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IN CHINA

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**WHEN MARKET TRANSFORMS: REFORMING THE TAKEOVER
DEFENSE REGIME IN CHINA**

*Lingzheng Kong**

I. INTRODUCTION

Since Professor Henry Manne published his seminal work *Mergers and the Market for Corporate Control*,¹ hostile takeovers—extolled as the hallmark of the market for corporate control—have been widely regarded as a fundamental external governance mechanism for reducing agency costs in firms.² Controversies, therefore, arise when the target’s board of directors deploys various takeover defenses to deter or even thwart hostile bids. In light of this, major developed countries in the world, such as the United States, the United Kingdom, and countries in the European Union, have developed comprehensive legal regimes to address the conflicts involved in hostile takeovers—mainly those between shareholders and the management of the target company.

Hostile takeovers are rare. If they do occur, they only occur in target companies with highly dispersed ownership.³ Based on this observation, commentators have held very pessimistic views toward hostile takeovers in China. Their reasoning is straightforward: because most of the Chinese-listed companies are state-owned enterprises (SOEs)—and in a socialist country like China, the state is unlikely to relinquish its control—hostile takeovers will not happen.⁴

* Lingzheng Kong is a Ph.D. candidate at China University of Political Science and Law, and a Michigan Grotius Research Scholar at the University of Michigan Law School. The author would like to thank Mr. Patrick Barry (clinical assistant professor at the University of Michigan Law School), Mr. Morgan Aveni (J.D. candidate at the University of Michigan Law School), and Mr. Cooper Tong (J.D. candidate at the University of Chicago Law School) for their priceless comments and assistance in developing this Article. Any errors are my own.

¹ See generally Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Note that although Professor Manne coined the phrase “the market for corporate control,” he did not clearly define this concept. See generally *id.* Professors Michael Jensen and Richard Ruback later defined it as “a market in which alternative managerial teams compete for the rights to manage corporate resources.” Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 6 (1983).

² See discussion *infra* Part VI.A.2.

³ See John Armour et al., *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT’L L.J. 219, 221 (2011).

⁴ See, e.g., *id.* at 274 (arguing that “[s]tate ownership of enterprise and regulatory requirements for major investments in Chinese firms create an environment where there is little immediate prospect for a market for corporate control developing in China.”); see also Hui Huang, *China’s Takeover Law: A Comparative Analysis and Proposals for Reform*, 30 DEL. J.

Yet, this Article finds that even in the era when SOEs dominated the stock market in China in terms of the number of listed companies and the corresponding aggregate market capitalization, hostile takeovers did occur in a few companies with exceptionally dispersed ownership.⁵ Furthermore, over the past decade, the market for corporate control in China has been bolstered by a phenomenal rise of privately-listed companies—an obvious trend of dispersed ownership among listed companies, and significantly broadened financing sources for takeovers. Accordingly, this Article provides a dynamic, updated and comprehensive picture of the market for corporate control in China—one that has not appeared in previous scholarship.

In addition to an effective market for corporate control, hostile takeovers must overcome two barriers to succeed. One is the legal regulations on takeovers, including rules on both the information disclosure for block share purchases and tender offers. These rules could considerably decrease or increase the cost of hostile takeovers, and thus have encouraging or chilling effects. The other barrier is takeover defenses, which have a more direct ability to defeat a hostile takeover.

In China, the rules on information disclosure for block share purchases and tender offers first appeared in the Interim Provisions on the Management of the Issuing and Trading of Stocks (the Stock Interim Provisions) in 1993.⁶ This regulation, among other things, imposed on acquirers an arduous disclosure requirement and a mandatory tender offer obligation.⁷ These rules, however, have been greatly relaxed over time. For

CORP. L. 145, 153 (2005) (stating that, in China, “in the face of such a high percentage of non-tradable state shares in listed companies, takeover attempts by tender offer are practically impossible.”); see also Guanghai Yu, *Takeovers in China: The Case Against Uniformity in Corporate Governance*, 34 COMM. L. WORLD REV. 169, 185 (2005) (arguing that in China “[t]he structure of shareholding in most listed companies makes it impossible for an acquiring company to accumulate control through buying shares on any stock exchange. So far, there has been no successful acquisition of control of a listed company by purchasing shares on the stock market.”). In addition, when examining the institutions that affect corporate governance in China, Professor Clarke intentionally omitted the role of hostile takeovers on the ground that “hostile takeover attempts are extremely rare in China.” Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT'L L. & BUS. 131, 149 n.62 (2010).

⁵ See discussion *infra* Part III.

⁶ Gupiao Faxing Yu Jiaoyi Guanli Zhanxing Tiaoli (股票发行与交易管理暂行条例) [Interim Provisions on the Management of the Issuing and Trading of Stocks] (promulgated by the St. Council, Apr. 22, 1993, effective Apr. 22, 1993), CLI.2.6224(EN) (Lawinfochina) [hereinafter Stock Interim Provisions].

⁷ *Id.* at Chapter IV.

example, the current regulation allows a partial tender offer instead of a mandatory tender offer to all shareholders for all outstanding shares as required by the previous regulation.⁸ Those relaxations have made hostile takeovers in China much easier and more cost efficient.

But the developing line of takeover defense legal regime in China is not as clear. The first regulation governing takeover defenses in 2002⁹ (the 2002 Takeover Regulation) prohibited the target's board from taking a wide range of measures in the face of a tender offer, suggesting a strong tendency of board neutrality as reflected in the City Code on Takeovers and Mergers in the United Kingdom.¹⁰ By contrast, the currently effective Chinese takeover regulation,¹¹ promulgated in 2006 (the 2006 Takeover Regulation), adopts fiduciary duties—the duty of care and the duty of loyalty—as the measuring rod for directorial behaviors in takeovers.¹² Ostensibly, the fiduciary duties stated in the 2006 Takeover Regulation resembles the same duties emphasized by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*¹³ The significance of the fiduciary duties, however, is tempered by the strict ban on post-bid defenses imposed by the same regulation. The regulator's hesitation between the fiduciary duties-based approach and the board neutrality approach, as reflected in the 2006 Takeover Regulation, created enormous controversy and ambiguity.

Accordingly, this Article proposes a reform to the takeover defense regime in China. The hope is to eliminate the controversy and ambiguity that plague the current regime. By looking into the commercial environment and the deeply-established legal principles in Chinese company law, this

⁸ See discussion *infra* Part IV.

⁹ Shangshi Gongsi Shougou Guanli Banfa (上市公司收购管理办法) [Regulations on the Takeover of Listed Companies] (promulgated by the China Securities Regulatory Commission, Sept. 28, 2002, effective Dec. 1, 2002, repealed Sept. 1, 2006), CLI.4.42687(EN) (Lawinfochina) [hereinafter The 2002 Takeover Regulation].

¹⁰ See discussion *infra* Part VI.B.1.

¹¹ Shangshi Gongsi Shougou Guanli Banfa (上市公司收购管理办法) [Measures for the Administration of the Takeover of Listed Companies] (promulgated by the China Securities Regulatory Commission, May 17, 2006, effective Sept. 1, 2006, rev'd Aug. 27, 2008, rev'd Feb. 14, 2012, and rev'd Oct. 23, 2014), CLI.4.237186(EN) (Lawinfochina) [hereinafter The 2006 Takeover Regulation]. Since promulgated in 2006, the 2006 Takeover Regulation has been amended in 2008, 2012, and 2014. *Id.* However, those amendments are generally minor and the provisions regulating takeover defenses have stayed intact. See *id.* For convenience and only for the purpose of this Article, the 2006 Takeover Regulation refers to the currently effective takeover regulation in China and includes all of the amendments made in 2008, 2012, and 2014.

¹² See discussion *infra* Part VI.B.2.

¹³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). For a detailed discussion of this case, see discussion *infra* Part VI.A.1.

Article argues that China should neither adopt a board neutrality policy as presented in the United Kingdom, nor a takeover defense regime based on board primacy as presented in the United States.¹⁴ Instead, what suits China best is a hostile takeover regime empowering the board of directors to adopt takeover defenses while subjecting them to ex-post shareholder approval.

This Article proceeds as follows: Part II outlines the evolving process of the market for corporate control in China. By providing various empirical facts and data, it shows that an effective market for corporate control is emerging in China and the conditions required for hostile takeovers are satisfied in the Chinese stock market. The case studies exhibited in Part III corroborate the development of the market for corporate control depicted in Part II and lays the foundation for discussing the legal issues probed in the subsequent parts. Part IV examines the legal rules regarding information disclosure and tender offers. The relaxation of these rules over time has significantly reduced the cost of hostile takeovers in China. Because takeover defenses concern the legal relationship between the board of directors and shareholders, Part V delineates this relationship under the greater landscape of Chinese corporate governance. Based on this analysis, Part V also summarizes the availability of takeover defenses in China. Part VI describes and analyzes the takeover defense regime in China. It depicts its developing path and reveals the controversy and ambiguity that plague the current takeover regime. Part VII builds upon Part VI and proposes a reform to the takeover defense regime in China. Part VIII concludes this Article.

II. THE MARKET FOR CORPORATE CONTROL IN CHINA: AN EVOLVING STORY

A. *The Stock Market Before 2005*

The opening of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) at the beginning of 1990s marked the formation of centralized stock markets in China.¹⁵ The Chinese government established these stock exchanges with the desire to finance, restructure,

¹⁴ See discussion *infra* Part V.A.

¹⁵ CHINA SEC. REG. COMM'N, Zhongguo Ziben Shichang Ershi Nian (中国资本市场二十年) [TWENTY YEARS OF CHINA'S CAPITAL MARKETS] 3 (2012) [hereinafter TWENTY YEARS OF CHINA'S CAPITAL MARKETS]. Before the opening of the SSE and SZSE in 1990, there had only been two over-the-counter markets established. *Id.* at 5.

and improve the corporate governance of Chinese SOEs.¹⁶ However, in fear of losing control over the listed SOEs through the potential transfer of shares from the state to the private holders—a would-be result of any stock market—the Chinese government implemented a “split-share system.”¹⁷ Under this system, all issued shares of the listed companies were divided into three categories: state-owned shares, legal person-owned shares, and publicly-owned shares. The system further stipulated that state-owned and legal person-owned shares could not be traded on the stock market.¹⁸ Until the end of 2004, the number of non-tradable shares was 454.3 billion.¹⁹ Seventy-four percent of them were state-owned, accounting for 64% of the total number of shares of all listed companies.²⁰ Considering the absolute predominance of SOEs on the stock market and the non-tradable feature of state-owned and legal person-owned shares, a nation-wide market for corporate control did not exist in China until the emergence of the reforms to the split-share system. However, exceptions did exist: even before 2005, several hostile takeovers did take place where target companies were non-SOEs with dispersed ownership structures. This Article will discuss these cases in detail in Part III.

B. *The Split-Share Structure Reform in 2005*

In 2005, the CSRC initiated the split-share structure reform to address the system’s shortcomings,²¹ including stock price distortion and impotence of restraining and incentivizing the management of listed

¹⁶ See Hua Cai, *Bonding, Law Enforcement and Corporate Governance in China*, 13 STAN. J.L. BUS. & FIN. 82, 85 (2007); see also Julian Du et al., *The Evolution of Corporate Finance and the Emergence of the Market for Corporate Control in China*, in ECONOMIC TRANSITIONS WITH CHINESE CHARACTERISTICS 123, 126 (Arthur Sweetman & Jun Zhang eds., 2009).

¹⁷ See TWENTY YEARS OF CHINA’S CAPITAL MARKETS, *supra* note 15, at 32.

¹⁸ *Id.* at 32-33.

¹⁹ See generally CHINA SEC. REGULATORY COMM’N, CHINA CAPITAL MARKETS DEVELOPMENT REPORT 204 (2008) [hereinafter CHINA CAPITAL MARKETS DEVELOPMENT REPORT].

²⁰ *Id.*

²¹ See TWENTY YEARS OF CHINA’S CAPITAL MARKETS, *supra* note 15, at 33-34. The blueprint of the reform was sketched out in 2004 by the St. Council. See Guowuyuan Guanyu Tuijin Ziben Shichang Gaige Kaifang He Wending Fazhan de Ruogan Yijian (国务院关于推进资本市场改革开放和稳定发展的若干意见) [Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets] (promulgated by the St. Council, Jan. 31, 2004, effective Jan. 31, 2004, repealed by the St. Council Nov. 27, 2015), CLI.2.51371(EN) (Lawinfochina) [hereinafter Opinions on Capital Markets]; see also Hui Huang, *The New Takeover Regulation in China: Evolution and Enhancement*, 42 INT’L LAW. 153, 155-58 (2008).

companies.²² The goal of the reform was largely achieved by 2007 when 1,298 listed companies had begun, or even completed, reforms away from a split-share system.²³ This number accounted for 98% of the listed companies involved.²⁴ The newfound transferability of state-owned and legal person-owned shares made the acquisition of control over any Chinese listed company at least legally possible. An empirical study in 2010 indicated a positive correlation between the split-share structure reform and listed companies' firm value.²⁵ This study also found that the reform had contributed to a more active market for corporate control in China.²⁶

C. *The Emergence of an Effective Market for Corporate Control in China*

The Chinese government has traditionally carried out a “corporatization without privatization” strategy when reforming SOEs,²⁷ and it is reluctant to transfer its shares in the listed SOEs despite the split-share structure reform legalizing such transfer.²⁸ Thus, split-share structure reform, on its own, did not affect the predominance of SOEs on the stock market. In the following decade, however, subsequent structural changes in the stock market altered the landscape of the market for corporate control in China on an unprecedented scale.

²² See TWENTY YEARS OF CHINA'S CAPITAL MARKETS, *supra* note 15, at 33.

²³ CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra* note 19, at 208.

²⁴ *Id.* Based on the data released by the CSRC, as of the end of 2004, the total number of listed companies on the two stock exchanges in China was 1,377. *Id.* at 180. This means 1,298 out of the total 1,377, or approximately 95%, of Chinese listed companies in 2004 have undergone the split-share structure reform.

²⁵ See generally Lu Yao (路遥), Jihuo Gongshi Kongzhiquan Shichang Dui Zhongguo Shangshi Gongsi Jiazhi de Yingxiang Yanjiu (激活公司控制权市场对中国上市公司价值的影响研究) [*Study on the Impact of Activating the Market for Corporate Control on Firm Value of Chinese Listed Companies*], 7 JINRONG YANJIU (金融研究) [J. FIN. RES.] 144 (2010).

²⁶ See *id.* at 156.

²⁷ The “corporatization” program, which arose in the 1980s in China, aimed at converting the previous state-owned enterprises—which had no independent legal personality or property and operated under the direct fiat of the government—into incorporated companies with independent legal personality, property and sound corporate governance. See Nicholas Calcina Howson, “Quack Corporate Governance” as Traditional Chinese Medicine: The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against Party State Political Economic Power, 37 SEATTLE U. L. REV. 667, 690-91 (2014). However, the “corporatization” process has not been followed by privatization, as the state still maintains control on companies in a wide range of industries. *Id.* at 691. For a detailed account of “corporatization without privatization” see generally *id.* at 689-94.

²⁸ See Opinions on Capital Markets, *supra* note 21, ¶¶ III-IV.

1. *The Rise of Privately-Listed Companies in the Chinese Stock Market*

To build a multi-tiered capital market and satisfy the financing needs of small and medium enterprises (SMEs), two new stock-trading systems, SME Board and ChinNext, were inaugurated in SZSE in 2004 and 2009, respectively.²⁹ Unlike the listed companies in the Main Board, which consists mainly of SOEs, the majority of the listed companies on SME Board and ChinNext are privately-listed companies.³⁰ As of May 31, 2012, among all of the listed companies in the Chinese stock market, privately-held companies outnumbered SOEs. They accounted for 30.06% of Main Board-listed companies, 76.18% of SME Board-listed companies, and 95.92% of ChinNext-listed companies.³¹ This result came as no

²⁹ See TWENTY YEARS OF CHINA'S CAPITAL MARKETS, *supra* note 15, at 70-78; Since the establishment of the SME Board, the pre-existing trading system has been called "Zhuban" (主板) [Main Board]. The fundamental reason for the establishment of the SME Board and ChinNext Market is that the listing standards for Main Board are too high for SMEs. See CHINA CAPITAL MARKETS DEVELOPMENT REPORT, *supra* note 19, at 178. For example, one of the listing requirements for the Main Board is that the issuer must be profitable for three consecutive years preceding the IPO. *Id.* at 179. This rule unfairly deprived a large number of SMEs of financing opportunities since they had not yet produced profit but were in urgent need for financing. See *id.* at 178. Apart from raising funds through the capital market, SMEs' access to the loan market is severely constrained, not only because the inherent risk involved in those enterprises, but also because Chinese banks, the majority of which are SOEs themselves, naturally prefer SOEs over SMEs.

³⁰ See Zhu Baochen (朱宝琛), Shangshi Gongsi Zhong Minyin Qiye Shuliang Guoban (上市公司中民营企业数量过半) [*The Number of Private Companies Accounts for More Than Half of All Listed Companies*], SEC. DAILY, May 31, 2012, at A2, <http://www.ccstock.cn/stock/gupiaoyaowen/2012-05-31/A794917.html>.

³¹ *Id.* As previously stated in this Article, the original purpose of the establishment of stock exchanges in China was for the financing needs and corporatization reform of SOEs. This purpose seemed to be modified, at least ostensibly, by the landmark document enacted by the St. Council in 2005 which unequivocally states that "[e]nterprises in the non-public sector of the economy shall be treated on an equal footing with the state-owned enterprises in stock issuance and listing in capital market." Guowuyuan Guanyu Guli Zhichi He Yindao Geti Siying Deng Feigongyouzhi Jingji Fazhan de Ruogan Yijian (国务院关于鼓励支持和引导个体私营等非公有制经济发展的若干意见) [Several Opinions of the State Council on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Sectors of the Economy] (promulgated by the St. Council, Feb. 19, 2005, effective Feb. 19, 2005), ¶ 11, CLI.2.57051(EN) (Lawinfochina). This position was confirmed by other important documents promulgated by the State Council and the CSRC. See Guowuyuan Guanyu Guli He Yindao Minjian Touzi Jiankang Fazhan de Ruogan Yijian (国务院关于鼓励和引导民间投资健康发展的若干意见) [Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment] (promulgated by the St. Council, May 7, 2010, effective May 7, 2010), CLI.2.130117(EN) (Lawinfochina); see also Zhongguo Zhengquan Jiandu Guanli Weiyuahui Guanyu Luoshi 'Guowuyuan Guanyu Guli He Yindao Minjian Touzi Jiankang Fazhan de Ruogan Yijian' Gongzuo Yaodian de

surprise given the fact that the private sector contributed more than 60% of the Chinese GDP in 2012.³² In 2015, the total market capitalization of privately-listed companies outweighed that of the SOEs for the first time in history.³³ At present, although SOEs are still major players in the Chinese capital market, it is reasonable to conclude that they no longer monopolize the market.

2. Increasing Trend Toward Dispersed Ownership

To compare ownership concentration over time in Chinese listed companies, I extracted from the China Stock Market & Accounting Research Database (CSMAR)³⁴ the original data on ownership concentration in all Chinese listed companies as of the end of 2004, 2009, and 2015, respectively. The three years were selected to represent the ownership concentration before the split-share structure reform, after the reform, and in the most recent year, respectively. The original data extracted from CSMAR included the shareholding percentage for the largest single shareholder (CR₁), the aggregate shareholding percentages for the largest three shareholders (CR₃), and the largest five shareholders (CR₅) for each listed company in the given sample.³⁵ Then, I assigned three measures for

Tongzhi (中国证券监督管理委员会关于落实《国务院关于鼓励和引导民间投资健康发展的若干意见》工作要点的通知) [Notice of China Securities Regulatory Commission on the Enforcement of 'Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment'] (promulgated by the China Sec. Reg. Comm'n, May 14, 2012, effective May 14, 2012), CLI.4.174910 (Lawinfochina).

³² See Pan Yue (潘跃), *Minying Jingji Zhan GDP Bizhong Chao 60% (民营经济占 GDP 比重超 60%)* [Private Economy Accounts for More Than 60% of the GDP], PEOPLE'S DAILY ONLINE (Feb. 3, 2013, 5:37AM), <http://finance.people.com.cn/n/2013/0203/c1004-20413925.html>.

³³ See Ni Mingya (倪铭娅), 2015 Nian A-Gu Shizhi Niandu Baogao Chulu (2015 年 A 股市值年度报告出炉) [The Release of the Annual Report on A-Share Market Capitalization for 2015], CHINA SEC. ONLINE (Jan. 27, 2016, 10:21AM), http://www.cs.com.cn/sylm/jsbd/201601/t20160127_4894171.html.

³⁴ CSMAR is a widely used commercial database for capital market researchers in China.

³⁵ Note that in the classic paper *Law and Finance*, Professors La Porta, Lopez-de-Silanes, Shleifer, and Vishny employed the aggregate shareholding percentages of the largest three shareholders in the top ten listed companies in each of the forty-nine countries to evaluate and compare ownership concentration. See Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1145-46 (1998). Considering that the state or the state-owned investment companies may represent the single largest shareholder in many listed SOEs in China, I also included in my data the single largest shareholder in Chinese listed companies. In addition, to

CR₁, CR₃, and CR₅ in each of the three years. The three measures are as follows: shareholding less than 30%, shareholding between 30% and 50%, and shareholding greater than 50%. I calculated the number of listed companies falling into each of the three measures (N) and their proportion against the total number of listed companies (N%) for a given year. To more clearly indicate the general trend of deconcentration, I also calculated the means and medians of CR₁, CR₂, and CR₃ of all the listed companies in a given year. Since the purpose of my calculation is to reveal the general trend of shareholding concentration over time in China, I did not correct for the possibility that some of the shareholders in a listed company are affiliated with each other. My calculations are reflected in the following three tables:

Table 1. The Ownership Concentration of Chinese Listed Companies as of Dec. 31, 2004 (1,377 Listed Companies in Total)

	Measures	N	N%	Mean	Median
CR ₁	<30%	477	34.64%	41.90%	39.94%
	30%-50%	417	30.28%		
	>50%	483	35.08%		
CR ₃	<30%	57	4.14%	55.57%	56.68%
	30%-50%	385	27.96%		
	>50%	935	67.90%		
CR ₅	<30%	30	2.18%	58.99%	60.70%
	30%-50%	295	21.42%		
	>50%	1052	76.40%		

minimize the effect of the possibility that several largest shareholders in a listed company may be affiliated with each other, I also added the aggregate shareholding of the largest five shareholders in each listed company to my sample.

Table 2. The Ownership Concentration of Chinese Listed Companies as of Dec. 31, 2009 (1,774 Listed Companies in Total)

	Measures	N	N%	Mean	Median
CR ₁	<30%	724	40.18%	36.29%	33.94%
	30%-50%	665	37.49%		
	>50%	385	21.70%		
CR ₃	<30%	256	14.43%	48.62%	48.46%
	30%-50%	678	38.22%		
	>50%	840	47.35%		
CR ₅	<30%	178	10.03%	52.17%	51.92%
	30%-50%	624	35.17%		
	>50%	927	52.25%		

Table 3. The Ownership Concentration of Chinese Listed Companies as of Dec. 31, 2015 (2,842 Listed Companies in Total)

	Measures	N	N%	Mean	Median
CR ₁	<30%	1233	43.38%	34.44%	32.53%
	30%-50%	1139	40.08%		
	>50%	470	16.54%		
CR ₃	<30%	395	13.90%	48.42%	48.10%
	30%-50%	1174	41.31%		
	>50%	1309	46.06%		
CR ₅	<30%	207	7.28%	52.96%	53.26%
	30%-50%	994	34.98%		
	>50%	1641	57.74%		

A comparison among the three tables indicates a clear trend toward deconcentration of the ownership in Chinese listed companies. The change between 2004 and 2009 is especially stark, which could be well explained

by the effect of the split-share structure reform starting from 2005. The deconcentration trend between 2004 and 2015 is also evidenced by the fact that much higher percentages of Chinese listed companies fall into the measure of “<30%”, while much lower percentages of Chinese listed companies fall into the measure of “>50%” regardless of CR₁, CR₃, or CR₅. This trend of deconcentration is bolstered by the sharp increase in the number of listed companies in China—a two-fold increase over the past decade. In 2004, there were only thirty Chinese listed companies in which the aggregate shareholding of the largest five shareholders was below 30%: the figure jumped up to 207 in 2015. Among those 207 listed companies were ideal targets for hostile takeovers due to their highly dispersed ownership.

3. *Financing Sources for Takeovers*

Dispersed ownership, while essential, will not lead to hostile takeovers per se. Takeovers are so costly that acquirers often need external financing.³⁶ Before 2008, the law prevented Chinese banks from financing takeovers.³⁷ This ban was partially lifted in 2008, allowing banks to extend loans that encompassed up to 50% of the total transaction price for a maximum term of five years.³⁸ These constraints were further relaxed in 2015, allowing loans for up to 60% of the total transaction price with a maximum of seven years.³⁹ While Chinese law qualifies banks as lenders for takeovers, it still disqualifies them as equity investors in non-bank entities.⁴⁰ However, insurance companies, another major type of financial

³⁶ During the heyday of hostile takeovers in the 1980s in the United States, junk bonds were commonly employed as financing instruments. See THERESE H. MAYNARD, *MERGERS AND ACQUISITIONS: CASES, MATERIALS AND PROBLEMS* 527 (3d ed. 2013).

³⁷ See Daikuan Tongze (贷款通则) [General Rules for Loans] (promulgated by People’s Bank of China, June 28, 1996, effective Aug. 1, 1996), art. 20, CLI.4.18161(EN) (Lawinfochina). Article 20 of Daikuan Tongze bans any “loan for equity investment purposes, except as otherwise provided for by the state.” *Id.*

³⁸ Shangye Yinhang Binggou Daikuan Fengxian Guanli Zhiyin (商业银行并购贷款风险管理指引) [Commercial Bank M&A Loan Risk Management Guidelines] (promulgated by China Banking Reg. Comm’n, Dec. 6, 2008, effective Dec. 6, 2008, revised Feb. 10, 2015), arts. 18-19, CLI.4.111391 (Lawinfochina).

³⁹ *Id.* at arts. 21-22. Zhongguo Yinjianhui Guanyu Yinfa ‘Shangye Yinhang Binggou Daikuan Fengxian Guanli Zhiyin’ De Tongzhi (中国银监会关于印发《商业银行并购贷款风险管理指引》的通知) [Notice of the China Banking Regulatory Commission on Issuing the “Commercial Bank M&A Loan Risk Management Guidelines”] (promulgated by China Banking Reg. Comm’n, Feb. 10, 2015, effective Feb. 10, 2015), arts. 21-22, CLI.4.245331 (Lawinfochina).

⁴⁰ Zhonghua Renmin Gongheguo Shangye Yinhang Fa (中华人民共和国商业银行法) [Law of the People’s Republic of China on Commercial Banks] (promulgated by Standing

institution in China, have been allowed to purchase shares of listed companies over the stock exchanges since 2004.⁴¹ In the early days following this deregulation, the amount insurance companies invested in the stock market could not exceed 5% of their total assets (with certain deductions) as of the end of the preceding year, and an insurance company's investment in a single listed company could not exceed 5% of total outstanding shares of such listed company.⁴² However, these restrictions have also been relaxed over time. As of the date of this Article, a Chinese insurance company can invest up to 30% of its total assets, calculated as of the end of the preceding quarter, in the stock market with a limitation of no more than 5% of its total assets in a single listed company.⁴³ But these two limitations could rise to 40% and 10%, respectively, provided that insurance companies invest in blue-chip stocks⁴⁴ and meet certain risk control

Comm. Nat'l People's Cong., May 10, 1995, revised Dec. 27, 2003, revised Aug. 29, 2015, effective Oct. 1, 2015), art. 43, CLI.1.256594(EN) (Lawinfochina).

⁴¹ Baoxian Jigou Touzizhe Gupiao Touzi Guanli Zhanxing Banfa (保险机构投资者股票投资管理暂行办法) [Interim Measures for the Administration of Stock Investments of Insurance Institutional Investors] (promulgated by China Ins. Reg. Comm'n and the China Sec. Reg. Comm'n, Oct. 24, 2004, effective Oct. 24, 2004), art. 1, CLI.1.256594(EN) (Lawinfochina).

⁴² Zhongguo Baoxian Jiandu Guanli Weiyuanhui Guanyu Baoxian Jigou Touzizhe Gupiao Touzi Youguan Wenti de Tongzhi (中国保险监督管理委员会关于保险机构投资者股票投资有关问题的通知) [Notice of China Insurance Regulatory Commission on Issues Regarding Share Investment by Insurance Institutional Investors] (promulgated by China Ins. Reg. Comm'n, Feb. 7, 2005, effective Feb. 7, 2005), ¶ II, CLI.4.58641 (Lawinfochina).

⁴³ Zhongguo Baoxian Jiandu Guanli Weiyuanhui Guanyu Jiaqiang He Gaijin Baoxian Zijin Yunyong Bili Jianguan de Tongzhi (中国保险监督管理委员会关于加强和改进保险资金运用比例监管的通知) [Notice of the China Insurance Regulatory Commission on Strengthening and Improving the Proportional Regulation of the Utilization of Insurance Funds] (promulgated by China Ins. Reg. Comm'n, Jan. 23, 2014, effective Jan. 23, 2014), arts. 2(1) & 3(1), CLI.4.218939(EN) (Lawinfochina). The proportions could be further increased if insurance funds are invested in certain types of stocks. However, the types of target companies of whose shares insurance companies can acquire a controlling block are limited to insurance enterprises, non-insurance financial enterprises and insurance-related enterprises. Baoxian Zijin Yunyong Guanli Zhanxing Banfa (保险资金运用管理暂行办法) [Interim Measures for the Administration of Utilization of Insurance Funds] (promulgated by China Ins. Reg. Comm'n, Apr. 4, 2014, effective Apr. 4, 2014), art. 14, CLI.4.223540(EN) (Lawinfochina).

⁴⁴ According to the China Insurance Regulatory Commission, blue-chip stocks refer to "stocks issued on main board of the Chinese mainland, each with a market capitalization of more than 20 billion yuan and a cash dividend payment ratio not lower than 10% or a dividend yield ratio higher than 3%." Zhongguo Baoxian Jiandu Guanli Weiyuanhui Guanyu Yinfa 《Baoxian Gongsu Changfu Nengli Baogao Bianbao Guize – Wenti Jieda Di Ershisan Hao: Lishi Cunliang Gaolilv baodan Zijin Touzi De Lanchougu》 De Tongzhi (中国保险监督管理委员会

requirements.⁴⁵ Because China has become the third largest insurance market with total insurance assets over 1,200 billion Renminbi (RMB),⁴⁶ the overall amount insurance companies could invest in the stock market are enormous. In fact, Chinese insurance companies have played an active role in acquiring block shares in listed companies in China, particularly in the real property industry.⁴⁸ As of the third quarter of 2015, the market capitalization of shares held by insurance companies has accounted for 41.38% of total institutional holdings in listed companies in China.⁴⁹

In sum, the significant decrease of SOEs' share in capital markets, the increasingly dispersed ownership of listed companies, and the greater availability of financing sources for takeovers have jointly sketched out a promising picture of an effective market for corporate control in China. Part III will demonstrate several high-profile hostile takeover cases in the Chinese capital market. The purposes of including these cases are twofold: (1) to present a real picture of the market for corporate control in China in a

委员会关于印发《保险公司偿付能力报告编报规则 – 问题解答第 23 号：历史存量高利率保单资金投资的蓝筹股》的通知) [Notice of the China Insurance Regulatory Commission on Issuing the Rules for the Preparation of Solvency Reports of Insurance Companies – Questions and Answers No. 23: Blue-Chip Stocks for Investment Using Funds from Existing Insurance Policies Underwritten in the Past with High Interest Rates] (promulgated by China Ins. Reg. Comm'n, June 24, 2014, effective June 24, 2014), CLI.4.228624(EN) (Lawinfochina).

⁴⁵ See Zhongguo Baojianhui Guanyu Tigao Baoxian Zijin Touzi Lanchougu Jianguan Bili Youguan Shixiang de Tongzhi (中国保监会关于提高保险资金投资蓝筹股票监管比例有关事项的通知) [Notice of the China Insurance Regulatory Commission on Issues Concerning the Increased Regulatory Ratio of Insurance Funds Invested in Blue-Chip Stocks] (promulgated by China Ins. Reg. Comm'n, Jul. 8, 2015, effective Jul. 8, 2015), art. 1, CLI.4.251061(EN) (Lawinfochina).

⁴⁶ Renminbi is the unit of Chinese currency.

⁴⁷ He Yuxin (何雨欣), Zhongguo Yi Chengwei Shijie Disanda Baoxian Shichang (中国已成为世界第三大保险市场) [*China Has Become the Third Largest Insurance Market in the World*], XINHUA NEWS (Feb. 12, 2016, 3:20PM), http://news.xinhuanet.com/fortune/2016-02/12/c_1118024188.htm.

⁴⁸ See Esther Fung, *China's Investing Insurers Acquire High-Stakes Appetite for Construction*, WALL ST. J. (Feb. 19, 2016, 12:35AM), <http://www.wsj.com/articles/chinas-investing-insurers-acquire-high-stakes-appetite-for-construction-1455860113>; see also *Insurance in China: the Big Anbang*, ECONOMIST (Feb 7, 2015), <http://www.economist.com/news/finance-and-economics/21642197-once-obscure-chinese-financial-firm-leaps-spotlight-big-anbang>.

⁴⁹ See Liang Xue (梁雪), Baoxian Chigu Guimo Shouchao Gongmu (保险持股规模首超公募) [*The Shareholding in Listed Companies by Insurance Companies Exceeds Public Securities Funds*], SEC. TIMES, Apr. 1, 2016, http://epaper.stcn.com/paper/zqsb/html/2016-04/01/content_805528.htm.

micro level and (2) to illustrate the evolution of hostile takeovers and antitakeover devices in China.

III. INFLUENTIAL HOSTILE TAKEOVERS IN CHINA'S CAPITAL MARKET

A. *Bao'an Acquiring Yanzhong: Inaugural Acquisition in China's Capital Market*

The first acquisition in the Chinese stock market, ironically, was a hostile takeover.⁵⁰ The acquisition of Shanghai Yanzhong Industrial Co., Ltd. (Yanzhong), a then-listed company on the SSE, by Shenzhen Bao'an Group Co., Ltd (Bao'an), a then-listed company on the SZSE, occurred in 1993 (the Yanzhong Takeover). Right before the acquisition, Yanzhong was one of the few listed companies with a very dispersed ownership. Ninety-one percent of its shares were owned by highly dispersed public shareholders.⁵¹ Since mid-September 1993, Bao'an, through three of its affiliates, had been secretly accumulating its shareholding in Yanzhong by open market purchases until it made public disclosure through the SSE on September 30, 1993.⁵² By that time, its actual shareholding in Bao'an had gone above 15%, making it the largest shareholder of Yanzhong.⁵³ Right after the disclosure, Bao'an held a press conference in Shanghai and officially announced its intent to become the largest shareholder of

⁵⁰ Bao'an acquiring Yanzhong is the first acquisition in the Chinese stock market and therefore regarded as heralding the emergence of the market for corporate control in China. See SHANGHAI STOCK EXCH. RES. CTR., *Zhongguo Gongsi Zhili Baogao* (2009): *Kongzhiquan Shichang Yu Gongsi Zhili* (中国公司治理报告(2009): 控制权市场与公司治理) [CHINA CORPORATE GOVERNANCE (2009): MARKET FOR CORPORATE CONTROL AND CORPORATE GOVERNANCE] 111 (2009). As illustrated by Part III.A., the nature of this takeover is hostile. See discussion *infra* Part III.A. The first friendly acquisition of listed companies in China, or Xieyi Zhuanrang (协议转让) [Contract-based Transfer], came one year after. See *id.* at 15.

⁵¹ See Guo Chenglin (郭成林), *Yanzhong Shiye: Zhongguo Ziben Shichang Shougou Diyi Gu* (延中实业: 中国资本市场收购第一股) [*Yanzhong: The First Acquisition in Chinese Capital Market*], SHANGHAI SEC. NEWS (Nov. 24, 2010, 7:41 PM), http://news.cnstock.com/news/sns_zxk/201407/3085726.htm.

⁵² *Id.*

⁵³ On September 30, 1993, Bao'an disclosed that its shareholding in Yanzhong reached the threshold of 5%, a triggering point for mandatory disclosure required by law. However, the disclosure turned out to be a misrepresentation. Based on the CSRC's subsequent investigation, it was concluded that shareholding by the three affiliates of Bao'an had reached 10.65% a day before the disclosure and more than 15% on the date of disclosure. See ZHU BAOXIAN (朱宝宪), *Gongsi Bingou Yu Chongzu* (公司并购与重组) [M&A AND RESTRUCTURING OF CORPORATIONS] 42-43 (2006).

Yanzhong and to appoint directors to Yanzhong's board.⁵⁴ Bao'an continued to increase its shareholding in Yanzhong through market purchases after the public disclosure, reaching 19.80% by October 6, 1993.⁵⁵ The disclosure and press conference came as utter surprises to Yanzhong's management, which was unaware of the acquisition until Bao'an's disclosure and did not even understand the nature of hostile takeovers.⁵⁶ However, Yanzhong's management acted swiftly and immediately engaged professionals from Schroders Group in Hong Kong as its antitakeover counsel and considered antitakeover tactics such as the "poison pill" and "white knight,"⁵⁷ both of which were ultimately rejected as infeasible.⁵⁸ Meanwhile, Yanzhong appealed to the CSRC, which was founded just a year before, and brought a lawsuit against Bao'an in the People's Court in Shanghai, accusing Bao'an of breaching its information disclosure duty mandated by the then-effective regulations.⁵⁹

The CSRC initiated an investigation, which led to a decision about one month later. Although the decision imposed on Bao'an a one-million RMB penalty fee for breaching its information disclosure duty, it confirmed Bao'an's shareholding in Yanzhong as valid.⁶⁰ Moreover, under the mediation of the CSRC, Yanzhong dropped the lawsuit against Bao'an.⁶¹ Since Yanzhong's second largest shareholder only held 1.48% of the outstanding shares, Bao'an, as the largest shareholder, holding nearly 20% of the outstanding shares, soon appointed its nominee as the chairman of

⁵⁴ See Qin Guoliang (秦国梁), 'Bao Yan Fengbo': Ziben Shichang Binggou Diyi An (宝延风波) 资本市场并购第一案 [The Bao'an and Yanzhong Incident: The First Case of Capital Market Mergers and Acquisitions], Zhongguo Zhengquan Bao Guanfang (中国证券报官方) [CHINA SEC. J.], Sept. 1, 2008, http://www.cs.com.cn/ssgs/gsxw/200809/t20080901_1571201.html.

⁵⁵ See Zhu, *supra* note 30, at 43.

⁵⁶ See Qin, *supra* note 54.

⁵⁷ See *infra* Part V.B.1 and Part V.B.4 respectively for the definitions of "poison pill" and "white knight".

⁵⁸ See *id.*; see also Zhao Di (赵迪), Yici Beifa: Shenbao'an Jupai Yanzhong Shiye (一次北伐: 深宝安举牌延中实业) [The Northern Expedition: Bao'an Acquiring Yanzhong], SHENZHEN EVENING, Nov. 7, 2010, at A17, http://wb.sznews.com/html/2010-11/07/content_1300305.htm.

⁵⁹ See Qin, *supra* note 54. Pursuant to the then-effective regulation governing acquisitions of listed companies, the acquirer was obliged to make disclosures once its shareholding in the target company crossed 5% and each time there was a change of 2% in its shareholding thereafter. Stock Interim Provisions, *supra* note 6, at art. 47.

⁶⁰ See Zhao, *supra* note 58.

⁶¹ See Qin, *supra* note 54.

Yanzhong's board.⁶² As a compromise, other members of Yanzhong's management team were retained.⁶³

The Yanzhong takeover took place at a time when capital markets had just entered the scene in China,⁶⁴ and the legal regimes governing hostile takeovers were largely a barren land.⁶⁵ But its implications on the market for corporate control in China cannot be overstated—it marked the beginning of an era for the market for corporate control in China.⁶⁶ Even at the time of its occurrence, Chinese scholars hailed it as a testament to the efficacy of the market for corporate control.⁶⁷ More meaningfully, the CSRC, which was still in its infancy, showed a very tolerant stance toward this hostile takeover.⁶⁸

B. *Dagang's Acquisition of ACE*

The target, Shanghai ACE Co., Ltd. (ACE), was listed on the SSE at the time of this hostile takeover. The acquirer, Dagang Youtian Group Co., Ltd. (Dagang), was a closely-held subsidiary of the giant SOE China National Petroleum Corporation.⁶⁹ Immediately prior to this takeover in 1998 (the ACE Takeover), ACE's shares were fully tradable and highly dispersed, with its largest shareholder owning less than 5% of the

⁶² See Zhu, *supra* note 30, at 43.

⁶³ See Qin, *supra* note 54.

⁶⁴ Not only everyday Chinese people but also the management of listed companies lacked a basic understanding of the capital market. Take the Yanzhong Takeover as an example. When Mr. Qin Guoliang, the then-CEO of Yanzhong first heard of Bao'an's acquisition, his immediate reaction was one of incredulity: "As both Bao'an and Yanzhong are led by the Chinese Communist Party, how could they do this kind of thing to us?" See Zhao, *supra* note 58.

⁶⁵ The first Company Law and Securities Law were promulgated in 1993 and 1998, respectively, and the first regulation directly governing takeovers of listed companies was promulgated in 2002. See discussion *infra* Part IV for a detailed account of the evolution of takeover regimes in China.

⁶⁶ See SHANGHAI STOCK EXCH. RES. CTR., *supra* note 50, at 8.

⁶⁷ See Shen Yifeng (沈艺峰), Gongsì Kongzhiquan Lilun de Xiandai Yanbian (公司控制权理论的现代演变: 下) [*The Modern Evolution of the Theory on Market for Corporate Control*], 3 ZHONGGUO JINGJI WENTI (中国经济问题) [ECON. ISSUES IN CHINA] 20, 32 (2000).

⁶⁸ This is evidenced by the CSRC's decision which confirmed Bao'an's shareholding in Yanzhong notwithstanding its breach of disclosure obligations. Actually, when Mr. Gao Xiqing, a high-level officer of the CRSC (and later its vice chairman), heard of this takeover, he hailed it as "exciting and encouraging." See *id.*

⁶⁹ Lü Hongbing (吕红兵) & Xu Chen (徐晨), Dagang Youtian Shougou ACE Gufen de Caozuo Shilu Yu Fali Tanxi (大港油田收购爱使股份的操作实录与法理探析) [*A Descriptive Record and Legal Theory Study on Dagong Acquiring ACE*], 6 Zhongguo Lüshi (中国律师) [CHINA ATT'Y] 50, 50 (1999).

outstanding shares.⁷⁰ The takeover was motivated mainly by Dagang's intent to go public via reverse takeover after taking control of ACE.⁷¹ In July 1998, Dagang, through three of its affiliates, continuously purchased shares of ACE over the market, accumulating a 10% shareholding in ACE.⁷² Dagang's unsolicited takeover was recognized as unfriendly by the ACE board. Unlike in the Yanzhong Takeover, where the target's only option was undertaking legal proceedings against Bao'an's breach of information disclosure duties, Dagang's takeover effort was withstood by the "shark repellent" provisions in ACE's corporate charter.⁷³ Those "shark repellent" provisions, pre-adopted in Article 67 of ACE's corporate charter, made the following stipulations:⁷⁴ (1) the proposed list of candidates for the board of directors and the board of supervisors, to be submitted to the shareholders' meeting for election, needed to be reviewed and decided by the incumbent board of directors upon consultation with shareholders; (2) only shareholders individually or jointly owning over 10% of outstanding

⁷⁰ Lü & Xu, *supra* note 69, at 50.

⁷¹ See *id.*; see also Liu Guo'an (刘国安) & Man Xuejie (满学杰), Zhongguo Shoujia Daxing Guoqi Jieke Shangshi (中国首家大型国企借壳上市) [*The First Large SOE Going Public by Reverse Takeover*], 48 OUTLOOK WEEKLY 43, 43. In China, reverse takeovers are called "Jieke Shangshi" (借壳上市) [going public through buying a listed shell company]. Before 1999, China had implemented an IPO system called "Pei'e Zhi" (配额制) [quota-based system], under which the fixed IPO quotas were assigned to different provinces or central governmental ministries. The provincial governments or central governmental ministries then had the discretionary power to decide which companies in their respective jurisdictions could be listed in stock exchanges. See Zhongguo Zhengquan Jiandu Guanli Weiyuanhui (中国证券监督管理委员会)[CHINA SEC. REG. COM'N], Guojishang Guanyu Xingu Faxing de Zhuyao Zhidu (国际上关于新股发行的主要制度) [*Major IPO Systems in the World*] (July 3, 2013), http://www.csrc.gov.cn/pub/newsite/ztl/xgftzgg/xgfbjcl/201307/t20130703_230244.html. Due to the quota-based system, being listed was a privilege and listed companies were a scarce resource. As a result, going public by acquiring an existing listed company became a desirable avenue for close companies intending to go public but failing to reach the quota for an IPO.

⁷² See Liu & Man, *supra* note 71, at 44.

⁷³ See Lü & Xu, *supra* note 69, at 51. Interestingly, the then-chairman of the ACE board was Mr. Qin Guoliang, the CEO of Yanzhong during the Yanzhong Takeover in 1993. Obviously, Mr. Qin learned lessons from his previous experience and adopted the "shark repellent" terms in ACE's corporate charter as a preventive anti-takeover measure. See Liu & Man, *supra* note 71, at 44. "Shark repellent" refers to the amendments made to corporate charters before a takeover bid emerges, aiming to deter possible takeovers in the future. See Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 777 (1982). Those charter amendments discourage potential acquirers by substantially increasing the difficulty of taking control of the target's board or executing a second-step freeze-out merger, or by making the acquisition much costlier. See *id.* at 780.

⁷⁴ See Lü & Xu, *supra* note 69, at 51.

shares (excluding proxy voting) for more than half a year were qualified to propose candidates for directors and supervisors;⁷⁵ (3) when the terms for the board of directors or board of supervisors expire, the number of newly-elected directors or supervisors could not be more than half of the respective total number.

Disputes between ACE and Dagang focused on the requirements on (1) the shareholding percentage and (2) the holding period for proposing candidates for the board of directors and the board of supervisors.⁷⁶ These antitakeover tactics also sparked wide debates among Chinese corporate law scholars. Some scholars endorsed the antitakeover tactics as proper actions falling within the scope of corporate autonomy, while others condemned them as improper impediments to legitimate, market-orientated acquisition activity.⁷⁷ Apart from such tactics included in the charter, ACE also employed the “scorched earth” tactic by selling off profitable assets, purchasing unrelated businesses at a high cost, guaranteeing debts for its shareholders with corporate assets, and making large short-term investments.⁷⁸ These actions made ACE’s financial performance lackluster and unattractive.⁷⁹

Dagang soon reported ACE’s allegedly improper takeover defenses to the CSRC. After a two-month investigation, the CSRC ordered

⁷⁵ According to the then-effective company law in China, directors cannot be removed without cause. Zhonghua Renmin Gongheguo Gongsifa (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by Nat’l People’s Cong., Dec. 29 1993, effective Jul. 1, 1994, amended Dec. 25, 1999, Aug. 28, 2004, Oct. 27, 2005 and Dec. 28, 2013), art. 115, CLI.1.7672(EN) (Lawinfochina). Article 115 of the then-effective company law, coupled with the staggered board arrangement in ACE’s charter, could make Dagang’s effort to control the board of ACE impossible without waiting for at least one election cycle of the board of directors.

⁷⁶ See Yao Zhen (姚铮), *Guoyou Qiye Erji Shichang Maike Shangshi Anli Fenxi* (国有企业二级市场买壳上市案例分析) [*Case Analysis of SOEs Going Public Through Reverse Takeover*], 2 CHIN. INDUS. ECON. 32, 33 (1999). The then-effective Chinese company law was silent on the shareholding requirements for proposing director candidates, but the then-effective Guidance for Articles of Listed Companies required a threshold of 5% to submit shareholder proposals to vote at the shareholders’ meeting. Shangshi Gongshi Zhangcheng Zhiyin (上市公司章程指引) [Guidance for Articles of Listed Companies] (promulgated by the China Sec. Reg. Comm’n, Dec. 16, 1997, effective Dec. 16, 1997, repealed Mar. 16, 2006), art. 57, CLI.4.19599 (Lawinfochina).

⁷⁷ See Liu & Man, *supra* note 71, at 44-45.

⁷⁸ Wei Cai, *Hostile Takeovers and Takeover Defences in China*, 42 HONG KONG L.J. 901, 920-21 (2012).

⁷⁹ See *id.* at 921. “Scorched Earth” is a defensive tactic that could be employed by the target company’s incumbent management to make the target company substantially unattractive to acquirers. See Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 33 n.78 (1985).

ACE to amend its charter provisions regarding those takeover defenses.⁸⁰ Finally, under the mediation of the Shanghai local government, which favored the takeover, Dagang and ACE came to terms. ACE agreed to call a special shareholders' meeting to remove the antitakeover provisions from the charter and accepted Dagang's nominees to the board.⁸¹ The takeover then proceeded successfully.

Compared with the Yanzhong Takeover five years before, the ACE Takeover presented a picture of a more mature capital market, a more complete legal regime, and a more sophisticated acquirer and target management. Meanwhile, the CSRC continued to show its tolerance toward hostile takeovers. The antitakeover provisions in ACE's charter also illustrated the commingling of antitakeover tactics with corporate governance, a topic that will be revisited in Part V of this Article.

C. *Jinyuxing's Acquisition of Founder*

The acquirer, Beijing Jinyuxing Electronic Technology Co., Ltd (Jinyuxing), was a Hong Kong-listed but mainland China-incorporated company. The target, Founder Yanzhong Technology Group Co., Ltd (Founder), was an SSE-listed company. Prior to this takeover (the Founder Takeover), Jinyuxing's shareholding was very dispersed, with the largest shareholder owning only 5% of the outstanding shares.⁸² Starting in May 2001, Jinyuxing, in concert with other five entities, purchased 5.4% of the total outstanding shares of Founder over the stock market and became its largest shareholder.⁸³ Jinyuxing soon proposed to appoint six directors into the nine-member board of directors and two supervisors to the three-member board of supervisors of Founder in the coming shareholders' meeting scheduled on May 28, 2001.⁸⁴ However, the proposal was denied

⁸⁰ See Lü & Xu, *supra* note 69, at 52. Because the CSRC document ordering such a charter amendment was not publicized, the details of CSRC's opinions concerning which specific content in ACE's charter was illegal or improper were unknown.

⁸¹ See Liu & Man, *supra* note 71, at 45.

⁸² See Li Junling (李峻岭), Yuxing Wehe Luobai? (裕兴为何落败?) [*Why Was Yuxing Defeated?*], SINA FIN. (July 11, 2001, 8:55AM), <http://finance.sina.com.cn/o/81596.html>.

⁸³ See *id.*

⁸⁴ See Gongsì Zhìlì Yú Dúlì Dǒngshì Ànlì (公司治理与独立董事案例) [Cases On Corporate Governance and Independent Directors] 65 (Liao Li et al. eds., Beijing: Tsinghua University Press, 2003). See also SHANGHAI STOCK EXCH., Shanghai Fangzheng YanZhong Keji Jituan Gufen Youxian Gongsì: Zhangcheng (上海方正延中科技集团股份有限公司:章程) [SHANGHAI FANGZHENG YANZHONG TECHNOLOGY GROUP CO., LTD.: ARTICLES OF INCORPORATION], arts. 93 & 134,

by the Founder board for some far-fetched and speculative reasons.⁸⁵ The power of the Founder board to deny the proposal stemmed from Article 67 of Founder's charter which, among other things, provided that shareholders' proposal to appoint directors should be reviewed and decided by the board.⁸⁶ In addition, Founder postponed the date of the shareholders' meeting by one month over Jinyuxing's objection.⁸⁷ Jinyuxing, citing the case of the ACE Takeover three years before, condemned Article 67 of Founder's charter as an overt deprivation of shareholders' inherent rights and appealed to the CSRC.⁸⁸ This time, however, the CSRC unexpectedly kept silent.⁸⁹ At the postponed shareholders' meeting on June 28, 2001, all of Jinyuxing's proposed candidates for directors and supervisors were precluded from the election.⁹⁰ Thus, the Founder Takeover ended up unsuccessful. But this was not the end of the story. Several months later, it encountered another attempted hostile takeover from Shanghai Gaoqing Digital System Co., Ltd. (Gaoqing), which, in concert with three other entities, increased their shareholding in Founder to 10.61% and became the largest shareholder.⁹¹ Gaoqing soon proposed to remove the incumbent directors and elect new directors.⁹² However, Gaoqing's takeover did not proceed as it gave up its takeover attempt for undisclosed reasons.⁹³

http://static.sse.com.cn/disclosure/listedinfo/announcement/c/600601_2001_g.pdf [hereinafter Founder's Charter] (Founder's then-effective corporate charter).

⁸⁵ The alleged reasons for denial include the following: (1) no consensus on Jinyuxing's proposed candidates prior to the shareholders' meeting; (2) the Founder board's suspicion toward the sustainability of the cooperative relationship among Jinyuxing and other concerted parties; (3) possible conflict of interest would ensue if Jinyuxing's proposed candidates were elected; and (4) the identity of one of the proposed candidates, who is a Hong Kong permanent resident, was not properly notarized. See Shanghai Fangzheng Yanzhong Keji Jituan Gufen Youxian Gongsi 2000 Niandu Gudong Dahui Jueyi Gonggao (上海方正延中科技集团股份有限公司 2000 年度股东大会决议公告) [*The Announcement of the Resolutions of Founder's Shareholders' Meeting of 2000 of Shanghai Fangzheng Yanzhong Technology Group Co., Ltd.*], SINA FIN. (June 30, 2001), <http://finance.sina.com.cn/stock/company/sh/600601/24/39.shtml>.

⁸⁶ Founder's Charter, *supra* note 84, at art. 67.

⁸⁷ See Li Wei (李蔚), Dui Gudong Dahui Yanqi Biaoshi Buman (对股东大会延期表示不满) [*Jinyuxing's Discontent with the Postponement of the Shareholders' Meeting*], CHINA SEC. J., May 22, 2001, at 1.

⁸⁸ See Li, *supra* note 82.

⁸⁹ See *id.*

⁹⁰ See *id.*

⁹¹ See Zhu, *supra* note 30, at 357.

⁹² *Id.* at 357-58.

⁹³ See *id.* at 358.

The Founder Takeover was another example of the power of the market for corporate control. It offered additional evidence that, even before the split-share structure reform, hostile takeovers did happen in individual target companies with dispersed ownership structure despite the fact that capital market as a whole was monopolized by the state. In addition, as was the case in the ACE Takeover, the Founder management utilized the corporate charter provisions as takeover devices. This practice indicated that the “shark repellent” tactic had been widely accepted by Chinese listed companies as an antitakeover device.

D. Baoneng Acquisition of Vanke

The target, China Vanke Co., Ltd. (Vanke), the largest listed company by market capitalization in SZSE as of December 2015,⁹⁴ is one of the best-known companies in China and also the world’s largest residential property developer by sales as of the time of the takeover (the Vanke Takeover).⁹⁵ The acquirer, Baoneng Group (Baoneng) is a conglomerate of real property development and insurance. Moreover, Baoneng has become notorious in recent years for the exponential growth of its insurance business.⁹⁶ Prior to the takeover and as of the third quarter of 2015, Vanke’s shareholding was dispersed, with the largest shareholder, China Resources Co., Ltd. (Huarun), holding 15.29% and the management of Vanke holding 4.14%.⁹⁷ Despite being the single largest shareholder, Huarun had long maintained a “hands-off” policy on Vanke’s operation and management. As a result, Vanke had been controlled by professional managers led by the chairman of the board, Mr. Wang Shi, a well-known entrepreneur in China.⁹⁸ From July 2015, Baoneng Group, through its two affiliates, Shenzhen Jushenghua, Ltd. (Jushenghua) and Foresea Life

⁹⁴ See *20 Leading Companies by Market Capitalization*, SHENZHEN STOCK EXCH., (Dec. 2015), <http://www.szse.cn/main/files/2016/01/05/RM020403.html>.

⁹⁵ See Esther Fung, *China Vanke Moves to Thwart Possible Takeover Attempt*, WALL ST. J. (Dec. 18, 2015, 8:17 AM), <http://www.wsj.com/articles/china-vanke-moves-to-thwart-possible-takeover-attempt-1450444633>.

⁹⁶ See Luo Chao (罗超), Qidi Baoneng Xi (起底“宝能系”) [*The Background of Baoneng*], BEIJING NEWS (Dec. 14, 2015, 03:19 AM), <http://business.sohu.com/20151214/n431148684.shtml>.

⁹⁷ Xin Fei (邢飞), Ba Wen Vanke Guquan Zhenduo zhan (八问万科股权争夺战) [*Eight Questions on the Fighting over Vanke’s Shares*], BEIJING TIMES, Dec. 22, 2015, at 34, http://epaper.jinghua.cn/html/2015-12/22/content_264790.htm.

⁹⁸ See Liang Weiwei (梁薇薇), Huarun Chushou: Vanke Guquanzhan Shenji (华润出手: 万科股权战升级) [*The Fighting Over Vanke’s Shares Escalated Due to Huarun’s Increase in Holding*], BEIJING NEWS, Sept. 10, 2015, at B08, http://epaper.bjnews.com.cn/html/2015-09/10/content_597333.htm; see also Fung, *supra* note 95.

Insurance, Ltd. (Foresea Insurance), started to purchase Vanke's shares over the stock market. Baoneng's shareholding in Vanke reached 24.26% on December 18, 2015, exceeding the aggregate holding percentage of both Huarun and the management team. This percentage also made Baoneng the largest shareholder of in Vanke.⁹⁹ The unsolicited acquisition put the management of Vanke on alert: Vanke's management soon expressed their disagreement with the takeover and decried Baoneng's "lack of credibility."¹⁰⁰ The takeover also attracted the attention of the CSRC, which expressed its concern but stressed that it would not intervene if the takeover conformed with relevant laws.¹⁰¹ However, more complications were added into the confrontation between Baoneng and Vanke's management, when Anbang Insurance Group (Anbang), an active institutional investor in the Chinese capital stock market, purchased about 5% of Vanke's shares on December 7, 2015, and thus became the kingmaker in the fight between Vanke and Baoneng.¹⁰² In the face of Baoneng's aggression, Vanke halted the trading of its shares for an alleged restructuring plan, which many believed to be an effort to prevent Baoneng from purchasing more of Vanke's shares.¹⁰³ Meanwhile, Vanke won Anbang's support.¹⁰⁴ Vanke's suspension on share trading lasted a long

⁹⁹ See Xin, *supra* note 97; see also Guo Chenglin (郭成林), Vanke Queren Baonengxi Chigu 24.26% (万科确认宝能系持股 24.26%) [*Vanke Confirms Baoneng's Shareholding at 24.26%*], SHANGHAI SEC. NEWS (Dec. 26, 2015), http://finance.ifeng.com/a/20151226/14137830_0.shtml. It seemed that Baoneng did a very careful investigation before launching the takeover. According to news reports, before the takeover actions were taken, Baoneng engaged legal counsel to look into Vanke's corporate charter, and Baoneng asked the legal counsel three questions: (1) Has Vanke adopted a dual-class share structure, granting the shares held by the management veto rights or superior voting rights? (2) Does the management of Vanke have the power to nominate the majority of the board members, and could directors be replaced before the expiration of their terms? (3) Has Vanke adopted a poison pill plan? After receiving negative answers to all three questions, Baoneng launched the takeover. See Zhang Hong (张洪), Baoneng Shougou Vanke Neimu: Ershiqi Ye Zhi Jueding Vanke de Mingyun (宝能收购万科内幕:二十七页纸决定万科的命运) [*The Insider Story about Baoneng's Acquisition of Vanke: Twenty-Seven-Page Charter Decided Vanke's Fate*], SINA FIN. (Dec. 23, 2015, 3:56 PM), <http://finance.sina.com.cn/stock/s/2015-12-23/doc-ifxmttcq1848154.shtml>.

¹⁰⁰ See Fung, *supra* note 95.

¹⁰¹ See Zhang Xiaochong et al., *China Securities Regulator Says Studying Vanke-Baoneng Deal*, REUTERS (Dec. 25, 2015, 8:09 AM), <http://www.reuters.com/article/us-chinavanke-baoneng-idUSKBN0U80K020151225>.

¹⁰² See Xin, *supra* note 97.

¹⁰³ See Tom Mitchell, *China Vanke Tale Shows Share Class Divide*, FIN. TIMES (Feb. 2, 2016), <https://next.ft.com/content/3241c2fa-c8d8-11e5-a8ef-ea66e967dd44>.

¹⁰⁴ See CHINA VANKE CO., LTD., Guyu Huanyin Anbang Baoxian Jituan Chengwei Vanke Zhongyao Gudong de Shenmin (关于欢迎安邦保险集团成为万科重要股东的声明) [*Declaration on Welcoming Anbang Becoming Vanke's Important Shareholder*] (Dec. 23, 2015), <http://www.vanke.com/news.aspx?type=8&id=3468>.

period of time: from December 18, 2015 until July 4, 2016.¹⁰⁵ During this period, Vanke disclosed its restructuring plan of purchasing assets from Shenzhen Subway Group Co., Ltd. (Shenzhen Subway) with the consideration being Vanke's shares.¹⁰⁶ Considering the scale of the transaction, Baoneng's shareholding would be significantly diluted if the transaction materialized.¹⁰⁷

Baoneng, however, did not surrender. Right before Vanke shares resumed trading, Baoneng proposed to call a shareholders' meeting and to remove ten incumbent directors from the fifteen-member board.¹⁰⁸ After this proposal was rejected by Vanke's board, it continued to purchase Vanke's shares, reaching 25% of Vanke's outstanding shares on July 6, 2016.¹⁰⁹ In response, Vanke reported to the CSRC and SZSE, questioning the legality of Baoneng's operation on the asset management plans,¹¹⁰ from which Baoneng had obtained most of its funding for the Vanke Takeover.

The outcome of this takeover still hinges on whether Baoneng will continue to purchase Vanke's shares or even launch a tender offer. However, there is no doubt that Vanke's tactics of halting its share trading, aligning with Anbang, and planning to issue a large number of shares to

¹⁰⁵ See CHINA VANKE CO., LTD., Guanyu Gongsi Gupiao Fupai de Tishixing Gonggao (关于公司股票复牌的提示性公告) [*The Preliminary Announcement on Resuming Share Trading*] (July 2, 2016), <http://www.cninfo.com.cn/finalpage/2016-07-02/1202445846.PDF>.

¹⁰⁶ See CHINA VANKE CO., LTD., Guanyu Yu Shenzhenshi Ditie Jituan Youxian Gongsi Qianshu Hezuo Beiwanglu de Gonggao (关于与深圳市地铁集团有限公司签署合作备忘录的公告) [*Announcement Regarding Signing Cooperation Memorandum with Shenzhen Subway Group Co.*] (Mar. 14, 2016), <http://www.cninfo.com.cn/finalpage/2016-03-14/1202041161.PDF>.

¹⁰⁷ The number of shares that would be issued to purchase the assets was not disclosed, but the total consideration was disclosed to be between 40-60 billion RMB. See *id.*

¹⁰⁸ See CHINA VANKE CO., LTD., Guanyu Shoudao Gudong Tiyi Zhaokai Linshi Gudong Dahui de Gonggao (关于收到股东提议召开临时股东大会的公告) [*Announcement Regarding the Receipt of Shareholder Proposal to Call Interval Shareholders' Meeting*] (June 27, 2016), <http://www.cninfo.com.cn/finalpage/2016-06-27/1202409796.PDF>; see also CHINA VANKE CO., LTD., Di Shiqi Jie Dongshihui Di Shierci Huiyi Jueyi Gonggao (第十七届董事会第十二次会议决议公告) [*Announcement on Resolutions of the Twelfth Board Meeting of the Seventeenth Term*] (July 4, 2016), <http://www.cninfo.com.cn/finalpage/2016-07-04/1202447796.PDF>.

¹⁰⁹ See CHINA VANKE CO., LTD., Vanke Xiangshi Quanyi Biandong Baogaoshu (万科企业股份有限公司详式权益变动报告书) [*Detailed Report on Equity Change in Vanke*] 23 (July 7, 2016), <http://www.cninfo.com.cn/finalpage/2016-07-07/1202457730.PDF>.

¹¹⁰ See CHINA VANKE CO., LTD., Guanyu Meiti Baodao de Shuoming Gonggao (关于媒体报道的说明公告) [*Announcement Regarding Explanation of Media Reports*] (July 20, 2016), <http://www.cninfo.com.cn/finalpage/2016-07-20/1202491732.PDF>.

Shenzhen Subway have made it much more difficult and costly for Baoneng to take control of Vanke than it would be without those antitakeover tactics.

The Vanke Takeover exhibited features that had not characterized previous takeovers in China. First, the target is a giant in the market with a huge market capitalization. Second, the large-scale funds for the takeover came from an insurance company and several asset management plans controlled by Baoneng. This feature reflects the growing number of financing avenues for takeovers in China. Moreover, an institutional investor plays an active role in the takeover.

As indicated in the beginning of this Article, Part III does not attempt to offer an exhaustive exposition of hostile takeovers that have occurred in China.¹¹¹ Nevertheless, from the four examples discussed above, we can draw an evolving line for hostile takeover behaviors and antitakeover tactics. This developmental arc corresponds with the incremental emergence of an effective market for corporate control in China as discussed in Part II, and leads to the analysis of the takeover regimes in China as displayed in the following parts of this Article.

IV. LEGAL REGIMES ON TAKEOVERS OF LISTED COMPANIES IN CHINA

In China, the first law regulating takeovers of listed companies was the Stock Interim Provisions, which included a particular chapter—Chapter 4—for the provisions governing acquisitions of listed companies.¹¹² The seven provisions included in Chapter 4 mainly focused on information disclosure requirements on block share purchases and tender offers. As the first article of Chapter 4, Article 46 prohibited any individual from holding more than 0.5% of the total outstanding shares of a listed company.¹¹³ This rule effectively foreclosed individuals from taking over listed companies. A legal person must make disclosures once its holding reached 5% of the total outstanding common shares of a listed company within three working days from the time of such holding's creation.¹¹⁴ Thereafter, that legal person must make disclosures whenever it purchased or sold 2% of such shares within three working days from the time of each transaction.¹¹⁵ Meanwhile, such legal person must suspend its trading on the shares from the time when a 5% holding or 2% change occurred and within two working days of the

¹¹¹ For a more complete list of hostile takeovers in China see Cai, *supra* note 78, at 916-17. See also SHANGHAI STOCK EXCH. RES. CTR., *supra* note 50, at 107-08.

¹¹² See Stock Interim Provisions, *supra* note 6, at Chapter IV.

¹¹³ *Id.* at art. 46.

¹¹⁴ *Id.* at art. 47.

¹¹⁵ *Id.*

disclosure.¹¹⁶ Once a legal person acquires 30% of the total common shares of a listed company, it must make a mandatory tender offer to all other shareholders of the listed company.¹¹⁷ The consideration per share must be in cash and be the higher of (1) the highest price the legal person paid for each share within twelve months prior to the tender offer; and (2) the average price of such share within thirty working days prior to the tender offer.¹¹⁸ The tender offer must be open for a minimum of thirty working days.¹¹⁹ Although partial tender offers were permissible under Stock Interim Provisions,¹²⁰ the tender offer would fail if, upon the expiration of the tender offer's open period, the offeror held less than 50% of the total outstanding common shares of the listed company.¹²¹

The mandatory tender offer rule in the Stock Interim Provisions took root in the City Code on Takeovers and Mergers (City Code) of the United Kingdom.¹²² However, the adoption of the British rules by the Chinese government seemed not to stem from the prudent search for the "best practice" in the world, but rather by coincidence. In the early 1990s, in addition to establishing two stock exchanges in mainland China to raise funds for SOEs, the Chinese government also desired to raise funds through foreign capital markets, particularly in the Hong Kong stock market.¹²³ As a result, the Hong Kong stock market regulators gained great leverage to persuade its mainland counterpart to adopt the Hong Kong takeover regime, which was based on the City Code.¹²⁴

The first Securities Law in China, promulgated in 1998, removed the ban on individuals as acquirers of listed companies.¹²⁵ The 1998

¹¹⁶ Stock Interim Provisions, *supra* note 6, at art. 47.

¹¹⁷ *Id.* at art. 48.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at art. 49.

¹²⁰ Partial tender offers are not explicitly permitted in the Stock Interim Provisions but could be implied from art. 51. Paragraph 3 of article 51 states that, when the number of shares the offeror commits to purchase is less than the number of shares tendered, the offeror should purchase shares pro rata from shareholders who have tendered their shares. *Id.* at art. 51.

¹²¹ *Id.* at art. 51.

¹²² See THE PANEL ON TAKEOVERS & MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, r. 9 (2013), <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf>. [hereinafter City Code].

¹²³ See Yu, *supra* note 4, at 178.

¹²⁴ *Id.* at 179-80.

¹²⁵ See Zhonghua Renmin Gongheguo Zhengquanfa (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, rev'd Aug. 28, 2004), Chapter IV, CLI.1.21319(EN) (Lawinfochina). Note that, although the Stock Interim Provisions has not been officially repealed, it has been replaced de facto by the 1998 Securities Law and later-promulgated laws or regulations wherever they contradict.

Securities Law also greatly reduced the hassle of disclosure for acquirers by raising the disclosure trigger of 2% for shareholding changes to 5%.¹²⁶ The first takeover regulation promulgated in 2002 extended the considerations in tender offers to include cash, legally transferable securities, and other legally permitted payment means.¹²⁷ In addition, the 2002 Takeover Regulation allowed the mandatory tender offer price to be the higher of (1) the highest price the acquirer paid for the same kind of shares within the six months preceding the announcement of the tender offer; or (2) 90% of the arithmetic average of the daily weighted average market price of such shares within thirty days preceding the announcement.¹²⁸ However, the 2002 Takeover Regulation imposed a more stringent full tender offer rule, which significantly increased the cost for the acquirer to obtain control of the target company. According to the rule, if the acquirer had acquired 30% of the outstanding shares of the target company and intended to further increase its holding, absent a special exemption granted by the CSRC, it had to make a universal offer to buy all outstanding shares of the target listed company's remaining shareholders.¹²⁹ This rule was largely revoked by the new takeover regulation promulgated in 2006, which legalized partial tender offers.¹³⁰

The development of Chinese takeover legal regime shows the deregulation trend in this field. The relaxations on the identity of acquirers, the disclosure requirements, and tender offer rules have greatly reduced the time and cost for acquirers and thus have had the effect of encouraging more takeovers to emerge. However, disclosure requirements and tender offer rules are not the only obstacles to takeovers. Takeover defenses adopted by the target company's management can erect insurmountable barriers to hostile takeovers. Therefore, it is key to examine the takeover defense legal regimes in China and evaluate their impact on hostile takeovers.

¹²⁶ Stock Interim Provisions, *supra* note 6, at art. 79.

¹²⁷ The 2002 Takeover Regulation, *supra* note 9, at art. 79.

¹²⁸ *Id.* at art. 34.

¹²⁹ *Id.* at art. 23.

¹³⁰ The 2006 Takeover Regulation, *supra* note 11, at art. 24. According to the 2006 Takeover Regulation, the acquirer could make a tender offer for a minimum of 5% of the outstanding shares of the target company. *Id.* at art 25.

V. CORPORATE GOVERNANCE AND TAKEOVER DEFENSES AVAILABILITY UNDER CHINESE CORPORATE LAW

A. *Takeover Defenses in the Chinese Corporate Governance Context*

Essentially, takeover defenses are actions taken by the board of the target company in opposition to hostile takeovers. Thus, the extent and effectiveness of takeover defenses rely on the powers of the board. According to Professor Ronald Coase, by forming a firm, all relevant factors enter into a long-term contract.¹³¹ Due to the difficulty of forecasting, it is undesirable to specify what the contracting parties are expected to do.¹³² Instead, the contract should only state the limits to the powers of the entrepreneur.¹³³ However, these limits are interpreted very differently by modern corporate laws in different jurisdictions.

In the United States, corporate law accords broad managerial powers to the board of directors,¹³⁴ making it the “ultimate locus of managerial powers.”¹³⁵ Since the board of directors is not mandated by duty to obey the wishes of the majority of the shareholders,¹³⁶ it actually enjoys a quasi-principal status in the traditionally-conceived principal-agent relationship between shareholders and the board of directors.¹³⁷ Board powers could be limited by corporate charters and subject to the boundaries of some fundamental shareholder rights and the fiduciary duties the directors owe to the company and its shareholders. While few public corporations elect to curtail boards’ managerial powers, shareholders’ default powers articulated in corporate statutes do play a role in restraining managerial excess.¹³⁸ However, the default powers of shareholders are very limited, which Professor Robert Clark summarized as the right to vote, the right to sue, and the right to information.¹³⁹ Observing the authoritative role of the board in American corporate governance, Professor Stephen

¹³¹ See R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 391 (1937) (arguing that firms are a cost-saving substitute for market mechanisms).

¹³² See *id.* at 391-92.

¹³³ See *id.* at 392.

¹³⁴ See 8 DEL. CODE ANN. tit. 8, § 141(a) (2016).

¹³⁵ See WILLIAM T. ALLEN ET AL., *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 104 (4th ed., 2012).

¹³⁶ See *id.*

¹³⁷ See *id.* at 103.

¹³⁸ See *id.* at 153.

¹³⁹ ROBERT CHARLES CLARK, *CORPORATE LAW* 93 (1986). Note that shareholders’ voting rights are limited to electing directors and voting on certain fundamental transactions such as mergers. See *id.* at 94.

Bainbridge rebuts the dogma of shareholder primacy or managerialism, and embraces the concept of director primacy.¹⁴⁰

Chinese company law interprets the relationship between shareholders and the board very differently. Articles 36 and 98 of the current Chinese company law (Chinese Company Law) unambiguously designate the shareholders' meeting as the highest governing body of a company.¹⁴¹ Article 37 enumerates the broad powers granted to the shareholders' meeting.¹⁴² These powers are not confined to the right to elect directors, amend the corporate charter, and vote on certain fundamental corporate transactions, including merger, split-ups, dissolutions, and change of corporate form.¹⁴³ They also include wide managerial powers, including, inter alia: (1) determining the company's operational guidelines and investment plans; (2) deliberating and approving company profit distribution plans and loss recovery plans; (3) making resolutions about the increase or reduction of the company's registered capital; and (4) making resolutions about the issuance of corporate bonds.¹⁴⁴ Article 46 stipulates that the board should be responsible for the shareholders' meeting and execute the resolutions of the shareholders' meeting.¹⁴⁵ By contrast, of the board's powers enumerated in Article 46, the majority are preliminary or suggestive, and subject to shareholders' final approval during a shareholders' meeting.¹⁴⁶ Boards are only left to decide: (1) the business plan and investment plan; (2) the establishment of internal departments of a company; (3) the appointment, removal, and the remuneration of the managers, vice managers and chief financial officers.¹⁴⁷

All of those provisions suggest an impotent and deferential board in corporate governance in China. However, this impression should be balanced by the fact that, for listed companies in China, shareholders' meeting is usually convened annually.¹⁴⁸ It cannot be expected that all of

¹⁴⁰ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003).

¹⁴¹ Zhonghua Renmin Gongheguo Gongsifa (中华人民共和国公司法) [Company Law of the People's Republic of China] (Promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014), art. 36 & art. 98, CLI.1.218774(EN) (Lawinfochina) [Hereafter Chinese Company Law].

¹⁴² *Id.* art. 37.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at art. 46.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* art. 100.

the important issues of a listed company could be decided in one meeting. Furthermore, due to the collective action problem, shareholders in companies with dispersed ownership may be rationally apathetic to cast a vote,¹⁴⁹ even if they are empowered by the law. A gap exists between the expectations of corporate law on a shareholders' meeting and its de facto functions. As a result, although Chinese Company Law allocates much more power to shareholders' meetings vis-à-vis the board, there is still space for the board to play a substantial role in corporate governance.

B. *The Availability of Takeover Defenses in China*

In the United States, takeover defenses have constantly evolved and it is hard to predict an end to the evolution.¹⁵⁰ Among various takeover defenses, poison pills and staggered boards are two of the most important in the United States.¹⁵¹ Another takeover defense, dual-class stock, though not as commonly used as the above two,¹⁵² has attracted public attention for its growing popularity in recent years.¹⁵³ This subsection will examine whether the board of directors in China could avail themselves of these three major takeover defenses, and also includes a brief discussion on other available takeover defenses in China.

I. *Poison Pills*

Poison pills, formally known as “shareholder rights plans,” were invented in the United States, and were upheld by the Delaware Supreme Court as a valid takeover defense.¹⁵⁴ A poison pill is triggered when a hostile bidder's ownership of shares exceeds a certain threshold; once triggered, the shareholders of the target company other than the hostile bidder are entitled to purchase shares of the target company at a significant

¹⁴⁹ See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).

¹⁵⁰ See CLARK, *supra* note 139, at 571.

¹⁵¹ See Michael Klausner, *The Empirical Revolution in Law: Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1349-50 (2013).

¹⁵² See *id.* at 1353.

¹⁵³ See Abigail Caplovitz Field, *Shareholder Opposition to Dual Class Structure Rising*, CORP. SECRETARY (May 8, 2014), <http://www.corporatesecretary.com/articles/proxy-voting-shareholder-actions/12718/shareholder-opposition-dual-class-structure-rising/>; see generally IRRC INSTITUTE, CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012), <http://irrcinstitute.org/wp-content/uploads/2015/09/FINAL-Controlled-Company-ISS-Report1.pdf>.

¹⁵⁴ See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

discount, resulting in a fatal dilution of the hostile bidder's holdings.¹⁵⁵ In the United States, the board can adopt a poison pill unilaterally.¹⁵⁶ In China, however, this takeover defense is not feasible. On the one hand, issuing new shares is a power exclusively reserved for the shareholders' meeting;¹⁵⁷ on the other hand, treasury shares are generally forbidden.¹⁵⁸ Lacking the power to issue shares to shareholders, it is impossible for a board of directors in China to employ the poison pill as a takeover defense.

2. *Staggered Boards*

In a staggered or classified board, directors are divided into three classes and serve three year terms. Only one class stands for election each year.¹⁵⁹ An effective staggered board forces an acquirer to spend about two years to replace the majority of the target board.¹⁶⁰ If a target company only has a poison pill, an acquirer can still circumvent it by waging a proxy fight to remove the majority of the incumbent board members at a single shareholders' meeting and having the newly-elected board redeem the poison pill. However, a staggered board, coupled with a poison pill, can create almost insurmountable difficulties for a hostile bidder.¹⁶¹ Empirical evidence also shows that no hostile bid has ever succeeded when the target had a combination of a staggered board and a poison pill.¹⁶²

Under Chinese Company Law, the term of directors should last no longer than three years and should be specified by corporate charters.¹⁶³ Moreover, directors can be reelected upon the expiration of their terms.¹⁶⁴

¹⁵⁵ See Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 382-83 (2002).

¹⁵⁶ See Klausner, *supra* note 151, at 1350.

¹⁵⁷ Chinese Company Law, *supra* note 141, art. 98.

¹⁵⁸ Under Chinese Company Law, companies are generally forbidden from holding their own shares. However, there are four exceptions, including reduction of registered capital, employee share ownership plans, mergers with other companies holding their shares, and repurchases of shares from dissenting shareholders in a merger or corporate split-up. *Id.* at art. 142.

¹⁵⁹ See Klausner, *supra* note 151, at 1352.

¹⁶⁰ An effective board means that, according to the charter or bylaw of the target company, or according to the corporate law of the state where the target company was incorporated, the shareholders cannot replace the majority of the board of the target at a single shareholders' meeting. For a detailed explanation of an "effective staggered board" and examples of ineffective boards, *see id.* at 1353 n.110.

¹⁶¹ *See id.* at 1352-53.

¹⁶² See Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887, 890 (2002).

¹⁶³ Chinese Company Law, *supra* note 141, art. 45 & art. 108.

¹⁶⁴ *Id.*

Because the law does not require that all directors have same terms, it is possible to include a staggered board arrangement in a corporate charter.¹⁶⁵ The effectiveness of staggered boards, however, could be impaired by shareholders' ability to call a special shareholders' meeting in between two annual meetings. Pursuant to Chinese Company Law, a company should convene a special shareholders' meeting within two months if shareholders, individually or jointly holding more than 10% of the outstanding shares, make a request.¹⁶⁶ Therefore, a hostile bidder with 10% or more shareholding could call a special shareholders' meeting and have staggered board provisions removed from the target's charter. However, removing such provisions is challenging because amending corporate charters requires a supermajority vote.¹⁶⁷

Another issue associated with the effectiveness of a staggered board is the shareholders' ability to remove directors without cause. As Chinese Company Law is silent on this issue,¹⁶⁸ corporate charters can specify these terms. It is noteworthy that the Guidance for the Articles of Listed Companies, promulgated by the CSRC, still provides that directors of listed companies should not be removed without cause before their terms expire.¹⁶⁹ The Guidance for Articles is not legally binding. However, it has considerable authority among listed companies because it reflects the position of the CSRC on this issue. Thus, staggered boards might serve as an effective weapon in the target's arsenal of takeover defenses in China, provided that it is properly structured in the corporate charter of a listed company.¹⁷⁰

¹⁶⁵ See Wang Jianwen (王健文), *Woguo Gongsi Zhangcheng Fanshougou Tiaokuan: Zhidu Kongjian Yu Shiyong Fangfa* (我国公司章程反收购条款：制度空间与适用方法) [*The Antitakeover Provisions in Corporate Charters in China: Institutional Structure and Application Method*], 142 L. REV. 135, 138 (2007).

¹⁶⁶ Chinese Company Law, *supra* note 141, at art. 100.

¹⁶⁷ *Id.* at art. 103.

¹⁶⁸ Before the company law in China was overhauled in 2005, the old law provided that directors could not be removed without cause. *Zhonghua Renmin Gongheguo Gongsifa* (中华人民共和国公司法) [Company Law of the People's Republic of China] (Promulgated by the Standing Comm. Nat'l People's Cong., Aug. 28, 2004, effective Aug. 28, 2004, re'd Oct. 27, 2005), art. 115, CLI.1.54989(EN) (Lawinfochina). This provision, however, was removed from the company law after the 2005 amendment.

¹⁶⁹ *Shangshi Gongsi Zhangcheng Zhiyin* (上市公司章程指引) [Guidance for the Articles of Listed Companies] (promulgated by the China Sec. Reg. Commn, Oct. 20, 2014, effective Oct. 20, 2014), art. 96, CLI.4.237199 (Lawinfochina).

¹⁷⁰ For example, a corporate charter could provide for a staggered board with only one third of the directors standing for election each year and further stipulate that directors could not be removed without cause. Those provisions, acting in conjunction, could create an effective staggered board.

3. *Dual-Class Stock*

A company has dual-class stock when it issues multiple classes of common stock, one of which is endowed with disparate voting rights.¹⁷¹ Normally, the management of the company owns the class of nonpublicly traded shares with superior voting rights, and the public investors own the class of publicly traded shares with inferior voting rights.¹⁷² The power of dual-class stock as a takeover defense is to perpetuate control in the hands of the management, who hold the nonpublicly traded class of shares with superior voting rights.¹⁷³ In the United States, about 6% of the public companies have adopted the dual-class stock structure.¹⁷⁴

Chinese listed companies could only issue a single class of shares before the promulgation of the regulation on preferred shares in 2014 (Preferred Shares Measures).¹⁷⁵ In addition, Chinese Company Law has long provided for a uniform rule of “one vote, one share” at a shareholders’ meeting.¹⁷⁶ Preferred Shares Measures seemed to provide for the possibility of dual-class stock in China: if well-structured in a corporate charter, preferred shares could serve the function of the class of shares with superior voting rights. This possibility, however, did not materialize in the Preferred Shares Measures. Pursuant to this regulation, preferred shareholders only have preference for profit and residual assets, and not superior voting rights.¹⁷⁷ Instead, preferred shareholders are only permitted to vote on a few limited matters on a one-share-one-vote basis.¹⁷⁸ Hence, dual-class stock cannot currently serve as a legitimate takeover defense in China.

¹⁷¹ See Douglas C. Ashton, *Revisiting Dual-class Stock*, 68 ST. JOHN’S L. REV. 863, 866 (1994).

¹⁷² See Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1052 (2010). Typically, the shares with inferior voting rights are entitled to one vote per share, while the shares with superior voting rights are entitled to ten votes per share. *Id.*

¹⁷³ See Donald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 811 (1987).

¹⁷⁴ See Gompers et al., *supra* note 172, at 1052.

¹⁷⁵ Youxiangu Shidian Guanli Banfa (优先股试点管理办法) [Measures for the Administration of the Pilot Program of Preferred Shares] (promulgated by the China Sec. Reg. Comm’n, Mar. 21, 2014, effective Mar. 21, 2014), CLI.4.221521(EN) (Lawinfochina) [hereinafter Preferred Shares Measures].

¹⁷⁶ Chinese Company Law, *supra* note 141, at art. 103.

¹⁷⁷ Preferred Shares Measures, *supra* note 175, at art. 2.

¹⁷⁸ *Id.* at art. 10.

4. *Other Takeover Defenses in China*

Despite lacking recourse to poison pills and dual-class stock, a board of directors can still rely on other defenses in China. For example, the board could invite a “white knight” who favors the target’s incumbent management to compete with hostile acquirers by purchasing the target’s shares in the stock market. Furthermore, in the face of a hostile takeover, a target’s board could initiate legal proceedings to counter the takeover. These legal proceedings will have a deterrent effect regardless of whether they are meritorious or meritless.¹⁷⁹ In addition, a target’s board could employ the most characteristically Chinese defense—applying for suspension on the trading of the target’s shares.¹⁸⁰ This tactic prevents a hostile acquirer from further purchasing a target’s shares, giving the target’s board plenty of time to respond to the hostile takeover. Alternatively, a target’s board could persuade current block shareholders to align with it to defeat a hostile acquirer’s proposal to replace incumbent board members.

It is true that the board of directors in China is not as powerful as its counterpart in the United States and has less takeover defenses at hand. Nevertheless, it is still left with considerable maneuvering room to deter or even defeat a hostile takeover. The board, of course, could adopt takeover defenses to benefit the company and its shareholders by defeating coercive

¹⁷⁹ This defensive tactic can be observed in all four of the hostile takeover cases illustrated in Part III, where the boards of the targets reported the alleged illegalities of the acquirers to the authorities, such as the CSRC or the stock exchanges. *See supra* Part III.

¹⁸⁰ Applying for suspension on trading of shares has become a widely used takeover defense in China in recent years. The most frequently cited reason for such suspension is that the target company is considering a material asset restructuring that will have an impact on stock price. *See Dou Shangshi Gongsi Bimeng Mimo Fanshougou Daji (多上市公司闭门密谋反收购大计) [Many Listed Companies Are Considering Antitakeover Tactics]*, XINHUA NEWS (Jan. 21, 2015, 09:08:06AM), http://news.xinhuanet.com/fortune/2015-01/21/c_127405829.htm. In the case of the Vanke Takeover, Vanke suspended its share trading for more than seven months before the trading was resumed on July 4, 2016. *See CHINA VANKE CO., LTD., supra* note 105. In light of this, both the SSE and SZSE have recently revised their rules regarding trading suspension and resumption, both limiting the trading suspension to a maximum of three months in the case of material assets restructuring. Any extension of suspension beyond three months will require shareholders’ approval. *Shangshi Gongsi Chouhua Zhongda Shixiang Tingfupai Yewu Zhiyin (上市公司筹划重大事项停复牌业务指引) [Guidelines on Trading Suspension and Resumption Due to Planned Material Issues of Listed Companies]* (promulgated by the Shanghai Stock Exch, May 27, 2016, effective May 27, 2016), art. 17, CLI.6.271109 (Lawinfochina); *Zhuban Xinxi Pilu Yewu Beiwanglu Dijiu hao – Shangshi Gongsi Tingfupai Yewu (主板信息披露业务备忘录第9号—上市公司停复牌业务) [Memorandum No. 9 on Information Disclosure of the Main Board: Trading Suspension and Resumption of Listed Companies]* (promulgated by Shenzhen Stock Exch., May 27, 2016, effective May 27, 2016), art. 7, <http://www.szse.cn>.

takeovers. It could also adopt these defenses for self-entrenchment purpose. This potential for abuse of board power calls for a legal regime to regulate takeover defenses in China.

VI. TAKEOVER DEFENSE REGIMES IN THE WORLD AND IN CHINA

In the current context of globalization, countries usually look at the pre-existing “best practice” in the world when establishing a new legal regime. Thus, when the Chinese securities regulators began to consider various takeover defense regimes, it was reasonable for them to probe into the existing legal regimes in the United Kingdom and the United States. These two jurisdictions represent two major but dissimilar legal choices on takeover defenses.

A. Takeover Defense Regimes From a Comparative Law Perspective

1. Two Influential Takeover Defense Regimes in the World

The takeover defense regime in the United Kingdom can be termed as a system of “board neutrality.”¹⁸¹ Rule 21.1 of the City Code imposes an overall bar on any takeover defenses adopted by the board in the face of a takeover without a prior consent of shareholders.¹⁸² Rule 21, however, only regulates post-bid defenses; pre-bid defenses in the United Kingdom are regulated by the fiduciary duties that a director owes to the company, including the duties to act within his powers and to promote the success of the company.¹⁸³ Due to these legal restrictions on boards’ powers, United Kingdom law generally forbids the unilateral adoption of pre-bid defenses such as poison pills and staggered boards.¹⁸⁴ Overall, the takeover defense regime in the United Kingdom reflects the fundamental creed of shareholder primacy.¹⁸⁵ This creed is clearly proclaimed in the introduction of the City Code, which states “[t]he Code is designed principally to ensure

¹⁸¹ See Armour et al., *supra* note 3, at 236.

¹⁸² The City Code, *supra* note 122, r. 21.1.

¹⁸³ See Alexandros Seretakos, *Hostile Takeovers and Defensive Mechanisms in the United Kingdom and the United States: A Case Against the United States Regime*, 8 ENTREPREN. BUS. L.J. 245, 259 (2013). The same fiduciary duties also apply to the post-bid defenses, but their effects are diminished by rule 21 of the City Code. *Id.*

¹⁸⁴ See *id.* at 256-57.

¹⁸⁵ See Armour et al., *supra* note 3, at 236.

that shareholders in an offeree company are treated fairly and are not denied an opportunity to decide on the merits of a takeover.”¹⁸⁶

By contrast, the takeover defense regime in the United States goes in the opposite direction.¹⁸⁷ Under Delaware law, the management of companies rests with the board of directors.¹⁸⁸ The board’s managerial powers, however, are subject to the judicially-created fiduciary duties that the board owes to the company and its shareholders: the duty of care and the duty of loyalty.¹⁸⁹ In Delaware, the judicial review standards for deciding whether the board properly discharged its fiduciary duties in relation to takeover defenses are so-called “intermediate” standards.¹⁹⁰ These standards were established by the venerable case of *Unocal* and its progeny.¹⁹¹ In *Unocal*, the Delaware Supreme Court recognized “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”¹⁹² With this concern in mind, the court devised a two-prong test that a target’s board is required to satisfy before it has the protection of the deferential business judgment rule. First, the board must reasonably believe that the takeover bid poses a threat to corporate policy and effectiveness. Second, the defensive measures taken must be reasonable in relation to the threat posed.¹⁹³ Once this test is met, the board is permitted and even obligated to discharge its fiduciary duties to adopt takeover defenses to protect the company and its shareholders from the perceived harm posed by the takeover bid.¹⁹⁴ Although the *Unocal* test is normally considered as an enhanced standard compared with the “regular” business judgment rule, it has turned out to be

¹⁸⁶ The City Code, *supra* note 122, at A1.

¹⁸⁷ Due to the leading position of Delaware law in this field, this Article’s discussion on the legal regime governing takeover defenses in the United States will be limited to Delaware law.

¹⁸⁸ 8 DEL. CODE ANN. tit. 8, § 141(a) (2016).

¹⁸⁹ See ALLEN ET AL., *supra* note 135, at 217.

¹⁹⁰ Before *Unocal*, there had been two judiciary standards for reviewing the duties of boards: the “business judgment rule” and the “entire fairness” standard. See Armour et al., *supra* note 3, at 244. The business judgment rule is “an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a).” Aronson v. Lewis, 473 A.2d 805, 812 (1984). It is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Id.* Under the entire fairness standard, which is applied in cases involving a controlling relationship between the parties and where the directors stand on both sides, the directors are required to prove the fair process and fair price of the challenged transaction. See Weinberger v. Uop, Inc. 457 A.2d 701, 710-11.

¹⁹¹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹⁹² See *id.* at 954.

¹⁹³ See *id.* at 955.

¹⁹⁴ See *id.*

another deferential rule that a target's board can easily satisfy. For example, the Delaware Supreme Court has never ordered a target's board to redeem its poison pill despite being challenged before the Court.¹⁹⁵ In light of the broad powers the board of directors has in resisting hostile takeovers, this Article refers to the legal regime on takeover defenses in the United States as the “director primacy” model, as opposed to the “board neutrality” model in the United Kingdom.

The United Kingdom model and the United States model have attracted followers worldwide. The European Union adopted the United Kingdom approach after long, intense deliberations and debates over controversies concerning the prohibition of takeover frustrating actions.¹⁹⁶ Article 9(2) of the Takeover Bids Directive of April 21, 2004 mandates the prohibition on post-bid takeover defenses.¹⁹⁷ Japan, by contrast, seemed to have adopted the *Unocal* two-prong test that was developed in Delaware.¹⁹⁸ The Japanese Takeover Guidelines requires that, when implementing takeover defense measures, the board of directors must prove there is a threat to shareholder interests and ensure that the defenses taken are reasonable in relation to the threat posed.¹⁹⁹ However, the Japanese Takeover Guidelines diverges from the *Unocal* test by encouraging shareholder approval of defensive measures taken by the board ex ante to ensure fairness.²⁰⁰

2. Theoretical Debate on Takeover Defense Policies

Board neutrality, also called managerial passivity, refers to the notion that the management of a target company should acquiesce and refrain from adopting takeover defenses in the face of a hostile takeover.²⁰¹

¹⁹⁵ See Alicia J. Davis, *The Institutional Appetite for “Quack Corporate Governance”*, 2015 COLUM. BUS. L. REV. 1, 33 (2015).

¹⁹⁶ See Seretakis, *supra* note 183, at 254; see also Klaus J. Hopt, *Takeover Defenses in Europe: A Comparative Theoretical and Policy Analysis*, 20 COLUM. J. EUR. L. 249, 258 (2013-14).

¹⁹⁷ Directive 2004/25, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142), art. 9(2). Note that article 12(1) of the EU Takeover Directive permits member states to opt out of the requirement in article 9(2). *Id.* at art. 12(1).

¹⁹⁸ *Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests*, MINISTRY OF ECON., TRADE AND INDUS. & MINISTRY OF JUST, 8 n.6 (May 27, 2005), translated at http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/shishin_hontai.pdf.

¹⁹⁹ *Id.* at 8.

²⁰⁰ *Id.* at 8 n.6.

²⁰¹ See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194 (1981).

The managerial passivity policy stems from the strong faith in the function of the market for corporate control, a concept established by Professor Henry Manne in his seminal work *Mergers and the Market for Corporate Control* in 1965.²⁰² In this work, Professor Manne argues that due to courts' deference to managerial decisions based on the business judgment rule, takeovers serve as the only means to discipline management, thereby providing strong protection to the interests of non-controlling shareholders.²⁰³ Professor Manne's view has been shared and developed by Judge Frank Easterbrook and Professor Daniel Fischel, who regard takeovers as an effective method to monitor the work of managers, reduce agency cost, and thereby increase shareholder welfare.²⁰⁴ Takeover defenses, on the contrary, will facilitate managerial entrenchment, keep agency costs high, and consequently reduce shareholder welfare.²⁰⁵ Those accusations on takeover defenses are also supported by empirical studies associating takeover defenses with lower firm value.²⁰⁶

The discourse surrounding takeover defenses is not one-sided, though. Mr. Martin Lipton, an enthusiastic supporter of takeover defenses, considers takeover defenses as an effective means to protect shareholders, to preserve the long-term value of a company, and to further the interests of other stakeholders, such as employees, consumers, suppliers, the communities, and other major constituencies.²⁰⁷ The crux of his argument

²⁰² See Manne, *supra* note 1, at 112.

²⁰³ See *id.* at 113.

²⁰⁴ See Easterbrook & Fischel, *supra* note 201, at 1168-74.

²⁰⁵ See *id.* at 1174-75.

²⁰⁶ See Bebchuk et al., *supra* note 162 at 925-27 (discussing an empirical study of the takeover bids between 1996 and 2000 indicating that the staggered boards significantly reduced target shareholder returns); see also Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003) (researching samples in the 1990s showing that companies with higher levels of shareholder rights and lower levels of takeover defenses outperformed the ones with lower levels of shareholder rights and higher levels of takeover defenses by a significant margin); see also Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (analyzing an empirical investigation, which found that six takeover defenses including staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments, were negatively correlated with firm valuation in the period of 1990-2003).

²⁰⁷ See Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369, 1370-71 (2005) [hereinafter Lipton, 2005]. Since the late 1970s, Mr. Martin Lipton has published a series of articles to justify takeover defenses. See Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); see also Martin Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); see also Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980).

is that the power of the board of directors to manage the business of the company cannot be circumscribed solely due to the nature of the issue being decided: the business judgment rule should apply to hostile takeovers as it does in the circumstances of mergers or assets acquisitions.²⁰⁸ In addition, some economists challenge the value-creating function of hostile takeovers by pointing out that some takeover bidders have engaged in “empire building”: the management of hostile takeover bidders is incentivized to seek size maximization for its own benefit at the cost of the bidder’s shareholders.²⁰⁹ Professor John Coffee, while acknowledging hostile takeovers’ role in reducing agency cost,²¹⁰ recognizes the limits of its disciplinary effect and its much higher cost vis-à-vis internal governance mechanisms such as independent boards.²¹¹ He concludes that a substantial increase in the frequency of takeovers will lead to serious diseconomies.²¹² This allegation is largely borne out by Professor Alicia Davis’ empirical study. Professor Davis found that, as the most sophisticated shareholders relative to other market participants, institutional investors prefer to invest in companies with high-quality internal governance.²¹³ Meanwhile, they have a high level of tolerance for investing in companies with takeover defenses.²¹⁴

B. The Takeover Defense Legal Regime in China

Compared with the United States and United Kingdom, China is a latecomer in regulating takeover defenses. The first regulation in this field was promulgated in 2002, and was replaced by the current regulation in 2006. From these two regulations, we can see China’s efforts to seek the “best practices” in the world and its struggles in shaping its own local rules.

1. The 2002 Takeover Regulation: A Board Neutrality Approach

The 2002 Takeover Regulation was the first law in China addressing takeover defenses. Although it was repealed and replaced by the 2006 Takeover Regulation, it reflected the original mindset of the CSRC

²⁰⁸ See Lipton, 2005, *supra* note 207, at 1370.

²⁰⁹ See John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1167-68 (1984).

²¹⁰ *Id.* at 1156.

²¹¹ See *id.* at 1202-03.

²¹² See *id.* at 1294.

²¹³ See Davis, *supra* note 195, at 71.

²¹⁴ *Id.* at 75.

toward takeovers. As discussed later in this Article, this mindset also affected the current takeover defense regime in China.²¹⁵

The first paragraph of Article 33 of the 2002 Takeover Regulation states that the measures taken by the target's management in response to a takeover should not harm the legal interests of the target and its shareholders.²¹⁶ A reasonable interpretation of this language would lead to the inference that takeover defenses are permissible, as long as they are adopted for the best interests of the company and its shareholders. The second paragraph of Article 33, however, makes a sharp turn from the first paragraph. The second paragraph bars the board from proposing six defensive measures after a tender offer bid is announced, apart from continuing to fulfill contracts that have already been entered into or executing resolutions that have already been adopted by shareholders.²¹⁷ Those proscribed measures include: (1) issuing shares; (2) issuing convertible corporate bonds; (3) repurchasing shares of the target; (4) amending the corporate charter; (5) entering into contracts that will have substantial impact on the assets, debts, equity, or operating results of the target, except in the ordinary course of business; and (6) disposing, purchasing substantial assets, or changing the principal business of the company.²¹⁸ Note that the second paragraph does not expressly prohibit the target's board from *taking* those measures—they are not conferred by law with those powers in the first place—rather, it prohibits the board from *proposing* those takeover defenses to the shareholders to adopt them.

The second paragraph contradicts the first paragraph in that the proscribed measures enumerated in Paragraph Two could be employed to thwart a truly coercive bid. Thus, they benefit the target company and its shareholders, which exactly falls within the permissible ambit of the first paragraph. Further, the six articulated measures are far from an exhaustive list of all the possible defensive tactics that could have an entrenchment effect and harm the interests of the target company and its shareholders.

Interestingly, apart from amending corporate charters, the remaining five listed defensive measures in Paragraph 2 of Article 33 of the 2002 Takeover Regulation are similarly listed in Rule 21.1 of the City Code.²¹⁹ This gives rise to speculation that the drafter of the 2002 Takeover

²¹⁵ See discussion *infra* Part VI.B.2.

²¹⁶ The 2002 Takeover Regulation, *supra* note 9, art. 33, ¶ 1.

²¹⁷ *Id.* art. 33, ¶ 2.

²¹⁸ *Id.*

²¹⁹ The City Code, *supra* note 122, r. 21.1.

Regulation had just copied and pasted the content in the City Code.²²⁰ This demonstrates how heavily the British takeover law has influenced the takeover legal regime in China.²²¹ Rule 21.1 of the City Code, however, bars the target board from taking, rather than proposing to take defensive measure, without the prior consent of the shareholders. In this sense, relative to the City Code, the 2002 Takeover Regulation imposes a far more stringent restriction on the board. Note that Article 33 only applies after an acquirer launches a tender offer. The 2002 Takeover Regulation is silent on the legitimacy of takeover defenses absent a tender offer.²²²

2. *The 2006 Takeover Regulation: A Hybrid Approach*

The 2006 Takeover Regulation was promulgated to adapt to the new changes in the Chinese capital market that resulted from the landmark reform on the spilt-share structure.²²³ Although CSRC has made some minor revisions on this regulation since 2006, the provisions regarding takeover defenses remain the same and still govern takeover defenses in China.²²⁴

Paragraph 1 of Article 8 clearly states that the management of the target company owes the duty of care and the duty of loyalty to the target company. Paragraph 2 of the same Article further provides that whatever measures the target's board takes in response to a takeover should be beneficial to the target company and its shareholders. The target's board should not abuse its powers to erect improper barriers to takeovers.²²⁵

At first glimpse, Article 8 seems to have established a regime resembling the Delaware law: the target's board is permitted to adopt takeover defenses to discharge the fiduciary duties it owes to the target company and its shareholders, subject to the prohibition on self-entrenchment.²²⁶ Note that Article 8 is a provision in Chapter 1, which expounds upon the general principles of the regulation. Consequently, it

²²⁰ See Huang, *supra* note 4, at 176.

²²¹ See Yu, *supra* note 4, at 180.

²²² According to the 2002 Takeover Regulation, an acquirer could, but was not required to, make a tender offer when it held less than 30% of the outstanding shares of the target company. A mandatory tender offer, however, had to be made once the acquirer held more than 30% and intended to increase its holding. The 2002 Takeover Regulation, *supra* note 9, art. 23.

²²³ See *supra* Part II.B.

²²⁴ See *supra* note 11.

²²⁵ The 2006 Takeover Regulation, *supra* note 11, at art. 8.

²²⁶ See Part VI.A.

applies not only to the situations involving tender offers but to the whole process of a takeover.

While the 2006 Takeover Regulation makes a laudable move to empower directorial powers with fiduciary duties, the efficacy of these rules are questionable given the legislative and judicial settings in China. It is well-known that the fiduciary duties which the board owes to the company and its shareholders, namely the duty of care and duty of loyalty, have been created, developed, and construed in common law system.²²⁷ China, as a member of the continental law family, lacks the tradition of judge-made laws. Despite the fact that directors' duty of care and duty of loyalty are stated in Chinese Company Law,²²⁸ they are defined in a very vague and general fashion. Therefore, they can hardly function as guidelines for directors.²²⁹ Consequently, the effectiveness of the fiduciary duties stated in Article 8 of the 2006 Takeover Regulation is severely discounted.

Article 33 of the 2006 Takeover Regulation, however, radically diverges from Article 8. It states that, beginning from the announcement of a tender offer and until its consummation, apart from carrying out ordinary business or executing the resolutions already adopted at a shareholders' meeting, without prior consent of the shareholders, the target's board is prohibited from taking measures that would have material impact on the assets, debts, equity or operating results of the company.²³⁰ The proscribed measures include, among other things, disposal of corporate assets, investment, adjustment of principal business, provision of guarantee, and incurrence of loans.²³¹ None of those enumerated powers are exclusively reserved for the shareholders under Chinese Company Law,²³² and the board could exercise those powers according to corporate charters.

Article 33 of the 2006 Takeover Regulation shares some similarities with Rule 21.1 of the City Code:²³³ certain directorial actions are prohibited without prior consent of shareholders. Article 33, however, has a much narrower focus. It aims to forestall the so-called "scorched

²²⁷ The concept of directors' fiduciary duties stems from *Charitable Corp. v. Sutton*, a case adjudicated by the Lord Chancellor of England in 1742. Since then, this concept has been reiterated and confirmed by courts as the duty of care and the duty of loyalty. See Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 678-79 (2009).

²²⁸ Chinese Company Law, *supra* note 141, at art. 147.

²²⁹ See Huang, *supra* note 21, at 174.

²³⁰ The 2006 Takeover Regulation, *supra* note 11, at art. 33.

²³¹ *Id.*

²³² The Chinese Company Law, *supra* note 141, at art. 37.

²³³ The City Code, *supra* note 122, r. 21.1; The 2006 Takeover Regulation, *supra* note 11, at art. 33.

earth” defensive tactic.²³⁴ As to other defensive tactics, such as poison pills, staggered boards and dual-class share structures, they are either unavailable under Chinese Company Law or subject to prior consent of shareholders.²³⁵ Another nuanced distinction between Article 33 of the 2006 Takeover Regulation and Rule 21.1 of the City Code is that the former only stresses the impact of defensive measures on target companies, while the latter is directed against the frustration effect on acquirers. It is also noteworthy that, in deciding the permissibility of the transactions on corporate assets in the face of a takeover, a “materiality” standard is employed in both Article 33 of the 2006 Takeover Regulation and Rule 21.1(b)(iv) of the City Code.²³⁶ While the City Code gives specific guidance on what constitutes “materiality”,²³⁷ the 2006 Takeover Regulation is silent in this respect, leaving broad unguided discretions to the CSRC.

Article 33 of the 2006 Takeover Regulation shows significant relaxations from its counterpart provision in the 2002 Takeover Regulation. Compared with Article 33 of the 2002 Takeover Regulation, Article 33 of the 2006 Takeover Regulation no longer restricts the board from *proposing* defensive measures to shareholders. Therefore, if the board believes that a takeover poses a threat to corporate value and effectiveness, it can propose takeover defenses to shareholders.

In addition to Article 8 and Article 33, Article 80 of the 2006 Takeover Regulation states that the CSRC has the power to order a listed company to correct relevant provisions regarding corporate control in its corporate charter, if those provisions run afoul of laws, administrative regulations, or the 2006 Takeover Regulation.²³⁸ Apparently, Article 80 targets “shark repellent” charter amendments that could deter potential takeovers.²³⁹ Article 80 will apply no matter whether the challenged “shark repellent” amendments are adopted before a tender offer or after it. Its effectiveness, however, could be attenuated because the 2006 Takeover Regulation does not specify with which parts of laws or regulations regarding corporate control the corporate charters should conform.

It is worth noting that the 2006 Takeover Regulation also authorizes the establishment of a special committee: the Takeover and

²³⁴ See Macey & McChesney, *supra* note 79, at 33 n.78.

²³⁵ See *supra* Part V.B.

²³⁶ The 2006 Takeover Regulation, *supra* note 11, at art. 33; the City Code, *supra* note 122, at r. 21.1(b)(iv).

²³⁷ The City Code, *supra* note 122, at 117.

²³⁸ The 2006 Takeover Regulation, *supra* note 11, at art. 80.

²³⁹ *Id.*; See Gilson, *supra* note 73, at 777.

Restructuring Committee.²⁴⁰ The committee is composed of specialists on takeovers. It provides advisory opinions to the CSRC on matters regarding, among other things, whether a takeover of a listed company does exist or whether there is any circumstance under which a listed company should not be taken over. Then the CSRC makes final decisions.²⁴¹ Although the Takeover and Restructuring Committee in China has much less authority compared with the Panel on Takeovers & Mergers, which independently enforces the City Code, it can deal with disputes in takeovers more efficiently and flexibly compared with what Chinese courts could do.

As a whole, the 2006 Takeover Regulation gives more breathing room to a target's board to adopt takeover defenses than the 2002 Takeover Regulation. A hybrid approach is present in the regulation: it combines the board neutrality policy in the United Kingdom and the fiduciary duties-based policy in the United States. But while transplanting foreign laws might be easy, reconciling and further adapting them to the local legal and commercial settings present the real challenge. While it is desirable to take fiduciary duties as a measuring rod for directorial behaviors in the face of a hostile takeover, Article 8 is doomed to lend itself to ambiguity given that such duties are short of legislative and judicial constructions in China. Furthermore, the fiduciary duties articulated in Article 8 and the prohibitions imposed on board actions in Article 33 create great controversies. These controversies essentially stem from the CSRC's hesitation between the board neutrality policy and the director primacy policy. These ambiguities and controversies, unfortunately, are exacerbated when taking into consideration the role of the board in corporate governance under Chinese law.²⁴² Accordingly, Part VII endeavors to propose a reform on the current regimes in hope to eliminate these ambiguities and controversies.

VII. SEEKING THE BEST TAKEOVER DEFENSE REGIME FOR CHINA

To eliminate the ambiguities and inconsistencies that plague the current takeover defense regime in China, we have to answer two questions. First of all, should China adopt a board neutrality policy such as that in the United Kingdom? A "yes" answer, of course, will terminate the whole discussion. A "no" answer, however, will bring us to the next question: provided that the board of directors is allowed to adopt takeover defenses without prior shareholder consent, should the law give the shareholders the

²⁴⁰ The 2006 Takeover Regulation, *supra* note 11, at art. 10.

²⁴¹ *Id.*

²⁴² *See supra* Part V.A.

final say on the preservation or removal of such defenses? Part VII endeavors to answer these two questions.

A. Is Board Neutrality an Optimal Choice for China?

China took a United Kingdom approach at the inception of its takeover law²⁴³ and the subsequent takeover defense regime was also highly influenced by the City Code.²⁴⁴ Therefore, a natural question would be whether the British board neutrality policy suits China. If it does, China should just follow the City Code and impose a blanket bar on board-initiated takeover defenses. However, because there is no overwhelming conclusion to the theoretical debates over takeover defenses and both the United Kingdom board neutrality policy and the United States director primacy policy are functioning well in their respective jurisdiction and have effects on some other jurisdictions,²⁴⁵ it is highly undesirable for China to blindly favor one policy over the other. Therefore, the most practical way to seek the best takeover defense regime for China is to look internally into its legal, commercial, and judicial environment and then build a system with necessary reference to experience from outside jurisdictions. This Article argues that the policy of board neutrality is not the best choice for China.

From a comparative perspective, the conditions justifying board neutrality policy in the City Code are currently not present in China. At the time when the City Code was enacted in the United Kingdom in the 1960s, institutional investors were a very influential force that actually dominated the drafting process.²⁴⁶ Institutional investors generally favor board neutrality because it allows them to reap the high premium offered by hostile bidders. The presence of a high percentage of institutional investors can also make board neutrality policy more feasible: as sophisticated investors, institutional investors have the ability to evaluate the identity of hostile bidders and adequacy of the offered price. By contrast, institutional investors in China are few and far between. They still lack the power to direct the management and act as the bellwether of all the shareholders.²⁴⁷

²⁴³ See *supra* note 124 and accompanying text.

²⁴⁴ See *supra* notes 219-21 and accompanying text.

²⁴⁵ See *supra* Part VI.A.

²⁴⁶ See Armour et al., *supra* note 3, at 237.

²⁴⁷ According to data provided by the SSE, as of the end of 2014, the shareholding percentage of institutional investors in companies listed at the SSE was 14.65%. SHANGHAI STOCK EXCH., SSE STATISTICS ANNUAL 512 (2015), http://2016.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2015.pdf.

Another feature supporting the board neutrality policy in the United Kingdom is the mandatory bidding rule requiring a tender offer to all the shares held by all other shareholders once acquirers cross the shareholding threshold of 30%.²⁴⁸ This rule ensures the equal treatment of all shareholders. It also effectively filters out acquirers with insufficient funding sources. The 2006 Takeover Regulation, however, legalized partial tender offers even when acquirers hold more than 30% of the target's outstanding shares.²⁴⁹ Allowing partial tender offers will make obtaining control of a listed company much less costly and will encourage more hostile takeovers, including those without sufficient funding. In light of this, it will be important for the target's board to investigate the background of the hostile bidder and to evaluate the adequacy of the offered price. If the board, in good faith and after reasonable investigation, concludes that the bidder is a looter or the offered price is inadequate, the board is justified to take reasonable defenses to protect the interests of the company and its shareholders.

In China, even if takeover defenses could provide certain benefits to listed companies, they would most likely be conferred upon privately-listed companies—not SOEs. As the state will always remain as the controlling shareholder,²⁵⁰ SOEs are almost bullet-proof from hostile takeovers. Any discussion on takeover defense regime, therefore, is irrelevant to SOEs. Takeover defense regimes mainly affect privately-listed companies, especially those with dispersed ownership.²⁵¹ Due to the socialist political and economic systems, the private sector in China is still fragile,²⁵² and Chinese entrepreneurs generally lack a sense of security.²⁵³

²⁴⁸ The City Code, *supra* note 122, r. 9.1.

²⁴⁹ The 2006 Takeover Regulation, *supra* note 11, at art. 24.

²⁵⁰ According to Chinese law, any transfer of state-owned shares requires the approval of the state-owned assets supervision and administration authorities; further approval from the government is mandated, if the transfer will lead to the loss of control by the state. Qiye Guoyou Zichan Jiandu Guanli Zhanxing Tiaoli (企业国有资产监督管理暂行条例) [Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises] (promulgated by the St. Council, Aug. 1, 2011, effective Aug. 1, 2011), art. 23, CLI.2.174136(EN) (Lawinfochina).

²⁵¹ Because SOEs, by definition, require the state to serve as the controlling shareholder, all of them have concentrated ownership. It could be easily deduced that all listed companies with dispersed ownership are private companies.

²⁵² SHANGHAI STOCK EXCH. RES. CTR., Zhongguo Gongsi Zhili Baogao (2005): *Minying Shangshi Gongsi Zhili* (中国公司治理报告(2005): 民营上市公司治理) [China Corporate Governance Report (2005): The Corporate Governance of Private Listed Companies] 26 (Shanghai: Fudan Univ. Press, 2005).

²⁵³ Liu Jianuo (刘嘉佑) & Cai Jue (蔡钰), Zhongguo Qiyejia Weihe Quefa Anquangan (中国企业家为何缺乏安全感) [*Why Do Chinese Entrepreneurs Lack Sense of Security?*], 32 FAXIAN 12 (2010).

The vulnerability to hostile takeovers would further discourage them from starting a business or, even if they have started one, taking their business public. Some pre-bid takeover defenses, such as “staggered boards” or “dual-class stock” structures, could be employed not only as means to thwart hostile bids, but also as effective apparatuses for ensuring the stability of enterprises.²⁵⁴ In fact, many Chinese privately-listed companies that are listed abroad have adopted dual-class stock structures or other similar defenses to ensure that control remains in the hands of the founders or the management.²⁵⁵ These companies are listed abroad, but not on the Chinese stock exchanges, partly because Chinese laws fail to provide similar defenses to ensure the stability of management.

Moreover, the concern surrounding empire-building takeovers does exist in China. Essentially, empire building is a reflection of the agency problem in corporations: the management will obtain private benefits at the cost of the shareholders.²⁵⁶ It will cause diseconomy because it involves inefficient transfers of control: the inefficient corporations may take over efficient corporations.²⁵⁷ Empire building, however, could be attenuated by shareholders’ closer monitoring of the management²⁵⁸ or by an efficient product market and employment market for managers.²⁵⁹ The worry concerning empire-building in China is exacerbated by the presence of a large number of SOEs. SOEs in China have a greedy appetite for

²⁵⁴ See Davis, *supra* note 195, at 41-42.

²⁵⁵ Many well-known Chinese companies listed abroad have adopted takeover defenses. For example, the U.S.-listed Chinese companies, Baidu, JD, and Qihoo have all adopted dual-class stock structures, under which the shares owned by the founders/management have superior voting powers. Alibaba has adopted a so-called “partnership system,” under which the management team has the power to appoint the majority of the board members regardless of their shareholdings. Note that although these companies conduct their main businesses in China, the listed companies are incorporated offshore. The laws of the places of incorporation, rather than Chinese law, govern the adoption of takeover defenses. See Baidu.com, Inc., Prospectus (Form 424(b)(4)) 31 (Aug. 4, 2005), <https://www.sec.gov/Archives/edgar/data/1329099/000119312505159073/d424b4.htm>; JD.com, Inc., Prospectus (Form 424(b)(4)) 12 (May 21, 2014), <https://www.sec.gov/Archives/edgar/data/1549802/000104746914005115/a2220275z424b4.htm>; Qihoo 360 Technology Co. Ltd., Prospectus (Form 424(b)(4)) 35 (Mar. 29, 2011), <https://www.sec.gov/Archives/edgar/data/1508913/000104746911002864/a2203165z424b4.htm>; Alibaba Group Holding Limited, Prospectus (Form 424(b)(4)) 229-31 (Sept. 18, 2014) https://www.sec.gov/Archives/edgar/data/1577552/000119312514347620/d709111d424b4.htm#toc709111_16.

²⁵⁶ See Angela Huyue Zhang, *Foreign Direct Investment from China: Sense and Sensibility*, 34 NW. J. INT'L L. & BUS. 395, 441 (2014).

²⁵⁷ See Coffee, *supra* note 209, at 1225.

²⁵⁸ See *id.* at 1269.

²⁵⁹ See Easterbrook & Fischel, *supra* note 201, at 1185.

expansion: the bigger they are, the more power they get.²⁶⁰ Blind expansion could be further fueled by a lack of monitoring on management and failure of the labor market for managers. One of the conundrums haunting the governance of SOEs in China is that no one in the monitoring chain is truly incentivized to carry out the monitoring function on behalf of the state.²⁶¹ Furthermore, the high-level managers of SOEs are appointed by the government or the Chinese Communist Party, usually out of political concerns or through political connections. Therefore, they are not subject to the product market or the labor market for managers. Moreover, the real threat that exists is that the inefficient but large SOEs may cannibalize efficient but small privately-listed companies. In this case, it is desirable to empower the board of a private target to adopt defensive measures to fend off inefficient takeovers from SOEs.

Therefore, management passivity is not an optimal choice for China. But, does it mean China should instead turn to the board primacy model in the United States? In other words, what role should shareholder democracy play in shaping the takeover defense regime in China?

B. China's Choice Between Board Primacy and Shareholder Democracy

The hostile takeover regime in the United States ultimately stems from the basic feature of corporate governance in the country: the board, rather than the shareholders, manages the company.²⁶² As Mr. Lipton argued, adopting takeover defenses falls within the ambit of a board's managerial power, and the board should not be deprived of its powers simply because the pending transaction is a hostile takeover.²⁶³ As a result, shareholders play a very weak role in the adoption or removal of takeover defenses in the United States.

The scenario in China is different. Although a board of a company has considerable managerial discretions in adopting takeover defenses,²⁶⁴ it enjoys much less power compared with its United States counterpart.²⁶⁵ Furthermore, shareholder democracy has been accepted as an underpinning of Chinese Company Law. Granting the board of directors powers that are

²⁶⁰ See Zhang, *supra* note 256, at 442.

²⁶¹ See Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 499 (2003).

²⁶² See *supra* Part V.A.

²⁶³ See *supra* note 207 and accompanying text.

²⁶⁴ See *supra* Part V.B.

²⁶⁵ See *supra* notes 141-47 and accompanying text.

as wide as those enjoyed by its counterpart in the United States would require a complete overhaul of the Chinese Company Law, which cannot be expected in the foreseeable future.

Yet, applying shareholder democracy to takeover defenses does not lead to the corollary that takeover defenses need to be approved by shareholders *ex ante*. On the contrary, considering the unsolicited nature of hostile takeovers and their potentially imminent threat to corporate policy and effectiveness, the target's board must respond quickly. Furthermore, given the lengthy procedures needed to call a shareholders' meeting, requiring *ex-ante* shareholder approval would possibly render any takeover defense in vain because the tender offer could be consummated before any takeover defenses are authorized by shareholders' resolutions. As a result, the most feasible choice is to allow the target's board to adopt takeover defenses within its legal power and then seek *ex-post* shareholder approval. The SSE and SZSE have endorsed this idea implicitly in their new rules regulating suspensions of share trading. Under these new rules, in the case of an alleged material restructuring, the board could decide to suspend the share trading for up to three months. Any expansion beyond three months would require shareholder approval.²⁶⁶

Requiring shareholder approval *ex post* also provides another benefit—it forestalls the lawsuits challenging takeover defenses. Adjudicating cases involving takeover defenses rests on two conditions: competent judges and well-developed doctrines regarding the board's fiduciary duties. Both conditions are missing in Chinese courts at present. As discussed in Part VI.B.2, the boundaries of fiduciary duties are not well defined in China.²⁶⁷ In addition, the Chinese courts are not reliable in adjudicating cases in relation to corporate governance because of their incompetence in this field and their lack of independence from political authorities.²⁶⁸ Shareholder approval, therefore, could provide justification for takeover defenses and avoid courts' efforts at second guessing the substance of takeover defenses. This may not be the most ideal choice, but it constitutes the most feasible choice for China given the undeveloped doctrines on fiduciary duties and the incompetent judges.

However appealing given the situation in China, allowing the board to take defensive measures will open the door for abuse. The caveat articulated in the *Unocal* case—"the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation

²⁶⁶ See *supra* note 180 and accompanying text.

²⁶⁷ See *supra* notes 227-29 and accompanying text.

²⁶⁸ See Clarke, *supra* note 4.

and its shareholders”²⁶⁹—is also applicable to the board of directors in China. While shareholder approval could serve as a means to prevent managerial entrenchment, the board still have opportunities to game the rules between the time a hostile takeover is on the horizon and the time for shareholder approval. Some hostile takeovers may not survive this period of time due to the insurmountable difficulties posed by takeover defenses and the high cost involved. To prevent such abuse, the two-prong test established in *Unocal*—the “threat test” and the “proportionality test”²⁷⁰—could be incorporated into the Chinese takeover defense regime to curb managerial opportunism. Because of the urgent nature of disputes arising in this period and the general incompetence of Chinese courts, courts do not provide a suitable forum to solve these disputes. Instead, the Takeover and Restructuring Committee under the CSRC could serve as an alternative institution to deal with legal disputes arising during this interim.²⁷¹ This would require an amendment to the 2006 Takeover Regulation to grant more powers to the Takeover and Restructuring Committee.

VIII. CONCLUSION

This Article has examined the takeover defense regime in China, analyzed its shortcomings, and proposed an institutional reform to optimize it. Takeover defense regimes hinge on the vitality of hostile takeovers, which in turn hinges on a dynamic market for corporate control. Absent an effective market for corporate control, all discussions on takeover defense regimes are moot.

In contrast to the previous literature on Chinese takeover defense regimes, this Article attains practical significance by basing its institutional analysis on the transformed market for corporate control in China, which indicates the emergence of an effective market for corporate control. The market change has been largely driven by the phenomenal development of the private sector within the Chinese economy, the considerable deregulation of listing requirements for non-SOEs, and the more diversified avenues of financing for takeovers. These positive changes in the markets are shown by hostile takeovers in the Chinese capital market. Meanwhile, the information disclosure requirements for block share purchases and the tender offer rules have been remarkably relaxed, significantly reducing the cost of takeovers.

²⁶⁹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

²⁷⁰ See *supra* note 193 and accompanying text.

²⁷¹ For a more detailed introduction to the Takeover and Restructuring Committee, please refer to notes 240-41 and accompanying text.

Developing countries like China tend to look at “best practices” in other jurisdictions when designing a legal regime. To formulate a sound takeover defense regime in China, this Article conducts a comparative study on the board neutrality policy in the United Kingdom and the board primacy policy in the United States—not only from the perspective of the content of such policies but also the institutional environment surrounding these regimes. By identifying the institutional divergences between China and the other jurisdictions, this Article rejects the notion that either policy provides the best fit for China. Instead, this Article looks into the market features and institutional environment in China and proposes a takeover regime that allows board-initiated takeover defenses but subjects them to ex post shareholder approval.

The only constant is change. This adage is especially true for China, which has experienced tremendous changes since the 1980s. The country is experiencing deep structural changes currently and will continue to do so well into the future. As a result, this Article does not mean to provide a solution to takeover defenses once and for all. As the balance of power among the players in the Chinese market for corporate control—particularly that between the management and institutional investors—evolves, a new analysis and perhaps further institutional reforms will be warranted.

**CALCULATION OF DAMAGES ON THE BASIS OF THE
BREACHING PARTY'S PROFITS UNDER THE CISG**

*Edgardo Muñoz*¹

*David Obey Ament-Gomez*²

I. INTRODUCTION

The United Nations Convention on Contracts for the International Sale of Goods of 1980 (CISG) is an international treaty that governs the international sale of goods in over eighty-five nations.³ As in all legal systems, liability for damages, including loss of profits, arises under the CISG when one of the parties breaches any of its obligations under the sales contract or the Convention.⁴ The remedy of damages is not limited by other concurrent remedies that the injured party may resort to, such as the avoidance of the contract or specific performance.⁵

The CISG embodies the principle of full compensation found in all legal systems whereby damages shall be equal to the financial loss suffered as a result of the breach.⁶ However, the precise contours of the principle of full compensation in the CISG are currently being determined by scholarship and case law. For example, a leading expert in this area has advanced that “the notion that the promisee must not be overcompensated cannot strictly be applied in the context of the Convention,”⁷ suggesting that it may be possible to take into account the benefit that the breaching party obtains from its breach when assessing and calculating damages.⁸

¹ Professor of Law, Universidad Panamericana, Facultad de Derecho, Prolongación Calzada Circunvalación Poniente No. 49 Ciudad Granja CP 45010 Zapopan, Jalisco, México. Email: emunoz@up.edu.mx. Ph.D. (Basel), LL.M. (UC Berkeley), LL.M. (Liverpool), LL.B. (U Iberoamericana).

² Law Associate at Von Wobeser & Sierra, Mexico City; Graduate in Law, Universidad Panamericana Facultad de Derecho, Mexico.

³ See U.N. COMM'N ON INT'L TRADE LAW, *United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980)*, http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html (last visited Jan. 6, 2017).

⁴ United Nations Convention on Contracts for the International Sale of Goods arts. 45(1)(b), 61(1)(b), 74, Aug. 31, 1981, S. TREATY DOC. NO. 98-9 (1983), 1489 U.N.T.S. 3 [hereinafter CISG].

⁵ This applies unless the obligee does not perform because of a *force majeure* or hardship situation covered by CISG art. 79. See *id.* at art. 79.

⁶ Ingeborg Schwenzer & Pascal Hachem, *The Scope of the CISG Provisions on Damages*, in *CONTRACT DAMAGES: DOMESTIC AND INTERNATIONAL PERSPECTIVES* 91, 92-93 (Djakhongir Saidov & Ralph Cunnington eds., 2008).

⁷ Ingeborg Schwenzer, *Article 74*, in *COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS 1002, 1002* (Ingeborg Schwenzer ed., 3d ed. 2010).

⁸ *Id.*; see also Nils Schmidt-Ahrendts, *Disgorgement of Profits under the CISG*, in *STATE OF PLAY: THE 3RD ANNUAL MAA SCHLECHTRIEM CISG CONFERENCE 89, 97-98* (Ingeborg Schwenzer & Lisa Spagnolo eds., 2012).

This article is written upon the above proposition. We endeavor to furnish arguments and support for the proposition that under some limited circumstances damages calculations may take into account the benefits that the breaching party obtained from its breach. The circumstances that warrant this approach under the CISG take place where, for example, the buyer who suffers a breach consisting of the non-delivery of the goods is unable to calculate its loss because, at the time of the breach, it had neither pre-orders from its own customers, nor had it ever in the past traded with the unique type of goods at stake in that transaction.

In section II, we revisit the principle of full compensation upon which the remedy of damages under the CISG is based. In section III, we explore whether the principle of “good faith” in Article 7(1) of the CISG provides support for an interpretation of the full compensation principle in Article 74 of the CISG, encompassing the profits made by the breaching party as a method to calculate damages. In section IV, we test the compatibility of the damages calculation method proposed here with the damages systems in Articles 74, 75 and 76 of the CISG. In section V, we provide arguments in favor of this methodology despite its opposition to the notion of efficient breach. In section VI, we reject the view that disgorgement of profits results from Article 84 of the CISG or that the same claim should be possible under domestic laws otherwise applicable to a CISG contract.

II. THE PRINCIPLE OF FULL COMPENSATION

The CISG remedies for breach are aimed at fully redressing any breach of contract or violation of the provisions in the convention. In this regard, Articles 45 and 61 of the CISG, which enumerate the remedies for breach of contract available to the seller and the buyer, respectively, entitle the aggrieved party to claim damages as provided in Articles 74 to 77, together with other compatible remedies.⁹ In order to achieve full indemnity, Article 74 of the CISG stipulates that the aggrieved party is entitled to be placed in the same financial position it would have been in had the other party not breached its obligations under the contract or the CISG.¹⁰ This approach is known as the “full compensation principle” and seeks to compensate the aggrieved party for all disadvantages suffered as a

⁹ CISG, *supra* note 4, at arts. 45(a)(b), 61(1)(b). This is contrary to what was stipulated in Article 82 of the Uniform Law on the International Sale of Goods, in which a distinction was made between damage caused when the contract was avoided and when it was not avoided. See Victor Knapp, *Article 74*, in COMMENTARY ON THE INTERNATIONAL SALES LAW: THE 1980 VIENNA SALES CONVENTION 538, 538-39 (C.M. Bianca & Michael Joachim Bonnell eds., 1987).

¹⁰ CONTRACTS FOR INT’L SALE OF GOODS ADVISORY COUNCIL, CISG ADVISORY COUNCIL OPINION NO. 6: CALCULATION OF DAMAGES UNDER CISG ARTICLE 74, comment 1.1 (2006), http://www.cisgac.com/file/repository/CISG_Advisory_Council_Opinion_No_6.pdf [hereinafter CISG ADVISORY COUNCIL OPINION NO. 6].

result of the breach.¹¹ Indemnity under Articles 74 to 77 also seeks to satisfy all related costs that are the result of the non-performance.¹² In view of this, the CISG allows the aggrieved party to recover other losses, such as incidental loss, consequential loss, and loss of profits.¹³

The principle of full compensation is, nevertheless, subject to two requirements found in Article 74. The first self-evident requirement is that there must be a breach of contract caused by the seller or the buyer, and a loss to the other party ensuing from such breach.¹⁴ The loss that follows the breach is a key element of the principle of full compensation because the breaching party is liable only for the loss suffered by the injured party as a consequence of that breach.¹⁵ In view of that, a party who wishes to claim damages under Article 74, including loss of profits, has the burden of proving, with a reasonable degree of certainty, that it suffered a loss and the extent of that loss.¹⁶ However, the amount of the loss does not need to be shown with mathematical precision.¹⁷ In this regard, other CISG provisions stipulate two non-exclusive methods of proving and calculating a party's

¹¹ CISG ADVISORY COUNCIL OPINION NO. 6, *supra* Note 10, comment 1.1.

¹² Article 74 establishes the general principle pursuant to which the party who suffers a breach of contract shall be indemnified for all loss arising out of that breach, Schwenzler, *supra* note 7, at 1000, while Articles 75 and 76 establish two methods to calculate the non-performance loss incurred by the suffering party. *Id.* at 1002. On the other hand, Article 77 establishes a duty for the suffering Party to mitigate its own loss. *Id.*

¹³ *Id.* at 1006; see CISG ADVISORY COUNCIL OPINION NO. 6, *supra* note 10, at comment 1.1-1.2. The principle of full compensation is found in most legal systems. *Id.* at 1.2. Common law jurisdictions regard damages as the primary remedy designed to place the injured party in the same economical position it would have been had the contract been performed in accordance with its terms, while civil law jurisdictions follow the same approach under the theories of *dannum emergens* and *lucrum cesans* that focus on both the losses incurred, and the gains that the promisee was prevented from obtaining due to the breach of contract. See Ulrich Magnus, *The Vienna Sales Convention (CISG) Between Civil and Common Law – Best of All Worlds?*, 3 J. CIV. L. STUD. 76-77 (2010); E. ALLAN FARNSWORTH, UNITED STATES CONTRACT LAW 167-68, 173 (1999 ed. 1991); INGEBORG SCHWENZLER, PASCAL HACHEM, & CHRISTOPHER KEE, GLOBAL SALES AND CONTRACT LAW 603 (2012); ROBERT CLARK, CONTRACT LAW IN IRELAND 543 (5th ed. 2004); MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 159 (4th ed. 2001); KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 503 (3d ed. 1998); CLAUDE D. ROHWER & ANTHONY M. SKROCKI, CONTRACTS IN A NUTSHELL 441-50 (8th ed. 2000).

¹⁴ For more on causation and causality, see generally DJAKHONGIR SAIDOV, THE LAW OF DAMAGES IN INTERNATIONAL SALES: THE CISG AND OTHER INTERNATIONAL INSTRUMENTS 79 (2008) [hereinafter THE LAW OF DAMAGES IN INTERNATIONAL SALES]; Djakhongir Saidov, *Methods of Limiting Damages Under the Vienna Convention on Contracts for the International Sale of Goods*, 14 PACE INT'L L. REV. 307, 344 (2002) [hereinafter *Methods of Limiting Damages*].

¹⁵ *Methods of Limiting Damages*, *supra* note 14; see THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 80.

¹⁶ *Methods of Limiting Damages*, *supra* note 14, at 371.

¹⁷ CISG ADVISORY COUNCIL OPINION NO. 6, *supra* note 10, at comment 2; see also Arbitration Tribunal of Russian Federation Chamber of Commerce and Industry, June 6, 2000, 406/1998, (Russ.), <http://cisgw3.law.pace.edu/cases/000606r1.html>; Beer Case, Oberlandesgericht Brandenburg [OLG] [Provincial Court of Appeals] Nov. 18, 2008, 6 U 53/07, (Ger.), <http://cisgw3.law.pace.edu/cases/081118g1.html>.

damages for breach of contract.¹⁸ Article 75 allows a party to prove and calculate its non-performance loss by taking into account the difference between the price for a substitute transaction and the price agreed in the breached contract.¹⁹ Article 75 requires that there be both a breach that causes the avoidance of the contract and a substitute transaction.²⁰ Both must take place within reasonable time²¹ and in a reasonable manner,²² otherwise, there is a risk of violating the duty to mitigate damages as required by Article 77 of the CISG.²³ On the other hand, Article 76 provides the aggrieved party with an alternative method to prove and calculate its non-performance loss.²⁴ Article 76 considers the difference between the price in the breached contract and the market price of the goods at the time of avoidance as an indicator of non-performance loss.²⁵ Accordingly, Article 76 requires that there is a breach that causes the avoidance of the contract and a market price for the goods in question.²⁶

Under the second requirement, damages arising out of the breach are, or ought to be, foreseeable by the breaching party at the time of the conclusion of the contract.²⁷ This principle, rooted in the common law of

¹⁸ Articles 75 and 76 apply to calculate non-performance loss when an avoidance of the contract takes place. *See* CISG, *supra* note 4, at arts. 75-76. Article 74, on the other hand, can be applied in order to calculate all types of losses, such as non-performance loss, incidental loss, consequential loss and loss of profit. *See id.* at art. 74.

¹⁹ *Id.* at art. 75.

²⁰ *See id.*; Canned Oranges Case, China International Economic & Trade Arbitration Commission, Nov. 30, 1997, CISG/1997/33, (China), <http://cisgw3.law.pace.edu/cases/971130c1.html>.

²¹ CISG, *supra* note 4, at art. 75; *see* Zweirad Technik v. Reinhardt, Supreme Court of Denmark, Oct. 17, 2007, 071017DK, (Den.), <http://www.cisgnordic.net/071017DK.shtml>; *see also* NV Secremo v. Helmut Papst, Hof van Beroep Antwerp [Court of Appeals Antwerp], Jan. 22, 2007, 2004/AR/1382, (Belg.), <http://cisgw3.law.pace.edu/cases/070122b1.html>.

²² CISG, *supra* note 4, at art. 75. This applies regardless of small differences in the kind or quality of the product. *See* Case No. 8128 of 1995, (ICC Int'l Ct. Arb.), <http://www.unilex.info/case.cfm?pid=1&do=case&id=207&step=FullText>.

²³ CISG, *supra* note 4, at art. 77; *see* Oberster Gerichtshof [OGH] [Supreme Court] Apr. 28, 2000, 1 Ob 292/99v, http://www.cisg.at/1_29299v.htm (Austria) [hereinafter Jewelry Case]; *see also* Bielloni Castello S.p.A. v. EGO S.A., Corte di Appello di Milano [Appellate Court Milan], Dec. 11, 1998, (Italy), <http://cisgw3.law.pace.edu/cases/981211i3.html>.

²⁴ *See* CISG, *supra* note 4, at art. 76.

²⁵ *Id.*

²⁶ *Id.* The concept of market is to be understood as a “community of suppliers and acquirers of goods and services, where the level of demand at a given time drives prices up or down.” Michael Bridge, *The Market Rule of Damages Assessment*, in *CONTRACT DAMAGES: DOMESTIC AND INTERNATIONAL PERSPECTIVES* 431, 438 (Djakhongir Saidov & Ralph Cunnington eds., 2008). Therefore, the market price is the amount of money that suppliers or acquirers of certain goods are willing to pay or charge for them. *See id.* For an alternate definition, *see* Schwenger, *supra* note 7, at 1038, which defines market price as “the price generally charged for goods of the same kind, traded in the same businesses under comparable circumstances at a particular location.”

²⁷ CISG, *supra* note 4, at art. 76. For a better comprehension of its application and use in courts, *see* Clothing Case, Case No. 8786 of 1997, (ICC Int'l Ct. Arb.), <http://www.unilex.info/case.cfm?id=463> and Legfelsőbb Biróság [Supreme Court of Hungary] 2000. Legf. Bir. Gf1.30.299/2000, <http://cisgw3.law.pace.edu/cases/000000h2.html#cx>.

contracts,²⁸ limits damages to what both parties must have been able to foresee as the consequence of a breach.²⁹ However, the foreseeability principle in Article 74 regards “the possible consequences of a breach, not whether a breach would occur or the type of breach.”³⁰ Therefore, if special circumstances are known by the parties, the latter are naturally held to have assumed that those circumstances may lead to damages in case of breach.³¹

III. INTERPRETATION OF THE FULL COMPENSATION PRINCIPLE IN ARTICLE 74 OF THE CISG PURSUANT THE PRINCIPLE OF GOOD FAITH IN ARTICLE 7(1) OF THE CISG

We submit that the possibility of calculating one party's damages on the basis of the benefits obtained by the other party from the breach by the other party exist in Article 74 of the CISG if Article 74 is interpreted in good faith. The proposed approach to calculate a party's loss will sound to many as a claim for disgorgement of profits.³² The basic example regards a seller that, after entering into the sales contract with the buyer but before delivery of the goods, decides to sell the same goods to a second buyer who is willing to pay more than the first buyer. The price given to the second buyer is high enough to make a larger profit, even if the producer has to indemnify the first buyer for the seller's non-performance losses. A claim for disgorgement of profits by the first buyer would seek to skim off the profits made by the seller (the breaching party) in the second sale.³³ Our submission rests on the premise that it is possible to calculate the aggrieved party's damages on the basis of the gains made by the breaching party. However, we do not argue that the breaching party should be sanctioned in this way whenever it breaches a contract. Rather, we submit that, under

²⁸ The relevant precedent is the House of Lords of England in *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 9 Ex. 341. It has been said that this ruling was a transplantation of a foreign rule. See Franco Ferrari, *Comparative Ruminations on the Foreseeability of Damages in Contract Law*, 53 LA. L. REV. 1257, 1266-67 (1993). Apparently, the House of Lords of England were not the ones who came up with this innovative limit on the damages claimable by a plaintiff, but it instead arose from American case law, which was based at the same time on the French Code Civil, specifically in Articles 1149, 1150 and 1151. *Id.* at 1267.

²⁹ Schwenger, *supra* note 7, at 1018-19. In Latin America, there is an exception to the foreseeability rule: if a debtor causes a breach of contract with gross negligence (*dolo*), he is to be held liable not only for the foreseeable damages caused, but also for the unforeseeable damage caused by his breach. Edgardo Muñoz, *Understanding the CISG System of Remedies from the Latin American Domestic Laws*, in *CISG AND LATIN AMERICA* 93, 107 (Ingeborg Schwenger ed., 2016). See *id.* for more discussion on the CISG system of remedies in Latin America.

³⁰ U.N. COMM. ON INT'L TRADE LAW [UNCITRAL], *Digest of Case Law on the United Nations Convention on Contracts for the International Sale of Goods*, 349 (2012), <https://www.uncitral.org/pdf/english/clout/CISG-digest-2012-e.pdf>.

³¹ See Schwenger, *supra* note 7, at 1019.

³² Disgorgement of profits refers to a claim of damages calculated based on the profits made by the party in breach. See generally E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985).

³³ See Schmidt-Ahrendts, *supra* note 8, at 99.

some circumstances, the approach offers the most reasonable and fair way to achieve full compensation in light of the principle of good faith in Article 7 of the CISG.

The general view regarding this issue under the CISG is that claims for disgorgement of the breaching party's profits must be rejected. The CISG Advisory Council has stated that Articles 74 to 76 preclude placing the aggrieved party in a better position than what it would have enjoyed if the contract had been properly performed.³⁴ Pursuant to this view, what is relevant for damages calculations is the actual loss incurred by the aggrieved party, not the benefits received or gains made by the breaching party.³⁵ Accordingly, an award of disgorgement of profits could easily lead to overcompensation.³⁶

That being said, Article 7 provides that in the interpretation of the Convention regard is to be had to the observance of good faith in international trade. The principle of good faith in Article 7 is not defined. Instead, this concept has been understood to mean "fairness, fair conduct, reasonable standards of fair dealing . . . a common ethical sense . . . and honesty in fact."³⁷ The good faith principle is also embodied in several other provisions of the Convention relating to the parties' statements, rights, and obligations.³⁸ For instance, Article 16(2)(b) of the CISG prevents a party from revoking an offer where it was reasonable for the other party to rely upon the offer being irrevocable.³⁹ Article 29 of the CISG allows a party to deviate from an agreed-upon, non-oral modification clause to the extent that it relied on the other party's conduct, and that the latter would not assert its rights under that clause.⁴⁰ Moreover, Article 40 of the CISG bars the seller from relying on the buyer's failure to examine the goods and give notice of non-conformity under Articles 38 and 39, if the seller knew or should have known of that lack of conformity.⁴¹ It must be noted, however, that the principle of good faith in Article 7(1) applies only to the interpretation of the CISG. It is not intended to integrate new obligations to the parties'

³⁴ CISG ADVISORY COUNCIL OPINION NO. 6, *supra* note 10, at ¶ 9; *see also* CONTRACTS FOR INT'L SALE OF GOODS ADVISORY COUNCIL, CISG ADVISORY COUNCIL OPINION NO. 8: CALCULATION OF DAMAGES UNDER CISG ARTICLES 75 AND 76, ¶ 1.3 (2008), http://www.cisgac.com/file/repository/CISG_AC_Opinion_8_English.pdf.

³⁵ THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 33.

³⁶ *See* Schmidt-Ahrendts, *supra* note 8, at 93-94; *see also* Schwenger, *supra* note 7, at 1017.

³⁷ Troy Keily, *Good Faith and the Vienna Convention on Contracts for the International Sale of Goods (CISG)*, 4 VINDOBONA J. INT'L COM. L. & ARB. 15, 17-18 (1999); *see generally* Paul J. Powers, *Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods*, 18 J.L. & COM. 333 (1999).

³⁸ *See generally* Bruno Zeller, *Good Faith - The Scarlet Pimpernel of the CISG*, 6 INT'L TRADE & BUS. L. ANN. 227 (2001).

³⁹ CISG, *supra* note 4, at art. 16(2)(b).

⁴⁰ *See* Zeller, *supra* note 38, at 241-42.

⁴¹ *Id.* at 239.

contract or to interpret the parties' statements and conduct.⁴² The criteria in Articles 8 and 9 are meant to fulfill that purpose.⁴³

In spite of the above, it has been recognized that when interpreting the provisions of the CISG under the principle of good faith, that principle may affect the parties' rights and obligations.⁴⁴ In light of this, some courts and scholars have made use of the principle of good faith to uphold that, for example, the declaration of avoidance required by Articles 75 and 76 of the CISG is unnecessary when "the debtor has finally and definitely refused to perform."⁴⁵ In the same line of argument, an Austrian Arbitral Tribunal decided that a seller that had repeatedly made statements to the buyer, from which the buyer could reasonably infer that the seller would not raise the defense of late notice in Article 39, was barred from invoking such provision pursuant to Articles 7(1) and the provisions invoking the concept of reliance expressed in Articles 16(2)(b) and 29(2).⁴⁶ The Tribunal referred to this as the "prohibition of *venire contra factum proprium*, which represents a special application of the general principle of good faith . . . one of the general principles on which the Convention is based."⁴⁷ In another case, an Appellate Court in Germany found that after two and a half years since the breach of contract, a buyer had lost its right to declare its avoidance.⁴⁸ As a consequence, the Court dismissed the buyer's claim for damages against the seller under Articles 45(1)(b) (remedy of damages),

⁴² See Zeller, *supra* note 38, at 244. In this regard, the Secretariat Commentary states that "the principle of good faith is, however, broader than these examples and applies to all aspects of the interpretation and application of the provisions of this Convention." Conference on Contracts for the International Sale of Goods, *Documents of the Conference and Summary Records of the Plenary Meetings and of the Meetings of the Main Committees*, 18, U.N. Doc. A/CONF.97/19 (1991).

⁴³ See CISG, *supra* note 4, at arts. 8-9. The limited scope of the principle of goods faith in Article 7(1) CISG dates back to the opposition raised by some countries during the drafting of the Convention (specially from the common law tradition), see Powers, *supra* note 37, at 344, and their resilience of imposing to the parties an abstract principle which could mean "different things to different people in different moods at different times and in different places." *C.f.* Michael G. Bridge, *Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?*, 9 CANADIAN BUS. L.J. 385, 407 (1984).

⁴⁴ Francesco G. Mazzotta, *Good Faith Principle: Vexata Quaestio*, in INTERNATIONAL SALES LAW: A GLOBAL CHALLENGE 120, 132 (Larry A. DiMatteo ed., 2014) (noting that "despite the limiting wording of Article 7(1), the good faith concept has been applied, *de facto*, to the conduct of the contracting parties.").

⁴⁵ Ingeborg Schwenzer & Pascal Hachem, *Article 7*, in COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS, *supra* note 7, at 120, 129; see D.B. GmbH v. C.N.H., Supreme Court of Poland, Jan. 27, 2006, III CSK 103/05, (Pol.), <http://www.unilex.info/case.cfm?pid=1&do=case&id=1129&step=FullText>; see also Iron Molybdenum Case, Oberlandesgericht Hamburg [Appellate Court Hamburg], Feb. 28, 1997, 1 U 167/95, (Ger.), <http://cisgw3.law.pace.edu/cases/970228g1.html>.

⁴⁶ See Rolled Metal Sheets Case, Arbitral Tribunal Vienna, June 15, 1994, SCH-4318, (Austria), <http://cisgw3.law.pace.edu/cases/940615a4.html>.

⁴⁷ *Id.*

⁴⁸ Automobiles Case, OLG München [Appellate Court Munich], Feb. 8, 1995, 7 U 1720/94, (Ger.), <http://cisgw3.law.pace.edu/cases/950208g1.html>.

45(2) (remedy of damages in conjunction with other remedies), and 49(1)(a) (remedy of avoidance of the contract).⁴⁹ The Court found that allowing the buyer to declare the contract avoided after such a long time would violate the principle of good faith contained in Article 7(1) of the Convention.⁵⁰

The above scholarship and cases reflect the increasing understanding that parties to a CISG contract shall conduct themselves in accordance with the principle of good faith during the conclusion of the sales contract and its performance. As stated by a scholar,

if good faith in international trade were to be promoted by a liberal application of the provisions of the Convention, how else can a judge promote ‘good faith’ in trade other than by requiring the parties to behave in good faith? Stated differently, good faith cannot exist in a vacuum and does not remain in practice as a rule.⁵¹

Despite this growing perception, the principle of good faith in the CISG shall not be used as a tool to integrate additional obligations. What it is clear, however, is that the drafters of the Convention intended to determine the extent of the rights and obligations under the CISG in light of the principle of good faith.⁵² In this regard, we submit that the principle of good faith in Article 7(1) of the CISG provides support for an interpretation of the full compensation principle that encompasses the possibility to calculate one party’s losses by taking into account the benefits that the breaching party obtained from the breach in the following scenario: where the buyer who suffers a breach consisting of the non-delivery of the goods is unable to calculate its loss of profits because at the time of the breach it neither had pre-orders from its own customers, nor had it ever traded with the unique type of goods at stake, making it impossible for the aggrieved buyer to prove an assumed loss from its own books.

As stated above,⁵³ the principle of full compensation seeks to compensate the aggrieved party for its own losses. That means that there is no apparent direct relationship between a party’s losses and the profits made by the party in breach.⁵⁴ Nevertheless, the benefits received by the breaching party cannot be simply overlooked. The “reflecting gains made by the breaching party may be an appropriate way of implementing the

⁴⁹ Automobiles Case, *supra* note 48.

⁵⁰ *See id.*

⁵¹ Phanesh Koneru, *The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles*, 6 MINN. J. GLOBAL TRADE 105, 140 (1997).

⁵² *Id.*

⁵³ *See* discussion *supra* Section II.

⁵⁴ THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 29.

compensatory purpose of damages.”⁵⁵ Leading authors would agree that this is the case when the seller breaches the contract by opting to sell the goods promised to the buyer to a third party.⁵⁶ In our view, this is only justified under the circumstances just described. The principle of good faith may only enlarge the methods of damages calculations in accordance with the principle of full compensation where an assumed loss exists that cannot be quantified, but on the basis of any profits made by the breaching party. In this regard, the principle of full compensation must not be limited to the pecuniary loss suffered as shown on the balance sheet of the non-breaching buyer,⁵⁷ *i.e.*, a concrete loss shown by a substitute purchase or lost profits reflected by failed pre-orders from the buyer’s customers. In circumstances where there is no way of calculating exactly how much the buyer would have made with the goods he did not receive,⁵⁸ the principle of good faith, which means reasonable standards of fair dealing and a common ethical sense, offers the justification for applying a more easily identified baseline to calculate such profits, *i.e.*, the breaching party’s profits.⁵⁹

Going back to the circumstances described above, let us imagine that the seller opted to breach the contract in order to sell directly to one of the buyer’s potential clients. Let us also assume that the goods in question are one of a kind. The aggrieved buyer is prevented from a resale opportunity. It may be impossible for the buyer to obtain equal goods that may allow it to make similar profits with different customers. In that case, the award of damages calculated solely on the basis of the price of the promised goods in the breached contract—either by applying Articles 75 or 76 of the CISG, or by calculating loss of profits on the basis of past sales of different goods—could not be considered as an appropriate method to indemnify the losses that one could assume the buyer actually suffered. Despite the fact that the buyer may not be able to furnish its own evidence of a concrete loss, one may assume that such loss exists, and that what is missing are the elements to calculate it.

At the conclusion of the contract, a seller covers its risk against falling prices, but assumes the risk that prices will increase. The buyer, on the other hand, covers against the risk of raising prices, but assumes the risk

⁵⁵ THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 33.

⁵⁶ Schwenger, *supra* note 7 at 1017; *see also* Schmidt-Ahrendts, *supra* note 8, at 98 (stating that the profits made by the seller in the second sale actually indicate what the first buyer himself could have made by reselling to a third party).

⁵⁷ Schwenger & Hachem, *supra* note 6, at 94. Generally, all other losses of the aggrieved party that do not directly appear on the balance sheet are simply deemed to be non-pecuniary and thus not compensable.

⁵⁸ Where, for example, the buyer had pre-orders from his customers, but not in relation to all of the good it was to acquire from the breaching seller.

⁵⁹ *See* Schmidt-Ahrendts, *supra* note 8, at 98-99.

that market prices may decline after the conclusion of the contract.⁶⁰ The CISG entitles the aggrieved party to an indemnity for the value of its unrealized contractual expectation in order to receive the benefit of the bargain.⁶¹ Therefore, if the seller decided to breach the contract and resell the same goods to a second buyer, the seller deprives the first buyer from the opportunity to resell the goods at the higher market price. That lost opportunity is the expectation interest existing at the conclusion of the contract, and it is just, fair, and reasonable (good faith as required by Article 7 of the CISG) that the profits made by the breaching party are taken as the baseline to calculate the indemnity for the damages, where there are no other elements to prove them.

In 1995, the Court of Appeals of Grenoble, France, applied the principle of good faith to expand the calculation method to achieve full compensation in different circumstances.⁶² In said case, the seller, a French jeans manufacturer, agreed to make various deliveries to the buyer in the United States of America. The contract stipulated that the goods were to be sent to and sold only in South America and Africa. The reason was that the seller already had “contracts with many foreign distributors and that, more specifically in the case of Spain where the brand name ‘Jeans Bonaventure’ is sought after, [the seller had] an interest in not allowing a parallel network of sale [parallel imports]”.⁶³ During the negotiations preceding the contract and its performance, the seller repeatedly demanded proof of the destination of the goods sold. Amidst the second delivery, it arose that the buyer had actually been shipping the jeans to Spain. The Court ordered the buyer to pay seller 10,000 French francs concluding that the buyer’s conduct “made worse by the judicial position taken by the [buyer] at trial constitute[d] an abuse of procedure...[and] the inconvenience caused by this trial to [the seller] justifies the sum requested.”⁶⁴ As Professor Saidov states in regard to this case, “[i]t can be argued that profits made by the buyer by reselling the goods in Spain would constitute an appropriate measure of recovery of compensatory damages particularly considering that they would most likely be reflective of profits the seller lost as a result of the breach.”⁶⁵

In a more recent CISG case, an arbitral tribunal constituted under Stockholm Chamber of Commerce arbitration rules reached a similar

⁶⁰ John Y. Gotanda, *Dodging Windfalls: Damages Based on Market Price, Actual Loss, and Appropriate Awards* (Villanova Univ. Sch. Law Pub. Law & Legal Theory, Working Paper No. 2015-1016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2683525.

⁶¹ CISG ADVISORY COUNCIL OPINION NO. 6, *supra* note 10, at comment 3.1.

⁶² Cour d’appel [CA] [regional court of appeal] Grenoble, Feb. 22, 1995, D. 1995, JR 100, 93/3275 (Fr.), <http://cisgw3.law.pace.edu/cases/950222f1.html> [hereinafter Grenoble case].

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 35.

conclusion.⁶⁶ A Brazilian seller agreed to sell a number of high accuracy and quality pressure sensors to a Chinese buyer that were to be integrated and used in the buyer's new series of pressure transmitters.⁶⁷ The parties also agreed that the seller would license the buyer on a non-exclusive basis so the buyer could use and integrate the pressure sensors into the buyer's new products to be sold in Asia.⁶⁸ The parties included a confidentiality clause in the contract, since the performance of the agreement meant that the seller would supply confidential information to the buyer.⁶⁹ In the arbitration proceedings, the buyer brought a claim of damages for breach of the seller's obligation to deliver pressure sensors in accordance to the contract.⁷⁰ The seller raised a counter-claim for the breach of the confidentiality clause.⁷¹ The seller argued that the buyer never had the genuine intention to perform its obligations under the agreement, and that it actually only entered into it as a tactical step to obtain access to the seller's confidential and proprietary technology in order to develop, manufacture, and sell the pressure sensors, which would directly compete with those manufactured and sold by seller.⁷² The seller claimed that, based on the information given to the buyer, the buyer had begun to manufacture and sell devices that incorporated proprietary technology.⁷³

The proof offered on this matter consisted of tests conducted by the seller on the buyer's sensors. These tests concluded that "the signal responses exhibited by [the buyer's] Sensors are identical or substantially similar to those exhibited by [the seller's] Sensors . . . such identity or substantial similarity is unlikely unless [the buyer's] Sensors incorporate[d] [the seller's] proprietary technology including its software."⁷⁴ Furthermore, the seller claimed that the buyer provided a third-party Chinese manufacturer access to the technology.⁷⁵ The tribunal agreed that "it would stretch incredulity too far to conclude that all the similarities were the result of chance."⁷⁶ Therefore, the tribunal concluded that the buyer copied the seller's confidential information, and that this was a breach of the agreement entitling the seller to relief.⁷⁷ The tribunal made an award for damages that equaled the amount of profits the buyer made within the twenty-four month period within which the buyer used the seller's

⁶⁶ Pressure Sensors Case (China v. Braz.) (Arb. Inst. of the Stockholm Chamber of Com. 2007), <http://cisgw3.law.pace.edu/cases/070405s5.html>.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

technology.⁷⁸ While the arbitrator did not refer to any specific CISG provision for awarding damages, he did state that he considered all the facts of the case.⁷⁹

The CISG does not expressly prohibit the calculation of damages under the method proposed here. As mentioned before, scholars have concluded that disgorgement is not allowed under the CISG because of the risk of overcompensating the aggrieved party, and that in that regard, the principle of full compensation would be infringed.⁸⁰ However, as seen in scenarios such as those described above, the method for damages calculation proposed here may be the fairest and most effective way to achieve full compensation.

Even assuming that calculation of damages on the basis of the breaching party's profits would give rise to a windfall in favor of the aggrieved party and consequently violating the principle of full compensation, the following should be considered. In a breach of contract scenario, a windfall takes place in favor of the breaching party. This poses the question of who should really keep the windfall derived from the breach when there is no evidence to prove the assumed loss by the suffering party. Looking at this question from a reasonable non-legal point of view, many may bend towards the aggrieved party. In particular, the opposite would allow the breaching party to escape full liability simply because it is impossible for the aggrieved party to prove its damages with enough certainty.⁸¹ The answer to this question therefore lies in the need of providing an alternative method for damages calculation where the usual methods are insufficient for such purposes.

A further argument that has been brought up against the method advocated here is that it discourages the aggrieved party from complying with its obligation of mitigating damages.⁸² It is argued that if the buyer is entitled to relief on the basis of the profits made by the breaching party, it may no longer have an incentive to make a substitute transaction in the hope of obtaining a higher profit with this alternative methodology.⁸³ In this regard, we submit that the obligation to mitigate a party's loss persists. A buyer shall attempt to make a cover purchase when it is reasonable and possible to mitigate its loss. That being said, when no substitute transaction

⁷⁸ Pressure Sensors Case, *supra* note 66.

⁷⁹ *Id.*

⁸⁰ *Id.*; see also Schmidt-Ahrendts, *supra* note 8, at 93.

⁸¹ CISG ADVISORY COUNCIL OPINION NO. 6, *supra* note 10, at comment 2.4.

⁸² CISG, *supra* note 4, at art. 77. Pursuant to Article 77, a party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If the aggrieved party fails to take such measures, the party in breach may claim a reduction of damages in the amount the aggrieved should have mitigated.

⁸³ John D. McCamus, *Disgorgement for Breach of Contract: A Comparative Perspective*, 36 LOY. L.A. L. REV. 943, 950 (2003).

is possible or no clear market price exist for the goods at stake, a party should be entitled to calculate its loss under Article 74 as proposed here.

IV. COMPATIBILITY OF THE PROPOSED DAMAGES CALCULATION METHOD WITH THE DAMAGES SYSTEMS IN ARTICLES 74, 75 AND 76 OF THE CISG

Article 74 of the CISG does not expressly state a methodology pursuant to which a court or tribunal may calculate damages for breach of contract, as long as the aggrieved party is fully compensated. Neither Articles 75 nor 76 bar the possibility of taking the breaching party's profits into account in the calculation of damages under the CISG. The aggrieved party can rely solely on Article 74, despite the two options for damages' calculation offered by Articles 75 and 76.

In fact, the concrete method of damages calculation stipulated in Article 75 of the CISG is also intrinsic in Article 74, but absent the requirements to which Article 75 is subject to.⁸⁴ This follows the ruling of the Supreme Court of Austria, which held that damages recovered under Article 74 might be calculated in much the same way they would be calculated under Article 75.⁸⁵ In this line of thought, an alternative concrete method of calculation can also be achieved under Article 74 by, for example, comparing the price of the infringed contract with the price of the second sale carried out by a breaching seller. This alternative interpretation of the concrete method of calculation should be applied in the scenarios mentioned below.⁸⁶ As a matter of reasonableness and good faith, it appears proper to replace the breaching party with the suffering party in the second transaction, so that the suffering party's losses are calculated on the basis of breaching party's profits.⁸⁷ The aggrieved party is also released from the burden of entering into a timely and proper substitute transaction that may be impossible under the circumstances. This approach may also enhance efficiency because the reference for damages' calculation, *i.e.*, the second sale by the breaching seller, is obtained immediately at the time of breach and comprises both a non-performance loss and a loss of profits.

Likewise, the abstract method of damages calculation stipulated in Article 76 of the CISG is inherent in Article 74 but absent the requirements

⁸⁴ Schwenger, *supra* note 7, at 1006. *See infra* Section II.

⁸⁵ Jewelry Case, *supra* note 23. To calculate the damages, the seller could choose between Article 75 (substitute transaction) and Article 76 (current price), but neither Article 75 nor Article 76 prevents the seller from claiming damages under Article 74 even if the contract is avoided.

⁸⁶ The circumstances that warrant this approach under the CISG take place where, for example, the buyer who suffers a breach consisting in the non-delivery of the goods is unable to calculate its loss of profits because, at the time of the breach, he neither had pre-orders from his own customers nor had he ever in the past traded with the unique type of goods.

⁸⁷ *See* discussion *infra* Section III.

to which Article 76 is subject to.⁸⁸ As submitted by a leading scholar, in cases where Article 76 may be applied, a party may still rely on Article 74 in order to calculate its non-performance loss or loss of profits abstractly.⁸⁹ The possibility has been endorsed by the Supreme Court of Austria that allowed the calculation of damages under Article 74, following the method found in Article 76 CISG.⁹⁰ The profits made by the breaching party may, in some circumstances, reflect the amount of money that suppliers or acquirers of certain goods are willing to pay or charge for the goods in question, *i.e.*, market price. This may be the case where the goods at stake are not part of official listings or widely known published databases. In such situations, the price paid by the second buyer, for example, could work as a general assumption that what it paid is actually the current market price for the goods in question, and therefore, the profits made by the seller are also what the buyer itself could have obtained by reselling the goods to any third party at the time of the breach of contract. This calculation of damages on the basis of the profits made by the breaching party may also be more efficient because it releases the aggrieved party from the burden of demonstrating a market price for goods that are not widely commercialized and thus are not part of official or widely accepted price indicators. In addition, it allows one to consider, as reference for damages calculation, a price effectively paid by a participant in the market, the second buyer, at the time of breach.

In this regard, using the profits made by the breaching party as the basis for damages calculation shifts the risk of uncertainty to the breaching party whose breach gave rise to the uncertainty.⁹¹ This, of course, does not deprive the seller from its right to prove that the buyer could not have sold the goods as profitably as it did.

As for the requirement of foreseeability in Article 74,⁹² it is also complied with when damages are calculated on the basis of the profits made by the breaching party. At the time of the conclusion of the contract both parties are aware of the risk of breach of contract and its financial consequences.⁹³ Compensatory damages for such a likely breach also

⁸⁸ See Schwenger, *supra* note 7, at 1006.

⁸⁹ Schwenger & Hachem, *supra* note 6, at 96; *see also id.* at 1016.

⁹⁰ See Jewelry Case, *supra* note 23.

⁹¹ Mid-America Tablewares, Inc. v. Mogi Trading Co., 100 F.3d 1353, 1367 (7th Cir. 1996) (holding “it is particularly in the area of quantifying the amount of lost profits that courts impose the risk of uncertainty on the breaching party whose breach gave rise to the uncertainty.”).

⁹² While it is true that the foreseeability requirement does not apply to Articles 75 and 76 of the CISG, the proposed methodology of damages calculation is based in Article 74, which does require it. See CISG, *supra* note 4, at art. 74.

⁹³ See Gotanda, *supra* note 60, at 6 (finding that a seller covers its risk against falling prices, but assumes the risk that prices of the goods sold will increase, but the buyer agrees on the contract price ensuring against the risk of raising prices, but assuming the risk that the price of the good may decline after the conclusion of the contract).

becomes part of the expectation interest. If things go as expected, both parties will obtain a windfall. However, if one of the parties breaches the contract it is also foreseeable that such a party will be liable to compensate the other party in an amount that may be equal or superior to the gains it made from its breach.

V. THE METHOD PROPOSED HERE AND THE THEORY OF EFFICIENT BREACH OF CONTRACTS

The calculation of damages on the basis of the profits made by the breaching party goes against the law and economics theory of efficient breach. This theory encourages contract breaches as long as it results in an efficient behavior.⁹⁴ For example, if a seller finds a second buyer who is willing to pay more value than the first buyer, then the seller should sell its goods to the second buyer. Given that the second buyer places a higher value on the goods, and provided that the first buyer's expectation loss is compensated at a lesser amount, the breach of contract generates at net wealth for everyone.⁹⁵

In normal circumstances this theory holds true. The breaching party is able to pay the first buyer off. The aggrieved buyer would receive, in theory, what it expected under the contract if it is capable of furnishing evidence of lost re-sales and profits.⁹⁶ However, the theory of efficient breach is perfect only where there is evidence of a concrete loss suffered.⁹⁷ In cases where the buyer cannot demonstrate with reasonable certainty that it was prevented from making profits through concrete contracts with other customers, no indemnity may be received by the aggrieved buyer.⁹⁸

In addition, an efficient breach of contract has costs that are often ignored and that bring inefficient results. These include costs resulting from the reallocation of goods, time and costs spent on looking for a new seller, negotiations with the customers of the buyer that ended up without product, or who may end up accepting a different product, and many more.⁹⁹ There are also the legal and business costs that will arise from the dispute between the first buyer and the seller, and it is not certain who will end up bearing them (especially if there is no clear rule in the proceedings about their

⁹⁴ In law and economics, in and contract law, efficiency is achieved when it is impossible to make one party better off without making someone worse off. See Tejvan Pettinger, *Pareto efficiency*, ECONOMICSHelp (Nov. 28, 2012), <https://www.economicshelp.org/blog/glossary/pareto-efficiency/>.

⁹⁵ McCamus, *supra* note 83, at 950.

⁹⁶ Gotanda, *supra* note 60, at 7.

⁹⁷ Lawrence A. Cunningham, *Cardozo and Posner: A Study in Contracts*, 36 WM. & MARY L. REV. 1379, 1450 (1995).

⁹⁸ *See id.*

⁹⁹ Gotanda, *supra* note 60, at 9.

allocation, or if each party has to bear its own costs).¹⁰⁰

Damages are usually difficult to prove, especially when dealing with goods that are unique, when no pre-orders have been made for the reselling of the goods, or when dealing with a new business that has no record of sales to compare prices with. On the contrary, the method proposed here only requires knowing the price at which the seller sold the goods to the second buyer.¹⁰¹

Finally, considering the breaching party's profits in damages calculations should be regarded as an alternative method that achieves full indemnity on the basis of what the parties negotiated as the risk for breach of contract.¹⁰² This method takes as evidence what the buyer could have gained from the goods by looking into the breaching seller's profits in cases where more accurate evidence is not available. This method may encourage contract performance as a matter of public policy in future CISG contracts. It is a convenient tool for protecting the parties' interests in the performance of the contract, and providing an incentive to respect their contractual obligations by respecting the principle of *pacta sunt servanda*.¹⁰³

VI. DISGORGEMENT OF PROFITS BY MEANS OF A CLAIM FOR UNJUST ENRICHMENT

Some scholars have suggested that a claim for disgorgement of profits is possible under Article 84 of the CISG.¹⁰⁴ This CISG provision calls for the restitution by the parties of any performance received or benefit obtained during the existence of the contract where the contract is eventually avoided with retroactive effect.¹⁰⁵ In fact, Article 84 embodies the general principle of unjust enrichment whereby a party shall not keep what it received from the other party and benefits derived thereof, if at some point there is no legal basis to hold them.¹⁰⁶ One scholar has for example submitted that "by applying the general principle of 'unjust enrichment' in Art. 84 [...], the aggrieved party would be made whole and the party in bad faith disgorged of all unduly received benefits".¹⁰⁷ Referring to *BRI*

¹⁰⁰ Gotanda, *supra* note 60, at 9.

¹⁰¹ See *supra* Section IV.

¹⁰² See *supra* Section II.

¹⁰³ Schmidt-Ahrendts, *supra* note 8, at 93.

¹⁰⁴ See, e.g., Koneru, *supra* note 51, at 127 n.101, 128; Schmidt-Ahrendts, *supra* note 8, at 99-100; Liu Chengwei, *Remedies for Non-performance - Perspectives from CISG, UNIDROIT Principles and PECL*, ch. 18.6, CISG DATABASE, INST. OF INT'L COMMERCIAL LAW, PACE L. SCH. (2003), <http://www.cisg.law.pace.edu/cisg/biblio/chengwei.html>.

¹⁰⁵ Article 84 states that, "(1) If the seller is bound to refund the price, he must also pay interest on it, from the date on which the price was paid. (2) The buyer must account to the seller for all benefits which he has derived from the goods or part of them"

¹⁰⁶ Schwenger & Hachem, *supra* note 45 at 139.

¹⁰⁷ Chengwei, *supra* note 104.

Production "Bonaventure" v. Pan African Export,¹⁰⁸ a different author considers that the buyer was indeed obliged to account to the seller for the profits, not under Article 74, but under Article 84(2), which he suggests should be applied by analogy to cases where the seller (and not the buyer) declared the contract avoided.¹⁰⁹ A third scholar is also very explicit in this regard:

The broader and primary goal of the Convention is to compensate the aggrieved party fully. Once this goal is accomplished, if there is still unjust enrichment on the part of the breacher, such unjust enrichment should be disgorged depending on the facts. [...] This analysis not only satisfies the general principles of full compensation and unjust enrichment, but also promotes good faith and reasonable behavior between the parties in international trade, thereby fulfilling the mandates of Article 7.¹¹⁰

Such an approach is respectfully rejected here. We submit that Article 84 shall not be applied in the compensation of damages. Despite the fact that Article 84 embodies the principle of unjust enrichment, this should only be applied to the unwinding of the contract. Compensation of damages is a matter expressly dealt with by the CISG's provisions on damages in Articles 74 to 77. As we submitted above, the calculation of damages on the basis of the breaching party's profits is possible by an interpreting the concept of full compensation in Article 74 in good faith.¹¹¹ In this line of thought, there is no internal gap that needs to be filled with a general principle on which the CISG may be based.¹¹²

In addition, the notion of unjust enrichment is quite different to the calculation of damages on the basis of the breaching party's profits. Unjust enrichment refers to profits made without the right to do so (without legitimacy). For example, the interest accrued from the price paid in a subsequently-avoided contract are to be given back to the buyer, since there is no legal relationship that entitles the seller to keep the interest in the first place. On the contrary, the seller is entitled under a valid second contract to the profits made with a second buyer, regardless of breaching the first contract with the first buyer. Furthermore, damages and their calculation are part of contract law remedies. Unjust enrichment, on the other hand, is an independent remedy that gives rise to a non-contractual claim under most

¹⁰⁸ Grenoble Case, *supra* note 62. *See also infra* Section III.

¹⁰⁹ Schmidt-Ahrendts, *supra* note 8, at 99-100.

¹¹⁰ Koneru, *supra* note 51, at 128.

¹¹¹ *See supra* Section III.

¹¹² As it is mandated in case of internal gaps by Article 7(2).

jurisdictions.¹¹³ From this perspective, claims for unjust enrichment would not be available under the CISG.¹¹⁴

The profits of the breaching party have also been targeted through claims of unjust enrichment on the basis of domestic laws. In *Adras Construction Co. Ltd. v. Harlow & Jones GmbH*, decided by the Supreme Court of Israel on November 2, 1998, an Israeli importer of steel had brought suit against a German seller for having resold part of the promised steel to a third party in Germany.¹¹⁵ However, the buyer's claim was dismissed because it had lost a right to the remedies under the predecessor of the CISG, the Uniform Law on the International Sale of Goods (ULIS),¹¹⁶ due to its failure to give notice of non-conformity within the established period. The buyer then filed new proceedings claiming this time that the seller, by not performing the contract and not being liable under ULIS, was unjustly enriched. In this new litigation, the Court found that the buyer was entitled to restitution of the profits made by the seller under the domestic laws of unjust enrichment, with no reference to the ULIS.¹¹⁷

The above approach is also rejected here. Already at the time of the *Adras* decision, scholars agreed that the unjust enrichment "remedy under domestic law [was] inconsistent with the [ULIS]".¹¹⁸ The award of damages and its calculation is an issue expressly settled by Articles 74 to 77 of the CISG. Claims for unjust enrichment as damages are therefore a matter preempted by the CISG.¹¹⁹ Since the unjust enrichment remedy is not contemplated within the provisions of damages for breach of contract, it is therefore safe to say that the so-called "restitution interest," which focuses not on the injured party's loss but on the breaching party's gain in order to prevent that party from being unjustly enriched, is not protected by the CISG.¹²⁰

¹¹³ See generally R. B. Grantham & C. E. F. Rickett, *Disgorgement for Unjust Enrichment*, 62 CAMBRIDGE L.J. 159 (2003).

¹¹⁴ Schmidt-Ahrendts, *supra* note 8, at 93.

¹¹⁵ D.R.F. O'Dair & Doran Lipshitz, *Adras Building Material Ltd v Harlow & Jones GmbH*, 3 Restitution L. Rev. 235, 237 (1995).

¹¹⁶ The ULIS or Uniform Law on the International Sales of Goods of July 1, 1964 was, together with the ULF Uniform Law of the Formation of Contracts, the basis for the "new" Uniform Sales Law drawn up by the United Nations Commission on International Trade Law (UNCITRAL), which influenced not only the basic structures and key concepts in the CISG, but also many of its detailed solutions.

¹¹⁷ O'Dair, *supra* note 115, at 239, 262, 273.

¹¹⁸ Daniel Friedmann & Yehuda Adar, *Israel*, in INTERNATIONAL SALES LAW, *supra* note 44, at 523; accord Hans Stoll & Georg Gruber, *Article 76*, in COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS 780, 782 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 2005).

¹¹⁹ In *Electrocraft Arkansas, Inc. v. Super Electric Motors, Ltd.*, the court held that an unjust enrichment claim is a matter preempted by the provisions on remedies for breach of contract under the CISG. No. 4:009CV00318 SWW, 2009 WL 5181854, at *7 (E.D. Ark. Dec. 23, 2009).

¹²⁰ THE LAW OF DAMAGES IN INTERNATIONAL SALES, *supra* note 14, at 33.

VII. CONCLUSION

The CISG provisions on damages neither expressly stipulate the possibility to calculate a party's loss on the basis of the breaching party's damages, nor expressly prohibit it. Nevertheless, this method to calculate a party's loss may be drawn from a good faith interpretation of Article 74 of the CISG. Courts and tribunals are requested to interpret the Convention's provisions in good faith pursuant to Article 7(1). Breaches of contract that make it too difficult for the aggrieved party to demonstrate its real loss other than by relying on the breaching party's profits warrant the use of the good faith principle to expand the notion of full compensation. The principle of full compensation must not be limited to the pecuniary loss suffered as shown in the balance sheet. The assumption that what the breaching party obtained in profits is what the aggrieved party could have gained from the correct performance of the contract reflects a loss that should be fully compensated under some circumstances. In particular, as advocated and demonstrated here, the calculation of damages on the basis of the breaching party's profits applies where a buyer, who suffers a breach consisting of the non-delivery of the goods, is unable to calculate its loss because at the time of the breach it neither had pre-orders from its own customers nor did it ever trade with the unique type of goods at stake in that transaction.

**IPRS, PHARMACEUTICALS, AND STOCK SHORTING: LIMITING
UNINTENDED “INNOVATION” OF POST-AIA PATENT LAW**

Tyler Del Rosario

I. INTRODUCTION

In effort to promote innovation, the Leahy-Smith American Invents Act (AIA)¹ brought substantial changes to U.S. patent law.² One of these changes was the introduction of Inter Partes Review (IPR) in the United States Patent and Trademark Office.³ The IPR process was intended as a less costly alternative to patent litigation to assist businesses, both big and small, in defending their economic interests in patents by contesting the validity of another entity’s patent.⁴ In an unexpected development, however, entities that have no interest in patents, specifically hedge fund managers, have attempted to benefit at the expense of pharmaceutical companies.⁵ For example, in 2015, after a hedge fund manager petitioned for an IPR against the pharmaceutical company Acorda, Acorda’s stock fell nearly 10%.⁶

The hedge fund managers seek financial gain by challenging key patents of pharmaceutical companies in IPRs and simultaneously shorting the pharmaceutical companies’ stock in hope that the IPR proceedings create shareholder panic.⁷ Many agree that this is an unintended consequence inconsistent with the intent of Congress.⁸ However, there is

* George Mason University School of Law, Juris Doctor May 2017; University of Virginia, Bachelor of Science, Mechanical Engineering May 2014.

¹ See generally Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011).

² See Steven M. Auvil, *5 Things Med Tech Companies Need to Know About the Leahy-Smith America Invents Act*, MEDCITY NEWS (Nov. 15, 2011, 2:01 PM), <http://medcitynews.com/2011/11/5-things-med-tech-companies-need-to-know-about-the-leahy-smith-america-invents-act/?rf=1>.

³ See Leahy-Smith America Invents Act, sec. 6, §§ 311-319, 125 Stat. 284, 299-306.

⁴ *The Impact of Abusive Patent Litigation Practices on the American Economy: Hearing Before the S. Comm. on the Judiciary*, 114th Cong. 18 (2015) [hereinafter Sauer Testimony] (testimony of Hans Sauer, Ph.D., Deputy General Counsel for Intellectual Property, Biotechnology Industry Association), <https://www.judiciary.senate.gov/imo/media/doc/03-18-15%20Sauer%20Testimony.pdf>.

⁵ See William Greider, *Can Wall Street Take Down Big Pharma?*, THE NATION (Jan. 20, 2015), <http://www.thenation.com/article/can-wall-street-take-down-big-pharma>; Ed Silverstein, *Should Hedge Funds Have Standing in IPR?*, INSIDECOUNSEL (July 22, 2015), <http://www.insidecounsel.com/2015/07/22/should-hedge-funds-have-standing-in-ipr>.

⁶ Robert Cyran, *Kyle Bass Wields New Weapon in Challenging Drug Makers*, N.Y. TIMES: DEALBOOK (Feb. 11, 2015, 2:36 PM), http://dealbook.nytimes.com/2015/02/11/kyle-bass-wields-new-weapon-in-challenging-drug-makers/?_r=0.

⁷ Greider, *supra* note 5.

⁸ Silverstein, *supra* note 5 (“Critics say that [it] is unfair given that IPR was not supposed to be a loophole for entities such as hedge funds.”).

debate on whether this practice should be stopped by the federal government because proponents believe it may enable greater public access to healthcare through cheaper pharmaceutical drugs.⁹ Further, even if the issue should be addressed, there is disagreement over solutions due to their potential effects on patent-interested entities of all sizes and industries.¹⁰

This article proposes that the practice should be stopped because there are more legitimate and equally productive means available that are more consistent with Congressional intent and patent law. In order to address the issue, this article will put forth a solution that can be implemented without confronting the larger patent policy debate and without creating negative consequences to the interests of patent interested entities.

Specifically, the USPTO should require IPR petitioners, real parties-in-interest, and privies of the petitioners to have no adverse “shareholder interest” in patent holders of contested patents. The Patent Trial and Appeals Board (PTAB) should only implement IPRs when such parties provide an affidavit, or even a disclosure, to demonstrate that the IPR is not requested for the purpose, at least in part, of economic gain through stock shorting of the company who owns the petitioned patent.

As compared to other solutions, such as requiring standing in IPRs, the proposed solution does not create inertia affecting future patent policy as to the protection of patents versus public access, small business versus large business, or the high tech industry versus the pharmaceuticals industry. Additionally, the solution does not bar advocates and producers of generic drugs from productively defending their interests. Thus the proposed solution may be implemented without controversy because, even if there should be a policy in patent law to promote decreased drug costs, hedge fund manager interests do not need representation in IPRs.

This article advocates for the proposed solution of limiting non-patent interested entities in IPRs by, first, providing a background on the purpose of patent law, the original patent reexamination proceedings, the American Invents Act, and Inter Partes Review. Second, this article will describe the IPR-stock shorting strategy, the pharmaceutical industry’s sensitivity to the strategy, and the public’s reaction to the strategy. Third,

⁹ Greider, *supra* note 5.

¹⁰ See generally *The Impact of Abusive Patent Litigation Practices on the American Economy: Hearing Before the S. Comm. On the Judiciary*, 114th Cong. (2015) [hereinafter Gupta Testimony] (testimony of Krish Gupta, Senior Vice President and Deputy General Counsel, EMC Corporation), <https://www.judiciary.senate.gov/imo/media/doc/03-18-15%20Gupta%20Testimony.pdf>.

this article will explore various solutions to addressing the IPR-stock shorting strategy, including allowance of the practice, and the arguments for and against each solution. Finally, this article will propose that the most practical and least controversial solution is for the PTAB or Congress to require IPR petitioners to request IPRs without any intent of shorting the stock of the patent holder.

II. BACKGROUND

A. *Fundamentals of Patent Law and the Original Reexamination Procedures.*

The Commerce Clause of the U.S. Constitution provides for federal patent law by stating that “Congress shall have power . . . to promote the Progress of . . . useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their respective . . . Discoveries.”¹¹ Thus, in order to stimulate innovation, Congress was empowered to grant temporary monopolies via patents to give monopolistic benefits to those whom create new inventions.¹² From the power granted by the Constitution, Congress established the Patent Office, now known as the United States Patent and Trademark Office (USPTO).¹³

The USPTO is charged with a variety of responsibilities to promote the useful Arts.¹⁴ According to the USPTO, these responsibilities are to serve the interests of inventors and businesses who invent.¹⁵ The main responsibility of the USPTO is the oversight of operations for granting and issuing patents¹⁶ to inventors that demonstrate that their inventions are novel, useful, and nonobvious.¹⁷ This responsibility is not only exercised through the USPTO’s patent examination proceedings to determine the

¹¹ U.S. CONST. art. I, § 8, cl. 8.

¹² John H. Barton & Ezekiel J. Emanuel, *The Patents-Based Pharmaceutical Development Process*, 16 THE J. OF THE AM. MED. ASS’N 2075, 2076 (2005).

¹³ See generally 35 U.S.C. (previously enacted as the Patent Act of 1836, ch. 357, 5 Stat. 117, 118-19 (1836)); see 35 U.S.C. § 1(a) (previously enacted as An Act to Amend the Trademark Act of 1946 and Title 35 of the United States Code to Change the Name of the Patent Office to the “Patent and Trademark Office”, Pub. L. No. 93-596, § 1, 88 Stat. 1949 (1975)).

¹⁴ See 35 U.S.C §§ 1-2 (2012).

¹⁵ U.S. PATENT AND TRADEMARK OFFICE, *Functions of the Patent and Trademark Office*, <http://www.uspto.gov/web/offices/pac/doc/general/function.htm> (last updated Sept. 24, 2016).

¹⁶ 35 U.S.C § 1 (2012).

¹⁷ *Id.* §§ 101-03.

existence of patentable subject matter, but is also exercised through reexamination proceedings.¹⁸

When a substantial new question of patentability arises for a granted patent,¹⁹ the USPTO has conducted *ex parte* reexaminations since 1981,²⁰ and in addition, *inter partes* reexaminations since 1999.²¹ Through these procedures a third party may challenge the validity of another party's patent.²² The original purpose for introducing the reexamination procedures was to provide: "(i) a more expeditious and less expensive resolution of validity disputes than litigation; (ii) involvement of the Patent Office and its expertise in validity disputes; and (iii) the reinforcement of 'investor confidence in the certainty of patent rights.'"²³

However, because *ex parte* reexaminations did not allow participation by third party challengers during the USPTO reexamination process,²⁴ experts believed the reexamination proceedings were an unattractive alternative to district court litigation.²⁵ Specifically, reexamination favored the patent owner because third parties could only "dump its prior art in front of the Examiner, and hope that he or she would have the legal and technical insight to persevere against experienced advocates with a better awareness of the overall context."²⁶ Therefore, third parties worried the procedures would "strength[en] a questionable patent without making it any less questionable,"²⁷ and would unduly cause "a

¹⁸ See 35 U.S.C. § 302.

¹⁹ See U.S. PATENT AND TRADEMARK OFFICE, U.S. DEPT. OF COMMERCE, MANUAL OF PATENT EXAMINING PROCEDURE ch. 2200 (2015) [hereinafter MPEP]. The requirement of a substantial new question of patentability is explained by the USPTO: "[i]t must first be demonstrated that a patent or printed publication that is relied upon in a proposed rejection presents a new, non-cumulative technological teaching that was not previously considered and discussed on the record during the prosecution of the application that resulted in the patent for which reexamination is requested, and during the prosecution of any other prior proceeding involving the patent for which reexamination is requested." *Id.* § 2216.

²⁰ *Id.* § 2201 (discussing *inter partes* reexamination).

²¹ On November 29, 1999, the American Inventors Protection Act of 1999 provided an 'inter partes' option to reexamination. *Id.* § 2601.

²² 37 C.F.R. § 1.913 (2011) ("[A]ny person other than the patent owner or its privies may . . . file a request for *inter partes* reexamination."); MPEP, *supra* note 19, at § 2209 (stating that "any person [can] file a request for *ex parte* reexamination . . ."); MATHEW A. SMITH, *INTER PARTES REEXAMINATION* 12-13 (1E ed. 2009).

²³ SMITH, *supra* note 22, at 13 (citing *Patlex Corp. v. Mossinghoff*, 758 F.2d 594, 602 (Fed. Cir. 1985)).

²⁴ See, e.g., H.R. REP. NO. 106-464, at 133 (1999) (Conf. Rep.) ("[A] third party who requests reexamination cannot participate at all after initiating the proceedings.").

²⁵ Smith, *supra* note 22, at 13.

²⁶ *Id.* at 13-14. "Prior art" is a term of art that refers to any reference that may be used as a basis for a novelty or obviousness rejection. See MPEP, *supra* note 19, at §§ 2121-2129.

²⁷ SMITH, *supra* note 22, at 13.

favorable patentability ruling over art the patent challenger might rely on in U.S. district court.”²⁸

In 1999,²⁹ Congress introduced inter partes reexamination (as opposed to inter partes review) to address this concern spawning from ex partes review.³⁰ Inter partes reexamination allowed third parties to participate after the filing of a reexamination request by commenting on the patentee’s submission, submitting evidence to challenge the patentee or findings of the USPTO, and filing or participating in appeals to the Patent Office Board and the Court of Appeals of the Federal Circuit.³¹ Because reexamination may not be requested anonymously, proponents of inter partes reexamination like Professor Matthew A. Smith believed that the visibility of third party challengers to patentees would provide an additional benefit of dissuading an extensive amount of offensive challenges by third parties who are unknown to the patentee, but who may be investigated by the patentee for infringement.³²

Once implemented, inter partes reexamination faced many problems that contributed to it being underutilized.³³ Because parties to the process would be bound by estoppel in subsequent litigation, parties were wary of the lack of discovery and cross examination procedures that were useful tools in conventional patent litigation.³⁴ Additionally, only patents issued on or after November 29, 1999 were eligible for the reexamination process.³⁵ These issues, in addition to more general problems with U.S. patent procedural and substantive law, led to the enactment of more contemporary patent legislation, particularly the American Invents Act.³⁶

²⁸ Michael L. Goldman & Alice Y. Choi, *The New Optional Inter Partes Reexamination Procedure and Its Strategic Use*, 28 AIPLA Q.J. 307, 314 (2000).

²⁹ MPEP, *supra* note 19, at § 2601.

³⁰ SMITH, *supra* note 22, at 14; *see also* Cooper Techs. Co. v. Dudas, 536 F.3d 1330, 1332 (Fed. Cir. 2008) (“The AIPA created the inter partes reexamination procedure to allow third parties to have an expanded role in the reexamination of issued patents.”).

³¹ SMITH, *supra* note 22, at 16.

³² *Id.* at 15-16.

³³ *See, e.g.*, U.S. PATENT & TRADEMARK OFFICE, REPORT TO CONGRESS ON INTER PARTES REEXAMINATION 4 (2004), <http://www.uspto.gov/web/offices/dcom/olia/reports/reexamreport.pdf>.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Protecting Small Businesses and Promoting Innovation by Limiting Patent Troll Abuse: Hearing Before the S. Comm. on the Judiciary*, 113th Cong. 3 (2013) [hereinafter Dickinson Testimony] (testimony of Q. Todd Dickinson, Executive Director., American Intellectual Property Law Association).

B. The American Invents Act and Inter Partes Review

The Leahy-Smith American Invents Act (AIA) was signed into law on September 16, 2011 and provided for a variety of substantive changes to U.S. patent law.³⁷ These changes included a first-to-file system, foreign public use counting as prior art, and the implementation of new reexamination procedures.³⁸ Much of the debate leading to the adoption of these changes were “driven by proposals to address concerns about the assertion of poor quality patents against companies and the need for better tools and litigation reforms to more efficiently and cost effectively resolve such disputes.”³⁹

Specifically, proponents of the AIA, such as the National Academies of Science and the American Intellectual Property Law Association, believed that a large number of poor quality patents were increasingly being used by non-practicing entities (NPEs) to assert patent infringement against companies, thus causing a negative effect on innovation.⁴⁰ Thus, Congress adopted the AIA in order to “improve the likelihood that invalid patents would be quickly weeded out of the system”⁴¹ in an effort to “establish a more efficient and streamlined patent system that will improve patent quality and limit unnecessary and counterproductive litigation costs.”⁴² As contended by Krish Gupta, a representative of the ‘high tech industry,’ “[a]busive patent litigation is a costly problem that [was] stifling American innovation and impeding job creation each and every day.”⁴³ Furthermore, a venture capitalist noted that “[w]hen companies spend money protecting their intellectual property position, they are not expanding; and when companies spend time thinking about patent demands, they are not inventing.”⁴⁴ Such abusive patent litigation caused adverse effects to small, medium, and large enterprises.⁴⁵

The AIA reexamination procedures of inter partes review, post-grant review, covered business method review were adopted to counter

³⁷ See generally Leahy-Smith America Invents Act.

³⁸ Auvil, *supra* note 2; see Leahy-Smith America Invents Act secs. 3, 5-6.

³⁹ Dickinson Testimony, *supra* note 36, at 189.

⁴⁰ Rochelle Cooper Dreyfuss, *Giving the Federal Circuit a Run for its Money: Challenging Patents in the PTAB*, 91 NOTRE DAME L. REV. 235, 236 (2015).

⁴¹ *Id.*

⁴² Changes to Implement Inter Partes, Review Proceedings, Post-Grant Review Proceedings, and Transitional Program for Covered Business Method Patents, 77 Fed. Reg. 48680-01 (Aug. 14, 2012) (codified at 37 C.F.R. pt. 42).

⁴³ Gupta Testimony, *supra* note 10, at 4.

⁴⁴ Robin Feldman, *Patent Demands & Startup Companies: The View from the Venture Capital Community*, 16 YALE J.L. & TECH., 236, 243 (2014).

⁴⁵ Gupta Testimony, *supra* note 10, at 4.

these issues.⁴⁶ Although the inter partes reexamination procedure was implemented to address similar issues,⁴⁷ it was still criticized because “there ought to be a way to select for more exhaustive examination prior to [litigating] those patents that the marketplace will favor.”⁴⁸ It was noted that the lack of an exhaustive examination was especially difficult on industries that required patents on technologies in which the USPTO lacked expertise and experience in examination.⁴⁹ Despite these shortcomings, inter partes reexamination provided a foundation for further reexamination reforms because “[t]he simplest and most direct way to [have a more exhaustive examination] is to let those whose economic welfare may be affected by a patent, specifically potential competitors, contest its validity.”⁵⁰ Thus, inter partes reexamination was replaced with inter partes review.⁵¹

Inter partes review (IPR) is a reexamination procedure administered by the Patent Trial and Appeal Board (PTAB) upon a showing by a petitioner that he is reasonably likely to prevail on at least one of the claims challenged.⁵² Like inter partes reexamination, any person may petition to review another’s issued patent to establish invalidity based on anticipation or obviousness.⁵³ However, there are many key differences, including the following:

- IPRs are conducted by a panel of three Administrative Patent Judges on the PTAB (rather than by a patent examiner),⁵⁴
- a patent holder “may file a preliminary response” on why petitioner’s request to institute an IPR should be denied;⁵⁵ and

⁴⁶ Dickinson Testimony, *supra* note 36, at 190 (“A key component of the reported abuses is the assertion of allegedly invalid or overbroad patents, the very abuse for which AIA post-grant procedures were created, in order to improve patent quality.”).

⁴⁷ SMITH, *supra* note 22, at 14; *see also* Cooper Technologies Co. v. Dudas, 536 F.3d 1330, 1332 (Fed. Cir. 2008).

⁴⁸ Frederick C. Williams, *Giving Inter Partes Patent Reexamination a Chance to Work*, 32 AIPLA Q. J. 265, 270 (2004).

⁴⁹ The author provides the example of banks whom face infringement assertions of “cover methods of operations, such as online banking and backroom operation routines.” *Id.* at 270.

⁵⁰ *Id.*

⁵¹ Leahy-Smith America Invents Act, sec. 6, §§ 311-319 (setting forth procedures for IPR).

⁵² *See* Heart Failure Techs., LLC v. Cardiokinetix, Inc., No. IPR2013-00183, 2013 Pat. App. LEXIS 5602, at *16 (P.T.A.B. July 31, 2013) (denying petition for IPR).

⁵³ 35 U.S.C. §§ 315(e)(2), 315(b) (2012).

⁵⁴ TAFT STETTINIUS & HOLLISTER LLP, *Inter Partes Review Replaces Inter Partes Reexamination*, (Oct. 5, 2012), <http://www.taftlaw.com/news/publications/detail/993-inter-partes-review-replaces-inter-partes-reexamination>.

⁵⁵ 7 C.F.R. § 42.107(a) (2016).

- any patent is eligible for IPR once nine months have passed from patent issuance or reissue.⁵⁶

Summarizing the changes from inter partes reexamination to IPR, “Congress raised the bar for granting petitions to review issued patents, but at the same time, advantaged petitions that do pass muster by expediting the process and allowing the reviews to take place before the Patent Trial and Appeal Board in the first instance, rather than on appeal.”⁵⁷ The USPTO provided further benefits to petitioners by letting them evaluate any patent, at nearly any time when potential prior art emerges during the patent’s lifetime.⁵⁸

Although IPRs were not commonly used during their original introduction, they became a frequently used tool in 2014.⁵⁹ By mid-February 2015, about 2,500 IPR petitions were filed.⁶⁰ As expected, companies, especially in the high tech industry, have used IPRs to challenge the validity of low quality patents asserted against them.⁶¹ IPRs have also been successfully used to protect small businesses and technology purchasers against infringement actions.⁶² Data shows that, “[s]o far, smaller players have been relatively successful at instituting reviews, halting co-pending litigation, and ultimately winning on the merits of their petitions. Moreover, manufacturers have been getting in on the act as well, using IPRs to shield customers that choose not to defend themselves.”⁶³

Accordingly, IPR advocates contend that IPRs are successfully eliminating, narrowing, and clarifying ambiguous patents, and “have already proven to be highly effective weapons in the battle against the poor

⁵⁶ 35 U.S.C. § 311(c) (2016).

⁵⁷ Brian J. Love, *Inter Partes Review as a Shield for Technology Purchasers: A Response to Gaia Bernstein's The Rise of the End-User in Patent Litigation*, 56 B.C. L. REV. 1075, 1079 (2015) (citing Justin A. Hendrix & Robert F. Shaffer, *Post Grant Proceedings of the ALA Provide New Opportunities and Require Reconsideration of Old Patent Litigation Strategies*, FINNEGAN, HENDERSON, FARABOW, GARRETT, & DUNNER LLP (June 15, 2012), <http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=598696f7-7eba-4fcb-83b8-2369caa91dd3>).

⁵⁸ Dreyfuss, *supra* note 40, at 244.

⁵⁹ Love, *supra* note 57, at 1079.

⁶⁰ Michelle K. Lee, Deputy Dir., U.S. Patent and Trademark Office, Keynote Speech at the IPO Education Foundation PTO IPO Day Luncheon (March 10, 2015), <http://www.uspto.gov/about-us/news-updates/remarks-michelle-k-lee-ipo-education-foundation-pto-ipo-day-luncheon>.

⁶¹ Gupta Testimony, *supra* note 10, at 7.

⁶² See Love, *supra* note 57, at 1094.

⁶³ *Id.*

quality patents that are the delight of patent trolls.”⁶⁴ Advocates further state that “[t]he potential impact is evident: these procedures can promote freedom to operate, facilitate settlement, lower the incidence of litigation, and curb NPE practice.”⁶⁵

However, even if these benefits have been realized, IPR criticism remains equally as vocal. Former Chief Judge of the United States Court of Appeals for the Federal Circuit, Randall Ray Rader, has criticized PTAB judges for “acting as death squads, [in] killing property rights.”⁶⁶ Through February 29, 2016, only 17% of instituted claims that have been subject to a final IPR decision (1,828 of 10,768) have been found valid⁶⁷ and 13% of patents that have undergone a final IPR decision (109 of 828) have survived unharmed.⁶⁸ As such, critics in the pharmaceutical industry have charged IPR proceedings, and the AIA in general, as “undermining the value and predictability of patent rights and wreaking havoc on the legitimate, investment-backed expectations of patent owners.”⁶⁹ Such critics further contend that this is contrary to Congressional intent because the IPR procedure “unfairly stacks the deck against patent owners in many ways, leading to patent invalidation rates far exceeding those seen in district court patent litigation involving similar types of patents and similar grounds for

⁶⁴ Letter from United for Patent Reform to Senator Christopher Coons (Mar. 16, 2015), <http://www.unitedforpatentreform.com/files/upr-letter-sencoons-strong-act1913422643.pdf> [hereinafter United for Patent Reform Letter]; see also Gupta Testimony, *supra* note 10, at 16.

⁶⁵ Dreyfuss, *supra* note 40, at 258.

⁶⁶ Tony Dutra, *Rader Regrets CLS Bank Impasse, Comments on Latest Patent Reform Bill*, BLOOMBERG BNA (Oct. 29, 2013), <http://www.bna.com/rader-regrets-cls-n17179879684>.

⁶⁷ U.S. PATENT AND TRADEMARK OFFICE, PATENT TRIAL AND APPEAL BOARD STATISTICS 12 (2016) <http://www.uspto.gov/sites/default/files/documents/2016-2-29%20PTAB.pdf>.

⁶⁸ *Id.* at 9. Concededly, the above-reported statistic on claim invalidation does not include claims instituted but not subject to a final IPR decision that remain patentable (5,479 claims). See *id.* at 12. However, the statistic also excludes claims cancelled or disclaimed by the Patent Owner (1,957 claims). *Id.* Accordingly, 67% of claims instituted have been either found invalid in a final IPR decision or cancelled (or disclaimed) by a Patent Owner (excluding all IPRs that have yet to reach a final decision). *Id.* at 9. Additionally, the USPTO reports a Petition Institution rate on the merits as 62%. See Dennis Crouch, *By The Numbers: Is the PTO Underreporting the Rate They Institute IPRs and CBMs?*, PATENTLY-O (May 16, 2016), <http://patentlyo.com/patent/2016/05/numbers-underreporting-institute.html>. However, the Petition Institution rate may be much higher because only proceedings “Completed To Date” are considered in the USPTO’s statistics. *Id.* Similarly, the invalidity rate of claims challenged may be underreported based on the USPTO’s statistics because many IPRs have yet to (or do not) reach a final decision. *Id.*

⁶⁹ Sauer Testimony, *supra* note 4, at 1.

challenges.”⁷⁰ Todd Dickinson, former Director of the USPTO, believes that even the USPTO is aware that the IPR invalidity rate is abnormally high.⁷¹

Due to IPR proceedings being allegedly stacked against patent owners,⁷² as supposedly demonstrated by high invalidation rates, pharmaceutical companies have become wary of an unexpected threat to their patent portfolios.⁷³ Particularly, pharmaceutical patent holders believe there is “emerging evidence that AIA proceedings also are being brought or threatened by entities that have no interest in the challenged patent other than to extract a settlement payment or unrelated concessions from the patent owner—or to profit from the declining stock value of companies subject to these challenges.”⁷⁴ The entities and activity referred to are hedge fund managers using IPRs as a tool in stock shorting.⁷⁵

C. The IPR-Stock Shorting Strategy and Pharmaceutical Companies

Stock shorting is an investing tool used to profit from a declining stock price, as opposed to the traditional method of profiting from an increasing stock price.⁷⁶ While stock shorting is controversial as to whether it should continue to be legal, proponents of the strategy state the benefits include: “contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations.”⁷⁷ The stock shorting method comprises, first, borrowing stock from an existing stock holder by paying

⁷⁰ Sauer Testimony, *supra* note 4, at 1.

⁷¹ INNOGRAPHY, *Inter Partes Review, Proposed Changes, and the Controversial Implications of Kyle Bass* (Sept. 22, 2015), <https://go.innography.com/inter-partes-review-and-kyle-bass-on-demand.html> (type in information in the ‘Watch Now’ form; then click ‘WATCH NOW’ to access the webinar)(agreeing with Gene Quinn that the USPTO is likely trying to hide amounts of patents invalidated because USPTO uses statistics in terms of claims rather than patent invalidated).

⁷² Sauer Testimony, *supra* note 4, at 18. (“[A]buses of the PTO administrative review system are attractive and growing because, as is quite clear to anyone following the evidence to date, the rules governing these proceedings are unfairly stacked against patent owners in many ways.”).

⁷³ See generally Greider, *supra* note 5.

⁷⁴ Sauer Testimony, *supra* note 4, at 19.

⁷⁵ See Greider, *supra* note 5.

⁷⁶ Raymond C. Niles, *The Case for Stock Shorting*, CAPITALISM MAGAZINE, Feb. 15, 2009, <http://capitalismmagazine.com/2009/02/the-case-for-stock-shorting/>.

⁷⁷ Press Release, Sec. and Exch. Comm’n, Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases (Oct. 1, 2008), <http://www.sec.gov/news/press/2008/2008-235.htm>.

the stock holder a fee.⁷⁸ Second, selling the stock immediately and keeping the proceeds in a brokerage account.⁷⁹ And third, at a future time, buying an equivalent amount of the same stock and returning it back to the original stock holder.⁸⁰ Stock shorting is carried out in hopes that the stock decreases in value between the short seller's selling and rebuying of the stock.⁸¹ If the short seller is correct, his profit is the difference between the selling and rebuying prices.⁸²

Investors have employed this strategy against pharmaceutical companies with a novel twist.⁸³ Investment managers take short positions against pharmaceutical companies, which depend heavily on patents, and then file IPR proceedings against such patents.⁸⁴ The investment managers use the strategy in hopes that the pharmaceutical companies' stocks will ultimately decrease.⁸⁵ Indeed, Hans Sauer, Deputy General Counsel for Intellectual Property in the Biotechnology Industry Association, contend that "[t]he mere filing of an IPR demonstrably can have significant impact on the stock prices of such companies."⁸⁶

The most well-known individual employing this method is a hedge fund manager named Kyle Bass.⁸⁷ Bass was the first to announce "plans to 'short' the stocks of more than a dozen biotech companies and then file IPRs against their most valuable product patents in an attempt to drive down their stock prices."⁸⁸ As of 2016, Bass and entities related to Bass have filed about three dozen petitions⁸⁹ against companies such as Acorda Therapeutics,⁹⁰ Celgene,⁹¹ Shire,⁹² and Horizon Pharma.⁹³ As of July 14, 2016, the PTAB has instituted IPRs for 57% of Bass's petitions (20 of 35).⁹⁴

⁷⁸ Niles, *supra* note 76.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ Sauer Testimony, *supra* note 4, at 18.

⁸⁴ Letter from Robert Menendez, N.J. Senator, to Mary Jo White, Chair, Sec. Exch. Comm'n (June 3, 2015),

<https://www.menendez.senate.gov/imo/media/doc/Letter%20to%20Mary%20Jo%20White%206.3.15.pdf>.

⁸⁵ *See id.*

⁸⁶ Sauer Testimony, *supra* note 4, at 1.

⁸⁷ *See generally* Greider, *supra* note 5.

⁸⁸ Sauer Testimony, *supra* note 4, at 18.

⁸⁹ Ryan Davis, *Bass AIA Challenge To Celgene Cancer Drug Patent Rejected*, LAW360 (last visited Sept. 11, 2016), <http://www.law360.com/articles/728628/bass-aia-challenge-to-celgene-cancer-drug-patent-rejected>.

⁹⁰ Cyran, *supra* note 6.

According to Hans Sauer, the pharmaceutical industry believes they have become a central target of this strategy for two reasons: First, “[r]esearch and development within the biotechnology industry comes at a very high cost, and every idea that is funded comes with a much greater risk of failure than success. Investment thus is predicated on an expected return in the form of patent-protected products or services that ultimately reach the market.”⁹⁵ Furthermore, Sauer contends “[b]iotech companies can be particularly vulnerable to such extortion because—in contrast to most high-tech companies—biotech companies often rely on just a handful of highly valuable patents to protect their products and massive investment therein.”⁹⁶ Second, Sauer contends “the statistically disproportionate ‘kill rates’ of IPR proceedings invite unintended abuses and predatory practices by those seeking to attack patents for illegitimate reasons, including for their own financial gain.”⁹⁷

While Bass is most certainly financially motivated, Bass says he intends to do good for society as well.⁹⁸ Specifically, Bass contends there is a conflict between pharmaceutical profits and societal interests because pharmaceutical companies are making profit from bad patents.⁹⁹ His IPR strategy is not without support.¹⁰⁰ For example, a critic of the pharmaceutical industry stated, “[t]he companies . . . are expanding patents by simply changing the dosage or the way they are packaging something are going to get knee capped [by Kyle Bass] . . . This is going to lower drug

⁹¹ See Susan Decker & Kelly Bit, *Bass Expands Drug Patent Fight as Celgene, Shire Make Five*, BLOOMBERG BUSINESS (last updated Apr. 23, 2015), <http://www.bloomberg.com/news/articles/2015-04-23/celgene-shire-make-five-as-kyle-bass-expands-drug-patent-fight>.

⁹² *Id.*

⁹³ See Matthew Bultman, *Hedge Fund Hits Another Horizon Patent With ALA Review Bid*, LAW360 (last visited Sept. 11, 2016), <http://www.law360.com/articles/664350/hedge-fund-hits-another-horizon-patent-with-ala-review-bid>.

⁹⁴ See Michael Loney, *Kyle Bass IPRs End up With 57% Institution Success Rate*, MANAGING INTELLECTUAL PROPERTY (Sept. 7, 2016, 10:00 PM), <http://www.managingip.com/Article/3561885/Kyle-Bass-IPRs-end-up-with-57-institution-success-rate.html>. All thirty-five IPR petitions in which Bass has been involved have reached a Decision on Institution but none have yet to reach a Final Decision. *Id.*

⁹⁵ Sauer Testimony, *supra* note 4, at 3-4.

⁹⁶ *Id.* at 18.

⁹⁷ *Id.* at 1.

⁹⁸ See generally Greider, *supra* note 5.

⁹⁹ *Id.*

¹⁰⁰ Balazs Koranyi, *U.S. Hedge Fund Plans to Take on Big Pharma Over Patents*, REUTERS (Jan. 7, 2015), <http://www.reuters.com/article/2015/01/07/pharmaceuticals-haymancapital-idUSL3N0UM42O20150107>.

prices for Medicare and for everyone.”¹⁰¹ In contrast, the pharmaceutical industry believes society will be harmed from Bass’s strategy. For example, Hans Sauer stated that the IPR-stock shorting actions are “market-manipulating, cynical efforts [that] not only damage the value of companies working on cures, but also hurt patients and their families who are eagerly waiting for such cures.”¹⁰²

III. ANALYSIS

Based on these conflicting views, it is not completely clear whether the IPR-stock shorting strategy is beneficial overall to society. With this in mind, the analysis below attempts to identify the arguments on both sides of the debate in context of the various suggestions on how to deal with the strategy. Through this discovery, this article attempts to determine the most practical solution.

This article discusses three options in particular for dealing with the IPR-stock shorting strategy that have been previously debated by proponents and opponents of the strategy. First, this article discusses the arguments for and against allowing the IPR-stock shorting strategy to continue. Second, this article discusses the arguments relating to implementing a stricter standing requirement intended to stop the IPR-stock shorting strategy. Third, this article discusses the arguments relating to USPTO judges exercising discretion to block patent challenges motivated by this strategy. The following analysis, based on the discussed arguments, proposes and analyzes a fourth option in which the strategy is disabled by requiring IPR petitioners to have no “adverse shareholder interest.”

A. Option 1: Do Not Regulate IPR-Stock Shorting Strategy

Proponents of the IPR-stock shorting strategy argue that Congress and the USPTO should not attempt to regulate the practice.¹⁰³ As noted previously, it is alleged that pharmaceutical companies are making profit from bad patents,¹⁰⁴ and the bad patents create a negative cost on society.¹⁰⁵ Thus, it is argued that allowing the IPR-stock shorting strategy provides a way to prevent the negative costs.¹⁰⁶ Erich Spangenberg, Kyle Bass’s

¹⁰¹ Koranyi, *supra* note 100.

¹⁰² Sauer Testimony, *supra* note 4, at 1.

¹⁰³ See INNOGRAPHY, *supra* note 71 (argument of Kyle Bass’s advisor, Erich Spangenberg).

¹⁰⁴ See Greider, *supra* note 5.

¹⁰⁵ See Koranyi, *supra* note 100.

¹⁰⁶ *Id.*

advisor, provides an additional reason why the strategy is legitimate.¹⁰⁷ Spangenberg asserts that the intent of the petitioner is completely irrelevant to the initiation of an IPR.¹⁰⁸ In support of his assertion, Spangenberg points to the lack of a motivation requirement in the IPR statute.¹⁰⁹ Additionally, the only limitation to being a petitioner is that the party must be “anyone else other than the patent owner.”¹¹⁰ Bass’s motivation is not unlike the motivations of large corporations, who also file IPRs.¹¹¹ For example, he states that Apple, one of the leading IPR filers, is also profit-driven,¹¹² and therefore he does not see a problem in asserting IPR for monetary purposes.¹¹³

Opponents of Bass’s strategy believe that “Congress never intended for the patent challenge system to be utilized by those attempting to profit from the confusion the current system creates.”¹¹⁴ Additionally, “[s]uch efforts not only damage the value of companies working on cures—but hurts those sick and suffering patients and their families who are eager for cures.”¹¹⁵ Gene Quinn, a U.S patent attorney and frequent blogger on the issue, believes that allowing the IPR-stock shorting strategy will only cause the strategy to be used more frequently and has the potential to be “catastrophic for the [pharmaceutical] industry.”¹¹⁶ As mentioned above, this is possible because pharmaceutical companies rely heavily on patents to protect their extensive investments in research and development.¹¹⁷ In terms of Congressional intent, Quinn states “it is difficult to understand why the Bass challenge[s] should be allowed to move forward” because “the [only] purpose for creating new post grant challenges was to create a low-cost alternative to litigation to determine the validity of patent claims,” and not to allow third parties to profit from challenging patents.¹¹⁸

Quinn’s hypothesis that the IPR-stock shorting strategy could be “catastrophic” is put to some doubt by a study published by J. Gregory

¹⁰⁷ INNOGRAPHY, *supra* note 71.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ INNOGRAPHY, *supra* note 71.

¹¹⁴ Silverstein, *supra* note 5 (quoting Jim Greenwood).

¹¹⁵ *Id.*

¹¹⁶ Gene Quinn, *Patent Abuse or Genius? Is Kyle Bass Abusing the Patent System?*, IPWATCHDOG (April 8, 2015) <http://www.ipwatchdog.com/2015/04/08/is-kyle-bass-abusing-the-patent-system/id=56613/>.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

Sidak and Jeremy O. Skog.¹¹⁹ The study admits that Bass's IPR petitions from February to April 2015, have produced abnormal negative returns in stocks.¹²⁰ However, from April to August 2015, there have been only normal returns and positively significant abnormal returns.¹²¹ The authors suggest that IPR challenges may not affect market participation expectations beyond the initial shock to Bass's strategy, or alternatively, the market has adjusted to IPR threats so that companies are not punished for being challenged in IPRs.¹²² Yet, the authors are careful to point out that it may be too early to conclude the strategy's effects due to the strategy being so new.¹²³

However, while none of Bass's successful IPR petitions have yet reached a final decision as of March 13, 2016,¹²⁴ the stock prices of pharmaceutical companies continue to be largely unaffected by the IPR activity of hedge fund managers.¹²⁵ Furthermore, in February 2016, Bass stated that he would return most of \$700 million dollars that he raised from investors for IPR challenges, stating "the strategy has fallen apart in the face of legal setbacks and market turbulence"¹²⁶ but would continue the current challenges to their "logical conclusion."¹²⁷

Yet, according Michael Yee, a biotech analyst, the lack of success in shorting stocks may be caused by a failure to challenge patents that would greatly impact a pharmaceutical company's profits.¹²⁸ For example, Yee cited an IPR challenge to a patent for the drug, Revlimid, in which, even if the patent was found invalid, a stronger patent still protected the

¹¹⁹ See J. Gregory Sidak & Jeremy O. Skog, *Attack of the Shorting Bass: Does the Inter Partes Review Process Enable Petitioners to Earn Abnormal Returns?*, 63 UCLA L. REV. DISCOURSE 120, 125-26 (2015).

¹²⁰ See *id.* at 136, 141.

¹²¹ *Id.*

¹²² *Id.* at 149.

¹²³ *Id.*

¹²⁴ Gene Quinn, *Bass, Spangenberg IPR of Juxtapid Gets Instituted by PTAB*, LAW360 (Mar. 13, 2016), <http://www.ipwatchdog.com/2016/03/13/bass-spangenberg-ipr-of-juxtapid-gets-instituted-by-ptab/id=67065/>.

¹²⁵ Scott A. McKeown, *PTAB Hedge Fund Failures Diffuse Early Market Hysteria*, IPWATCHDOG (Nov. 15, 2015), <http://www.ipwatchdog.com/2015/11/15/ptab-hedge-fund-failures-diffuse-early-market-hysteria/id=63142/>.

¹²⁶ Julia La Roche, *Kyle Bass Gave Back Most of the Investor Money He Raised for His Big Pharma Short, but He's Not Giving Up the Fight*, BUSINESS INSIDER (Feb. 23, 2016, 8:31 AM), <http://www.businessinsider.com/kyle-bass-to-return-most-of-money-from-hayman-pharma-vehicle-2016-2>.

¹²⁷ Stephen Foley & David Crow, *Kyle Bass Returns Funds Amid Retreat on Pharma Shorting Campaign*, FINANCIAL TIMES (Feb. 23, 2016, 11:16 AM), <http://www.ft.com/cms/s/0/0ffc05d2-d97e-11e5-98fd-06d75973fe09.html#axzz4JjvZdD3>.

¹²⁸ *Id.*

underlying drug from being produced by generic competitors.¹²⁹ Therefore, whether the IPR-stock shorting strategy may be continually successful when more essential pharmaceutical patents are challenged is still unclear.

B. Option 2: Standing Requirement in IPRs

In order to eliminate the IPR-stock shorting strategy, parties have asked Congress to require that a standing requirement be written into the IPR statute.¹³⁰ Such a requirement was presented in Senator Chris Coons's bill, entitled the Support Technology and Research for Our Nation's Growth Patents Act of 2015 (the Strong Act).¹³¹ Senator Coons stated that the Strong Act is intended "to strengthen the system for all" instead of making "trade-offs that benefit one innovative sector at the expense of another."¹³² Senator Coons made this remark in reference to pharmaceutical industries having a different structure from other industries.¹³³ More specifically, Senator Coons noted: "[i]f you're in an industry where your innovation cycles are short and the race to market is paramount, your view of patent protection is likely much different than if your industry requires years of development for each product, hundreds of millions of dollars in high-risk investment and heavily regulated clinical trials to get a single product into the hands of consumers."¹³⁴ Additionally, the Strong Act is intended by Senator Coons to assist small businesses instead of "stack[ing] the deck in favor of big companies."¹³⁵

Critics of the Strong Act assert that the IPR standing requirement contradicts these intentions.¹³⁶ First, the standing requirement would favor big companies (and "patent trolls") over small businesses.¹³⁷ In a letter to Senator Coons, various patent-interested entities stated that the standing requirement would "[let] trolls game who will be eligible to challenge their patents before the PTO."¹³⁸ Additionally, "[a]ll members of the public are harmed by poor quality patents and should be permitted to challenge them

¹²⁹ *Id.*

¹³⁰ Support Technology and Research for Our Nation's Growth Patents Act of 2015, S. 632, 114th Cong. § 101(d)(1) (2015).

¹³¹ The bill requires an IPR petitioner to have standing to bring a declaratory judgment action in federal court. *See id.*

¹³² Chris Coons, *We Need a Patent System That Works for All Innovators*, RECODE (Mar. 2, 2015, 8:30 PM), <http://www.recode.net/2015/3/2/11559626/we-need-a-patent-system-that-works-for-all-innovators>.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *See* United for Patent Reform Letter, *supra* note 64.

¹³⁷ *Id.*

¹³⁸ *Id.*

before the PTO.”¹³⁹ With a standing requirement, manufacturers that shield customers (and even small businesses), with little capability to mount an infringement defense, may not be able to continue to do so since they may lack a standing requirement.”¹⁴⁰ Indeed, the Electronic Frontier Foundation and other similar non-profit organizations, all whom lack financial interest to patents, would be barred from defending the “public good.”¹⁴¹ As such, according to Gene Quinn, such entities are against the STRONG Act.¹⁴²

Second, critics assert that current patent legislation, such as the Strong Act, are weakening patent protection for the high tech industry.¹⁴³ These critics continue to refer to the issue of patent assertions by non-practicing entities: “[i]n short, the patent system that was created to promote innovation, has, in far too many instances, actually had a detrimental impact on innovation by taking money and resources from those who innovate and handing it over to those who do not.”¹⁴⁴ As such, critics note that it has been difficult to agree upon a “balance between protecting those wrongly accused and protecting patentees from challenges to their patents.”¹⁴⁵ The difficulty is that that the high tech industry believes innovation is best promoted by making it more difficult for patent assertion entities to assert infringement, while the pharmaceutical companies want to narrow the ability to invalidate patents¹⁴⁶—invalidity being a defense to infringement.¹⁴⁷

C. Option 3: USPTO Discretion

As an alternative measure to eliminate the IPR-stock shorting strategy, parties have considered whether the USPTO may provide a solution.¹⁴⁸ When making a decision whether to institute an IPR, USPTO judges have a “great deal of discretion.”¹⁴⁹ Particularly, a decision whether

¹³⁹ *Id.*

¹⁴⁰ Love, *supra* note 57, at 1089-90.

¹⁴¹ INNOGRAPHY, *supra* note 71.

¹⁴² *Id.*

¹⁴³ Gupta Testimony, *supra* note 10, at 6-7.

¹⁴⁴ *Id.*

¹⁴⁵ Lionel Lavenue et al., *United States: A Review Of Patent Bills In The 114th Congress*, MONDAQ (Aug. 4, 2015), <http://www.mondaq.com/unitedstates/x/417804/Patent/A+Review+Of+Patent+Bills+In+The+114th+Congress>.

¹⁴⁶ *Id.*

¹⁴⁷ 35 U.S.C. § 282(b) (2012) (stating patent invalidity is a defense to patent infringement).

¹⁴⁸ Silverstein, *supra* note 5.

¹⁴⁹ *Id.*

to institute inter partes review is generally not reviewable by the Federal Circuit.¹⁵⁰ Accordingly, the USPTO judges could use their discretion to deny IPRs based on the intended purpose of petitions by Kyle Bass and the like.¹⁵¹ As such, USPTO judges could make decisions based on the intended results that are dictated by policy.¹⁵²

On September 2, 2015, the PTAB allegedly exercised its discretion to deny the institution of an IPR for a petition by Kyle Bass.¹⁵³ In the IPR case of *Biogen*,¹⁵⁴ Bass's petition was denied because the USPTO refused to recognize evidence posited by Bass as prior art.¹⁵⁵ However, Gene Quinn suggests that the USPTO's rationale for the denial was "dubious" and that the USPTO may be making decisions based on the motives of Kyle Bass rather than the law.¹⁵⁶ Quinn believes a similar concern may have motivated the USPTO to also deny Bass's petition against Acorda.¹⁵⁷

Erich Spangenberg believes it is not "politically expedient" for judges to use their discretion in this manner, even if allowed by USPTO policy.¹⁵⁸ Such a use of discretion would "ultimately hurt the credibility of the PTAB."¹⁵⁹ Furthermore, Spangenberg asserts that decisions using judge discretion would ultimately hurt the high tech industry.¹⁶⁰

D. Option 4: No "Adverse Shareholder Interest"

This article suggests a fourth option based on the criticisms of the other suggested plans of action. Specifically, to initiate an IPR, petitioners, real parties-in-interests, and privies of the petitioners should be required by Congress (or the USPTO through regulations) to have no "adverse shareholder interest" in the holders of the contested patents. The PTAB should only initiate IPRs when such parties demonstrate that they are not

¹⁵⁰ See *Cuozzo Speed Techs., LLC v. Lee*, 136 S.Ct. 2131, 2136 (2016).

¹⁵¹ *Id.* at 2140.

¹⁵² INNOGRAPHY, *supra* note 71.

¹⁵³ Coalition for Affordable Drugs LLC, v. Biogen Inc., No. IPR2015-01136, 1-2 (P.T.A.B. Sept. 2, 2015).

¹⁵⁴ *Id.*

¹⁵⁵ Gene Quinn, *With Dubious Logic and Inaccurate Statements of Law, PTAB Denies Another Kyle Bass IPR Petition*, IPWATCHDOG (Sept. 2, 2015), <http://www.ipwatchdog.com/2015/09/02/ptab-denies-another-kyle-bass-ipr-petition/id=61333/>.

¹⁵⁶ *Id.*

¹⁵⁷ Gene Quinn, *USPTO Denies Kyle Bass IPR Patent Challenge Against Acorda Therapeutics*, IPWATCHDOG (Aug. 25, 2015), <http://www.ipwatchdog.com/2015/08/25/uspto-denies-kyle-bass-ipr-patent-challenge-against-acorda-therapeutics/id=61016/>.

¹⁵⁸ INNOGRAPHY, *supra* note 71.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

requesting an IPR for the purpose, at least in part, of economic gain through stock shorting of the company who owns the petitioned patent.

This proposal would effectively disable the IPR-stock shorting activity even when new shorting strategies are attempted. For example, instead of petitioning for an IPR himself, Spangenberg requested that a third-party volunteer file his draft petition.¹⁶¹ In this case, if the volunteer files with the intent to profit off of a stock shorting strategy, or if the volunteer is assisted by someone who uses the strategy, the proposed rule change would prevent such an IPR filing from being successful because Spangenberg would be a real party-in-interest.¹⁶² In the new strategy, Spangenberg requires the volunteer to pay all IPR fees; this could prevent Spangenberg from being labeled an “interested party.”¹⁶³ However, in such a case, assuming the volunteer is not motivated by any IPR-stock shorting strategy, the volunteer would only petition if the value of personal or public access of the targeted invention, multiplied by the probability of showing invalidity, was greater than the cost of IPR filings. If it is less than the cost of the filings, it is not cost effective for the volunteer to file the IPR. Therefore, the “no adverse interest” rule would help to make sure IPRs are only sought for reasons related to the conceptual framework of the U.S. patent system—securing temporary monopolies for new inventions and maintaining the rest within the public domain.¹⁶⁴

Additionally, such a rule change would avoid much of the controversy of the Strong Act and its IPR standing requirement. There would be no unintended consequences of reducing the ability of small companies, technology purchasers, and their related interest groups to use IPRs to protect their interests.¹⁶⁵ Instead, only parties who have “adverse shareholder interests” will be barred from initiating IPRs.

¹⁶¹ Ryan Davis, *Bass ‘Patent Troll’ Ally Seeks Help Targeting Depomed IP*, LAW360 (Sept. 2015), <http://www.law360.com/articles/708511/bass-patent-troll-ally-seeks-help-targeting-depomed-ip>.

¹⁶² A real party-in-interest is, for example, “a party that funds and *directs and controls* an IPR or PGR petition or proceeding.” Office Patent Trial Practice Guide; Rule, 77 Fed. Reg. 48,756, 48,760 (Aug. 14, 2012)(to be codified at 37 C.F.R. 42) (emphasis added). However, whether a party is a real party-in-interest is determined on a case-by-case basis. *Id.*

¹⁶³ Davis, *supra* note 161.

¹⁶⁴ In *Graham v. John Deere Co. of Kansas City*, the Supreme Court stated that “[Congress may not] enlarge the patent monopoly without regard to the innovation, advancement or social benefit gained thereby ... [and] may not [issue] patents whose effects are to remove existent knowledge from the public domain” in order to “promote the Progress . . . of useful Arts.” 383 U.S. 1, 6 (1966).

¹⁶⁵ Love, *supra* note 57, at 1094.

Bass would likely assert that this would be unwise because his IPR filings will benefit society by lowering drug prices, in addition to his own benefit in the form of personal wealth.¹⁶⁶ However, patent-interested entities could also fulfill this role. Even Spangenberg admits that he expects generic brand pharmaceutical companies to use IPRs against the key patents of other pharmaceutical companies.¹⁶⁷

The stated rule change would also avoid the problematic nature of wide discretionary activity by the USPTO judges. USPTO judges would not have to “put a thumb on the scale”¹⁶⁸ to determine whether to implement an IPR based on the intentions of the parties. Instead, USPTO judges would merely use a hard line rule. Specifically, if there is any short position by the petitioner, real party-in-interest, or privy of the petitioner on the company whom they are seeking an IPR against, the judge would deny the IPR Petition. Such a rule would coincide with Spangenberg’s request for the USPTO to call “balls and strikes” for both the high tech and pharmaceutical industries.¹⁶⁹

Furthermore, the rule change avoids affecting general patent policy, which is in great controversy as to how innovation may be best protected.¹⁷⁰ While many agree that there need to be changes to current patent law, there is very little agreement about what is the correct measure.¹⁷¹ Therefore, any significant reform patent act may be stalled in Congress due to disagreement.¹⁷² In consideration of the uncertainty of the long-term effect of the IPR-stock shorting strategy on the stocks of companies,¹⁷³ it would also be unwise for any patent act to use the strategy as a reason to implement ambitious changes to patent law. However, this article’s suggested rule change is not ambitious in scope, but rather, simply and quickly disables an unintended consequence of the AIA.¹⁷⁴

IV. CONCLUSION

Any indirect public benefit of lower cost drugs can be more legitimately achieved (in relation to Congressional intent and the purpose of

¹⁶⁶ Greider, *supra* note 5.

¹⁶⁷ INNOGRAPHY, *supra* note 71.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *See generally* Lavenue et al., *supra* note 145.

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ Sidak & Skog, *supra* note 119.

¹⁷⁴ The unintended consequence being the allowance of the IPR-stock shorting strategy, see Quinn, *supra* note 116.

patent law) by generic brand pharmaceutical companies and pharmaceutical public interest groups implementing IPRs as compared to hedge fund managers using IPR-stock shorting strategies. Therefore, Congress—or the USPTO—should disallow such strategy by allowing IPRs only when the petitioner, real party-in-interest, and privies of the petitioner do not pursue economic gain through stock shorting the company who owns the petitioned patent. This solution avoids the continuing patent policy debates of other alternatives. Furthermore, this narrowly tailored solution avoids causing unintended consequences by simply addressing an unintended consequence of the AIA. As such, the solution may be more amenable to Congress and the various patent-interested entities, and therefore be implemented more quickly.

**NEGOTIATING THE TRANSATLANTIC TRADE AND
INVESTMENT PARTNERSHIP: IS THERE ROOM FOR
COMPROMISE ON THE ISSUE OF FOOD REGULATORY
POLICY?**

*Sarah Marks**

I. INTRODUCTION

Every once in a while, when I was living in England in 2012, I would get homesick, and long for something “American.” In those moments of weakness, I would run into the closest Starbucks and ask for a caramel Frappuccino, or dash into a McDonald’s and order a chocolate milkshake and french fries. Unfortunately, after my order was made, I remembered why these iconic “American” items did not remind me of American food at all. They did not taste the same. Food laws in Europe and the United Kingdom are stricter than in the United States;¹ therefore, many of the ingredients that are used in food in the United States are banned in the United Kingdom² or the European Union.³

For example, McDonald’s french fries sold in the U.S. are made from thirteen ingredients.⁴ On the other hand, McDonald’s french fries sold

* George Mason School of Law, J.D., May 2017.

¹ See generally Elizabeth Grossman, *Banned In Europe, Safe In The US*, ENSIA (June 9, 2014), <http://ensia.com/features/banned-in-europe-safe-in-the-u-s/>.

² On June 23, 2016, the United Kingdom voted to leave the European Union. See generally Alex Hunt & Brian Wheeler, *Brexit: All You Need to Know About the UK Leaving the EU*, BBC NEWS (Nov. 10, 2016), www.bbc.com/news/uk-politics-32810887. The UK’s official exit from the EU is still being negotiated, and at this point any commentary I could include on the effects the UK’s exit will have on the Transatlantic Trade and Investment Partnership would be pure speculation. If the UK does invoke Article 50 and leave the EU, then it would likely either be a separate party to the TTIP, or need to negotiate its own similar treaty with the USA. See *id.*; see also Patrick Wintour, *US Seeking Bilateral Trade Deal with UK to Press EU on TTIP*, THE GUARDIAN (July 20, 2016 1:41 PM), <https://www.theguardian.com/us-news/2016/jul/20/us-seeking-bilateral-trade-deal-with-uk-to-press-eu-on-ttip>.

³ See Grossman, *supra* note 1; see also Susanna Kim, *11 Food Ingredients Banned Outside the U.S. That We Eat*, ABC NEWS (June 26, 2013), <http://abcnews.go.com/Lifestyle/Food/11-foods-banned-us/story?id=19457237>.

⁴ The ingredients are: potatoes, canola oil, soybean oil, and hydrogenated soybean oil, natural beef flavor (wheat and milk derivatives), citric acid, dextrose, sodium acid pyrophosphate, dimethylpolysiloxane, TBHQ, corn oil, and salt. *Our Food, Your Questions*, MCDONALD’S, <https://www.mcdonalds.com/us/en-us/about-our-food/our-food-your-questions.html> (last visited Nov. 17, 2016) [hereinafter U.S. McDonald’s Fries Ingredients] (select “Ingredients”; then click “What are the ingredients in your fries?”).

in the UK are made from six ingredients.⁵ The ingredients themselves are not the only difference; in the U.S., french fries are cooked in a medley of oils,⁶ but in the UK, french fries are only cooked in non-hydrogenated vegetable oil.⁷ While this may not matter to some consumers, other American consumers are concerned that United States McDonald's french fries have eleven more ingredients in them (including "natural beef flavor" and dimethylpolysiloxane) than its UK counterpart.⁸ While in the past these discrepancies have largely been ignored, today American consumers are starting to pay more attention to what goes in their food.⁹ Given the rise in popularity of "farm to table" restaurants, organic food, and healthy eating, many American consumers are looking for food options that do not have a laundry list of ingredients.¹⁰

In 2013 it appeared that a possible solution to the discrepancies between products in the EU and the U.S. was on the horizon. The Transatlantic Trade and Investment Partnership (TTIP) is a comprehensive trade and investment agreement between the United States and the European Union.¹¹ In June 2013, President Obama announced his intentions to begin TTIP negotiations and released a list of goals; among them was the elimination of "tariffs, and other duties and charges on trade in agricultural, industrial, and consumer products between the United States and the EU,"

⁵ The ingredients are: potatoes, sunflower oil, rapeseed oil, dextrose, non-hydrogenated vegetable oil, and salt. *McDonald's Fries*, MCDONALD'S, www.mcdonalds.co.uk/ukhome/product_nutrition.sides.44.mcdonalds-fries.html (last visited Nov. 17, 2016) [hereinafter UK McDonald's Fries Ingredients] (click on "Ingredient and Allergen information").

⁶ The "oil blend" contains canola oil, corn oil, soybean oil, hydrogenated soybean oil, as well as some preservatives. U.S. McDonald's Fries Ingredients, *supra* note 4.

⁷ Compare U.S. McDonald's Fries Ingredients, *supra* note 4, with UK McDonald's Fries Ingredients, *supra* note 5.

⁸ Compare U.S. McDonald's Fries Ingredients, *supra* note 4, with UK McDonald's Fries Ingredients, *supra* note 5.

⁹ See generally Scarlett Schaefer, *Let's Stop Worrying and Learn to Love Transparency: Food and Technology in the Information Age*, 10 J. FOOD L. & POL'Y 233, 237 (2014).

¹⁰ See Christopher Doering, *Consumers Demand Healthier Ingredients*, USATODAY (Apr. 3, 2015 4:24 PM), <http://www.usatoday.com/story/money/business/2015/04/03/companies-respond-to-demand-for-healthier-ingredients/25250867>; Nancy Gagliardi, *Consumers Want Healthy Foods – And Will Pay More For Them*, FORBES (Feb. 18, 2015 11:30 AM), <http://www.forbes.com/sites/nancygagliardi/2015/02/18/consumers-want-healthy-foods-and-will-pay-more-for-them/>. See generally Schaefer, *supra* note 9, at 375.

¹¹ *Transatlantic Trade and Investment Partnership (T-TIP)*, OFFICE OF THE U.S. TRADE REPRESENTATIVE, <https://ustr.gov/ttip> (last visited Nov. 17, 2016).

and to promote transparency in regulatory practices.¹² The TTIP would eliminate all trade barriers between the U.S. and the EU.¹³ In theory, this would lead to economic growth through an increase in trade, and would result in the creation of more jobs and safer, transparent food regulations.¹⁴ The U.S. and EU negotiated for over three years but were unable to come to a final agreement on TTIP before the end of the Obama administration, and currently there is no set ending date in sight.¹⁵

The European Union has repeatedly stated that they take the purity of their food seriously, and they are unwilling to lower their food regulation standards.¹⁶ Conversely, the United States is unlikely to merely adopt the European Union's policy concerning food additives, genetically modified organisms (GMOs), and food regulation. Additionally, the U.S. is unlikely to bind itself to an unequal "trade partnership" wherein the EU rejects products from the U.S. that do not conform to its standards, but the EU is allowed to export to the U.S., tariff-free, any food products that it wants due to the comparatively lower food regulatory standards of the U.S.¹⁷ Since the election of President Trump, the European Commission has conceded that TTIP negotiations are "in the freezer."¹⁸

This article will discuss the current status of TTIP, and argue that even if the TTIP fails to be implemented, the U.S. should still adopt an amendment to its current food regulatory laws that specifies guidelines that detail the basic scientific processes that all companies should use when testing for the safety of proposed food additives. Additionally, this note will

¹² *U.S. Objectives, U.S. Benefits in the Transatlantic Trade and Investment Partnership: A Detailed View*, OFFICE OF THE U.S. TRADE REPRESENTATIVE (Mar. 11, 2014), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2014/March/US-Objectives-US-Benefits-In-the-TTIP-a-Detailed-View>.

¹³ European Comm'n, *The Transatlantic Trade and Investment Partnership (TTIP): TTIP Explained*, at 1 (Mar. 19, 2015), http://trade.ec.europa.eu/doclib/docs/2014/may/tradoc_152462.pdf.

¹⁴ *Id.*
¹⁵ Elfriede Bierbrauer (Directorate-Gen. for External Policies Policy Dep't), *In-Depth Analysis: The Transatlantic Trade and Investment Partnership (TTIP): The Sluggish State of Negotiations*, at 27, PE 549.074 (Oct. 20, 2015), [http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/549074/EXPO_IDA\(2015\)549074_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/549074/EXPO_IDA(2015)549074_EN.pdf).

¹⁶ See European Comm'n, *Questions and Answers About TTIP: Basics, Benefits, Concerns*, <http://ec.europa.eu/trade/policy/in-focus/ttip/about-ttip/questions-and-answers/> (last updated Sept. 6, 2016) (follow links under "What are some of the concerns?").

¹⁷ See Mark Weaver, *The Proposed Transatlantic Trade and Investment Partnership (TTIP): ISDS Provisions, Reconciliation, and Future Trade Implications*, 29 EMORY INT'L L. REV. 225, 255-56 (2014).

¹⁸ Cecilia Malmström, Eur. Comm'r for Trade, *The future of EU trade policy*, at 2 (Jan. 24, 2017), http://trade.ec.europa.eu/doclib/docs/2017/january/tradoc_155261.pdf.

advocate for additional food testing in the face of conflicting scientific research concerning the safety of proposed food additives or products. These actions would increase both the consumer welfare of American citizens, and the chances of successful TTIP negotiations by alleviating some of the major differences between EU and U.S. food regulatory processes.

First, this article will discuss the U.S. and the EU's current regulatory processes regarding food additives, and each system's approval process for food additives. In addition, this article will explain what the TTIP is, highlight some criticisms of the TTIP, and look at the negotiations between the U.S. and the EU. Second, this article will analyze the differences between EU and U.S. laws concerning food additives and regulatory policies, and explain why these differences matter. Finally, this article will evaluate proposed solutions to negotiate the differences between the U.S. and EU in regards to the TTIP, and then offer a solution that would solve the negotiation disputes while at the same time increasing food safety for U.S. consumers.

II. BACKGROUND

Article In order to understand the arguments the TTIP negotiators have raised, one must first understand the current U.S. food regulatory laws, the Food and Drug Administration (FDA) food additive approval process, the current EU food regulatory laws, the EU's food additive approval process, and the current TTIP status.

A. *The United States' Current Policies and Laws Governing Food Additives and Food Regulatory Standards*

The Food and Drug Administration (FDA) is the oldest consumer protection agency in the United States federal government.¹⁹ The Federal Food, Drug, and Cosmetic Act of 1938 (FDCA) established the modern-day FDA and gave it the power to regulate food standards, food packaging and quality, medicine, cosmetics, and mandated pre-market approval of all new drugs.²⁰ On September 27, 2007, President George W. Bush signed into law the Food and Drug Administration Amendments Act of 2007, which gave

¹⁹ *History*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/AboutFDA/WhatWeDo/History/> (last updated Mar. 23, 2015).

²⁰ 21 U.S.C. § 393(b); *FDA History Part II*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/AboutFDA/WhatWeDo/History/Origin/ucm054826.htm> (last updated Sept. 24, 2012).

the FDA additional authority in the area of medicines and medical products.²¹ President Obama signed the FDA Food Safety Modernization Act (FSMA), the most sweeping reform of food safety laws in more than seventy years, into law on January 4, 2011.²² The goal of FSMA was to shift the focus of federal food safety regulators from responding to potential food-borne illness outbreaks, to preventing them.²³

The laws concerning definitions and standards for food, adulterated food, and food additives are codified in chapter nine, subchapters two and four the FDCA.²⁴ A food additive is broadly considered “any substance added to food.”²⁵ The FDA specifically defines it as “any substance the intended use of which results or may reasonably be expected to result, directly or indirectly, in its becoming a component or otherwise affecting the characteristics of any food.”²⁶ Direct food additives are directly added to food products, while indirect food additives are those that become part of the food in trace amounts due to its packaging, storing, or other handling.²⁷

Not all food additives need pre-approval before they can be used in products.²⁸ Certain food additives, like baking soda or salt, can be added to food products without preapproval because they are considered to be safe additives.²⁹ According to the FDA,

any substance that is reasonably expected to become a component of food is a food additive that is subject to

²¹ See generally Food and Drug Administration Amendments Act of 2007, Pub. L. No. 110-85, 121 Stat. 823 (2007); *Food and Drug Administration Amendments Act (FDAAA) of 2007*, U.S. FOOD & DRUG ADMIN., <https://www.fda.gov/RegulatoryInformation/LawsEnforcedbyFDA/SignificantAmendmentstothefDCAAct/FoodandDrugAdministrationAmendmentsActof2007/default.htm> (last updated Dec. 2, 2011).

²² See generally FDA Food Safety Modernization Act, Pub. L. No. 111-353, 124 Stat. 3885 (2011); *FDA Food Safety Modernization Act*, U.S. FOOD & DRUG ADMIN., <https://www.fda.gov/Food/GuidanceRegulation/FSMA/default.htm> (last updated Apr. 05, 2017).

²³ *FDA Food Safety Modernization Act*, *supra* note 22.

²⁴ See generally 21 U.S.C. §§ 321, 341-42, 348.

²⁵ *Overview of Food Ingredients, Additives, & Colors*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/Food/IngredientsPackagingLabeling/FoodAdditivesIngredients/ucm094211.htm> (last updated Dec. 2, 2014).

²⁶ 21 U.S.C. § 321(s).

²⁷ *Overview of Food Ingredients, Additives, & Colors*, *supra* note 25.

²⁸ *Determining the Regulatory Status of a Food Ingredient*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/Food/IngredientsPackagingLabeling/FoodAdditivesIngredients/ucm228269.htm> (last updated Feb. 10, 2017).

²⁹ See *Overview of Food Ingredients, Additives, & Colors*, *supra* note 25.

premarket approval by FDA, unless the substance is generally recognized as safe (GRAS) among experts qualified by scientific training and experience to evaluate its safety under the conditions of its intended use, or meets one of the other exclusions from the food additive definition in section 201(s) of the Federal Food, Drug, and Cosmetic Act (FFDCA).³⁰

New food additives must undergo premarket approval through the petition process.³¹ The petition process for new food additive approval is as follows: 1) A company creates, for example, a new synthesized sugar that has zero calories, that they want to use in their final food product. 2) The company engages in scientific research, and seeks to demonstrate that the product is not harmful to consumers.³² The FDA offers guidance and a suggested approach to scientific investigations,³³ but companies may use their own approach as long as it satisfies applicable statutes and regulations.³⁴ 3) The scientists present their findings to the company.³⁵ 4) The company either presents the research to the FDA to get approval, or goes back to the drawing board.³⁶ If the company wishes to seek immediate approval, the company must bring scientific evidence to the FDA that shows the product is not harmful to consumers.³⁷ If the research indicates that the proposed food additive is harmful to consumers, then the FDA will reject it or require further research.³⁸ If the research indicates that it is safe, then the FDA will likely approve the food additive.³⁹ That is an incredibly simplified nutshell of how a company obtains food additive approval in the United States.⁴⁰ Steps two and three are loaded with mini-steps and issues,

³⁰ *Determining the Regulatory Status of a Food Ingredient*, *supra* note 28. Exclusions to the food additive definition are codified in the FDCA. 21 U.S.C. § 321(s)(1)-(6).

³¹ *See Determining the Regulatory Status of a Food Ingredient*, *supra* note 28.

³² *See* 21 C.F.R. § 171.1(j) (2016).

³³ *Guidance for Industry: Questions and Answers About the Petition Process*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/Food/GuidanceRegulation/GuidanceDocumentsRegulatoryInformation/Ingredients/Additives/GRASPackaging/ucm253328.htm> (last updated July 1, 2016).

³⁴ *See* 21 C.F.R. § 171.1(k), (m).

³⁵ *Guidance for Industry: Questions and Answers About the Petition Process*, *supra* note 33.

³⁶ *Id.*

³⁷ *See Overview of Food Ingredients, Additives, & Colors*, *supra* note 25.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *See* generally 21 C.F.R. § 171.1-8 for the detailed petition process.

and give rise to much of the debate concerning the regulatory process for new food additives in the U.S.⁴¹

A “not harmful food additive” is typically one that has not yet been proven to be harmful to consumers, but is not necessarily beneficial either.⁴² It is this category that the FDA has a great amount of discretion over, and can choose to reject or accept the proposed food additive as it sees fit.⁴³

Controversies typically arise when a company cannot prove conclusively whether or not a product is harmful, or when a company is able to prove that a product is not harmful right now, but is also unable to prove that it will not be harmful later on after years of human consumption.⁴⁴ In those instances, courts have given the FDA discretion to determine whether or not to allow the food additive to be used.⁴⁵ The agency guidelines concerning the approval or rejection of new food additives have several exceptions to them, specifically regarding products that only contain “trace amounts” of a food additive, and are arguably broader in interpretation than many of the FDA’s foreign counterparts, including EU law.⁴⁶

Companies must go through this process to obtain formal approval status for new food additives.⁴⁷ What about already approved food additives that have been altered in some way? Before 1997, for both types of additives (new and old), FDA scientists had to conduct detailed reviews of the companies’ research.⁴⁸ However, in 1997 everything changed.⁴⁹ In response to industry complaints that the process was too cumbersome and

⁴¹ See 21 C.F.R. § 171.1(j)-(k), (m). See also, *Guidance for Industry: Questions and Answers About the Petition Process*, supra note 33.

⁴² See 21 C.F.R. § 180.1.

⁴³ *Id.*

⁴⁴ See Baruch Fischhoff, *Communicating Risks and Benefits: An Evidence-Based User’s Guide*, U.S. FOOD & DRUG ADMIN. 93 (2011), <https://www.fda.gov/downloads/AboutFDA/ReportsManualsForms/Reports/UCM268069.pdf>.

⁴⁵ *Weinberger v. Bentex Pharmaceuticals, Inc.*, 412 U.S. 645, 653-54 (1973) (noting that the FDA has discretion in cases where the scientific research is inconclusive); see also *Nutraaceutical Corp. v. Von Eschenbach*, 459 F.3d 1033, 1043 (10th Cir. 2006) (finding “[t]he review of scientific literature is properly in the province of the FDA”).

⁴⁶ See Emilie H. Leibovitch, *European Union Food Law Update*, 5 J. FOOD L. & POL’Y 265, 270 (2009).

⁴⁷ *Guidance for Industry: Questions and Answers About the Petition Process*, supra note 33.

⁴⁸ Kimberly Kindy, *Food Additives on the Rise as FDA Scrutiny Wanes*, THE WASHINGTON POST, (Aug. 17, 2014), https://www.washingtonpost.com/national/food-additives-on-the-rise-as-fda-scrutiny-wanes/2014/08/17/828e9bf8-1cb2-11e4-ab7b-696c295ddfd1_story.html.

⁴⁹ *Id.*

did not actually improve food safety, the FDA proposed that companies that were using common, not new, food additives that were Generally Recognized as Safe (GRAS)⁵⁰, did not have to submit all of their research and raw data.⁵¹ In order to streamline the process, the companies could just share a summary of their findings with the FDA.⁵² These changes did not work out the way the FDA intended.⁵³ While some companies continued to pursue FDA approval through the formal petition process, other companies introduced additives without informing the FDA, or opted for the new cursory GRAS process if their product qualified to be reviewed under it.⁵⁴

The FDA does have some ways to deal with companies that submit a less than accurate GRAS petition, or decide not to inform the FDA of food additives in their products. The recently enacted FDA Food Safety Modernization Act is intended to help the FDA to strengthen the food safety system by focusing on contamination prevention at food facilities, and mandating inspection frequencies and food testing by accredited laboratories.⁵⁵ The FSMA also expanded the FDA's discretionary power of administrative detention, the "procedure the FDA uses to keep suspect food from being moved."⁵⁶ The FDA may order the detention of any food product during an inspection, examination, or investigation, if it has reason to believe it is adulterated or misbranded.⁵⁷ While processes such as administrative detention can be used to keep certain food products out of

⁵⁰ Kindy, *supra* note 48; *Frequently Asked Questions About GRAS for Substances Intended for Use in Human or Animal Food: Guidance for Industry*, U.S. FOOD & DRUG ADMIN., 4 (Oct. 2016), <https://www.fda.gov/downloads/Food/GuidanceRegulation/GuidanceDocumentsRegulatoryInformation/UCM525233.pdf> ("Under sections 201(s) and 409 of the Federal Food, Drug, and Cosmetic Act, any substance that is intentionally added to food is a food additive, that is subject to premarket review and approval by FDA, unless the substance is generally recognized, among qualified experts, as having been adequately shown to be safe under the conditions of its intended use, or unless the use of the substance is otherwise excluded from the definition of a food additive.").

⁵¹ Kindy, *supra* note 48.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *See generally Background on the FDA Food Safety Modernization Act (FSMA)*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm239907.htm> (last updated July 13, 2015).

⁵⁶ *Id.* *See generally* 21 U.S.C. § 334(a)(1) ("[a]ny article of food, drug or cosmetic that is adulterated or misbranded" may be seized).

⁵⁷ *Guidance for Industry: What you need to know about Administrative Detention of Foods Small Entity Compliance Guide*, U.S. FOOD & DRUG ADMIN., <https://www.fda.gov/downloads/Food/GuidanceRegulation/UCM342591.pdf> (last revised Mar. 2013).

the market until a decision is made concerning their safety, it is still ultimately up to the FDA to either prohibit the food product or release it from detention.⁵⁸ Conversely, the European Union has adopted a different strategy concerning food safety and policy.

B. The European Union's Current Policies and Laws Governing Food Additives and Food Regulatory Standards

In contrast to the U.S. approach of prohibiting only additives that are known to be harmful, the EU approach is that additives cannot be used unless they have been proven to be safe. Multiple food incidents in the late 1990s highlighted the need to establish principles and requirements concerning food and animal feed at an EU-wide level.⁵⁹ The food-related crises, involving Bovine Spongiform Encephalopathy (BSE, and commonly referred to as mad cow disease),⁶⁰ Salmonella,⁶¹ and dioxins⁶² destroyed consumer confidence in the food production and distribution system at that time.⁶³ Therefore, the European Commission, the governing body of the EU, developed an integrated approach to food safety that it called “farm to table,”⁶⁴ and in 2002, the EU adopted Regulation No. 178/2002 (General Food Law Regulation), which outlined the general principles and requirements for food law for all EU member states.⁶⁵ The regulation also

⁵⁸ *Guidance for Industry*, *supra* note 57.

⁵⁹ *General Food Law*, EUROPEAN COMM'N http://ec.europa.eu/food/safety/general_food_law_en (last updated April. 6, 2017). Previously, each member of the European Union determined its own food safety standards and policies.

⁶⁰ Bovine Spongiform Encephalopathy, also known as “mad cow disease,” is a brain disorder in cattle that may be spread to humans through diseased meat. *See Bovine Spongiform Encephalopathy (BSE) Questions and Answers*, U.S. FOOD & DRUG ADMIN., www.fda.gov/BiologicsBloodVaccines/SafetyAvailability/ucm111482.htm (last updated Aug. 24, 2015).

⁶¹ Salmonella is a type of bacteria that commonly causes food poisoning. *Salmonella Enterocolitis*, U.S. NAT'L LIBRARY OF MED., <https://medlineplus.gov/ency/article/000294.htm> (last updated Mar. 13, 2016).

⁶² Dioxins are environmental pollutants that are highly toxic. *Dioxins and Their Effect on Human Health*, WORLD HEALTH ORG., <http://www.who.int/mediacentre/factsheets/fs225/en/> (last updated Oct. 2016).

⁶³ European Commission Memo/12/869, FAQ: European Food Safety Authority (EFSA) @ 10 years (Nov. 16, 2012), http://europa.eu/rapid/press-release_MEMO-12-869_en.htm [hereinafter EFSA FAQ].

⁶⁴ *See Food Safety: Overview*, EUROPEAN COMM'N http://ec.europa.eu/food/index_en.htm (last updated Nov. 21, 2016). “Farm to table” refers to “the stages of production of food: harvesting, storage, processing, packaging, sales, and consumption.” Richard Pitman, *Food Safety Risks with Farm-To-Table*, NOBLE COMMUNIC'NS, <http://www.noble.net/leadership/food-project-two/> (last visited Nov. 20, 2016).

⁶⁵ *See generally* Regulation (EC) No 178/2002 of the European Parliament and of the Council of 28 January 2002 Laying Down the General Principles and Requirements of Food

established an independent agency responsible for scientific advice and support, called the European Food Safety Authority (EFSA).⁶⁶ The EFSA is responsible for providing independent scientific advice and technical support for EU policy concerning food safety.⁶⁷ It has a network of 1,500 external experts and more than 300 scientific institutions.⁶⁸

The EFSA oversees the risk assessment of food additives and genetically modified organisms (GMOs).⁶⁹ EU member states may adopt or implement stricter food safety guidelines, but no member state may have looser regulations than those laid out in the GMO regulations or any of its amendments, and those adopted by the EFSA.⁷⁰ The EFSA strictly checks proposed GMO products, which are allowed on a case-by-case basis only.⁷¹ Some EU member areas such as Northern Ireland and Scotland have issued an outright ban on all GMO products.⁷²

Under EU legislation, food additives must be authorized before they can be used in foods.⁷³ All accepted food additives are assigned an “E number” for future reference by both companies and the EFSA.⁷⁴ In 2009, the EFSA published the data requirements for the evaluation of food additive applications.⁷⁵ Pursuant to Regulation (EC) No. 1333/2008 on food additives, “food additives should be approved and used only if they . . .

Law, Establishing the European Food Safety Authority and Laying Down Procedures in Matters of Food Safety, 2002 O.J. (L 31) 1 [hereinafter *EC Regulation*]; *General Food Law*, *supra* note 59.

⁶⁶ *EC Regulation*, *supra* note 65, at art. 22; *General Food Law*, *supra* note 59.

⁶⁷ *General Food Law*, *supra* note 59.

⁶⁸ EFSA FAQ, *supra* note 63.

⁶⁹ LIBRARY OF CONG., *Restrictions on Genetically Modified Organisms: European Union*, <http://www.loc.gov/law/help/restrictions-on-gmos/eu.php> (last updated June 9, 2015).

⁷⁰ *Id.*; Conor Macauley, *GM-crop Growing Banned in Northern Ireland*, BBC NEWS (Sept. 21, 2015), <http://www.bbc.com/news/world-europe-34316778>.

⁷¹ See *EC Regulation*, *supra* note 65, at art. 22; Regulation (EC) No 1829/2003 of the European Parliament and of the Council of 22 September 2003 on genetically modified food and feed, (9) 2003 O.J. (L 268) 1, 2; LIBRARY OF CONG., *supra* note 69.

⁷² Macauley, *supra* note 70.

⁷³ See EUROPEAN FOOD SAFETY AUTH., *Food Additives*, <http://www.efsa.europa.eu/en/topics/topic/additives> (last visited Nov. 21, 2016) [hereinafter *Food Additives*](select “EU Framework”).

⁷⁴ See *id.*

⁷⁵ Leibovitch, *supra* note 46, at 270.

[are] safe when used, there . . . [is] a technological necessity for their use, and their use does not mislead the consumer.”⁷⁶

EU food legislation separates the roles of risk assessment and risk management.⁷⁷ The EFSA is responsible for risk assessment and providing scientific advice, but the ultimate decision-making power to admit or deny a food additive is held by the European Commission.⁷⁸ The process for authorization of a new food additive under EU law, in a nutshell, is as follows: 1) The company must submit a formal request (application) to the European Commission with information on the proposed additive, including scientific data concerning its safety.⁷⁹ 2) If the European Commission deems the application to be acceptable, it sends the application to the EFSA for its scientific opinion on the safety of the proposed food additive.⁸⁰ 3) The EFSA determines whether or not the food additive is safe, and makes sure it conforms to all current European Commission regulations.⁸¹ If the EFSA deems the proposed additive to be safe, it is often approved.⁸² This second round of scientific testing is a major difference between the FDA food additive approval process in the U.S., and the EU’s process under the European Commission and the EFSA.⁸³

C. *The Transatlantic Trade and Investment Partnership (TTIP)*

The European Union and the United States are currently negotiating the Transatlantic Trade and Investment Partnership, a free trade agreement whose goal is to create jobs and stimulate economic growth by removing trade barriers.⁸⁴ The main elements of the proposed agreement are market access, improved regulatory coherence, and improved cooperation for setting international standards.⁸⁵

⁷⁶ *Id.*; see Regulation (EC) No 1333/2008 of the European Parliament and of the Council of 16 December 2008 on food additives, art. 6 2008 O.J. (L 354) 16, 21.

⁷⁷ See *Food Law General Principles*, EUROPEAN COMM’N, ec.europa.eu/food/safety/general_food_law/principles_en (last updated Nov. 22, 2016).

⁷⁸ *Id.*

⁷⁹ *Food Additives*, *supra* note 73.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ Leibovitch, *supra* note 46, at 299; see generally Rosemary Lyster, *Sustainability, Regulatory Dilemmas, and GMOs: the US and the EU Compared*, 8 ASIA PAC. J. ENVTL. L. 111 (2004).

⁸⁴ European Comm’n, *The Transatlantic Trade and Investment Partnership (TTIP): TTIP Explained*, *supra* note 13, at 1.

⁸⁵ *Id.*

Throughout the TTIP negotiations, all of EU's member states are represented by the European Commission.⁸⁶ The United States Trade Representative represents the U.S.⁸⁷ The first round of TTIP negotiation talks began in June 2013 and had continued every few weeks, until the election of President Trump put TTIP negotiations on the back burner.⁸⁸

Despite both the U.S. and EU committing to the common goals of the TTIP, both governing bodies have different regulatory structures and traditions.⁸⁹ Many products in the U.S. contain GMOs and food additives that are currently banned in the EU, either expressly by the EFSA or by particular member states.⁹⁰ Food law and regulatory standards have been, and continue to be, a major point of contention between the U.S. and the EU, and the most recent TTIP negotiation talks in 2015 had not seen either side relenting.⁹¹

The European Union is concerned that the U.S. food regulatory laws allow GMOs and certain EU-banned food additives because the EU does not want these products slipping into its countries.⁹² The U.S. does not require companies to indicate the presence of GMOs in food, and does not require companies that produce crop seeds to indicate whether or not the seeds are genetically modified.⁹³ This is alarming to the EU, considering that many of its countries have outright banned GMOs and GMO products.⁹⁴ The EU's approach to food safety is that if a product cannot be proven to be safe, it is not allowed.⁹⁵ Many EU citizens have expressed worries that the TTIP will lead to lower regulatory protection and lower

⁸⁶ European Comm'n, *The Transatlantic Trade and Investment Partnership (TTIP): TTIP Explained*, *supra* note 13, at 3.

⁸⁷ *Id.*

⁸⁸ *Id.*; See Malmström, *supra* note 18.

⁸⁹ European Comm'n, *The Transatlantic Trade and Investment Partnership (TTIP): TTIP Explained*, *supra* note 13 at 1-2.

⁹⁰ See Stefan Martinić & Mihael Maljak, *Certain Controversial Issues of EU-US Trade Negotiations Leading to the Signing of the Transatlantic Trade and Investment Partnership (TTIP)*, 10 CROATIAN Y.B. EUR. L. & POL'Y 341, 350 n.45 (2014).

⁹¹ European Comm'n, *Food Safety and Animal and Plant Health in TTIP* (Jan. 2015), <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1230> (click "Factsheet on Food Safety and Animal and Plant Health (SPS)").

⁹² European Comm'n, *TTIP and Regulation: An Overview*, Feb. 10, 2015, http://trade.ec.europa.eu/doclib/docs/2015/february/tradoc_153121.pdf.

⁹³ David Johnson and Siobhan O'Connor, *These Charts Show Every Genetically Modified Food People Already Eat In The U.S.*, TIME MAG., April 30, 2015, <http://time.com/3840073/gmo-food-charts/>.

⁹⁴ Leibovitch, *supra* note 46, at 299-301; LIBRARY OF CONG., *supra* note 69; Macauley, *supra*, at 71.

⁹⁵ See generally Lyster, *supra* note 83, at 113.

food safety standards.⁹⁶ To alleviate internal opposition to the TTIP, the EU has repeatedly stated that the TTIP will do nothing to change the current EU food safety laws; hence, throughout the negotiations, they have refused to entertain any contractual clauses that would lower current EU regulatory standards.⁹⁷ The TTIP faces much criticism, even beyond the food regulatory provisions. It is possible that the Trump administration will not pursue further TTIP negotiations.⁹⁸ Some fear that the benefits of free trade “have flowed disproportionately to corporations, investors, and well-educated workers.”⁹⁹ Another criticism is that the harm to less-educated workers will outweigh the benefits to consumers.¹⁰⁰ Part of the free trade movement involves the free movement of labor, which some fear may ultimately lead to an increase in American unemployment as companies move their factories elsewhere in search of cheaper labor.¹⁰¹

While the Obama administration supported free trade and the TTIP negotiations, the Trump administration has expressed skepticism about free trade deals.¹⁰² In fact, President Trump has exhibited an “America first approach” that involves taking a stand against foreign competitors, and signing a Presidential Memorandum to withdraw from the Trans-Pacific Partnership (TPP) free trade agreement that was negotiated by the Obama administration.¹⁰³ Despite the perilous and uncertain fate of the TTIP, the U.S. will still benefit from an amendment to the current food regulatory laws. An additional round of independent scientific testing for proposed food additives would help ensure that the proposed additive is indeed safe for consumption, and would increase the overall welfare of American consumers.

⁹⁶ The European Comm’n, *TTIP and Regulation: An Overview*, *supra* note 92, at 3.

⁹⁷ *Id.* at 6.

⁹⁸ See Malmström, *supra* note 18.

⁹⁹ Sewell Chan, *Greenpeace Leaks U.S.-E.U. Trade Deal Documents*, N.Y. TIMES, May 2, 2016, <https://www.nytimes.com/2016/05/03/world/europe/ttip-greenpeace-leak-trade-deal.html>.

¹⁰⁰ *Id.*

¹⁰¹ See *id.*

¹⁰² See *Barack Obama on Free Trade*, On The Issues, http://www.ontheissues.org/2016/Barack_Obama_Free_Trade.htm (last updated Oct. 12, 2016); See also Edward Alden *The Roots of Trump’s Trade Rage*, POLITICO, Jan. 16, 2017, <http://www.politico.com/magazine/story/2017/01/the-roots-of-trumps-trade-rage-214639>.

¹⁰³ Peter Baker, *Trump Abandons Trans-Pacific Partnership, Obama’s Signature Trade Deal*, N.Y. TIMES, Jan. 23, 2017, <https://www.nytimes.com/2017/01/23/us/politics/tpp-trump-trade-nafta.html>; Mem. on the Withdrawal of the United States From the Trans-Pacific Partnership Negotiations and Agreement, 82 Fed. Reg. 8497 (Jan. 25, 2017).

III. ANALYSIS

Currently, there are major food regulation differences between the FDA and EFSA.¹⁰⁴ These differences have led to somewhat of a stalemate in the TTIP negotiations.¹⁰⁵ The United States currently produces a lot of its produce and crops using GMOs.¹⁰⁶ It would not be economically feasible for this practice to cease immediately due to the massive amounts of genetically modified food grown and consumed in the U.S.¹⁰⁷ It would also not make sense for the U.S. to enter into an agreement with the EU whereby tariffs are lifted on imports and exports, but regulatory law remains as it is. This would result in an influx of cheaper EU food goods coming into the U.S., but the U.S. would not be able to reciprocate without changing certain ingredients and manufacturing processes to comply with EU standards. Hence, each side is not willing to concede to the other's regulatory standards.

This analysis will evaluate the major differences in food regulation between the U.S. and EU, and why they present a problem for TTIP negotiations. Then it will introduce and review proposed solutions to end the TTIP stalemate that have been presented by other academics, the EFSA, and the U.S. Finally, it will present a new solution to the TTIP negotiation stalemate.

A. *The Major Differences Between the FDA and EFSA Policies Concerning the Regulation of Food Additives, and Why They Matter*

A major point of contention in the TTIP negotiations stemmed from the differences in FDA regulations compared to the EFSA procedures. The FDA's comparatively lax standards are seemingly incompatible with the EFSA's more stringent requirements. To understand why, it is important to critically analyze the differences between FDA and EFSA policies. A complete understanding of the differences, and of proposed solutions, will help promote trade between the U.S. and EU in regards to foods and food products.

¹⁰⁴ See generally Martinić, *supra* note 90 at 366.

¹⁰⁵ *Despite Obama's Push, TTIP Talks Are Stalled*, POLICY REV., (Apr. 2016), <http://www.policyreview.eu/despite-obamas-push-ttip-talks-are-stalled/>.

¹⁰⁶ See Johnson, *supra* note 93.

¹⁰⁷ See Jason Lusk and Henry I. Miller, *We Need G.M.O. Wheat*, N.Y. TIMES, (Feb. 2, 2014), http://www.nytimes.com/2014/02/03/opinion/we-need-gmo-wheat.html?_r=0.

I. *Food Additive Regulatory Policies: The FDA versus the EFSA*

The FDA and EFSA have adopted different regulatory approaches concerning the processes that food additives and other consumer products must undergo in order to enter the market.¹⁰⁸ The EU follows the precautionary principle, meaning producers must demonstrate the safety of food additives before they can be approved for sale on the market.¹⁰⁹ The precautionary principle implements the EU's "better safe than sorry" approach.¹¹⁰ EU regulations prohibit the circulation of food or other consumables in its markets unless it has been proven that they are not completely healthy.¹¹¹ The EFSA requires all companies submitting applications for new food additives to include scientific data that proves that the additive is not harmful.¹¹² If the scientific data is inconclusive, the food additive will be rejected.¹¹³

In contrast to the EU approach, in the U.S., FDA regulators give food additives no additional oversight beyond the petition materials submitted by manufacturers and companies.¹¹⁴ Companies must prove that either the additive is not harmful, or that scientific research shows that it cannot be determined whether the product is harmful or not.¹¹⁵ If scientific research is inconclusive, the FDA has the discretionary power to approve or deny petitions.¹¹⁶ Historically, the FDA has allowed scientifically inconclusive additives, with the mindset that the products can always be pulled from the market if subsequent scientific research shows that the additive does indeed have harmful effects.¹¹⁷

In the EU, companies are required to submit food additive approval applications to the European Commission, which then reviews them and passes them on to the EFSA for a second round of review.¹¹⁸ In

¹⁰⁸ Compare 21 C.F.R. § 171.1-8 with *Food Additives*, *supra* note 73.

¹⁰⁹ *EC Regulation*, *supra* note 65, at Art. 7.

¹¹⁰ Martinić, *supra* note 90, at 351.

¹¹¹ *Id.*

¹¹² *Food Additives*, *supra* note 73.

¹¹³ *Id.*

¹¹⁴ Martinić, *supra* note 90, at 351.

¹¹⁵ See *Guidance for Industry: Questions and Answers About the Petition Process*, *supra* note 33.

¹¹⁶ This power was given to the FDA under the Food, Drug, and Cosmetic Act (FDCA). See *Nutraceutical Corp. v. Von Eschenbach*, 459 F.3d 1033, 1034-44 (10th Cir. 2006).

¹¹⁷ Sandra Fung, *Negotiating Regulatory Coherence: The Costs and Consequences of Disparate Regulatory Principles in the Transatlantic Trade and Investment Partnership Agreement Between the United States and the European Union*, 47 CORNELL INT'L L.J. 445, 448-50 (2014).

¹¹⁸ See *General Food Law*, *supra* note 59.

the U.S., the FDA is the only agency that evaluates the food additive approval process.¹¹⁹ Because the EU's approval process contains an additional evaluating agency and a second round of scientific review, the EFSA's approval process is more rigorous and thorough than the FDA's approval process.

For example, in the U.S., food safety is ensured at the end of the process, once a food product is in its finished form and ready for consumer consumption.¹²⁰ Conversely, in the EU, food safety is ensured from production to consumption.¹²¹ For example, in the U.S., oysters themselves are not tested, only the water they are harvested from is; however, in the EU, the oysters themselves are tested to ensure that no bacteria or disease has manifested.¹²²

2. *The Current TTIP Negotiations and Why the Lack of Agreement Between the U.S. and EU on Food Regulatory Policies is a Problem*

The EU has already stated that it will not allow EFSA food standards to be reduced, and that "EU standards simply aren't up for negotiation."¹²³ This hard stance is part of the reason for the current TTIP stalemate.¹²⁴ Negotiations are still ongoing, but neither the U.S. nor the EU seems willing to bend on the issue of food regulatory policies.¹²⁵ The U.S. will not abandon its cost-benefit analysis approach, and the EU will not yield on its "better safe than sorry" approach.¹²⁶

This is a problem for two reasons. First, after three years of negotiations, neither side is willing to budge on this issue.¹²⁷ (It is likely that neither side wants to appear weak by giving in after two years of debating this issue.) Second, eliminating trade tariffs with the current standards in place would mean that the U.S. would open its market to many EU food producers, but food producers from the U.S. would still find themselves

¹¹⁹ *Determining the Regulatory Status of a Food Ingredient*, *supra* note 28.

¹²⁰ *Id.*

¹²¹ *EC Regulation*, *supra* note 65, at art. 1.

¹²² See European Comm'n, *The Top 10 Myths About TTIP*, at 5, http://trade.ec.europa.eu/doclib/docs/2015/march/tradoc_153266.pdf (2015).

¹²³ *Id.* at 4.

¹²⁴ See Emma Powell, *How EU-US Trade Deal Will Boost Business Prospects*, 24 INT'L TAX REV. 44, 44-45 (2013-2014).

¹²⁵ See *id.* at 45.

¹²⁶ Fung, *supra* note 117, at 447.

¹²⁷ See European Comm'n, *Textual Proposal on Regulatory Cooperation in TTIP* (May 4, 2015), http://trade.ec.europa.eu/doclib/docs/2015/april/tradoc_153403.pdf; see also Fung, *supra* note 117, at 447.

shut out of the EU market due to the stricter EU food regulations.¹²⁸ This is something the U.S. will not agree to. Furthermore, certain products made with food additives that the EU currently bans, are more cost-effective and cheaper than their EU counterparts.¹²⁹ If the EU were to accept FDA standards, “not only would cheaper products arrive on the EU market, but [also the cost of] existing, regular products would also have [to decrease] in price in order to compete with [the new products] from the U.S.”¹³⁰ This is a scenario that some EU citizens are currently facing in the wake of the recently concluded EU-Vietnam Free Trade Agreement (FTA).¹³¹ EU rice farmers have been protesting the EU-Vietnam FTA because they worry that cheaper, tariff-free rice from Vietnam will damage local business by making it harder for EU rice brands to compete.¹³²

3. *Previously Proposed Solutions to End the TTIP Stalemate*

Three main solutions have been proposed by academics: 1) The U.S. should adopt the EU’s food regulatory policies; 2) The U.S. should allow the EU to ship products, tariff free, to the USA, but the USA should respect the EU’s stricter food regulations and only export products that comply with the EU’s policies; and 3) The USA and the EU should mutually agree to respect and abide by each other’s policies.¹³³

Concerning the first proposed solution, a complete adoption of the EU’s food regulations and EFSA’s policies is not feasible in practice. At least 70% of processed foods in U.S. supermarkets contain GMOs.¹³⁴ Conversely, the EU and its members tightly regulate and in some cases outright ban GMOs and GMO products.¹³⁵ Based on the widespread usage of GMO products in the U.S., it would be a great economic hardship for the U.S. to completely eliminate them.¹³⁶

¹²⁸ See Weaver, *supra* note 16, at 255.

¹²⁹ Martinić, *supra* note 90, at 354.

¹³⁰ *Id.*

¹³¹ Chiara Teofili, *Hogan: EU-Vietnam Deal Won’t Hurt Italian Rice*, EURACTIV (Aug. 28, 2015), <http://www.euractiv.com/sections/agriculture-food/hogan-eu-vietnam-deal-wont-hurt-italian-rice-317152>.

¹³² *Id.*; see *Infra* Part B.

¹³³ See Weaver, *supra* note 16, at 255; see also Fung, *supra* note 117, at 447-48.

¹³⁴ Fung, *supra* note 117, at 456; Center For Food Safety, *About Genetically Engineered Foods*, <http://www.centerforfoodsafety.org/issues/311/ge-foods/about-ge-foods#> (last visited Oct. 29, 2016).

¹³⁵ LIBRARY OF CONG., *supra* note 69.

¹³⁶ See Farzad Taheripour, et al., *Evaluation of Economic, Land Use, and Land Use Emission Impacts of Substituting Non-GMO Crops for GMO in the US*, AGECON, 2015, <http://ageconsearch.tind.io/record/204907/files/AAEA%20GMO%20final3.pdf>.

Also, the EU divides food regulation between the European Commission, which has final management and approval authority, and the EFSA, which independently provides a risk assessment and scientific check on food products.¹³⁷ Separating the FDA in a similar manner would require a restructuring of the entire agency itself, and probably require legislative action. A complete adoption of EU regulations and EFSA policy is not practical due to the large amount of time, cost, and legislative action that would be required to implement such a large change. An amendment to the language of 21 U.S.C. § 348, which gives the FDA wide latitude in determining the approval process for new food additives, as discussed later, is more appropriate.¹³⁸

The second proposed solution, wherein the U.S. is only allowed to export products that comply with current EU standards,¹³⁹ is not in the U.S.'s best interests for trade and economic reasons. If this solution were to be implemented, many products from the EU would enter the U.S. tariff-free, but the U.S. would not reciprocally benefit via exports. The EU would have greater access to the U.S.'s market, but the U.S. would not have greater access to the EU market. The purpose of the TTIP is for both the U.S. and the EU to benefit via open trade and economic growth and stimulation.¹⁴⁰ In this scenario, the EU's benefits would outweigh the benefits to the U.S.

The final proposed solution, wherein the U.S. and EU mutually agree to abide by each other's current policies,¹⁴¹ is also likely to fail. There are conflicts between U.S. food policies under the FDA, and EU food policies under the European Commission and EFSA, that will not be resolved naturally. For example, the conflicting testing procedures for oysters in the EU versus in the U.S. do not have a natural resolution. While some might say, "do both," under the cost-benefit analysis that the FDA follows,¹⁴² it is redundant to check the oysters twice before they are approved to be safe for consumption. Additionally, the price of the oysters themselves would likely increase due to the extra costs associated with testing them twice before they are sold to consumers.

Also, the FDA evaluates the research and scientific studies done by companies on proposed food additives, but it does not conduct its own

¹³⁷ *General Food Law*, *supra* note 59.

¹³⁸ *Infra* Section II, B.

¹³⁹ Weaver, *supra* note 16, at 241; Fung, *supra* note 117, at 447.

¹⁴⁰ *See* Weaver, *supra* note 16.

¹⁴¹ *Id.*; Fung, *supra* note 117, at 448.

¹⁴² Fung, *supra* note 117, at 449.

independent scientific studies for every proposed additive.¹⁴³ The EFSA does do its own independent scientific studies to make sure that the results proffered by the company and the results that its scientists obtain are the same.¹⁴⁴ How would those policies be naturally reconciled? They would not, without legislation, reach a natural harmony. Furthermore, this idea, proposed by Sandra Fung in her article “Negotiating Regulatory Coherence: The Costs and Consequences of Disparate Regulatory Principles in the Transatlantic Trade and Investment Partnership Agreement Between the United States and the European Union,” suggests that if under one country’s policy, a product is allowed, then the other country should accept that product too.¹⁴⁵ This would basically lead to the EU adopting U.S. standards because the U.S. has looser food regulatory standards, and allows more food additives than the EU does.¹⁴⁶ Therefore, this proposed solution will ultimately fail because the EU has repeatedly stated that it is unwilling to lower its food regulatory standards.¹⁴⁷

B. An Alternative Proposed Solution to the TTIP Stalemate: Congress Should Amend the Policy of Automatic FDA Discretion and Require an Extra Round of Scientific Testing Before The Agency Makes a Final Decision.

To help facilitate the TTIP negotiations and increase the consumer welfare of American citizens, Congress should adopt an amendment to 21 U.S.C § 348.¹⁴⁸ The amendment should provide more detailed guidelines for the scientific process of testing food additives, implement a more conservative policy by altering automatic FDA discretion, and require an extra round of scientific testing when inconclusive scientific data is presented.

The FDA has broad discretion in determining the safety of food additives.¹⁴⁹ Food additives are deemed unsafe unless they conform to the terms of an exemption, or are in conformity with a regulation issued under

¹⁴³ *Guidance for Industry: Questions and Answers About the Petition Process*, *supra* note 33.

¹⁴⁴ Leibovitch, *supra* note 46 at 127, 128 (2009).

¹⁴⁵ See Fung, *supra* note 117, at 471.

¹⁴⁶ See Monica Eng, *U.S. Allows Chemicals In Food That Are Illegal Elsewhere*, CHICAGO TRIBUNE NEWS (Jan. 21, 2013), http://articles.chicagotribune.com/2013-01-21/news/ct-met-banned-food-practices-20130121_1_safety-of-food-additives-bvo-ingredient.

¹⁴⁷ Martinić, *supra* note 90, at 350.

¹⁴⁸ This statute describes food additives, the petition process for a new food additive to be introduced into the market, and food additives exempted from the petition process.

¹⁴⁹ See *Nutraceutical Corp. v. Von Eschenbach*, 459 F.3d 1033, 1035 (10th Cir. 2006).

21 U.S.C. § 348.¹⁵⁰ Under the law, the FDA must consider certain factors when making the decision whether or not to allow a food additive. These mandatory factors are: the probable consumption of the additive, the cumulative effect of the additive in the diet of humans or animals, and “safety factors which in the opinion of experts qualified by scientific training and experience to evaluate the safety of food additives, are generally recognized as appropriate.”¹⁵¹ Also, 21 U.S.C. § 348(c)(4) sets a tolerance limit for food additives; the FDA must establish tolerance limits to ensure safety when tolerance limits are appropriate.¹⁵² Unfortunately, these codified limits and factors do not provide a clear, definitive framework for determining food additive safety because they are vague, and leave many decisions (such as what an appropriate limit is) to agency deference.

An amendment with more definitive language concerning the parameters and guidelines for food additives would both increase American consumer welfare and possibly help ease some tension between EU and U.S. food regulatory policies. The FDA produces a large guidance document (FDA Guidance for Industry) outlining its current thinking on safety assessments and scientific studies for proposed food additives.¹⁵³ The FDA Guidance for Industry contains information concerning the basic elements of a safety assessment for an additive, the chemical information the FDA looks for, and the suggested scientific documentation to support a petition for food additive approval.¹⁵⁴ However, this document contains nonbinding recommendations, not required steps that all companies must follow.¹⁵⁵ The FDA Guidance for Industry represents the FDA’s current opinion on a topic, but the FDA and American food producers are not bound by it.¹⁵⁶

The U.S. should codify the FDA Guidance for Industry through an amendment to 21 U.S.C. § 348. With this change, both American and EU consumers would not have to question the process that food additives undergo because there would be a uniform process that all American companies would have to abide by. One point of contention brought up by the EU during TTIP negotiations is the lack of uniformity and the broad,

¹⁵⁰ 21 U.S.C. § 348 (a)(1)-(2).

¹⁵¹ 21 U.S.C. § 348 (c)(5)(A)-(C).

¹⁵² See 21 U.S.C. § 348(c)(4).

¹⁵³ *Guidance for Industry: Questions and Answers About the Petition Process*, *supra* note 33.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Food Guidance Documents*, U.S. FOOD & DRUG ADMIN., <http://www.fda.gov/Food/GuidanceRegulation/GuidanceDocumentsRegulatoryInformation/> (last updated Mar. 31, 2017).

discretionary nature of U.S. food safety laws.¹⁵⁷ This change would help alleviate that argument. If the FDA Guidance for Industry became a mandatory document that all American companies must follow, then EU food regulators could read this document and know what process American companies used to test the safety of food additives.

Any Congressional remedy will likely be hard to attain due to potential Congressional gridlock, and the likelihood that this particular issue will not be a Congressional priority.¹⁵⁸ Even if TTIP negotiations fail, this solution should still be implemented. The importance of uniform food regulations extends beyond any free trade agreement. Codifying the FDA Guidance for Industry would add a new level of transparency to the food additive process because both regulators and consumers would know what safety assessments a U.S. company undertook during the testing phase of new food additives. By codifying this document, consumers, not just regulators, would know what safety assessments and scientific documentation companies had to provide during the petition process.

However, the codification of the FDA Guidance for Industry faces hurdles besides Congressional gridlock. Technology is constantly evolving. The FDA Guidance for Industry would likely need to be edited in order to account for new potential technological developments that might increase the accuracy or efficiency of the food additive testing process. If it was codified, it would also need to be broad enough to encompass changes in technology, without needing additional Congressional amendments. Simultaneously, it would need to be detailed enough to adequately explain the testing process and scientific documentation that each company seeking food additive approval would need to provide. While this may be a challenge for the editors of the FDA Guidance for Industry, it is necessary to promote a uniform testing process.

Despite the possible hardships a Congressional amendment will likely face, to further aid in TTIP negotiation efforts, and increase the consumer well being of American citizens, the policy of automatic FDA discretion should be amended. When the FDA is faced with inconclusive scientific data concerning a proposed food additive (data that does not prove whether a food product is harmful or not), the FDA should conduct a second round of scientific testing in an effort to eliminate the inconclusive scientific results. After this round of testing, if the results are still

¹⁵⁷ *TTIP and Regulation: An Overview*, *supra* note 92, at 13.

¹⁵⁸ At this point, it is uncertain if President Trump will seek to abolish TTIP negotiations altogether, or merely place the TTIP towards the bottom of his list of priorities. Any opinion about the future of TTIP negotiations is mere speculation at this point.

inconclusive, then the FDA should be given discretion to ban or allow the food product. This second round of testing is vital because it will help to lessen the chances that the FDA wrongly approves a food additive that later turns out to be harmful.

For example, after many scientific reviews and studies denouncing the evils of trans-fats, the FDA finally banned partially hydrogenated oils.¹⁵⁹ Partially hydrogenated oils are “no longer recognized as safe” in human food, and the FDA has given food manufacturers three years to remove partially hydrogenated oils (PHOs) from their products.¹⁶⁰ PHOs gained widespread use in the 1950s.¹⁶¹ Sixty years later, after the publication of numerous independently conducted scientific studies, the FDA finally acknowledged that partially hydrogenated oils are harmful to humans and can cause clogged arteries, heart disease, and other health problems.¹⁶² The proposed amendment to 21 U.S.C. § 348, containing uniform food additive policies that all companies must follow, will help the FDA catch harmful food additives before they enter market circulation, and might have prevented PHOs uninhibited entry into Americans foods.¹⁶³ In addition, a second round of scientific testing may have produced the data necessary for the FDA to deem PHOs as an unsafe food additive years ago.

This policy would benefit American consumers by reducing the chance that harmful food additives make it into the market. This policy somewhat mirrors the EU’s policy of two rounds of scientific approval (the first with the European Commission and the second with the EFSA).¹⁶⁴ While this policy may be seen as a step away from a cost-benefit analysis policy and towards a “better safe than sorry” policy, in the long run, this

¹⁵⁹ Jen Christensen, *FDA Orders Food Manufacturers to Stop Using Trans Fats Within Three Years*, CNN, <http://www.cnn.com/2015/06/16/health/fda-trans-fat/> (last updated June 16, 2015).

¹⁶⁰ *Id.*; *Final Determination Regarding Partially Hydrogenated Oils (Removing Trans Fats)*, U.S. FOOD & DRUG ADMIN <http://www.fda.gov/Food/IngredientsPackagingLabeling/FoodAdditivesIngredients/ucm449162.htm> (last updated Oct. 7, 2016).

¹⁶¹ Kalyn Weber, *Is the U.S. Finally Saying ‘Goodbye’ to Trans Fats?*, HUFFINGTON POST, http://www.huffingtonpost.com/kalynweber/healthnews_b_4661109.html (last updated Apr 5, 2014).

¹⁶² *Final Determination Regarding Partially Hydrogenated Oils (Removing Trans Fats)*, *supra* note 160.

¹⁶³ I do acknowledge that technology and scientific testing has rapidly changed and evolved in the past 60 years. I am not suggesting that 60 years ago the FDA should have implemented this policy (and figured out that partially hydrogenated oils are bad); rather, I am suggesting that if the FDA were to implement this policy now, scientifically proven harmful food additives would probably not remain in consumer products for over 60 years.

¹⁶⁴ *General Food Law*, *supra* note 59.

would ease some of the EU's hesitancy towards negotiating food regulations under the TTIP.

By demonstrating that the USA is willing to alter its policies on food regulations, the EU may be willing to alter its position as well, should TTIP negotiations ever be revived. Despite taking a hard stance during treaty and implementation negotiations, the EU is capable of compromise. On December 2, 2015, the EU and Vietnam finalized all remaining issues and concluded negotiations on an EU-Vietnam Free Trade Agreement.¹⁶⁵ This agreement represents the result of negotiation and compromise on both sides.¹⁶⁶ While the European Commission calls the FTA a "fair deal," many European rice farmers are worried that it is not.¹⁶⁷ At the beginning of negotiations, the EU claimed the agreement would not disadvantage European companies. However, some have claimed that the EU "used the rice sector as a bargaining chip in a commercial deal with the Southeast Asian countries."¹⁶⁸

In order to make trade agreements or partnerships of this magnitude work, both sides must be open to compromise. Despite the complaints of one particular group in Europe (in this case, the rice farmers¹⁶⁹), the EU-Vietnam agreement will benefit the economies of both countries by increasing trade between them. The EU-Vietnam FTA will eliminate nearly all tariffs (specifically, 99% of tariffs) and will reduce non-tariff barriers to European exports.¹⁷⁰ It took two and a half years of negotiations, but ultimately what most observers consider a mutually beneficial agreement was drafted.¹⁷¹

In 2013, the EU compromised and drafted a trade deal with China concerning solar panels.¹⁷² China had been flooding the market by

¹⁶⁵ European Comm'n, *The EU and Vietnam Finalize Landmark Trade Deal* (Dec. 2, 2015), <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1409>.

¹⁶⁶ *Id.*

¹⁶⁷ Teofili, *supra* note 131.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ European Commission Press Release MEMO/15/5468, Facts and Figures: Free Trade Agreement Between EU and Vietnam (Aug. 4, 2015), http://europa.eu/rapid/press-release_MEMO-15-5468_en.htm.

¹⁷¹ European Commission Press Release IP-15-5467, EU and Vietnam Reach Agreement On Free Trade Deal (Aug. 4, 2015), http://europa.eu/rapid/press-release_IP-15-5467_en.htm.

¹⁷² *EU Imposes Definitive Measures on Chinese Solar Panels, Confirms Undertaking With Chinese Solar Panel Exporters*, EUROPEAN COMM'N (Dec. 2, 2013), <http://trade.ec.europa.eu/doclib/press/index.cfm?id=996>.

selling photovoltaic modules¹⁷³ at prices far below production costs, and the EU initiated punitive tariffs in order to protect European solar power companies.¹⁷⁴ To solve this issue and prevent a trade war, Chinese manufacturers promised to keep a minimum price for the modules and agreed to limits on the total volume of modules shipped to Europe.¹⁷⁵ In return, the EU lifted the punitive tariff on the modules.¹⁷⁶ Neither side was completely happy, but the negotiations resulted in what some solar industry experts called “a fair deal.”¹⁷⁷

As the EU-Vietnam FTA and 2013 EU-Chinese negotiations show, the EU is capable of compromise. Adopting an amendment to 21 U.S.C. § 348 that includes specific guidelines detailing the scientific process for testing food additives, might demonstrate a good faith effort on the part of the U.S. to contribute to TTIP negotiations, and may persuade the EU that compromise on the food related issues surrounding TTIP negotiations is possible. In the long run, the TTIP would expose American citizens to more varieties of food at a competitive price, and would stimulate economic growth in both economies.¹⁷⁸

IV. CONCLUSION

Even if the TTIP negotiations fail, and the TTIP is ultimately not implemented, the United States should still seek to improve its food laws. If the United States would be willing to add an amendment to 21 U.S.C. § 348 to include specific guidelines detailing the scientific process for testing food additives, and add a second round of scientific research and testing before agency discretion is given, it would increase the welfare of American consumers. The benefits of this amendment would be two-fold. First, the amendment would impact consumers directly, via access to healthier food options. Second, the amendment would impact consumers indirectly, through the overall health and wellness effects that come from having a diet rich in vitamins, proteins, and minerals, and low in artificial additives and

¹⁷³ A photovoltaic module is a number of solar cells electrically connected to each other and mounted in a support structure or frame. Multiple photovoltaic modules make up solar panels. Gil Knier, *How Do Photovoltaics Work?*, NASA SCIENCE (Aug. 6, 2008), <http://science.nasa.gov/science-news/science-at-nasa/2002/solarcells/>.

¹⁷⁴ Saroja Coelho, *Solar Trade Deal with China 'a fair compromise'*, DW NEWS, Feb. 8, 2013, <http://www.dw.com/en/solar-trade-deal-with-china-a-fair-compromise/a-16992403>.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *U.S. Objectives, U.S. Benefits in the Transatlantic Trade and Investment Partnership: A Detailed View*, *supra* note 12.

sweeteners. In addition, a tightening of the American regulatory policies concerning food additives may lead to smoother TTIP negotiations, as the policy change may alleviate some of the hesitancy on the part of the EU.

The shift towards simpler, wholesome ingredients is on the rise in America.¹⁷⁹ Consumers are demanding healthier products, with fewer food additives, and companies are responding.¹⁸⁰ For example, Hershey announced that it will use simpler ingredients in its candies: replacing artificial vanilla for real vanilla, switching to non-genetically modified sugar and milk, and using cocoa butter to thicken its chocolate instead of polyglycerol polyricinoleate.¹⁸¹ “Organic” and “all natural” are buzzwords that American consumers are gravitating towards.¹⁸² They want healthier products, and are willing to pay for them. The TTIP would likely lead to cheaper, healthier, and differentiated food products in the United States, and expand consumer choices both in the EU and U.S. in a safe manner. I do not know about you, but I think there are eleven ingredients in my french fries that need to be removed.

¹⁷⁹ See Doering, *supra* note 10.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² See Gagliardi, *supra* note 10.

**THE IMPLICATIONS OF APPLYING *CORNING GILBERT*:
HOW TO PROTECT PATENT HOLDER RIGHTS IN ITC
EXCLUSION ORDER LITIGATION**

*Tanya J.S. Secor**

INTRODUCTION

Imagine you are an inventor.¹ You have spent countless hours developing the new and improved Widget 3000, which far overshadows any other widgets currently on the market. To protect your design, you apply for a patent.² After anxiously waiting two years for your application to be processed,³ the United States Patent and Trademark Office (USPTO) issues you your patent. Finally your hard work and dedication are formally recognized and, most importantly, your product is protected from infringement, or rather, you are accorded a remedy upon infringement. Soon you notice foreign-made widgets on the market that remarkably resemble your own design. Furious, you approach the entity most suitable to resolve the issue: the United States government. After pleading and showing adequate proof of infringement, the United States International Trade Commission (ITC) bans the foreign goods that infringe your patent from entering the country in the form of an exclusion order.⁴ Once again, you feel your work is adequately recognized and protected.

Your effort in protecting the Widget 3000 from infringement is likely not over. The scope of the exclusion order may cover only certain importers or be limited to products with certain characteristics, allowing other, unnamed importers to transport infringing goods into the United States market.⁵ Furthermore, if the United States Customs and Border Protection (CBP or Customs), who is charged with enforcing the exclusion order at the border, is not adequately informed about the exclusion order's scope or your product's unique characteristics, then two scenarios could happen which would negatively affect your interests. First, CBP might inadvertently allow infringing goods into the market.⁶ Alternatively, CBP

* George Mason University School of Law, Juris Doctor, May 2017. I would like to thank my family, friends, and professors for their support and guidance throughout my legal education.

¹ The facts in the introduction are hypothetical but loosely based on *Corning Gilbert Inc. v. United States*, 896 F. Supp. 2d 1281 (Ct. Int'l Trade 2013) discussed later in this Note.

² A patent is a "grant to the patentee, his heirs or assigns, of the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States." 35 U.S.C. § 154(a)(1).

³ As of May 2017, patent applications take an average of 24.8 months to be processed. *May 2017 Patents Data, at a Glance*, U.S. PATENT & TRADEMARK OFFICE, <https://www.uspto.gov/dashboards/patents/main.dashxml>.

⁴ See *infra* Part I(B) discussion on exclusion orders.

⁵ *Id.*

⁶ See *infra* Part I(B)(ii).

might deny entry to goods based on the exclusion order, prompting a challenge by the importer to the Court of International Trade (CIT). Either way, if you believe that the imported goods violate the exclusion order, then you must turn to the ITC for help.

While you can plead directly to the CIT as *amicus curiae*, there is no guarantee that the court will consider your brief.⁷ Therefore, your best option is to appeal to your apparent white knight to represent your interests, the same government agency that granted the exclusion order in the first place—the ITC.⁸ Whether the imported Widget 3000 look-alikes actually infringe your patent or not, one thing becomes clear: it is difficult, time-consuming, and costly for you to defend your interests in this process.

This Note argues that the ITC, CBP, and CIT should enable the involvement of patent holders in all matters concerning alleged infringement to protect the patent holders' rights and to facilitate trade by enabling inter partes communication and participation, effectuating transparency between entities and parties, and establishing clear procedural rules. It does so by analyzing a CIT case, *Corning Gilbert Inc. v. United States*,⁹ in which a patent holder was unable to participate in litigation between the ITC and a company which was importing allegedly infringing goods into the U.S. Whether or not the imported goods actually infringed the patent will not be addressed here. Instead, it is controversial that the patent holder was unable to adequately represent its interests when the patent's integrity was at issue. Patent holders deserve to participate in all aspects of litigation when their interests and rights are at the forefront.

Part I of this Note introduces *Corning Gilbert Inc. v. United States*, and reviews the relevant players in exclusion order enforcement litigation, particularly the International Trade Commission, Customs and Border Protection, and Court of International Trade. It further addresses the current avenues patent holders and importers may take to protect their interests and rights during litigation. Part II of this comment analyzes how ITC exclusion order litigation, in its current form, can disregard patent holder interests and rights. Part III discusses potential solutions to protect patent holder rights and proposes a transparent system that promotes straightforward communication between all parties, agencies, and adjudicators involved.

⁷ See *infra* Part I(B)(iii).

⁸ See *infra* Part I(B)(i).

⁹ There are two relevant cases with the same name that are based on the same facts. In 2012, the CIT held that it would not defer to the patent holder's *amicus* brief. *Corning Gilbert Inc. v. United States (Corning Gilbert I)*, 837 F. Supp. 2d 1303 (Ct. Int'l Trade 2012). In 2013, the CIT held that Corning Gilbert's connectors did not infringe the '194 Patent. *Corning Gilbert Inc. v. United States (Corning Gilbert II)*, 896 F. Supp. 2d 1281 (Ct. Int'l Trade 2013).

I. BACKGROUND

Corning Gilbert Inc. v. United States illustrates how protecting a U.S. patent from infringing foreign goods by exclusion order is a complicated process wherein the voice and power of the patent holder may be significantly diminished. Before delving into the inefficiencies of exclusion order enforcement, it is first necessary to examine the procedural history of *Corning Gilbert* and have a fundamental understanding of the key U.S. entities involved.

A. *Corning Gilbert Inc. v. United States*

On July 21, 2000, John Mezzalingua Associates, Inc. d/b/a PPC (PPC) submitted a patent application¹⁰ to the USPTO hoping to protect a specific type of coaxial cable connector and method of operation.¹¹ Nearly three years later on May 6, 2003, the USPTO granted PPC U.S. Patent No. 6558194 (the '194 Patent).¹²

By 2008, several foreign companies were attempting to bring into the United States coaxial cable connectors resembling the product protected by the '194 Patent.¹³ Therefore, PPC petitioned the ITC to investigate the importation of these products, claiming they unlawfully infringed the '194 Patent.¹⁴ Accordingly, the ITC launched investigation 337-TA-650 (the 650 Investigation) to look into the respondent importers that PPC specifically named in its complaint.¹⁵ All the respondents in the 650 Investigation either defaulted or settled.¹⁶ In 2009, an ITC administrative law judge held that the defaulting respondents did indeed infringe certain claims of the '194 Patent.¹⁷ One of the infringing products was the Fei Yu FY-037.¹⁸ In 2010, without reviewing the administrative law judge's findings in regards to the '194 Patent, the ITC issued a general exclusion order (650 GEO), which prohibited the unlicensed entry into the United States of any coaxial cable connectors that infringed the '194 Patent.¹⁹

¹⁰ John Mezzalingua Associates, Inc. is the assignee from inventor Noah Montana. U.S. Patent No. 6558194 (filed July 21, 2000).

¹¹ '194 Patent. A coaxial cable connector is a device that connects electronic devices such as televisions to sources of electronic signals, such as cable providers. *Id.*

¹² *Id.*

¹³ *Corning Gilbert II*, 896 F. Supp. 2d 1281.

¹⁴ *Id.* at 1284.

¹⁵ *Id.*; *In the Matter of Certain Coaxial Cable Connectors and Components Thereof and Products Containing Same*, Inv. No. 337-TA-650, USITC Pub. 4283 (Nov. 2011), https://www.usitc.gov/intellectual_property/documents/pub4283.pdf [hereinafter USITC 650 Investigation].

¹⁶ *Corning Gilbert II*, 896 F. Supp. 2d at 1284.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 1283; USITC 650 Investigation, *supra* note 15, at 59.

Corning Gilbert, Inc. (Corning Gilbert) was not a respondent in the 650 Investigation.²⁰ However, when Corning Gilbert attempted to import its coaxial cable connectors, CBP denied entry based on the 650 GEO and on the similarity of Corning Gilbert's connectors to the Fei Yu FY-037.²¹ Corning Gilbert protested the ruling, but CBP upheld the denial of entry.²² In response to the denial, Corning Gilbert appealed the CBP ruling in the CIT.²³ PPC, though the holder of the '194 Patent, was not a party in *Corning Gilbert Inc. v. United States*.²⁴ Determined to have its interests heard, however, PPC filed a motion to appear as amicus curiae and to file briefs regarding any motions or final dispositions of the case.²⁵

In 2012, the CIT denied the motion (*Corning Gilbert I*), not believing that "PPC's participation at this point in the litigation will assist with the 'just, speedy, and inexpensive determination' of this action."²⁶ In 2013, under a de novo standard of review,²⁷ the CIT reversed the CBP ruling and allowed Corning Gilbert's cable connectors entry into the United States (*Corning Gilbert II*).²⁸ The CIT held that the CBP ruling did not warrant deference because the CBP decision was not "thorough, logical, nor expert."²⁹ The CIT concluded that CBP was essentially negligent in its claim construction³⁰ and in applying the 650 GEO to Corning Gilbert's cable connectors.³¹ PPC spent nearly thirteen years attempting to protect its coaxial cable connectors only for the CIT to allow the importation of Corning Gilbert's allegedly infringing connectors.³²

²⁰ *Corning Gilbert II*, 896 F. Supp. 2d at 1284.

²¹ *Id.* at 1283.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Corning Gilbert I*, 837 F. Supp. 2d 1303 (Ct. Int'l Trade 2012).

²⁶ *Id.* at 1306.

²⁷ The CIT reviews CBP decisions de novo according to 28 U.S.C. § 2640(a)(1); *Ford Motor Co. v. United States*, 800 F. Supp. 2d 1349, 1351 (2011) ("a Customs decision does not enjoy a statutory presumption of correctness on questions of law, but may be entitled to respect proportional to its power to persuade.").

²⁸ *Corning Gilbert II*, 896 F. Supp. 2d at 1287-88.

²⁹ *Id.* at 1292.

³⁰ Claim construction is used to determine the scope of a patent and involves the interpretation of the patent's words and phrases. See David L. Schwartz, *Courting Specialization: An Empirical Study of Claim Construction Comparing Patent Litigation Before Federal District Courts and the International Trade Commission*, 50 WM. & MARY L. REV. 1699, 1705 (2008).

³¹ CBP appealed the decision to the U.S. Court of Appeals for the Federal Circuit, however the appeal was dismissed. *Corning Gilbert II*, 896 F. Supp. 2d 1281, *appeal dismissed*, No. 13-1299 (Fed. Cir. May 16, 2013).

³² See *Corning Gilbert II*, 896 F. Supp. 2d at 1287-88; *Corning Gilbert I*, 837 F. Supp. 2d 1303 (Ct. Int'l Trade 2012).

B. The Agencies and Parties Involved in Exclusion Order Enforcement

Litigation concerning the enforcement of exclusion orders is a complex system with many interrelated and independent components. At each stage in the enforcement process there are specific procedural rules regarding jurisdiction, parties involved, and an appeal process. The responsibilities and limitations of each agency mean that stakeholders can only participate in some, not all, adjudicative processes.

i. The ITC's Section 337 Authority

The U.S. International Trade Commission is an independent federal agency whose responsibilities include administering U.S. trade remedy laws, informing the White House and Congress regarding international trade matters, overseeing tariff rates, and determining whether certain imported articles constitute patent infringement.³³ Section 337 of the Tariff Act of 1930 declares certain trade practices unlawful, including the importation of articles into the U.S. that infringe a valid and enforceable patent.³⁴ Section 337 authorizes the ITC's six commissioners, who are appointed by the President, to investigate potential import trade violations.³⁵ Section 337 investigations are aimed to be an expedited alternative to federal court adjudication.³⁶

To initiate a Section 337 investigation, U.S. patent holders must file a complaint to the ITC describing "specific instances of alleged unlawful importations."³⁷ The complaint must include a nontechnical description of the patented article, visual representations of both the domestic and imported article, and, "when practicable, a chart that applies each asserted independent claim of each involved U.S. patent to a representative involved article of each person named as violated section 337."³⁸ The complaint must name as respondents producers of the goods the patent holder believes to be infringing.³⁹ The respondents typically have

³³ See generally, 19 U.S.C. §§ 1331-1339. See also, *About the USITC*, U.S. INT'L TRADE COMM'N, https://www.usitc.gov/press_room/about_usitc.htm (last visited May 18, 2017).

³⁴ 19 U.S.C. § 1337 (a)(1). Section 337 covers not only patents, but trademarks and copyright as well.

³⁵ §§ 1330, 1337.

³⁶ 19 C.F.R. § 210.2. See also *General Elec. Co. v. Int'l Trade Comm'n*, 692 F.3d 1219, 1221 (Fed. Cir. 2012) ("Expeditious adjudication is the hallmark of proceeding of the International Trade Commission."). As of the second quarter of 2017, the average length of Section 337 investigations concluded by a final determination on the merits was 16 months. *Section 337 Statistics: Average Length of Investigations*, U.S. INT'L TRADE COMM'N, https://www.usitc.gov/intellectual_property/337_statistics_average_length_investigations.htm (last updated Apr. 7, 2017).

³⁷ 19 C.F.R. § 210.12(a)(3).

³⁸ § 210.12(a)(9).

³⁹ § 210.12(a)(4).

twenty days to respond and the ITC has thirty days to determine whether the complaint merits an investigation.⁴⁰ Once the Section 337 investigation begins, an ITC administrative law judge (ALJ) has forty-five days to set a target date for its final determination, which depending on the investigation, is usually within twelve and eighteen months.⁴¹ The ALJ then conducts an evidentiary hearing similar to a federal court bench trial and issues an initial determination of whether or not there has been a Section 337 violation.⁴² The ALJ's initial determination is subject to review by the six commissioners.⁴³

If the ITC determines that certain imported articles infringe a valid and enforceable patent, it may issue exclusion orders to prohibit those articles from entry into the United States.⁴⁴ The ITC may issue one of either two types of exclusion orders.⁴⁵ "Limited exclusion orders" are limited to specific goods determined to be violating a patent imported by the named respondents in the ITC proceedings.⁴⁶ "General exclusion orders" are "good against the world" in that they are broader and prevent the importation of infringing articles regardless of whether or not they are products of the named respondents.⁴⁷ In this sense, general exclusion orders are intended to provide stronger protection for patent holders.⁴⁸

Throughout the process of issuing exclusion orders, there are three parties whose interests are at stake: the patent holder, the importer, and the public.⁴⁹ The ITC employs Investigative Attorneys whose primary function is to protect the public interest in Section 337 investigations.⁵⁰ Investigative Attorneys ensure all issues are explored and that a complete and accurate record is developed.⁵¹ Although the ITC issues exclusion orders as a result

⁴⁰ §§ 210.10(a)(1), 210.13(a).

⁴¹ § 210.51(a).

⁴² The evidentiary hearing falls under the authority granted by the Administrative Procedure Act, 5 U.S.C. §§ 551 *et seq.* See also Section 337 Investigations: Answers to Frequently Asked Questions, USITC Pub. 4104, 2 (Mar. 2009), http://www.usitc.gov/intellectual_property/documents/337_faqs.pdf [hereinafter Section 337 FAQs].

⁴³ Each party, unless found to be in default, may petition the Commission to review the initial determination. 19 C.F.R. § 210.43(a). If the Commission does not grant a petition for review, then the ALJ's initial determination becomes final. § 210.42(h)(2).

⁴⁴ 19 U.S.C. § 1337(d)(1).

⁴⁵ Gary M. Hnath, *General Exclusion Orders Under Section 337*, 25 NW. J. INT'L L. & BUS. 349, 351 (Winter 2005).

⁴⁶ 19 U.S.C. § 1337(d)(2); Hnath, *supra* note 45.

⁴⁷ 19 U.S.C. § 1337(d)(2)(A); DONALD KNOX DUVALL, PHILIP J. MCCABE, JOHN W. BATEMAN, UNFAIR COMPETITION AND THE ITC: ACTIONS BEFORE THE INTERNATIONAL TRADE COMMISSION UNDER SECTION 337 OF THE TARIFF ACT OF 1930 § 7:15 (Kenyon & Kenyon LLP, Thomson West 2007); Hnath, *supra* note 45.

⁴⁸ Hnath, *supra* note 45.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

of a patent holder's complaint, it is also responsible for ensuring for trade by protecting the interests of the public good.⁵²

Exclusion orders become effective within sixty days, unless denied by the President for policy reasons, then are issued to CBP for enforcement.⁵³

ii. Exclusion Order Enforcement by U.S. Customs and Border Protection

The U.S. Customs and Border Protection is a federal law enforcement agency under the Department of Homeland Security.⁵⁴ It is responsible for border security, including the protection and facilitation of legitimate trade.⁵⁵ As such, when the ITC issues an exclusion order, CBP must enforce the order by denying the specified merchandise from entry into the United States.⁵⁶ CBP may enforce exclusion orders either in advance to the importation or at the border.⁵⁷

(1) Enforcement Prior to Importation: Advance Rulings

Importers of new or redesigned products may wish to obtain an advanced ruling from CBP prior to importation to determine whether an exclusion order applies.⁵⁸ CBP can issue an advanced ruling through its administrative ruling process. This requires a CBP case attorney to review the importer's request, examining any relevant information including the

⁵² Section 337 FAQs, *supra* note 42, at 1.

⁵³ 19 U.S.C. § 1337(j)(2); Section 337 FAQs, *supra* note 42, at 3. For more discussion on exclusion orders see DUVALL, *supra* note 47 at §§7:15-:18.

⁵⁴ Prior to the creation of the Department of Homeland Security in 2002 as a response to the September 11 attacks, the Secretary of Treasury had authority over customs regulations. 6 U.S.C. § 212 (2002). See *Vision and Strategy 2020*, U.S. CUSTOMS & BORDER PROT., 6 (Mar. 2015), <https://www.cbp.gov/sites/default/files/documents/CBP-Vision-Strategy-2020.pdf>

⁵⁵ *Vision and Strategy 2020*, *supra* note 54, at 6.

⁵⁶ 19 C.F.R. § 12.39(b)(1) states:

If the [International Trade] Commission finds a violation of section 337, or reason to believe that a violation exists, it may direct the Secretary of the Treasury to exclude from entry into the United States the articles concerned which are imported by the person violating or suspected of violating section 337. The Commission's exclusion order remains in effect until the Commission determines, and notifies the Secretary of the Treasury, that the conditions which led to the exclusion no longer exist, or until the determination of the Commission on which the order is based is disapproved by the President.

The authority of the Secretary of Treasury in this matter is now held by the Secretary of Homeland Security. 19 C.F.R. § 0.2(a) (2008).

⁵⁷ U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-78, INTELLECTUAL PROPERTY: U.S. CUSTOMS AND BORDER PROTECTION COULD BETTER MANAGE ITS PROCESS TO ENFORCE EXCLUSION ORDERS 9 (2014), <http://www.gao.gov/assets/670/667074.pdf> [hereinafter GAO-15-78].

⁵⁸ See *id.* at 19.

exclusion order, a product sample, prosecution history, and ITC determinations.⁵⁹ The case attorney may contact the ITC for clarification, however the ITC does not provide guidance on products other than those in the original Section 337 investigation.⁶⁰ The advance ruling process is *ex parte* in that only the importer may participate, not the complainant.⁶¹ However, once a ruling is determined, a copy of the decision is sent to the complainant and the ITC.⁶²

(2) *Enforcement at the Border: A Four-Step Process*

Enforcement at the border requires four phases.⁶³ First, CBP issues trade alerts⁶⁴ on its internal network that typically include product descriptions, enforcement instructions, and names of companies that typically import infringing merchandise.⁶⁵ Second, strategies are developed to help identify shipments carrying merchandise covered by the exclusion order.⁶⁶ To enforce general exclusion orders, port officials typically utilize cargo hold requests so they may manually review the shipments.⁶⁷ The third phase is product examination.⁶⁸ Here, port officials often seek guidance from CBP's Intellectual Property Rights Branch, undergo specialized training as requested by the complainant,⁶⁹ or use specialized equipment.⁷⁰ Lastly, if CBP officials determine that an exclusion order prohibits the importation of a shipment, they exclude that merchandise from entry.⁷¹ Typically, the ITC will then direct CBP to seize the infringing merchandise.⁷² Upon the seizure and forfeiture order, CBP updates the trade alert, but does not inform the complainants.⁷³

⁵⁹ GAO-15-78, *supra* note 57, at 19-20.

⁶⁰ *Id.* at 20.

⁶¹ *Id.* at 21.

⁶² *Id.* at 20.

⁶³ *Id.* at 9.

⁶⁴ CBP does not routinely issue trade alerts. In 2014, 83 trade alerts of 94 exclusion orders were posted. However, seventeen of the alerts were posted after the Government Accountability Office began its audit. *Id.* at 22.

⁶⁵ *Id.* at 12.

⁶⁶ *Id.*

⁶⁷ *Id.* at 14.

⁶⁸ *Id.* at 15.

⁶⁹ The complainant refers to the intellectual property right holder protected by the exclusion order.

⁷⁰ GAO-15-78, *supra* note 57, at 15. For example, CBP used handheld tools to scan pills to determine the formula of the powder inside. *Id.* at 15-16.

⁷¹ *Id.* at 16.

⁷² *Id.* at 16; 19 C.F.R. § 210.75(b)(6).

⁷³ GAO-15-78, *supra* note 57, at 17.

iii. CIT Adjudication of Exclusion Orders

In 1926, Congress established the United States Customs Court under Article I of the Constitution as an administrative tribunal responsible for reviewing decisions by Customs officials.⁷⁴ In 1956, Congress statutorily changed the Customs Court to be established under Article III of the Constitution.⁷⁵ To expand the court's jurisdiction, Congress passed the Customs Courts Act of 1980, which changed the court's name to the United States Court of International Trade.⁷⁶ Because the CIT is an Article III court, the President appoints, upon consent of the Senate, all nine judges who constitute the tribunal for life terms.⁷⁷

The Court of International Trade has exclusive jurisdiction over civil actions.⁷⁸ In particular, the CIT has "exclusive jurisdiction of any civil action commenced to contest the denial of a protest, in whole or in part, under section 515 of the Tariff Act of 1930."⁷⁹ Section 515 is classified to 19 U.S.C. §1515 and covers the review of protests against CBP.⁸⁰ The CIT has a "hybrid nature of subject matter jurisdiction."⁸¹ In some actions, such as those brought under § 1581(a), the court functions as a federal district court.⁸² In other actions, such as those brought under § 1581(c), the CIT functions as a federal circuit court of appeals by reviewing agency determinations that are based on the record.⁸³ Due to this hybrid nature, the CIT's rules are unique depending on what role the CIT is playing.⁸⁴

In particular, patent holders may only participate in CIT proceedings as *amicus curiae*, not as parties or interveners. The standard to submit an *amicus* brief or participate in the oral arguments is very high and, according to Rule 76, "will be granted only for extraordinary reasons."⁸⁵ Permission allows the *amicus* to enter a brief on all matters, essentially but not formally intervening in the case.⁸⁶ Intervention is statutorily barred

⁷⁴ *About the Court*, U.S. COURT OF INT'L TRADE, <http://www.cit.uscourts.gov/AboutTheCourt.html> (last modified Apr. 26, 2017).

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ See 28 U.S.C. §§ 1581-85.

⁷⁹ The CIT had jurisdiction over *Corning Gilbert I*, 837 F. Supp. 2d 1303 (Ct. Int'l Trade 2012), under 28 U.S.C. § 1581(a).

⁸⁰ 19 U.S.C. § 1515.

⁸¹ *Corning Gilbert I*, 837 F. Supp. 2d at 1305.

⁸² *Id.* at 1306; 28 U.S.C. § 1581(a).

⁸³ *Corning Gilbert I*, 837 F. Supp. 2d at 1306. 28 U.S.C. § 1581(c) provides, "The Court of International Trade shall have exclusive jurisdiction of any civil action commenced under section 516A of the Tariff Act of 1930." 28 U.S.C. § 1581(c).

⁸⁴ *Corning Gilbert I*, 837 F. Supp. 2d at 1305.

⁸⁵ U.S. CT. INT'L TRADE R. 76.

⁸⁶ *Corning Gilbert I*, 837 F. Supp. 2d at 1305.

under 28 U.S.C. § 2631(j), which states, “no person may intervene in a civil action under section 515 or 516 of the Tariff Act of 1930.”⁸⁷

B. Remedies and Appeals Available to Patent Holders and Importers

If an ITC ALJ’s initial determination is not reviewed by the Commission, parties may petition for review claiming that: (1) a finding of material fact was clearly erroneous; (2) a legal conclusion was erroneous, unprecedented, or constituted an abuse of discretion; or (3) the determination affected ITC policy.⁸⁸ If the Commission approves the exclusion order, then any person who is adversely affected by the decisions may appeal the decision to the U.S. Court of Appeals for the Federal Circuit.⁸⁹ Only the appellant and the ITC are initial parties to the appeal, but the party that prevailed at the ITC may intervene in defense of the ITC order.⁹⁰ Furthermore, upon the request of any person, the ITC may issue an advisory opinion as to whether any person’s conduct would violate an exclusions order to further their Section 337 enforcement powers.⁹¹

Besides seeking injunctive relief of alleged patent infringement by appealing to the ITC for an exclusion order, patent holders may seek monetary damages for patent infringement from importers in a U.S. district court.⁹² However, ITC respondents are entitled to a stay of the U.S. district court litigation pending the outcome of the Section 337 investigation.⁹³ This ensures that both the ITC litigation and the district court litigation are consistent in their determinations.

CBP decisions regarding the exclusion of merchandise from entry is final and conclusive unless the importer files a protest or unless a civil action is commenced in the CIT.⁹⁴ If CBP denies entry of merchandise, importers may protest the CBP decision claiming any clerical error, mistake of fact, or other inadvertence that resulted in an adverse determination.⁹⁵ Importers are not the only ones that may seek to appeal a CBP decision. If CBP determines that certain merchandise is not included in an exclusion order, the patent holders may wish to appeal the CBP order. Because 28 U.S.C. § 1581(a) only allows the review of the denial of an importer’s protest, patent owners generally rely on § 1581(h) (relating to classification, valuation, rate of duty, marking, restricted merchandise, entry requirements,

⁸⁷ 28 U.S.C. § 2631(j).

⁸⁸ 19 C.F.R. 210.43(a)-(b).

⁸⁹ 19 U.S.C. § 1337(c) (2004); Section 337 FAQs, *supra* note 42, at 3.

⁹⁰ *Id.*

⁹¹ 19 C.F.R. § 210.79.

⁹² See Section 337 FAQs, *supra* note 42, at 24; see also FAQs, INT’L TRADE COMM’N TRIAL LAWYERS ASS’N, <http://www.itctla.org/resources/faqs> (last visited May 18, 2017).

⁹³ *Id.*

⁹⁴ 19 U.S.C. § 1514(a)(4).

⁹⁵ *Id.*

drawbacks, vessel repairs, or similar matters”) or §1581(i) (relating to the revenue, tariffs, fees, and taxes from imports) in seeking the review at the CIT.⁹⁶ Appeals to CIT decisions are heard by the United States Court of Appeals for the Federal Circuit.⁹⁷

II. THE IMPLICATIONS OF *CORNING GILBERT* ON LITIGATORS AND ADJUDICATORS

The *Corning Gilbert* decisions have created uncertainty in exclusion order litigation.⁹⁸ For example, it is unclear whether an importer’s protest of a CBP denial or CIT litigation and an ITC Section 337 investigation may proceed simultaneously.⁹⁹ Furthermore, if the CIT and ITC result in conflicting judgments, it is unclear whether the ITC is given deference.¹⁰⁰ What is clear is that CBP must change its practices to avoid its decisions being reversed by the CIT. Moreover, patent holders and importers should litigate their interests in an inter partes process.¹⁰¹

A. CBP’s Expanded Role

Prior to the 2013 *Corning Gilbert II* decision, CBP did not determine whether certain merchandise infringed a patent, but rather whether the merchandise was included under a Section 337 exclusion order.¹⁰² This case effectively expanded CBP’s role in the enforcement of Section 337 orders.¹⁰³ In *Corning Gilbert II*, CBP claimed it had “the limited role with respect to Section 337 enforcement and that it may only refuse entry to merchandise that the ITC has ‘instructed’ Customs to exclude.”¹⁰⁴ CBP also believed it was “simply required to determine whether the product encompassed by the GEO is excluded from entry by

⁹⁶ Alice Alexandra Kipel, *The Role of the United States Court of International Trade in the Enforcement of Intellectual Property Rights*, 19 TUL. J. INT’L & COMP. L. 627, 633 (2011).

⁹⁷ *About the Court*, U.S. COURT OF INT’L TRADE, <http://www.cit.uscourts.gov/AboutTheCourt.html>.

⁹⁸ See *Corning Gilbert II*, 896 F. Supp. 2d 1281 (Ct. Int’l Trade 2013).

⁹⁹ Alexander W. Koff, Tina Potuto Kimble, & Gus Coritsidis, *U.S. International Trade Disputes*, in INTERNATIONAL ASPECTS OF U.S. LITIGATION: A PRACTITIONER’S DESKBOOK (James Berger ed., ABA 1st ed., 2016).

¹⁰⁰ *Id.*

¹⁰¹ International Trade Commission Trial Lawyers Association, Comment Letter in Response to OMB’s Request for Public Comments on the Interagency Review of Exclusion Order Enforcement Process (July 22, 2013), <https://www.regulations.gov/document?D=OMB-2013-0003-0011>, [hereinafter ITCTLA Comments].

¹⁰² Kipel, *supra* note 96 at 632-33.

¹⁰³ Jeffrey M. Telep, Augustine Lo, Gilbert Kaplan, & Tony Pezzano, *CBP’s Expanded Role in Enforcing ITC Exclusion Orders*, KING & SPALDING, LLP (2013).

¹⁰⁴ See *Corning Gilbert II*, 896 F. Supp. 2d 1281, 1288 (Ct. Int’l Trade 2013).

applying the ITC record without examining the underlying findings.”¹⁰⁵ But the CIT disagreed, holding that CBP

may exercise its discretion and have the importer furnish records or analyses to substantiate the certification. Customs may effectively become more than a mere enforcer of the GEO. Customs may have to go beyond the mechanical application of the ITC’s Section 337.¹⁰⁶ It may have to look at evidence and analyze whether the importer, particularly a non-party such as Corning Gilbert, has established non-infringement.¹⁰⁷

Furthermore in *Corning Gilbert II*, CBP argued that it was entitled to deference pursuant to *United States v. Mead Corp.*,¹⁰⁸ stating that “written agency decisions may warrant deference in accord with their ‘thoroughness, logic, and expertness, [and] fit with prior interpretations, and any other sources of weight.’”¹⁰⁹ Recall that the ITC did not construe the claims of the ’194 Patent because all the respondents in the 630 Investigation either settled or defaulted.¹¹⁰ Therefore when Corning Gilbert protested the CBP ruling, it was protesting the “implicit interpretation” given to the term “cylindrical body member” from the ’194 Patent.¹¹¹ The CIT rejected CBP’s claim for deference, stating,

A proper analysis of whether the Excluded Connectors were properly excluded by necessity requires the court to examine whether those connectors infringe the claims of the ’194 Patent, and must therefore begin with the construction of the claim term “cylindrical body member.” Because Customs did not engage in this claim construction, its decision is not so thorough, logical, nor expert as to warrant deference pursuant to *Mead*.¹¹²

How CBP can ensure its rulings will warrant deference by the CIT is unclear. While CBP must clearly take a more active role in analyzing the underlying findings of exclusion orders, it is uncertain what the basis of that interpretation should be.

The *Corning Gilbert* decisions are of significant interest when importers introduce new products that are designed around an existing

¹⁰⁵ *Corning Gilbert II*, 896 F. Supp. 2d at 1288.

¹⁰⁶ Telep, *supra* note 103, at 1-2.

¹⁰⁷ *Corning Gilbert II*, 896 F. Supp. 2d at 1289 (internal citations omitted).

¹⁰⁸ *United States v. Mead*, 533 U.S. 218 (2001).

¹⁰⁹ *Corning Gilbert II*, 896 F. Supp. 2d at 1288 (citing *Mead*, 533 U.S. at 235).

¹¹⁰ *Corning Gilbert II*, 896 F. Supp. 2d at 1292.

¹¹¹ *Id.*

¹¹² *Id.*

patent after an ITC investigation concludes.¹¹³ If an importer fails to request a CBP advance ruling, the ITC will have no opportunity prior to the attempted importation to investigate whether the products infringe patent claims or are sufficiently unique.¹¹⁴ Rather, CBP will be faced with the sole decision of enforcing exclusion orders against newly designed products.¹¹⁵ CBP must now make substantive decisions regarding the enforcement of Section 337 orders.¹¹⁶

What the new CBP role means for litigators is uncertain. Patent holders and the ITC must trust CBP to accurately construct the claims of the patents and exclusion orders. Furthermore, patent holders, the ITC, and importers will be skeptical of any CBP determination, leading to more appeals, more money, more time, and possibly more violations of patent holders' rights.

B. Beware the Floodgates at the CIT

Because it remains unclear how CBP may protect their determinations from being overturned by the CIT, there will likely be more appeals to the CIT, like the one in *Corning Gilbert*. If CBP denies entry to an importer's products, then *Corning Gilbert* signals to the importer that reversal is possible, even likely, from the CIT.¹¹⁷ After *Corning Gilbert*, the CIT should expect and therefore be prepared to hear many more petitions of CBP rulings under 18 U.S.C. § 1581(h) and (i).

Because it is likely that the CIT's docket will be filled with more protests against CBP determinations on exclusions, there is the possibility that a CIT appeal will occur simultaneously with a patent holder's request for an advisory opinion from the ITC. If the ITC declares the exclusion order to prohibit certain products from entry, but the CIT issues a conflicting opinion, then which adjudicator rules? Whether the CIT must defer to an ITC enforcement order as having precedential value has not been established.¹¹⁸ Furthermore, although ordinarily any CBP decision regarding the scope of an exclusion order does not bind the ITC, whether a CIT judgment arising from a CBP order has precedential value for the ITC is also unclear.¹¹⁹

¹¹³ Koff, *supra* note 99, at 62.

¹¹⁴ See GAO-15-78, *supra* note 57, at 21.

¹¹⁵ Although CBP must make similar investigations when processing advance rulings, here there is no case attorney who may defer to the ITC for guidance.

¹¹⁶ Telep, *supra* note 103.

¹¹⁷ See *Corning Gilbert II*, 896 F. Supp. 2d 1281, 1297 (Ct. Int'l Trade 2013).

¹¹⁸ Telep, *supra* note 103, at 3.

¹¹⁹ *Id.*

C. *Patent Holders and Importers in Ex Parte Litigation*

Corning Gilbert confirmed that the CIT retains jurisdiction to review a foreign importer's appeal of a CBP order denying certain goods entry into the United States.¹²⁰ However, only the importer and the United States are parties to the CIT appeal.¹²¹ The ITCTLA claims that, "the result of the ex parte process is that interested parties are unable to review and respond to comments made by others."¹²²

The ITC serves as the main source of protection for patent holders against the importation of infringing products. This means that the patent holder does not have a chance to confront the importer directly at every enforcement point or appeal opportunity. The ITC, and therefore CBP, may be able to participate during any litigation point at the CIT, but the patent holder cannot. Similarly, importers are not given the chance to defend their products to the patent holder except during the initial ALJ hearing or a district court proceeding. Out of this ex parte litigation arise questions and doubts about whether due process is sufficiently granted as guaranteed under the Fifth Amendment.¹²³

Although the ITC serves to represent the patent holder's interest by issuing and defending exclusion orders,¹²⁴ in reality, the patent holder's interest may actually be hindered by the ITC's role. When an importer challenges a CBP ruling, it is challenging the government.¹²⁵ However, the patent holder has an interest in the proceeding just as important, if not more important, than the ITC's interest. When the patent holder is prohibited from intervening in the CIT proceeding, then arguably their due process has been violated because the patent holder cannot represent its own interests.

Furthermore, there is new uncertainty concerning how patent holders can enforce ITC exclusion orders. Because the patent holder is statutorily barred from intervening in an importer's appeal in the CIT, it must look to other ways of protecting its interests. One way the patent holder can "participate" is to seek an advisory opinion from the ITC regarding the exclusion order's scope.¹²⁶ Patent holders can petition for an ITC order, but this is time-consuming and expensive.¹²⁷

¹²⁰ *Corning Gilbert II*, 896 F. Supp. 2d at 1288.

¹²¹ Koff, *supra* note 99, at 62.

¹²² ITCTLA Comments, *supra* note 101, at 6.

¹²³ U.S. Const. amend. V.

¹²⁴ 19 U.S.C. § 1337(d)(1).

¹²⁵ Koff, *supra* note 99, at 62.

¹²⁶ Telep, *supra* note 103, at 3.

¹²⁷ See *FAQs*, *supra* note 92.

III. PROPOSED PROTECTIONS FOR PATENT HOLDERS

The implications resulting from *Corning Gilbert* have attracted the attention of various stakeholders. In June 2013, the Office of the U.S. Intellectual Property Enforcement Coordinator (IPEC) issued a Request for Public Comments: Interagency Review of Exclusion Order Enforcement Process.¹²⁸ IPEC understood there were flaws in the system and therefore began an interagency review “directed at strengthening the procedures and practices used during enforcement of exclusion orders issued by the U.S. International Trade Commission.”¹²⁹ Furthermore, the IPEC office intended to “review existing procedures that U.S. Customs and Border Protection (“CBP”) and the ITC use[d] to evaluate the scope of exclusion orders and work to ensure the process and criteria utilized during exclusion order enforcement activities are transparent, effective, and efficient.”¹³⁰ As a result of the IPEC’s initiative, there were many comments from various agencies that suggested procedures that would improve the exclusion order enforcement process.

A. The Necessity of Accessible Information and Transparency

Most of the comments made in response to IPEC’s request addressed the lack of accessible information and transparency.¹³¹ The lack of transparency creates uncertainty in adjudication and thus confusion in litigation because patent holders, and their attorneys, are not fully informed in how CBP enforces a specific exclusion order or how the ITC effectively represents the patent holder’s interests. To increase transparency, there should be a formal procedure for obtaining the relevant information and stimulating communication between litigants, Customs, the ITC, and the CIT. Information should be clear, accessible, transparent, and from all interested parties. An inter partes process should replace the current ex parte process.

To facilitate enforcement of exclusion orders, CBP should write clear guidelines on what information would be useful for them in analyzing an ITC exclusion order. These guidelines should be given to the ITC and to patent holders. Patent holders have an incentive to elucidate their interests to the ITC so that the ITC may issue a specific and accurate exclusion order. This is especially true of general exclusion orders because they are broader and do not name specific respondents.¹³² The guidelines will also assist the

¹²⁸ Office of Mgmt. & Budget, Exec. Office of the President, Request for Public Comments: Interagency Review of Exclusion Order Enforcement Process, 78 Fed. Reg. 37242 (June 20, 2013).

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ See Comment Letters on the Interagency Review of Exclusion Order Enforcement Process (2013), <https://www.regulations.gov/docket?D=OMB-2013-0003>.

¹³² Hnath, *supra* note 45, at 351.

ITC to clearly detail exclusion orders so that the CBP can accurately enforce them. CBP has incentive to provide clear guidelines so that their decisions remain consistent and do not get overturned. As government agencies, the ITC and CBP must perform their responsibilities in a transparent and reliable manner to earn and maintain trust of United States citizens.

In response to IPEC's request for comments on the approval of the enforcement of exclusion orders, the International Trade Commission Trial Lawyers Association (ITCTLA) recommended the following to be considered: (1) CBP should retain the "initial responsibility for enforcement of exclusion orders as border remedies"; (2) CBP should make "a determination within 90-120 days . . . to prevent unnecessary and inappropriate interference in legitimate trade"¹³³ and; (3) CBP may request guidance from the ITC as to whether a product is included in a GEO.¹³⁴ Implementation of these procedures would not need statutory amendments.¹³⁵ The ITCTLA suggests that the ITC could provide for such a process as part of an exclusion order itself, noting that exclusion orders currently "provide limited direction to Customs as they merely state that a broad category of products covered by one or more specified claims of a patent . . . are excluded from entry into the United States."¹³⁶ This is an efficient means to solving the information problem created by *Corning Gilbert*.¹³⁷

Essentially, every exclusion order should include a disclaimer or list of conditions or guidelines for CBP to follow in enforcing the order. Additional information should be used to specify products that are included or excluded in the general exclusion order. Pictures are already used in some general exclusion orders, but additional specifications may be appropriate and necessary. This is especially relevant for cases of redesign, where an importer attempts to bring in products that are not necessarily identical to a protected product, but which the ITC nonetheless intends to prevent entry to.

When the CIT reviews the petition of a CBP order, there should be information from both complainants and respondents.¹³⁸ Patent holders are experts in their field and it is possible, even likely, that the ITC and CBP officials miss a detail of either the patented or alleged infringing device,

¹³³ Consider that it took years for Corning Gilbert to import their non-infringing products into the United States.

¹³⁴ ITCTLA Comments, *supra* note 101, at 8.

¹³⁵ *Id.* at 9.

¹³⁶ *Id.*

¹³⁷ *Corning Gilbert II*, 896 F. Supp. 2d 1281 (Ct. Int'l Trade 2013).

¹³⁸ ITCTLA Comments, *supra* note 101, at 114.

which would resolve the entire case. In other words, the *Corning Gilbert I* court wrongly denied the patent's holder's amicus curiae petition.¹³⁹

B. A Proposal to Change USCIT Rule 76

Because intervention is statutorily barred in CIT civil actions based on a protest of a CBP ruling, the patent holder must be given the opportunity to be heard in another way.¹⁴⁰ As noted above, USCIT Rule 76 allows the CIT discretion in accepting a party's amicus curiae.¹⁴¹ Similar to other federal courts, the CIT is not required to accept any amicus briefs. However, the CIT is unique in many aspects. It was specifically created with the Customs Courts Act of 1980, which, according to the CIT Chief Justice Timothy Stanceu, "equipped the federal judicial system to deal effectively and efficiently with the complex problems arising from international trade litigation."¹⁴² The CIT "ensures expeditious procedures, avoids jurisdictional conflicts among federal courts and provides uniformity in the judicial decision-making for import transactions."¹⁴³

Because the CIT has unique jurisdiction and procedural rules, it should deviate from the practice of other federal courts and adopt a unique rule requiring the acceptance of patent holders' amicus briefs. The language of USCIT Rule 76 should be changed so that the CIT *must* accept a patent holder's amicus brief if offered.¹⁴⁴ This does not mean that the CIT must necessarily give deference to the amicus brief. If this were the case, then the CIT's decision would favor the patent holder every time. Without the amicus brief, the patent holder's rights are underrepresented in the CIT. The CIT should accept the amicus brief to protect patent holders the right to defend their patent and ITC order.

Opponents of this idea may argue that patent holders are sufficiently protected by ITC exclusion orders. The ITC is charged with the responsibility of protecting the rights of patent holders by issuing exclusion orders with specificity.¹⁴⁵ Furthermore, patent holders can ask the ITC for an advisory opinion on the scope of an exclusion order.¹⁴⁶ However, it is possible that the ITC issues an exclusion order that does not include all the patent holder's intended claims. *Corning Gilbert* shows that ITC and CBP proceedings can be effectively overturned by a CIT decision. Therefore, the ITC and CBP should not be the only avenues patent holders have to prevent the importation of alleged infringing products. Patent holders need to be

¹³⁹ *Corning Gilbert I*, 837 F. Supp. 2d 1303, 1305 (Ct. Int'l Trade 2012).

¹⁴⁰ 28 U.S.C. § 2631(j).

¹⁴¹ U.S. CT. INT'L TRADE R. 76.

¹⁴² *About the Court*, *supra* note 97.

¹⁴³ *Id.*

¹⁴⁴ U.S. CT. INT'L TRADE R. 76.

¹⁴⁵ Hnath, *supra* note 45, at 350.

¹⁴⁶ *FAQs*, *supra* note 92.

able to protect their interests by appealing directly to the CIT without relying on the ITC and CBP. The ITC and CBP, although serve to promote fair trade, may also act as barriers for the patent holder in directly articulating their concerns to the CIT.

C. Patent Holders Should Be Entitled to Stays on CIT Litigation

Just as ITC respondents are entitled to a stay of the U.S. district court litigation pending the outcome of the Section 337 investigation,¹⁴⁷ patent holders should be entitled to a stay of CIT litigation pending an ITC investigation. The ITC has more expertise than the CIT when it comes to the patent and exclusion order, so when possible the ITC should be given deference. ITC exclusion orders constitute the “written agency decisions [that] may warrant deference in accordance with their ‘thoroughness, logic, and expertness, [and] fit with prior interpretations, and any other sources of weight.’”¹⁴⁸

CONCLUSION

In 2016, the U.S. imported approximately \$2.7 trillion worth of goods and services.¹⁴⁹ There were seventy-nine new Section 337 complaints and ancillary proceedings in 2016, which was more than the previous five years.¹⁵⁰ While Section 337 also applies to copyright and trademark infringement, most of these Section 337 investigations involve patent infringement.¹⁵¹ Patent holders rely on the efficiency and effectiveness of these investigations. However, the *Corning Gilbert* decisions have created much uncertainty in the realm of ITC exclusions orders.¹⁵² The ITC, CBP, and the CIT are charged with the responsibility to promote fair trade practices.¹⁵³ Embedded in this responsibility is the duty to protect the rights and interests of patent holders.¹⁵⁴

¹⁴⁷ *FAQs*, *supra* note 92.

¹⁴⁸ *Corning Gilbert II*, 896 F. Supp. 2d 1281, 1288 (Ct. Int’l Trade 2013); *United States v. Mead*, 533 U.S. 218, 235 (2001).

¹⁴⁹ Kimberly Amadeo, *U.S. Imports and Exports: Components and Statistics*, BALANCE, <https://www.thebalance.com/u-s-imports-and-exports-components-and-statistics-3306270> (last updated July 2, 2017).

¹⁵⁰ *Number of New, Completed, and Active Investigations by Fiscal Year*, U.S. INT’L TRADE COMM’N, https://www.usitc.gov/intellectual_property/337_statistics_number_new_completed_and_active.htm (last updated Apr. 4, 2017).

¹⁵¹ *See Types of Unfair Acts Alleged in Active Investigations, FY 2006—FY 2015*, U.S. INT’L TRADE COMM’N, https://www.usitc.gov/intellectual_property/337_statistics_types_unfair_acts_alleged_active.htm (last visited May 18, 2017).

¹⁵² *Corning Gilbert I*, 837 F. Supp. 2d 1303, 1306-07 (Ct. Int’l Trade 2012); *Corning Gilbert II*, 896 F. Supp. 2d at 1292.

¹⁵³ 19 U.S.C. §1337(d)(1); Section 337 FAQs, *supra* note 42, at 2; *About the Court*, *supra* note 97.

¹⁵⁴ § 1337; *Vision and Strategy 2020*, *supra* note 54; 18 U.S.C. § 1581.

Corning Gilbert forces CBP to have an expanded role in the enforcement of Section 337 ITC exclusion orders.¹⁵⁵ What exactly that entails remains unclear. The first step in making the exclusion order process less confusing and frustrating for stakeholders is to obtain relevant and necessary information. Patent holders, importers, and litigators need clear guidelines on what information CBP would find useful in making its rulings. The ex parte process of exclusion order enforcement can damage the interests of both patent holders and importers of products that may have wrongfully been excluded. Therefore, there should be a unified formal process in place that ensures the communication of all parties involved. This also requires that the CIT hear the patent holders' interests from the patent holders themselves when presiding over a petition of a CBP ruling. Although the ITC acting as the patent holders' representative may intend efficiency, in reality it serves as another barrier between patent holders' and their right to due process.

Further, USCIT Rule 76 should be changed as to require the CIT to accept amicus briefs from patent holders, rather than permitting the court to determine when to allow them.¹⁵⁶ Although other federal courts do not allow this, the new rule would constitute one of many unique characteristics of the CIT.¹⁵⁷ Furthermore, patent holders should be entitled to a stay on any CIT litigation regarding alleged infringement on their patents. While the ITC and CIT's focus on quick adjudication brings many benefits, but they must not sacrifice fair trade practices. The 2012 *Corning Gilbert I* decision incorrectly rejected the patent holder's participation in the case by focusing on quick adjudication rather than a just outcome.¹⁵⁸

Although CBP often makes appropriate decisions, ultimately the ITC is responsible for the oversight of fair trade practices in the importation of foreign products. It is not realistic for CBP to obtain ITC approval of every border determination. To prevent improper CBP decisions, the ITC should be very clear in describing their underlying findings of exclusion orders and the overall scope of the order. If the ITC is clear in their descriptions, then CBP can relay what information they need from patent holders and importers.

Formal procedures establishing clear inter partes communication is necessary to promote efficiency and fairness in the system. When the procedure of enforcing exclusion orders is efficient and clear, then the CIT can expect fewer petitions and the ITC can expect smoother oversight. *Corning Gilbert* will require a more active role from the ITC, CBP, patent holders, importers, and litigators. A system that ensures participation of patent holders at every point in the litigation of

¹⁵⁵ *Corning Gilbert II*, 896 F. Supp. 2d at 1288-89.

¹⁵⁶ U.S. CT. INT'L TRADE R. 76.

¹⁵⁷ *About the Court*, supra note 97.

¹⁵⁸ *Corning Gilbert I*, 837 F. Supp. 2d at 1306-07.

exclusion order enforcement will help protect patent holders from the unfair importation of infringing products.