent of its parent and on that basis the court allowed the parent company to claim compensation for the compulsory acquisition of the subsidiary's premises.[45] The crucial difference between this case and *Salomon* is that in the *Smith* case the business of the subsidiary was never transferred and remained the property of its principal member. However, Moore concludes that nowadays "*a parent company will only be deemed by a court to be acting as a de facto agent of its subsidiary in a very exceptional range of circumstances*".[46]

In *Re FG Films*,[47] a US company wanted to profit from tax advantages offered by the British government. For this purpose, the US company incorporated wholly owned subsidiary in the UK. By using British subsidiary, the parent company created and released a movie; however, it was directed and filmed in the United States and financed by parent company money. Therefore, it was exceptionally hard to establish a sufficient link in order to use tax advantages. The court, in deciding whether or not to award tax advantages, held that the UK subsidiary was only an agent of the US company and refused to treat the UK company as a separate entity distinct in law from the parent company.[48] In a similar case concerned with tax payments, *Firestone*

[42] ibid [1026]-[1030] (Slade LJ)
[43] Moore (n 35) 184
[44] French, Mayson, Ryan (n 7) 135
[45] Kershaw (n 36) 58-60
[46] n 43
[47] [1953] 1 WLR 483
[48] However, the fact that one company is a subsidiary of another company does not itself make the subsidiary an agent of its parent company – *Ebbw Vale Urban District Council v South Wales Traffic Area*

Tyre & Rubber Co Ltd v Lewellin,[49] the court held that a foreign parent company who carried on business in England through its English subsidiary company was acting as an agent of the parent and was liable to pay UK tax.[50]

Around the 1970's, the courts increasingly demonstrated a desire to extend the range of situations where they could lift the veil of incorporation beyond fraud or agency circumstances.[51] The judges wanted to include the general approach based on the interest of justice principle.[52] In the 1985 case *Re A Company*,[53] the court lifted the veil when a defendant took steps to conceal his assets by forming a network of companies.[54] The court held that the veil should be lifted "*in order to establish exactly what defendant owned and where it was located and it should be done in the interest of justice irrespective of the legal efficacy of the corporate structure*".[55]

The same approach was later applied in *Creasey v Breachwood Motors Ltd*[56] where the veil was lifted in order to allow the plaintiff to receive damages for unfair dismissal. The company wanted to escape its liability by transferring the assets to another company incorporated solely for this purpose. The court held that in the interest of justice for the plaintiff, the veil should be lifted.[57] In a 1976 case, *DHN Food Distributors v Tower Hamlets*,[58] the court had to resolve the issue of veil piercing of the companies in a group. DHN operated a business on the premises of a wholly owned subsidiary company. Public authority compulsorily acquired the premises for the compensation available to DHN, provided they could prove their interest in the land. DHN had been the only licensee of the ground and therefore the company was not able to prove legitimate interest. However, the court recognised that both DHN

Licensing Authority [1951] 2 KB 366 [370] (Cohen LJ); see also F.G. Rixon, 'Lifting the veil between holding and subsidiary companies' (1986) Law Quarterly Review 102 415-423

[49] [1957] 1 All ER 561

[50] Wild, Weinstein (n 13) 29; see also *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd* [1916] 2 AC 307

[51] Dignam, Lowry (n 15) 34

[52] see also *Wallersteiner v Moir* [1974] 1 WLR 991

[53] [1985] BCLC 333

[54] Birds, A J Boyle (n 9) 67-68

[55] Morse (n 4) 28

[56] [1993] BCLC 480

[57] J.P. Lowry, *Lifting the corporate veil*, "Journal of Business Law", 1993, 41-42

[58] *D.H.N. Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852

and the owner of the ground were the same, single economic entity[59] and therefore refused to treat them as separate legal entities and enabled DHN to claim compensation for that mandatory acquisition.[60]

However, in *Woolfson v Strathclyde Regional Council*,[61] the court had to rule on a similar issue as the one presented in the *DHN* case – whether a subsidiary and parent can be regarded as a single economic entity. In *Woolfson*, the court retreated from the *DHN* ruling[62] in treating companies in a group as single economic entities.[63] Instead, Lord Keith declared that "*the veil would be pierced only where special circumstances exist indicating that it is a mere façade concealing the true facts*",[64] albeit he abstained from specifying what the term 'special circumstances' entails. Nevertheless, the *Woolfson* judgment was a direct refusal of both 'interest of justice' and 'single economic entity' precedents and more pro-*Salomon* ruling.[65]

As it can be seen, after judgments described above, already tangled veil lifting jurisprudence got even more complicated and incomprehensible. The Court of Appeal in the landmark *Adams v Cape Industries plc*[66] decision wanted to finally bring order and certainty to the confused body of case law. This case related to the issue of veil lifting in a group companies. Cape Industires was an international company, a US subsidiary of Cape pursued business related to asbestos. Due to the contact with asbestos, many employees suffered diseases and decided to sue the US company for damages – the US court awarded those damages. However, US subsidiary lacked funds to pay for the awarded damages to the claimants. Because of this, the claimants brought the case to the UK and sued the parent company to receive damages – an issue arose of whether the veil of incorporation could be lifted and whether US judgment could be executed against a UK parent

[59] Birds, A J Boyle (n 9) 76
[60] Ottolenghi (n 29) 349
[61] [1978] S.C. (H.L.) 90
[62] However, the *DHN* decision was not overruled but was distinguished on the facts, see Birds, A J Boyle (n 9) 76
[63] Same result in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563; *Dimbleby & Sons Ltd v NUJ* [1984] 1 All ER 751
[64] *Woolfson v Strathclyde Regional Council* [1978] S.C. (H.L.) 90 [96] (Lord Keith of Kinkel)
[65] Same approach was applied in *exempli gratia National Dock Labour Board v Pinn & Wheeler Ltd* (1989) 5 B.C.C. 75 and *Acatos & Hutcheson plc v Watson* [1995] 1 B.C.L.C. 218
[66] [1990] Ch. 433

company.[67] Claimants put forth arguments based on the previous precedents, *inter alia* 'the façade argument' (*Gilford* case), 'single economic unit argument' (*DHN* case) and 'agency argument' (*Re FG Films* case). The court rejected all of these arguments[68] and established a very restrictive approach to the veil lifting doctrine.[69] Lord Justice Slade explained his reasoning by referencing the *Salomon* judgment and stated that "*the subsidiary companies (…) will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities*".[70] He also explained possible exceptions to the *Salomon* ruling. The first exception was the argument put forward by Lord Keith in *Woolfson* – that the veil can only be pierced where special circumstances exist which indicate that the company is a mere *façade* concealing the true facts.[71] The second exception is if the company was incorporated to exercise a fraud, and the third exception is when statute allows to lift the veil of incorporation.[72]

The second exception was present in the case of *Re H*.[73] In this case, the defendants who controlled two companies made fraud of evasion of excise duties on a large scale and misappropriated money for their own benefit. The court, basing their rulings on *Adams*, held that in these circumstances, it was appropriate to lift the veil because of the fraudulent acts of the defendants.

The decision in *Adams* has been endorsed in many other rulings, *inter alia* - a 1998 case *Ord v Belhaven Pubs* Ltd[74] endorsed both *Adams* and *Woolfson*, and expressly overruled the *Creasey* ruling in which a justice argument was established as a precedent and doubted the validity of *DHN* decision.[75]

Another example of a veil lifting attempt following *Adams* was the *Trustor AB v Smallbone (No. 3)*[76] case, in which case the director of a company made unauthorized

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[67] As to the tortorious liabilty see also *Lubbe v Cape plc* [2000] UKHL 41 and *Chandler v Cape plc* [2012] EWCA Civ 525
[68] L. Linklater, *op. cit.*, 66
[69] Dignam, Lowry (n 15) 36-39
[70] *Adams v Cape Industries plc* [1990] Ch. 433 [536] (Lord Justice Slade)
[71] *Woolfson v Strathclyde Regional Council* [1978] SC (HL) 90
[72] Dignam, Lowry (n 15) 38-39
[73] [1996] 2 BCLC 500
[74] [1998] 2 BCLC 447
[75] Sealy, Worthington (n 24) 64
[76] [2001] 1 WLR 1177

transfers of money to another company, which was also controlled by him. The court lifted the veil "*because it was used as a device to conceal the true facts*".[77] As it can be seen, looking at the case examples presented above, the veil lifting jurisprudence became clearer and more comprehensible around the 1990s. This was done by overruling previous precedents and establishing in *Adams* a very restrictive, pro-*Salomon* approach to the veil lifting doctrine.[78] The exceptions to *Salomon* were those established in earlier cases such as *Gilford* or *Jones* – incorporation of the company as a cloak or the fraudulent purpose of incorporation.[79] Toulson J in *Yukong Line Ltd v Rendsburg Investments Corporation*[80] held that in the absence of above mentioned exceptions, the court will not lift the veil of incorporation.

The Supreme Court also had the opportunity to consider the problem of lifting the veil of incorporation. In *VTB Capital plc v Nutritek International Corp*,[81] the Supreme Court refused to extend the veil piercing doctrine to contract law.[82] Lord Neuberger stated that the court will not lift the veil because it is "*contrary to a higher authority*",[83] which was a referrence to the *Salomon* ruling. Also, the Supreme Court made ambiguous and somehow enigmatic remarks that it is not clear whether the doctrine of veil lifting actually exists.[84] It also referred to *Woolfson* and *Adams*, by saying that those rulings "*have some force in the argument"*.[85] However, they were *obiter dictum* and naturally not binding on the Supreme Court. The court adjudicated that without special circumstances, the veil of incorporation cannot be lifted,[86] which in fact endorsed the approach presented in *Adams*.

Another Supreme Court case, *Prest v Petrodel Resources Ltd,*[87] concerned the divorce of the parties and ancillary financial relief proceedings. Mr Prest claimed that he was not the owner of residential premises, but instead they belonged to a

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[77] Morse (n 4) 30
[78] Dignam, Lowry (n 15) 39
[79] L.C.B. Gower, *Gower's principles of modern company law*, London 1997, 137
[80] [1998] 1 WLR 294
[81] [2013] UKSC 5
[82] French, Mayson, Ryan (n 7) 139
[83] *VTB Capital plc v Nutritek International Corp* [2013] UKSC 5 [126] (Lord Neuberger)
[84] ibid [348] and see also P. Breakey 'Is piercing the veil contrary to high authority? A footnote to the never-ending story' 2013 Company Lawyer 34(11) 352, 353
[85] ibid
[86] *VTB Capital plc v Nutritek International Corp* [2013] UKSC 5 [139] (Lord Neuberger)
[87] [2013] UKSC 34, see also Daniel Lightman, Emma Hargreaves 'Petrodel Resources Ltd v Prest: where are we now?' 2013 Trusts & Trustees 19(9) 887-888

company, that was controlled by him. The question was whether Prest was entitled to those premises. Lord Sumption, giving judgment, used the so-called 'concealment principle' – which referred to a 'company as a *mere façade*' (*Woolfson*)[88] – and the 'evasion principle' (explained in *Gilford* and *Jones* above).[89] In the *Prest* case, the court decided that the veil cannot be pierced in the absence of impropriety[90] and concluded that the "*veil can be pierced only if it is necessary to do so and when all other remedies have proved to be of no assistance*".[91] This case proved adequacy of court decisions following *Adams* and once again presented a pro-*Salomon* approach.[92]

V. CONCLUSION

Throughout this article, the author presented two available manners of lifting the veil of incorporation in the company law of the United Kingdom – statutory devices established by the Parliament and judicial precedents. As it was explained, until judgment in *Adams*, the case law was completely tangled and as Keenan concludes "*it was difficult to be precise about the circumstances in which a judge will lift the corporate veil*"[93] or, as Dignam submits "*the most accurate statement about situation when the veil can be lifted is that sometimes the courts lift the veil and sometimes they refuse to*".[94] Without a doubt, at that time it was "*a wilderness of isolated precedents*".[95] However, scholars suggest that the peak of the precedents approach was the *DHN* case[96] and then, after the decision in *Adams*, the trend had changed to represent a strong affirmation of the *Salomon* principle, allowing only a narrow and well established exception to justify the judicial veil lifting,[97] such as those explained in *Woolfson*. Prentice also concludes that "*Salomon has proven remarkably durable (…) and in current form may endure for another hundred years*".[98] However, recent Supreme Court judgments indicated a still uncertain

[88] ibid [28] (Lord Sumption)
[89] ibid [35] (Lord Sumption), [81] (Lord Neuberger)
[90] Dignam, Lowry (n 15) 42-43
[91] *Prest v Petrodel Resources Ltd* [2013] UKSC 34 [63] (Lord Neuberger)
[92] French, Mayson, Ryan (n 7) 141
[93] Wild, Weinstein (n 13) 27
[94] Dignam, Lowry (n 15) 33
[95] Prentice (n 1) 469
[96] Sealy, Worthington (n 24) 54
[97] Kershaw (n 36) 76-77
[98] Prentice (n 1) 485

approach to the veil lifting doctrine, and as Ottolenghi urged "*it is time for the legislature to lay down definite rules to this branch of company law*".[99]

[99] Ottolenghi (n 29) 338

CEFTA and CISFTA as Mechanisms for Introducing Free Trade in Central and Eastern Europe Post-1989

Maria Bun[*]

Abstract

Central and Eastern European (CEE) states and the Commonwealth of Independent States (CIS) have had to adopt and adapt to international trade norms in a very short period of time since the region begin its transition to a free market. What challenges threaten trade relations in post-communist Europe in the context of current geopolitical trends? Do they measure up to global standards? Part I of this paper opens with a definition of the regional groupings in the CIS and CEE areas and offers a historical overview of the transition from trade under communism to the plurilateral trade agreements in place today. Part II explores some intermediary challenges to regional integration, such as power imbalances in the CIS and the failure of CEE regionalism. Part III compares the approaches to trade liberalisation in the CISFTA and CEFTA and contrasts integration in the CEE with isolation in the CIS to show the diverging commercial trends in the two regions. The final Part IV explores the implications of CIS and CEE trade policies with a view to these states' continued integration in global markets.

I. INTRODUCTION

It is a quarter century after the fall of old communist regimes in Eastern Europe and the economies of post-communist states are still newly born. When centrally planned markets gave way to economic liberalisation in 1989, post-communist Central and Eastern Europe (CEE) started to build its political and financial institutions from an invisible foundation. As new actors in international trade, these states created for themselves a framework for external economic

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relations that had never existed before. Marketplaces behind the fallen iron borders found themselves suddenly open to new products and flourishing commerce. Over the past 25 years, the CEE region has lifted itself from poverty and developed economies more stable than ever in their history. A large part of this economic development can be attributed to the opening of trade markets through the ratification of bilateral and multilateral trade agreements within the region and with the rest of the world. But not all new CEE democracies are cut from the same cloth.

Examining the paths taken by former Soviet states in comparison to their post-communist neighbours to the West, it becomes clear that differing approaches to trade relations have led to opposing patterns of development in the region. The area of the Commonwealth of Independent States (CIS) followed trade policies more isolationist in nature, as evidenced by the implementation of the Commonwealth of Independent States Free Trade Agreement (CISFTA) and its intended economic union. Non-Soviet CEE states, to the contrary, adopted more integrationist tactics. These included the negotiation of the mechanisms of accession to the European Union (EU) and the Central European Free Trade Agreement (CEFTA). In the CEE, this led to a fast-paced liberalisation of trade, a great increase in imports and exports, and closer economic relations with the EU.

Two focus questions arise. On one hand, how have the two regions responded to international trade norms, and do they continue to measure up to global standards? Furthermore, what challenges threaten post-communist Europe in light of the region's approach to trade relations in the context of current geopolitical trends?

Part I of this paper opens with a definition of the regional groupings in the CIS and CEE areas and offers a historical overview of the transition from trade under communism to the plurilateral trade agreements in place today. Part II explores some intermediary challenges to regional integration, such as power imbalances in the CIS and the failure of CEE regionalism. Part III compares the approaches to trade liberalisation in the CISFTA and CEFTA and contrasts integration in the CEE with isolation in the CIS to show the diverging commercial trends in the two regions. The final Part IV explores the implications of CIS and CEE trade policies with a view to these states' continued integration in global

markets.

The analysis of the CEFTA and CISFTA shows a strong dichotomy between integration and isolation. The two respective regions have consequently faced very different levels of economic growth. The CEE, aiming towards integration, has enjoyed significantly more development than the more insular CIS region. However, an examination of current geopolitical trends shows that part of the CIS is following in the footsteps of the CEE by developing stronger trade relations with the EU and the rest of the world. While this move from isolation to integration will prompt the growth of those states' economies, it poses a threat to CIS cohesion and decreases Russia's economic influence in the region.

II. BACKGROUND

A. Definitions

The groupings referred to throughout this paper differentiate between the EU-oriented CEFTA region and the Russia-oriented CIS region. For these purposes, the CEE refers to the CEFTA founding parties, and subsequent members who are all now members of the European Union. These include Poland, Hungary, Slovakia, and the Czech Republic as well as Romania, Bulgaria, Slovenia, and Croatia. This grouping also encompasses the current CEFTA parties, namely Macedonia, Bosnia & Herzegovina, Albania, Serbia, Montenegro, Moldova, and Kosovo. CIS states include the parties to CISFTA, namely Russia, Ukraine, Moldova, Belarus, Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.

B. Trade pre-1989

After building a trading system from the ground up, this region's substantial economic growth makes for a pertinent analysis of the trade liberalisation factors that contribute to development. Before the opening of the markets, communist Europe traded through a system of bartering and mutual exchange of goods.[1] Other states,

[1] Eric Engle, ed, *The EU, Russia, and the Commonwealth of Independent States* (The Hague: Eleven International Publishing, 2012) at 6

like Romania, abstained from trade altogether.[2] For states that did trade, foreign commerce was limited. The United States often used its trade relations as a political tool to influence and contain Soviet policy.[3] When it did occur, foreign trade was not so much "trade" as it was a sort of bartering system. For example, Russia and Cuba would exchange goods through a bartering system in which one party sent manufactured products that the other exchanged for shipments of sugar.[4]

States that were more reluctant to trade would not import goods even when their own supplies ran dry. In communist Romania, for example, power outages were the rule rather than the exception due to recurring domestic energy shortages. Nicolae Ceausescu's government mandated blackout hours that ran shorter or longer depending on the state's energy supply.[5] In terms of consumables, the supply was limited to locally produced materials. The USSR secured its rations by seizing agricultural products from farmers in its satellite states. Hungarian producers, in particular, suffered within this quota system.[6] More "exotic" products were rarely available because the central powers simply did not import them. Markets were very limited in the CEE and CIS before 1989; trade virtually did not exist. Filling in the gaps proved to be slow and challenging. In fact, it took the better part of the 1990s for CEE states to become self-sufficient economies, and the effort continues even today in some post-Soviet markets.

Building a trade framework was thus a large undertaking. These efforts began in the USSR in the mid-1980s, when socialist states began a series of reforms to gradually liberalise markets and eventually accede to the GATT.[7] After the 1989 revolutions, CEE followed suit. For the most part, these states presently meet the membership requirements of the WTO, an indicator of the compliance they have

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[2] Joseph Rothschild and Nancy M Wingfield, *Return to Diversity: A Political History of East Central Europe Since World War II* (Oxford: Oxford University Press, 2000) at 246—247

[3] E.g. the United States extended a "conditional" MFN rate to the USSR throughout the 1960-70s which it could (and did) withdraw at any time. See Backgrounder from Susan P Woodward (7 May 1979) in The Heritage Foundation vol 83, online: <heritage.org/research/reports/1979/05/most-favored-nation-status-trade-with-communist-nations>

[4] José F Alonso and Ralph J Galliano, "Russian Oil-For-Sugar Barter Deals 1989—1999" (1999) 9 Cuba in Transition: Papers and Proceedings of the Ninth Annual Meeting of the Association for the Study of the Cuban Economy, cited in Engle, *supra* note 1

[5] Rothschild & Wingfield, *supra* note 2

[6] *Ibid.* at 158

[7] IMF, European Department, *25 Years of Transition: Post-Communist Europe and the IMF*, Regional Economic Issues, Special Report (Washington: IMF, 2014) at 2—3 [*IMF Report*]

achieved with international trade norms. Most are either full WTO members or they are on the road to accession. However, the transition has not come easily.

III. EARLY OBSTACLES TO REGIONAL INTEGRATION

Early developments in post-communist trade led to some successes and some failures throughout the 1990s. The main policy orientation was towards regionalism, a natural continuation of the close political economic ties that already existed under the communist regimes. By definition, regionalism is an attempt at greater integration between two or more economies.[8] At the outset of the post-1989 transition, regionalism was tempered by state sovereignty. Due to this and other initial instabilities, regionalism proved unsuccessful across post-communist Eastern Europe.

As the first part of this section will demonstrate, CEE states did not create strong mutual trade relations. In order to progress beyond their own abilities, they required external intervention. To this end, the EU offered economic assistance, signalling a clear intent to promote integration between the two regions.[9] This partnership formally took the form of the CEFTA agreement in 1992. The CEFTA was to be a mechanism for European integration, a means of introducing the framework of free trade, and a form of assistance to promote economic development.

The CIS attempted its own form of regionalism, though it was poorly implemented and more fragmented than in the CEE. The second part will explain the challenges CIS states encountered in this early stage of development. As a reflection of many failed attempts at regionalism, internal divisions arose within the CIS. Great power imbalances developed as well, which continue to this day. Many states consequently turned to smaller regional groups and to the WTO to avoid overdependence on Russia despite the CISFTA that they renegotiated in 1999 and again in 2011 to replace the region's multiplicity of bilateral and plurilateral trading schemes.

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[8] Michael Roberts and Peter Wehrheim, "Regional Trade Agreements and WTO Accession of CIS Countries" (2011) 36:6 *Intereconomics* 315 at 316

[9] *IMF Report*, *supra* note 7 at 33

A. The failed CMEA experiment

Before embracing European integration, the CEE region attempted to structure its trade policy as a collaborative trading bloc. This took the form of the Council for Mutual Economic Assistance (CMEA), which originally included Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union, but later spanned across the entire communist world, even though it proved to be a failure.[10] Trade among its members was limited, implying that intra-regionalism would not be a success in the years following the dissolution of the Soviet Union and the fall of communist regimes in CEE states.

Some argue that the CMEA did nothing to increase trade relations due to its members' inherent aversion to trade.[11] Trade policy in communist Europe was implemented narrowly as a function of communist leadership models that relied predominantly on domestic production. Furthermore, power struggles between the Soviet Union and non-Soviet members threatened the collaborative goals of the CMEA.[12] Taking these factors into consideration, both economic policy and political division can explain the low occurrence of trade in communist Europe under the auspices of the CMEA.

Trade policy in the region diverged radically when the CMEA became defunct. CEE states, perhaps influenced by their earlier political division within the CMEA,[13] realized that intra-regional trade would not lead to substantial economic growth. The CEFTA was negotiated in 1992 and came into effect on March 1st 1993,[14] its framework clearly distinct from the previous CMEA-imposed isolation. While the post-Soviet states remained insular, CEE turned to Europe.

B. The CEFTA is born

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[10] United States, Library of Congress Federal Research Division, *Czechoslovakia: A Country Study*, by Ihor Gawdiak (Washington: Library of Congress, 1989), online: < http://www.loc.gov/item/88600487/>

[11] Martin Dangerfield, "CEFTA: between the CMEA and the European Union" (2004) 26:3 Journal of European Integration 309 at 312

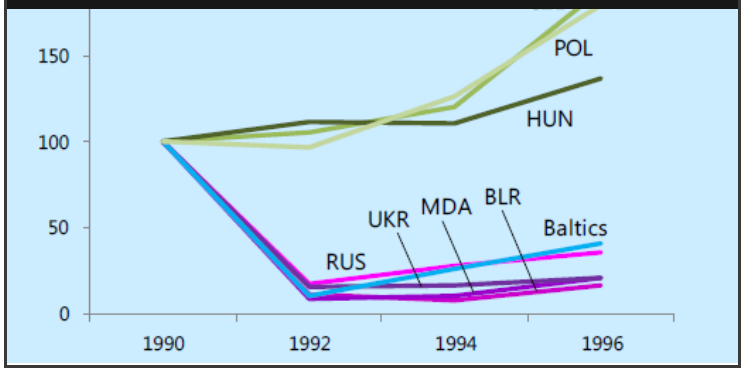
[12] Elena Dragomir, "The Formation of the Soviet Bloc's Council for Mutual Economic Assistance: Romania's Involvement" (2012) 14:1 Journal of Cold War Studies 43

[13] *Ibid.*

[14] *Central European Free Trade Agreement (CEFTA)*, signed 21 December 1992, entered into force 1 March 1993, 34 ILM 8 (1995) ch 3 art 40(1) [*CEFTA*].

In complete opposition to the CMEA's restrictions on economic relations with non-CMEA members, the CEFTA was an effort directed by the European Union and embraced in the CEE region for its emphasis on regional integration with Europe. It marked a symbolic turn from isolation to openness, an attitude well captured by Andras Köves: "Joining Europe, as seen from Poland or Hungary, is not just joining a dynamic form of regional integration (the EC) in place of the defunct CMEA but integration into the international economy after forty years of involuntary seclusion."[15]

Figure 1: Gross Exports of Selected CEE Countries



Source: IMF

The original CEFTA agreement between Poland, Hungary, Czech Republic, and Slovakia, identified three objectives: (i) to expand trade, develop economic activity between the Parties, improve living conditions, and increase productivity and financial stability; (ii) to introduce competition in the free market; and (iii) to contribute to the WTO's goals of removal of barriers to trade and expansion of world trade.[16] It was a response to the poor performance of centrally planned economies under the regimes of the past as well as a commitment to European integration. The CEFTA also had a clear purpose of serving as an accession mechanism to the EU. Trade would play an important role in the region's economic development, as would stimulus from the EU through various CEFTA-related instruments.

Meanwhile, trade remained stagnant in the post-Soviet region throughout the 1990s (see Figure 1). The new democracies assembled themselves into the Commonwealth of Independent States, conducted a number of bilateral trade treaties among each other, and formed their own free trade agreement that came into effect

[15] Cited from Dangerfield, *supra* note 11
[16] *CEFTA*, *supra* note 14 art 1(2)

in 2011, although it has not yet been fully implemented. As will be discussed shortly, the CIS threw off its own isolationist shackles to embrace free trade, only much later, and to a different extent than the CEE.

C. Divisions in the CIS

It is counterintuitive to imagine that an economic union like the USSR would have trouble picking up the pieces after its dissolution to create a system of mutual economic relations, albeit one based on the free market rather than planned economies. Indeed, the CIS remained reluctant, or perhaps unable, to create a cohesive trade system throughout much of the 1990s. A partial reason for this is their desire to preserve close ties with their neighbours while at the same time protecting their newly attained sovereignty.[17] Despite commonalities in their legal systems and governance structures, CIS states were unable to transform the Soviet model of regionalism into a modern form of liberal trade.[18] Andrei Shleifer and Daniel Treisman suggest this was because the CIS was "torn between the global phenomenon of economic modernization and geographical convergence".[19] Similar to the CEE, CIS states found themselves within a larger network of economic actors. However, their import and export markets were still inter-dependent. The CIS was faced with a double-edged sword: regionalism offered a stable continuation of trade practices with assured trading partners and similar legal frameworks, but resulted in stagnation; on the other hand, global integration was desirable for its potential to stimulate growth, but most of the CIS was too underdeveloped to participate. The dispersed regional groupings that emerged at this time indicated a *de facto*

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[17] Joop de Kort and Rilka Draganeva, "Russia's Role in Fostering the CIS Trade Regime" (Paper delivered at the European Association for Comparative Studies 9th Bi-Annual Conference, Brighton, 7—9 September 2006), Leiden University Faculty of Law at 1; see also Steven Aris and Mark Webber, "Loosely-coupled Confederalism: The Commonwealth of Independent States and the Post-Soviet Space" in Sören Zibrandt von Dosenrode-Lynge, ed, *Limits to Regional Integration* (Surrey: Ashgate 2015) 133.

[18] For a discussion of the convergence of commercial law within the CIS, see Alexander Trunk, "Harmonization of International Commercial Law Within the Commonwealth of Independent States" in Morten M Fogt, ed, *Unification and Harmonization of International Commercial Law* (Netherlands: Kluwer Law International, 2012) 223.

[19] Andrei Schleifer and Daniel Treisman, "Normal Countries: The East 25 Years after Communism", *Foreign Affairs* (November/December 2014), online: <scholar.harvard.edu/shleifer/publications/normal-Countries-East-25-Years-After-Communism>

commitment to integration, but the economic viability was limited due to various non-tariff barriers to trade.[20] A great decline in intra-CIS trade indicated that the CIS had turned to domestic production or third country imports as an alternative to any cooperative trade agreement. In other words, regionalism had failed in the CIS as well.

1. Non-tariff barriers to trade

The CIS' failure to coordinate its economic policy was not for lack of trying.[21] Wehrheim makes a distinction between the creation of *de jure* structures for integration and *de facto* implementation through reciprocal trade. Before being consolidated into the CISFTA, many bilateral trade agreements (BTAs) existed in the region.[22] They were not implemented for the most part. In fact, even today the CISFTA is not fully ratified and implemented by all parties. The IMF reports that these "partnership agreements" differed in nature from the BTAs that Central and South-Eastern European states signed with the EU, and that they did not entail much liberalisation in practice.[23] Certain barriers prevented the smooth operation of a regional system of trade prior to the CISFTA.

Corruption is a non-tariff barrier that constitutes a reality in the CIS zone. The implementation of RTAs requires a complex system of administration and classification. Customs declarations, seemingly simple in nature, were not easy to put in place, where no customs declarations had ever existed before. Because of weak border control and lack of discipline in customs officials, smuggling and corruption led to the under-valuation of imports.[24] Additionally, parties would often choose to apply the most favoured nation (MFN) rate for imported goods because it was more cost-effective than establishing the product's origin, which could cost up to 5% of

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[20] Roberts & Wehrheim, *supra* note 8 at 323

[21] Aris & Webber, *supra* note17, offer an extensive description of the regional subgroupings that emerged in the CIS before the CISFTA came into force.

[22] Roberts & Wehrheim, *supra* note 8 at 320

[23] *IMF Report*, *supra* note 7

[24] Lev Freinkman, Evgeny Polyakov and Carolina Revenco, "Trade Performance and Regional Integration of the CIS Countries" (2004) World Bank Working Paper No 38 at 2, online: <elibrary.worldbank.org/doi/abs/10.1596/0-8213-5896-0> [*World Bank*]

the product's total value.[25] Such tactical issues discouraged rigorous application of the new trading norms agreed upon through the BTAs and resulted in more barriers than the CIS could have envisioned, with an eventual result of stagnant intra-regional trade.

A second non-tariff barrier that plagued the early stages of CIS free trade was the absence of secure trade corridors. The multiplicity of bilateral and plurilateral agreements created a segmented network of trade between different parts of the CIS. While inclusive of some, these agreements excluded others. For example, the GUUAM regional organisation hoped to develop a transit corridor with Central Asia in order to bypass Russia as a middleman.[26] Because the CIS could not, or perhaps would not, establish and maintain a unified transit network for either outbound or intra-regional trade, divisions inevitably formed.

2. Harmonisation and conformity with WTO standards

Yet another challenge that any newly formed free market will encounter in its infancy is a struggle to keep up with longstanding international standards and norms. Just as international watchdog organisations monitor post-communist democratic development,[27] the WTO holds a mandate to oversee its members' compliance with trade norms. In order to facilitate CIS compliance with the WTO's expectations, the World Bank recommended the harmonisation of CIS regional trade agreements with WTO practices so that "the CISFTA may serve as a vehicle for global trade integration".[28] In practice, this has not exactly been the case, neither within the CISFTA nor among its predecessors.

Exclusion clauses disqualified many RTAs within the CIS from qualifying under article XXIV as legitimate FTAs because they did not cover "substantially all trade". The CIS giants: Russia, Ukraine, and Kazakhstan excluded 40% of goods from BTAs of the 1990s.[29] They were able to do so in accordance with an enabling

[25] Roberts & Wehrheim, *supra* note 8 at 317
[26] *Ibid.* at 322
[27] For example, the OSCE's oversight of elections in the CIS region, and the recent UN missions to monitor and report on Ukraine's federal elections. See www.osce.org and the OSCE Special Monitoring Mission in Ukraine, www.osce.org/ukraine-smm
[28] *World Bank*, *supra* note 24 at 53
[29] *Ibid.* at 45

clause like the one in article 3(2) of the CISFTA.[30] Prior to 1999, there was a mutual understanding that allowed CISFTA parties, especially the economically influential ones, to enact arbitrary exclusions.[31] At the same time, Russia was the top trading partner for all CIS states, receiving 80% of their exports.[32] A large disparity between the expectations of free trade benefits and the actual benefits accrued paints a grim picture of the difficult early stages of regional trade in the CIS. Most of the trade arrangements were clearly unilateral, with benefits not evenly distributed but largely in favour of the more developed parties. It was the informal concessions offered by the powerful parties, like lower energy prices, that kept the less productive CIS states committed to regional participation.

More complex standards concerning anti-dumping and intellectual property protections would prove even more difficult for CIS states to measure up to. The distortion in levels of development creates a difficulty in harmonisation of standards within the CIS region. This difficulty is magnified when considering the inability of the CIS to measure up to the even higher global standards. There is a parallel with the recent critiques of the high standards of Trans-Pacific Partnership for IP protections and whether some parties will be able to meet them. In some ways, CIS states that are not able to comply with international trade standards can serve as a detriment to the region's performance as a whole, leading to further isolation and the inability of some members to participate in global trade because they are held back by dependent trade partners.

3. Subregional groupings

CIS states embraced sovereignty as a defining principle of statehood after the dissolution of the USSR, ruling out the possibility of extensive supranational control exerted by an overarching institutional entity. Because post-Soviet states wished to regulate their own affairs, they did not develop many means of formal cooperation.

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[30] *Commonwealth of Independent States Free Trade Agreement* (*CISFTA*), proposed 15 April 1994, signed 18 October 2011, entered into force 2012 (Armenia, Belarus, Kazakhstan, Moldova and Russia), 2013 (Kyrgyzstan), 2014 (Uzbekistan) art 3(2) (allows parties to create a "general Schedule of exceptions to free trade regime and methods of application") [*CISFTA*]

[31] Kort & Draganeva, *supra* note 14 at 7

[32] *IMF Report*, *supra* note 7 at 33

Rejecting any institutional encroachment of state sovereignty and enacting only ad-hoc cooperation measures amounted to a sort of "loosely-coupled confederalism" according to Aris & Webber.[33] This also meant that the CIS region did not enact any significant changes in their trade practices or policies.[34] Even when the CISFTA was signed in 1994 it was largely aspirational. It "envisioned" the elimination of trade barriers and the creation of an economic union but failed to put in place the mechanisms required to execute those trade goals.

The CIS, even after concluding the CISFTA, was not committed to regionalism nor to the principles of confederalism that would be necessary to implement it at the institutional level. Additionally, the region itself was divided due to the economic and geopolitical pull of neighbours outside the CIS. Eric Engle claims that the CIS failed to establish itself because it lacked a common vision and due to inexperience with the administration of supranational institutions.[35] Interestingly, though, these elements can be observed within smaller regional groupings, indicating that certain CIS states did share a common vision for development, and even the will to institutionalise it.

CIS states signed a multitude of institutional and supranational agreements with new trading partners throughout the 1990s.[36] This was especially the case during Russia's rouble crisis of 1998. Scholars and some of the organisations themselves, such as the Eurasian Economic Community, claimed that subregional agreements allowed stronger cooperation that was not possible within the CIS framework.[37] The World Bank suggests that acting as global players within the international trade network would help these newly independent nations develop, but the 1990s were not an overall success in the CIS. Domestic production capacities were limited and

[33] Aris & Webber, s*upra* note 17 at 135
[34] Roberts & Wehrheim, *supra* note 8 at 322
[35] Engle, *supra* note 1 at 12
[36] Plurilateral subregional agreements include the *Economic Cooperation Organisation* (ECO) between Afghanistan, Iran, Pakistan and Turkey; the *Black Sea Economic Cooperation Organisation* (BSEACO) between Armenia, Azerbaijan, Georgia, Moldova, Russia and Ukraine along with Albania, Bulgaria, Greece, Romania and Turkey; the *GUUAM* mutual support group of Georgia, Ukraine, Uzbekistan, Azerbaijan, and Moldova; the *Central Asian Economic Union* (CAEU) including Kazakhstan, Kyrgystan, Uzbekistan and Tajikistan; and the *Eurasian Economic Union* (EEU)between Russia, Kazakhstan, and Belarus as well as Tajikistan and the Kyrgyz Republic. See Roberts & Wehrheim, *supra* note 8 at at 321
[37] Trunk, *supra* note 18 at 227.

states possessed no comparative advantage that would allow them to trade efficiently with more developed nations.

The political divisions that arose within these subregional groupings posed a threat to the CIS. GUUAM was very critical of the CIS and presented itself as a more functional alternative. Ukraine further sought to distance itself and rely on its independence following a trade dispute with Russia over sugar.[38] This particular sugar crisis is only exemplary of the greater conflict that existed between CIS states in agricultural trade, which comprised the largest part of CIS trade in the 1990s.[39] While some CISFTA parties preferred other regional trade nodes to the weaker CIS alternative, and conflicts developed between various groups, some members chose to remain neutral.[40] These disputes illustrate the progression (or lack thereof) of the CIS in the 1990s, marked by divided subregionalism and lack of cohesion in the former USSR. The CIS rolled into the new century with an equal lack of supranational cooperation.

D. Convergence: the CISFTA Agreement

The CISFTA was signed in 1994[41] but languished for fifteen years until a new agreement was signed in 2011, to be ratified by individual parties between 2012 and 2014. Why was the CISFTA no more than a ghostly presence until so long after its inception?

The global trend in regional trade agreements in the 21st century is one of convergence, or the gathering together of a spaghetti bowl of trade agreements.[42] Following the successes of some of its existing regional agreements, CIS states began to ratify the CISFTA treaty within their national parliaments. They drew elements from some developments of the 1990s to create a model for *de facto* regionalism. The

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[38] Roberts & Wehrheim, *supra* note 8 at 322

[39] *World Bank*, *supra* note 24 at 9

[40] Turkmenistan, for example, did not join any of the CIS plurilateral agreements and its economy developed with a low level of regional integration. See Roberts & Wehrheim, *supra* note 8 at at 321; *World Bank*, *supra* note 24 at 9, 23.

[41] *CISFTA*, *supra* note 30 art 25(3)

[42] Roberto V Fiorentino, Luis Verdeja and Christelle Toqueboeu, "The Changing Landscape of Regional Trade Agreements" (2006) World Trade Organization Trade Policies Review Division Discussion Paper No 12 at 2, online: <https://www.wto.org/english/res_e/booksp_e/discussion_papers12a_e.pdf>

Russia-Belarus Economic and Monetary Union, which included a common currency and supranational institutions, inspired the economic and customs union proposed in articles 1 and 21 of the CISFTA.[43] The GUUAM, which was seen as an alternative to the CIS, inspired the harmonisation provisions in articles 1(1), 4, 6, and 7 in the areas of economic policy, technical regulations, nomenclature, and customs duties.[44] In Central Asia, some CIS states were already implementing an economic union by pooling their resources together to create economies of scale in order to facilitate more efficient trade.[45] Successes at the sub-regional level had an influence on the willingness of the CISFTA parties to put a larger trade agreement into effect.

Developed from a mixed model of amalgamated Soviet law and model legal codes, the CISFTA was notified by Kazakhstan to the WTO in 1999.[46] The WTO does not yet recognize it as being in force while parties are still in the process of ratification. However, it is clear that intra-regional CIS trade increased in the 21st century in comparison to the 1990s, with the exception of Russia and Ukraine, which have reoriented their trade to new partners.[47] The following section will take a closer look at the trade liberalisation provisions in both the CISFTA and CEFTA and how they are being implemented.

IV. PROVISIONS RELATING TO TRADE LIBERALISATION

Though each region lacked some form of cohesion in their post-revolution economic policies, they both shared a common goal of transitioning to free markets. Trade agreements played an important role in this development. They called for the development of economic instruments like Protocols for the implementation of customs duties,[48] and other multilateral agreements.[49] For the most part the economic goals of post-communist states were expressed in broad and aspirational terms. A closer look at the statistics shows that they did achieve liberalisation, in some cases

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[43] Roberts & Wehrheim, *supra* note 8 at 320.
[44] *Ibid.* at 321
[45] Roberts & Wehrheim, *supra* note 8 at 321
[46] Regional Trade Agreements Notified to the GATT/WTO and in Force, WTO RTA Database, online: <rtais.wto.org/>
[47] *World Bank*, *supra* note 24 at 56
[48] *CEFTA*, *supra* note 14 art 3(2)
[49] Kort & Draganeva, *supra* note 14 at 7

quicker than in others. This section will consider various indicators of trade openness in the CEE and CIS in order to compare and contrast their development, and to evaluate the role of regionalism in this transition. Indicators of trade liberalisation include exports as a percentage of GDP, annual growth of GDP, the level of product diversification, and a composition of each state's trading partners.

A. In the CEFTA

Trade data in the CEE region matches up to the aspirational statements that inspired the CEFTA agreements of 1992 and 2006. Stemming from their commitments in the Visegard Declaration, the CEFTA founding parties were oriented toward European integration. They also identified a commitment to free markets as the base of economic relations as did the CISFTA.

The CEFTA identified European integration as a key goal in articles 14.3, 20, 21, and 27. Article 14(3) binds the CEE region's technical regulations (such as the administration of customs duties and tariffs to WTO standards and EU regulations. Articles 20 and 21 introduce competition rules in the brand new liberal economies in alignment with the well-established EU equivalents.[50] Article 27 goes on to extend the objective of liberalisation to the market for services "in the context of European integration".

More generally, the CEFTA shows a clear commitment to free trade in its preamble. State parties identified a commitment to "the principles of market economy, which constitute the basis for their economic relations" and to "pluralistic democracy based on the rule of law, human rights and fundamental freedoms" .as their primary goal[51] They further resolved to "conduct their mutual trade relations in accordance with the rules and disciplines of the WTO whether or not they are members of the WTO". There has been significant progression towards pluralistic democracy, and all former and current CEFTA parties are now fully recognized WTO members. Trade relations have also evolved in the direction envisaged in the original agreement among all parties, old and new.

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[50] For an example of the EU regulations, see the Treaty Establishing the European Union, arts 81, 82, 86, 87.

[51] *CEFTA*, *supra* note 14 Preamble

B. In the CISFTA

1. Growth from the ground up

CISFTA commitments to free markets followed along the same lines as the CEE, but they were more oriented towards technical goals of basic fiscal growth, the improvement of living conditions, and forming an economic union. The CIS region also showed less of an interest in WTO accession in comparison to the CEE's full representation as of 2000. Most CISFTA parties hold WTO membership, with the exception of Uzbekistan and Azerbaijan. Kazakhstan acceded in 2015.[52] The remaining CISFTA parties are currently only observers and are at various stages of WTO accession.[53] While the CEFTA indicates clear alignment with the WTO's mandate for the removal of barriers to free trade and greater global cooperation on the harmonisation of trade norms, the CSIFTA does not.

Even the aspirational provisions of the CISFTA target development on a smaller scale, in contrast to the goals of the CEFTA outlined above. The preamble guides regional trade efforts towards "introducing in practice the principles of market economy" in a similar vein to the CEFTA, but in comparison to the subsidiary CEFTA goals of democratic development and international integration, the CISFTA further identifies the "stabilization of economic conditions" and an "aspiration to the regular increase of living standards of the population".[54] It is hard to say exactly how a free trade agreement can bring about the envisioned change in living standards. This paper has so far investigated economic growth in relation to regionalism, but the focus shifts now to actual indicators of growth with the aim of determining the effect of trade openness on economic development in both the CIS and CEE.

2. Measuring development in the CIS

(1) Sovereignty and Isolation

At its outset the CISFTA attempted to bring together the CIS states in a supranational way that did not exist prior to 2011. Whereas the CEFTA is structured

[52] WTO, online: <https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm>
[53] *Ibid.*
[54] *CISFTA*, *supra* note 30 Preamble

to limit intra-regional dependence, the CIS emphasizes it through the creation of a customs union and through *de facto* trade patterns. This can perhaps be explained by low levels of trade openness and the fact that market-based institutions were slow to emerge in the CIS. Furthermore, the creation of an economic union accentuates reciprocal trade obligations that mainly depend on Russia. The first consequence of the CISFTA economic union is that it imposes limits on relations with other markets. Article 1(1) envisions the "coordination of trade policy with respect to the countries which are not signatories to this Agreement" and article 1(4) requires contracting parties to "refrain from actions that contradict the provisions of this Agreement and prevent from achieving its objectives (...) in particular, terms and conditions of participation (…) in other regional economic groups".[55] Article 15 extends cooperation and coordination of economic activity on "issues of export control", which has led to an observable trend of trade deflection. Because of their strategic position as the portal to Central Asia, Russia and Kazakhstan act as "regional distribution centres" that bring in goods from less developed CIS states and trade them with their own partners. They are able to circumvent the rules of origin agreements by bribing officials into forging certificates that attribute origin to Russia, at a lower cost than the revenue obtained from the applied tariff rate.[56] The internal cooperation provisions in the CISFTA are orchestrated to continue the informal nature of CIS trade patterns, which were often haphazard and skewed in favour of the region's more powerful members.

The CISFTA's isolationist nature goes one step further with the Notify and Inform clause, which states that any party to the agreement must conduct their trade and integration agreements through the CISFTA administration.[57] This captures an explicit obligation for all states to negotiate trade flows with the CIS as a whole, subject to the approval of all trading partners. This allows the CISFTA administrative bodies to take on such an important role that their instruments supersede international standards. Article 20(1) requires that compliance with international

[55] *CISFTA*, *supra* note 30 arts 1(1), 1(4)
[56] *World Bank*, *supra* note 24 at 5
[57] *CISFTA*, *supra* note 30 art 20(3)

agreements does not contradict any terms of the CISFTA.[58] This is quite a departure from the reluctance of the CIS to commit to supranationally imposed norms until 2011.

State sovereignty over economic policy comes to a crossroads with the CISFTA. On one hand, the agreement asserts the right of the parties to act outside the confines of the economic union and the cooperation clauses described above. Article 2 serves as an exception clause: "The Contracting Parties shall reserve the right to a self-dependent and independent determination of a regime of foreign economic relations with the States which are not signatories to this Agreement".[59] But economic decisions at the national level are restricted by articles 1(1) and 1(4), which place the decision-making power in the Council of Heads of States. From a legal point of view, the Council's decisions are of a declaratory political nature rather than an international agreement.[60] From the perspective of international law, this violates state sovereignty.[61] The ambiguity between the trade agreement's validity as a restrictive supranational economic union and CIS states' own decision-making power is one that further emphasizes how the CISFTA has not been thus far meaningfully implemented.

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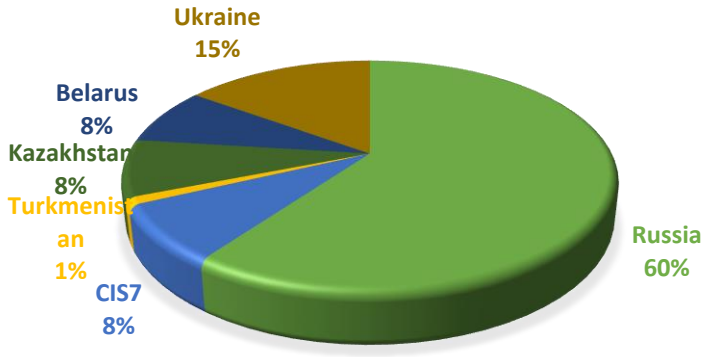
[58] "Nothing in this Agreement can be considered as something that prevents any of the Contracting Parties from fulfilling the taken obligations in compliance with any other international agreement of which this Contracting Party is a signatory or may be a signatory, provided these obligations do not contradict the provisions and objectives of this Agreement", *CISFTA*, *supra* note 30 art 20(1)

[59] *Ibid.* art 2

[60] Kort & Draganeva, *supra* note 14 at 2

[61] Under international law, valid treaties create obligations only with the "mutual consent" of all parties. See Hugh M Kindred, Phillip M Saunders and Robert J Currie, eds, *International Law Chiefly as Interpreted and Applied in Canada* (Toronto: Emond Montgomery Publications, 2014) at 7

Figure 2: Composition of CIS Trade Flows, 2001



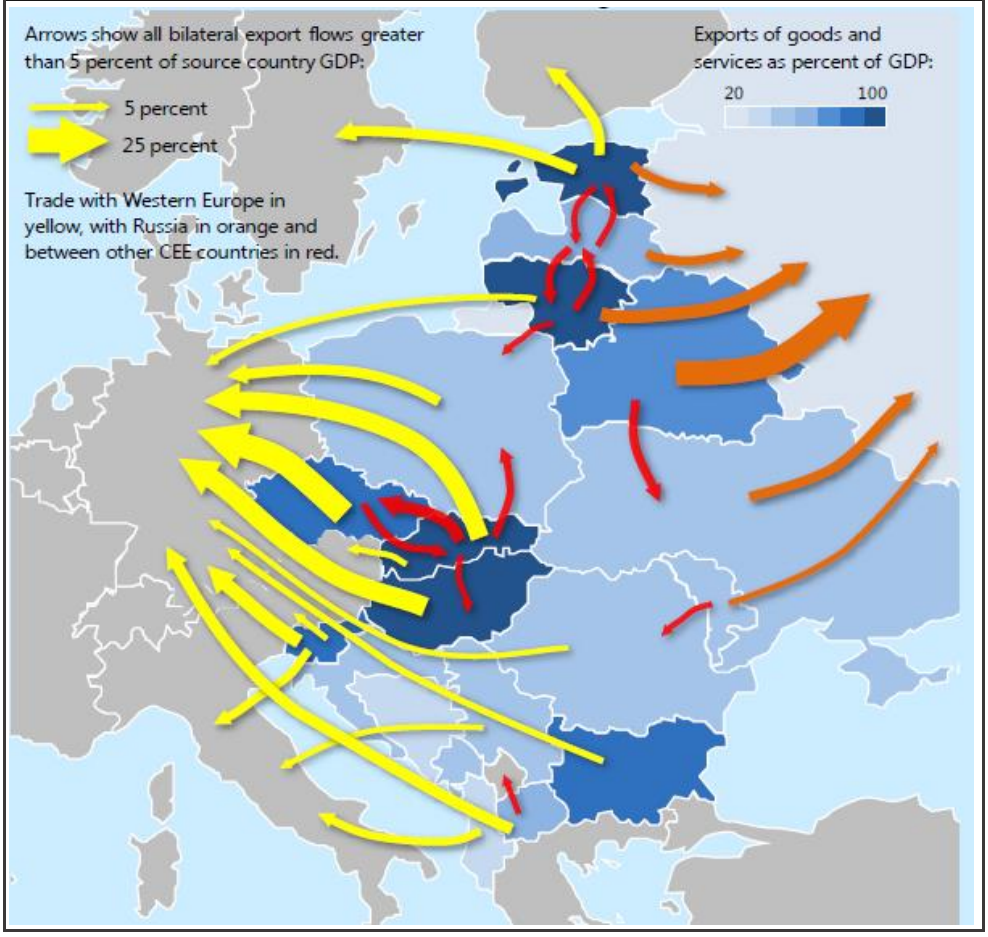
Source: World Bank

Because of the significant portion it occupies in the CISFTA trade node, Russia emerges as a natural leader whose interests dominate the decision-making instruments. Figure 2 shows that Russia makes up 60% of the volume of trade in the CIS region; it is by far the region's most economically dominant actor. This is further evident in the snowball effect that the 1998 Russia crisis had on the other CIS parties, which were largely dependent on Russia and suffered when its currency plummeted.[62] Russia dominates the CISFTA as each party's number 1 trading partner. This allows Russia to use the CISFTA provisions to its advantage – arguably for the purposes of trade deflection, and arguably in a more political sense through its tremendous influence in the Council of Heads of State.

[62] *World Bank*, *supra* note 24 at 7

Turning to external trade partners around the world is to Russia's benefit, as is evident in its more geographically diverse trade portfolio compared to that of the

Figure 3: Trade directions in CEE region, 2013



Source: IMF

CIS7. But as we can see in Figure 3, the other CISFTA parties are not so geographically connected. Their inbound trade is to Russia's advantage; it acts as a benefactor in making concessions such as lower energy prices[63] in return for other benefits, like arbitrary exclusions (which violate the terms and intent of the WTO RTA regulations) and obtaining certificates of origin for its own outbound trade.

Therefore, International organisations and the standards they impose challenge the volatile power relations in the CIS region. But the IMF and the World

[63] See Russia's energy deal with Ukraine, for example

Bank contend that external orientation is conducive to growth.[64] This refers to WTO membership in particular, which not all CISFTA parties have obtained. The positive effects of WTO membership include reduced tariffs, strong regulatory and political frameworks, and independent dispute settlement mechanisms.[65] By 2000 more than half of the CEE states had acceded to the WTO and the trade data reflect the benefits associated with membership. As the CIS states establish themselves as full-fledged WTO members and actively contribute to the removal of global trade barriers, they may experience similar growth patterns, too. Private investment is equally a part of the picture. WTO association also increases legitimacy and the perception of economic stability, which in turn encourages foreign direct investment. In its recommendations, the IMF suggests that post-communist markets should stabilise their domestic economic policy in order to attract foreign investment.[66] The two go hand in hand and serve as indicators of economic progress.

Even before its implementation, the CISFTA reflected a divide between state sovereignty and regional integration. The mechanisms of the CISFTA, such as its intent to create an economic union[67] and the Notify and Inform clause,[68] create a mutual dependence between the parties. In reality, however, the more economically developed actors share a greater proportion of trade, and, consequently, growth. Although international organisations suggest that the CIS states should extend their trade relations towards greater global integration, a strong dependence on Russia and their own underdevelopment prevents them from achieving this. In this isolationist and loosely-coupled context, the CISFTA becomes both a limitation and a liability.

(2) The Economic Court

Development in the context of the CISFTA is not limited only to economic growth. One should also take into account the progress of its legal dimension from Soviet law to a new system comprised of a multitude of sources. The Economic Court is one of the dispute settlement mechanisms identified in article 19 of the CISFTA. As it is the only uniquely CIS-centric institution for conflict resolution, it is

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[64] *World Bank*, *supra* note 24 at 53; *IMF Report*, *supra* note 7 at 34
[65] *IMF Report*, *supra* note 7 at 33
[66] *Ibid.* at 59
[67] *CISFTA*, *supra* note 30 art 1
[68] *Ibid.* at article 20(3)

of central importance when examining trade disputes within the region.

The CIS Economic Court differs from the dispute resolution systems of other RTAs in that it supersedes the CISFTA and applies to a larger extent to other disputes unrelated to trade. The Court declares its mandate in very broad terms: to "ensure the implementation of economic obligations within the Commonwealth".[69] In the CISFTA it is only the third step of the dispute resolution system. Article 19 grants the Court the power to hear disputes between parties at their request and only with their agreement.[70] Despite its broad reach, CIS parties tend not to resort to the Court but rather to negotiate resolutions to disputes on an informal basis. A brief comparison between the 116 cases heard by the NAFTA Tribunal[71] and the "handful"[72] of cases that have come before the Economic Court since 1992 demonstrates the limits of the Court's influence.

As is generally true of all legal development in the region, the Court evolved from Soviet law to incorporate legal norms from around the world. While it applies a uniform law – the CIS Model Civil Code, it also draws its sources from separate codes in specific legal areas following the Soviet tradition.[73] While the dispute settlement mechanisms of other RTAs rely on international arbitral procedures such as the UNCITRAL Rules and ICSID's Additional Facility Rules,[74] the Economic Court attempts to set its own conflict resolution laws. A continuation of Soviet law is evidently not a move in the right direction—Armenia formally left the Economic Court in 2006,[75] as did Moldova in 2010.[76] The remaining parties are also reluctant to participate.

The composition of the Court is equally exclusionary. There are currently

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[69] Article 32 of the *CIS Charter*, cited from Gennady M Danilenko, "The Economic Court of the Commonwealth of Independent States" (1999) 31:893 NYU Journal of International Law and Politics 893 at 898. On the jurisdiction of the Economic Court, see Danilenko at 898—906

[70] *CISFTA*, *supra* note 30 art 19 (emphasizes that disputes are to be brought to the Economic Court only with the "mutual consent" of state parties)

[71] Decisions are available from the NAFTA Secretariat, online: <https://www.nafta-sec-alena.org> .

[72] Kort & Draganeva, *supra* note 14 at 3

[73] Trunk, *supra* note 18 at 225

[74] NAFTA, 17 December 1992, US-Can-Mex, 32 ILM 289 (chs 1–9); 32 ILM 605 (chs 10—22)(1992) ch 11.

[75] CIS Executive Committee's note of November 22, 2005

[76] *Lege nr 126 din 23 decembrie 2009 pentru denunţarea Acordului privind statutul Tribunalului Economic al Comunităţii Statelor Independente*, Monitorul Oficial, 22 January 2010, (NC 8-10), (2009) LPC126, online: <lex.justice.md/index.php?action=view&view=doc&lang=1&id=333463>

three acting judges who represent Belarus, Kazakhstan, and Russia. The President of the Court is from Belarus.[77] As demonstrated above, Kazakhstan and Russia are the region's most influential actors, and Belarus is arguably under significant political control by Russia.[78] Other CIS states are therefore at a loss for representation within the judiciary of the Economic Court. While each CIS party is represented in the Plenum of the court, only the acting judges write decisions in cases. Furthermore, the selection of judges cannot be challenged. Even if a complaint is made against an acting judge, it is the President of the Court who chooses their successor, not the mutual agreement of parties.[79] The judiciary of the Court are also under significant political control on the part of Russia and reflect the lack of freedom and transparency in other areas of the CISFTA agreement.

Finally, enforcement and lack of representation of private parties also pose a problem to the Economic Court's functionality. The Court only hears disputes between states, unlike the NAFTA tribunals, which can hear investor-state disputes.[80] On one hand the lack of established independent forms of dispute resolution in the CIS region may discourage investment due to uncertainty about potential avenues for the settlement of conflicts. However, it may also be a positive sign if the CIS states bypass the Economic Court altogether in order to seek the administration of justice through international dispute resolution procedures. The trend has rather been towards the less legitimate solution; intra-CIS trade disputes are often resolved informally between the parties. Enforcement also serves only to heighten the illegitimacy of the Economic Court. The CISFTA presents a fourth stage of dispute settlement "within the framework of other procedures provided by international

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[77] Economic Court of the CIS, online: <http://courtcis.org/index.php/2013-05-14-08-49-44/judges> .

[78] The democratic institutions in Belarus have been challenged by international organisations and scholars of the region. Its current president, Alexander Lukashenko, reportedly won the latest presidential elections with 84.7% of the vote and 87% turnout. OSCE election observers deemed the election flawed but the CIS observers, led by Russia, claimed they were "transparent, open and competitive". The political situation in Belarus is representative of many other CIS states. The lack of democratic legitimacy illustrates that CIS institutions are not as free and transparent as they claim to be. See OSCE Office for Democratic Institutions and Human Rights (ODIHR), *Belarus Presidential Election Statement of Preliminary Findings and Conclusions*, 12 October 2015, online: <http://www.osce.org/odihr/elections/belarus/191586> and OSCE ODIHR, *Statement by Mr. Alexander Lukashevich, Permanent Representative of the Russian Federation, at the 1071st Meeting of the OSCE Permanent Council*, PC.DEL/1356/15, 15 October 2015

[79] Danilenko, *supra* note 69 at 896—897

[80] *Ibid.* at 902

law".[81] In practice CIS states prefer the international law alternative, but when they do resort to the Economic Court the judgements rendered have no binding force nor means by which they can be enforced. For example, in a 1996 dispute submitted to the Court by Kazakhstan against Belarus, Kazakhstan failed to comply with the judgement rendered.[82] On another occasion, Kazakhstan's administration directly stated that "nobody pays any attention to the decisions adopted by the Court".[83]

It seems that, given its unstable structure, the Economic Court has not been a successful dispute resolution mechanism under the CISFTA. The Court's lack of legitimacy in enforcement of judgements, composition of the judiciary, and sources of law discourage CISFTA parties from resorting to its jurisdiction. In a symbolic way, it also represents uncertainty and imbalance in the region's legal developments in the context of economic relations and trade.

(3) Limited industry and lack of product diversification

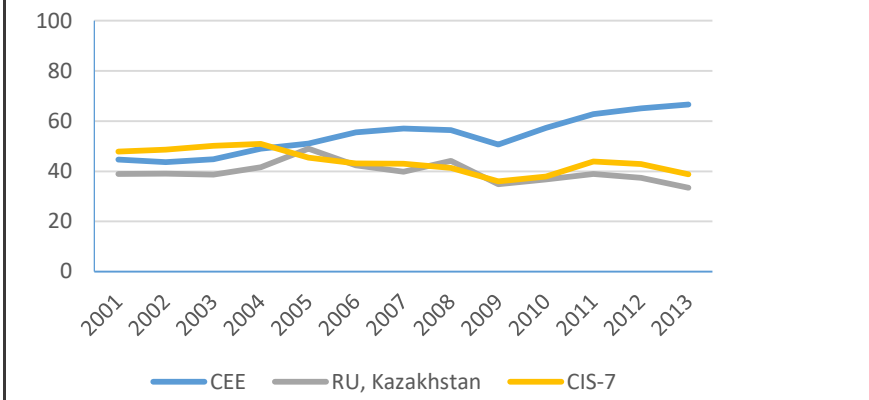
We have seen in Figure 1 that the CIS isolation of the 1990s and the CISFTA's lack of persuasive control of trade initiatives resulted in substantially lower rates of exports in comparison to the CEE. This trend has continued into the 21st century despite greater efforts at integration. This can be attributed to the slow development of industry in the region, its low comparative advantage,[84] and lack of diversification.[85]

The CIS region's instability has resulted in both a low level of inbound investment and outbound sources of revenue (i.e. exports). In Figure 4, we can see that the exports of all CIS states have decreased as a proportion of their GDP. This downward trend has resulted in a 10% decrease, compared to a 35% increase in the CEE. These statistics include both intra-CIS trade and external trade with non-CISFTA parties. This data does not show complete decrease of regionalism as implied by the proportionately lower level of exports in the region; in fact, the opposite. On the side of inbound investment, Figure 5 shows that foreign direct investment has increased substantially since 1998. Although surpassed by the level of

[81] *CISFTA*, *supra* note 30 art 19(1)
[82] Danilenko, *supra* note 69 at 907—908
[83] Kort & Draganeva, *supra* note 14 at 3
[84] *World Bank*, *supra* note 24 at 18
[85] *Ibid.* at 28

investment in the CEE, the CIS has nonetheless benefited from increased inbound stimulus packages. This may point to the region's ability to improve the viability of its industries in global markets.

Figure 4: Exports as Percentage of GDP

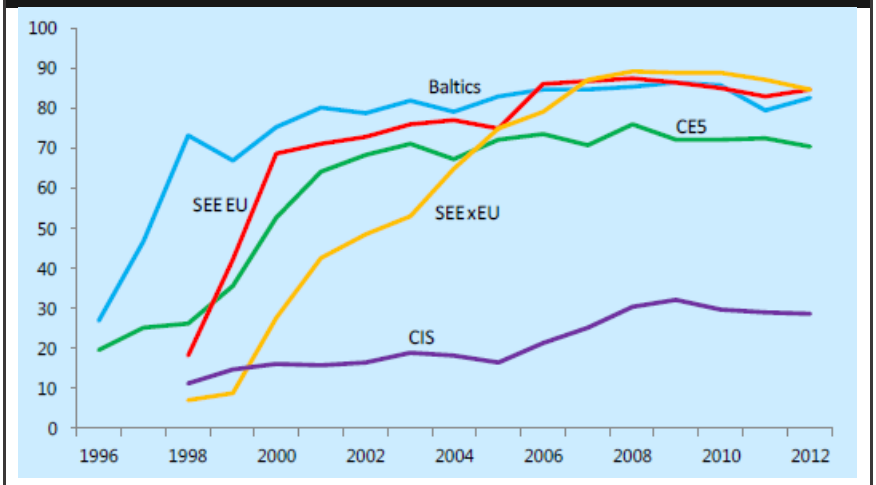


Source: World Bank

However, the region's continued dependence on trade in raw materials, energy, and within the agricultural sector may impede growth as it has done in the past 25 years. Azerbaijan, Russia, and Kazakhstan were successful in global trade throughout the 1990s due to the oil boom.[86] Kazakhstan's energy trade is on the rise, as shown in Figure 6. At the same time, the other CISFTA parties do not enjoy the same revenue from energy. Their trade profile is mostly comprised of agricultural products, the majority of which are traded within the CIS.[87] It was this exact concentration of agricultural dependence that stunted the growth of CIS states throughout the 1990s.[88] Similarly, a dependence on raw materials like petroleum has also highlighted the volatility of the CIS. Although the region has benefited from an increase in investment, sustained economic growth will require the strengthening of local industries through diversification of products.

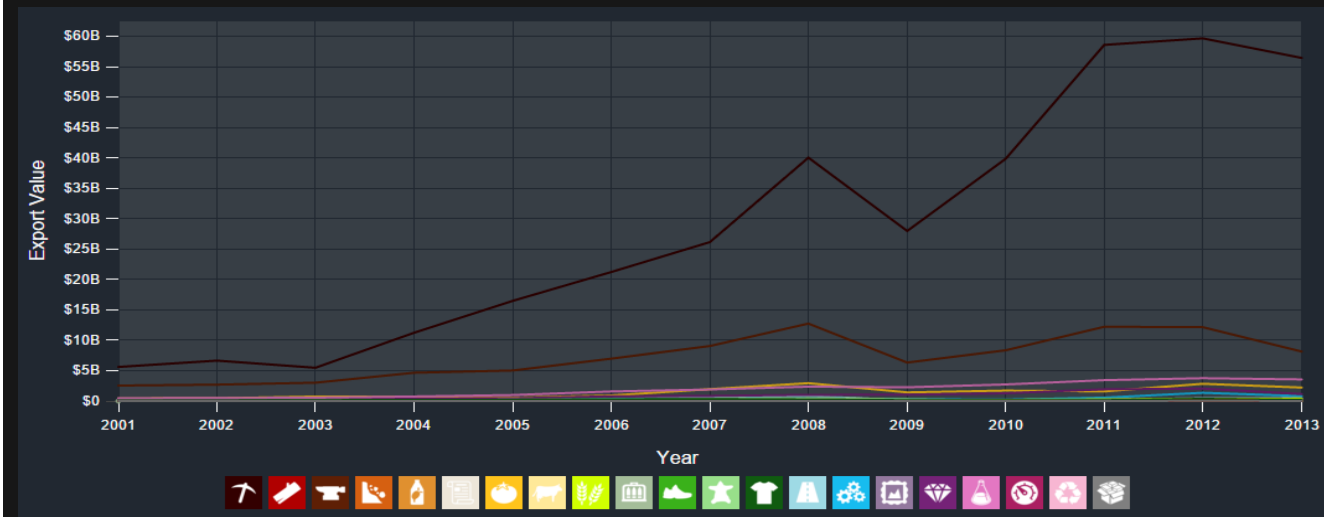
[86] *World Bank*, *supra* note 24 at 9
[87] *Ibid.* at 28
[88] *World Bank, supra* note 24 at 28

Figure 5: Foreign Bank Participation (percentage of banking sector assets)



Source: World Bank

Figure 6: Kazakhstan Exports by Product



Source: http://atlas.media.mit.edu/en/

The World Bank and the IMF have identified the potential for growth within the CIS, but they also emphasized the importance of participation in global trade. While some regional trade blocs, like the CIS, are naturally isolated and inter-

dependent,[89] a continued isolation can only hinder trade to the same extent it has in the past. The next section will examine how the CISFTA is becoming increasingly endangered as its parties react to the pull of other trading partners.

V. FUTURE IMPLICATIONS AND THREATS TO CIS COHESION

The paths of the CIS and CEE split from the very beginning of the economic liberalisation effort. While European integration propelled CEE states towards inclusion in a more powerful trade node that, in turn, helped their economies develop, the CIS had a much slower development due to fractured regionalism and poorly implemented regional trade agreements. Today the two find themselves at different stages of development, each region with its own challenges and successes. The overall trends show that Russia is losing influence as the dominant economic actor in the CIS region while other CIS states turn to Europe and to other international trade partners, who, they hope will speed up their development. At the same time, CEE states must evaluate the strength of their own economies. Even though they are safe within the realm of the EU and behind the shield of its powerful economic ties, they must temper their dependence.

A. European Integration

The prominence of EU states as importers of CIS goods is on the rise for Russia and for all other CIS states, as well. The World Bank reports that the EU's market share in the CIS grew significantly.[90] Aris & Webber argue that Russia values its association with the EU and WTO more than the CIS Customs Union, and, therefore, "its role as a motor for military, economic and political cooperation has diminished" within the CIS.[91] As the CIS area specializes in the production of goods that are more in demand in Europe and across the world, the CIS will only continue to weaken.

Increasingly, CISFTA parties are formally withdrawing from CIS institutions

[89] *World Bank*, *supra* note 24 at 42
[90] *World Bank*, *supra* note 24 at 11.
[91] Arbis & Webber, *supra* note 17 at 156

in favour of partnership deals with the EU. Ukraine, Moldova, and Georgia are notable examples. Georgia left the CIS after the war in Abkhazia and South Ossetia in 2008.[92] At that time, Georgia was hit with the double shock of war and the global financial crisis, which crippled its economy with lower than ever FDI and exports.[93] Since then, Georgia has matched its diminishing intra-CIS trade with partnership agreements with the EU, most recently joining the EU-Moldova-Ukraine Deep and Comprehensive Free Trade Area (DCFTA).[94] The Association Agreements that led up to the DCFTA were not achieved easily. In Ukraine, public support of the EU Association Agreement was so divisive that it resulted in a revolution and a presidential coup. Moldova followed suit in 2015, as protests broke out in its capital against government corruption, which is largely related to its relations with Russia. The protesters supported the assistance measures from the EU, which constitute a recognition of Moldova's move towards more stable governance, sustainable development, and administrative efficiency in trade, consequently allowing Moldova to increase its competitiveness in European markets.[95]

The EU agreements in the western parts of the CIS have had a dual effect. They have shifted the region's dependency away from Russia. The EU has become the number 1 trade partner of Ukraine, Moldova, and Georgia. In Moldova, in particular, trade with the EU comprises the most significant portion of its GDP than trade with any other partner since 1991.[96] Moldova's participation in both the CEFTA and the CISFTA makes for an interesting comparison in development trends. While Moldova's intra-CIS trade has decreased, its exports are expected to increase by 18% and its GDP is expected to rise by €142 million.[97] Its association

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[92] Trunk, *supra* note 18 at 224

[93] WTO Trade Policy Review Body, *Report by the Secretariat on Georgia*, WT/TPR/224 (3 November 2009) at paras 4, 34 [*Georgia TPR*

[94] European Commission, Memo, 14/430, "The EU's Association Agreements with Georgia, the Republic of Moldova and Ukraine" (23 June 2014), online: <europa.eu/rapid/press-release_MEMO-14-430_en.htm>

[95] European Commission, Press Release, IP/07/1690, "European Commission proposes additional autonomous trade preferences (ATPs) for Moldova" (14 November 2007), online: <europa.eu/rapid/press-release_IP-07-1690_en.pdf>

[96] *Ibid.*

[97] European Commission, Directorate General for Trade, "Evaluarea impactului comerţului asupra dezvoltării durabile în sprijinul negocierilor ZLSAC dintre UE şi Republica Moldova" Working Paper (Rotterdam: Ecorys, 14 April 2012), online: <trade.ec.europa.eu/doclib/docs/2013/february/tradoc_150564.pdf>

with the European Union has helped to defy the trend of decreasing exports in the rest of the region, which poses a challenge, as the decrease in intra-CIS trade is not matched by an increase of trade with other parties. At the same time, the movement away from the CIS serves as a geopolitical realignment. If the rest of the CIS follows the same path as Russia towards stronger trade relations with Europe, the CIS structure will become increasingly irrelevant. While this will help CIS economies in the same way as it has helped Moldova and Ukraine, it creates geopolitical tensions between the CIS allies and also means a potential overextension of European hegemony.

B. Global Integration

Unlike European integration, which poses a lot of open-ended questions for the CIS, greater participation in global trade is a clear-cut positive direction. As has already been discussed, WTO membership, in particular, is a goal that has been endorsed by many as a pathway to development. It offers more stable institutions, globally recognised standards, and a perception of stability that can encourage new trade relationships and inbound investment.

As WTO members, each CIS state is equal. The power imbalances discussed in the previous chapter no longer pose a major obstacle to trade. Members' participation in the accession process is an example of how the WTO ushers in fairness and neutrality between member states. Wehrheim argues that WTO membership could be used to attract concessions and to negotiate through a neutral institution from a positon of power, as CIS parties were able to do in negotiating Russia's membership conditions.[98] At the moment, most CISFTA parties are WTO members, with the exception of Azerbaijan and Uzbekistan. More and more are also distancing themselves from the CIS Economic Court. And their participation in the WTO is remarkable.

In the short time since their accession, CIS states have appeared as parties to 8 disputes before the WTO, and Russia as a respondent to many more.[99]

[98] Roberts & Wehrheim, *supra* note 8 at 318

[99] See WTO disputes by country, online: <https://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm>

Comparatively, disputes involving CIS states are greater in number than those involving CEE states at the WTO level, indicating that the latter is more successful at resolving any disputes through alternative mechanisms.[100] While the CEFTA arbitration clause excludes the possibility of bringing disputes before the WTO,[101] the CISFTA explicitly mentions it as a possibility in article 19 as the fourth and last stage in the dispute resolution hierarchy. In reality, it is evident that CIS states bypass the lower stages of dispute resolution entirely in favour of the more stable WTO system that is, ironically, seen by CEE states as less legitimate than their own CEFTA-imposed system of arbitration.

The CIS aversion to their own Economic Court is evident from the lack of cases brought before the Court throughout its existence. But resorting to other means of dispute resolution poses a legal problem: the Economic Court's exclusive jurisdiction in the CIS Charter contradicts the freedom of parties to seek judgement elsewhere. Article 31(1) of the CIS Charter emphasizes that members "have no right to resort to other international judicial organs without first turning to the Economic Court".[102] In an advisory opinion that attempted to reconcile the discrepancy between the Court's foundational sources and the CISFTA provisions, the Court held that "participating states may turn to these organs only if it is not possible to resolve their difference through the Economic Court of the CIS".[103] This general unwillingness of the CIS states to adhere to institutional frameworks within the CISFTA is widespread, but it is arguably warranted considering their volatile and illegitimate construction. For a region that has not yet established stable and incorruptible institutions, international alternatives like the WTO are a stable intermediary to which the CIS states can turn.

C. Dependence on Single Economic Actors

Both the CEE and CIS face their own issues of dependency. Because the CEFTA is a mechanism to stimulate economic development in the CEE region with

[100] Namely, the arbitration clause in the *CEFTA*, article 43
[101] *CEFTA*, *supra* note 14 art 43(4)
[102] *CIS Charter* art 31(1), cited from Danilenko, *supra* note 69 at 901
[103] *Ibid.*

the aid of the EU, parties to the agreement are largely dependent on the EU market. Similarly, the CIS faces an intra-regional dependency oriented towards Russia. While dependence may stimulate development, as it has in the CEE's early years (see Figure 1), it can also be detrimental in the event of economic shocks.

The global financial crisis had a marked impact on the CEE. From 2008—2009, those markets collapsed suddenly as foreign capital inflow stopped.[104] EU-oriented CIS states also suffered (for example, FDI and exports plummeted in Georgia,[105]), but the CIS region withstood the shock to a greater extent than the CEE. This was largely due to Russia's oil exports, which accounted for 12% of its GDP in 2007.[106] However, the CIS region faced its own reactionary economic decline in 1998 when Russia's currency deflated and the CIS had to turn to other trade partners to sustain their economies.[107] The CIS states have faced similar troubles in recent years as Russia battles through another financial crisis, arguably on the same scale as that of 1998.

As both the CIS and CEE states seek new trade opportunities outside the CISFTA and the CEFTA, they can only hope to see an increase in national revenue from exports, legitimacy in the global marketplace, and greater product diversification. However, it is hard to say whether the trade opportunities between the CIS and the EU through Autonomous Trade Preferences (ATPs) and the DCFTA will help those economies develop, and at what expense, if closer EU relations will pull these states away from Russia.

D. Sanctions

CIS and CEE markets are evidently very vulnerable to economic and geopolitical shifts within their trade nodes, especially when they affect their primary trade partners (Russia and the EU). Therefore, current economic crisis in Russia poses a threat to the current development in the CIS region, as well as to its previously peaceful relations with the EU.

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[104] *IMF Report*, *supra* note 7 at 47-48
[105] *Georgia TPR*, *supra* note 93 at para 95.
[106] *IMF Report*, *supra* note 7 at 47-48
[107] Roberts & Wehrheim, *supra* note 8 at 321

Sanctions does not constitute a new measure to keep the actions of the CIS region in check. During the Cold War the United States often extended trade preferences in order to obtain political leverage. The current use of sanctions in the CIS is reciprocal. Russia is exerting its economic influence over CIS states, whose domestic markets are largely dependent on Russia, to extend its hegemony and obtain political concessions. One notable example is the energy negotiations with Ukraine and the renewal of Russia's lease on the Sevastopol fleet. In 2010, Russia renewed the *Partition Treaty on the Status and Conditions of the Black Sea Fleet* (Black Sea Treaty) with Ukraine, extending its lease of the Sevastopol naval base until 2042.[108] In exchange, Russia offered Ukraine a 30% decrease in gas prices.[109] Russia holds tremendous leverage to offer discounted energy prices to Ukraine and other CIS states. It has a current $1.5 billion trade deficit in energy exports to the CIS, which it claims "will not harm Gazprom's financials".[110]

Following Russia's annexation of Crimea in 2014, the Black Sea Treaty is no longer in force. Russia's actions in the region have met opposition, which has manifested itself in the form of sanctions. These sanctions, combined with a worldwide decline in oil prices, have proven detrimental to Russia's economy. Russia may be facing an economic slowdown on a similar scale to its 1998 crisis. As Russia's economy sinks, the CIS may turn to other trade partners. And they are likely better equipped to break out on their own, no longer in the confines of the CIS, now more than ever before.

VI. CONCLUSION

Moving forward, the Commonwealth of Independent States is becoming increasingly irrelevant. The region has been following in the footsteps of its neighbours to the west, who have seen economic growth largely due to their integration with the European Union through successful trade policies like the CEFTA. The CEFTA has proven to be a successful economic growth model that

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[108] *Partition Treaty on the Status and Conditions of the Black Sea Fleet*, Russia and Ukraine, 28 May 1997 (entered into force 12 July 1999; denounced on 31 March 2014)
[109] Luke Harding, "Ukraine Extends Lease for Russia's Black Sea Fleet", *The Guardian* (21 April 2010), online: <theguardian.com/world/2010/apr/21/ukraine-black-sea-fleet-russia>
[110] *World Bank*, *supra* note 24 at 11; The Guardian, *supra* note 109

has resulted in the accession of its founding members to the European Union. Although the CEE region is unique in its historical evolution, political situation, and post-communist economic development, it provides an interesting window on power balances within regional trade groupings. It also illustrates an achievement in economic development. When magnified, the economic integration mechanisms of the CEFTA show that reciprocal economic relations lead to economic development as envisioned by the WTO, resulting in the removal of barriers to trade and in the proliferation of domestic economies.

Isolation and institutional regionalism have not led to a comparable success in the CIS region. While Central & Eastern Europe grew, the CIS stagnated. The CIS states are now increasingly turning to global trade partners, a development which many predict will boost their economic growth. This is likely to be the case as CIS members conclude an increasing number of trade agreements with European and international partners. However, they must proceed with caution, and with a view to the independent sustainability of their domestic economies.

An ocean apart: Comparison of Insider Trading regulations in the US and in the EU

Michał Bałdowski[*]

Abstract

This article provides an outline of the present regulations concerning both US and EU law on insider trading. Another comparison is necessary since the vast majority of previous works that compare insider trading in the US and in the EU are outdated due to the recent changes in the EU regime regarding this matter. Therefore, the goal of this article is to provide a regulation outline for both regimes, which will present both advantages and disadvantages of those two very different systems, the author's view on them, as well as predictions concerning the regulations' future.

I. INTRODUCTION

The phenomenon of insider trading has given rise to countless discussions among economists and lawyers for decades. It is one of the few issues related to financial markets, which consists of such fundamentally different approaches. Some authors express the opinion that insider trading should be banned completely as a threat to corporate investment which decreases the efficiency of corporate behavior,[1] while others, including Economic Nobel prize winner Milton Friedman, believe that insider trading should be completely legal, since it has a positive impact on the market.[2] Finally, the rest of the authors opt for only a partial prohibition of insider trading.[3]

These different approaches are reflected in the regulations concerning insider trading in the US and in the EU. In the US, insider trading was regulated for

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[1] Michael Manove, 'The Harm from Insider Trading and Informed Speculation' [1989] 4 The Quarterly Journal of Economics 823

[2] JK Aier, 'Insider Trading In Loss Firms' [2014] vol. 52, no. 5 Journal of Accounting Research 12 13

[3] Daniel R. Fischel and David J Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' [1991] vol 105 no 2 Harvard Law Review 503 524

the first time in the world, and the whole regime has made a significant transition through case law and the Security Exchange Commission's (hereinafter "SEC") administrative actions, from a general prohibition of insider trading to the present, complex system which relates insider trading to a violation of fiduciary duties. On the other side of the Atlantic Ocean, the EU had based its insider trading regime on the equal access to information principle, which results in a broad prohibition of any kind of insider trading.

This article provides an outline of the present regulations concerning both US and EU law. It seems that another comparison is necessary, since the vast majority of previous works that compare insider trading in the US and in the EU are outdated due to the recent changes in the EU regime concerning insider trading regulation. The new regulation differs from both the previous regulations and the initial project of the present regulation, which served as the base for the most recent articles concerning insider trading.

Therefore, the goal of this article is to provide an outline of regulation for both regimes, which will present both advantages and disadvantages of those two very different systems, the author's view on them, as well as predictions concerning the regulations' future.

1. United States Law

A. Introduction

It is in the United States where insider trading regulations were born. As the US is continually the largest capital market in the world, with decades of jurisprudence dealing with all kinds of market abuse which includes insider trading and regulations that deal with securities dating back to the 1930s, it is a cradle of knowledge and experience on insider trading.[4]

[4] Stephen M Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M. Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 1

This section outlines the legal background of the regulations that deal with insider trading; analyses the definition of inside information; shows the significant transition towards the very foundation of banning insider trading; and explains the fiduciary duty principle, as well as the misappropriation theory. Moreover, it deals with the scope of the insiders, the tippers, and tippees. Ultimately, it provides a clear outline of the US insider trading regulation, its advantages and flaws, as well as the main differences and similarities with the EU regulations.

B. Legal background of insider trading

Historically, the statutory ban on insider trading goes back to administrative actions taken by the SEC under the section § 10(b) of the Securities Exchange Act of 1934.[5] The entire section § 10(b) is at most indirectly connected to insider trading, as it generally prohibits usage of any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security registered on the national securities exchange or any security not registered as such. It provides competence for the SEC to exercise its authority and without that it is an empty norm.[6] Eight years after the Securities Exchange Act had been passed, the SEC under the discretion of provision § 10(b) adopted the famous rule 10b-5.[7] Rule 10b-5 made it unlawful for any person in connection with the purchase or sale of a security:

"(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made [. . .] not misleading, or

(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person".

It is clear that Rule 10b-5 does not directly deal with insider trading. In fact, it is evident that, initially, it was not even supposed to target insider trading.[8] The first

[5] 15 U.S.C. § 78j(b)

[6] S. Bainbridge 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M. Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 3

[7] 17 C.F.R. 240.10b-5

[8] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no. 257 3 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

time that Rule 10b-5 had been actually applied in connection with insider trading occurred almost two decades after its creation in the SEC administrative ruling in *In re Cady, Roberts & Co.*[9]

Only in 2000, the SEC adopted Rule 10b5-1[10] in order to finally clarify and define insider trading. According to the Rule, insider trading is the purchase or sale of a security of any issuer, on the basis of material non-public information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material non-public information. Furthermore, the SEC in paragraph (b) settled the issue of trading with 'usage' v. 'in possession' of inside information by stating that a purchase or sale of a security of an issuer is 'on the basis of' material non-public information about that security or issuer, if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale. Therefore, the SEC chose to penalise trading of inside information, yet it provides means of affirmative defence for traders that purchase or sell securities on the basis of pre-existing plans, contracts, or instructions that ensure that the transaction was not based on the knowledge of material non-public information.[11]

Furthermore, the SEC introduced Rule 10b5-2,[12] which clarifies duties of trust or confidence in misappropriation insider trading cases. This Rule, however, will be further analysed in the section concerning misappropriation.

The legislative impact on the insider trading regulation is modest at most in contrast with the EU regulations. The most important source of insider trading regulations is created through SEC administrative actions and the US jurisprudence.

C. Definition of inside information

The starting point of the analysis is to define the inside information which outlines the scope of the insider trading. In the United States, inside information is

[9] 40 S.E.C. 907 (1961)
[10] 17 C.F.R. 240.10b5-1
[11] Marc I. Steinburg, *Understanding Securities Law* (5th edn, LexisNexis 2009) 375
[12] 17 C.F.R. 240.10b5-2

defined as material non-public information about a security.[13] Therefore, we may establish three key elements that define the scope of inside information. The first one is materiality, the second is non-public character and the last one is the relation of the inside information to a security. Interestingly, contrary to the European jurisprudence and doctrine, the American doctrine does not put much emphasis solely on the definition of inside information, but rather focuses on other elements of insider trading regulation in its analysis.

The materiality of inside information is determined by the substantial likelihood that the investor will take that information into consideration when deciding whether to buy or sell particular securities.[14] Moreover, the investor should also consider such information to be important.[15] In the United States, the emphasis of the materiality is not on the potential change of the price, but rather on the mind of the investor.[16] Therefore, this prerequisite comes down to the so-called 'reasonable investor test', which needs to be determined on a case-by-case basis. The main concern is undoubtedly the potentially broad scope of this prerequisite. First, it may be difficult to determine who is a reasonable investor. Is it a person with an average knowledge about capital markets? And if yes, what can be actually considered as average knowledge? The other concern is the effect that inside information has on a prudent investor. Is it sufficient that the investor might take the information under consideration or should a higher threshold be applied? Such a broad scope of materiality affects the legal certainty of companies revealing inside information, as well as insiders.

Inside information has to have a non-public character. Therefore, insiders may not trade using the inside information, until it is disclosed. The disclosure of the information has to be effectively made to the public. To the minimum, insiders should wait with trading until the information could be reasonably expected to

[13] U.S. v. Svoboda 347 F.3d 471, 475 n. 3 (C.A.2 (N.Y.) 2003
[14] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988)
[15] S. Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing, 2013) 11-12
[16] Stephen Herne, 'Inside Information: Definitions in Australia, Canada, the U.K., and the U.S' [1986] 8 J. Int'l L. 1 10

appear in the business news wire services.[17] Generally, under US jurisprudence, the non-public character requirement is defined as if the information were not known or were unavailable to the public.[18] While it seems clear what unknown information means, the unavailability needs some further explanation. An example of information that is known but not available was presented in the *Texas Gulf Sulphur* case, where the court stated that it is information, which although disclosed, was not readily translatable into investment action.[19]

Inside information, in contrast with EU legislation, has to directly concern the company or its business.[20] This approach seems to be a far more reasonable choice than the very wide EU approach. Limiting the scope of inside information only to those that directly concern the company or its business eliminates a great amount of uncertainties that arise with the inclusion of indirect information.

The definition of inside information in the US, similarly to the EU definition, leaves a lot of room for interpretation and the prerequisites that form its scope force a case-by-case analysis of their fulfilment. That approach guarantees less legal certainty for the traders and companies, but at the same time, leaves more elasticity for interpretation.

D. From the equal access to information principle to the fiduciary duty principle

The early approach towards banning insider trading was much more similar to the modern European regulations than to the current US approach. In the early 1960s, the SEC had developed a so-called 'disclose or abstain' rule which originated from the equal access to information principle.[21] It was first introduced in the above mentioned *In re Cady, Roberts & Co* case[22] and further developed into a full and equal

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[17] S Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 12

[18] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), cert. denied, 394 U.S. 976 (1968)

[19] Ibid. 854

[20] Dirks v. SEC. 463 U.S. 646 (1983)

[21] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no 257 4 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

[22] 40 S.E.C. 907 (1961) at 911

access to information principle in the *Texas Gulf Sulphur* case.[23] *Texas Gulf Sulphur* is arguably one of the most important and most famous cases dealing with insider trading in the US. Texas Gulf Sulphur Co was a company which conducted mining activities in Canada, during which it found an area which was very rich in resources. Some employees and officers of the company, as well as people affiliated with them, started to purchase shares of the company, before the disclosure of information about the discovery. After revealing the information, the price of the shares increased significantly, providing substantial profits for the investors that traded using the inside information. The claim against the investors had been brought by the SEC on the basis of a violation of Rule 10b-5. The court ruled that the traders in possession of inside information should either disclose the information to the public or abstain from buying securities. The reasoning of the court, similarly to *In Re Cady, Roberts & Co* case, was based on the equal access to information principle, which prohibits getting an advantage by the investors that use information not yet available to the public. In other words, the court's ruling was supposed to grant all investors exposure to identical risks.[24]

The broad approach taken by the court in the *Texas Gulf Sulphur* case was widely criticised by both financial and legal circles, as a potential threat that could impede the development of the US capital market.[25] Few years later, however, the Supreme Court of Justice rejected the equal access to information principle and established the "disclose or abstain" rule in the groundbreaking *Chiarella v. U.S.* judgement that introduced the concept of fiduciary duties to insider trading.[26]

Vincent Chiarella was an employee in a company that prepared tender offer disclosure materials. Although the company used codes to hide the names of the companies involved in thetender procedure, Chiarella managed to break those codes, and acquired shares of a target company before the bid was announced. After

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[23] 401 F.2d 833 (2nd Cir. 1968)

[24] S. Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 7

[25] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no 257 5 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

[26] 445 U.S. 222 (1980)

announcing the bid, the stock price of the target company went up significantly and as a result Chiarella made considerable profits. Although Chiarella had been caught and convicted of insider trading and his conviction was upheld by the Second Circuit, the Supreme Court reversed the judgement. Chiarella had clearly violated Rule 10b-5 under the equal access to information principle but in this judgement, the Supreme Court rejected this principle by applying a new fiduciary duty concept. In a nutshell, the Court stated that in order to affirm the equal access to information principle it would have to recognise the general duty between all participants of the market transaction to forego trades based on material non-public information and it refused to do so.[27] Instead, the court createda concept which requires a fiduciary relationship to be established between the parties of the particular transaction, a so-called 'duty to speak'. In other words, if there is no fiduciary duty between the parties, then trading on the basis of inside information is not prohibited and if there is a fiduciary duty between the parties then the duty to disclose arises. In the case at hand, the Court found that Chiarella had no fiduciary duties towards shareholders of thecompany whose shares he acquired and, therefore, he had no obligation to disclose inside information to them.

Therefore, the Court had set forth two conditions under which it is prohibited to trade on the basis of inside information:

1) Violating a fiduciary duty between the parties of a transaction (duty to disclose);
2) Trading on the basis of material non-public information.

This approach has created a lot of legal doubts concerning the scope of fiduciary duties, caused in particular by conflicts with other precedents and resulted in disputes between the SEC and the judicial branch as to the scope of the prohibition.[28] Undoubtedly, it limits the scope of insider trading prohibition compared to the equal access to information rule, but at the same time, it fails to

[27] S Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 7

[28] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no 257 6 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

impose clear boundaries between what is prohibited and what is acceptable. This approach also results in opening up gaps for traders that encourage the use of inside information, which requires reaction from the SEC. This may be well exemplified by the action taken by the SEC after *Chiarella v. US* case. The SEC has passed Rule 14e-3 under the Williams Act[29] that imposed the duty to disclose or abstain on any person in possession of material, non-public information relating to a tender offer.[30] It seems, therefore, that instead of finding a comprehensive solution to the problem created by applying the fiduciary duty concept, the SEC created *ad hoc* solutions to the gaps revealed by the courts' jurisprudence.

E. Misappropriation principle

With regard to the classical form of insider trading prohibition based on the fiduciary duty principle developed in *Chiarella* case, where a corporate insider trades in the securities of the corporation based on the material, non-public information, the US jurisprudence developed a second form of insider trading called the misappropriation principle.[31]

The misappropriation principle was developed in the *United States v. O'Hagan* case and it holds liable corporate outsiders that misappropriate confidential information for securities trading purposes, in breach of a duty owed to the source of information.[32] The case dealt with a liability of O'Hagan, a partner of a law firm that was providing legal services to a company called Grand Metropolitan PLC that was interested in acquiring a company called Pillsbury Company. O'Hagan did not work on the case himself, but using the information about the planned acquisition he acquired a significant number of shares of the target company, without disclosing that fact to the law firm in which he worked. After the information of a planned acquisition was made public, the price of Pillsbury Company went up and O'Hagan

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[29] Williams Act, Public L. No. 90-439 § 3(e), 82 Stat. 454, 457 (1968) (codified as amended at 15 U.S.C. §
78n(e) (1988)); 17 C.F.R. § 240.14e-3 (1990). See 45 Fed. Reg. 60,410 (1980).

[30] Samuel N Allen, 'The Scope of the Disclosure Duty under SEC Rule 14e-3' [1981] 38 Wash. & Lee L. Rev. 1055

[31] Steven R Glaser and Daniel B Weinstein, 'Law on Insider Trading Misappropriation Theory Remains Unsettled' *New York Law Journal* (New York, 3 November 2014) 1 < https://www.skadden.com/sites/default/files/publications/070111401Skadden.pdf> accessed 3 December 2016

[32] United States v. O'Hagan, 521 U.S. 642, 651-52 (1997)

made significant profits. The court held him liable of breaching Rule 10b-5 and made the misappropriation theory the law of the land.[33] The scope of the liability under the misappropriation theory is therefore as follows:

1) Duty of confidence and trust between the source of the material non-public information and the trader;
2) Trader uses the information without disclosing it to the source of the information;
3) Trader uses the information for personal gain.

Fulfilment of the three prerequisites triggers liability for the trader under violation of Rule 10b-5.

The misappropriation theory bears the same issue as the classical theory, since it is also based on establishing a fiduciary duty, which often raises interpretation issues.[34]

In order to clarify the scope of the misappropriation theory, the SEC established the aforementioned Rule 10b5-2.[35] It creates the following conditions that establish the duty of trust or confidence for the purposes of the misappropriation theory of insider trading:

"Duty of confidence or trust exists in the following circumstances:

1) Whenever a person agrees to maintain information in confidence;
2) Whenever the person communicating the material non-public information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material non-public information expects that the recipient will maintain its confidentiality; or
3) Whenever a person receives or obtains material non-public information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust

[33] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no 257 8 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

[34] ibid 9

[35] 17 C.F.R. 240.10b-5

> or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information."

The misappropriation theory is still at least troubling to apply in practice. For instance, in the *United States v. McGee*, the court had to determine, whether there was a duty of trust or confidence between the AA (Anonymous Alcoholic) members[36] or in *SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010*), where there was a question of a confidentiality agreement between a majority shareholder and the CEO of the company that dealt with inside information.[37] In *US v. McGee*, the court determined that there had been a fiduciary duty between the members of AA, which might potentially broaden the scope of the misappropriation theory.[38] In *SEC v. Cuban*, Cuban was found not guilty and the case created the requirement that in order to hold a trader reliable for breaching the Rule 10b5-2, it needs to be proven that he not only agreed to keep the information confidential but also that he agreed to refrain from trading.[39]

However, we may find recent cases, where the court gradually withdraws from establishing a fiduciary duty in determining liability for insider trading, since it would result in absurd and unwanted results. Thus, in *SEC v. Dorozhko*, the court found Dorozhko liable for insider trading, even though there was no fiduciary duty applicable to him.[40] He was a Ukrainian citizen who hacked the computer of an employee of the IMS Health Inc. and stole the financial report of the company that was supposed to be disclosed the next day. Based on the information that he obtained 'put options' and inquired significant profits after the report was disclosed.

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[36] 763 F.3d 304 (3d Cir. 2014)
[37] 620 F.3d 551 (5th Cir. 2010)
[38] Steven R Glaser and Daniel B Weinstein, 'Law on Insider Trading Misappropriation Theory Remains Unsettled' *New York Law Journal* (New York, 3 November 2014) 3 < https://www.skadden.com/sites/default/files/publications/070111401Skadden.pdf> accessed 3 December 2016
[39] ibid
[40] 574 F.3d 42 (2009)

The court found Dorozhko liable for insider trading based on fraudulent access to inside information, not the breach of fiduciary duties.

F. Insiders, tippers and tippees

After explaining the concept of the classic fiduciary duty principle and the misappropriation theory, it is easier to determine the scope of the potential insiders. The aim of presenting further jurisprudence is to outline the issue of the responsibility of tippers and tippees.

Traditionally, US doctrine and jurisprudence distinguish classical corporate insiders, constructive insiders, tippers and tippees.[41] One of the first approaches to determine the scope of insiders was taken in the *Texas Gulf Sulphur* case[42] and was later settled in the *Chiarella* case.[43] Corporate directors and management officers were traditionally considered as insiders and those two judgements have broadened the scope of all the corporate employees.

In *Dirks v. SEC*, the court clarified the category of insiders called constructive insiders.[44] In *Chiarella*, the scope of classic insiders was limited to corporate agents, fiduciaries, and those in whom sellers of the securities placed their trust.[45] According to the *Dirks* case, not all the corporate agents are employees of the company, but this category includes people from outside of the corporation. In *Dirks*, the court found that certain relations between the outsiders and a corporation are qualified as fiduciary, for instance with accountants, lawyers, underwriters, and consultants.[46] Those insiders are called constructive insiders.

More importantly in the *Dirks* case, the court ruled on a difficult issue of the tippees' liability. On one hand, the court wanted to remain consistent with the

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[41] S Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 14-15

[42] Dennis C Hensley, 'Securities Regulation - Trading by Insiders - S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)' [1969] 10 Wm. & Mary L. Rev. 755 760 <http://scholarship.law.wm.edu/wmlr/ vol10/iss3/15> accessed 3 December 2016

[43] S Bainbridge, 'An overview of insider trading law and policy: an introduction to the insider trading research handbook' in Stephen M Bainbridge (ed), *Research Handbook on Inside Trading* (Edgar Elgar Publishing 2013) 14

[44] 463 U.S. 646 (1983)

[45] ibid 654-655

[46] ibid 655

previous *Chiarella* judgement and based insider trading liability on a breach of fiduciary duties. On the other, it did not want to create a loophole that would allow one to bypass the insider trading regulation. Therefore, the court established certain conditions, which upon fulfilment impose a liability on a tippee and establish a violation of fiduciary duties. The conditions established by the court are as follows:

1) The tipper violated a fiduciary duty by disclosing information;
2) The tipper received a personal benefit from tipping;
3) The tippee knows or has a reason to know the breach of the duty.

These conditions significantly limit the scope of the tippees' liability, compared to the EU regulations. Based on those conditions for example, a waiter that would overhear a business conversation about inside information over lunch could legally use it to trade, since the first two conditions would not have been met. Similarly, we may analyse an example of a 'chain' of tipping as follows:

The CEO of company A tips his friend who is an owner of a consulting company B about an unsuspected increase in the revenues of company A, which will be disclosed the following week. Owner of company B uses that information to consult his clients about an opportunity to make significant profits out of company A's shares. Even though his clients might know or have a reason to know that their consultant possesses inside information, they would not be liable, since their tipper did not have a fiduciary duty towards the shareholders of company A.

G. Conclusion

Under the US law three main concepts of insider trading liability may be established. The first, classical approach, is based on a breach of fiduciary duties, the second one is the misappropriation theory, which penalises trading that violates the duty of trust or confidence owned to the source of information, and finally tippees, who may be found liable for trading while using inside information, if their tipper had breached a fiduciary duty for his personal gain and the tippee knew about the breach.

The thing that first strikes one about the US insider trading regulation is its complexity. The concept of fiduciary duties is very counterintuitive for civil law lawyers, but also raises a lot of interpretational issues for common law lawyers. For

supporters of a narrow approach to banning insider trading, it is undoubtedly a more appealing concept than the ultra-wide European approach. However, in my opinion, the same results could be achieved without using the concept of fiduciary duties but simply using the EU approach with fewer safeguards and restrictions.

Moreover, cases like *SEC v. Dorozhko* or even *Chiarella*, clearly show that the US approach leaves gaps that allow traders to get an unfair advantage and which have to be filled by the Court *ad hoc* by finding new solutions to those issues, or later by the SEC which fights against the use of such loopholes. Therefore, it seems that the whole US insider trading regulation regime got stuck in a concept that does not quite fit in a modern capital market and which needs a new approach to improve fulfilment of its goals.

2. European Union Law

A. Introduction - From MAD to MAR

The history of insider trading regulations in the EU is much shorter than in the US, but during this brief period it evolved significantly and gained a lot of attention from both legal and economy circles. The first attempt to regulate issues concerning insider trading and revealing inside information was made in 1989 by passing the Council Directive of 1989 coordinating regulations on insider dealing.[47] The principle taken by the European Economic Community was to ensure asmooth and effective operation of the capital market, which required a fair and equal access to information for all of investors and which considered insider trading as a threat that could undermine investors' trust towards financial markets.[48] The directive set minimal standards for the Member States to penalise insider trading and allowed them to introduce stricter standards.[49] That led to the creation of very diverse

[47] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing [1989] OJ L 334
[48] ibid preamble
[49] ibid art 2-7

standards in different Member States and fragmentary provisions of the directive caused the EEC insider dealing regime to be very inconsistent.[50]

For those reasons, in 2003, the European Parliament and the European Council introduced the new Market Abuse Directive (hereinafter "MAD")[51], which developed regulations concerning insider trading, inside information, duty to reveal inside information and market manipulation. Similarly to the Directive of 1989, MAD was supposed to improve the access to information for investors on capital markets and, at the same time, decrease the differences between the Member States.

However, after several years, the European Commission (hereinafter "EC") conducted research to check the implementation process of the MAD among the Member States, which led to the conclusion that a new piece of legislation is needed.[52] The main issues with the MAD were, among others, lack of harmonisation among the Member States, which led to significant differences between insider trading regimes across the EU, gaps in the regulations of new markets and lack of clarity and legal certainty. To address those issues, the EC proposed to amend existing regulations with a new Market Abuse Regulation (hereinafter "MAR")[53] and Market Abuse Directive II (hereinafter "MAD II").[54]

Establishing rules concerning insider trading and market manipulation in a form of a regulation has a great significance and is a fundamental change, since a regulation is applicable directly in all of the Member States and does not require further implementation.[55] This does not preclude, however, different interpretation of the same regulation across the Member States, which may be, nevertheless, limited

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[50] W Nawrot, 'Zmiany w procesie regulacyjnym Unii Europejskiej w zakresie rynków papierów wartościowych' [2005] 5 Bank i Kredyt 54 55

[51] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), [2003] OJ L 96/16

[52] Commission, Proposal for a Regulation of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse) and Proposal for a Directive of the European Parliament and of the Council on Criminal Sanctions for Insider Dealing and Market Manipulation COM 2011 651 final

[53] Regulation No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC [2014] OJ L 173/1

[54] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive) [2014] OJ L 173/179

[55] M Siems and M Nelemans, 'The Reform of the EU Market Abuse Law: Revolution or Evolution?' [2012] 19 Maastricht J. Eur. & Comp. L. 195 197

by the Court of Justice of the European Union (hereinafter "CJEU") jurisprudence or the guidelines of the European Securities and Market Authority (hereinafter "ESMA").[56] Furthermore, criminal sanctions for market abuse in the form of a directive will not resolve the problem of different penalties across the Member States, since such a directive provides only minimal sanctions for insider trading and the Member States are free to impose higher penalties.[57]

Under the paragraph concerning EU regulations, this article provides an analysis of the definition of inside information, the scope of insiders and in-depth reflections upon the scope of insider trading prohibition. The conclusion shows that under the MAR regime there are various interpretational issues and that it manifolds mistakes which were criticised under the regime of the previous MAD.

B. Definition of inside information

Contrary to US jurisprudence and doctrine in the EU, the definition of inside information is extensively analysed by the doctrine and often widely criticised for a lack of legal certainty. It is necessary to conduct an in-depth analysis of the inside information definition, since it outlines the scope of the insider trading regulation. Under the MAR, inside information is information of a precise nature, which has not been made public, related, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.[58]

Therefore, the following prerequisites of inside information may be distinguished by:

precise nature of information;

non-public character;

direct or indirect relation to one or more issuers or to one or more financial instruments;

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[56] ibid
[57] MAD II art 7
[58] MAR art 7

likelihood of having a significant effect on the price of a security or related derivative financial instruments.

The first prerequisite is fulfilled when the information fulfils two cumulative conditions. Therefore, in order for information to be categorised as precise, it must refer to a set of circumstances which exist or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so; and secondly, it must be specific enough to enable one to draw a conclusion as to the possible effect of that set of circumstances or event on the prices of the financial instruments concerned or related derivative financial instruments.[59] Therefore, this condition is not fulfilled for rumours or a prognosis based on well-known facts.[60]

The condition of a non-public character of information is fulfilled when the information has not been disclosed to the public yet; it is only known to a closed circle of people and other investors cannot get access to that information easily.[61] After the disclosure, the information ceases to be inside information.

The condition of relation to one issuer or a financial instrument is very broad, since it includes information that relates both directly and indirectly. Although it is simple to determine, whether information relates to securities directly, it may be very difficult to outline the scope of information that relates to them indirectly. Potentially, it may be an extremely broad scope which could be practically impossible to determine. Since intentional insider trading triggers criminal liability, it seems to be potentially dangerous to create such a broad scope of inside information definition which is also very difficult to determine.

The last prerequisite is determined using a 'rational investor' test.[62] The application of the test requires to determine, whether the average investor would consider this information relevant when buying or selling securities and should be done *ex ante* the purchase. Therefore, the 'likeliness' of a significant change in the price of a security should be done from an investor's point of view, and whether such information in fact had an impact *ex post* on the price of the security can be

[59] Case C-11/19 *Geltl v. Daimler AG,* [2011] EU:C:2012:397; MAR art 7 par 2
[60] M Glicz, 'Obowiązki publikacyjne emitentów w zakresie informacji poufnych' [2005] 10 Przegląd Prawa Handlowego 53 54
[61] ibid 55
[62] MAR preamble para 14

used to check the presumption that the *ex ante* information was price sensitive, but should not be used to take action against persons who drew reasonable conclusions from *ex ante* information available to them.[63]

The EU definition of inside information is, in general, very similar to the US definition. Both definitions require a non-public character and determination of a value of the information by the average investor. The biggest difference between the European approach and the US approach lies in including information that relates only indirectly to the securities inside the scope of inside information by the EU regulation.

It should also be pointed out that MAR uses the same definition of inside information both for dealing with insider trading and for disclosure duties. The European insider trading regulation is based on the equal access to information principle and, therefore, MAR imposes a duty on companies that are within its scope to disclose any inside information as soon as possible.[64] Although initial projects of MAR provided two separate definitions of inside information[65], the final version contains only one definition which is widely criticised by the doctrine for setting the threshold in the definition, which is too low for disclosure duties.[66] Such a low threshold impedes the functioning of companies which have to make immediate decisions to qualify large groups of information as inside or not ,and then reveal them in order to avoid high punishments. However, according to the EC such a broad definition of inside information in fact increases investor's trust in financial markets and, at the same time increases their efficiency and liquidity.[67]

C. Insiders

[63] ibid preamble para 15
[64] ibid art 17
[65] Commission, Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM (2011) 651 final
[66] Lachlan Burn, 'Capital Markets Union and regulation of the EU's capital markets' [2016] vol 11 no 3 Capital Markets Law Journal 352 364
[67] Call for evidence – Review of Directive 2003/6/EC on insider dealing and market manipulation (Market Abuse Directive), Brussels 2009

A person who is in possession of inside information is called an insider.[68] Under the EU regime, we may distinguish two categories of insiders, primary and constructive insiders.[69]

Primary insiders are persons who possess inside information as a result of:

1) being a member of the administrative, management or supervisory bodies of the issuer or the emission allowance market participant;

2) having a holding in the capital of the issuer or emission allowance market participant;

3) having access to the information through the exercise of an employment, profession or duties; or

4) being involved in criminal activities.

In comparison to the US regulation, insiders from points 1, 2 and 3 would be considered as corporate insiders or constructive insiders based on their fiduciary duty. As to the fourth point, even though such a criminal would not be considered an insider because of the lack of a fiduciary duty, nevertheless, he would probably be held liable for insider trading based on a precedent established in *SEC v. Dorozhko*.[70]

A secondary insider, on the other hand, is any person who obtained inside information under circumstances other than outlined for primary insiders, where that person knows that it is inside information.[71] Therefore, two conditions may be established to qualify a person as a secondary insider:

1) This person possesses inside information;

2) This person knows that the information he or she possesses is inside information.

Being qualified as a secondary insider has an important legal significance, since it applies the same rules as to the primary insiders. That regulation shows a major difference between the US and the European system. Under the EU law, there

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[68] M Hotel, 'Wybrane zagadnienia nowej europejskiej regulacji dotyczącej nadużyć na rynku kapitałowym' [2015] 3 Europejski Przegląd Sądowy 21 22

[69] MAD II art 3 para 2

[70] Marco Ventoruzzo, 'Comparing Insider Trading in the United States and in the European Union: History and Recent Developments' [2014] European Corporate Governance Institute - Law Working Paper no 257 18 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442049> accessed 3 December 2016

[71] MAD II art 3 para 3

is no prerequisite of violating a fiduciary duty by the tipper; therefore, using an example of a tipping chain which was presented in the section 2.6, everyone who used information to trade in securities would be held reliable. Furthermore, using the second example, a waiter overhearing a business conversation about inside information would also be held reliable, if he would use it to trade in securities. This is probably the most visible difference between the European equal access to the information approach and the US fiduciary duty approach. Under the EU regime, it comes down to the rule that no person who knowingly possesses inside information may trade in securities with the use of that information. The philosophy and the goalbehind this wide approach is about creating an integrated, efficient and transparent financial market, where all investors have an equal and fair access to information.[72]

D. Insider trading

Under the EU regime, insider trading is considered an unfair advantage being obtained from inside information to the detriment of third parties,[73] and as a result it's avoidance has an impact on eliminating information asymmetries.[74] For that reason, both MAR and MAD II contain detailed rules that outline the scope of insider trading.[75] Insider trading arises where a person possesses inside information and uses that information to acquire or dispose of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates. The use of inside information by cancelling or amending an order concerning a financial instrument to which the information relates where the order was placed before the person concerned came into possession of the inside information is considered to be insider dealing. In relation to auctions of emission allowances or other auctioned, the use of inside information also comprises

[72] MAR preamble para 2 and 23
[73] ibid preamble para 23
[74] Gloria Esteban De La Rosa, 'The Insider Trading in the European Union Law' [2014] Vol VII Issue IX Version I Global Journal of Management and Business Research (E) 65
[75] MAR art 8-10; MAD II art 3 para 4 *in fine* and art 4

submitting, modifying or withdrawing a bid by a person for its own account or for the account of a third party.[76]

This extensive definition contains several significant provisions. Firstly, under the EU regime the insider trading ban, contrary to US law, is based on the use of inside information, not merely possessing it. Such a regulation settled doubts that had arose under the previous regulations.[77] Secondly, a violation occurs when the insider purchases or sells securities for his own account or for the account of a third party. MAR introduced a significant change in comparison to the MAD, since it also punishes cancelling or amending a previously made order concerning the security, if the was placed before obtaining inside information. It appears that this provision efficiently eliminated a loophole that was available to insiders under the previous regime.

Furthermore, article 9 of the MAR seems to contain restrictions on the scope of a broad definition of insider trading. It provides provisions that regulate certain instances where although the trader possesses inside information and trades in securities related to that information, he may not be held reliable for insider trading. These provisions are as follows:

1) Legal person that has established, implemented and maintained adequate and effective internal arrangements and procedures that effectively ensure that neither the natural person who made the decision on its behalf to acquire or dispose of financial instruments to which the information relates, nor another natural person who may have had an influence on that decision, was in possession of the inside information and has not encouraged, made a recommendation to, induced or otherwise influenced the natural person who, on behalf of the legal person, acquired or disposed of financial instruments to which the information relates.

2) Where the trader for the financial instrument to which that information relates, is a market maker or a person authorised to act as a counterparty, and the acquisition or disposal of financial instruments to which that information relates is made legitimately in the normal course of the exercise of its

[76] MAR art 8

[77] See: K Langenbucher, 'The 'Use or Possession' Debate Revisited - Spector Photo Group and Insider Trading in Europe' [2010] vol 5 no 4 Capital Markets Law Journal 452 452-470

function as a market maker or as a counterparty for that financial instrument; or is authorised to execute orders on behalf of third parties, and the acquisition or disposal of financial instruments to which the order relates, is made to carry out such an order legitimately in the normal course of the exercise of that person's employment, profession or duties.

3) If a person has used that information and has thus engaged in insider dealing on the basis of an acquisition or disposal where that person conducts a transaction to acquire or dispose of financial instruments, and that transaction is carried out in the discharge of an obligation that has become due in good faith and not to circumvent the prohibition against insider dealing, and that obligation results from an order placed or an agreement concluded before the person concerned possessed inside information or that transaction is carried out to satisfy a legal or regulatory obligation that arose, before the person concerned possessed inside information.

4) If a person has obtained that inside information in the conduct of a public takeover or merger with a company and uses that inside information solely for the purpose of proceeding with that merger or public takeover, provided that at the point of approval of the merger or acceptance of the offer by the shareholders of that company, any inside information has been made public or has otherwise ceased to constitute inside information.

5) When a person uses their own knowledge that it has decided to acquire or dispose of financial instruments in the acquisition or disposal of those financial instruments that does not in itself constitute use of inside information.

It may be noted that the first four provisions are not necessary, because they *a priori* do not include the usage of inside information and thus do not fall under the scope of insider trading.[78] The only provision that in practice excludes the liability of an insider is the last one, since it deals with a situation of front-running which falls under the scope of article 8 of the MAR.[79]

[78] M Hotel, 'Wybrane zagadnienia nowej europejskiej regulacji dotyczącej nadużyć na rynku kapitałowym' [2015] 3 Europejski Przegląd Sądowy 21 26
[79] ibid

II. CONCLUSION

A comparison of insider trading regulations in the US and the EU shows, how choosing a different principle that stands behind the regulation of the same phenomenon affects the whole regime of the regulation and results in two very different outcomes. The US system rejected the equal access to information principle and based the insider trading ban on the violation of fiduciary duties and the misappropriation theory instead. This approach had significantly limited the scope of insider trading prohibition but also resulted in creating an overly complex legal system with a low level of legal certainty. On the other hand, the EU had chosen to base its system on the equal access to information theory that aims to eliminate information asymmetries in capital markets. It may be well argued that although the EU regime under the MAR and the MAD II provides a relatively high level of legal certainty and more clear definitions than the US regime,[80]at the same time it fails to fulfil the main goal of introducing the equal access to information principle which is to ensure financial markets' efficiency. This is mainly caused by creating a very broad definition of inside information that includes information that relates only indirectly to the issuer or the financial instrument and the disclosure obligationsrelated to it . This issue could be easily solved by creating two separate definitions of inside information – one for insider trading and one for disclosure obligations. However, the chances that this issue will be solved in near future are highly unlikely. The same may be said about the US regime, although keeping the fiduciary duties principle seems to be developing a whole new system of insider trading regulation.

It seems that what is a strong suit of one system at the same time is a disadvantage of another. Lack of legal certainty and clarity is compensated by a more proportional scope of liability in the US, while in the EU the extensive and broad scope of the liability is compensated with a high level of clarity and legal certainty.

Ultimately, although both systems are at first glance completely different, in similar situations they produce the same results. The main difference from a practical

[80] Eric Engle, 'Global Norm Convergence: Capital Markets in U.S. and E.U. Law' [2010] vol 21 issue 4 European Business Law Review 465 490

point of view lies in a tippee's liability and a higher standard of proof developed under the US system, since it requires proving a violation of fiduciary duties in order to impose liability on a trader. It is impossible to answer a question which system is better without an in-depth economic analysis and even with such an analysis, there is no agreement as to the extent, to which insider trading should be prohibited.

The system of monitoring wholesale energy markets for electricity and gas – the REMIT Regulation

Julia Rychlińska[*]

Abstract

Inspiration for the analysis of REMIT as well as the creation of the article is the Schuman Declaration of May 9 1950. In Schuman's view, only merging economic interests could be the foundation for creating a deeper community of European nations based on mutual trust and integrity. His declaration became the basis for working on establishing the European Coal and Steel Community, which included leading European states and initiated European integration processes. Consequently, the aforementioned development of the unification of the Old Continent led to the creation of the European Community and then the European Union, one of which the main objectives are unification and equalization of the economy of the states belonging to that particular organization. Moreover, the community, in addition to the consolidation of states, striving to achieve its goals, introduces a number of programs to implement the planned changes. One of them is "Europe 2020" which, in one of its most important points, includes plans for climate change and sustainable energy use. In addition, the descriptions of the European Coal and Steel Community included in the Schuman Declaration could be compared to the current European Union policy on electricity and gas, which is undoubtedly a basis for a current energy policy. The author of the article will detail the objectives of the REMIT Regulation, REMIT market participants' obligations and supervisory system, as well as a system of penalties for non-compliance with REMIT obligations.

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I. INTRODUCTION

The inspiration for the analysis of the issue is the Schuman Declaration of 9 May 1950,[1] in which a proposition was made to place "the entire Franco-German production of coal and steel under a common High Authority in an organization open to the participation of other European countries" and to make "a fusion of interests necessary to establish economic community and the introduction of a much wider and deeper community of countries long divided by bloody conflicts.". The aim of the above-mentioned proposal was communitarisation of the selected - there is no doubt, that at that time the essential - segment of the economies of France and Germany with the participation of other European countries wishing to join the economic community. According to Schuman, only a merger of economic interests could have become the foundation for the creation of a deeper community of European nations based on mutual trust and honesty.[2] The Schuman's Declaration was the basis for the work to establish the European Coal and Steel Community, which included the leading European countries and started the European integration processes.[3] Consequently, the above-mentioned development of the unification of the Old Continent led to the creation of the European Community and then the European Union, one of whose main objectives is to unify and align the level of the economies of countries belonging to this characteristic organization. What is more, the community, in addition to the consolidation of the countries, by striving to achieve the intended objectives, introduces a number of programs designed to put the planned changes into practice. Undoubtedly, the great example of the strategy to achieve those initiatives by the European Union is the 'Europe 2020', whose most important points include plans concerning climate change and sustainable energy use.[4] However, there is continually a lot of controversy surrounding "the marriage" of coal and electricity.[5] A detailed discussion about them goes beyond the scope of

[1] Schuman Declaration of 9 May 1950
[2] R. Schuman, For Europe, Cracow 2009
[3] European Coal and Steel Community as the beginning of the modern European Union, 2 May 2009, www.stosunkimiedzynarodowe.pl [availability – 31 March 2016]
[4] Europe 2020 - aims, European Commission, www.ec.europa.eu, [availability – 31 March 2016]
[5] The Chance for coal, 14 February 2016, www.biznes.pl, [availability – 31 March 2016]

this essay, and probably would distort its proportions, so it is necessary to limit it only to a signalization. However, they cannot be omitted.

Returning to the fundamental principles of the European Union, i.e. the mutual trust and integrity of the Member States – it should be emphasized that they manifest themselves through the regulations and directives, respected by the countries of the European Union and issued by the competent authorities A special regulation of the European Parliament and of the Council of the EU, which I would like to pay attention to in this essay, is the Regulation no.1227/2011 on wholesale Energy Market Integrity and Transparency „REMIT", dated 25 October 2011.[6]

II. THE AIMS OF THE REGULATION

The primary aim of the REMIT Regulation is to maintain the electricity market as a market subject to strict, restrictive rules of publication and disclosure of all information that may affect the price of energy products on the wholesale energy market, including the absolute prohibition on market manipulation. The REMIT Regulation also regulates the rules of cooperation between the Member States in the monitoring of gas and electricity in order to prevent fraud. It imposes on market participants a number of obligations in the field of information and reporting related to e.g. the prohibition of market manipulation and use of inside information. The REMIT Regulation includes the equipment of the regulatory authorities with the powers needed to provide investigations and enforcement of the regulation, obliging the Member States to introduce specific regulations in that matter.[7] It should be noted, that the above-mentioned Regulation has been directly applicable in the Polish law since 28 December 2011 (pursuant to Article 288 TFEU[8] - the Regulation is directly applicable in all Member States and does not require implementation), while under Article 22 of the Regulation on wholesale Energy Market Integrity and

[6] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[7] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[8] Article 288 Treaty on the Functioning of the European Union

Transparency,[9] the applicability of the provisions of the Regulation concerning the reporting of transactions was postponed until a decision by the European Commission on implementing acts to REMIT is issued.

III. OBLIGATIONS OF MARKET PARTICIPANTS UNDER THE REMIT

The basic obligations of the EU Member States, as indicated in the Regulation are: the prohibition of using inside information by a market participant, the obligation to publish inside information, the prohibition of market manipulation and the obligation of reporting to the Agency. Cooperation of Energy Regulators (ACER) transactions on wholesale energy markets and the basic data, as well as the obligatory registration of market participants in the register maintained by the President of Polish Energy Regulatory Office (ERO).[10] As mentioned, the main responsibilities provided for in the Regulation can be divided into those that already exist and those that will come into force only after the adoption by of the Act Implementing REMIT accepted by the Commission.

The first duty is to ban the use of inside information by a market participant until the effective publication of inside information in the manner specified in REMIT, due to the fact that this information is confidential and subject to legal protection. This protection is described in article 3 of REMIT,[11] which states that the prohibition of the use of inside information, which came into force from the moment of the entry of REMIT into force, i.e. as of 28 December 2011.

Moreover, in the preamble to the REMIT Regulation,[12] it is demonstrated that „the use or attempted use of inside information to trade either on one's own account or on the account of a third party should be clearly prohibited. Use of inside

[9] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[10] Energy Regulatory Office, www.gov.ure.pl, [availability – 31 March 2016
[11] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[12] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)

information can also consist in trading in wholesale energy products by persons who know, or ought to know, that the information they possess is inside information".
In contrast, under the aforementioned article 3 of REMIT[13] - "Persons who possess inside information in relation to a wholesale energy product shall be prohibited from:

(a) using that information by acquiring or disposing of, or by trying to acquire or dispose of, for their own account or for the account of a third party, either directly or indirectly, wholesale energy products to which that information relates;

(b) disclosing that information to any other person unless such disclosure is made in the normal course of the exercise of their employment, profession or duties;

(c) recommending or inducing another person, on the basis of inside information, to acquire or dispose of wholesale energy products to which that information relates."

There are, however, a few exceptions that this prohibition does not include, e.g. the prohibition of insider trading will not apply to transactions carried out under an obligation that has become due (more information in article 4(4)(a) of REMIT) and transactions carried out by producers of electricity and natural gas, storage operators and others, where a a failure to enter into such a transaction would result in the fact, that the market participant would not be able to meet the existing contractual obligations. The prohibition to use insider information refers to persons possessing inside information mentioned in article 3(2) of REMIT, who include but are not limited to the members of the administrative, management or supervisory bodies of the company, persons holding shares in the company, and also to any person with access to such information by virtue of employment.[14]

Another of the foremost responsibilities which entered into force, in accordance with article 4 .1 of the Regulation[15] is the duty of administration by

[13] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[14] T. Brzeziński, A. Mathews, Monitoring system of wholesale electricity and gas markets
[15] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)

market participants to the public inside information. Internal information is defined in the Regulation by the four criteria which are:

a) information of a precise nature

b) information that has not been made public,

c) information that relates directly or indirectly to one or more wholesale energy products,

d) information that has been made public and which would significantly affect the prices of wholesale energy products.

In addition, pursuant to article 4(1) of the Regulation,[16] the disclosure of inside information includes information relevant to the capacity and use of facilities for production, storage, consumption or transmission of electricity or natural gas or related to the capacity and use of LNG facilities, including planned or unplanned unavailability of these facilities. What is more, it is also necessary to note that, in accordance with the provisions of REMIT, the publication of inside information, including information in aggregated form, involves the simultaneous, complete and effective public disclosure in accordance with Regulation (EC) No. 714/2009 or Regulation (EC) No. 715/2009, or guidelines and network codes adopted pursuant to those Regulations.[17] Moreover, the President of the Energy Regulatory Office in the Communication No. 23/2014 of 9 June 2014,[18] pointed out that taking into account "the functioning of the Exchange Information Platform as a place of publication of orderly and transparent communications (data on the energy system in Poland, as well as places to publish internal information)", it is necessary to introduce a system of publication of inside information, in cooperation with the Polish Power Exchange SA, which requires simultaneity, completeness and effectiveness."

Another important requirement introduced by Regulation No. 1227/2011 is the obligation to report transactions to ACER. Article 8(1) of REMIT[19] involves

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[16] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)

[17] T. Brzeziński, A. Mathews, Kancelaria Wawrzynowicz i Wspólnicy, Nowa Energia, "Information about obligations resulting from the REMIT for market participants at electricity and gas fuels markets", No. 2-3, 2014

[18] Announcement of the President of ERO, No. 23/2014, 9 June 2014

[19] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)

providing the Agency with a record of wholesale energy market transactions, including orders to trade, precise identification of the wholesale energy products bought and sold, the price and quantity agreed, the dates and times of execution, the parties to the transaction and the beneficiaries of the transaction and any other relevant information. Specific provisions in this field will contain, e.g. the implementing act to REMIT. It is important to note that the committee working on this document shall be composed of the representatives of the Ministries competent for energy and national energy regulators. It is worth noting that during the consultation on the draft of the implementing act to REMIT, market participants mentioned, e.g. that the Commission should establish minimum thresholds, the achievement of which will generate an obligation to report the transaction. Apart from that, there are signals that there is insufficient time for the market participant to prepare for the changes and for adaptation of organized trading facilities to report information on the concluded contracts. Also, the implementing act to REMIT in its current version provides for an obligation to report any changes or modifications to contracts within the scope of REMIT. According to market participants, the reporting obligation should be limited only to crucial changes which have a significant impact on the market.[20]

In addition to the two above-mentioned obligations, there is one which is extremely important – the prohibition of market manipulation which was set forth in article 5 of REMIT. "Any engagement in, or attempt to engage in, market manipulation on wholesale energy markets shall be prohibited." Article 2 of REMIT introduced the definition of manipulation, which should be understood as any activity in wholesale energy markets, undertaken by persons that artificially create prices to set them at a level not justified by market forces of supply and demand, including actual availability of production capacity, storage or transport. Moreover, it should be noted that the EU legislator also provided for forms that can accept manipulation on wholesale energy markets, such as placing and withdrawal of false orders, dissemination of false or misleading information or rumours through the

[20] T. Brzeziński, A. Mathews, Kancelaria Wawrzynowicz i Wspólnicy, Nowa Energia, "Information about obligations resulting from the REMIT for market participants at electricity and gas fuels markets", No. 2-3, 2014

media, or deliberately making pretence of the availability of electricity generation capacity or natural gas availability or available capacity were different than they are actually and technically available, where such information affects or may affect the price of wholesale energy products. In addition, ACER provided more examples of manipulation in its non-binding guidelines. What is more, an attempt at manipulation was determined as attempted violation of obligations under REMIT.

The last of the primary obligations imposed on market participants by REMIT, which I present in this essay is mandatory registration of the participants in the register maintained by the President of the Polish Energy Regulartory Office (ERO). This obligation is governed by article 9 of the Regulation,[21] under which: "Market participants entering into transactions which are required to be reported to the Agency in accordance with article 8(1) shall register with the national regulatory authority in the Member State in which they are established or resident or, if they are not established or resident in the Union, in a Member State in which they are active.". REMIT thus assumes that the register will contain sufficient information to identify the market participant, and each market participant will receive a personalized badge. These data will be transmitted by the competent national regulatory authority to ACER, which will then create a European register of market participants.[22]

Taking it into account, one of the main responsibilities launching the whole system associated with the REMIT regulation is to register before the first transaction is notifiable to ACER. The obligation to provide information on concluded standard contracts to ACER was established on 7 October 2015. And, the obligation to report custom contracts will be established on 7 April 2016. Until that day, market participants must be registered in order not to violate the regulations of REMIT and avoid sanctions.[23]

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[21] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)

[22] T. Brzeziński, A. Mathews, Monitoring system of wholesale electricity and gas markets introduced by Regulation REMIT - an analysis of the obligations of market participants

[23] "When the registration process should be completed?", ure.gov.pl, 17 March 2015, [availability – 31 March 2016]

IV. THE SURVEILLANCE SYSTEM AND SYSTEM OF SANCTIONS FOR NON-COMPLIANCE WITH OBLIGATIONS UNDER REMIT

In addition to many duties, the REMIT Regulation lists a number of sanctions that could be imposed on market participants for non-compliance with the above-mentioned Regulation. Through the introduction of Regulation No. 1227/2011, EU Member States were obliged to include sanctions for infringements in their legislation and to equip their national regulatory authorities (in Poland, the President of ERO) with powers of investigation and enforcement pursuant to the provisions of the REMIT Regulation. Moreover, these sanctions need to be proportionate, effective and dissuasive – they should reflect the gravity of the infringements, the damage caused to consumers and potential gains resulting from the infringement. What is more, in the present case, point 31 of the preamble to the REMIT Regulation[24] is undoubtedly important, as it indicates that penalties for infringements of the REMIT Regulation should be carried out in accordance with the national law of the Member States through the implementation of the MAD Directive.[25] The provisions aim to ensure that REMIT is observed through control of their performance and establishing penalties for failures to perform their duties, are introduced into the legal system by amending the European Parliament, which gives significance to obligations under REMIT. A failure to comply with the obligations referred to therein may result in far-reaching consequences. In addition to the above, the EP amendment gives the President of the ERO actual competence in respect of the obligations under REMIT.[26] Every suspicion of manipulation, attempt to engage in market manipulation or illegal use of inside information are the basis for the President of the ERO to conduct an inspection or investigation. Initiation of the control is followed by providing authorized entity to conduct control by the President of ERO. Persons who conduct inspections have broad authority to control e.g.: the right to access to

[24] Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency (REMIT)
[25] Penalties for non-compliance with the REMIT Regulation, Commentary C/M/S, 08 May 2013
[26] Adam Jodłowski, Konrad Szybalski, "Obligations of market participants resulting from REMIT and amended Energy Law" (Vol. I), www.wysokienapiecie.pl, 15 October.2015, [availability – 31 March 2016]

both offices and premises of the controlled entity and its means of transport, the right to request access to records, books and all kinds of documents and media, and oral explanations. During the inspection, the inspector may be assisted by officials of other state control authorities or the Police. The controlled entity is obliged to make all facilities available for the inspection, e.g. to allow inspectors to make copies of the documents, to provide a separate room and make means of communication available. It is worth mentioning, that in this case the President of the Energy Regulatory Office must obtain the consent of the Court of Competition and Consumer Protection. In particularly justified cases, the consent of the above-mentioned Court may be given before the commencement of the audit procedure. Moreover, all documents containing information relevant to the object of the inspection can be retained for up to 7 days (the seizure of the documents may also be a result of forced receiving). After the inspection, the controlled entity can receive a recommendation to remove the irregularities found during the inspection within the period of not less than 14 days. Only in exceptional cases, when it is required by trading safety or interests of investors, the President of ERO may submit recommendations before the end of the control, setting the controlled a deadline for removing the irregularities in less than 14 days. Control procedures may lead to finding a violation of law, which is subject to an administrative penalty for a market participant in the amount of PLN 10,000 to PLN 1,000,000. This penalty may be imposed on an entity that, contrary to the obligation:

a) does not provide inside information to the public;
b) does not provide the ACER (in case of using installation, it also applies to the President of the ERO), or provide inaccurate or incomplete data on transactions on wholesale energy markets or the capacity and use of facilities related to the functioning of the energy market;
c) sells energy products on the wholesale energy market without the required entry in the register of ACER market participants or does not update the data given in the registration form, or gives incomplete or incorrect data in the registration form;
d) makes it difficult to complete the operations in the inspection proceedings or investigation.

In accordance with the above-mentioned, penal provisions are introduced in the Energy Law, which shall ensure that behaviours that interfere with the free operation of the market will be eliminated. Moreover, the President of ERO was given the power to conduct an investigation, the aim of which is to find whether there are grounds to file a notification on suspicion of committing a crime.[27]

V. REMIT - THE EFFECTIVENESS OF THE INTRODUCED REGULATION

The electricity market, due to its characteristics, does not operate in conditions of perfect competition. The reasons for this are primarily: the lack of storage capacity in a cost-effective manner and on a significant scale commodity for the electricity, low flexibility of demand and technical limitations of the power system. These and other reasons mean that the electricity market is particularly susceptible to all kinds of distortions, abuse and manipulation. In order to prevent this from occurring, their identification and drawing any consequences from those examples, the electricity market is monitored in order to prevent from committing illegal practices.[28]

It is possible to operate on the markets of the Member States of the European Union due to the Regulation on wholesale Energy Market Integrity and Transparency "REMIT" dated 25 October 2011, No. 1227/2011. The provisions introduced in this regulation are intended to bring the European Union to market transparency and integrity, that is, to prevent unfair competition, as well as to maintain the transparency of prices. Strict compliance with the provisions contained in that regulation is expected to result in transparent trading of wholesale energy products. These assumptions may, however, turn out to be untrue, if not properly implemented and respected by the EU Member States. The evaluation of the

[27] Adam Jodłowski, Konrad Szybalski, Obligations of market participants resulting from the REMIT and amended Energy Law (Vol. I), www.wysokienapiecie.pl, 15 October.2015, [availability – 31 March 2016]

[28] Mariusz Krupa, Monitoring of electricity, PSE Innowacje Sp. z o.o. Grupa Kapitałowa PSE Operator.

effectiveness of the REMIT Regulation will be possible, but only after a reasonable time, which will allow one to determine both the disadvantages and advantages of the implemented regulations. The implementation of the Regulation on wholesale Energy Market Integrity and Transparency is very important and leads to the development of the constantly growing energy sector of the EU. Undoubtedly, it is necessary to notice that it may provide a solid foundation for the introduction of „Energy Union" in the European Union proposed by Donald Tusk, President of the European Council.[29] The European Union Energy, in accordance with the concept of the President of the European Council, should be based on a gas solidarity mechanism, joint-purchasing of energy, rehabilitation of coal and radical diversification of energy supply sources, and more specifically, it would be based on the fundamental pillars related to energy infrastructure, solidarity mechanisms, increased bargaining power of the Member States and the EU with external suppliers, the development of indigenous sources of energy in the EU or the diversification of energy supplies to the EU.

The proposition to create a union of energy causes controversy both among the EU Member States, as well as among European gas companies that are interested in the greatest possible freedom in preparing contracts - rather than averaging the prices of raw materials. What is more, most of the propositions, on which the mentioned union would be built, already function in the EU Member States.

Both the introduction of REMIT and the desire to create a union of the internal energy market of the Member States cause a lot of discussion. The effect and legitimacy of the REMIT regulation and refining the plan for the creation of energy union is currently impossible to assess. Only future generations will be able to assess the effectiveness of these solutions.

[29] „Tusk on union energy: gas solidarity, coal rehabilitation", www.cire.pl, 29 March 2014, [availability: 31 March 2016]