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ARTICLES:

THE EUROPEAN COMMISSION'S COMMUNICATION ON STANDARD ESSENTIAL PATENTS: A STEP FORWARD TOWARDS THE DIGITAL SINGLE MARKET AND THE INTERNET OF THINGS?

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THE EUROPEAN COMMISSION'S COMMUNICATION ON STANDARD ESSENTIAL PATENTS: A STEP FORWARD TOWARDS THE DIGITAL SINGLE MARKET AND THE INTERNET OF THINGS?

Dr. Spyros Makris¹

I. INTRODUCTION

By enabling interoperability and enhancing innovation through the development of high-performance cutting-edge technologies, standardisation² has led to a continuous growth in many industries, especially in the Information and Communication Technology (ICT) sector. The evolving digitalization of the economy and particularly the emerging Internet of Things (IoT) will profit greatly from standardisation.³

Standards are developed and set within Standard Development Organisations (SDOs). In technology-heavy sectors (for instance, in the wireless telecommunication industry), standards driven by SDOs are widely based on technology protected by patents. As a rule, holders of patents essential for complying with a standard (Standard Essential Patents or SEPs) are encouraged by SDOs to make their SEPs accessible to users on Fair, Reasonable and Non-Discriminatory (FRAND) terms and conditions.⁴ The actual content of FRAND is to be determined on a case-by-case basis by the SEP holder and the standards user in good faith negotiations. In practice, licensing negotiations for SEPs can be challenging, particularly when parties with limited or no experience in this field engage in such negotiations, for instance, market entrants or small and medium sized enterprises (SMEs). It is, therefore, not surprising that FRAND licensing

¹ Dr. Spyros Makris is a syndic lawyer at Ericsson. The views expressed in this paper are those of the author and do not represent the views of Ericsson.

² The term standardisation used in the present paper refers to so-called “*de jure*” standards, that is, standards developed through a formal procedure and endorsed by a Standard Development Organisation. *De jure* standards are to be distinguished from “*de facto*” standards, which refer to technological solutions adopted widely in the market, without having been developed within a standardisation body.

³ The European Commission (Commission) estimates that the so called “Digital Single Market” will contribute EUR 415 billion per year to Europe’s GDP. See *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Digital Single Market Strategy for Europe*, at 3, COM (2015) 192 final (May 6, 2015) [hereinafter *A Digital Single Market Strategy for Europe*].

⁴ For instance, Article 6.1. of the Intellectual Property Rights (IPRs) Policy (IPR Policy) of the European Telecommunications Standards Institute (ETSI) reads as follows: “When an ESSENTIAL IPR relating to a particular STANDARD or TECHNICAL SPECIFICATION is brought to the attention of ETSI, the Director-General of ETSI shall immediately request the owner to give within three months an irrevocable undertaking in writing that it is prepared to grant irrevocable licences on fair, reasonable and non-discriminatory (“FRAND”) terms and conditions under such IPR [...]” *ETSI Directives: Rules of Procedure: Annex 6: ETSI Intellectual Property Rights Policy*, EUR. TELECOMM. STANDARDS INST. 38, art. 6.1 (2019) [hereinafter *ETSI IPR Policy*].

and the enforcement of SEPs are major issues discussed in the context of standardisation.

On 29th November 2017, the European Commission (Commission) published a Communication entitled “*Setting out the EU Approach to Standard Essential Patents*” (Communication).⁵ The Communication is part of an initiative called “*A Digital Single Market Strategy for Europe*,” which was introduced by the Commission back in 2015 as a policy enhancing the European Single Market.⁶ In the Commission’s eyes, standards support innovation and growth in Europe by enabling interoperability of the digital technologies that are the foundation of the Digital Single Market (DSM); particularly, IoT and 5G standards (along with big data technologies, cloud and cybersecurity) were identified as the “essential technology building blocks” of the DSM.⁷

In the Communication, the Commission laid down its views on current and future challenges of standardisation, particularly with an eye on the digital economy and the IoT. The Communication defines its objectives as follows: incentivising “the development and inclusion of top technologies in standards,” by (1) preserving “fair and adequate return” for contributions to standards and (2) ensuring “smooth and wide dissemination of standardised technologies based on fair access conditions.”⁸

From this starting point, the Commission addressed recommendations to stakeholders involved in standardisation mainly on three key topics: the transparency of the framework for the declaration of SEPs (*see* Part B), the licensing of SEPs (*see* Part C), and the enforcement of SEPs (*see* Part D). Besides that, the Commission also expressed its basic position on the relationship between standardisation and Open Source projects (*see* Part E). The Commission’s recommendations are non-binding and rather have the function of a roadmap, initiating further discussions on the relevant topics.

⁵ See generally *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee: Setting out the EU Approach to Standard Essential Patents*, COM (2017) 712 final (Nov. 29, 2017) [hereinafter *Setting out the EU Approach to Standard Essential Patents*]. On the same day, besides the Communication, the Commission published a “bundle” of similar instruments, covering a wide range of topics related to the protection of Intellectual Property Rights (IPRs), including the fight against counterfeit and the enforcement of IPRs. See generally *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee: A balanced IP enforcement system responding to today's societal challenges*, COM (2017) 707 final (Nov. 29, 2017); *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee: Guidance on certain aspects of Directive 2004/48/EC of the European Parliament and of the Council on the enforcement of intellectual property rights*, COM (2017) 708 final (Nov. 29, 2017).

⁶ See *A Digital Single Market Strategy for Europe*, *supra* note 3, at 2, 3, 20.

⁷ *Id.* at 15; *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee: The annual Union work programme for European standardisation for 2017*, at 2, COM (2016) 357 final (June. 1. 2016).

⁸ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 2.

This paper offers an overview of these recommendations, which in each case is followed by a critical assessment, focusing on the aspects that need to be further elaborated in future debates. The main findings derived from this analysis are summarized in the closing part of the paper.

II. TRANSPARENCY OF THE FRAMEWORK FOR THE DECLARATION OF SEPS

The declaration of patents as potentially essential to a standard, typically required by SDOs, supports standardisation efforts in two main ways: (1) Respective declarations clarify whether patented technology needed to implement the standard will be accessible to users on FRAND terms and conditions,⁹ and (2) declarations ensure that the standardisation work can proceed at a fast pace.¹⁰ Accordingly, the frameworks laid down by SDOs for the declaration of SEPs (SEP declaration frameworks) focus on serving the standardisation work itself (which, as a rule, excludes commercial discussions); in their current state, they are not designed to fulfil further functions, for instance to assist or facilitate FRAND determination.¹¹

This basic understanding will prove to be valuable, when approaching the Commission's recommendations on the transparency of SEP declaration frameworks which are presented and analysed next.

A. *The Commission's Recommendations*

The Commission considers that transparent information on the existence, scope and relevance of essential patents is required for enabling fair licensing negotiations. Particularly new players with little or no experience with SEP licensing, for instance inexperienced companies in the IoT field, rely on transparent information to assess their exposure to SEPs.¹²

The Commission finds that information on SEPs currently available to implementers needs to be improved in terms of both accessibility and quality.¹³ In the Commission's view, implementers cannot rely on the declaration databases maintained by SDOs to determine

⁹ *Id.* at 3.

¹⁰ For instance, Article 4.1. ETSI IPR Policy reads as follows: "[...] each member shall use its reasonable endeavours, in particular during the development of a standard or technical specification where it participates, to inform ETSI of essential IPRs in a timely fashion. In particular, a member submitting a technical proposal for a standard or technical specification shall, on a bona fide basis, draw the attention of ETSI to any of that member's IPR which might be essential if that proposal is adopted." *ETSI Directives: Rules of Procedure: Annex 6: ETSI Intellectual Property Rights Policy*, EUR. TELECOMM. STANDARDS INST. 38, art. 4.1 (2019). Article 8 of ETSI IPR Policy also lays down the procedure to be followed, in case that a respective declaration is missing (a measure to be taken is, among others, searching for technical alternatives). *See id.* at 40-41, art. 8.

¹¹ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 3.

¹² *See id.*

¹³ *Id.*

essentiality because they are not subject to scrutiny regarding such essentiality.¹⁴

i. Operational Improvement of Declaration Databases Maintained by SDOs

As a tool for improving transparency, the Commission suggests the operational improvement of SEP declaration databases maintained by SDOs. In terms of accessibility, the Commission recommends that these databases must have “user friendly interfaces” and allow access to SEP holders and implementers, as well as third parties.¹⁵ Further, information contained in the databases should be “searchable” based on the relevant standardisation projects.¹⁶ In terms of quality, SDOs should ensure that “duplications or other obvious flaws” are eliminated and that the available information is linked to databases of patent offices, including updates of patent status, ownership and patent transfer.¹⁷

ii. Modification of the Declaration System

In addition to the operational improvement of existing SDO databases, the Commission also recommends modifications to the current declaration system practiced by SDOs, as a further means to enhance transparency.

In particular, SEP holders should be requested to provide more up-to-date and accurate information regarding to their declarations towards SDOs. Declarations should contain, at least, a reference to the section of the standard to which the SEP relates, a link to the patent family, and information on how to contact the SEP holder.¹⁸

Furthermore, the Commission finds that SEP holders “should review” the relevance of their declarations (1) at the time of the final adoption of the standard, (2) when the standard is significantly revised, and (3) when the final patent granting decision is taken (SEP declaration reviews).¹⁹ According to the Commission, the reasoning behind this lies in the fact that the standard constantly evolves during the usually long-lasting development process, so that patent claims relevant for the standard at an early stage of the process might become irrelevant for the standard that is finally adopted.²⁰ To incentivise SEP holders to review their declarations (and discourage “over-declaration”), the Commission also encourages

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 3.

¹⁸ *Id.* at 4.

¹⁹ *Id.*

²⁰ *Id.*

SDOs to consider establishing (modest) fees for confirming declarations after the release of the standard and the grant of the patent.²¹

The Commission further holds that the essentiality of SEPs should be subject to scrutiny by an independent third party “at the right point in time” (essentiality checks).²² This tool shall act as a counterweight, particularly to the “risk of broad over-declarations.”²³ The Commission assumes that patent offices may be an adequate forum for taking on essentiality checks.²⁴ In the Commission’s eyes, any “scrutiny requirement” that is introduced, however, has to be balanced against the respective costs.²⁵ These costs, states the Commission referencing a 2016 study of Charles River Associates, “may be negligible” compared to “licensing revenues in key technologies.”²⁶ Nevertheless, the Commission understands that an “incremental approach” is needed, whereby essentiality checks will be performed “at the request” of the parties involved in SEP licensing and could be limited in terms of both “depth of scrutiny” and number of examined SEPs (for instance, checks covering only one patent within a patent family or limited to samples).²⁷

Besides that, the Commission suggests that making information on the outcomes of litigation or arbitration/mediation proceedings involving SEPs²⁸ (particularly the outcomes of proceedings regarding to essentiality and patent validity) available to stakeholders through the SDOs is another tool for enhancing transparency, which ought to be taken into account.²⁹

Considering that the recommended modifications will involve additional efforts and costs, the Commission introduces the notion of proportionality;³⁰ stakeholders should not be burdened with “excessive burdens.”³¹ The Commission takes the view that a possible way to achieve proportionality is by extending such measures gradually and applying them

²¹ *Id.* at 5.

²² *See Setting out the EU Approach to Standard Essential Patents, supra* note 7, at 5.

²³ *Id.*

²⁴ *See id.* Since April 2018, the Japan Patent Office (JPO) offers a mechanism for the assessment of the essentiality of patents for a standard. This mechanism is based on the existing “Hantei” (or Advisory Opinion) system, which allows interested parties to request from the JPO a (non-binding) assessment of the technical scope of a (Japanese) patent. *See generally* Trial & Appeal Dep’t, *Manual of “Hantei” (Advisory Opinion) for Essentiality Check*, JAPAN PATENT OFFICE (Mar. 2018), https://www.jpo.go.jp/e/system/trial_appeal/document/hantei_hyojun/01_e.pdf (describing a detailed presentation of the new mechanism for essentiality checks) [hereinafter *Manual of “Hantei” (Advisory Opinion) for Essentiality Check*].

²⁵ *Setting out the EU Approach to Standard Essential Patents, supra* note 7, at 5.

²⁶ *Id.* at 5 n.20 (citing PIERRE RÉGIBEAU ET AL., TRANSPARENCY, PREDICTABILITY, AND EFFICIENCY OF SSO-BASED STANDARDIZATION AND SEP LICENSING: A REPORT FOR THE EUROPEAN COMMISSION (Charles River Associates 2016)).

²⁷ *Id.*

²⁸ *See id.* at 4.

²⁹ *Id.* at 4, 11.

³⁰ *Id.* at 4.

³¹ *Setting out the EU Approach to Standard Essential Patents, supra* note 7, at 4.

only to new or key standards, such as the upcoming 5G standard.³² When assessing proportionality, however, the Commission recommends that stakeholders ought to bear in mind that currently incurred costs might be reduced if transparency is increased—particularly the costs SEP holders must bear in licensing negotiations for substantiating the essentiality of their patents as well as the patent-infringing use by the implementer.³³

B. Assessment of the Commission's Recommendations

The Commission's recommendations on enhancing the transparency of the declaration framework supporting the standardisation process seem, in general, to be a good base for further discussions. Questions arise, however, particularly when looking at the specific implementation of the recommended measures.

i. Operational Improvement of Declaration Databases Maintained by SDOs

Better accessible information of higher quality could, in principle, enhance transparency in connection with the licensing of SEPs, as the Communication suggests. Nevertheless, the respective recommendations seem to require further elaboration and a cost-benefit analysis.

First, one should keep in mind that essentiality declarations are only a source of indirect information; such declarations are not linked to the licensing of SEPs. Indeed, as already pointed out above, their function lies in making the standard accessible to users and supporting the progress of standardisation work.

Further, the Communication does not directly address in this context the question of the costs attached to implementing the recommended measures: Who will have to bear these additional costs? Could such additional costs (and the delay that such processes would imply) pose burdens on the standardisation process and/or the incentives to contribute in standardisation?

Given that the Commission addresses the respective recommendations to SDOs, it must be assumed that any additional costs incurring in connection with the operational improvement of declaration databases will have to be shouldered by the latter. The proposed measures could, however, require significant investments (*e.g.* costs of external service providers, additional staff costs). Considering that database structures currently maintained by SDOs vary in terms of quality from organisation to organisation, such investments could be challenging particularly for SDOs maintaining only basic structures so far. Thus, it cannot be ruled out that the respective cost burden could, for instance, lead

³² *See id.* at 5.

³³ *See id.* at 4.

to the introduction of additional fees by SDOs, in order to finance such investments. This could, in turn, eventually have the potential to make participation in standardisation less attractive or unaffordable by SMEs, thus contradicting the World Trade Organisation's (WTO) "openness" principle, which SDOs usually subscribe to.³⁴ Moreover, since essentiality declarations are generally not used as the basis for FRAND negotiations, it appears advisable to take a closer look at both the cost and the added value questions, before formulating specific (and binding) operational requirements for databases maintained by SDOs.

The same is true with respect to the suggested reporting on the outcomes of litigation or arbitration/mediation proceedings involving SEPs by the SDOs. As a rule, arbitration and mediation proceedings are subject to strict confidentiality restrictions covering the overall process, including the outcomes. Besides confidentiality issues that need to be resolved in this context, the question arises regarding who will have to shoulder the burden of collecting and making such information publicly available. Since SDOs appear to be best situated to assume this task, the cost-benefit question discussed above is posed again.

ii. Modification of the Declaration System

Although the modifications of the current declaration system recommended by the Commission represent initial thoughts that need further development, they appear to be a good starting point for further discussions on the respective topics. A closer debate seems particularly desirable with regards to the two measures, which are expected to have the most substantial practical impact on the standardisation ecosystem: the proposed SEP declaration reviews and the essentiality checks.

a) SEP Declaration Reviews

Although not expressly mentioned in the Communication, the Commission seems to suggest making mandatory for SEP holders to introduce SEP declaration reviews ("rightholders should review the relevance of their declarations").³⁵ Assuming that this is the case, the Commission should first elaborate on the concrete prerequisites of compliance with the respective obligation, after which the legal effects attached to the introduction of such reviews should be carefully considered.

In terms of specifying the prerequisites of compliance with a (future) obligation to perform SEP declaration reviews, it will be

³⁴ The principle of "openness" requires that participation in every stage of the (formal) standardization process should be open to all interested parties. See Fredrik Nilsson, *An Appropriate Base to Determine a Fair Return on Investment: A legal and Economic Perspective on FRAND*, 13 J. INTELL. PROP. L. & PRAC. 414, 416 (2018).

³⁵ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 4 ("Therefore, rightholders should review the relevance of their declarations at the time of adoption of the final standard (and subsequent significant revisions) and when a final granting decision on the patent is taken.").

particularly needed to clarify the point in time at which the SEP holder would be required to carry out respective reviews. Does the “adoption of the final standard” stated in the Communication³⁶ refer to the time the standard specification text is finalised within the SDO or the time the standard has been adopted in the market? Using the finalisation of the standard specification text as a reference point might prove to be ineffective, since the assessment of essentiality prior to market adoption of the standard will most likely have limited value for stakeholders (the SEPs embedded in the standard will probably not be widely used at this point). Furthermore, which subsequent revisions of the standard are to be considered “significant” in terms of the Communication, triggering a need for a further review of the declaration by the SEP holder? Standards are constantly being updated, particularly in industries where standards are developed at a very fast pace, for instance, the wireless telecommunication field where new publications within the same release can take place every few months.³⁷ Also, is every new standard release “significant” *per se*, or is it required that the revised standard incorporates substantial technological development, and if so, to what extent?

Considering, on the other hand, the potential legal effects of imposing SEP declaration reviews on SEP holders, several questions need to be addressed. For instance, should refraining from a SEP declaration review after a “significant revision”³⁸ of the respective standard be sanctioned, and if so, by whom and how? Should the SDO charge SEP holders with respective “late fees”? Could potential sanctions reach so far as to affect the legal standing of the respective SEP declaration and if so, with what further implications, for instance for the accessibility of the standard to users (*e.g.*, is the patent still subject to a FRAND undertaking, if a review is omitted)? The legal uncertainties emerging from these questions could have the potential to lead to more disputes and, accordingly, to more litigation, creating hurdles in the way of standardisation efforts.

Furthermore, taking into account that SEP holders would avoid being accused of patent ambush,³⁹ could “over-declaration” be solved by continuous updates? Is “over-declaration” *per se* a problem requiring measures to be taken at the level of the SDOs? Keeping in mind that SEP declarations are not designed to serve licensing, but to ensure the accessibility of standards, particular caution is required when considering

³⁶ *Id.*

³⁷ See *Releases*, 3GPP, <http://www.3gpp.org/specifications/67-releases> (last visited Apr. 13, 2019).

³⁸ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 4 (“Therefore, rightholders should review the relevance of their declarations at the time of adoption of the final standard (and subsequent *significant revisions*) and when a final granting decision on the patent is taken.”).

³⁹ “Patent ambush” occurs when a patent holder withholds information during the development of a standard about a SEP that he holds (or that it has pending, or intends to file) and asserts that patent, after the standard is adopted, in order to extract higher royalties.

adding complexities in the declaration process, such as new obligations for stakeholders.

b) Essentiality Checks

The Communication does not expressly clarify whether the recommended essentiality checks should be mandatory, and if so, under which conditions. Who should be entitled to request an essentiality check to be carried out? Would only parties involved in ongoing licensing negotiations or SEP related litigation be entitled to a respective request,⁴⁰ or would third parties also have the right to assert such a request (which would most likely make this procedure prone to abuse)?

Furthermore, which is “the right point in time” for performing such checks referred to in the Communication?⁴¹ Should a party be able to request an essentiality check only after the adoption of the “final standard”, or also after a “significant” revision of the standard and/or the final granting decision of the patent, as the Commission suggests with respect to SEP declaration reviews? Insofar, the same questions regarding to the determination of the right point in time posed above in the context of SEP declaration reviews will still need to be answered (for instance, when is the “final standard” adopted, or when does a “significant” revision of the standard take place?).

Apart from the above, since essentiality checks will be performed by third parties, standards regarding to the independence, neutrality, and competence of such bodies will need to be considered. Will entities (even patent offices) entrusted with essentiality checks need some kind of accreditation and if so, who could assume this task and on which basis? In this respect, a coherent approach at an international level seems to be preferable, in order to ensure that uniform standards are applied.

Particularly for safeguarding basic due process, it will be required to establish not only mechanisms allowing the parties involved to be sufficiently heard before a (non-binding) “opinion” on essentiality is rendered, but also mechanisms allowing the party affected (either the SEP holder or the implementer) to challenge the outcomes of such checks, especially, if the outcomes could be made publicly available outside the context of ongoing licensing negotiations or litigation.⁴² This would, however, very likely add further complexities to the SEP licensing system, which should not be overlooked, when evaluating the risks and benefits attached to the introduction of essentiality checks.

⁴⁰ For instance, essentiality checks offered by the JPO by utilizing the so-called “Hantei” system are available only to parties of a dispute (or disagreement in licensing negotiations). See *Manual of “Hantei” (Advisory Opinion) for Essentiality Check*, *supra* note 26, at 4-5.

⁴¹ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 5.

⁴² For example, the JPO makes (non-binding) opinions rendered on the essentiality of patents following the “Hantei” scheme available to the public. See *Manual of “Hantei” (Advisory Opinion) for Essentiality Check*, *supra* note 26, at 3, 21.

c) Costs/Benefits

Based on the above, the question of the costs and benefits associated with the introduction of SEP declaration reviews and essentiality checks requires additional attention. The clear commitment of the Commission to ensure proportionality between the respective costs and the expected benefits may be heading in the right direction, but it needs to be fleshed out by further analysis.

The Communication does not explicitly refer to the costs for SEP declaration reviews, in contrast to the costs for essentiality checks. These costs may, however, pose a significant burden on SEP holders, since the recommended repeated review of the declarations (reviews are required at the final adoption of the standard, every subsequent “significant” revision and after the final granting decision on the SEP) will very likely be time-consuming and work-intensive. Any proportionality assessment with respect to the above costs cannot, therefore, take place without considering this parameter.

Furthermore, when approaching proportionality in this context, one ought to consider that SEP holders usually have no other choice than to make their declarations towards SDOs at an early stage of the standards development process (which, in the first place, generates the need for a later review of such declarations). Early declaration is usually encouraged by SDOs’ policies governing the standards development process;⁴³ it further rules out the risk that the SEP holder will be confronted with the allegation of so-called “patent ambush”, after the standard has been adopted.

In contrast to SEP declaration reviews, the Communication expressly refers to the costs associated with essentiality checks. The validity of the assumptions, on which the Commission based its notion, has, however, to be questioned. Particularly the assumption that the cost of essentiality checks may be “negligible” must be subject to closer scrutiny. Currently, rigorous and reliable essentiality checks produce costs amounting to approximately EUR 10,000.00 per patent family, on average.⁴⁴ Considering this and the fact that evidence on the value of the declaration of potential essentiality of patents in FRAND licensing negotiations is missing, a thorough (re-)assessment of the proportionality of this measure seems to be needed. In this context, it is also worth keeping in mind that essentiality checks will probably have a limited impact on cases, in which

⁴³ See ETSI IPR Policy, *supra* note 12, at 38, art. 4.1; (requesting patent holders “to inform ETSI of essential IPRs in a timely fashion”).

⁴⁴ According to the study cited by the Commission in this respect, the costs for evaluating the essentiality of a single patent family by an external advisor amounts to EUR 10,000.00. RÉGIBEAU ET AL., *supra* note 29, at 24. According to the same study, “quick internal evaluations” usually cost less (approximately EUR 1,000.00). *Id.* However, the latter would probably not have an added value in the context of SEP licensing. See Kelce S. Wilson, *Designing a Standard Essential Patents (SEP) Program*, 53 LES NOUVELLES 202, 206 (Sept. 2018).

SEP users are unwilling to get a license or only under terms under FRAND (also known as “hold-out”).⁴⁵

In addition, since the risk of “over-declaration” is mentioned as one of the main reasons for introducing essentiality checks⁴⁶, any further considerations on proportionality in this respect should take into account that “over-declaration” is still a highly disputed phenomenon. Indeed, the opinions expressed on the extent of such phenomenon diverge widely. For instance, a study on patents and patent applications declared as essential to the 3GPP and 3GPP2 standards suggested that only approximately 21 percent of the declared SEPs were actually essential.⁴⁷ These results have, however, encountered substantial criticism both in terms of objectivity and research methodology.⁴⁸ More important than the percentage of over-declaration is rather whether over-declaration is a problem at all, considering it is (1) typically not even considered in SEP licensing negotiations, (2) ensures that innovators are not unjustly accused of patent ambush, and (3) guarantees that users get access on FRAND terms to all declared patents that are or become essential.

III. LICENSING OF SEPS

The Commission believes that negotiations in good faith between SEP holders and implementers are the adequate mechanism for the licensing of SEPs on FRAND terms and conditions.⁴⁹ In the Commission's eyes, such negotiations have, however, proven to be difficult in practice, especially when it comes to the valuation of FRAND.⁵⁰ Litigation over FRAND could delay the spread of standardised technologies, particularly in the IoT sector.⁵¹

A. *The Commission's Recommendations*

To address the above challenges, the Commission developed a set of principles that should govern SEP licensing. As a starting point, the Commission points out that there is “no one-size-fit-all solution on what FRAND is.”⁵² Moreover, what can be considered FRAND can differ “from

⁴⁵ See *infra* Part D.2; see also *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 10.

⁴⁶ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 5.

⁴⁷ See generally David J. Goodman & Robert A. Myers, *3G Cellular Standards and Patents*, IEEE WIRELESSCOM 2005, (June 13th, 2005) <http://eeweb.poly.edu/dgoodman/wirelesscom2005.pdf>.

⁴⁸ See Donald L. Martin & Carl De Meyer, *Patent Counting, a Misleading Index of Patent Value: A Critique of Goodman & Myers and its Uses*, 2-3 (Dec. 5, 2006) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=949439.

⁴⁹ *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 6.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

sector to sector and over time.”⁵³ As a rule, (1) “efficiency” considerations, (2) “reasonable license fee expectations” on both sides, and (3) “the facilitation of the uptake by implementers to promote wide diffusion of the standard” should be taken into account when determining FRAND.⁵⁴

On this basis, the Commission laid down the following four principles for the valuation of FRAND:

(1) FRAND has to “bear a clear relationship to the economic value of the patented technology”; this value needs primarily to “focus on the technology itself” and should, in principle, “not include any element resulting from the inclusion of the technology in the standard”. However, in case that the technology is developed “mainly for the standard”, alternative valuation methods should apply, such as the “relative importance of the technology in the standard compared to other contributions in the standard”⁵⁵.

(2) The “present value added” of the patented technology should be considered (that is the value discounted to the time of the conclusion of a licensing agreement). This value should be determined “irrespective of the market success of the product that is unrelated to the patented technology.”⁵⁶

(3) “Continued incentives” for SEP-holders to “contribute their best available technology to standards” must be ensured.⁵⁷

(4) A “reasonable aggregate rate” for the standard, which shall be determined by an assessment of the “overall added value of the technology”, must be taken into account⁵⁸ (in order to avoid so-called “royalty stacking”).⁵⁹

Furthermore, in the Commission’s view, the non-discriminatory element of FRAND requires that “similarly situated” implementers are not treated differently by SEP holders.⁶⁰ Insofar, the Commission expressly refers to existing case law on this question,⁶¹ namely the decision of the UK High Court of Justice in the matter *Unwired Planet v Huawei*.⁶²

In terms of efficiency (for keeping transaction costs to the necessary minimum), the Commission considers that worldwide licenses

⁵³ *Id.*

⁵⁴ *Id.* at 8.

⁵⁵ *Setting out the EU approach to Standard Essential Patents*, *supra* note 7, at 6-7.

⁵⁶ *Id.* at 7.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ “Royalty stacking” is defined as “the excessive total royalty that licensees might have to pay when the rights to which they need access are owned by different, independent agents.” See RÉGIBEAU ET AL., *supra* note 29, at 15.

⁶⁰ *Setting out the EU approach to Standard Essential Patents*, *supra* note 7, at 9.

⁶¹ *Id.*

⁶² See *Unwired Planet v. Huawei*, [2017] EWHC (Pat) 711 (Eng.).

are, as a rule, FRAND compatible, particularly with respect to products with a global circulation. On the contrary, country-by-country licensing does not appear to comply with recognised commercial practice.⁶³

Finally, the Commission also encourages SDOs and SEP holders to develop and facilitate the licensing of a large number of implementers in the IoT environment (especially SMEs) via patent pools or other licensing platforms.⁶⁴ The Commission believes that such mechanisms could have a positive impact on SEP licensing by “offering better scrutiny on essentiality” as well as “more clarity on aggregate licensing fees”, the latter being an additional tool to help avoid “royalty stacking.”⁶⁵

B. *Assessment of the Commission's Recommendations*

In overall terms, the Commission seeks to strike a balance between the opposing interests of the parties involved in SEP licensing. Further debates are expected, however, on several topics, particularly on the principles for the valuation of FRAND set forth by the Commission in the Communication.

i. FRAND Valuation

Particularly valuable is the acknowledgment that there is no “one-size-fits-all” solution to what FRAND is and what can be considered as FRAND can vary “from sector to sector and over time”. By emphasising this understanding, the Commission confirms that flexibility in determining FRAND is one of the key conditions for securing a well-functioning standardisation environment.

The FRAND valuation principles subsequently reflected in the Communication are meant to contribute to the same end. For this purpose, however, a further development and substantiation of these principles will be required in the future, considering the current practice in the SEP licensing ecosystem.

The first principle is a controversial one, holding that the economic value of the patented technology (which must be reflected by FRAND) should as a rule not encompass the value resulting from the incorporation of the technology in the standard. Courts have expressed contrary views on this notion. While courts particularly in the United States have adopted this view in some cases,⁶⁶ in Europe, the UK High Court of Justice has, for instance, embraced a much different approach. Indeed, in *Unwired Planet v Huawei*, the Honorable Justice Birss took the view that FRAND should not

⁶³ See *Setting out the EU approach to Standard Essential Patents*, *supra* note 7, at 7.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ See *Ericsson v. D-Link*, 773 F.3d 1201, 1232 (Fed. Cir. 2014) (“the patentee’s royalty must be premised on the value of the patented feature, not any value added by the standard’s adoption of the patented technology.”).

be regarded “as a scheme which meant the patentee could not appropriate some of the value that is associated with the inclusion of his technology into the standard and the value of the products that are using those standards.”⁶⁷ This appears to be a more balanced approach: the exclusion of SEP holders from any share of the benefits created downstream the value chain bears the risk of depriving SEP holders of their fair reward for their contribution to the standard, which, in turn, could reduce the incentives to develop and contribute cutting-edge technology to standardisation work.⁶⁸

By contrast, the notion further expressed in the Communication is not expected to trigger controversy—the notion that alternative valuation methods ought to apply to technologies developed mainly for the standard. This approach appears to be essential for implementing FRAND. This is particularly illustrated by the example of the “carrier aggregation” of LTE: this technology which consists in combining multiple bands of radio spectrum, in order to provide more spectrum to users who, in a certain point in time, have higher needs than others (for instance those using mobile video streaming compared to those using only texting services), was designed for standardised 4G mobile networks and would, therefore, have little market value outside this standard.

As for the second principle contained in the Communication, pursuant to which FRAND should be based on the “present value added” (*i.e.*, the value discounted to the time of the conclusion of the license agreement), no substantial objections are expected to be raised against. As a rule, licensing agreements are long-term agreements and the value of SEPs varies as technology constantly evolves. Having said that, determining FRAND based on discounted value requires a complex calculation that has to consider a series of parameters. Insofar, the mere remark that the “present value added” should be “irrespective of the market success of the product which is unrelated to the patented technology” appears to pose more questions than it answers. Does the Commission suggest that the “market success” in terms of (future) sales of the licensed product should not play a role when determining the discounted value? Or does the Commission mean that, when determining FRAND, the value generated from standardised technology should be isolated from the value added by additional features of the product, which also contribute to making the product attractive to consumers? If so, on which basis shall the respective distinction between the value of the standardised technology and the value of non-standardised product features take place?

There is no need for respective clarification with respect to the third principle laid down in the Communication, according to which FRAND evaluation should “ensure continued incentives for SEP holders to

⁶⁷ See *Unwired Planet v. Huawei*, [2017] EWHC (Pat) 711, [97] (Eng.).

⁶⁸ See Gregory J. Sidak, *Apportionment, FRAND Royalties, and Comparable Licenses After Ericsson V. D-Link*, U. ILL. L. REV. 1809, 1864 (2016).

contribute their best available technology to standards.” Insofar, the Commission directs the attention of stakeholders involved in SEP licensing to one of the main pillars of the overall standardisation process, namely the need to ensure a fair and adequate reward for the SEP holders for their contributions to the standard.⁶⁹ This is an important signal, making clear that the Communication is not intended to question the foundation of the existing standardisation environment.

On the other hand, when approaching the last valuation principle set forth in the Communication, pursuant to which a “reasonable aggregate rate” for the standard should be taken into account when determining FRAND to avoid “royalty stacking,” one should not lose sight of the fact that “royalty stacking” is still a controversial phenomenon.⁷⁰ Indeed, there are studies indicating that particularly in the telecommunications industry, aggregate cumulative royalties paid by handset manufacturers to SEP holders are quite low. For example, Mallinson calculates they amount to no more than five percent of the handset revenues.⁷¹

Interestingly, the Communication does not refer to comparable licenses as a means to value SEPs, although comparable licenses are widely accepted as an adequate instrument not only in many European jurisdictions, but also in other major jurisdictions worldwide.⁷² In particularly in Europe, the District Court (Landgericht) of Düsseldorf, Germany in the case *Saint Lawrence v Vodafone* ruled that comparable

⁶⁹ See ETSI IPR Policy, *supra* note 12, at art. 3.2; (defines one of the core objectives of standardisation as follows: “IPR holders whether members of ETSI and their affiliates or third parties, should be adequately and fairly rewarded for the use of their IPRs in the implementation of standards and technical specifications[.]”).

⁷⁰ See *Ericsson*, 773 F.3d at 36. In a case, in which the implementer raised a defence based on the “royalty stacking” argument, the U.S. District Court of the Eastern District of Texas found that due to lack of evidence, “[t]he best word to describe Defendants’ royalty stacking argument is theoretical.”

⁷¹ See generally Keith Mallinson, *Cumulative Mobile-SEP Royalty Payments No More Than Around 5% of Mobile Handset Revenues*, WISEHARBOR (2015), <http://www.wisearbor.com/pdfs/Mallinson%20on%20cumulative%20mobile%20SEP%20royalties%20for%20IP%20Finance%202015Aug19.pdf>; See Gregory J. Sidak, *What Aggregate Royalty Do Manufacturers of Mobile Phones Pay to License Standard-Essential Patents?*, THE CRITERION JOURNAL OF INNOVATION, Vol. 1, 701, 701 (2016). See generally Alexander Galetovic, et al., *A New Dataset On Mobile Phone Patent Licence Royalties*, HOOVER INSTITUTION WORKING GROUP ON INTELLECTUAL PROPERTY, INNOVATION, AND PROSPERITY STANFORD UNIVERSITY, Working Paper No. 16011 (2016).

⁷² *Laser Dynamics, Inc. v. Quanta Comp., Inc.*, 694 F.3d 51, 79 (Fed. Cir. 2012). In the United States, the Court of Appeals for the Federal Circuit has emphasized that “actual licenses to the patented technology are highly probative as to what constitutes a reasonable royalty for those patent rights because such actual licenses most clearly reflect the economic value of the patented technology in the marketplace.” See [IWNCOMM v. Sony], 2017 BEIJING INTELLECTUAL PROPERTY COURT (Beijing Intellectual Property Ct.) (China). In China, the Beijing Intellectual Property Court ruled for the SEP holder in a case involving SEP licensing using comparable agreements to determine FRAND. See *Ericsson v. Micromax*, High Court of Delhi, Judgment dated 12th November 2014. In India, the High Court of Delhi similarly based its royalty calculation on 26 comparable licenses the SEP holder had signed with other Indian parties.

licensing agreements represent an “important indicator” of the FRAND conformity of the licensing terms offered to an implementer by the SEP holder.⁷³ In the UK, the High Court of Justice in the matter *Unwired Planet v Huawei* also used comparable licenses as basis for its FRAND calculation, since they represent “the best evidence of the value of the portfolio in issue.”⁷⁴

Finally, the clarification that discrimination cannot occur when licenses granted to companies doing business in different sectors (or companies following different business models) differ from one another, is particularly valuable for the interpretation of the “non-discrimination” element of FRAND.⁷⁵ In this respect, it is also interesting to note that, by citing *Unwired Planet v Huawei*, the Commission appears to also adopt the view followed by the Honorable Justice Birss—that the FRAND undertaking does not force the SEP holder to offer the same FRAND terms as that agreed with another similar situated licensee, unless the difference would distort competition between the licensees affected (*i.e.* the court favoured a “soft-edged non-discrimination”).⁷⁶

ii. Licensing Platforms

By encouraging the creation of patent pools and licensing platforms particularly with respect to the evolving IoT, the Commission seems to have met the pulse of the times. Indeed, in the last years, licensing platforms have emerged, especially in the IoT field. A good example is Avanci, a platform offering a fixed royalty model for SEPs regarding to the 2G, 3G, and 4G cellular standards in terms of a one-stop solution.⁷⁷

Licensing platforms allowing implementers, and particularly new market entrants, to have a transparent access to cutting-edge standardized technology needed for the development of their products and services appear to have the potential to improve the efficiency of SEP licensing to a significant extent, as the Commission suggests.⁷⁸

IV. ENFORCEMENT OF SEPS

The Commission holds the view that a clear, balanced, and predictable framework for the enforcement of SEPs can positively impact SEP licensing negotiations (especially by clarifying to the parties to such

⁷³ Landgericht [LG] [District Court of Düsseldorf] Mar. 31, 2016, Case No. 4a O 73/14, para. 273, 2016 (Ger.).

⁷⁴ *Unwired Planet v. Huawei* [2017] EWHC 711, [170] (Eng.).

⁷⁵ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 7.

⁷⁶ *Unwired Planet v. Huawei* [2017] EWHC 711, [501] (Eng.).

⁷⁷ See generally *Pricing*, AVANCI (2019), <http://avanci.com/pricing/>.

⁷⁸ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 7.

negotiations the consequences of their behaviour) and, in turn, promote the further spread of standardised technologies.⁷⁹

A. *The Commission's Recommendations*

The Commission's recommendations regarding to the enforcement of SEPs revolve mainly around the well-balanced framework established by the Court of Justice of the European Union (CJEU) in the matter *Huawei v ZTE* (*Huawei* judgment).⁸⁰ In the *Huawei* judgment, the Court set forth affirmative conduct obligations for both parties involved in SEP licensing negotiations;⁸¹ meeting these obligations turns on whether injunctive relief will be available to SEP holders and whether implementers can effectively defend themselves against an injunction request. Following the Court's ruling, national courts in Europe have been providing further guidance to stakeholders by interpreting and clarifying the *Huawei* framework.⁸²

The Commission took up this national jurisprudence and expressed the following views on core obligations established by the *Huawei* judgment:

- **SEP holder's obligation to make a FRAND offer:** SEP holder's offer must contain "clear explanations" on (1) the essentiality of its patent(s) for a standard, (2) the allegedly infringing products of the SEP user, (3) the proposed royalty calculation, and (4) the non-discriminatory element of FRAND.⁸³ Furthermore, according to "recognised commercial practices," the SEP holder's offer may refer to a worldwide portfolio license, provided that the portfolio "is limited to all SEPs that the implementer needs to produce or market its products."⁸⁴
- **Implementer's obligation to make a FRAND counter-offer:** The implementer's counter-offer must (1) be concrete and specific (meaning that it cannot be "limited to contesting the SEP holder's offer and a general reference to third-party determination of the royalty"),⁸⁵ (2) contain information on the "exact use" of the standard in the specific product,⁸⁶ (3) cover all SEPs which the implementer needs for

⁷⁹ *Id.* at 9.

⁸⁰ Case C-170/13, *Huawei v ZTE*, 2015 E.C.R. 477.

⁸¹ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 9.

⁸² A comprehensive library of summaries of decisions handed down by national courts in Europe after the *Huawei* judgement is provided by 4iP Council, a non-profit European organisation focusing on rigorous empirical research on intellectual property and innovation, available at <https://caselaw.4ipcouncil.com/>. For an overview of the respective case law, see also Claudia Tapia & Spyros Makris, *Negotiating SEP Licences in Europe After Huawei v ZTE: Guidance from National Courts*, *Managing Intellectual Property*, May 2018, at 21-29.

⁸³ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 10.

⁸⁴ *Id.* at 10-11.

⁸⁵ *Id.* at 10.

⁸⁶ *Id.*

its products/services (and not be limited to individual patents)⁸⁷ and (4) be made in a timely manner (whereas the reasonable time frame shall be determined on a case-by-case basis, mainly based on the quality and the detail of both the information provided by the SEP holder in his initial offer and the information on the essentiality of the patent(s) in question generally available, for instance via SEP declaration systems maintained by SDOs).⁸⁸

- **Implementer's obligation to provide security:** The amount of security to be provided by the implementer as a protection against an injunction, should be determined at a level that "discourages patent hold-out strategies."⁸⁹

Besides the above, the Commission reminds that in assessing the enforceability of SEPs by means of injunctive relief, courts are bound to proportionality considerations derived from Article 3(2) of the Directive 2004/48/EC⁹⁰ on the enforcement of Intellectual Property Rights (IPRs).⁹¹ The Commission further confirms its commitment to promote the use of Alternative Dispute Resolution (ADR) mechanisms, such as mediation and arbitration, in the context of SEP related disputes, particularly for the benefit of SMEs.⁹²

Regarding the enforcement of SEPs by non-practicing Patent Assertion Entities (PAEs) the Commission believes that no additional action is required at the present; PAEs should be treated in the same manner as any other SEP holder.⁹³ The Commission takes the view that European litigation systems have sufficient safeguards to absorb potential harmful effects of the activities of PAEs.⁹⁴ Nevertheless, the Commission will still monitor the impact of PAEs in the European market.⁹⁵

B. Assessment of the Commission's Recommendations

By embracing the *Huawei* judgment, which imposes obligations for conduct on both SEP holders and implementers, the Commission implicitly recognises that FRAND is a two-way street. This clarification is very valuable, since the Commission had previously followed a rather one-

⁸⁷ *Id.* at 11.

⁸⁸ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 10.

⁸⁹ *Id.*

⁹⁰ Council Directive 2004/48/EC, art. 3(2), OJ (L 195/16) (EC) (2004).

⁹¹ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 10.

⁹² *Id.* at 11.

⁹³ *Id.* at 11-12.

⁹⁴ *Id.* at 11.

⁹⁵ *Id.* at 12.

sided approach by focusing mainly on SEP holders' obligations⁹⁶ and by only raising risks for competition of a theoretical hold-up.⁹⁷

In its attempt to flesh out the obligations established by the *Huawei* judgment, the Commission refrained from any regulatory "corrections" to the case law rendered by the national courts of the EU member states following the Court's ruling. Moreover, the Commission expressly adopted the views taken by national courts, for instance, the notion expressed by the UK High Court of Justice in *Unwired Planet v Huawei*⁹⁸ that worldwide portfolio licensing, as a rule, complies with FRAND.⁹⁹

Furthermore, reflecting the balance between the interests of SEP holders and implementers struck by the CJEU in the *Huawei* judgment, the Communication recognised for the first time both hold-up and hold-out concerns by recommending setting the amount of security to be paid by the implementer for the use of SEPs "at a level that discouraged hold-out strategies."¹⁰⁰ The fact that the Commission equally refers to both hold-up and hold-out as risks attached to SEP licensing is important, since the patent hold-up theory had overshadowed hold-out concerns to a great extent, although it has been hardly backed-up by substantial empirical evidence¹⁰¹. Concerns that an imbalance in the perception of the hold-up and hold-out risks exists, have been recently articulated also by the US Department of Justice.¹⁰²

⁹⁶ Joaquin Almunia, Address at Paris IP Summit 2013: Intellectual Property and Competition Policy Speech at the Paris IP Summit 2013 (Dec. 9 2013).

⁹⁷ See Joaquin Almunia, Competition Policy for the Post-Crisis Era, Lewis Bernstein Memorial Lecture (Mar. 30 2013). In 2013, for example, the former Vice President of the European Commission responsible for Competition policy stated that "[Any company that holds these] standard essential patents can effectively hold up the entire industry with the threat of banning the products of competitors from the market." Joaquin Almunia, Introductory Remarks on Motorola and Samsung Decisions on Standard Essential Patents (Apr. 29 2014). In 2014, Almunia said that seeking injunction "may be" abusive if there is a FRAND commitment and the potential implementer is merely expressing its willingness to enter into a FRAND license.

⁹⁸ *Unwired Planet v. Huawei* [2017] EWHC 711, [535] (Eng.).

⁹⁹ The FRAND conformity of worldwide portfolio licenses has been recognized also by further courts in Europe. See, e.g., *Pioneer v. Acer*, Landgericht (LG) [District Court of Mannheim] Jan. 8, 2016, Case No. 7 O 96/14, [119] (Ger.), *Saint Lawrence v. Vodafone*, Landgericht (LG) [District Court of Düsseldorf] Mar. 31, 2016, Case No. 4a O 73/14, [310] (Ger.).

¹⁰⁰ See *Setting out the EU approach to Standard Essential Patents*, supra note 7, at 10.

¹⁰¹ Vincent Angwenyi & Marie Barani, *Smokescreen Strategies: What Lies Behind the Hold-up Argument*, GRUR INT. 204, 204-16 (2018) (critiquing the hold-up theory). See also Bowmann Heiden & Nicolas Petit, *Patent "Trespass" and the Royalty Gap: Exploring the Nature and Impact of Patent Holdout*, 34 SANTA CLARA HIGH TECH. L. J., 179, 179-204 (2018).

¹⁰² Makan Delrahim, Assistant Attorney General, Remarks at the USC Gould School of Law's Center for Transnational Law and Business Conference, Nov. 10, 2017 (pointing out that "too often lost in the debate over the hold-up problem is recognition of a more serious risk: the hold-out problem.").

V. RELATIONSHIP BETWEEN STANDARDISATION AND OPEN SOURCE

Finally, the Commission also expresses its basic opinion on the relationship between standardisation and Open Source. The Commission argues that both standards and Open Source projects can profit from an increased interaction, irrespective of the differences that exist between these models.¹⁰³ This can result in an acceleration of the uptake of advanced technologies, from which particularly SMEs can profit. The Commission will, therefore, promote a more effective integration between standards and Open Source projects by several measures, including funding studies on relevant topics.¹⁰⁴

The Commission's views on the overall positive effects, which an increased interaction between Open Source projects and standards development within SDOs can produce, mirror already ongoing efforts in this respect. A key point for promoting an effective collaboration between Open Source and SDO driven standardisation, will, however, be ensuring that the IPR position of innovators contributing their technology to the standard can be maintained and not be compromised. Concrete suggestions on how to achieve this goal are missing in the Communication. Insofar, it will be interesting to see, whether the comprehensive research activities in this field announced by the Commission will, in the future, result in tangible recommendations regarding to these questions.

VII. CONCLUSION

The Communication attempts to embrace an overall balanced approach mainly on three key issues regarding to standardisation driven by SDOs: the transparency of the SEP declaration framework supporting the standardisation process as well as the licensing and enforcement of SEPs. Although non-binding, the recommendations laid down in the Communication will guide – but also trigger – further discussions with respect to the above issues among stakeholders involved in standardisation.

Looking particularly at the practical implementation of the Commission's recommendations on the transparency of the SEP declaration process, several aspects appear to need further scrutiny. In this context, the Commission focuses on three measures: the operational improvement of declaration databases maintained by SDOs, the introduction of SEP declaration reviews and the introduction of (third party) essentiality checks. With respect to all three measures, the balance between costs and benefits should be given further attention. The Commission's general commitment to ensure proportionality needs to be fleshed out, with a closer analysis of both the costs associated with the introduction of new measures and the

¹⁰³ See *Setting out the EU Approach to Standard Essential Patents*, *supra* note 7, at 12.

¹⁰⁴ *Id.*

potential complexities such measures could generate within the existing standardisation ecosystem. For the latter, the legal framework for the implementation of SEP declaration reviews and essentiality checks needs to be developed, in order to be able to adequately assess the practical impact of these measures.

Besides that, a closer debate appears to be needed especially with respect to the following two principles suggested by the Commission for the valuation of FRAND: First, the recommended exclusion of the value resulting from the incorporation of patents in a standard requires special consideration, since it is based on a notion which is still controversial in legal theory and jurisprudence. Second, the Commission's view that a "reasonable aggregate rate" for the standard should be taken into account when determining FRAND also needs further elaboration, not least due to the high degree of complexity of the questions arising in this respect.

On the other hand, the Commission's recommendations regarding to the enforcement of SEPs offer clear guidance to parties involved in SEP licensing. By avoiding the temptation of regulatory "corrections" to the solid case law handed down by national courts in the EU following the *Huawei* judgment of the CJEU as well as by attributing, for the first time, equal weight to both hold-up and hold-out concerns, the Commission strengthens the framework for the licensing of SEPs in Europe.

PROMOTING LEGAL INNOVATION IN JAPANESE STARTUP FINANCING

A. Reid Monroe-Sheridan¹

I. INTRODUCTION

Over the past fifteen years, Silicon Valley has witnessed a variety of legal innovation designed to promote the funding of early-stage² startup businesses.³ Although newly developed seed funding⁴ instruments include repurposed forms of preferred stock and convertible notes, in many ways the most interesting and innovative tool in this category is convertible equity.⁵ In particular, in 2013, the startup accelerator Y Combinator released a new “simple agreement for future equity” (the “Safe”), which was designed to address the business and legal objectives of Y Combinator itself and the companies in which it invests.⁶ The Safe offers a simpler, faster, and generally more startup-friendly approach than other mainstream seed funding instruments,⁷ and it is increasingly used for startup fundraising outside of Y Combinator.⁸ To the extent that the Safe simplifies and speeds up the seed financing process for startups at a time when these companies typically face tight limitations on cash and time, it likely plays an important role in promoting a startup-friendly business environment.

In recent years, Japanese policymakers and businesspeople have devoted increasing attention to the development of a robust “startup ecosystem” in Japan, and the Japanese venture capital market, while still

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² As used in this Article, “early stage” refers generally to companies at an early stage of development. (It does not refer to companies at the Series A or Series B round of financing, as the term is sometimes used in the venture capital industry.)

³ John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 165-171 (2014).

⁴ “Seed” capital refers to the “initial capital raised by a [startup] company.” See, e.g., Geoff Ralston, *A Guide to Seed Fundraising*, Y COMBINATOR (Jan. 7, 2016), <https://blog.ycombinator.com/how-to-raise-a-seed-round>.

⁵ See generally Coyle & Green, *supra* note 3, at 165-171.

⁶ *Id.* at 166-170.

⁷ *Id.* at 169-170.

⁸ For example, the Securities and Exchange Commission has expressed concern about the use of Safes in crowdfunding transactions and the risk posed to investors. See *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, U.S. SECURITIES AND EXCHANGE COMMISSION (May 9, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

much smaller than the U.S. market, has grown to a record scale.⁹ Why this focus on startups? In addition to promoting technological innovation, new businesses are a major source of employment in Japan.¹⁰ Seed funding plays a critical role in the success of new technology ventures because it provides the capital necessary for startup founders to turn a mere idea into a viable product with some level of demonstrable market traction, which is typically required before venture capital funds will agree to make a large investment in a company.¹¹ Despite their importance, the legal instruments used in Japanese seed financings have not yet evolved in the manner of their Silicon Valley counterparts. Indeed, in Japan, common stock is still the typical security used for seed investments,¹² even though it suffers from considerable disadvantages as an early-stage investment instrument.¹³

Since Y Combinator announced the creation of the Safe, several Japanese lawyers have published analyses of the instrument itself or convertible equity in general, and many lawyers, founders, and investors in Japan are now aware of the Safe and its features.¹⁴ If convertible equity does offer meaningful advantages in Japan as compared to common stock and other fundraising instruments—a likely proposition discussed in more detail in Part II.D.iv—one would expect it to see it used in a sizeable

⁹ Kana Inagaki, *Japanese Venture Capital Investment Hits Record Levels*, FINANCIAL TIMES (March 1, 2018), <https://www.ft.com/content/927a9d14-1d21-11e8-aaca-4574d7dabfb6>. For an example of the focus on developing a startup ecosystem, see the Japanese government's Project for a Bridge of Innovation between Silicon Valley and Japan. "Japan Startup Selection" to be delegated to world's leading innovation ecosystem under "HIYAKU Next Enterprise" program, MINISTRY OF ECONOMY, TRADE AND INDUSTRY (Oct. 20, 2017), http://www.meti.go.jp/english/press/2017/1020_004.html.

¹⁰ For example, in 2014, companies established in 2005 or later accounted for approximately 20% of employment in Japan. MINISTRY OF ECONOMY, TRADE AND INDUSTRY, CHŪSHO KIGYŌ HAKUSHO [2018 WHITE PAPER ON SMALL AND MEDIUM ENTERPRISES IN JAPAN] 39 (2018), https://www.chusho.meti.go.jp/pamflet/hakusyo/H30/PDF/chusho/00Hakusyo_zentai.pdf.

¹¹ Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (Oct. 2008).

¹² Interview with Yohei Sawayama, Managing Partner of 500 Startups Japan, in Tokyo, Japan (Feb. 26, 2018) (on file with author). In fact, in 2016 over 29% of venture capital investments by yen amount were conducted using common stock, according to survey of Japanese VCs (¥24.974 billion of ¥85.463 billion in total, calculated from the responses of VCs who provided information on the investment instruments used). VENTURE ENTERPRISE CENTER, JAPAN, VEC YEARBOOK 2017 II-9 (2018) [hereinafter VEC YEARBOOK 2017].

¹³ See *infra* Part II.D.i.

¹⁴ See, e.g., Nobuki Takeuchi & Shuya Ogawa, *Shoki Raundo ni Okeru Shikin Chōtatsu no Jitsumu to Kadai* [Issues and Practice Relating to Initial Fundraising Rounds], 2087 SHŌJI HŌMU 37 (Dec. 15, 2015); see generally Anri Okamoto, *SAFE (Gaiyō)* [SAFE (A Summary)], JPXSV STARTUP LAWYER, <http://jp-sv-startuplawyer.blogspot.jp/2015/07/safe.html> (last visited Aug. 14, 2018); Junsuke Matsuo & Yoshimasa Umemoto, *Shōrai kabushiki shutoku ryakushiki keiyaku sukimu (SAFE) to kuraudo fandingu* [Crowdfunding and Contractual Arrangements for the Acquisition of Future Stock (SAFE)], 99 SHŌKEN KEIZAI KENKYŪ 1 (Sept. 2017), available at http://www.jsri.or.jp/publish/research/pdf/99/99_01.pdf.

number of early-stage financing transactions. And yet, convertible equity remains a rare choice for fundraising in Japan, with just a few exceptions.¹⁵

There are both legal and environmental factors present in the Japanese market that appear conducive to the widespread adoption of convertible equity, and under Japanese law convertible equity even offers certain benefits that are not present under U.S. law.¹⁶ In light of the technical advantages of convertible equity over other seed financing tools, the most compelling explanation for its disfavor in Japan is that certain environmental obstacles (*i.e.*, factors that are external to the legal instrument itself) are obstructing the spread of contractual innovation in this area.¹⁷ Accordingly, if these obstacles can be identified and mitigated, convertible equity might become an important part of the toolkit for Japanese startups to bridge the gap between inspiration and execution.

To build an understanding of the barriers to a broader use of convertible equity in Japan, this Article draws on legal scholarship, statistical information on the Japanese and American venture finance markets, practical guidance from key players in the startup communities in both Japan and the U.S., and interviews with over a dozen investors, founders, and lawyers in Silicon Valley and Tokyo.¹⁸ Synthesizing information from these sources, this Article presents an analysis of (i) the technical advantages of convertible equity (in the form of the Safe) as compared to other seed funding instruments, (ii) environmental and other factors that have led to increasingly widespread use of the Safe in Silicon Valley, and (iii) how these properties and other factors apply or fail to apply in Japan in light of the Japanese legal system, the alternative instruments currently used for seed financing in Japan, and certain characteristics of the Japanese venture finance market. This analysis is significant in part because it draws from a real convertible equity use case to conclude that the failure of convertible equity to proliferate in the Japanese market to date is the result of environmental or other external factors and not the properties of convertible equity within the Japanese legal system. Finally, this Article suggests some possible measures that influential participants in the Japanese

¹⁵ This is discussed in detail in Part II.D.iv.

¹⁶ This is discussed in detail in Parts II.C and II.D.

¹⁷ This is discussed in detail in Part II.E.

¹⁸ The interviewees were drawn from the author's personal and professional networks or introduced to the author by members of those networks, with a particular focus on persons with professional experience in both Silicon Valley and Tokyo. Accordingly, the interviewees may not be a representative sample of Silicon Valley- or Tokyo-based professionals, and their responses may not be representative of their respective broader professional groups. Because detailed quantitative information on the seed-stage market is scarce, the interviewees provided valuable qualitative responses based on their professional experience, in some cases drawn from firsthand involvement in dozens or hundreds of startup financing transactions. The interviewees were granted anonymity upon request to promote candor in their interviews; certain interviewees' professional titles have been modified slightly to better preserve their anonymity.

startup community could take to promote the wider availability of convertible equity as a tool for Japanese founders and investors.

II. COMPARATIVE ANALYSIS OF THE USE OF CONVERTIBLE EQUITY IN SILICON VALLEY AND JAPAN

At present, the driving force behind convertible equity's popularity as a seed funding instrument in Silicon Valley is undoubtedly the Safe, which is used far more frequently than any other convertible equity instrument in the market.¹⁹ In analyzing the Safe's predominance, the factors animating its popularity can be roughly split into two categories: (i) "internal" factors that relate to the technical characteristics of the Safe as a legal instrument and (ii) "external" factors that relate to environmental attributes of the Silicon Valley startup community and the efforts of certain parties to promote the Safe. Although there is some overlap between the categories, this internal-external distinction is particularly helpful because it highlights different advantages and challenges for convertible equity when transposed to the Japanese market. In addition, as this analysis will demonstrate, both categories appear to be important components of the Safe's success.

A. *Internal Factors: The Safe's Technical Characteristics as a Driver of Its Popularity*

i. Background

The Safe's technical merits are clearest in light of the historical context. Until roughly 2005, common stock was the instrument of choice for seed-stage investments in Silicon Valley.²⁰ Technological advances at that time made it possible for founders to develop a viable product for internet-based businesses with far less capital than had been necessary in

¹⁹ Although no comprehensive data set on the use of seed funding instruments exists, the Safe has received far more attention than any other instrument both in the news media and regulatory sphere. *See, e.g.*, Joe Green, *COMMENTARY: SEC rightly concerned about 'so-called SAFE' securities in crowdfunding*, REUTERS (June 2, 2017, 3:30 AM), <https://www.reuters.com/article/bc-finreg-crowdfunding-safe/commentary-sec-rightly-concerned-about-so-called-safe-securities-in-crowdfunding-idUSKBN18S63M>; Paul Martino, *Here's How the Smartest Startup Founders Raise Funds*, YAHOO! FINANCE (Mar. 3, 2017), <https://finance.yahoo.com/news/smartest-startup-founders-raise-funds-020019799.html> (mentioning the Safe but no other convertible equity instruments). In addition, the Silicon Valley-based lawyers and founders interviewed for this Article typically had direct experience with Safes but little or no such experience with other convertible equity seed funding instruments. Interview with Attorney 1, Partner at a California-based Law Firm (Mar. 2018); Interview with Founder 1, Chief Executive Officer of a California-based Startup (Mar. 2018); Interview with Startup Executive 1, Vice President of a California-based Startup (Mar. 2018) (all interviews are on file with the author).

²⁰ Coyle & Green, *supra* note 3, at 136.

the past, creating new demand for a pre-Series A²¹ round of startup financing that would provide the startup with more capital than could be raised from friends and family.²² However, common stock offered angel investors²³ little protection for such investments, while preferred stock required excessively time-consuming and costly negotiations.²⁴ Furthermore, a startup that sells common stock to investors in a seed round subsequently faces limitations on its ability to issue stock options that imply a lower enterprise valuation for the startup, which in turn limits the startup's ability to use inexpensive options to recruit and incentivize employees.²⁵

Convertible notes, based on venture financing bridge notes but simplified and fine-tuned for seed funding, largely solved these problems.²⁶ A seed financing convertible note is in essence a corporate promissory note that converts into Series A preferred stock at the time of the startup's Series A financing, thus allowing the investor and founder to avoid the time and expense of negotiating preferred stock terms and valuing the company at the seed stage. By obviating the need for a valuation, convertible notes also permit the startup to avoid the increase in the appraised value of the company's common stock that typically accompanies a common stock-based investment, thereby allowing the startup to continue issuing inexpensive options for common stock. Furthermore, the Series A conversion allows the convertible note investors to enjoy the favorable terms offered to Series A investors rather than riding along with the common stock holders until the company's exit,²⁷ and a conversion discount

²¹ Series A financing generally refers to a startup's first full round of financing from venture capital funds (although some VC funds invest at earlier stages as well). It is so called because the investors in such rounds typically subscribe for "Series A preferred stock." Series A rounds involve a significant capital commitment on the part of investors. The median 2018 Series A financing round size was \$9.1 million as of mid-2018. Kate Clark, *Automation Anywhere raises huge Series A as deal sizes continue to inflate in 2018*, PITCHBOOK (July 2, 2018), <https://pitchbook.com/news/articles/automation-anywhere-raises-huge-series-a-as-deal-sizes-continue-to-inflate-in-2018> (last visited Mar. 1, 2019).

²² By raising additional funds before the Series A financing, a founder can reach important business milestones before Series A funding becomes necessary and accordingly negotiate a better valuation for the Series A round, resulting in less dilution for the founder. Coyle & Green, *supra* note 3, at 157-58.

²³ "Angel investors are wealthy individuals who personally finance the same high-risk, high-growth start-ups as venture capitalists but at an earlier stage." Ibrahim, *supra* note 11, at 1406. This Article uses the term "seed investment" to refer broadly to pre-Series A investments other than those raised from the founder's friends and family (some industry sources draw a distinction between "angel" and "seed" financings).

²⁴ Coyle & Green, *supra* note 3, at 159.

²⁵ Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 891-92 (2003).

²⁶ Coyle & Green, *supra* note 3, at 161.

²⁷ The exit is an event that provides liquidity to the company's investors, generally an acquisition or initial public offering.

and conversion cap²⁸ sweeten the deal for seed investors to compensate them for the increased risk of a pre-Series A investment and protect them against venture capital (“VC”) investors overvaluing the startup in the Series A round.²⁹

Despite the convertible note’s strengths, within a few years, the next phase of contractual innovation began to take shape. Between 2012 and 2014, various Silicon Valley lawyers were working separately on developing an improved seed funding instrument—evidence that convertible notes suffered from significant shortcomings apparent to legal specialists in the industry.³⁰ At the same time, Y Combinator was drafting and fine-tuning the Safe for use in its own portfolio companies.Carolynn Levy, a Y Combinator partner and attorney formerly at Wilson Sonsini Goodrich & Rosati, developed the Safe in collaboration with other partners at Y Combinator as well as various angel investors and VC firms.³¹

The Safe is a relatively simple contract and is similar to a convertible note in that a Safe investor acquires the right to receive a certain number of shares of equity issued in the startup’s next equity financing.³² Although there are many versions of the Safe available on the internet, Y Combinator makes the standard version of the document available for free on its website.³³ As with a convertible note, a Safe investor can negotiate a conversion discount and a valuation cap, providing compensation to seed investors for the extra risk they take on relative to Series A investors.³⁴ The principle differences between the Safe and convertible notes are that the Safe (1) does not bear interest, (2) does not have a maturity date or default

²⁸ These provisions provide convertible note investors with economic terms that are superior to the Series A investors when the convertible notes convert into Series A preferred stock. To provide a simplified example, a \$100,000 convertible note that converts at a 20% discount would convert into Series A preferred stock valued at \$120,000 based on the price paid by the Series A investors. (In practice, conversions are messier because multiple convertible instruments typically convert simultaneously, sometimes with different conversion mechanics, and convertible notes also accrue interest that converts together with the principal amount of the notes.)

²⁹ Coyle & Green, *supra* note 3 at 159-60.

³⁰ Among these efforts were Y Combinator’s SAFE, Yoichiro Taku’s “convertible security”, 500 Startup’s KISS, Cooley Godward Kronish’s Series AA, and Fenwick & West’s Series Seed. *See generally id* at 166-76. *See generally* Gregory Raiten, 500 Startups Announces ‘KISS’, 500 STARTUPS (July 3, 2014), <https://500.co/kiss/>.

³¹ Coyle & Green, *supra* note 3, at 168-169.

³² *SAFE Primer*, Y COMBINATOR, https://www.ycombinator.com/docs/SAFE_Primer.rtf (last visited Apr. 5, 2019).

³³ *See Startup Documents*, Y COMBINATOR, <https://www.ycombinator.com/documents/> (last visited Apr. 5, 2019). For more on certain other versions of the Safe, *see, e.g.*, Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-so-Safe Safe*, 102 VA. L. REV. ONLINE 168, 176 (2016) (noting that WeFunder has adopted its own form of Safe) and *SAFE: Simple Agreement for Future Equity (Seed-Stage Startup)*, THOMSON REUTERS, <https://us.practicalallaw.thomsonreuters.com/w-001-3072> (last visited Apr. 5, 2019) (Practical Law’s form of Safe).

³⁴ *See generally SAFE Primer*, *supra* note 32.

concept, (3) is a form of equity³⁵ rather than debt, and (4) is a shorter, simpler document.³⁶ Levy rejects the idea that the Safe is a radical departure from other seed funding instruments, describing it instead as “just a convertible note with the ‘event-of-default,’ interest, and maturity date provisions stripped out.”³⁷ By using a familiar framework for the Safe, Y Combinator hoped to increase the likelihood that members of the startup community in Silicon Valley would adopt the new instrument.³⁸

The simplified structure of the Safe offers several benefits. Because “the interest rate for a debt financing functions as the price of the deal,” the economic terms of a convertible note interest rate can be essentially replicated via adjustments to the Safe’s other price terms, namely the discount and valuation cap.³⁹ Accordingly, the removal of an interest rate provision does not necessarily disadvantage investors but does allow founders to avoid the “time sink” of interest rate negotiations.⁴⁰

Given that the maturity date of a convertible note is not a purely economic term, its absence from the Safe is a founder-friendly development. Typical seed notes may automatically convert into common stock at a pre-agreed (typically investor-favorable) valuation if the maturity date occurs prior to the company completing its next equity financing, but the investors may alternatively have the right to demand repayment of the note at maturity.⁴¹ If the company cannot repay the convertible note at maturity, the investor theoretically has the ability to bankrupt the startup.⁴² Some investors use this leverage to extract certain business or legal concessions from founders, such as “re-negotiat[ing] the terms of a note,” which, unsurprisingly, is vexing for founders.⁴³ The Safe’s lack of a maturity date provision means that a Safe-holder typically does not have

³⁵ The Safe does not fit perfectly within the category of equity, but at least from an accounting standpoint, it is more equity-like than debt-like. Zach Abramowitz, *Innovation More Than Another App: How Wilson Sonsini Lawyer Turned YC PartnerCarolynn Levy Is Revolutionizing Startup Investing*, ABOVE THE LAW (Jan. 20, 2015, 4:02 PM), <https://abovethelaw.com/2015/01/innovation-more-than-another-app-how-wilson-lawyer-turned-yc-partner-carolynn-levy-is-revolutionizing-startup-investing>. Alternatively, given that Safe holders are not owed fiduciary duties, from a legal standpoint it may be more accurate to characterize the Safe as a derivative. Green & Coyle, *supra* note 33, at 172.

³⁶ *Startup Documents*, *supra* note 33.

³⁷ Abramowitz, *supra* note 35.

³⁸ Coyle & Green, *supra* note 3, at 168.

³⁹ Spencer Williams, *Venture Capital Contract Design: An Empirical Analysis of the Connection Between Bargaining Power and Venture Financing Contract Terms*, 23 FORDHAM J. CORP. & FIN. L. 105, 137 (2017).

⁴⁰ Abramowitz, *supra* note 35.

⁴¹ See, e.g., *Series Seed Notes – Convertible Promissory Note*, GITHUB (June 21, 2017), <https://github.com/CooleyLLP/seriesseed/blob/master/notes/Series%20Seed%20Notes%20-%20Convertible%20Promissory%20Note.md> (explaining Cooley LLP’s form convertible promissory note for seed funding).

⁴² Coyle & Green, *supra* note 3, at 167.

⁴³ Abramowitz, *supra* note 35. This topic also came up twice in the interviews conducted for this Article. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

any right to demand repayment or conversion of the instrument unless a triggering event occurs, and when such an event does occur, the conversion is generally automatic.⁴⁴

As the Safe is a form of equity, Safe-holders do not enjoy the same repayment preference as convertible noteholders, which has been a point of concern for some seed investors.⁴⁵ Safe-holders are entitled to repayment of their investment amount in preference to the company's stockholders in the event that the company is dissolved, but this repayment obligation is typically subordinated to the Company's debt repayment obligations.⁴⁶ Levy explains this characteristic of the Safe as consistent with the philosophy that "startup investing is not about loaning money - it's about investing money."⁴⁷ The Safe's subordination to debt obligations is consistent with the business model of many experienced angel investors, who focus on generating returns through a few wildly successful investments rather than small exits and claw-backs of investment capital from unsuccessful portfolio companies.⁴⁸

ii. Advantages of the Safe's Technical Characteristics

Admittedly, some of the technical characteristics of the Safe are only advantageous from one party's perspective. For example, founders generally view the lack of a maturity date as a strength of the Safe, while some investors may view it as a drawback that negatively impacts their negotiation leverage should the company fail to raise its Series A financing within the anticipated timeframe.⁴⁹ Notably, however, certain characteristics of the Safe are beneficial for both founders and investors. After all, both parties typically share the medium-term goal of a successful Series A financing and the long-term goal of a successful exit for the startup.

⁴⁴ *Startup Documents*, *supra* note 33.

⁴⁵ Abramowitz, *supra* note 35.

⁴⁶ See, e.g., *SAFE*, Y COMBINATOR, https://www.ycombinator.com/docs/SAFE_Cap.rtf (last visited Aug. 14, 2018). However, some modified forms of the Safe place it *pari passu* with convertible debt. See, e.g., *SAFE: Simple Agreement for Future Equity (Seed-Stage Startup)*, *supra* note 33.

⁴⁷ Abramowitz, *supra* note 35.

⁴⁸ Green & Coyle, *supra* note 33 at 172-73 ("Savvy startup investors typically view the outcomes of seed investments in these companies as essentially binary: The companies will either succeed or go bust, leaving the investors with either a lucrative multiple return on their investment or a loss of most, if not all, of their principal. Often, in the downside scenario, the founders and investors try to salvage as much of their investments (and reputations) as possible through a sale or acqui-hire, but modest, middling returns are not what most investors are seeking in the feast-or-famine world of seed-stage startup investing[.]").

⁴⁹ Two lawyers with venture financing practice experience in Silicon Valley raised this point during interviews for this Article. Interview with Attorney 2, Former Partner at International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author); Interview with Attorney 3, Partner at International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author). See also Abramowitz, *supra* note 35.

Levy has characterized the appeal of convertible instruments as “speed, lack of friction and cost.”⁵⁰ In discussions of the Safe specifically, this sentiment was echoed by a Silicon Valley lawyer and a Silicon Valley-based startup founder interviewed for this Article.⁵¹ The lawyer, who frequently represents both VC funds and startups, described several ways in which these traits of the Safe can also benefit investors: (1) seed stage investors want a startup to use its limited funds on developing its business and not on fundraising transaction expenses; (2) using a convertible note’s maturity to force a company into bankruptcy is usually a waste of time and resources, because the company is not likely to have any significant assets that could be used to make the noteholder whole; (3) investors are aware that if they squeeze founders upon the maturity of convertible notes, they are likely to acquire a bad reputation and lose access to investments in the most promising startups; and (4) an investor who genuinely believes that she will need the negotiation leverage provided by a note reaching maturity to keep the founders in line may be better off not investing in that company and instead finding a startup with more trustworthy and competent management.⁵² The appeal of the Safe to founders is straightforward: It is a fast, inexpensive means of executing seed financing and is “highly company-favorable” as compared to a convertible note.⁵³ Basically, Safes preserve for founders the advantages of the convertible note over capital stock while also eliminating a few of the investor-favorable terms of convertible notes and the time required to negotiate those terms.⁵⁴ In light of these factors, a simple, low-cost instrument with a well-known standard form that does not require founders and investors to spend time negotiating an interest rate and maturity date may have broad appeal for certain types of early financing transactions.

iii. Disadvantages of the Safe’s Technical Characteristics

Importantly, despite its appeal to founders and some investors, the Safe is not well-suited to every context. Joseph Green and Professor John Coyle have written at length about the Safe’s structural reliance on the investee pursuing a typical startup fundraising plan in order for the Safe to achieve its intended outcomes.⁵⁵ For example, if founders take seed investment in the form of Safes and then proceed to further finance their business with bank loans rather than equity issuances, extract corporate wealth through high executive salaries and dividend distributions, and never exit through a sale or initial public offering, the Safe-holders are stuck holding essentially worthless paper with no legal right to extricate

⁵⁰ Abramowitz, *supra* note 35.

⁵¹ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

⁵² Interview with Attorney 1, *supra* note 19.

⁵³ Green & Coyle, *supra* note 33, at 173.

⁵⁴ These benefits are, namely, not needing to negotiate a valuation at the time of the investment, not owing fiduciary duties to investors until the investment converts into capital stock, and not having to negotiate the relatively complex terms of a preferred stock investment.

⁵⁵ See generally Green & Coyle, *supra* note 33, at 170.

themselves from their investment.⁵⁶ The risk of this type of exploitative founder behavior is low in Silicon Valley for reasons that are discussed in Part B, but it may be higher in other environments.⁵⁷

When asked about the potential drawbacks of Safe investments, two Silicon Valley-based professionals interviewed for this Article mentioned that occasionally founders misconceive the founder-friendly characteristics of the Safe as offering some intrinsic protection against excessive founder dilution when the company raises its Series A financing.⁵⁸ For example, a founder who raises \$2.5 million through Safes at a \$5 million valuation cap has essentially sold 50% of the company's equity, on top of the dilution that will result from the Series A financing, even if the Series A round is later raised at a \$20 million valuation.⁵⁹ Some founders erroneously assume that an instrument known to be founder-friendly must include an inherent protection against such dilution if they can achieve a sufficiently high valuation for the Series A round.⁶⁰ It is even possible for the dilutive effect of prior convertible fundraisings, especially those at a valuation that is much lower than the contemplated Series A round, to be so extreme that VC funds decline to invest in a startup.⁶¹

Notably, although there may be technical solutions to these disadvantages of the Safe that could be incorporated into the instrument, both of the above-mentioned issues (investors' inability to prevent exploitative founder behavior and founders' potential misconception of the instrument's terms) can also be mitigated through certain external measures described in Part i below. It is likely that any technical solutions would add to the complexity of the Safe, thereby eroding one of the Safe's chief strengths: simplicity.⁶² In any event, despite certain shortcomings, the Safe's technical strengths deserve serious consideration in that they have been sufficient, in concert with the extrinsic factors described in Part B below, to spur a large number of founders and investors in Silicon Valley to use the instrument in startup financings.

⁵⁶ *Id.* at 177-78.

⁵⁷ Green and Coyle focus on the crowdfunding context, which has also drawn the attention of the Securities and Exchange Commission. See *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, *supra* note 8.

⁵⁸ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. See also Pascal Levensohn & Andrew Krowne, *Why SAFE notes are not safe for entrepreneurs*, TECHCRUNCH (July 9, 2017), <https://techcrunch.com/2017/07/08/why-safe-notes-are-not-safe-for-entrepreneurs/>.

⁵⁹ In a typical Safe, the fully diluted capitalization of the company (used to calculate the number of shares into which the Safe should convert) is calculated including all stock options, warrants, the stock option pool but excluding all Safes and convertible notes and the new funds to be contributed by the equity financing investors. See *SAFE*, *supra* note 46.

⁶⁰ Levensohn & Krowne, *supra* note 58.

⁶¹ *Id.*

⁶² Green & Coyle, *supra* note 33, at 180 ("This desire for simplicity is attributable, at least in part, to the unique needs of this particular contracting community. These are deals for relatively small amounts of money and there is a strong desire to keep legal fees and friction low so as to execute the transaction quickly.").

B. External Factors: Environmental Attributes of Silicon Valley and Third-Party Activity as Drivers of the Safe's Popularity

i. The Availability of Effective Channels of Informal Control

Years before the development of the Safe, Professor Darian Ibrahim explored the motivations of angel investors in Silicon Valley who choose to invest in startups using simple, founder-friendly contracts.⁶³ This behavior is particularly striking because “extreme levels of uncertainty, information asymmetry, and agency costs in the form of potential entrepreneurial opportunism [...] plague angel investments.”⁶⁴ Ibrahim argued that, among other factors, certain aspects of the Silicon Valley ecosystem make simplified angel investment contracts economically rational despite apparent incentives for angels to use more detailed contracts that would mitigate legal risk in seed-stage startups.⁶⁵ Notwithstanding changes in seed funding practices over the past decade, the responses of the Silicon Valley lawyers interviewed for this Article are remarkably consistent with key aspects of Ibrahim’s analysis. Understanding the environmental factors that incentivize angel investors to use simplified investment contracts is a critical part of understanding the Safe’s popularity in Silicon Valley and how that may or may not be transferable to the Japanese market.

One factor in Ibrahim’s analysis that also surfaced in interviews conducted for this Article is the existence of “informal substitutes for the venture capitalist’s formal contract protections.”⁶⁶ These informal substitutes include (1) introductions from trusted parties, reducing the need for traditional due diligence; (2) angels investing in founders or industries they know well, reducing information asymmetry; and (3) angels investing in companies that are physically close to their homes and actively participating in the startup’s business, allowing them to both build trust and informally monitor the startup.⁶⁷ Another important factor is that angels’ investment contracts are typically unwound relatively quickly, which is also true of the Safe because it automatically converts into preferred stock at the time of the startup’s next equity financing.⁶⁸

Noting that costly contracting theory supposes that “contracts will be simpler when self-enforcement, in addition to court-enforcement, is available to an aggrieved party,” Ibrahim raises the possibility that the “reputation market among venture capitalists and entrepreneurs” may partially explain angels’ comfort with simplified contracts in light of “the

⁶³ Ibrahim, *supra* note 11, at 1406.

⁶⁴ *Id.* at 1420.

⁶⁵ *Id.* at 1405.

⁶⁶ *Id.* at 1431.

⁶⁷ *Id.* at 1431-33.

⁶⁸ Ibrahim, *supra* note 11, at 1434-35.

tight-knit nature of communities such as Silicon Valley.”⁶⁹ However, Ibrahim ultimately concludes that the impact of reputational sanctions is “unclear.”⁷⁰ In contrast, Professors Gregg Polsky and John Coyle have argued in more recent scholarship that “reputational concern, self-image, and a desire to avoid social sanctions” operate as restraints on exploitative entrepreneurial behavior in the acquihire context.⁷¹

Polsky and Coyle propose that investors have means of exerting pressure on opportunistic founders by (i) refusing to finance a founder’s future endeavors, (ii) appealing to a founder’s sense of moral obligation to those who have supported her business, and (iii) threatening to ostracize a founder.⁷² There is no reason that seed-stage investors would not be able to make use of these same means of influence, especially social sanctions, which are “perhaps most relevant in the context of smaller angel investors.”⁷³ In other recent scholarship, Professor Brad Bernthal similarly proposes that relationship networks in investment accelerators “make[] it possible to quickly mobilize group social sanctions where an individual’s deviations from norms become problematic.”⁷⁴ The general view of this more recent scholarship, then, is that robust relationship networks and threat of informal sanctions are significant factors in constraining opportunism in Silicon Valley.

Interestingly, the threat of reputational sanctions against *investors* may also work to the Safe’s advantage. As discussed in Part ii above, an investor’s aggressive use of a convertible note’s maturity date to extract concessions from a founder would violate behavioral norms among certain circles of Silicon Valley angels, including influential accelerators such as Y Combinator, and could damage an investor’s reputation.⁷⁵ There is evidence that reputation is truly important for investors: in the venture capital context, empirical research indicates that “high-reputation VCs are more likely to have their offers accepted than are low-reputation VCs” and that “high-reputation VCs pay between 10 and 14 percent *less* for shares than do low-reputation VCs.”⁷⁶ This means that, for angel investors who travel

⁶⁹ *Id.* at 1435.

⁷⁰ *Id.* at 1436.

⁷¹ Gregg D. Polsky & John F. Coyle, *Acqui-Hiring*, 63 DUKE L.J. 281, 311 (2013).

⁷² *Id.* at 314.

⁷³ *Id.* at 319. Ibrahim notes, however, that angel investors have an incentive to avoid public sanctions on wayward founders because the founder’s failure is tantamount to the angel’s investment failing as well. Ibrahim, *supra* note 11, at 1436.

⁷⁴ Brad Bernthal, *Investment Accelerators*, 21 STAN. J.L. BUS. & FIN. 139, 189 (2015).

⁷⁵ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. See also Abramowitz, *supra* note 35 (“[S]tartup investing is not about loaning money - it’s about investing money (really, RISKING money) for a potentially significant return. YC’s philosophy is that this early / seed-stage money is about helping the company get to the next level. It’s not important to claw it all back if the startup fails or if there is a weak acqui-hire.... But I fully appreciate that YC’s philosophy is different from the view of many other investors[.]”).

⁷⁶ ANDREW METRICK & AYAKO YASUDA, *VENTURE CAPITAL & THE FINANCE OF INNOVATION* 83, John Wiley & Sons (2d ed. 2010) (emphasis in original).

within these circles, a maturity date repayment right in a seed investment contract is not likely to be exercised and is therefore of limited value. Accordingly, many investors may decide (and, given the popularity of the Safe, appear to have decided in fact) that they are willing to forego this low-value provision in exchange for a faster, cheaper and smoother execution of their investment.⁷⁷

ii. Seed-Stage Investor Preferences

Ibrahim raises certain other possible contributing explanations for angel behavior that merit consideration in the context of a comparison with the Japanese market. First, subsequent venture capital investment is typically necessary for angel investors to receive a return on their investments, meaning that angels have an incentive to use simple or at least reasonable investment instruments that do not discourage VCs from making a Series A investment in the startup.⁷⁸ Second, seed investors overvaluing a startup is one of the most common issues that can hinder a Series A financing; convertible instruments reduce this risk by postponing the startup's valuation until the time of the Series A fundraising.⁷⁹ Third, angel investors may use simple, founder-friendly contracts to signal to entrepreneurs that they trust in the founder's judgment and will be easy to work with; this signaling may help angel investors get access to the best startup investment opportunities.⁸⁰

The typical business model of Silicon Valley seed stage investors is another important point in this comparative analysis, and one that arose repeatedly in interviews conducted for this Article.⁸¹ Angels' "most lucrative returns" result from companies that have consummated an initial public offering or been purchased at a high price, and these home-run deals

⁷⁷ See, e.g., Coyle & Green, *supra* note 3, at 180 ("These are deals for relatively small amounts of money and there is a strong desire to keep legal fees and friction low so as to execute the transaction quickly[.]").

⁷⁸ Ibrahim, *supra* note 11, at 1428. Startups' need for subsequent venture capital investment also allows larger angel investors to exert influence by carving up capital investment into staged financings. Zenichi Shishido, *Does Law Matter to Financial Capitalism?*, 37 *FORDHAM INT'L L.J.* 1087, 1118 (2014). However, smaller angel investors may not have the financial resources to participate in future funding rounds.

⁷⁹ Ibrahim, *supra* note 11, at 1430 ("Susan Preston, an experienced angel investor, also advises angels to keep the terms of their investment simple because '[n]othing can prevent follow-on funding faster than an overly complicated and burdensome first round, which a VC must try to unwind, often demanding a discounted value and other 'cram-down' requirements to offset onerous or overreaching first-round terms.'"). Nonetheless, there is still some risk that a valuation cap in a convertible instrument can be treated by seed investors and company insiders as a de facto valuation. See, e.g., Mark Suster, *Bad Notes on Venture Capital, BOTH SIDES OF THE TABLE* (Sept. 17, 2014), <https://bothsidesofthetable.com/bad-notes-on-venture-capital-5967b9e7ec74>.

⁸⁰ Ibrahim, *supra* note 11, at 1442.

⁸¹ Interview with Investor 1, Partner at a Venture Capital Investment Firm in Tokyo, Japan (Feb. 2018) (on file with author); Interview with Attorney 4, Partner at an International Law Firm in Tokyo, Japan (Mar. 2018) (on file with author); Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

“compensate angels for the far larger number of start-ups that fail.”⁸² Similarly, investment accelerators, such as Y Combinator, are in the “hits business,”⁸³ where “one successful investment can make up for a whole bunch of investments with a zero return.”⁸⁴ This is also consistent with the behavior of VCs, which typically “ignore... lesser payoffs and focus attention on the places where the payoffs are significant.”⁸⁵ In the aggregate, this collective focus on big hits rather than small or medium-sized returns means that investors in Silicon Valley are typically not focused on recouping their invested capital from failed startups. In light of this, it is perhaps not surprising that many angel investors are willing to accept the Safe’s sacrifice of certain investor protections in favor of increased speed and reduced costs.

The popularity of the Safe also likely reflects that promising founders currently command substantial negotiation leverage in Silicon Valley.⁸⁶ If the terms of the Safe were grossly inconsistent with the balance of founders’ and investors’ relative leverage, it is extremely unlikely that these parties would agree to use the instrument for such a large number of transactions.⁸⁷ Indeed, the Safe’s founder-friendly terms appear to reflect in part a Silicon Valley fundraising environment where for the best startups there is something approaching “access to unlimited capital” and investors are loath to upset the most promising founders.⁸⁸ To this end, the Safe provides angel investors a tool that they can use to signal their trust in founders and willingness to let founders maintain control of the startup, thereby increasing the angels’ chance of getting access to the most desirable deals.⁸⁹ This may be a particularly useful signaling mechanism for angels because many Silicon Valley angels invest in part for non-financial reasons, such as an intense interest in a startup’s technology or an emotional attachment to the startup.⁹⁰

⁸² Ibrahim, *supra* note 11, at 1428.

⁸³ Bernthal, *supra* note 74, at 185.

⁸⁴ Abramowitz, *supra* note 35.

⁸⁵ METRICK & YASUDA, *supra* note 76, at 179.

⁸⁶ See, e.g., Steve Blank, *When Founders Go Too Far*, HARVARD BUSINESS REVIEW (Nov.-Dec. 2017), <https://hbr.org/2017/11/when-founders-go-too-far> (“Whereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing too few quality start-ups[.]”).

⁸⁷ Williams, *supra* note 39, at 159 (“[V]enture financing supply has a statistically significant relationship with price and non-price terms in both equity and debt financings.”). As noted in Part II.A.i, Y Combinator structured the Safe while considering input from both founders and investors and trying to strike a fair balance in the context of the Silicon Valley ecosystem. Coyle & Green, *supra* note 3, at 170.

⁸⁸ Sheelah Kolhatkar, *At Uber, A New C.E.O. Shifts Gears*, THE NEW YORKER (Apr. 9, 2018), <https://www.newyorker.com/magazine/2018/04/09/at-uber-a-new-ceo-shifts-gears>.

⁸⁹ Ibrahim, *supra* note 11, at 1442.

⁹⁰ Ibrahim, *supra* note 11, at 1438-39. Relinquishing control would typically be less costly for an angel investor with non-financial motivations than for a financially-oriented investor, who will generally seek formal channels of influence over startup decision-making to maximize its investment.

iii. The Impact of Y Combinator

The factors described in Parts II.B.i and II.B.ii above explain why a simple, fast, and low-cost seed funding contract might gain popularity in Silicon Valley, but do not explain why the Safe, rather than an alternative such as Yoichiro Taku's convertible security, has become the market's convertible equity instrument of choice.⁹¹ To understand the Safe's predominance, it is necessary to consider Y Combinator's role in Silicon Valley and the actions it has taken to promote the Safe. Because Y Combinator functions as a "kingmaker, research center, and massive instigator of change" in the startup community, investors will typically give serious consideration to investing in Y Combinator-graduated startups.⁹² Furthermore, Y Combinator invests in over 200 startups per year, meaning that active angels and VCs are likely to encounter Y Combinator's portfolio companies with some frequency.⁹³ As Y Combinator invests in startups using the Safe,⁹⁴ both founders and investors have strong incentives to gain an understanding of the instrument: Founders are eager to enter the program and benefit from mentorship and investor connections, and investors are eager to find the next Airbnb or Dropbox (both Y Combinator graduates).⁹⁵

In addition to deploying the Safe in real-world investments at a rapid pace, Y Combinator uses its website as a platform to increase public knowledge of the Safe.⁹⁶ The combination of hundreds of real-world use cases among top-class startups and public promotion by Silicon Valley's leading startup accelerator has surely contributed to the Safe's popularity, at minimum by reducing the number of founders and investors who are unfamiliar with the mechanics and terms of the Safe.⁹⁷ And the efforts by Y

⁹¹ This "convertible security" is a convertible equity instrument with Safe-like terms that Taku, a partner at Wilson Sonsini Goodrich & Rosati, introduced the year before Y Combinator created the Safe. Coyle & Green, *supra* note 3, at 167.

⁹² Sandra Upson, *At Y Combinator's Demo Day, The Age of Overpromises Is Over*, WIRED (Mar. 20, 2018, 2:30 PM), <https://www.wired.com/story/y-combinator-demo-day-uber-for-x>. At Y Combinator's Demo Day, startups that are graduating the program have the opportunity to pitch to "500 of Silicon Valley's top investors." Aditi Roy, *For Many Tech Investors in Silicon Valley, This is the Most Important Event of the Year*, CNBC (Mar. 21, 2017, 8:41 PM), <https://www.cnbc.com/2017/03/21/y-combinator-demo-day-what-is.html>; see also Nathaniel Rich, *Silicon Valley's Start-Up Machine*, N.Y. TIMES (May 2, 2013), <https://www.nytimes.com/2013/05/05/magazine/y-combinator-silicon-valleys-start-up-machine.html>.

⁹³ The 2017 winter batch alone included 120 companies. See Roy, *supra* note 92.

⁹⁴ Paul Graham, *Announcing the Safe, a Replacement for Convertible Notes*, Y COMBINATOR (Dec. 6, 2013), <https://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes>.

⁹⁵ Y Combinator's acceptance rate for its winter 2017 batch was less than 2% (7,000 applications for 120 or fewer spots). Roy, *supra* note 92.

⁹⁶ For example, Y Combinator has promoted the Safe on its website, published a Safe primer on its website, and explained in its blog how the Safe can be used by startups for seed funding. See Graham, *supra* note 94; *SAFE Primer*, *supra* note 32; Ralston, *supra* note 4.

⁹⁷ Statements by Levy in a 2015 interview suggest lack of understanding of the Safe's terms was at least a partial impediment to its use by certain lawyers and investors who were unfamiliar with the instrument. Abramowitz, *supra* note 35.

Combinator to draft the terms of the Safe in a manner that would be palatable to both founders and investors has likely reduced the number of parties who, being familiar with the terms of the Safe, reject it based on the substance of the instrument.

The various forms⁹⁸ of the Safe that Y Combinator makes available also serve as standard documents for Safe investments in Silicon Valley. Some parties modify the Safe, but the standard form is commonly used as a starting point and modifications are generally limited.⁹⁹ In contrast, there is no single market-standard form of convertible note.¹⁰⁰ The result is that Safes are less likely to include highly unusual terms, drafting errors, or other irregularities that may require additional time and expense to resolve or that may discourage subsequent venture capital firms from investing in the startup.¹⁰¹ Clerky (a Y Combinator graduate itself) is a tool that further streamlines this process by automatically generating execution-ready Safe documents based on Y Combinator's form, collecting signatures, and producing fully executed contracts at closing.¹⁰²

Y Combinator's physical presence in Silicon Valley and its requirement that participating founders relocate to Y Combinator's offices for the duration of its three-month accelerator program¹⁰³ may facilitate the development of trust networks and bolster the efficacy of reputational sanctions. Specifically, the "social integration of an [investment accelerator] system" helps "build networks that utilize prior connections and overlay pre-existing norms already present in the startup community" and "lowers the cost to mobilize group social sanctions where an individual deviates from behavioral norms."¹⁰⁴ As discussed in Part i above, the threat of reputational sanctions appears to be a key supplement to the limited legal rights investors acquire via a Safe.

Y Combinator and other highly reputable accelerators may also increase investor comfort with the Safe by conducting screening activities that would not be possible for individual angel investors.¹⁰⁵ Y Combinator's

⁹⁸ The forms offered are (1) cap, no discount; (2) discount, no cap; (3) cap and discount; and (4) most-favored nation clause, no cap, and no discount. *Startup Documents*, *supra* note 33.

⁹⁹ Interview with Attorney 1, *supra* note 19.

¹⁰⁰ *Id.* This is also clear from the fact that various well-known startup- and venture-focused law firms offer different forms of convertible note on their respective websites. *See, e.g., Series Seed Notes – Convertible Promissory Note*, *supra* note 41; Kristine M. Di Bacco et al., *Convertible Note (Seed-Stage Start-Up)*, LEXISNEXIS, <https://www.fenwick.com/FenwickDocuments/Convertible-Note-Seed-Stage-Startup.pdf> (last visited Aug. 14, 2018).

¹⁰¹ Interview with Attorney 1, *supra* note 19.

¹⁰² *See generally*, CLERKY, <https://www.clerky.com> (last visited Aug. 14, 2018).

¹⁰³ *Frequently Asked Questions*, Y COMBINATOR (June 2016), <https://www.ycombinator.com/faq/#q24>.

¹⁰⁴ Bernthal, *supra* note 74, at 145.

¹⁰⁵ Y Combinator alone reviews thousands of startup applications for each semiannual intake. Roy, *supra* note 92.

selection process and intensive three-month program may act as a substitute for the trusted referrals that angels use to screen out low-quality deals and also reduce the need for due diligence.¹⁰⁶ Although successful completion of a prestigious accelerator program is no guarantee that a founder has a sound business idea and will behave ethically, the risks of a flatly unworkable business model or exploitative founder behavior are surely lower for graduates of a highly selective program as compared to the entire universe of startups. Within this pre-screened group, investors may be more willing to bear the risk of reduced contractual protections for the most attractive investment opportunities.¹⁰⁷

Finally, Y Combinator and other major investment accelerators may perform a critical role within the Silicon Valley startup community by “aggressively us[ing] communications platforms – especially blogs, books, and an industry group association – to congeal startup community norms.”¹⁰⁸ Y Combinator’s blog touches on a wide range of topics, including fundraising.¹⁰⁹ Paul Graham, the co-founder and “paterfamilias” of Y Combinator,¹¹⁰ was a prolific blogger for many years, writing on topics related to startup founders and investors.¹¹¹ The norms that Y Combinator and others promote through these communication platforms may thus make streamlined contracts easier to use by bolstering the informal rules that act as a backstop when contractual protections are inadequate to discourage opportunistic behavior.

iv. Summary

In short, the Safe offers a low-cost, simplified set of terms that generally reduces the negotiation burden on both parties compared to the mainstream alternatives,¹¹² eliminates a convertible note provision (the maturity date) that has been known to vex founders, allows the postponement of the company’s valuation, is subordinated to the company’s debt obligations, and converts into the company’s Series A preferred stock when the company raises its Series A funding. One important drawback of

¹⁰⁶ Ibrahim, *supra* note 11, at 1432.

¹⁰⁷ However, it is important to note that successful completion of even a program like Y Combinator is no guarantee of investment. For example, about 20% of Y Combinator’s 2011 summer batch either did not or could not raise capital from investors following completion of the program. RANDALL STROSS, *THE LAUNCH PAD* 233 (2012).

¹⁰⁸ Bernthal, *supra* note 74, at 182.

¹⁰⁹ See, e.g., Ralston *supra* note 4, and Aaron Harris, *Process and Leverage in Fundraising*, Y COMBINATOR (May 7, 2018), <https://blog.ycombinator.com/process-and-leverage-in-fundraising>.

¹¹⁰ See Steven Levy, *Y Combinator Has Gone Supernova*, WIRED (June 28, 2017, 6:55 AM), <https://www.wired.com/story/y-combinator-has-gone-supernova>.

¹¹¹ See *Essays*, PAUL GRAHAM, <http://www.paulgraham.com/articles.html> (last visited Aug. 14, 2018).

¹¹² Although common stock requires the negotiation of only an issuance price, fixing the issuance price requires agreeing on a valuation for the company. A common stock investor may also seek to execute a shareholders’ agreement, which will increase the complexity of the investment.

the Safe is an increased risk that founders may use the funds imprudently or elect to postpone future equity fundraising because the Safe provides investors little legal recourse in such cases. However, mechanisms for informal sanctions, including robust informal relationship networks (which are bolstered by investment accelerator communities) provide an additional check on founder behavior. Furthermore, angel investors may be willing to use the Safe because their primary focus is on achieving a small number of hugely successful investments and because a willingness to use the founder-friendly Safe may act as a positive signal to in-demand founders deciding to apportion a seed round among a limited number of investors. Finally, Y Combinator's use of the Safe for its own investments and continued advocacy for the instrument has likely helped increase both widespread understanding of the Safe and willingness of other parties to use it in their own investments.

C. *Overview of the Japanese Startup Landscape*

In examining how the factors contributing to the widespread availability of convertible equity as a tool for seed fundraising in Silicon Valley might apply in the Japanese context, it is necessary to consider certain key aspects of the legal, business and financial environment for startups in Japan. Interestingly, many characteristics of the Japanese startup environment appear conducive to the widespread use of a lightweight convertible equity instrument. Nonetheless, such a trend has not yet materialized. Part E below discusses possible explanations for this somewhat counterintuitive outcome.

An extreme difference in scale is the most salient contrast between the Japanese and American¹¹³ venture financing markets. The Japanese market is very small relative to the American market in terms of both total amount invested and average deal size. In 2016, American VC investment totaled about \$69 billion (across 8,136 deals), compared to approximately \$1.4 billion (across 1,387 deals) of VC investment in Japan.¹¹⁴ Within this small market, the breakdown of startup funding sources is notably different from that of the American market. According to a 2017 survey, the most

¹¹³ At times, this Article refers to the “Silicon Valley” market and the “American” or “U.S.” market in a manner that implies interchangeability. Although the Silicon Valley market is just one of several markets that make up the whole U.S. venture financing market, it is by far the single largest venture financing market in the United States. VENTURE ENTERPRISE CENTER, JAPAN, BENCHĀ HAKUSHO 2017 [VENTURE WHITE PAPER 2017] I-62 (2017). The author takes sole responsibility for the accuracy of all citations to Japanese-language sources throughout this Article, including this note 113 and notes 118, 126, 130, 133, 140, 144, 145, 149, 150, 166, 187, and 204. This Article relies on overall U.S. market data because the available data for the Silicon Valley market is far less detailed.

¹¹⁴ VEC YEARBOOK 2017, *supra* note 12, at II-41. Throughout this Article, references to a particular year with respect to statistical Japanese market data refer to the typical Japanese fiscal year, which runs from April 1 to March 31 (e.g., Japanese market data for “2016” covers the period beginning on April 1, 2016 and ending on March 31, 2017).

frequent sources of startup funds in Japan were banks and credit unions, which were used even more commonly than founder self-funding.¹¹⁵ Angel funding is limited; angel investors supplied only 6.5% of the total money raised by startups since their inception, and 6.3% of the total money raised by startups in the year prior to the 2017 survey.¹¹⁶ Nonetheless, angel financing appears to be an important step in startups securing VC funding, as during the same period 36.0% of companies that secured venture capital investments had raised funds from angel investors, while only 25.0% of companies that failed to secure venture capital investment had raised from angels.¹¹⁷

Investments in Japanese VC funds in 2016 were sourced (by amount of capital) approximately 23% to corporates and 26% to banks, trusts, and credit unions, which are particularly risk averse.¹¹⁸ Often, these limited partners (“LPs”) are “not genuinely equity-oriented” because they commonly have an ownership or other business relationship with their chosen VC fund, which creates a high barrier to the LP redirecting future investments to other funds that offer superior performance.¹¹⁹ As a result, poorly performing funds “can and do survive” in Japan.¹²⁰ Furthermore, in comparison to the U.S., the proportion of VCs in Japan that are “owned by banks, insurance companies (financial firms) and corporates is relatively large.”¹²¹

These differences in VC fund structure and incentives do not appear to foster strong performance. As of 2017, “[w]hen aggregated by launch year, all 427 Japanese venture capital funds surveyed by [Japan’s Venture Enterprise Center] had inferior performance to their U.S. peers, with the exception of the funds launched in the 1982-to-1984 period and funds launched in 1999.”¹²² In addition, the startups in which U.S. VCs

¹¹⁵ Specifically, among all startup financings in the year prior to the survey, more rounds involved fundraising from banks and credit unions than from founders. VEC YEARBOOK 2017, *supra* note 12, at I-69.

¹¹⁶ VEC YEARBOOK 2017, *supra* note 12, at I-68-69. According to the Pitchbook-NVCA Venture Monitor, angel and seed financing rounds amounted to \$7.5 billion in 2018, compared to a total \$130.9 billion in VC investment, meaning angel and seed funding comprises about 5.7% of the total. John Gabbert et al., *4Q 2018 Venture Monitor*, PITCHBOOK 4, 8, https://files.pitchbook.com/website/files/pdf/4Q_2018_PitchBook_NVCA_Venture_Monitor.pdf (last visited Mar. 1, 2019).

¹¹⁷ VEC YEARBOOK 2017, *supra* note 12, at I-67. However, other factors (such as the startups that attract angel investment simply being more promising than those that do not) could also explain this correlation.

¹¹⁸ *Id.* at II-21. TETSUYA ISOZAKI, KIGYŌ NO FAINANSU ZŌHŌKASEIBAN [STARTUP FINANCE, EXPANDED AND REVISED EDITION] 255 (2015) [hereinafter ISOZAKI, STARTUP FINANCE, EXPANDED AND REVISED EDITION].

¹¹⁹ See Shishido, *supra* note 78, at 1119-20.

¹²⁰ *Id.* at 1120.

¹²¹ Wako Watanabe, Early Results of the VC Project 2 (Aug. 17, 2018) (unpublished early report of research for the Economic and Social Research Institute, Cabinet Office, Japan) (on file with author).

¹²² VENTURE ENTERPRISE CENTER, JAPAN, VEC YEARBOOK 2016 I-42 (2017) [hereinafter VEC YEARBOOK 2016].

invest outperform their Japanese counterparts over time in terms of both job-creation and operating revenue.¹²³

Japanese VC firms that are directly affiliated with banks, securities companies, and large corporates have a reputation for being traditional-minded and rigid in their structure, with little investment discretion allocated to the employees responsible for sourcing and managing deal flow.¹²⁴ These employees also typically do not enjoy an equity or profit-sharing incentive.¹²⁵ Investment decisions are generally slow, taking anywhere from one month to as long as one year from the date of first contact with the founder.¹²⁶ Corporate VC investors (“CVCs”) are also a popular source of startup funding, with a majority of startups anticipating investment from a corporate investor.¹²⁷ An increasingly large number of CVCs have funded investment accelerators or launched their own accelerators.¹²⁸ One company that specializes in helping CVCs set up accelerators, Creww Inc., stated in 2016 that it had already implemented or was scheduled to implement over 230 accelerator programs.¹²⁹

The Japanese seed financing market is similar to the pre-2005 Silicon Valley market in one important respect: common stock is still the seed funding instrument of choice.¹³⁰ Although in Silicon Valley seed-stage investing is more typically the purview of angel investors and “micro-VCs,”¹³¹ in Japan it is common for VCs to invest in seed-stage companies.¹³² This is likely in part due to the fact that there are far fewer angel investors in Japan than in America.¹³³ Despite the relatively small size of the market, competition for access to the most promising seed-stage deals in Japan is fierce and has been increasing in recent years.¹³⁴

Classified stock has gradually increased in popularity to overtake common stock as the instrument of choice for Japanese VC investments on

¹²³ Watanabe, *supra* note 121, at 9.

¹²⁴ ISOZAKI, *STARTUP FINANCE, EXPANDED AND REVISED EDITION*, *supra* note 118, at 275-76.

¹²⁵ Shishido, *supra* note 78, at 1119.

¹²⁶ HIDEYUKI SHIMAUCHI, *BENCHĀ KYAPITARU KARA NO SHIKINCHŌTATSU [FUNDRAISING FROM VENTURE CAPITAL]* 120 (3rd ed. 2012).

¹²⁷ VEC YEARBOOK 2017, *supra* note 12, at I-70.

¹²⁸ *Id.* at I-33.

¹²⁹ VEC YEARBOOK 2016, *supra* note 122, at I-52.

¹³⁰ Yukihiro Machida, *Shinkabuyoyakukentsukishasai no katsuyō nitsuite no ikkōsatsu (jō) [Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part I of 2)]*, 2139 SHŌJI HŌMU 20, 21-22 (July 15, 2017).

¹³¹ These are VCs that focus on seed-stage investments and generally manage relatively small funds. See Samir Kaji, *Where is the Micro-VC Market Going*, CB INSIGHTS (Sept. 4, 2014), <https://www.cbinsights.com/research/revisiting-micro-vc-market>.

¹³² In 2016, 19.2% of total VC investments by number and 21.0% of the total amount invested went to seed-stage companies. VEC YEARBOOK 2017, *supra* note 12, at II-15.

¹³³ TETSUYA ISOZAKI, *KIGYŌ NO EKUITI FAINANSU—KEIZAI KAKUMEI NO TAME NO KABUSHIKI TO KEIYAKU [STARTUP EQUITY FINANCE—STOCK AND CONTRACTS FOR AN ECONOMIC REVOLUTION]* 69 (2014) [hereinafter ISOZAKI, *STARTUP EQUITY FINANCE*].

¹³⁴ VEC YEARBOOK 2017, *supra* note 12, at I-14.

the whole,¹³⁵ bringing the Japanese market practice closer in line with the American practice, which relies heavily on preferred stock.¹³⁶ However, Japanese VC investment contracts often include a “buyback” mechanism, something that is rarely, if ever, seen in the United States.¹³⁷ Under this provision, the founders are typically obligated to repurchase the VC’s investment at cost upon demand.¹³⁸ This arrangement is extremely unfavorable to founders, and—even worse, from the founder’s perspective—VCs actually use the provision with some frequency. In 2016, approximately 27.5% of VCs’ exits were achieved through buybacks by company management.¹³⁹ To analyze how these factors are conducive or obstructive to the use of convertible equity in Japan, it is also necessary to understand the key technical characteristics of the investment instruments currently used in Japanese seed financing transactions.

D. Overview of Seed Financing Instruments in Japan

i. Common Stock

Despite its prevalence in Japan, seed financing via common stock suffers from many of the same drawbacks as it does in the United States, and in some respects common stock is an even more cumbersome tool in Japan. From the founder’s perspective, common stock is likely to result in more dilution than a convertible instrument, because market practice in Japan is to provide relatively low startup valuations in the seed round.¹⁴⁰ A 2017 Japanese book on startup finance, for example, advises founders to target a seed round valuation of at least ¥50 million (about \$500,000),¹⁴¹ while the average seed-stage valuation in the US is more than ten times that amount.¹⁴² As in the United States, it is often difficult for Japanese founders to make a case to investors about any kind of objective value of their companies, because seed stage companies typically have almost no revenue and face highly uncertain long-term prospects.¹⁴³ With such extreme downward pressure on seed round pricing, postponing a company’s

¹³⁵ VEC YEARBOOK 2016, *supra* note 122, at I-30.

¹³⁶ Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1164-65 (2013).

¹³⁷ See Shishido, *supra* note 78, at 1121.

¹³⁸ See *id.*

¹³⁹ VEC YEARBOOK 2017, *supra* note 12, at I-19. A Tokyo-based lawyer interviewed for this Article speculated that many of these exits may be at enormous discounts from the VC’s equity purchase price. Interview with Attorney 2, *supra* note 49.

¹⁴⁰ *Konbātiburu • ekuiti ga nihon no sutātoappu wo kaeru* [Convertible Equity Will Change Japan’s Startups], BUSINESS LAWYERS (Sept. 21, 2017, 10:50 AM), <https://business.bengo4.com/category16/article236> [hereinafter Convertible Equity Will Change Japan’s Startups].

¹⁴¹ ISOZAKI, STARTUP EQUITY FINANCE, *supra* note 133, at 71.

¹⁴² Kate Clark, *Late-stage valuations have increased nearly 20% in 2018*, PITCHBOOK (May 8, 2018), <https://pitchbook.com/news/articles/late-stage-valuations-have-increased-nearly-20-in-2018>.

¹⁴³ Machida, *supra* note 130, at 20.

valuation until the Series A financing can be very important for founders seeking to minimize the dilution of their ownership share.

Additionally, the tax complications of common stock fundraising in the United States have analogues in Japan. Under Japanese law, for startup managers and employees to receive certain favorable tax treatment of their stock options, the exercise price of the option must be equal to the value of the stock at the time of the grant.¹⁴⁴ In effect, the sale of common stock to investors can act as a ratchet for the exercise price on any future option grants to employees.¹⁴⁵ The impact of this on a startup can be significant, because stock options with a low exercise price are a key method of recruiting and incentivizing employees, especially in a company's early stages.¹⁴⁶ Given that many seed-stage founders in Japan identify human resources as their single largest concern, the availability of cheap stock options as a means of attracting top talent would seem to be particularly important.¹⁴⁷ Japan also suffers from a comparative lack of professional managers, making recruiting a strong management team very difficult for Japanese founders.¹⁴⁸ In these respects, common stock-based seed financing is particularly disadvantageous for startups in Japan.

There is also another tax issue at play. Subscriptions for a corporation's capital stock are subject to a 0.7% registration tax to the extent the capital contributed is used to increase the registered corporate capital of the corporation,¹⁴⁹ and under Japanese law at least 50% of capital via an equity issuance must be allocated to an increase in registered corporate capital.¹⁵⁰ Even assuming that the tax is minimized to the extent possible, 0.35% of any common stock seed investment is effectively extinguished as soon as the investment is made as a result of this tax liability. At the seed stage where every dollar (or yen) counts, even this small percentage can be significant.

With low valuations as a market norm, a founder is likely to sell a significant share of her company at the seed stage, and through subsequent financing rounds, it is certainly possible that majority control of the

¹⁴⁴ Sozei Tokubetsusochihō [Act on Special Measures Concerning Taxation], Law No. 26 of 1957, art. 29, para. 2(3) (Japan) (available at http://elaws.e-gov.go.jp/search/elawsSearch/elaws_search/lsg0500/detail?lawId=332AC0000000026&openerCode=1#881).

¹⁴⁵ KATSUYA GOTO ET AL., BENCHĀ JITSUMU A TO Z [VENTURE PRACTICE A TO Z] 312-13 (2016).

¹⁴⁶ See, e.g., Scott Kupor, *Recommendations for Startup Employee Option Plans*, ANDREESSEN HOROWITZ (July 26, 2016), <https://a16z.com/2016/07/26/options-plan>.

¹⁴⁷ In a 2017 survey, 28% of all founders, and 20% of seed stage founders, identified human resources as their top concern. VEC YEARBOOK 2017, *supra* note 12, at I-71.

¹⁴⁸ ISOZAKI, STARTUP FINANCE, EXPANDED AND REVISED EDITION, *supra* note 118, at 255-56.

¹⁴⁹ Tōroku Menkyo Zeihō [Registration and License Tax Act], Law No. 35 of 1967, annex table 1, item 24(1)(4) (Japan).

¹⁵⁰ Kaishahō [Companies Act], Law No. 86 of 2005, art. 445, para. 2, translated in (Japanese Law Translation [JLT DS]), <http://www.japaneselawtranslation.go.jp> (Japan).

company could slip out of the founder's grasp.¹⁵¹ When selling a significant stake of common stock, founders in Japan relinquish more control than their American counterparts. Unlike Delaware corporations, which have two primary governing documents (the charter and the bylaws), Japanese corporations (*kabushiki kaisha*) are governed solely by their corporate charter.¹⁵² Shareholders have the ability to amend the corporate charter unilaterally by special resolution, without the resolution of the board of directors that would be required under Delaware law.¹⁵³ As insightfully noted by Professor Gen Goto, this means that in theory shareholders can unilaterally amend a company's charter to give themselves voting rights over a corporation's ordinary business matters without the consent of the company's board.¹⁵⁴

It gets worse (for founders). Japanese law requires that a company's shareholders fix the maximum aggregate compensation for the company's directors.¹⁵⁵ Although the shareholders vote to simply establish the size of the total pool of funds for annual director compensation,¹⁵⁶ in a startup with one, two, or three directors, the intended compensation for each director is likely to be obvious, and the majority shareholders effectively have a veto right over any irksome founder compensation arrangement.

On top of low seed-stage valuations and twofold tax complications, common stock seed investments may also involve substantial contractual complexity in the Japanese market. In Japan, VCs' common stock investments are often accompanied by detailed side contracts, and because these contracts are non-public and no accepted standard forms exist, there is confusion among Japanese founders regarding which terms can be negotiated and to what extent.¹⁵⁷ Additionally, because the overwhelming majority of Japanese founders are first- or second-time founders, they are very likely to lack experience and know-how in negotiating seed-stage investment contracts.¹⁵⁸ Accordingly, common stock seed investments in Japan can be exceedingly unfavorable for founders, diluting their equity stakes, ratcheting up the exercise price at which they can grant stock options

¹⁵¹ Investors contributed an average of ¥95.9 million per seed stage deal in 2016 and ¥58.9 million in 2015. VEC YEARBOOK 2017, *supra* note 12, at I-13. A founder receiving an average amount of investment would lose control of her company in a just a single funding round at a low-but-conceivable seed stage valuation of ¥50 million.

¹⁵² Gen Goto, *Legally "Strong" Shareholders of Japan*, 3 MICH. PRIVATE EQUITY & VENTURE CAP. L. 125, 129-30 (2014).

¹⁵³ *Id.* at 129-30 (citing Companies Act, *supra* note 150, art. 466; DEL. CODE ANN. tit. 8, § 242(b)(1) (2011)).

¹⁵⁴ *Id.* at 130 (citing Companies Act, *supra* note 150, art. 295).

¹⁵⁵ *Id.* at 131 (citing Companies Act, *supra* note 150 art. 361, para. 1).

¹⁵⁶ *Id.*

¹⁵⁷ Takeuchi & Ogawa, *supra* note 14, at 44.

¹⁵⁸ According to a 2017 survey, for example, 71% of founders were first-time founders and 21% of founders were second-time founders. VEC YEARBOOK 2017, *supra* note 12, at I-73.

employees, weakening their control of the business, and offering limited (if any) benefits in terms of speed and legal cost.

Nonetheless, some of these weaknesses of common stock from the founder's perspective may represent positive features from the investor's perspective. The stock option exercise price ratchet and increased delay and expense of complicated financing contracts are not likely to help either party, but the founder's dilution means that the investor holds a greater share of the company's equity, the founder's loss of control is a result of the investor's gain of some shareholder protections, and the opacity of the side contracts provides an aggressive investor an opportunity to negotiate more favorable terms (though at increased expense).

Even from the founder's perspective, there are circumstances where common stock does offer some advantages. One Japanese founder interviewed for this Article noted that he had chosen to raise seed funding using common stock because requesting a straight common stock raise with no special terms allowed him to minimize the risk that investors would ask for an onerous founder-buyback provision.¹⁵⁹ If a founder succeeds in securing investors' agreement to these terms, the founder will also be able to avoid the contractual complexity that arises from detailed side agreements, thus reducing legal costs, and may be able to increase his chance of obtaining subsequent financing by agreeing to use an instrument familiar to Japanese VCs.¹⁶⁰

There is also one respect in which raising capital through the sale of common stock benefits both founders and investors: the lack of a corporate registration (*toki*) requirement.¹⁶¹ Under Japanese law, seed financing through convertible notes and convertible equity is effected using of a type of warrant (*shinkabuyoyakuken*, sometimes also referred to as a "stock option" or "stock acquisition right") that, once issued, the company must register with the Legal Affairs Bureau.¹⁶² Classified stock is subject to a similar registration requirement.¹⁶³ The terms of side contracts can be excluded from the corporate registration, but the terms that must be registered include the exercise price and enough information to allow a third

¹⁵⁹ Interview with Founder 2, Chief Executive Officer of Japan-Incorporated Startup with Overseas Headquarters in Tokyo, Japan (May 18, 2018) (on file with author).

¹⁶⁰ Venture capital firm employees not understanding an instrument, or having difficulty explaining the instrument to their superiors, can delay or sink an investment deal. *See, e.g.*, Convertible Equity Will Change Japan's Startups, *supra* note 140; Machida, *supra* note 130, at 23 (explaining that this may be a current hindrance to the use of convertible equity in the Japanese market). *See* discussion *infra* Part II.E.ii.c.

¹⁶¹ Machida, *supra* note 130, at 22.

¹⁶² *Id.* at 22-23.

¹⁶³ *Id.* at 22-23.

party to calculate the valuation.¹⁶⁴ Because the information registered with the Legal Affairs Bureau is available to the public, the material terms of these seed financings are essentially public information once the registration is complete.¹⁶⁵ In fact, Yohei Sawayama, a Managing Partner of 500 Startups Japan (recently rebranded as Coral Capital), has created a large database of deal information based on this public disclosure, including amount invested, investment instrument, and pre- and post-money valuation.¹⁶⁶ Some Japanese investors cite the ability to avoid this public disclosure as one of the appealing aspects of investing via common stock.¹⁶⁷

ii. Classified or Preferred Stock

Classified stock carries many of the same disadvantages in seed-stage financings in Japan as it does in the United States. First, as in the United States, creating and issuing a new class of stock in Japan requires negotiating a valuation and amending the corporate charter, which increases transaction costs.¹⁶⁸ In addition, registered corporate capital contributed in exchange for classified stock is also subject to the 0.7% registration tax that applies to capital contributions for common stock.¹⁶⁹ Although the terms of classified stock can be structured so that it functions similarly to convertible equity, these disadvantages still make the instrument less appealing than a convertible equity instrument under typical circumstances.¹⁷⁰

Classified stock does offer one important advantage over common stock in that, unlike common stock, an issuance of classified stock does not immediately set a floor for the exercise price of future tax-favorable issuances of options to purchase common stock.¹⁷¹ However, the terms of classified stock issuances are subject to the corporate registration (*toki*) requirement, meaning that key valuation terms will become public information after the transaction is closed.¹⁷² In some cases, there is also a corporate law requirement for separate shareholder meetings of classified

¹⁶⁴ See Companies Act, *supra* note 150, art. 911, para. 3(12), art. 915, para. 1 (setting forth the items that must be registered upon the issuance of *shinkabuyoyakuen*); art. 108, para. 2; art. 915, para. 1 (requiring amendments to the articles of incorporation in the case of creation of new series of classified stock and requiring an update of the corporate registration in the case of such amendment).

¹⁶⁵ Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁶⁶ See generally Yohei Sawayama, *Chōsa repōto: 186-sha no tōkibo kara wakatta sutātoappu no shikinchōtatsu no "sōba"* [Survey Report: The Fundraising "Market" for Startups as Determined from 186 Companies' Corporate Registrations], CORAL CAP., INC. (June 19, 2017), <https://coralcap.co/2017/06/deal-terms/>. The author has also reviewed the spreadsheet.

¹⁶⁷ Takeuchi & Ogawa, *supra* note 14, at 43. In Delaware, there is no such disclosure requirement.

¹⁶⁸ Companies Act, *supra* note 150, art. 108(2); Machida, *supra* note 130, at 22.

¹⁶⁹ Convertible Equity Will Change Japan's Startups, *supra* note 140. See also Registration and License Tax Act, *supra* note 149, annex table 1, item 24(1)(4).

¹⁷⁰ See Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁷¹ GOTO ET AL., *supra* note 145, at 312-13.

¹⁷² Machida, *supra* note 130, at 22.

stock holders, which creates an administrative burden for both startups and investors.¹⁷³

iii. Convertible Notes

Although convertible notes are an increasingly popular method of seed financing in Japan, they are not yet mainstream.¹⁷⁴ In Japan, seed financing notes are generally structured as corporate promissory notes paired with stock warrants, and they allow founders and investors to avoid some of the most troublesome aspects of fundraising through capital stock.¹⁷⁵ Because the price at which the note's principal and interest converts into capital stock can be based on the stock's future issuance price to Series A investors, a valuation is not necessary at the time the convertible note is issued.¹⁷⁶ Additionally, a cap and a discount can be employed to compensate seed-stage investors for the additional risk of their early-stage investments.¹⁷⁷ According to a Tokyo-based lawyer interviewed for this Article, Japanese convertible seed notes tend to bear interest at a low rate of 2% to 3%.¹⁷⁸ Convertible notes also allow seed investors to benefit from the favorable terms negotiated by the Series A investors, as the convertible note will convert into Series A preferred stock. This is increasingly relevant in Japan given that classified stock is becoming the standard instrument for venture financings.¹⁷⁹

Despite these strengths, convertible notes in Japan suffer from significant shortcomings. One disadvantage that may surprise American investors is simply the nature of convertible notes as indebtedness. Traditional-minded Japanese companies are often reluctant to do business with a startup that has an apparently excessive level of debt on its balance sheet, even if the debt is entirely the result of convertible note seed financings.¹⁸⁰ Furthermore, there is a significant possibility that angel investors in Japan, where startup financing norms are not yet broadly standardized, will demand the repayment of a convertible note if the maturity date is reached before the company raises equity financing.¹⁸¹

The issuance of a convertible note in Japan also requires compliance with numerous contractual formalities to avoid onerous obligations under the Companies Act of Japan, such as the appointment of a company bond administrator.¹⁸² Furthermore, the stock warrant portion of

¹⁷³ *Id.*; see also Companies Act, *supra* note 150, art. 324.

¹⁷⁴ Takeuchi & Ogawa, *supra* note 14, at 42.

¹⁷⁵ Machida, *supra* note 130, at 23; Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁷⁶ Machida, *supra* note 130, at 23.

¹⁷⁷ *Id.*

¹⁷⁸ Interview with Attorney 2, *supra* note 49.

¹⁷⁹ See discussion *supra* Part II.C; see *supra* text accompanying note 135.

¹⁸⁰ Convertible Equity Will Change Japan's Startups, *supra* note 140; Machida, *supra* note 130, at 23.

¹⁸¹ Takeuchi & Ogawa, *supra* note 14, at 43.

¹⁸² Companies Act, *supra* note 150, art. 702; Takeuchi & Ogawa, *supra* note 14, at 42.

the note must be registered through the *toki* process described in Part II.D.i above.¹⁸³ As with classified stock, this registration essentially makes the terms of the financing publicly available information. Revisions to the terms of a warrant that are disadvantageous to warrant-holders require the consent of all warrant-holders,¹⁸⁴ so it is not possible to contractually set a lower consent threshold (for example, a majority of all warrant-holders) for the startup's convenience, a mechanic that is employed in Silicon Valley with some frequency.¹⁸⁵ Finally, although convertible notes used in Silicon Valley seed financing transactions are typically stripped down and lacking nearly all of the investor protections of a typical Series A investment,¹⁸⁶ there does not appear to be consensus among Japanese lawyers and investors that seed financing documents should employ this level of simplicity.¹⁸⁷ There are also a number of contractual terms for convertible notes that are required to be fixed by statute, including many that are not included in a typical Silicon Valley-style convertible note.¹⁸⁸ Although these terms are not likely to be the focus of negotiation,¹⁸⁹ they certainly increase the complexity of the required legal documentation and thus increase the time necessary for document preparation and review for a note-based seed investment.

iv. Convertible Equity

There is still some debate around the preferred form of convertible equity in Japan, with lawyers suggesting that each of convertible notes, classified stock, common stock, and stock warrants could be structured in some way to achieve at least an imitation of a Silicon Valley-style convertible equity instrument.¹⁹⁰ Masakazu Masujima, a partner at the Tokyo-headquartered law firm of Mori Hamada & Matsumoto, is the lawyer most prominently involved in the development of convertible equity

¹⁸³ Machida, *supra* note 130, at 23.

¹⁸⁴ Takeuchi & Ogawa, *supra* note 14, at 42.

¹⁸⁵ See, e.g., *Series Seed Notes – Convertible Promissory Note*, *supra* note 41.

¹⁸⁶ Coyle & Green, *supra* note 3, at 160.

¹⁸⁷ Yukihito Machida, *Shinkabuyoyakukentsukishasai no katsuyō nitsuite no ikkōsatsu (ge)* [Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part 2 of 2)], 2140 SHŌJI HŌMU 40, 44-45 (July 25, 2017) (suggesting that seed stage investors should seek contractual representations and warranties as to the (i) accuracy of the startup's financial statements, (ii) the startup's proper ownership of intellectual property, and (iii) lack of litigation facing the startup, among other matters, as well as a board observer seat, pro rata rights, notice rights for certain important events, and tag along rights for equity sales by the company's managers).

¹⁸⁸ Machida, *supra* note 130, at 23; cf. *Series Seed Notes – Convertible Promissory Note*, *supra* note 41.

¹⁸⁹ The terms that are not included in a U.S.-style convertible note but are required by statute would not generally affect the key legal rights of the parties or the economics of the transaction.

¹⁹⁰ Takeuchi & Ogawa, *supra* note 14, at 42-43; *Convertible Equity Will Change Japan's Startups*, *supra* note 140.

in Japan.¹⁹¹ Initially inspired by the Silicon Valley-based Founder Institute's 2012 introduction of a convertible equity instrument for seed funding,¹⁹² Masujima set out to create a similar instrument in Japan.¹⁹³ His first attempt was a perpetual, subordinated, zero-coupon convertible note that offered two of the key benefits of the Founder Institute's instrument by eliminating the need for a startup to repay the note and eliminating the need to negotiate and document an interest rate.¹⁹⁴ The structure was received well by a large startup incubator,¹⁹⁵ but there was one problem: traditional-minded potential business partners viewed the subordinated convertible note debt as a risky liability on the startup's balance sheet, even though the note never needed to be repaid and bore no interest.¹⁹⁶

Ultimately concluding that a debt instrument was impractical in the Japanese market, Masujima designed a series of classified stock with the characteristics of convertible equity.¹⁹⁷ This, unfortunately, suffered from the disadvantages discussed in Part II.D.ii above, including requiring an amendment to the startup's charter and giving rise to a 0.7% registration tax on the amount of the investment that was allocated to increase the company's registered corporate capital.¹⁹⁸ These disadvantages were vexing enough to send Masujima looking for yet another investment structure.¹⁹⁹

Although Masujima had worked with stock warrants (*shinkabuyoyakuken*) on some fundraising transactions for public companies, prior to his adoption of the warrant for seed funding, warrants alone had apparently never been used for startup fundraising in Japan.²⁰⁰ A warrant offered the advantages of a convertible note, including the ability to postpone the negotiation of a valuation and to offer a valuation cap and conversion discount to investors.²⁰¹ In addition, using a warrant instead of a convertible note obviated the need to negotiate an interest rate, did not add debt to the startup's balance sheet, and eliminated the risk of an angel investor demanding repayment of the note at maturity.²⁰²

¹⁹¹ See, e.g., Convertible Equity Will Change Japan's Startups, *supra* note 140.

Masujima is an advisor to the Japan Venture Capital Association and created the Japanese version of 500 Startups' convertible equity Keep It Simple Security. *Id.*; *About JVCA, JAPAN VENTURE CAP. ASS'N*, <https://jvca.jp/about/directors> (last visited Apr. 21, 2019).

¹⁹² Adeo Ressi, *Startups Can't Borrow Their Way to Success*, FOUNDER INSTITUTE (Aug. 31, 2012) <https://fi.co/insight/startups-can-t-borrow-their-way-to-success-by-adeo-ressi>.

¹⁹³ See Interview with Masakazu Masujima, Partner at Mori Hamada & Matsumoto in Tokyo, Japan (Mar. 12, 2018) (on file with author).

¹⁹⁴ *Id.*; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁵ Interview with Masakazu Masujima, *supra* note 193.

¹⁹⁶ *Id.*; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁷ Convertible Equity Will Change Japan's Startups, *supra* note 140.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ Interview with Masakazu Masujima, *supra* note 193; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁰¹ Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁰² See Interview with Masakazu Masujima, *supra* note 193; see also Convertible Equity Will Change Japan's Startups, *supra* note 140.

In light of these factors, Masujima settled on the warrant as his instrument of choice when he was tasked with developing a convertible equity instrument for 500 Startups Japan.²⁰³ In creating the Japanese instrument, 500 Startups Japan sought as much as possible to preserve the substance of its U.S. law Keep It Simple Security (KISS), with necessary adjustments only to accommodate the Japanese legal system.²⁰⁴ Because Japanese corporate law requires that warrants undergo corporate registration (*toki*) procedures, Masujima had to educate the staff of the Japanese Legal Affairs Bureau²⁰⁵ on the mechanics of this new instrument to minimize the possibility that the Legal Affairs Bureau would reject future filings from 500 Startups' investees.²⁰⁶

E. Comparative Analysis of Convertible Equity in Japan

The advantages of convertible equity in comparison to common stock, preferred stock and convertible notes highlighted above are not the only strengths of the instrument. In addition, the corporate registration fee for a warrant is only ¥90,000 (less than \$900), in contrast to the 0.7% tax that would be levied on a capital increase through the sale of capital stock, and no amendment to the company's Articles of Incorporation is necessary in connection with a warrant issuance.²⁰⁷ Furthermore, the ability to include valuation cap and discount terms appears to be an important benefit for investors; according to Masujima, Japanese seed investors who use a convertible instrument typically convert at the valuation cap and as a result receive a discount in the range of 40% to 50% of the Series A price in the conversion.²⁰⁸ In light of the benefits that convertible equity offers as compared to common stock, preferred stock, and convertible notes, its limited use to date in the Japanese market merits serious analysis.

As a starting point for this inquiry, it is instructive to revisit the factors that appear to have contributed to the Safe's success. Among these, Part A identifies the following technical characteristics of the Safe: (1) low cost, (2) simplicity, (3) speed, and (4) preservation of the terms (discount and valuation cap) that are most important to many influential angel investors. Part B further identifies the following external factors as likely

²⁰³ Interview with Masakazu Masujima, *supra* note 193.

²⁰⁴ Interview with Yohei Sawayama, *supra* note 12. The KISS comes in a debt version and an equity version, but 500 Startups decided to create a Japanese version of the equity version only. See Raiten, *supra* note 30; Yohei Sawayama, *J-KISS: Dare mo ga jiyū ni tsukaeru, shīdo shikinchōtatsu no tame no tōshikeiyakusho* [The J-KISS: An Investment Contract Anyone Can Use Freely for Seed Fundraising], CORAL CAP., INC. (Apr. 28, 2016), <https://coralcap.co/2016/04/j-kiss/> [hereinafter The J-KISS].

²⁰⁵ These are local offices that handle administrative matters for Japan's Ministry of Justice. *Civil Affairs Bureaus*, MINISTRY OF JUSTICE, <http://www.moj.go.jp/MINJI/index.html> (last visited Apr. 21, 2018).

²⁰⁶ Machida, *supra* note 130, at 23; Interview with Masakazu Masujima, *supra* note 193.

²⁰⁷ Registration and License Tax Act, *supra* note 149, annex table 1, item 24(1)(10).

²⁰⁸ Convertible Equity Will Change Japan's Startups, *supra* note 140.

supporting the Safe's proliferation in Silicon Valley: (1) the availability of informal protective mechanisms and informal sanctions to curtail bad behavior even when the vulnerable party lacks contractual recourse, (2) the preferences of seed-stage investors, and (3) Y Combinator's role in building widespread awareness of the Safe and promoting the Safe among its own portfolio companies as well as Silicon Valley startups at large. These factors can be analyzed in turn from a comparative perspective to examine to what extent the Japanese market may be conducive to the use of convertible equity instruments in seed financing transactions.

i. Comparative Analysis of the Technical Characteristics of Convertible Equity in Silicon Valley and Japan

Like the Safe in Silicon Valley, convertible equity in Japan offers greater simplicity than all seed financing alternatives except common stock.²⁰⁹ And because common stock is frequently paired with detailed supplementary contracts, convertible equity may be an even simpler tool than common stock in many cases.²¹⁰ This simplicity allows relatively high-speed negotiation and completion of financing transactions, because fewer terms need to be agreed between founders and investors before the deal can be closed.²¹¹

From a cost perspective, the relative merit of convertible equity depends in part on the amount of funds raised. Assuming that a founder raising money through capital stock minimizes the corporate capital registration tax by allocating only 50% of funds raised to registered corporate capital, the registration tax for a capital stock financing would exceed the ¥90,000 convertible equity registration tax when the amount of funds raised exceed ¥25.7 million (about \$233,500 at exchange rates as of May 17, 2019).²¹² The average seed financing in Japan exceeds this threshold.²¹³ Importantly, any contracts negotiated together with a common stock issuance would typically generate additional legal fees on top of the corporate capital registration tax. In addition, attorneys' fees for the review of convertible notes or preferred stock are generally more expensive than

²⁰⁹ See Machida, *supra* note 130, at 22-23.

²¹⁰ See *supra* text accompanying note 157.

²¹¹ See *infra* note 267. Convertible equity instruments are, however, subject to corporate registration. See *supra* text accompanying note 206.

²¹² Under these circumstances, the effective registration tax on capital stock would be 0.35% (50% of 0.7%). This effective 0.35% registration tax would exceed the ¥90,000 registration fee on a convertible equity issuance when the amount raised is greater than ¥25.7 million.

²¹³ See VEC YEARBOOK 2017, *supra* note 12, at I-13.

for convertible equity.²¹⁴ On the whole, convertible equity is at least highly competitive from a cost standpoint, if not always the cheapest seed financing instrument.²¹⁵ Furthermore, the relatively small amount of funds raised in a typical Japanese seed round should increase the importance of cost-competitiveness, as the transaction costs comprise a greater portion of the money being raised.²¹⁶

The ability to postpone a company's valuation until the Series A round offers similar benefits to both Japanese and American founders by reducing founder dilution and preserving a low exercise price for employee stock options.²¹⁷ Recall, furthermore, that these factors may have particular importance for Japanese founders.²¹⁸ Additionally, given that angel investors' aggressive use of convertible note maturity dates has been a problem for founders in Japan just as in Silicon Valley, Japanese convertible equity offers another significant benefit to founders by removing this provision (though at the cost of investors losing a source of leverage over founders).²¹⁹ From the investors' perspective, receiving the rights and benefits of the Series A preferred stock after the convertible equity converts into preferred stock is a significant advantage.²²⁰ The registration requirement for warrants means that—unlike in the United States—the key terms of convertible equity investments will become public information, but in light of the fact that most Series A and later stage venture financings are already subject to this requirement in Japan, this is a practice to which the seed financing market should adjust if sufficiently incentivized by convertible equity's other benefits.²²¹ In sum, despite

²¹⁴ Given that convertible notes include a stock warrant subject to the ¥90,000 registration fee and also incorporate additional terms beyond those in a typical convertible equity instrument, in general the legal fees associated with a convertible equity financing should be lower than those for a convertible note transaction. Machida, *supra* note 130, at 23. Classified stock typically includes a wider array of negotiated terms in addition to requiring an amendment to the company's charter and subjecting the raised capital to a corporate capital registration tax, making it the most expensive fundraising tool. *Id.* at 22.

²¹⁵ Admittedly, this comparison assumes that the attorneys involved in the transaction are at least somewhat familiar with the concept of convertible equity. If not, the legal fees associated with a convertible equity transaction would likely increase.

²¹⁶ This point was raised by a Japanese investor interviewed for this Article, who also commented that Japanese accelerators typically invest in the range of ¥2 million to ¥3 million (about \$20,000 to \$30,000) in their portfolio companies. Interview with Investor 2, Vice President, Venture Capital Investment Firm (Mar. 13, 2018) (on file with author). Recent survey data on the average size of Japanese seed-stage financings is not available. One compilation of publicly available data calculated an average investment size for Series A financings of ¥260 million (about \$2.3 million); however, this calculation is not limited to data based on recent years. Sawayama, *supra* note 166. In the U.S., the median 2018 Series A round was approximately \$9 million as of mid-2018. Clark, *supra* note 21.

²¹⁷ See *supra* text accompanying notes 25 and 144.

²¹⁸ This is due to relatively low valuations for Japanese companies at the seed stage, the robust rights available to Japanese stockholders, and the difficulty of recruiting staff to startups. See *supra* Part II.D.i.

²¹⁹ See *supra* text accompanying notes 43 and 181.

²²⁰ See *supra* Part II.D.iii.

²²¹ See *supra* text accompanying note 166.

certain meaningful differences, in the aggregate the technical features of Japanese convertible equity offer advantages over other fundraising instruments that are remarkably similar to those offered by the Safe. Accordingly, the failure of convertible equity to proliferate in the Japanese market to date must be the result of environmental or other external factors and not characteristics of the Japanese legal system.

ii. Comparative Analysis of Relevant Characteristics of the Startup Ecosystems in Silicon Valley and Japan

a) Effective Channels of Informal Control

The availability of informal sanctions that function effectively as a check on opportunistic behavior appears to be an important consideration for at least some Japanese investors. Despite the rarity of convertible equity in Japan, one of the Japanese VCs interviewed for this Article described a frustrating experience in which a convertible equity-based investment provided no legal remedies to address material inaccuracies in information disclosed by a startup investee during the due diligence process.²²² As discussed in Part B, contract theory proposes that the underlying factors that enable the effective functioning of these informal sanctions are complex and multilayered.

Part II.B.i notes that rich relationship networks in Silicon Valley make reputation maintenance important for investors who want access to tomorrow's best deals and for founders who want future investment. Part II.B.iii describes how these relationship networks, in turn, are supported by (1) investment accelerators that pull startup mentors and founders into a single community with a clear set of norms, and (2) influential investors' and founders' use of communications platforms to quickly disseminate information about norms. How do these features of Silicon Valley compare to their analogues in the Japanese market?

To some extent, these relationship networks exist in Japan as well,²²³ and the growing number of startup incubators and investment accelerators in Japan is likely to strengthen this aspect of the Japanese startup ecosystem.²²⁴ But deeper analysis reveals that the Japanese market still lacks certain key elements necessary for informal sanctions to be fully effective. Brad Bernthal, in a synthesis of contract theory as applied in the Silicon Valley context, proposes that the following three factors are necessary for social sanctions to displace contractual remedies as the

²²² Interview with Investor 4, Vice President of a Venture Capital Investment Firm in Tokyo, Japan (Apr. 12, 2018) (on file with author).

²²³ VEC YEARBOOK 2016, *supra* note 122, at I-50, (“[T]here exist[] well-developed networks within the startup space and the community shares not only which entrepreneur is trying to disrupt which area, the strategies of each startup, and technology portfolios, but also which investor is worth dealing with[.]”).

²²⁴ One company, Creww Inc., said that it alone had implemented or was scheduled to implement over 200 corporate accelerator programs. *Id.* at I-52.

primary constraint for opportunistic behavior by participants in a given community: “First, behavioral norms must be well-established in [the] community over time. Second, circumstances must exist for reputation to police behavior that deviates from community norms. And third, informal norms are frequently embedded within formal structures.”²²⁵

A review of these factors offers insight into why the Japanese startup community’s relationship networks appear unable to provide the robust support necessary to sustain a new, founder-friendly investment instrument. For example, two Tokyo-based venture capitalists interviewed for this Article, as well as Masujima (commenting in a media interview), described Japanese founders as often lacking knowledge about the technical structure of seed investments,²²⁶ while investors demanding a return of capital upon a convertible note reaching maturity remains a real concern for founders in Japan.²²⁷ The overall picture of the Japanese seed financing market reveals a lack of clear, generally accepted standard terms and norms. According to Masujima, founders routinely come to view as exploitative the investment terms they accepted at an early stage, and that alone (if broadly representative) would be strong evidence that the market suffers from a lack of broadly accepted standards.²²⁸

The apparent lack of shared standards in the Japanese market may not be surprising, given that behavioral norms can take “decades or longer” to become sufficiently established to regulate behavior.²²⁹ However, respected and influential investment accelerators (and perhaps other institutions) can speed the establishment of behavioral norms through use of communications platforms such as blogs and the promotion of norms among professional service providers, such as lawyers and accountants, in the startup community.²³⁰ The early stages of this effort are visible in Japan. For example, Masujima runs a blog similar to Silicon Valley lawyer Yoichiro Taku’s well-known “Startup Company Lawyer” blog, with a focus on disseminating information about legal topics relating to startups and venture finance;²³¹ 500 Startups Japan (rebranded as Coral Capital in March 2019) also runs an active blog;²³² and the Tokyo-based accelerator Incubate Fund runs an “Incubate School” educational program for founders hoping to

²²⁵ Bernthal, *supra* note 74, at 174.

²²⁶ Interview with Investor 2, *supra* note 216; Interview with Investor 4, *supra* note 222; Convertible Equity Will Change Japan’s Startups, *supra* note 140.

²²⁷ Takeuchi & Ogawa, *supra* note 14, at 43.

²²⁸ See Convertible Equity Will Change Japan’s Startups, *supra* note 140.

²²⁹ Bernthal, *supra* note 74, at 145.

²³⁰ *Id.* at 186-87.

²³¹ See generally *Startup Innovators ni tsuite [About Startup Innovators]*, STARTUP INNOVATORS, <https://startupinnovators.jp/about> (last visited Apr. 21, 2018).

²³² See generally *Insights – Kigyōka no tame no kontentsu [Insights – Content for Founders]*, CORAL CAP., INC., <https://coralcap.co/insights> (last visited June 17, 2019).

raise funds in the future.²³³ However, given that knowledge of market norms has not yet permeated the founder and investor communities, these activities must not yet be sufficiently advanced to have installed widespread standards throughout the market.

The second requirement Bernthal identifies, effective reputational enforcement, is also largely unmet in Japan. For reputational enforcement to be an effective tool to curb opportunism, there must be “shared expectations about appropriate behavior,” among other factors.²³⁴ With the lack of widespread standards in the Japanese seed financing market, there do not appear to be consensus expectations regarding key aspects of participant behavior, such as whether it is appropriate for investors to demand the return of principal of a convertible note at maturity.²³⁵ This complication may be exacerbated by the practices of certain players in the Japanese startup community. For example, some Japanese CVCs have a practice of seconding employees to startup portfolio companies and later bringing these employees back to the corporate institution.²³⁶ If these employees are not given startup-related assignments once they are returned to the corporate investor, this practice can effectively sever—or at least greatly reduce the utility of—the business relationships developed by the employees within the startup community.²³⁷ Furthermore, once they are pulled out of the startup community, these seconded employees are likely no longer in a position to use their relationship network to punish founders, or be punished themselves, for behavior that violates the community’s norms.

Nonetheless, there is reason to be optimistic that in time the Japanese market will develop the features necessary for effective reputational enforcement. The intense concentration of startups and investors in Tokyo facilitates repeat transactions between market participants and makes participants’ behavior more easily observable to others in the market, two additional factors Bernthal identifies as necessary for effective reputational policing.²³⁸ Additionally, an increasing number of large events in Tokyo cater to startup founders and investors, including the

²³³ See generally *Incubate School Daiyonki [4th Incubate School]*, PEATIX, <https://incubateschool4-4.peatix.com/view> (last visited Apr. 21, 2018). One of the interviewees for this Article identified Incubate Fund, Skyland Ventures, and East Ventures as leading investment accelerators in Japan. Interview with Employee 1, Startup Service Provider in Tokyo, Japan (Jan. 19, 2018) (on file with author).

²³⁴ Bernthal, *supra* note 74, at 175.

²³⁵ Takeuchi & Ogawa, *supra* note 14, at 43.

²³⁶ See VEC YEARBOOK 2016, *supra* note 122, at I-51.

²³⁷ Consider the case of Asahi Glass Ventures, which established an office in Silicon Valley and had a practice of sending employees from Japan for three-year rotations to Silicon Valley. The result was that the Silicon Valley office consistently lacked a strong connection to local networks of founders and investors. See ANDREW ROMANS, MASTERS OF CORPORATE VENTURE CAPITAL 41-42 (2016).

²³⁸ Bernthal, *supra* note 74, at 175. Tokyo-based startups accounted for approximately 61% of all Japanese VC investment by investment amount in 2016. VEC YEARBOOK 2017, *supra* note 12, at I-15.

Infinity Ventures Summit, Tech in Asia Tokyo, Slush Tokyo, and the New Economy Summit.²³⁹ Besides promoting communication among members of the startup community, these events host discussions and panels with influential community members, providing an opportunity to build shared expectations about behavior.²⁴⁰ The final factor Bernthal identifies as necessary for a functioning reputation market is that “consequences exist for social norm violations.”²⁴¹ This factor is likely to be present in Japan (at least in circumstances where widely shared norms exist), as the means of informal sanction available to American angel investors discussed in Part i above are equally available to Japanese angels and VCs.²⁴²

Finally, the short-term outlook in Japan for the embedding of informal norms within formal structures—which Bernthal identifies as the third necessary condition for informal sanctions to displace contractual remedies—is relatively positive. The rapidly-growing number of startup incubators and accelerators in Japan has the potential to provide a large number of formally structured organizations through which community norms can be effectively disseminated,²⁴³ especially because a few key consultants are responsible for helping companies establish hundreds of these structures.²⁴⁴ Even if informal norms are not yet widely agreed within the seed financing market, much of the infrastructure necessary to disseminate norms, once they achieve consensus, may already be in place.

Staged financings are also relevant in Japan as a tool that larger seed round investors (such as VCs that make seed stage investments) may utilize to exert informal control over a portfolio company and discourage opportunistic founder behavior.²⁴⁵ Although “the rate of continuous investments over different rounds by the same VC is much lower in Japan than in the United States,”²⁴⁶ in 2016 approximately one quarter of capital invested by Japanese VCs was used for follow-on investments, so staged financing does play a significant role in the Japanese market.²⁴⁷ Staged financing as a market practice offers an additional benefit: because these

²³⁹ VEC YEARBOOK 2016, *supra* note 122, at I-86; *NEST2019 TOKYO - NEST2019*, NEW ECON. SUMMIT, <https://nest.jane.or.jp/tokyo> (last visited Apr. 21, 2019).

²⁴⁰ Bernthal, *supra* note 74, at 175.

²⁴¹ *Id.*

²⁴² See *supra* text accompanying note 73.

²⁴³ Bernthal, *supra* note 74, at 177.

²⁴⁴ VEC YEARBOOK 2017, *supra* note 12, at I-33. In addition, according to a Tokyo-based lawyer and a Tokyo-based investor interviewed for this Article, a substantial amount of startup legal work in Japan is concentrated in the AZX Professionals Group law firm, which might be able to exert significant influence on the use of a particular form contract in the market if it so desired. Interview with Attorney 2, *supra* note 49; Interview with Investor 2, *supra* note 216.

²⁴⁵ Shishido, *supra* note 78, at 1117-18.

²⁴⁶ *Id.* at 1118.

²⁴⁷ This calculation is based only on the survey responses of VCs who provided information on new and follow-on investments; some declined to provide this information. VEC YEARBOOK 2017, *supra* note 12, at II-12.

financing arrangements “are costlier for low-quality companies,” which are more likely to fail to achieve the required milestones for follow-on investment, such arrangements allow investors to mitigate adverse selection in the funding process in addition to exerting informal control over the investee.²⁴⁸ In an environment of high informational asymmetry, such as the seed financing market, a practice of staged financing could be particularly valuable by helping to screen low-quality companies or founders inclined toward opportunistic behavior.

Writing in 2014, Professor Zenichi Shishido identified bank- and securities firm-affiliated VCs making “one-shot portfolio investments” (perhaps in part to diversify risk)²⁴⁹ and the lack of syndicate financing led by a single investor as being the principal reasons for the comparatively low rate of staged financing in Japan.²⁵⁰ One of the Japanese VCs interviewed for this Article described syndicated financings with a lead investor as typical in the current market, suggesting that this practice may have changed since 2014.²⁵¹ In light of this and the significant portion of overall VC investment dedicated to follow-on rounds in Japan, the Japanese market may be moving generally toward an American model where staged financings are the norm.²⁵² If so, this may become an important factor in supporting a broader use of convertible equity in the Japanese market.

Despite the currently limited effectiveness of informal sanctions in the Japanese market, two measures that Ibrahim identifies as informal substitutes for contractual protections among angel investors are readily available in Japan.²⁵³ First, the concentration of startups in Tokyo provides angel investors a wide selection of potential investees that are physically close to the investor, allowing active participation in the investee’s business.²⁵⁴ Second, the physical proximity of startups, investors, and events facilitates in-person introductions of potential investees to angels by trusted parties.²⁵⁵ These factors can help angel investors screen out opportunistic founders and then maintain close contact and ongoing bilateral information-sharing with their investees. However, although these tools are available to angels in Japan, the small number of angel investors in the country may reduce the extent to which these factors impact the overall willingness of seed-stage investors to accept reduced formal contract protections.

In summary, the relationship networks in the Japanese startup community lack certain key features that contract theory suggests are

²⁴⁸ Williams, *supra* note 39, at 133.

²⁴⁹ Shishido, *supra* note 78, at 1118-19.

²⁵⁰ *Id.*

²⁵¹ Interview with Investor 3, Vice President of a Venture Capital Investment Firm in Tokyo, Japan (Apr. 11, 2018) (on file with author).

²⁵² Shishido, *supra* note 78, at 1117-18.

²⁵³ See *supra* text accompanying note 67.

²⁵⁴ See *id.*

²⁵⁵ See *id.*

necessary for informal sanctions to serve as an effective extralegal constraint on opportunistic behavior. In particular, a lack of established norms and a lack of shared behavioral expectations appear to be the greatest impediments to effective informal sanctions. In contrast, the abundance of startup accelerators in Japan offers a sturdy infrastructure for the dissemination of community norms (once established), and the significant deployment of VC capital to staged financings indicates that some investors are already developing alternative avenues of informal control over their portfolio companies.

b) Seed-Stage Investor Preferences

The intense focus on big hit investments that prevails among Silicon Valley investors is largely absent in Japan. Japanese VCs, for example, are much more interested in small exits than a typical Silicon Valley investor.²⁵⁶ The prevalence of founder buy-back provisions and their frequent use by Japanese VCs is evidence of how much importance Japanese VCs attach to a return of capital, even when they realize no significant return on investment.²⁵⁷ And this impacts the seed financing market as well; in 2016, Japanese VCs invested about 25% of their funds in seed stage companies.²⁵⁸ Furthermore, many Japanese angel investors take a similar approach to their investments.²⁵⁹

The Safe's general lack of investor protections is not well suited to an environment where investors prioritize a return of their invested capital across all investments. As unsuccessful startups almost always lack sufficient assets to return their investors' capital, an investor hoping to claw back its funds from a failing investment will want a means of influencing the company's decision-making before the company fails completely and becomes insolvent.²⁶⁰ The Safe offers investors no such tools.

The relative scarcity of ex-founder angel investors in Japan also has an important implication for seed-stage investor preferences.²⁶¹ Recall that angels who are ex-founders often have some non-financial motivations

²⁵⁶ This topic came up in interviews with a Tokyo-based lawyer and a Tokyo-based investor. Interview with Attorney 4, *supra* note 81; Interview with Investor 1, *supra* note 81. Masujima addressed this point somewhat obliquely in a public interview, noting that if Silicon Valley investors demanded a return of capital on a convertible note, they would be cut off from the startup angel investing ecosystem—implying that Japanese investors sometimes do this without suffering such negative consequences. *Convertible Equity Will Change Japan's Startups*, *supra* note 140.

²⁵⁷ See *supra* text accompanying notes 137-139. The use of this provision demonstrates that many Japanese VCs are willing to forego the opportunity to develop a founder-friendly reputation simply to get a return of their investment capital.

²⁵⁸ VEC YEARBOOK 2017, *supra* note 12, at I-11.

²⁵⁹ Interview with Attorney 4, *supra* note 81; Interview with Investor 1, *supra* note 81.

²⁶⁰ See, e.g., Coyle & Green, *supra* note 3, at 161 (“Security interests also largely fell by the wayside, as they provided little to no protection for investors in a seed-stage company, few of which would have had any meaningful assets to serve as collateral.”)

²⁶¹ ISOZAKI, *STARTUP EQUITY FINANCE*, *supra* note 133, at 69.

for investing (such as excitement about an investee's vision), making them less focused on financial outcomes and detailed contractual protections, at least as compared to other investors.²⁶² As discussed in Part II.B.ii above, in an environment where founders enjoy considerable leverage, these angels may find founder-friendly convertible equity contracts to be a convenient signaling mechanism by which they can distinguish themselves from other investors and gain access to high-demand financing deals. In contrast, founders in Japan enjoy neither large numbers of ex-founder angels nor a favorable investment environment, which weakens the appeal of a Safe-like instrument.²⁶³

Nonetheless, a more investor-favorable market is not, by itself, a bar to the use of convertible equity in Japan. Convertible equity instruments can be structured flexibly, and the standard form of 500 Startups Japan's Keep It Simple Security (typically called the "J-KISS"), for example, includes various investor-friendly provisions that the standard form of Safe does not.²⁶⁴ By employing these or similar terms, a more investor-favorable form of convertible equity could be designed for the Japanese market.²⁶⁵ However, one of the principal benefits of the Safe is that its exceptionally founder-favorable terms provide time and cost savings for investors as well as founders.²⁶⁶ If convertible equity in Japan requires detailed investor protections, such as those in the J-KISS, in order to reflect the balance of negotiation leverage between Japanese founders and investors, that would

²⁶² Ibrahim, *supra* note 11, at 1439.

²⁶³ It is hard to quantify to what extent founders enjoy negotiation leverage in a given startup investment market, in particular because the number of highly promising startups (i.e., prime investment targets) is key but evaluating what constitutes a "highly promising startup" is extremely difficult. However, the large difference in valuations offered to startups in seed financing rounds in Japan versus the United States is an important indicator of the relatively high investor leverage in Japan. *See* discussion *supra* Part II.D.i. Additionally, interviews conducted for this Article evidenced a shared view in Japan that the Japanese market remains more investor-favorable than Silicon Valley. Interview with Investor 1, *supra* note 81; *see also* Interview with Founder 3, Chief Executive Officer of a Tokyo-based Startup (Mar. 8, 2018) (on file with author). A Silicon Valley founder and Silicon Valley lawyer both described an environment in Silicon Valley where investors want to get into the top startups' seed funding rounds with as little burden as possible on the founders. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19.

²⁶⁴ The standard form of the J-KISS includes relatively detailed (compared to the Safe) company representations and warranties, a most favored nation provision, information and participation rights for major investors, and a maturity date at which a majority of the J-KISS investors may elect to convert their J-KISSes into common stock if no Series A financing has occurred. *See* The J-KISS, *supra* note 204.

²⁶⁵ Notably, the terms of the J-KISS were not selected specifically to match the balance of negotiation leverage in the Japanese market. Instead, the instrument was designed principally mirror the terms of 500 Startups' Keep It Simple Security in a way that would comply with Japanese corporate law. Sawayama believes that the introduction of a seed funding contract in Japan that closely tracks a Silicon Valley standard will benefit the Japanese startup ecosystem. Interview with Yohei Sawayama, *supra* note 12.

²⁶⁶ Abramowitz, *supra* note 35.

weaken the incentive for market participants to adopt the instrument by diminishing the cost and speed incentives.²⁶⁷

Despite these differences in the Japanese and Silicon Valley markets, convertible equity may nonetheless become an appealing medium for many seed investments in Japan. This is, in part, because convertible notes face unique challenges in the Japanese market by virtue of their nature as indebtedness.²⁶⁸ And because common stock remains the most commonly used seed investment instrument, convertible equity is not necessarily an inferior instrument with respect to allowing investors to recover their investment capital in the event that the startup fails.²⁶⁹ At the same time, convertible equity would allow angels to send a positive signal to founders and allow founders to avoid the many disadvantages associated with common stock discussed in Part II.D.i above. Furthermore, this founder-friendly approach could be increasingly useful over time, as investor competition over seed-stage deals is increasing in Japan.²⁷⁰

c) Accelerators as Champions for Convertible Equity

In Silicon Valley, the existence of a single, highly standardized and well-known form of convertible equity (*i.e.*, the Safe) is an important contributor to the cost and time savings associated with convertible equity investments.²⁷¹ Y Combinator's public form of the Safe enjoys such a high level of trust that Silicon Valley investors and startups frequently negotiate the investment amount, discount, and cap, and then execute and fund the Safe without the use of legal counsel.²⁷² This means that once the investor is satisfied as to due diligence, the negotiation, finalization, and execution of the legal documentation for a Safe investment can be completed in a matter of hours at virtually no cost to the founder or investor. The registration obligation for convertible equity in Japan is only required after the investment is completed, so a similar level of speed and cost efficiency is technically possible under Japanese corporate law, but in an environment

²⁶⁷ Importantly, according to Yohei Sawayama of Coral Capital (formerly 500 Startups Japan), despite its investor-favorable terms (relative to the Safe), use of the J-KISS significantly shortens the time necessary to close a seed funding investment in Japan. Sawayama says that the process of preparing and finalizing J-KISS documentation generally takes less than one week, while in the case of common stock it often takes about one month. Interview with Yohei Sawayama, *supra* note 12. In Japan, the consummation of VC investments can take between one month and one year from the first VC contact with the investor. SHIMAUCHI, *supra* note 126, at 120.

²⁶⁸ See *supra* text accompanying note 180.

²⁶⁹ See *supra* text accompanying note 130. Note, however, that common stock investors will enjoy the benefits of Japan's strong protections for capital stockholders, discussed in Part II.D.i, and holders of convertible equity will not.

²⁷⁰ VEC YEARBOOK 2017, *supra* note 12, at I-14. Masujima believes that some seed investors, especially investment accelerators, do use founder-favorable investment structures as means of marketing themselves and competing for the most favorable investments, but it is unclear how widespread the practice is. Interview with Masakazu Masujima, *supra* note 193.

²⁷¹ Interview with Attorney I, *supra* note 19. The lawyer has represented parties in more than 100 startup financing transactions over the past three years.

²⁷² *Id.*

where many investors are unfamiliar with the concept of convertible equity, such speed remains unlikely.²⁷³

Perhaps Y Combinator's most important contribution to the Safe's success is the accelerator's work²⁷⁴ to build widespread knowledge of the Safe among founders and investors, which appears to be a critical factor in the instrument's prevalence in Silicon Valley.²⁷⁵ This broad awareness not only reduces the time and cost required to consummate Safe-based investments, it also mitigates the risk that venture capital investors will find the Safe confusing and decline to invest in subsequent funding rounds because a company has Safes in its capitalization table.²⁷⁶ The Japanese market, in contrast, has not yet coalesced around a single, definitive convertible equity instrument, let alone built a broad understanding of such an instrument among founders and investors. The J-KISS is Japan's closest analog to the Safe in that the standard form of the J-KISS is publicly available and Coral Capital (formerly 500 Startups Japan) provides an annotated version of the documentation as well as a free explainer for the instrument.²⁷⁷ Masujima has also added a more general convertible equity explainer to his startup blog to help build awareness of this relatively new mechanism for investment.²⁷⁸ Indeed, there are some small signs of broader market adoption of the J-KISS.²⁷⁹

However, despite these efforts, interviews for this Article confirmed that the terms of the J-KISS are not yet broadly understood in the Japanese market and many angel investors and venture capital firms still do

²⁷³ A more realistic timeframe for an expedited investment in the Japanese market would be about one week, which is still substantially faster than a typical common stock seed investment. *See supra* note 267.

²⁷⁴ Among Y Combinator's activities in this regard, the use of the Safe in Y Combinator's own investments stands out. *See* discussion *supra* Part II.B.iii.

²⁷⁵ Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. *See also* discussion *supra* Part II.B.iii. In fact, the Safe is now so widely known in Silicon Valley that multiple law firms and legal services companies have created their own forms of Safe or tools to assist with the drafting and execution of Safes. For example, Cooley LLP, Clerky, and Practical Law Company all offer either a Safe-generation tool or their own version of the Safe form contract. *See, e.g.,* Matthew Bartus, *Generate Your Y Combinator Safe Financing Documents*, COOLEYGO, <https://www.cooleygo.com/generate-y-combinator-safe> (last visited Apr. 22, 2019); *Fundraising*, CLERKY, <https://www.clerky.com/fundraising> (last visited Mar. 30, 2018); THOMSON REUTERS, *supra* note 102.

²⁷⁶ Two interviewees for this Article described the Safe as "low friction" for both founders and investors. Interview with Attorney 1, *supra* note 19; Interview with Founder 1, *supra* note 19. As noted in Part II.A.iii, this does not always yield perfect results. Founders are sometimes surprised at the degree to which their shares are subject to dilution, and investors are sometimes frustrated by their lack of rights as holders of convertible equity. *See* Green & Coyle, *supra* note 33, at 169.

²⁷⁷ *See* The J-KISS, *supra* note 204.

²⁷⁸ *See generally* Masakazu Masujima, *Convertible Equity ni tsuite* [About Convertible Equity], STARTUP INNOVATORS (Nov. 26, 2015), <https://startupinnovators.jp/blog/178>.

²⁷⁹ For example, the J-KISS has been used by at least a few investors, such as Asahi Shinbun, in deals that were not led by 500 Startups. Convertible Equity Will Change Japan's Startups, *supra* note 140.

not have the experience of investing in a company that has received investment via J-KISSEs.²⁸⁰ In part, this may reflect the relative complexity of the J-KISS as compared to the Safe.²⁸¹ A more complex agreement requires increased time and effort on the part of market participants before they can fully grasp all the key terms of the instrument. The lack of understanding of the J-KISS in the Japanese market also means that a founder or investor seeking to use the J-KISS may need to invest time and effort in explaining the terms of the J-KISS to the counterparty and convincing them of the instrument's merits, which would impede, rather than facilitate, speedy financing transactions.²⁸²

The lack of widespread awareness of the J-KISS presents additional obstacles. Traditional-minded VC investors, and especially CVCs, are still resistant to the instrument.²⁸³ Masujima and others speculate that this is because it remains difficult to convince internal decision-makers at CVCs and other traditional firms, who are typically somewhat removed from the startup community and are mostly unfamiliar with convertible equity.²⁸⁴ CVCs also generally have a different business model than VC firms and this may cause CVCs to evaluate investment risks differently.²⁸⁵ Additionally, the risk of a poorly structured seed investment frustrating subsequent fundraising rounds is a legitimate concern for both founders and seed investors.²⁸⁶ Accordingly, using a seed instrument with mechanics that are not well understood or are seen as inconsistent with market practice is a risky decision for founders and may increase the difficulty of securing subsequent investment.

The confusion around convertible equity in Japan prompts an important question: could Coral Capital or other market players actively build an awareness in the Japanese market comparable to what Y Combinator has built in Silicon Valley? There is no single incubator, accelerator, or investment fund that holds a position in Japan fully analogous to Y Combinator's role in Silicon Valley, meaning that even the support of a respected investment accelerator would likely not have the same effect in Japan as Y Combinator's support of the Safe in the Silicon

²⁸⁰ Interview with Investor 2, *supra* note 216; Interview with Employee 1, *supra* note 233.

²⁸¹ See discussion *supra* Part II.E.i.

²⁸² Interview with Investor 1, *supra* note 81; Interview with Employee 1, *supra* note 233; see also Machida, *supra* note 130, at 23.

²⁸³ Convertible Equity Will Change Japan's Startups, *supra* note 140.

²⁸⁴ *Id.*; see also Machida, *supra* note 130, at 23.

²⁸⁵ ROMANS, *supra* note 237, at 77 ("Unlike a financial VC a corporate VC that is trying to create commercial and strategic relationships with startups cannot afford to have just one success that carries the fund. This will not be seen as a success by the business as there is a high internal cost for all the failures."). A Silicon Valley startup executive interviewed for this Article who had fundraised from both financial VCs and CVCs raised the same point. Interview with Startup Executive 1, *supra* note 19.

²⁸⁶ Ibrahim, *supra* note 11, at 1430; Convertible Equity Will Change Japan's Startups, *supra* note 140 (noting the risk of overvaluation in seed investments).

Valley community.²⁸⁷ With Y Combinator and Paul Graham, “the closest thing the start-up world has to a pre-eminent guru,” promoting the Safe and using it to invest in hundreds of top-shelf startups every year, the instrument quickly became something that investors would need to understand in order to access some of the choicest deals.²⁸⁸ Also, Y Combinator’s and other top accelerators’ role in screening a large number of startups likely helps investors get comfortable with the limited protections offered by the Safe.²⁸⁹

Notably, convertible notes began to displace common stock in Silicon Valley seed financings without significant help from Y Combinator or any other accelerator (as no others existed at the time), so a single accelerator with powerful market influence is clearly not a precondition for widespread seed-stage contractual innovation.²⁹⁰ This suggests that a “Japanese Y Combinator” backing convertible equity is not a prerequisite for its proliferation in Japan. This is fortunate, because it is extremely unlikely that any one accelerator in Japan could speed the widespread

²⁸⁷ Among many distinctions, Y Combinator was the first startup investment accelerator in the United States, and although its unique position in Silicon Valley is difficult to quantify, it stated in 2017 that its portfolio companies now have an estimated aggregate value of \$100 billion. Bernthal, *supra* note 74, at 151; Steven Melendez, *Y Combinator says its companies are on target for \$100B total valuation*, FAST COMPANY (Feb. 16, 2017), <https://www.fastcompany.com/4030834/y-combinator-says-its-companies-are-on-target-for-100b-total-valuation>. Compare Y Combinator’s scale to that of Samurai Incubate, which the Japanese Ministry of Economy, Trade, and Industry identified in a 2016 report as one of the country’s most notable, long-surviving startup accelerators. KABUSHIKI KAISHA UZU GURŪPU, HEISEI 28 NENDO WAGAKUNI NI OKERU DĒTA KUDŌGATA SHAKAI NI KAKARU KIBANSEIBI (IoT SUTĀTOAPPU SHIEN NI KANSURU GURŌBARU RENKEICHŌSAIJGYŌ) CHŌSA HŌKOKUSHO [2016 SURVEY REPORT: FUNDAMENTAL INFRASTRUCTURE IN JAPAN FOR A DATA-DRIVEN SOCIETY (SURVEY BUSINESS WITH GLOBAL COLLABORATION ON SUPPORT FOR IOT STARTUPS)] 8 (Feb. 2, 2016) (available at http://www.meti.go.jp/medi_lib/report/H28FY/000156.pdf). Although the estimated value of Samurai Incubate’s portfolio is not public, in 2017, the accelerator raised its sixth fund of ¥3 billion (about \$30 million) with an intention to invest in about 150 companies. PR Times Henshūbu, *Samurai Inkyubēto ga 30 oku kibo no rokugō fando sosei, nihon, isuraeru, afurika no sutātoappu wo taisho [Samurai Incubate Creates Sixth Fund, Targeting Startups in Japan, Israel, Africa]*, THE BRIDGE (July 24, 2018), <http://thebridge.jp/2018/07/samurai-incubate-6th-fund>; *Samurai inkyubēto ga shin fando [Samurai Incubate’s New Fund]*, NIHON KEIZAI SHINBUN (July 19, 2018), <https://r.nikkei.com/article/DGXMZO33155250Z10C18A7000000>. In contrast, Y Combinator invests in over 200 companies per year and runs a continuity fund that makes single investments of up to \$50 million. Roy, *supra* note 92; Harry McCracken, *Y Combinator is Launching A “Grad School” For Booming Startups*, FAST COMPANY (Feb. 8, 2018), <https://www.fastcompany.com/40524163/y-combinator-is-launching-a-grad-school-for-booming-startups>.

²⁸⁸ John Herrman, *Have the Tech Giants Grown Too Powerful? That’s an Easy One*, N.Y. TIMES (July 11, 2018), <https://www.nytimes.com/2018/07/11/magazine/facebook-google-uber-tech-giants-power.html>.

²⁸⁹ See discussion *supra* Part II.B.iii.

²⁹⁰ Convertible notes assumed a prominent role in seed funding in 2005. Coyle & Green, *supra* note 3, at 136. Y Combinator began just that same year as a small-scale experiment. Paul Graham, *How Y Combinator Started*, Y COMBINATOR (Mar. 15, 2012), <http://old.ycombinator.com/start.html>.

understanding and adoption of convertible equity to the degree that Y Combinator has in Silicon Valley.²⁹¹

III. POSSIBLE MEASURES TO MAKE CONVERTIBLE EQUITY MORE WIDELY AVAILABLE IN JAPAN

While Working from the analysis in Part E, it is possible to propose certain concrete steps that are likely to make convertible equity a more readily available tool for Japanese founders and investors. Importantly, these steps are not intended to encourage the use of convertible equity when other instruments would be superior, but rather to create an environment in which participants in the Japanese startup community have the opportunity to benefit from the strengths of convertible equity in appropriate transactions. This, in turn, would increase the speed and efficiency at which Japanese startups can raise funds and improve their chances of surviving until they can secure Series A financing.

First, it bears emphasis again that there do not appear to be major legal impediments to the broader use of convertible equity in Japan, meaning that changes to the Companies Act or other regulations are not necessary to achieve this goal. In examining the environmental factors discussed in Part ii above, the most salient difference in the Japanese and Silicon Valley markets is the lack of effective informal sanctions as means of limiting opportunistic founder behavior in the absence of contractual protections.²⁹² Currently, Japan appears to lack the deep and mature startup relationship networks as well as the community consensus around norms for seed-stage financings that contract theory proposes are necessary for such sanctions to function effectively. Although the former characteristic may be largely a function of time and the natural growth of formal associations, informal groups, and networking opportunities, the latter can be addressed at least in part through a more proactive use of communications platforms, such as blogs, panel discussions, and other internet media, by Japanese investment accelerators, angel investors, and founders to broadcast their views on appropriate founder and investor behavior and build a public consensus through open dialogue.²⁹³

²⁹¹ Nonetheless, startups that have graduated from Japan's most prestigious accelerator programs could emphasize that fact to boost their credibility when trying to convince investors to use convertible equity for an investment. In this respect, well-known accelerators that lack Y Combinator's unique market position could still indirectly contribute to a broader use of convertible equity.

²⁹² Although this Article argues in Part II.E.ii.b that simplicity is not a necessary precondition to the proliferation of convertible equity in Japan, simplicity and speed would certainly increase the value that convertible equity offers to Japanese founders and investors.

²⁹³ For example, in Silicon Valley, "[investment accelerator] principals aggressively shape startup culture through communications that include books, prominent blogs, and an industry group." Bernthal, *supra* note 74, at 145.

Although no single Japanese organization occupies a position equivalent to that of Y Combinator, several prominent accelerators and investors acting in concert, perhaps together with one or two law firms, could likely exert substantial influence on the Japanese seed financing market and lend credibility to a mutually agreed form document for seed financings. To some extent, Coral Capital and Masujima are already taking steps to this end with the J-KISS, but without buy-in from additional investors, the scale of these efforts is necessarily limited.²⁹⁴ If two or three more accelerators began using the J-KISS (or some other instrument) and a prominent startup law firm began to publicly promote the instrument, that would help establish the instrument as a standard form for the market rather than just one investor's preferred contract. In particular, well-regarded investment accelerators could play a critical role by using the instrument for their own investments and thereby quickly introduce the contract into the marketplace and create a strong incentive for other investors to gain an understanding of the instrument. However, parties pursuing this approach would be wise to follow Levy's example in seeking extensive input from both investors and founders to ensure that the ultimate form of the instrument used reflects the balance of negotiation leverage in the Japanese market. If the instrument's terms are inconsistent with market realities, resistance from either investors or founders could prove an insurmountable obstacle to its widespread adoption. This consideration is particularly important given that the most high-profile convertible equity instrument—the Safe—was developed with input from prominent Silicon Valley investors, whose core business model differs from that of the typical Japanese VC.

To be broadly successful, any coordinated effort by influential market participants to promote a specific instrument would likely need to be paired with extensive public education about the instrument's mechanics and benefits.²⁹⁵ This is because the market cannot develop behavioral norms around negotiation and performance of a contractual instrument's key terms without a broad-based understanding of those terms, and those norms are a prerequisite for the operation of effective informal sanctions.²⁹⁶ Once the

²⁹⁴ As of April 22, 2019, 500 Startups Japan (rebranded as Coral Capital in March 2019) listed 36 portfolio companies as “featured startups” on their website. *Portfolio*, CORAL CAP., INC., <https://coralcap.co/portfolio>, (last visited Apr. 22, 2019). In contrast, Y Combinator lists over 1,900 portfolio companies on their homepage. *YC Companies*, Y COMBINATOR, <http://www.ycombinator.com/companies> (last visited Mar. 30, 2019). This comparison is admittedly imperfect but the difference in scale is notable.

²⁹⁵ 500 Startups Japan (now Coral Capital), for example, has hosted in-person informational sessions about the J-KISS in addition to blogging about the instrument. Miyako Yoshizawa, *Yamaguchi bengoshi ni kiku, shōdo sutātoappu no tame no shikinchōtatsu – J-KISS no kōshōjīkō to keiyakusho*[*Fundraising for Seed-Stage Startups – Negotiation Points and Contracts for the J-KISS, According to Attorney Yamaguchi*], CORAL CAP., INC. (Sept. 29, 2017), <https://coralcap.co/2017/09/j-kiss-guide-for-early-stage-startups>.

²⁹⁶ Market participants will not be able to understand the substance of norms that promote certain behavior in respect of a contractual term if they do not understand the contractual term in the first place.

instrument's terms are generally understood in the market, the network of relationships and communications platforms necessary to enforce informal sanctions can provide infrastructure onto which new norms regarding the convertible equity instrument can be grafted. These networks can help disseminate as well as enforce the norms.

In summary, active use of communications platforms by community members to create a public dialogue giving rise to widely shared norms, concerted effort among several investment accelerators and possibly lawyers to promote a single form of instrument, use of the instrument in actual investments by these accelerators, and substantial public education about the instrument are all concrete steps that market players could take to help create an environment in which convertible equity is more readily available as a fundraising tool for Japanese startups. It may be challenging for several accelerators to agree on a single form document,²⁹⁷ but such an effort could be coordinated through an industry organization such as the Japan Venture Capital Association, which operates "Venture Ecosystem" and "Fund Ecosystem" committees.²⁹⁸

IV. CONCLUSION

Perhaps the most remarkable aspect of the Safe's rapid diffusion throughout Silicon Valley is the unprecedented nature of the instrument. Although Levy downplays the Safe's uniqueness,²⁹⁹ it is the first widely-used seed funding contract that was deliberately engineered by a single organization in order to help startups succeed. While the extent of the Safe's impact on the market is hard to measure, it has certainly simplified the process of seed financing (and thereby reduced transaction costs) for thousands of young companies. Given the disadvantages of early-stage fundraising with common stock under Japanese law, the small size of seed rounds in Japan, the informational asymmetries between Japanese founders and investors in respect of fundraising terms, and the reputational issues associated with debt fundraising, it would seem that convertible equity has a great deal to offer the Japanese startup community. However, as this Article's analysis indicates, a variety of important circumstances have helped create an environment in Silicon Valley that is particularly conducive to the use of a simplified, founder-friendly investment instrument. Replicating—or compensating for the lack of—these environmental factors is a daunting challenge. Indeed, participants in the Japanese startup community who seek to make convertible equity a widely

²⁹⁷ One of the Japanese VCs interviewed for this Article (who is also involved in an accelerator program) noted that Japanese investment accelerators tend to use their own forms of investment contracts, even when they use the same law firm. Interview with Investor 2, *supra* note 216.

²⁹⁸ *Committee*, JAPAN VENTURE CAP. ASS'N, <https://jvca.jp/committee> (last visited Apr. 22, 2019).

²⁹⁹ *See* Abramowitz, *supra* note 35.

available tool will likely have to convince competing investors to work together to overcome substantial obstacles if they hope to realize that ambition. By offering a clear view of those obstacles and the beginnings of a strategy to surmount them, this Article aims to help guide those ambitious participants at least a few more steps toward their goal.

CLEANING UP THE MESS: INCENTIVIZING THE SALVAGE OF ORBITAL DEBRIS

*D. Perry Rihl II**

I. INTRODUCTION

On October 4, 1957 at 10:29 PM local time, *Sputnik I*, the first man-made object to orbit the Earth, was launched from Moscow in the Soviet Union¹. The launch, and the accompanying fervor,² sparked the rapid development of technology and exploration, culminating in boot prints on the moon and volumes of information about what lies beyond our planet. Thousands of objects have followed *Sputnik* into orbit, resulting in volumes upon volumes of valuable scientific insight and an increased sense of global connectedness. However, these launches have left behind upwards of 500,000 pieces of debris that continue orbit the earth.³ This debris ranges from ten centimeters in diameter up to the size of used rocket stages and inactive satellites.⁴ Additionally, there are millions of pieces of floating debris that are undetectable and untraceable due to their size.⁵ This floating debris has the potential to cause untold damage to current and future space missions, and each launch must be carefully calculated to account for the immense cloud of debris floating overhead.⁶

The economic and environmental cost presented by abandoned orbital debris could be solved, at least in part, by salvage operations aimed at collecting and utilizing debris for more efficient uses.⁷ Unfortunately, there is no comprehensive orbital salvage law or any international body governing Earth's orbit. There is only general law applying to outer space which focuses primarily on peaceful use and exploration and grants perpetual ownership of orbital objects to their launching states.⁸ The lack of

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¹ *Sputnik and the Dawn of the Space Age*, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION, <https://history.nasa.gov/sputnik/>.

² *The Launch of Sputnik, 1957*, UNITED STATES DEPARTMENT OF STATE, <https://2001-2009.state.gov/r/pa/ho/time/lw/103729.htm>.

³ Jesse D. Lively, *Orbital Debris: An Argument in Support of Keeping the Non-Binding Framework*, 42 *Transp. L.J.* 225, 227 (2015); *Space Debris and Human Spacecraft*, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION, https://www.nasa.gov/mission_pages/station/news/orbital_debris.html.

⁴ Lively, *supra* note 3, at 227.

⁵ Lively, *supra* note 3, at 227; *Space Debris and Human Spacecraft*, *supra* note 3.

⁶ *Space Debris and Human Spacecraft*, *supra* note 3 (“NASA has a set of long-standing guidelines that are used to assess whether the threat of such a close pass is sufficient to warrant evasive action or other precautions to ensure the safety of the crew[.]”)

⁷ Alexander William Salter, *Space Debris: A Law and Economics Analysis of the Orbital Commons*, 19 *STAN. TECH. L. REV.* 221, 235 (2016).

⁸ G.A. Res. 2222 (XXI) at 14 (Dec. 19, 1966).

salvage law leaves open questions and potential hazards surrounding the growing volume of orbital debris.⁹

An amendment to the current law must be introduced that incentivizes the collection of hazardous orbital debris and minimizes the existing problem. Some point to maritime salvage as a guide for orbital salvage,¹⁰ but that regime's requirement of *voluntariness* and *success* in salvage missions would fail to efficiently manage astrosalvage. These requirements deal specifically with the nature of the sea and are ill-suited for direct application to astrosalvage.

This comment will address the lack of orbital salvage law by recommending an amendment to the existing United Nations ("UN") Rescue and Liability Agreements that adds a good faith component to the applicable maritime salvage principles and applies them with a broad standard of dereliction that takes into account the difference between orbital and maritime debris.¹¹ By adding a good faith component to the elements of voluntariness and success, private and public entities will be incentivized to salvage orbital debris with a diminished risk of loss should the salvage mission fail. A broader definition of dereliction, on the other hand, will do away with perpetual ownership of objects once they are non-operational, incentivizing salvors to collect or repair debris in a timely fashion. These changes will act as a first step toward diminishing the danger to current and future space operations and limiting the environmental impact of orbital debris while also incentivizing investment into salvage.

By way of clarification, the recommended amendments to the UN Rescue and Liability Agreements are not intended to create a comprehensive system of orbital salvage law. Instead, this comment proposes a first step upon which a system of law can develop. The ultimate goal is that space-faring nations will be incentivized to limit their production of orbital debris and will mitigate existing debris while also allowing private investors the opportunity to invest in the potentially profitable industry of orbital debris collection and salvage.

Part II of this paper will discuss the current state of international space law, its purpose and goals, and how it leaves room for salvage without expressly addressing it. Part III will examine maritime salvage law,

⁹ Craig Fishman, *Space Salvage: A Proposed Treaty Amendment to the Agreement on the Rescue of Astronauts, the Return of Astronauts and the Return of Objects Launched into Space*, 26 VA. J. INT'L L. 965, 978 (1986). ("There is no explicit doctrine of salvage in space because pre-treaty space law was occupied with the development of broad and essential principles primarily aimed at confining the Cold War to this planet.")

¹⁰ N. Jasentuliyana, *Regulation of Space Salvage Operations: Possibilities for the Future*, 22 J. SPACE L. 5, 9 (1994) ("The general concepts of abandonment at sea and the classification of derelict craft, therefore, may provide ideas and analogous situations to assist policy-makers in determining standards and practices for space salvage operations.")

¹¹ See *id.* at 9. Dereliction, or deliberate abandonment, only occurs by an obvious and intentional renunciation of ownership.

including a summary of controlling law and a description of the elements of maritime salvage and how they would be ineffective if applied to astrosalvage. Finally, Part IV will discuss proposed solutions to the orbital debris problem and their various shortcomings, as well as a discussion of the application of good faith and dereliction to orbital salvage.

II. THE CURRENT SYSTEM OF SPACE LAW

Human activity in outer space is primarily governed by five United Nations agreements.¹² The first and most important agreement is the 1967 UN Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and other Celestial Bodies (“Outer Space Treaty”).¹³ The four subsequent agreements, the 1968 UN Agreement on the Rescue of Astronauts, the Return of Astronauts and the Return of Objects Launched into Space (“Rescue Agreement”),¹⁴ the 1972 UN Convention on International Liability for Damage Caused by Space Objects (“Liability Agreement”),¹⁵ the 1975 UN Convention on Registration of Objects Launched into Outer Space (“Registration Agreement”),¹⁶ and the 1979 UN Agreement Governing the Activities of States on the Moon and Other Celestial Bodies (Moon Treaty),¹⁷ were all developed to support and strengthen the Outer Space Treaty. To that end, each agreement has been successful to a different extent. For the purposes of this comment, only the Outer Space Treaty, Rescue Agreement, Liability Agreement, and Registration Agreement will be discussed

A. *The Outer Space Treaty*

The Outer Space Treaty was promulgated at the height of the Cold War and reflects the intent of the United States and Soviet Union to keep the other from achieving a scientific, military, or territorial advantage.¹⁸ Article II of the agreement states that no nation can make any claim or appropriation of a celestial body “by occupation or any other means.”¹⁹ This has, for the past 50 years, kept outer space and celestial bodies free of sovereign claim despite many manned and unmanned missions throughout

¹² *Space Law Treaties and Principles*, UNITED NATIONS OFFICE FOR OUTER SPACE AFFAIRS, <http://www.unoosa.org/oosa/en/ourwork/spacelaw/treaties.html>.

¹³ See generally G.A. Res. 2222, *supra* note 8, at 13.

¹⁴ G.A. Res. 2345 (XXII) at 5 (Dec. 19, 1967).

¹⁵ G.A. Res. 2777 (XXVI) at 25 (Nov. 29, 1971).

¹⁶ G.A. Res. 3235 (XXIX) at 16 (Nov. 12, 1974).

¹⁷ G.A. Res. 34/68, at 77 (Dec. 5, 1979).

¹⁸ Brandon C. Gruner, *A New Hope for International Space Law: Incorporating Nineteenth Century First Possession Principles into the 1967 Space Treaty for the Colonization of Outer Space in the Twenty-First Century*, 35 SETON HALL L. REV. 299, 317 (2004).

¹⁹ G.A. Res. 2222, *supra* note 8, at 13.

the solar system.²⁰ Additionally, Article IV outlaws the use or placement of weapons of mass destruction in orbit and bans the establishment of military installations on celestial bodies.²¹ Both the United States and the Soviet Union were signatories to the Outer Space Treaty, each limiting their own capability in hopes of future security against the other.²²

The Outer Space Treaty also addresses the fear that technology or personnel launched into space would be captured by other nations. Article V states that astronauts are to be considered “envoys of mankind” and are to be promptly returned to their launching state should they land or crash in foreign territory.²³ Similarly, Article VIII states that all objects launched into space remain the property of their launching state and are to be returned should they land or crash.²⁴ These articles are strengthened by Article XI, which calls for the establishment of national and international registries for objects launched into space to maintain ownership and liability,²⁵ and by the later Rescue, Liability, and Registration agreements.²⁶

There is no provision in the Outer Space Treaty specifically governing the collection or salvage of orbital debris.²⁷ The Outer Space Treaty does, however, address ownership and liability in a way that stalls orbital salvage. Article VIII grants a launching party perpetual ownership of any object it launches,²⁸ and Article VII, using similar logic, dictates that states are liable for any damage caused by objects they have launched.²⁹ Finally, the establishment of national and international registries in Article XI ensure that ownership and liability can be publicly known and enforced.³⁰ Despite intentionally general terminology,³¹ the Outer Space Treaty establishes standards of ownership and liability in a way that discourages the collection of any debris in orbit, abandoned or not. In this

²⁰ See generally, Lynn M. Fountain, *Creating Momentum in Space: Ending the Paralysis Produced by the Common Heritage of Mankind Doctrine*, 35 CONN. L. REV. 1753 (2008).

²¹ G.A. Res. 2222, *supra* note 8, at 14.

²² Fishman, *supra* note 9, at 978.

²³ G.A. Res. 2222, *supra* note 8, at 14.

²⁴ *Id.*

²⁵ *Id.*

²⁶ See Bryon C. Brittingham *Does the World Really Need New Space Law?*, 12 Or. Rev. Int'l L. 31, 40 (2010).

Strict state ownership was expanded and implemented by the International Space Station Agreement, which states that governments maintain ownership in modules they build and launch, and any discoveries become the intellectual property of the state who launched the module. See *id.*

²⁷ Fishman, *supra* note 9, at 978.

²⁸ G.A. Res. 2222, *supra* note 8, at 14.

²⁹ *Id.*

³⁰ *Id.*

³¹ P.J. Blount, *Renovating Space: The Future of International Space Law*, 40 DEV. J. INT'L & POL'Y 515, 524 (2011) ([The Outer Space Treaty] “holds very few hard prescriptive articles, and instead regulates with open language that requires states to communicate in order to avoid conflicts.”)

way, the Outer Space Treaty does not present legal obstacles to any parties that wish to engage in salvage.

The Outer Space Treaty and its establishment of perpetual ownership and liability have had a chilling effect on salvage in two ways.³² First, private or foreign actors are disincentivized to attempt salvage because there is no ownership or rewards granted by collection of debris.³³ While this mirrors maritime law to an extent, perpetual ownership of orbital objects does not allow for abandonment in the same way that maritime law allows for deliberate abandonment and open claim on certain shipwrecks. Second, state actors are unlikely to collect their own debris, regardless of liability, because the costs of collection and maintenance currently outweigh the potential damage debris may cause.³⁴ This leads to a continued crowding of orbital space, creating a “tragedy of the commons” problem, that is, overuse which detrimentally impacts other parties.³⁵ Even if clean-up was effectively encouraged, it is generally difficult to assign liability because much of the existing debris is too small or damaged to be identified to a launching state.³⁶

Despite the lack of developed salvage law, the Outer Space Treaty provides a basis on which all other space law has been built, and the Outer Space Treaty has served its intended purposes – the prevention of proprietary claims and military installations – quite well. While broad, it allows signatory states to have a level of security in their own development and exploration of space without the risk of rival powers making claims, capturing astronauts or spacecraft, or placing weapons in space.³⁷ This security, however, came at the price of limiting future claims or new appropriation of land or chattel. Nonetheless, the Outer Space Treaty provides a nexus that has been expanded and strengthened by subsequent agreements which, while enforcing the articles of the Outer Space Treaty more comprehensively, further limited the discussion of orbital salvage.

B. *The Rescue Agreement*

The Rescue Agreement significantly expanded upon the powers of Articles V and VIII of the Outer Space Treaty.³⁸ The Rescue Agreement requires states to notify launching parties of the crashed personnel and craft, and to provide necessary aid to return them to their home country.³⁹ It also required signatory states to render all possible assistance to all crashed craft

³² See generally *id.*

³³ See generally, G.A. Res. 2222, *supra* note 8, at 14.

³⁴ *Id.*

³⁵ Salter, *supra* note 7, at 228 (citing generally Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968)).

³⁶ Jasentuliyana, *supra* note 10, at 11.

³⁷ See generally, G.A. Res. 2222, *supra* note 8, at 14.

³⁸ See generally, G.A. Res. 2345, *supra* note 14.

³⁹ *Id.* at 6.

and personnel, regardless of national origin.⁴⁰ The Rescue Agreement affirms the ownership of member states over their craft and personnel established in Articles V and VIII of the Outer Space Treaty.⁴¹

Article I of the Rescue Agreement requires signatory states to inform the launching party of a craft of the discovery of personnel or spacecraft of that state.⁴² Signatory states are required to do so publicly and by “all appropriate means.”⁴³ Article IV then requires signatory states to return crashed personnel and spacecraft to their launching states.⁴⁴ In one regard, Articles I and IV of the Rescue Agreement help states maintain control over their own personnel and space craft.⁴⁵ In another, these articles serve the Outer Space Treaty’s overarching goal of keeping space a neutral territory.⁴⁶ Both features solidify and confirm the exclusive ownership that states have in their own craft and limit the ability of salvors to benefit from or collect orbital debris.

Articles II and III require states to render assistance in the event of a crash within their own territory or in international waters, respectively.⁴⁷ This could serve several purposes, but it primarily stops states from withholding aid from astronauts or spacecraft based on national origin. It also stops states from making claims to objects simply because they crash within national borders. Presumably, Articles II and III also have the added benefit of balancing the interests of launching states and those required to render assistance, incentivizing states to assist in recovery absent the possibility of benefit.

The Rescue Agreement grants confirmation and support to the perpetual ownership states have in their craft without granting salvors any specific rights.⁴⁸ No claim can be placed on an object based on where it crashes,⁴⁹ and all personnel and craft must be returned to home states as quickly as possible.⁵⁰ Further, states are required to expend all appropriate effort in notifying the launching state and in rescuing crashed objects and astronauts.⁵¹ While orbital debris and salvage are not specifically mentioned, the Rescue Agreement grants support to ownership rights granted by the Outer Space Treaty by stopping other states from making claims to fallen craft.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Gruner, *supra* note 18, at 299.

⁴⁷ G.A. Res. 2345, *supra* note 14, at 6.

⁴⁸ See G.A. Res. 2345, *supra* note 14, at 6.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

C. *The Liability Agreement*

While the Rescue Agreement gives support to state ownership, the Liability Agreement reinforces the responsibility states have for any damage done by craft or debris they own.⁵² This includes damage done in orbit, on the surface of the earth, or on other celestial bodies.⁵³ The Liability Agreement overlaps with the Rescue Agreement in that both agreements dictate that all crashed material is to be returned to the launching state.⁵⁴ The Liability Agreement then departs, enforcing liability and outlining how damages and indemnification are to be collected.⁵⁵

The Liability Agreement begins by dictating that states are liable for any damage or loss of life resulting from any stage of launch, spaceflight, or landing.⁵⁶ All damages are to be collected through diplomatic channels.⁵⁷ States share joint and severable liability in cases of cooperative launches,⁵⁸ and jointly liable states are allowed indemnification from other states involved.⁵⁹ However, damages and indemnification between co-liable states can only be collected where the damage is clearly caused by the launching state.⁶⁰

However, proving liability can be difficult because the condition or size of fallen objects often makes them unidentifiable as to their state of origin.⁶¹ After all, liability cannot be enforced when most damage-causing debris cannot be tied to a particular state. This requirement of clear proof of liability, therefore, indicates the growing need for astrosalvage. States can only be held liable for damage that has been caused by a craft with clear ties to the launching state.⁶² Additionally, states are barred from collecting any debris when the state of origin is unclear. A system of dereliction and salvage would help resolve this issue and mitigate the problem of danger debris, regardless of identifiability.

D. *The Registration Agreement*

The Registration Agreement has sought to strengthen the Outer Space Treaty, Rescue Agreement and Liability Agreement by requiring states to list launched objects within registries overseen by the UN.⁶³ The registration includes information about an object's design and markings as

⁵² G.A. Res. 2777, *supra* note 15, at 25.

⁵³ *Id.*

⁵⁴ G.A. Res. 2345, *supra* note 14, at 6. *See also*, G.A. Res. 2777, *supra* note 15, at 26.

⁵⁵ G.A. Res. 2777, *supra* note 15, at 25.

⁵⁶ *Id.*

⁵⁷ *Id.* at 26.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* at 25.

⁶¹ Jasentuliyana, *supra* note 10, at 11.

⁶² G.A. Res. 2777, *supra* note 15, at 26.

⁶³ G.A. Res. 3235, *supra* note 16, at 16-17.

well as its proposed path and mission.⁶⁴ The registered information is meant to help identify launched objects to their nation of origin and supports the perpetual ownership of objects in space by keeping other states apprised of who owns what.⁶⁵

This system, however, will never be able to catalog all the debris in orbit. It is unlikely that the drafters of the Registration Agreement foresaw the buildup of orbital debris, especially the 5 million or more pieces of debris that cannot be tracked adequately because of their size.⁶⁶ Pieces of orbital debris, large or small, still legally belong to their launching states under the Outer Space Treaty,⁶⁷ but there is no way to effectively identify them. This expands ever-increasing volume of material in orbit that presents a serious hazard, but will never be claimed unless amendments are made to the Rescue and Liability agreements that allow salvors to collect orbital debris.

The Outer Space Treaty, as well as the Rescue, Liability, and Registration Agreements have sought to preserve the rights of launching states while limiting the possibility of rival nations establishing proprietary or hostile occupation of space. To that end, space law is well structured, generally applying to space while outlining specific rights and responsibilities. However, the way humanity interacts with outer space is changing. Concerns about national security and hostile claims in space still exist, but there has also been an enormous private investment into space launches and use over the past decade.⁶⁸ While private space flight has historically occupied a very small area of the market, there were over 30 private space launches planned in 2016 alone,⁶⁹ which only represents the activity of two firms launching from one site.⁷⁰ Increased private investment raises new issues that were not anticipated by the existing UN agreements. Nations and private actors will presumably be forced to examine other sources of law for any number of new space-related questions as our reach extends further beyond earth's atmosphere.

III. MARITIME SALVAGE LAW

On its face, it seems reasonable to borrow heavily from maritime salvage law to define an astrosalvage regime. Both outer space and the deep sea are widespread, inaccessible without technological assistance, and

⁶⁴ *Id.* at 17.

⁶⁵ Jasentuliyana, *supra* note 10, at 11

⁶⁶ *Id.*

⁶⁷ G.A. Res. 2222, *supra* note 8, at 14.

⁶⁸ See generally, Joseph Stromberg, *Private Spaceflight, explained*, VOX (Sept. 4, 2015) <https://www.vox.com/2015/2/6/18073658/private-space-flight>.

⁶⁹ *U.S. Private Space Companies Plan Surge in Launches This Year*, REUTERS (Jan. 1, 2018), <http://www.reuters.com/article/us-space-launches/u-s-private-space-companies-plan-surge-in-launches-this-year-idUSKCN0VC2G7>

⁷⁰ *Id.*

difficult to subject to proprietary claim.⁷¹ There is also a wealth of history behind maritime salvage law that could educate the development of orbital salvage law. For nearly as long as mankind has been sailing the seas, nations have been developing common and statutory law to deal with salvage disputes.⁷² This historical background has shaped modern salvage law wherein most coastal countries use similar models with only small differences between nations.⁷³ Modern maritime salvage law is governed primarily by the 1989 International Convention on Salvage⁷⁴ which draws heavily from the historical law of UN member states.⁷⁵ Notably, while many developed nations are party to the International Convention on Salvage, large seafaring nations such as the United States and China have not officially signed the Convention,⁷⁶ opting instead to establish domestic law and smaller agreements between themselves governing the open ocean and seabed in a way better suited to their economic needs.⁷⁷

This section provides a brief history and the current state of international salvage law and presents general principles that run throughout salvage law. This section will demonstrate how maritime law could be used as a template for orbital salvage law while also indicating that direct application of maritime salvage law to orbit would be problematic.

A. *Historical Common Law Salvage*

The Marine Ordinance of Trani (1063 A.D.) was the first maritime statute to be formally recorded and promulgated.⁷⁸ It awarded the “finder with half the goods found floating at sea if the owner appeared” and granted full ownership to the finder “if at the end of thirty days the owner [did] not appear.”⁷⁹ This idea of salvage changed very little until the 13th century when the Laws of Oleron were established in Britain as a precursor to formal English salvage law based on common law.⁸⁰ From that point,

⁷¹ Brittingham, *supra* note 26, at 49.

⁷² Olivia Lennox-King, *Laying the Mark to Port and Starboard: Salvage under Duress and Economic Duress at Contract Law*, 21 AUSTL. & N.Z. MAR. L.J. 32, 34 (2007). *See also*, Marc E. Montgomery, *Navigating the Back Channels of Salvage Law: Procedural Options for a Small Boat Salvor*, 83 TUL. L. REV. 1463, 1465 (2009).

⁷³ *Id.* at 35.

⁷⁴ *Id.*; *See also*, International Convention on Salvage, art. 2, 13, Apr. 28, 1989, 1953 U.N.T.S. 33479.

⁷⁵ While other law governing practices at sea exist, such as the United Nations Conventions on the Law of the Sea (“UNCLOS”), these agreements leave the issue of salvage to existing international and domestic law. *See generally* Ricky J. Lee, *Reconciling International Space Law with the Commercial Realities of the Twenty-First Century*, 4 SING. J. INT'L & COMP. L. 194, 226, 242 (2000).

⁷⁶ Salter, *supra* note 7, at 235.

⁷⁷ *Id.*

⁷⁸ Lawrence J. Lipka, *Abandoned Property at Sea: Who Owns the Salvage "Finds"?*, 12 WM. & MARY L. REV. 97, 97-98 (1970), available at <http://scholarship.law.wm.edu/wmlr/vol12/iss1/7>.

⁷⁹ *Id.* at 98.

⁸⁰ *Id.*

English salvage law focused primarily on “ownership by possession,⁸¹” only developing different types of claims by later statutes.

Today, via additional statutes and developments in case law, most countries conform to traditional salvage claims. Unidentified and unclaimed goods washed up on shore generally belong to the government, while anything lost at sea belongs to its original owner who may contract for salvage or conduct independent collection.⁸² The notable exception to this rule is that coastal states have claim on any unclaimed shipwreck on the seabed between their coastal boundary and the continental shelf.⁸³ It is in the spaces between these coastal and continental boundaries where questions persist about ownership of lost goods.

B. *International Convention on Salvage*

The International Convention on Salvage (“Salvage Convention”) was debated and established in the United Kingdom in 1989, updating the previous Brussels Convention on Assistance and Salvage at Sea (“Brussels Agreement”).⁸⁴ The Salvage Convention states that all salvors owe a duty to owners of craft or equipment lost at sea,⁸⁵ and delves deeply into when rewards are owed to a salvaging party⁸⁶ and by what terms and considerations parties can enter into salvage contracts.⁸⁷ Notwithstanding historic common law and domestic salvage law unique to each nation, the Salvage Agreement is the primary source of international salvage law.⁸⁸

The Salvage Agreement begins by stating that it was established to bridge the historical gap between the Brussels Agreement of 1910 and today.⁸⁹ As such, the drafters spend much of the text defining the nature of negotiations involved in salvage to account for modern trade and technology.⁹⁰ Articles V through VII deal specifically with the powers given to private and public operators as they negotiate salvage contracts.⁹¹ Article VIII of the Salvage Agreement states that salvaging parties owe a duty to owners of sunken objects to practice due care during salvage operations to minimize damage and costs, and to seek assistance when necessary to keep damage operational costs low.⁹² In return, salvees must cooperate with

⁸¹ *Id.*

⁸² *See generally, id.*

⁸³ *See* United Nations Convention on the Law of The Sea, Annex II art. 1-9. *See also* Elizabeth Barrowman, *The Recovery of Shipwrecks in International Waters: A Multilateral Solution*, 8 Michigan J. Int'l L. 231, 235 (1987).

⁸⁴ *See generally* International Convention on Salvage, *supra* note 76, at 3.

⁸⁵ *Id.* at 4.

⁸⁶ *Id.* at 5-6.

⁸⁷ *Id.* at 4.

⁸⁸ *See generally id.*

⁸⁹ International Convention on Salvage, *supra* note 76, at 3.

⁹⁰ *Id.*

⁹¹ *Id.* at 4.

⁹² *Id.* at 4-5.

salvage operations and accept delivery of salvaged goods.⁹³ Article VIII serves the interest of the party that owns the object by limiting damage and costs associated with collection, but also ensures salvors that their efforts will not go unrewarded.⁹⁴ Article VIII also defends against salvors who may deliberately commit to costly salvage operations without seeking assistance in hopes of hoarding the reward.⁹⁵

The Salvage Agreement continues by outlining how rewards of salvage are established and calculated.⁹⁶ Article XII provides ten criteria by which the size of a reward is decided, including the value of the salvaged property, the measure of success of the salvor, and the operating costs incurred by salvors while completing the operation.⁹⁷ Presumably, by providing a concrete list of considerations, the costs incurred in negotiating a contract are limited, and both parties better understand the costs and benefits of a salvage operation.

The remainder of the Salvage Agreements deals first with distribution of awards among salvors and claims that may be placed on salvaged objects by maritime lien or other devices, and continues through the means of ratification, entry into force, and amendment processes.⁹⁸ Taken together, the Salvage Agreement provides a comprehensive regime on maritime salvage.

C. General Principles

Certain general principles of salvage can be gleaned from the existing law. First, property rights of states and private owners are perpetual in sunken objects. This protects them from adverse claims and prevents a “finders-keepers” approach to salvage. Such an approach is only allowed in cases of dereliction where an owner intentionally abandons ownership rights. Additionally, the existing body of salvage law provides three requirements for a salvor to collect the reward of a salvage operation. While these principles present a template upon which orbital salvage can be based, they need to be adapted to fit the needs of orbital operations.

i. Property Rights are Perpetual in Sunken Objects

Property rights remain with the original owner of sunken craft forever, allowing for a collection or salvage of material at any time.⁹⁹ This stops salvors from staking claims on anything they pull up. Instead salvors are granted rewards for services rendered, as defined either by a salvage

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.* at 5-6.

⁹⁷ *Id.* at 5

⁹⁸ *Id.* at 6-10 (art. 14-33).

⁹⁹ Jasentuliyana, *supra* note 10, at 18.

contract or by international law.¹⁰⁰ Granting perpetual ownership removes the risk that a vessel would be taken before the owner had a chance to collect or contract for salvage.

Perpetual ownership is akin to Article VIII of the Outer Space Treaty, as well as the Liability and Rescue Agreements, stating that any object launched into space remains the property and responsibility of the launching state.¹⁰¹ It serves a similar purpose in both areas of law, keeping rival nations from claiming another craft for their own purposes. However, perpetual ownership rights do not serve the same purpose in space as they do at sea. As will be discussed more deeply below, perpetual ownership does not necessarily serve the economic interests of nations and private actors or eliminate the environmental hazard created by orbital debris. Additionally, perpetual ownership may be redundant in space as adverse claims are more difficult and expensive to make than on the ocean floor.

ii. Elements of Maritime Salvage

There are three prerequisites for a salvor to be able to collect a reward for a salvage operation.¹⁰² First, the object must be in actual peril.¹⁰³ Simply put, it must be in a situation that requires salvage and where the craft cannot be saved without additional assistance.¹⁰⁴ The second prerequisite is that the salvage act must be voluntary for both the salvor and the salve.¹⁰⁵ This allows owners to control who conducts salvage missions and for how much. The voluntariness requirement also has the added effect of stopping those with a preexisting duty to a vessel, such as crew members, from conducting salvage for a reward.¹⁰⁶ Finally, salvors must be “successful or [at least] partially successful in saving . . . at least a part of the property at risk[.]” to claim a reward.¹⁰⁷ Only if all three prerequisites are fulfilled can a salvor collect for services rendered.¹⁰⁸

iii. Dereliction

Unlike space law, maritime law allows for an object to become derelict, or abandoned for anyone to collect.¹⁰⁹ Such situations are governed

¹⁰⁰ Jasentuliyana, *supra* note 10, at 18.

¹⁰¹ G.A. Res. 2222, *supra* note 8, at 14.

¹⁰² Fishman, *supra* note 9, at 979.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 979-80.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 980.

¹⁰⁸ *Id.* at 979.

¹⁰⁹ Jasentuliyana, *supra* note 10, at 16.

by the law of finds¹¹⁰ and, if challenged, the courts must decide whether a sunken object was indeed abandoned.

The law of finds and international law define dereliction in multiple parts.¹¹¹ First, the object must be abandoned by the owners without hope of recovery (*sine spe recuperandi*).¹¹² This puts a definitive end on the claim of the original owner. Second, it must be considered abandoned property (*res derelictae*), to which the law of finds applies instead of the law of salvage.¹¹³ Under the law of finds, the subsequent finder establishes an ownership right superior to all but the original owner.¹¹⁴ Additionally, the object must be abandoned in international waters.¹¹⁵ Any object abandoned within a state's territory or coastal boundaries becomes the property of that state.¹¹⁶ Once an item becomes derelict, it is considered ownerless, and any party with the ability to claim it may do so.¹¹⁷ Dereliction allows for the removal of dangerous obstacles while simultaneously allowing sunken objects to have economic benefits via collection and use.

Maritime salvage law has been crafted over the centuries into a system specifically designed to efficiently manage the collection of lost goods and vessels, as well as the reimbursement of owners and salvors who expend the effort to collect them.¹¹⁸ As such, ownership rights are enforced effectively and fairly. This historical model, with all its elements of collection and dereliction, could be applied to orbit with relatively little adjustment, making orbital salvage as economically viable and accessible as maritime salvage.

IV. ECONOMIC IMPACT OF ORBITAL DEBRIS

The lack of effective astrosalvage law creates a net loss for the global community. Millions of dollars are invested into each orbital mission and, due to mission failure, planned jettison, or lack of maintenance, objects of varying size are left non-operational in orbit.¹¹⁹ These objects,

¹¹⁰ The law of finds is essentially a system of "finders' keepers" in which the one who finds and makes a constructive claim on the object possesses property rights superior to everyone but the original owner. See Fishman, *supra* note 9, at 979. James A. R. Nafziger, *Finding the Titanic: Beginning an International Salvage of Derelict Law at Sea*, 12 COLUM.-VLA J.L. & ARTS 339, 343-44 (1987).

¹¹¹ See Jasentuliyana, *supra* note 10, at 16.

¹¹² *Id.*

¹¹³ Nafziger, *supra* note 112, at 343.

¹¹⁴ See *id.* at 343-44.

¹¹⁵ Jasentuliyana, *supra* note 10, at 16.

¹¹⁶ See *id.*

¹¹⁷ *Id.* (citing WILLIAM RANN KENNEDY, SIR, ET AL., *KENNEDY'S LAW OF SALVAGE* 85-86 (5th ed. 1985)).

¹¹⁸ See *International Convention on Salvage*, IMO, <http://www.imo.org/en/About/Conventions/ListOfConventions/Pages/International-Convention-on-Salvage.aspx> (last visited Feb. 28, 2019).

¹¹⁹ Lively, *supra* note 3, at 227.

representing millions of dollars in research and development, are often left unclaimed, creating safety and environmental hazards.¹²⁰ This tragedy of the orbital commons and crowding of orbital space continues because states are not required to collect or repair their orbital craft or debris. Additionally, states maintain perpetual ownership of objects they launch, which removes any incentive they might have to remove their debris. This lack of action indicates that states consider maintenance and collection costs for orbital debris to be higher than the potential cost of liability.

A change in the astrosalvage law would incentivize private actors to participate in salvage operations.¹²¹ Further, this shift would incentivize states to minimize their orbital debris by collecting debris within a defined period or performing maintenance on the same.¹²²

A. *The Losses of Current Astro Salvage Policy*

Outer space and orbit are enormous common areas potentially presenting a public good to humanity. No one person or state controls access to space, and similarly, no one can limit the use of outer space resources or the are inhabited by orbital objects.¹²³ In one sense, this is positive. As a public good, space presents the opportunity for different states to cooperate in exploration and scientific investigation.¹²⁴ In this light, outer space can be considered the “common heritage of mankind,”¹²⁵ and used for the common benefit and advancement of humanity without the establishment of proprietary claims.¹²⁶ However, the current space law regime creates a situation in which states and actors who have the actual ability to reach space will likely reject international arrangements that do not favor of their own interests, leading to overuse.¹²⁷

A similar problem of overuse has developed in orbit. Since states have perpetual ownership of objects they launch and lack the incentive to minimize or remedy their clutter, a tragedy of the commons problem has arisen.¹²⁸ In *The Tragedy of the Commons*, Garrett Hardin describes a

¹²⁰ Salter, *supra* note 7, at 228.

¹²¹ *Id.* at 236. (“A more involved response would have private firms bidding on contracts for removal or destruction of debris.”).

¹²² *Id.* at 232. (“To summarize thus far, the space debris problem exists because of externalities that some spacefaring agents impose on others and because of the tragedy of the commons. At the general level, the most reliable solution to such problems is the establishment and enforcement of private property rights.”).

¹²³ *See id.* at 228.

¹²⁴ *Id.* at 227.

¹²⁵ Barbara Ellen Heim, *Exploring the Last Frontiers for Mineral Resource: A Comparison of International Law Regarding the Deep Seabed, Outer Space, and Antarctica*, 23 VAND. J. TRANSNAT'L L. 819, 827 (1990) (listing the elements of the Common Heritage of Mankind doctrine.)

¹²⁶ *Id.* (citing Grier C. Raclin, *From Ice to Ether: The Adoption of a Regime to Govern Resource Exploitation in Outer Space*, 7 NW. J. INT'L L. & BUS. 727, 739 (1986)).

¹²⁷ The United States has created agreements with other industrialized nations to create a rival legal regime to the UN Law of the Sea Convention. *See generally id.* at 829.

¹²⁸ Salter, *supra* note 7, at 228.

situation in which all parties try to reap the greatest benefit from a given resource, but harm one another through the additional consumption of a depleted public good.¹²⁹ Applied to orbit, this means that the individual cost to states of minimizing or collecting orbital debris is too great given that no additional cost is incurred by leaving it in orbit.¹³⁰

The problem is two-fold. First, every piece of additional orbital debris makes every subsequent launch more hazardous and expensive to complete.¹³¹ It can be assumed that this increasing cost directly incurred by other space actors will eventually become too costly or dangerous to achieve.¹³² Second, there is the matter of waste. Each object launched into space is made of valuable material that, when inoperable, is wasted as it orbits the earth unutilized.¹³³ This material, which could be sold as scrap, studied for scientific investigation, or sold to collectors, presents no benefit as debris.¹³⁴ This, of course, relies on the assumption that there is a market for orbital debris, but even when sold at a low price, the sheer volume of orbital debris presents enormous value.¹³⁵ Further, as stated above, if it is left to collect, waste would build on itself and the net loss will continue to grow. The law fails to address these issues. There must be a change focused on maximizing the benefits of the debris floating overhead.

B. *Potential Economic Gains from Astrosalvage*

There are multiple benefits to be gained from allowing salvors to access orbit to salvage. The scrap metal in orbital debris represents an estimated millions, if not billions, of dollars in value that is not being claimed, potentially offsetting the massive cost to collect it.¹³⁶ These materials could be repurposed, sold to collectors, or used as scrap. As an example, salvage could present the opportunity to minimize the net weight of craft leaving the planet subject to the amount of scrap that could be collected and utilized for construction of tools and instruments or potential manufacturing and mining efforts on celestial bodies.¹³⁷ It has even been suggested that the remains of what has already been launched into space

¹²⁹ See generally Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1234, 1244 (1968) available at <http://science.sciencemag.org/content/162/3859/1243.full>. s

¹³⁰ Salter, *supra* note 7, at 228.

¹³¹ See *id.*

¹³² JOINT AND COALITION OPERATIONAL ANALYSIS (JCOA), MULTINATIONAL EXPERIMENT 7, ACCESS TO GLOBAL COMMONS: PROTECTING ACCESS TO SPACE (July 8, 2013), <https://www.hsdl.org/?view&did=754742>.

¹³³ *Id.*; see also Salter, *supra* note 7, at 233.

¹³⁴ Salter, *supra* note 7, at 233.

¹³⁵ *Id.* at 233-34.

¹³⁶ *Id.* at 233 (“A major difficulty lies in the realization that much debris is valuable scrap material that is already in orbit.”).

¹³⁷ See *id.* at 233-34.

could be collected and repurposed to build a new space station or lunar facility.¹³⁸

The gains from salvage law are not limited to monetary or scientific application. There is also a significant environmental gain from allowing the salvage of orbital materials.¹³⁹ It is estimated that, assuming a limited creation of new orbital debris, the level of dangerous debris in orbit can be stabilized within the next century with the removal of just five large pieces of debris per year.¹⁴⁰ This, in turn, would help to minimize collisions in orbit and limit the risk of debris falling into populated areas, as was anticipated by the Outer Space Treaty and the Liability Agreement.¹⁴¹ This approach would make strides toward solving the tragedy of the commons problem while granting a general economic incentive and financial boost from the utilization of orbital material.

The global market would benefit from increased incentives and lowered barriers of access to salvage operations in a couple of ways. First, allowing for property rights in orbital objects to lapse would incentivize states to either collect their debris or lose it to salvors. This increased opportunity could incentivize salvors to make the investment to collect orbital debris to benefit from the new opportunities. While the cost of such an endeavor would be expensive, the benefits available from salvaging contracts with states, the historical and cultural heritage tied up in many pieces of orbital debris, and the face value and sheer volume of orbital objects could potentially offset the costs. This new market has the potential to result in better launch and collection practices and allow for a more efficient use of orbital debris. There are many benefits to be reaped from astrosalvage, provided that the global community were to amend the current law to allow for the collection and use of material.

None of this is to say that changing the legal regime surrounding orbital salvage would make for a quick benefit to individual salvors, states, or the global community. Space travel, even that which never leaves orbit, is prohibitively expensive, which serves as a barrier to entry for many would-be salvors.¹⁴² However, these barriers are significantly higher when one considers the fact that there is currently no incentive or motivation for states or private firms to develop the affordable means and technology to collect valuable orbital debris.

¹³⁸ Megan Garber, *The Trash We've Left on the Moon*, *THE ATLANTIC* (Dec. 19, 2012), <https://www.theatlantic.com/technology/archive/2012/12/the-trash-weve-left-on-the-moon/266465/>.

¹³⁹ Jer-Chyi Liou, et al., *Controlling the Growth of Future LEO Debris Populations with Active Debris Removal*, 66 *ACTA ASTRONAUTICA* 648, 648 (2010).

¹⁴⁰ Salter, *supra* note 7, at 235 (citing Liou, *supra* note 142, at 648).

¹⁴¹ G.A. Res. 2222, *supra* note 8, at 14 ; G.A. Res. 2777, *supra* note 16, at 16.

¹⁴² See Andre Radensky, *'The Force Awakens' for Commercial Space Flight and Space Tourism*, *BUS. TODAY* (Mar. 23, 2018), <http://journal.businesstoday.org/bt-online/2018/the-force-awakens-for-commercial-space-flight-and-space-tourism>.

One might argue that the salvage debate is moot until countries develop the necessary plans and technology to collect orbital debris, but this fails to recognize that the way must be opened for salvors to access profitable debris before they will invest the time and capital necessary to conduct salvage. Additionally, many countries who possess the ability to access orbit and outer space also possess the capability to track, access, and move orbital debris to less hazardous orbital locations. It is not hard to imagine that this same technology could be integrated into the collection of orbital debris, shifting focus back to the changes which must be made to the existing legal regime to bring commercial salvage within reach.

V. PROPOSED SOLUTIONS FOR ASTROSALVAGE LAW

As national space programs and private companies discuss and plan new and exciting space missions, the issues that plague the current regime of space and orbital law have come to the forefront of aerospace discussions. Much of the discourse, however, has been focused on the establishment of proprietary ownership of land on celestial bodies such as the Moon and Mars.¹⁴³ Aside from the fact that the Outer Space Treaty and successive treaties have made such claims legally problematic,¹⁴⁴ the discussion has also been virtually devoid of discourse about orbital salvage, resulting in a lack of legal and scholarly material aimed at addressing orbital debris.

There seems to be an impasse of conflicting capabilities and intentions. Those in the best position to deal with the environmental and safety hazards of orbital debris have not been sufficiently incentivized to minimize the creation of debris,¹⁴⁵ and those in a position to benefit economically from the collection, repurposing, and sale of orbital debris have been blocked by the existing law that disincentivizes the use of space for fear of loss.¹⁴⁶ To address the problem, some have suggested applying maritime salvage law directly to orbit.¹⁴⁷ However, there are key differences between orbital and oceanic salvage that make direct application

¹⁴³ See generally David Collins, *Efficient Allocation of Real Property on the Planet Mars*, 14 B.U. J. SCI. & TECH. L. 201 (2008); Glenn Harlan Reynolds, *Staking a Claim*, 190 POPULAR MECHANICS 50 (2013); Rachel Riederer, *Whose Moon Is It Anyway?* 61 DISSENT 6 (2014); Sarah Jane Fox, *SPACE: The Race for Mineral Rights 'The Sky is No Longer the Limit' Lessons From Earth!*, 49 RESOURCES POL'Y 165 (2016).

¹⁴⁴ Collins, *supra* note 117, at 208 ("The uncertain legal framework of the existing treaty regime would undermine optimal investment since there would be fear of uncompensated expropriation under the auspices of the UN or some other international organization favoring absolute common ownership of all extra-planetary resources.").

¹⁴⁵ Salter, *supra* note 7, at 227-28.

¹⁴⁶ Adam G. Quinn, *The New Age of Space Law: The Outer Space Treaty and the Weaponization of Space*, 17 MINN. J. INT'L L. 475, 488 (2008) (describing how the common heritage and common domain interpretations of international law have led to an underuse problem of space resources).

¹⁴⁷ R. Cargill Hall, *Comments on Salvage and Removal of Man-Made Objects from Outer Space*, 33 J. AIR L. & COM. 288, 290 (1967).

problematic.¹⁴⁸ Another approach would be to leave salvage to the determination of space-faring nations responsible and liable for their own debris. This too, however, presents a problem of incentivizing states to make salvage deals in the first-place due to the expense and risk.

To solve myriad of problems surrounding orbital salvage, it has been recommended that maritime salvage be adjusted in a way that better allows for application to orbit.¹⁴⁹ Specifically, the requirement of success and voluntariness must be loosened to limit the costs to salvors, thereby incentivizing participation.¹⁵⁰ This comment also posits that a dereliction amendment must be borrowed from existing maritime law and applied to orbital salvage in a way that halts ownership rights in orbital craft and debris after a fixed time. The loss of ownership would force states to either collect their debris or leave it free for claim by salvors.

A. *Direct Application of Maritime Salvage Law*

Applying existing maritime salvage law to orbit seems to make logical sense.¹⁵¹ Both outer space and the sea are vast areas, largely unexplored, and accessible to anyone with the appropriate equipment.¹⁵² Additionally, space and the sea have similar legal systems in which original owners maintain ownership and liability in sunken and non-operational debris.¹⁵³ The debris on the ocean floor and in orbit also share the distinction of representing the cultural heritage of their nation and of humanity.¹⁵⁴ For these reasons, application of maritime law would appear to make a good model for astrosalvage. However, while maritime law represents the closest parallel to the legal environment of outer space, there are differences between the two that make direct application impractical.¹⁵⁵

The salvage of orbital debris represents a much costlier and logistically more hazardous situation than salvage from the seabed. This distinction requires a change to the three salvage requirements to be applicable to space. Salvage requires that a vessel be in actual peril, that salvage be voluntary for both the owner and salvor, and that the salvage operation be at least partially successful for the salvor to collect any

¹⁴⁸ Fishman, *supra* note 9, at 985-86 (regarding the voluntariness and success requirements of maritime salvage law).

¹⁴⁹ *See id.*

¹⁵⁰ *Id.*

¹⁵¹ Jasentuliyana, *supra* note 10, at 9.

¹⁵² *See* Heim, *supra* note 126, at 821-22 (stating that the deep seabed, outer space, and Antarctica are considered the "common heritage of mankind").

¹⁵³ G.A. Res. 2222, *supra* note 8, at 14; *see also*, Kenneth E. Roberts, *Sinking, Salvage, and Abandonment*, 51 TUL. L. REV. 1196, 1197 (1976-1977).

¹⁵⁴ Eden Sarid, *International Underwater Cultural Heritage Governance: Past Doubts and Current Challenges*, 35 BERKLEY J. INT'L L. 219, 221 (2017); *see generally* Alice Gorman, *Saving space junk, our cultural heritage in orbit*, CONVERSATION (Apr. 2, 2012), <http://theconversation.com/saving-space-junk-our-cultural-heritage-in-orbit-6025>.

¹⁵⁵ Fishman, *supra* note 9, at 988.

reward.¹⁵⁶ The peril requirement is easily applied. Craft or debris must be in a situation that cannot be remedied without the intervention of the salvor.¹⁵⁷ Objects in orbit are, for the most part, stuck there until someone pulls them down, satisfying the low bar of actual peril.¹⁵⁸

Voluntariness and success, on the other hand, are difficult to apply in the same way they are applied to maritime salvage.¹⁵⁹ Voluntariness requires that the owner of the vessel consent to the salvage and that the salvor himself conduct the operation separate from any preexisting duty to the owner or the vessel.¹⁶⁰ Applied to astrosalvage, the voluntariness requirement presents two problems. First, the hazard presented by orbital debris presents a risk to the lives of any third party launching into outer space.¹⁶¹ At sea, wrecks and debris exist mostly on the ocean floor, allowing states and salvors the opportunity to negotiate rewards and plan salvage operations without risking the safety of other vessels.¹⁶² In space, however, each additional object in orbit makes subsequent launches more dangerous to complete.¹⁶³ Second, voluntariness is difficult to apply to astrosalvage because, while many objects are identifiable to their original owner through existing registries, many more objects are unidentifiable.¹⁶⁴ This prevents original owners from giving consent for objects to be collected.¹⁶⁵

The success requirement of maritime salvage also requires adjustment before it can be applied to astrosalvage.¹⁶⁶ At sea, the success requirement prevents the salvor from 'feigning at salvage' to collect rewards at minimal cost.¹⁶⁷ However, because of the high cost and potential hazards of getting into orbit to conduct salvage, the success requirement poses too high a bar.¹⁶⁸ Because of these inherent differences, direct

¹⁵⁶ Roberts, *supra* note 156, at 1197 ("In order to have a valid salvage claim, three elements are necessary: (1) Marine peril; (2) services voluntarily rendered, *i.e.*, not required as an existing duty or from a special contract; and (3) success, in whole or in part, or contribution to such success by the service rendered.") (first citing *The Sabine*, 101 U.S. 384 (1879); then citing MARTIN J. NORRIS, *THE LAW OF SALVAGE* 24 (1958)).

¹⁵⁷ Fishman, *supra* note 9, at 979.

¹⁵⁸ *See id.* at 985 (noting that the real peril requirement can be directly applied to orbital salvage law from maritime salvage law and that two other "traditional salvage requirements – voluntariness and success – are not suitable requirements for space salvage.").

¹⁵⁹ *Id.*

¹⁶⁰ *See id.* at 979-80.

¹⁶¹ *Id.* at 985.

¹⁶² Fishman, *supra* note 9, at 985.

¹⁶³ Salter, *supra* note 7, at 228 ("In this situation, the actions of each party are imposing costs on other parties, in the form of leaving orbit more crowded than it previously was, without the other parties' consent[.]")

¹⁶⁴ Jasentuliyana, *supra* note 10, at 11 ("[B]ecause of the untrackable and unidentifiable nature of most orbital debris, it is not known to whom all orbital debris belongs[.]")

¹⁶⁵ *Id.* at 13 (citing HOWARD A. BAKER, *SPACE DEBRIS: LEGAL AND POLICY IMPLICATIONS* 69-71 (1989)).

¹⁶⁶ Fishman, *supra* note 9, at 985.

¹⁶⁷ *See id.* at 980.

¹⁶⁸ *Id.* at 986.

application would be problematic without additional amendments and conditions aimed at minimizing risk and increasing opportunity for salvors.

B. *Good Faith Amendment to the Rescue Agreement*

Good faith simply means that parties who are conducting operations make a substantial investment and effort toward collecting orbital debris.¹⁶⁹ Because owners can track salvage operation remotely and because of the hazards of conducting salvage,¹⁷⁰ it has been recommended that a good faith salvage amendment be added to the Rescue Agreement to allow salvors the opportunity to conduct salvage with minimized risk.¹⁷¹ This good faith amendment would incentivize salvors to make good faith attempts because the amendment would remove the requirement of bringing back salvaged material to recoup operating costs.¹⁷² Additionally, the owners of debris would be free from worry that salvors are not undertaking proper efforts.¹⁷³

At sea, one of the only ways to demonstrate a proper effort at salvage is to bring home at least an identifiable portion of the craft or debris.¹⁷⁴ With this success requirement replaced with a good faith amendment, salvors could receive a percentage of their operating costs in the face of loss or mission failure. The nature of space and of earth's orbit is "inherently complex and uncertain," differing from the deep sea which has largely predictable conditions even without knowing the full topography of the seabed.¹⁷⁵ Because of this uncertainty, salvors will want a guarantee that they are going to receive some portion of payment once they have invested a determined amount of time and capital into an operation.¹⁷⁶ This amount could be set within the good faith amendment, "taking into consideration ... the expenses incurred by the [salvor], the value of the property salvaged, and the risk incurred by the [salvor] in conducting the operation,"¹⁷⁷ or by contract between the parties. Then, as in the Rescue and Liability Agreements, compensation claims could be made via diplomatic channels and conflicts would be decided by international courts.¹⁷⁸ The amendment would assume the ability of debris owners to track the progress of orbital operation and allow them to make determinations of good faith based on the investment and action taken by the salvor.

¹⁶⁹ *Id.* at 992.

¹⁷⁰ *See id.* at 991-92 ("A requirement of successful or even partially successful salvage under the inherently complex and uncertain conditions in space could create an undesirable disincentive to salvage.")

¹⁷¹ Fishman, *supra* note 9, at 988, 991-92.

¹⁷² *Id.* at 991-92.

¹⁷³ *Id.* at 992.

¹⁷⁴ *See* Roberts, *supra* note 156, at 1197.

¹⁷⁵ Fishman, *supra* note 9, at 992.

¹⁷⁶ *Id.* at 986.

¹⁷⁷ *Id.* at 989.

¹⁷⁸ *Id.* at 990, 988 (explaining that paragraph 6 of the proposed amendment incorporates by reference the dispute resolution procedures of the Convention on International Liability for Damage Caused by Space Objects).

This amendment would protect both salvors and the owners of debris. However, it only allows salvage of debris that is identifiable to the owner. Regarding the hundreds of thousands of pieces of debris that are unidentifiable or difficult to track,¹⁷⁹ exact agreements for salvage, even in good faith, would be virtually impossible.¹⁸⁰ Additionally, the good faith amendment, while protecting both salvors and owners and incentivizing salvors to enter the market, does not necessarily incentivize states to make salvage agreements in the first place. Without a threshold for dereliction, states will likely leave debris in orbit instead of collecting it.

C. *State Determination*

Another option is to allow states to determine and negotiate their own salvage agreements without the intervention of international law or any change to the current regime. Coastal states already have systems regarding the salvage and ownership of sunken objects.¹⁸¹ Salvors can simply contract with the government, setting the terms and payment for the collection of sunken or abandoned vessels. This works especially well for military or government vessels that the state wishes to keep from collection or identification for national security reasons.¹⁸² A similar system could be applied to space, in which launching states contract with salvors to collect only that orbital debris which belongs to the state. These contracts would clarify the terms of salvage and allow parties to negotiate for their own good faith compensation without adjusting or amending international law.

However, salvage determined purely by contracts between states and salvors fails to minimize or eliminate problems that exist within astrosalvage. First, without a substantial change to the law, there is nothing incentivizing state governments to engage in salvage any more than they already do.¹⁸³ Much of the existing debris would continue to orbit the earth because the cost to nations, even under contract, is too high to justify hiring a contractor.¹⁸⁴ Additionally, the state determination model would give an unfair bargaining advantage to states who are not being held to any standard of behavior.¹⁸⁵ This presents a disincentive to potential salvors because they are unable to dictate terms or costs to the extent they would need.¹⁸⁶

¹⁷⁹ Jasentuliyana, *supra* note 10, at 11 (“[B]ecause of the untrackable and unidentifiable nature of most orbital debris, it is not known to whom all orbital debris belongs.”)

¹⁸⁰ Fishman, *supra* note 9, at 992.

¹⁸¹ See generally Lipka, *supra* note 80, at 108-09.

¹⁸² See *id.* at 105-09.

¹⁸³ Salter, *supra* note 7, at 228.

¹⁸⁴ See *id.* at 233, 236.

¹⁸⁵ See *id.* at 233-34.

¹⁸⁶ *Id.* at 230 (“A clearly announced legal rule placing the financial burden (of coping with spacecraft destroyed by debris) on private actors would incentivize investment in technologies that would help cope with existing debris.”)

D. *The Good Faith and Dereliction Amendment*

The introduction of the above good faith amendment is the strongest recommendation mentioned and would be the most effective way to protect owners and salvors while encouraging active market participation. It does not, however, go far enough to encourage states to mitigate orbital debris and engage in salvage operations with private entities. The introduction of an additional dereliction amendment, in which owners of orbital debris lose their claim after a certain number of years, would put pressure on states to internalize the costs of their debris and place power in the hands of salvors to negotiate terms. This would go a long way towards eliminating the environmental and safety hazard presented by orbital debris and create a market for salvage that would benefit the global market.

Dereliction, or abandonment, occurs when the original owner of a craft or debris deliberately abandons it without hope of recovery and without intention of recovering it.¹⁸⁷ Dereliction is evidenced by an express waiver of ownership rights, non-use of the object, or a lapse of time demonstrating *sine animo revertendi*.¹⁸⁸ In applying dereliction, the law of finds would supplant the law of salvage, granting the finder rights superior to everyone but the original owner (if the owner has expressed an interest in collecting on the property).¹⁸⁹ Conflicts over dereliction are decided by the courts of the state in which the owner is a citizen.¹⁹⁰ To overcome dereliction, it must be shown that the object can be identified to the original owner who is asserting claim and that the owner did not deliberately abandon the object.¹⁹¹

Dereliction would be simple to apply to the salvage of orbital debris. Over time, many pieces of orbital debris have been created, ranging in size from the size of a grain of rice to the size of spacecraft.¹⁹² Some objects, such as satellites, simply stop working and are left non-operational in orbit indefinitely.¹⁹³ This article recommends that the perpetual ownership in these objects, established by the Outer Space Treaty and maintained by the Registration and Liability agreements, be amended in cases where debris has been left unrepaired or unmaintained for twenty years or more. This amendment would not be applied retroactively, and would apply the statutory period to all non-operational debris from the

¹⁸⁷ Nafziger, *supra* note 115, at 343.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 343-44 (quoting *Cobb Coin Co., Inc. v. Unidentified, Wrecked and Abandoned Sailing Vessel*, 525 F.Supp. 186, 195 n.3 (S.D. Fla. 1981)).

¹⁹⁰ This implies that the object is not found in international waters. *See generally* G.A. Res. 2345, *supra* note 14; G.A. Res. 2777, *supra* note 15; G.A. Res. 3235, *supra* note 16.

¹⁹¹ *See* Jasentuliyana, *supra* note 10, at 11.

¹⁹² Garcia, *supra* note 3.

¹⁹³ Sandra May, *What is Orbital Debris?*, NASA, <https://www.nasa.gov/audience/forstudents/k-4/stories/nasa-knows/what-is-orbital-debris-k4.html> (last updated Aug. 7, 2017).

moment of ratification. After that period, objects will become derelict, the property of no one, and open for collection by interested parties.

Assuming acceptance of the amendment, this would incentivize states and private actors to go into orbit to collect debris before the statute of limitations expires to prevent rival nations or firms the opportunity to profit from their investment. For launching states, this would mean that they are given ample opportunity to either collect or repair debris or risk losing their investment. The amendment would also encourage states to minimize future debris that could be collected and used by other state or private actors.¹⁹⁴ This minimization of debris would address the environmental and safety concerns associated with orbital debris, making future launches safer.¹⁹⁵ For salvors, this would create an opportunity to collect, repurpose, and sell orbital debris for scientific and commercial purposes and create a market for collectors to obtain objects that have floated in Earth's orbit.¹⁹⁶ Additionally, the amendment would allow salvors to collect the smaller and unidentifiable pieces of debris without the permission of launching states, thereby continuing to diminish the cloud of debris endangering orbital missions.¹⁹⁷ Finally, this new market would spur innovation as potential salvors race to collect objects in space.¹⁹⁸ Ownership of these objects could even be reserved on a temporary basis in conjunction with the good faith amendment to allow a statutory period of collection that begins when a salvor announces an intention to collect an object. Conflicts over these claims could be decided by courts within the nation of either party.

Albeit, approval of such an amendment is based on a large assumption. For the same reasons that states don't clean up their current debris, states are unlikely to willingly give up their property rights without proper motivation. Aside from economic concerns, there are national security concerns that are sure to keep some nations from agreeing to a dereliction amendment. History has demonstrated that states will only act if the liability risk of debris becomes too high or if enough development has occurred in salvage markets domestically to bring the value of salvage back

¹⁹⁴ See Jasentuliyana, *supra* note 10, at 18-19.

¹⁹⁵ Salter, *supra* note 7, at 235 (“[I]f five sufficiently large pieces of debris are removed per year over the next 100 years, orbital access and LEO can be stabilized. 57 However, stabilization is conditional on (a) all future launches, including non-US launches, complying with NASA guidelines concerning deorbiting and (b) no new major collisions creating new debris in the interim.”) (citing Liou, *supra* note 142, at 648).

¹⁹⁶ See *id.* at 234-35.

¹⁹⁷ Jasentuliyana, *supra* note 10, at 7 (“It is estimated that for every trackable object, 20 untrackable 1 centimeter objects and 10,000 untrackable 1 millimeter objects are created. Because only objects of a certain size can be catalogued, only estimates can be made on the actual number of objects that exist in orbit.”) (citing DAVID S. F. PORTREE, ET AL., *ORBITAL DEBRIS AND NEAR-EARTH ENVIRONMENTAL MANAGEMENT: A CHRONOLOGY 1* (Lyndon B. Johnson Space Center, 1993)).

¹⁹⁸ See Michael Cooney, *Lost in space: The space junk conundrum*, HEWLETT PACKARD ENTERPRISE (Apr. 4, 2018), <https://www.hpe.com/us/en/insights/articles/lost-in-space-the-space-junk-conundrum-1804.html>.

to their home states.¹⁹⁹ In the meantime, potential concerns could be addressed by other requirements on salvors, such as volume caps, which prevent states from completely abandoning their ownership. Such caps are not within the scope of this comment, but are certainly worth discussing.

Obstacles to the identification and collection of debris, and in the ratification of the proposed amendment, do not diminish its necessity. The collection and sale of orbital debris would reap value from objects that are not being used and providing no benefit.²⁰⁰ A good faith and dereliction amendment would incentivize states and private actors to collect all orbital debris, not just that which is identifiable to its launching states. In this way, orbital debris can benefit all of mankind by encouraging launching states to mitigate their debris and allowing salvors to collect abandoned objects for personal and industry gain.

VI. CONCLUSION

The current space law regime is not designed effectively to diminish orbital debris or managing salvage operations. In the meantime, objects are being launched into space, each creating more of a hazard to the environment and to the safety of future missions.²⁰¹ This problem is then aggravated by states' perpetual ownership in orbital debris,²⁰² which puts no pressure on states to mitigate their debris.²⁰³ Even if maritime salvage law were to be applied, the requirement of success and voluntariness would stop salvors from engaging in salvage because the risk is too high for the rewards that are proposed.

Instead, the international community must amend the Rescue and Liability Agreements to include good faith and dereliction clauses that, respectively, partially reimburse salvors for their investment and allow for the ownership of abandoned and non-operational spacecraft and debris after a statutory period.

It is worth mentioning that such amendments would not likely be passed or ratified by the global community, especially by more developed nations who do not wish to jeopardize their orbital property rights. This reflects two motivations on the part of the signatory states. First, states are unlikely to sign amendments in which they lose their investment to unknown parties. Second, the risk of liability may simply not be high enough, currently, to incentivize states to bind themselves to dereliction. This reluctance to change is motivated by the same impulses that stop nations from cleaning up orbital debris in the first place. However, a lack of willingness to adopt the amendments does not change their level of

¹⁹⁹ See *supra* Part III.

²⁰⁰ Salter, *supra* note 7, at 233.

²⁰¹ *Id.* at 226.

²⁰² G.A. Res. 2222, *supra* note 8, at 14.

²⁰³ Salter, *supra* note 7, at 228.

necessity. With the addition of these amendments to the Rescue and Liability agreements, the hazard of orbital debris will decrease while at the same time bringing value to objects that currently benefit nobody.

Finally, the proposed good faith and dereliction amendment is not meant to be a cure-all. Mankind's interaction with space is only going to increase, and more launches will naturally result in more debris. There are also sure to be additional challenges and conditions that are currently unforeseeable, both in orbit and internationally, that could affect orbital salvage and space exploration in general. Despite this, foundational salvage amendments need to be put in place, addressing issues proactively before the orbital debris problem becomes untenable.

FIGHT THE FIG: DUE PROCESS IN INTERNATIONAL SPORT GOVERNANCE

*Frannie Monasterio**

I. INTRODUCTION

The Olympic Games are made possible by the International Olympic Committee (“IOC”), an international non-government organization that governs over international sports federations that, in turn, governs the sport for which it is named. Both the IOC and the international federations have self-created, self-governing laws.¹ The IOC’s laws govern itself and all entities that are part of the Olympic Games.² The Global Association of International Sports Federations (“GAISF”)³ is another organization, separate and independent of the IOC, but is also comprised of independent international sports federations and other organizations that “contribut[e] to sport[s] in various fields[,]” organize “multi-sports events[,] and supports the organisation of” international, multi-sports events by its members.⁴ GAISF also has its own self-governing laws.⁵

The Court of Arbitration for Sport (“CAS”) is a private, non-government “arbitral tribunal that handles both commercial matters related to sports in the first instance and also serves as an appellate body,”⁶ thus offering services for “the settlement of sports-related disputes through arbitration or mediation by means of procedural rules adopted to the specific needs of the sports world.”⁷ When hearing a dispute, CAS may use governing statutes created by the IOC, GAISF, or the international federations involved in the dispute.⁸ Upon resolution of a dispute, CAS issues an arbitration award which “resolves the subject dispute, orders

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¹ INT’L OLYMPIC COMM., OLYMPIC CHARTER 16-17 (2017), <https://stillmed.olympic.org/media/Document%20Library/OlympicOrg/General/EN-Olympic-Charter.pdf> [hereinafter “OLYMPIC CHARTER”].

² *Id.* at 56, 86.

³ GLOBAL ASSOCIATION OF INTERNATIONAL SPORTS FEDERATIONS, STATUTES 1 (2017) <http://oomfjgjh.preview.infomaniak.website/wp-content/uploads/sportaccord-statutes-2017-eng.pdf> [hereinafter “GAISF Statutes”]. The Global Association of International Sports Federations was previously known as SportAccord.

⁴ *Id.* at 4.

⁵ *Id.* at 12-13.

⁶ Horacio A. Grigera Naón and Paul E. Mason, International Commercial Arbitration Practice: 21st Century Perspectives § 40.01 (LexisNexis Matthew Bender).

⁷ *Frequently Asked Questions*, COURT OF ARBITRATION FOR SPORT, <https://www.tas-cas.org/en/general-information/frequently-asked-questions.html> (last visited Feb. 2, 2019).

⁸ *See e.g.*, Paolo Barelli v. Fédération Internationale de Natation (FINA), CAS 2016/A/4924 & 4943, ¶ 51 (2016), <http://jurisprudence.tas-cas.org/Shared%20Documents/4924,%204943.pdf> (applying the rules and regulations of the Fédération Internationale de Natation to determine whether the Appellant had standing on the dispute).

appropriate relief, and is final and binding on the parties.”⁹ “CAS arbitration awards are creating a uniform body of Olympic and international sports law, a so-called *lex sportiva*[.]”¹⁰

This comment argues that IOC and GAISF should revise their governing statutes to provide for due process mechanisms and increased transparency in their operations. Part I describes the hierarchy and functions of international sports government. It also describes the potential issues that a non-IOC regulated sports community may experience when an IOC-regulated governing body tries to govern over the sports community. Specifically, this comment describes how the parkour community has responded to an attempt by the international governing body for gymnastics to govern over parkour.

Part II analyzes the problems resulting from this kind of conduct. These problems include the contradictory statement made by sports governing organizations to become more transparent while not disclosing its decision-making processes or their criteria, the absence of due process guarantees coupled with limited availability of judicial relief, and the absence of rules and guidance where several organizations want to govern a sport. Part II then describes how these problems can be addressed by revising the existing governing statutes to improve transparency and provide for due process and involvement opportunities for entities not formally recognized by major international sports governance entities that may be affected by decisions made by major international sports governing entities.

II. BACKGROUND

The Olympic Games are managed by the IOC, a private, non-government organization so influential that in 2016, the United Nations resolution “reaffirmed the recognition of the autonomy of the [IOC] and the role of sport as an ‘important enabler’ of peace[.]”¹¹ “Participation in the Olympic Games is voluntary. Thus, nations and individuals [participating] in the Olympic Games submit themselves to the rules and regulations established by the IOC[.]”¹²

A. *Governance Over the Olympic Games*

⁹ Matthew J. Mitten, *Resolving Disputes in Olympic and International Sports*, 16 INSIGHTS ON L. & SOC'Y 12, 15 (2016).

¹⁰ *Id.*

¹¹ INT'L OLYMPIC COMM., IOC ANNUAL REPORT 2016 4 (2017), <https://www.olympic.org/documents/ioc-annual-report>.

¹² David J. Ettlinger, *The Legal Status of the International Olympic Committee*, 4 PACE Y.B. INT'L L. 97, 104 (1992), citing James A.R. Nafziger, *foreword* to Barbara O'Neill, *International Sports: Have States Succeeded Athletes as the Players?*, 6 DICK. J. INT'L L. 403, 424 (1988) (footnotes omitted).

The Olympic Games are one part of a set of actions called the Olympic Movement. The Olympic Movement “is the concerted, organized, universal and permanent action” executed under IOC’s authority.¹³ The IOC, National Olympic Committees, and international federations¹⁴ are the three main constituents of the Olympic Movement.¹⁵ The Olympic Charter is the codification of laws that governs all the constituents.¹⁶ It includes “the Fundamental Principles of Olympism, Rules, and Bye-laws adopted by the [IOC].”¹⁷ All organizations “belonging in any capacity . . . to the Olympic Movement [are] bound by the . . . Olympic Charter and shall abide by” the IOC’s decisions.¹⁸

The Olympic Charter defines the “reciprocal rights and obligations of the three main constituents.”¹⁹ It also describes various measures the IOC may use²⁰ if a constituent violates the Olympic Charter, the Olympic Movement Code, or any other regulation.²¹ For example, the Olympic Charter authorizes the IOC to withdraw a discipline or an event from the Olympic Games if an international federation violates a regulation.²² The Olympic Charter, through the requirement that international federations adopt the World Anti-Doping Code, may also ban individuals from participating in Olympic Games.²³

i. The International Olympic Committee

The IOC is the ultimate authority of the Olympic Movement.²⁴ Under the Olympic Charter, decisions made by the IOC are final.²⁵ Any dispute over the IOC’s “application or interpretation may be resolved solely by the IOC Executive Board and, in certain cases, by arbitration before the Court of Arbitration for Sport.”²⁶ The Olympic Charter authorizes the IOC to, among other things, recognize (1) an activity as a sport,²⁷ and (2)

¹³ OLYMPIC CHARTER, *supra* note 1, at 11.

¹⁴ See e.g., *id.* at 15, 55. “International federation” and “international sports federation” are used interchangeably.

¹⁵ Mitten, *supra* note 9, at 12; Other constituents of the Olympic Movement, include “national associations, clubs[,] and institutions recognized by the IOC.” See also OLYMPIC CHARTER, *supra* note 1, at 15-16. Athletes “belonging in any capacity whatsoever to the Olympic Movement” are also part of the Olympic Movement.

¹⁶ OLYMPIC CHARTER, *supra* note 1, at 9.

¹⁷ *Id.*

¹⁸ *Id.* at 16.

¹⁹ *Id.* at 9.

²⁰ *Id.* at 99.

²¹ *Id.* Other regulations include the World Anti-Doping Code.

²² OLYMPIC CHARTER, *supra* note 1, at 100.

²³ WORLD ANTI-DOPING AGENCY, *World Anti-Doping Code* § 10.12.1 2015 75-76 (2017), https://www.wada-ama.org/sites/default/files/resources/files/wada_anti-doping_code_2018_english_final.pdf.

²⁴ Mitten, *supra* note 9, at 12.

²⁵ OLYMPIC CHARTER, *supra* note 1, at 103.

²⁶ *Id.*

²⁷ Ettinger, *supra* note 12, at 99-100. (“IOC’s responsibilities also include choosing the host cities for the Games and ensuring that the selected host city follows the rules of the

international federations that govern a sport and disciplines of that sport.²⁸ The IOC is also tasked with “encourag[ing] and support[ing] the promotion of ethics and good governance in sport.”²⁹ The “general meeting of the members of the IOC” is called the Session.³⁰

ii. International Federations

International federations are non-government organizations³¹ that take part in organizing various activities of the sport for which they are named at an international level. For example, an international federation may make and enforce rules for the sport and disciplines within the sport that it governs.³² While IOC recognizes various organizations as the international authority governing a sport,³³ an organization need not be recognized by the IOC to be an international federation.³⁴ The World Skateboarding Federation is an example of an international federation that is not recognized by the IOC but participates in organizing and facilitating skateboarding activities by, among other things, “assist[ing] in building quality skateparks” and “creat[ing] a centralized judging and scoring system[.]”³⁵

A discipline is “[a]ny of the sports and/or activities defined” in a sport.³⁶ For example, the international federation for gymnastics manages at least six disciplines: “Men’s Artistic Gymnastics, Women’s Artistic Gymnastics, Rhythmic Gymnastics, Trampoline Gymnastics, Acrobatic Gymnastics and Aerobic Gymnastics[.]”³⁷ An international federation’s rules extensively regulate the sport. Regulations may, for example, expressly determine which companies may furnish the equipment for use at the Olympic Games.³⁸ Regulations can also establish appeals processes for

Olympic Charter; recognizing and supporting the National Olympic Committees' (NOCs) and International Federations' (IFs) respective rights; determining new IOC members; and negotiating television rights.”)

²⁸ *Id.*

²⁹ OLYMPIC CHARTER, *supra* note 1, at 16.

³⁰ *Id.* at 42.

³¹ *Id.* at 55.

³² Other responsibilities of international federations include maintaining integrity of their sport on the international level and to ensure “the development of their sports throughout the world.” *Id.* at 56; *see also* INT’L OLYMPIC COMM., *International Sports Federations*, OLYMPIC GAMES, <https://www.olympic.org/ioc-governance-international-sports-federations> (last accessed Oct. 13, 2017) [hereinafter “IOC Federations”].

³³ IOC Federations, *supra* note 32.

³⁴ *Id.*

³⁵ *About: Mission Statement*, WORLD SKATEBOARDING FEDERATION, <http://worldskateboardingfederation.org/about/> (last visited Feb. 3, 2019).

³⁶ *Statutes*, FÉDÉRATION INTERNATIONALE DE GYMNASTIQUE 4 (2017) [hereinafter “FIG Statutes”]. Both the Olympic Charter and the Global Association of International Sports Federations’ Statutes mention “discipline,” but do not define it. *See generally* OLYMPIC CHARTER, *supra* note 1; GAISF, *supra* note 3, at 6, 7.

³⁷ FIG Statutes, *supra* note 36, at 27.

³⁸ OLYMPIC CHARTER, *supra* note 1, at 87.

technical matters of a sport.³⁹ Rules created by the IOC-recognized international federation extend “by reference to those organizations recognized by the international . . . federations as governing such sports at the national level.”⁴⁰ Thus, IOC-recognized international federations are responsible for managing and monitoring the “everyday running of the world’s various sports disciplines, including for those on the [Olympic Games] program[.]”⁴¹

IOC-recognized international federations “maintain[] [their] independence and autonomy in the governance of [their] sport[s].”⁴² Thus, IOC-recognized international federations and sports activities governed by such international federations are regulated by their own international federation-specific statutes.⁴³ These statutes must be consistent with the Olympic Charter.⁴⁴

iii. National Olympic Committees

National Olympic committees are national level, non-government sports organizations recognized by the IOC as “authority for the representation of their respective countries at the Olympic Games and at the regional, continental, and world multi-sports competitions patronized by the IOC.”⁴⁵ National Olympic committees are responsible for the development, promotion, and protection of the Olympic Movement in their own countries.⁴⁶ One of their responsibilities is to recognize a single national sports organization as a national federation for a sport governed by the respective IOC-recognized international federation.⁴⁷

iv. National Federations

National federations, also known as national sports federations, are non-government organizations that “govern[] and administer [a] sport” at the national level in addition to the Olympic Committee administering sports at the “world level.”⁴⁸ Any national federation recognized by a national Olympic committee is additionally affiliated with the IOC-recognized international federation that administers the sport that they represent.⁴⁹ For example, USA Gymnastics is the national federation for

³⁹ *See id.* at 88 (defining more examples of subjects regulated by an international sports federation, including “characteristics of the required technical installations and the sports equipment to be used at the venues during the Olympic Games.”).

⁴⁰ *Id.* at 55.

⁴¹ IOC Federations, *supra* note 32.

⁴² OLYMPIC CHARTER, *supra* note 1, at 55.

⁴³ *See id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 60.

⁴⁶ *Id.* at 59, 63, 66.

⁴⁷ *Id.* at 63.

⁴⁸ *Sports Councils’ Recognition Policy*, UK SPORT 2.6 (2017) <https://www.sportengland.org/media/12132/uk-recognition-policy-2017.pdf>; *see also* IOC Federations, *supra* note 32; OLYMPIC CHARTER, *supra* note 1, at 66.

⁴⁹ *See* OLYMPIC CHARTER, *supra* note 1, at 66.

gymnastics recognized by the United States National Olympic committee,⁵⁰ and thus is governed by the statutes created by the Federation of International Gymnastics (“FIG”).⁵¹ Like international federations, an organization need not be recognized by a national Olympic committee to be a national federation.⁵²

To be recognized by the IOC as a member of a national Olympic committee, an organization must “exercise a specific, real and on-going sports activity, be affiliated to an [international federation] recognized by the IOC and be governed by and comply in all aspects with both the Olympic Charter and the rules of its [international federation].”⁵³

v. Court of Arbitration for Sport (“CAS”)

CAS, despite its name, is not a court of law,⁵⁴ but instead is an international arbitral tribunal formed by the IOC “to resolve Olympic and international sports legal disputes by arbitration before an independent and impartial body.”⁵⁵ CAS was established in 1983⁵⁶ by the then-President of the IOC Juan Antonio Samaranch and an International Court of Justice

⁵⁰ *About USA Gymnastics*, USA GYMNASTICS,

https://usagym.org/pages/aboutus/pages/about_usag.html (last visited Nov. 26, 2017).

⁵¹ *About the FIG*, FEDERATION INTERNATIONALE DE GYMNASTIQUE,

<http://www.gymnastics.sport/site/about.php> (last visited Nov. 26, 2017).

⁵² For example, the Australian Parkour Association is a “nationally recognised organisation” that aims to “primarily act as the pre-eminent organization for the development of Parkour in Australia.” Australian Parkour Association, *About the Australian Parkour Association*, AUSTRALIAN PARKOUR ASSOCIATION, <https://parkour.asn.au/about/> (last accessed Feb. 3, 2019).

⁵³ OLYMPIC CHARTER, *supra* note 1, at 66.

⁵⁴ Ken Foster, *Lex Sportiva and Lex Ludica: The Court of Arbitration for Sport's Jurisprudence*, 3 ENTMT & SPORTS L. J. 1, 11 (2005) (“[CAS] is not a fully-fledged judicial procedure that replaces national courts. Neither is it an international court, such as the International Criminal Court, because that would need national governments to have established it by treaty.”)

⁵⁵ Mitten, *supra* note 9, at 12. CAS’ independence was questioned in a proceeding in Switzerland’s highest court, the Swiss Federal Tribunal. Westlaw, *Swiss Federal Tribunal*, UK PRACTICE LAW, <https://uk.practicallaw.thomsonreuters.com/7-523-9007> (last accessed Nov. 2, 2017). CAS was later restructured to have a separate governing body “empowered with administrative functions [and the] responsibility for amending the Court of Arbitration for Sport procedural rules.” Louise Reilly, *An Introduction to the Court of Arbitration for Sport (Court of Arbitration for Sport) & the Role of National Courts in International Sports Disputes*, 2012 J. DISP. RESOL. 63, 64 (2012). The Swiss Federal Tribunal later acknowledged CAS’ independence from the IOC in a later proceeding in which two cross-country skiers challenged the IOC and the International Ski Federation. *Id.* The Swiss Federal Tribunal referred to CAS as the “true Supreme Court of world sport” and that CAS “offered all guarantees of independence and impartiality.” *Id.* (citing Tribunal fédéral [TF] [Swiss Federal Tribunal] Mar. 15, 1993, Arrêts du Tribunal Fédéral Suisse [ATF] 119 271 (Switz.), translated into English in MATTHIEU REEB, DIGEST OF COURT OF ARBITRATION FOR SPORT AWARDS 1, 1986-1998 545 (2001)).

⁵⁶ *History of the Court of Arbitration for Sport*, COURT OF ARBITRATION FOR SPORT, <http://www.tas-cas.org/en/general-information/history-of-the-cas.html> (last accessed Oct. 17, 2017). Although other sources state Court of Arbitration for Sport was established in 1984. *See e.g.*, Reilly, *supra* note 55, at 63.

judge, Kéba Mbave,⁵⁷ after Samaranch recognized a “need to create a specialised authority capable of settling international disputes[.]”⁵⁸ CAS thus “provides a forum for the world’s athletes and sports federations”⁵⁹ and offers an alternative to a court by providing “a flexible, quick and inexpensive procedure”⁶⁰ that “resolv[es] disputes arising in the context of sport by arbitration and/or mediation.”⁶¹ With few exceptions, all international federations recognize CAS “as the final instance of appeal for international disputes, to the exclusion of national courts.”⁶²

Individuals such as athletes as well as organizations belonging to national federations or international federations may⁶³ file “appeals against the decision of a federation, association, or sports-related body” only if the statutes or regulations of the federation, association, or sports-related body provide them.⁶⁴ Alternatively, appellants may appeal to the extent that the parties involved have a specific arbitration agreement and “if the [a]ppellant has exhausted the legal remedies available to him prior to the appeal, in accordance with the statutes or regulations of the said sports-related body.”⁶⁵ In short, for CAS to have jurisdiction over a dispute, both parties must have agreed to arbitration in some way.⁶⁶ For example, CAS has been recognized by Swiss courts as “an independent and impartial arbitration system[.]”⁶⁷ CAS decisions are appealable to the Swiss Federal Tribunal.⁶⁸

B. GAISF

GAISF is a “not-for profit association, composed of the autonomous and independent international sports federations and other international organisations contributing to sport in various fields.”⁶⁹ Independent from the Olympic Movement, GAISF works “to organise . . . multi-sports events and support the organisation of multi-sports games by

⁵⁷ Reilly, *supra* note 55, at 63.

⁵⁸ *History of the Court of Arbitration for Sport*, *supra* note 56.

⁵⁹ Mitten, *supra* note 9, at 12.

⁶⁰ *History of the Court of Arbitration for Sport*, *supra* note 56.

⁶¹ *Statutes of ICAS and Court of Arbitration for Sport*, COURT OF ARBITRATION FOR SPORT ¶ C.1.S12 (2017) http://www.tas-cas.org/fileadmin/user_upload/Code_2017_FINAL__en_.pdf (2017).

⁶² Court of Arbitration for Sport lacks jurisdiction over “North American profession sports leagues, which operate their own form of arbitration.” Reilly, *supra* note 55, at 67.

⁶³ Mitten, *supra* note 9, at 12.

⁶⁴ Reilly, *supra* note 55, at 66.

⁶⁵ *Id.*

⁶⁶ *History of the Court of Arbitration for Sport*, *supra* note 56.

⁶⁷ Foster, *supra* note 54, citing *A & B v IOC*, judgment of 27 May 2003, 1st Civil Chamber, Swiss Federal Tribunal (concluding that by bringing their case before Court of Arbitration for Sport, athletes impliedly accept Court of Arbitration for Sport as impartial).

⁶⁸ See e.g., Bundesgericht [Federal Supreme Court Apr. 19, 2011, A._____ v. Trabzonspor and TFF, 4A_404/2010 (Switz.)], available online at <http://www.swissarbitrationdecisions.com/sites/default/files/19%20avril%202011%204A%20404%202010.pdf>.

⁶⁹ GAISF Statutes, *supra* note 3, at 4.

its Members in agreement and cooperation with its Members[.]”⁷⁰ GAISF is governed by its own statutes.⁷¹ GAISF’s executive body is called the Council.⁷²

GAISF is similar to the IOC in that its structure includes an international federation and a national federation, which its statutes define as “a body representing a sport or a number of sports in a country that is recognised by the NOC and/or the highest sporting authority of the country[.]”⁷³

C. *Recognition Processes*

i. *Criteria for International Federation Recognition by the IOC*

To become recognized as an international federation by the IOC, a non-government organization must send an official letter to the IOC Sports Department stating “its willingness to apply for IOC recognition[.]”⁷⁴ Second, GAISF studies the organization’s request.⁷⁵ The analysis “serve[s] as a basis for discussion within the IOC, which will submit potential recognition request to the IOC Executive Board for a provisional recognition of two years, and subsequently to the IOC Session for full recognition.”⁷⁶ Third, “the IOC Executive Board . . . stud[ies] and decide[s] upon the recognition requests from applicants.”⁷⁷ “This provisional period is, by default, two years.”⁷⁸ “Official notification of recognition or non-recognition will be sent by the IOC to each applicant.”⁷⁹ Fourth, the IOC Session “decides whether or not full recognition of the [international federation] concerned will be granted” “[a]t the end of the provisional recognition period, and upon the recommendation of the IOC Executive Board[.]”⁸⁰

In considering the organization’s application for recognition, the IOC evaluates several themes, including governance, history and tradition, universality, and development of the international federation or sport.⁸¹ Within the themes are several criteria, which each have at least one item to

⁷⁰ *Id.*

⁷¹ *Id.* at 10.

⁷² *Id.* at 12.

⁷³ *Id.* at 9.

⁷⁴ *International Sports Federations Requesting IOC Recognition*, INT’L OLYMPIC COMM., 6 (July 2013), http://www.slalomskateboarder.com/ISSA/2015-Discussion/IOC_MASTER_Recognition_procedure_document_for_IFs.pdf.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *See generally id.* at 3.

be evaluated.⁸² The governance theme includes a criteria on “[g]ood governance basic principles[.]” which includes the items “[e]xistence of transparent and enhanced international dispute resolution mechanism” and

“[s]ubmission to the Court of Arbitration for Sport . . . of all disputes which cannot be settled amicably or through local arbitration or mediation; types of disputes for which the Court of Arbitration for Sport is used; number of cases in which the [international federation] is involved.”⁸³

The history and tradition theme includes the general criteria World Championships, which includes the items “Year the World Championships and Junior World Championships were first held for each discipline or sport, for men and women”⁸⁴ and “Number of World Championships and Junior World Championships held to date for each discipline or sport, for men and women[.]”⁸⁵ The “[o]ther multi-sports [g]ames”⁸⁶ criteria includes the item “[n]umber of times each recognised discipline or sport has been included in the selected multi-sports Games (World Games, Universiade, Commonwealth Games, Continental Games – All Africa Games, Asian Games, Pan-American Games and Mediterranean Games, Sport Accord Multi-Sports Games)[.]”⁸⁷

The universality⁸⁸ theme includes the criteria “Number of affiliated national federations[.]”⁸⁹ which includes an item on the “[n]umber of [n]ational [f]ederations affiliated to the [i]nternational [f]ederation which correspond to the National Olympic Committees[.]”⁹⁰ “Active member national federations” is another criterion⁹¹ which includes the item “[n]umber of [n]ational [f]ederations which participated in the last two [c]ontinental [c]hampionships for men and women[.]”⁹²

Finally, the “[d]evelopment of the [international federation]/ Sport”⁹³ theme includes the criteria “[t]echnical evolution of the sport”⁹⁴ which includes the item

“[e]xistence of means to control the technical evolution within the sport regarding venues, sports equipment (items used by athletes in

⁸² See e.g., *International Sports Federations Requesting IOC Recognition*, *supra* note 74 at 2-5.

⁸³ *Id.* at 3.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* at 5.

⁹⁴ *Id.*

the practice of the sport) and competition clothing (items worn by athletes and subject to IF technical specifications)].⁹⁵

Another criteria is on “[t]ransparency and fairness on the field of play”⁹⁶ which includes the item

“[s]teps taken by the [international federation] to ensure that the outcome of the competition will be as objective and fair as possible, including selection & evaluation process for judges, training and certification and impact of judging on results[.]”⁹⁷

The applicant-organization’s

“statutes, practice and activities of the [international federations] within the Olympic Movement must be in conformity with the Olympic Charter, including the adoption and implementation of the World Anti-Doping Code as well as the Olympic Movement Code on the Prevention of Manipulation of Competitions. Subject to the foregoing, each [international federation] maintains its independence and autonomy in the governance of its sport.”⁹⁸

It is worth noting that IOC’s recognition criteria for international federations are not easily accessible or otherwise easy to locate on the IOC’s official page.⁹⁹

ii. Criteria for Internal Federation Recognition by GAISF

GAISF has two main categories of members, Full Members and Associate Members, which are then categorized into one of five divisions.¹⁰⁰ GAISF may grant applicant-organizations “observer status,”

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ OLYMPIC CHARTER, *supra* note 1, at 55.

⁹⁹ GAISF’s statutes describe its recognition process for membership admission. GAISF Statutes, *supra* note 3, at 5. Searching the website of the Olympics with terms like “international federation recognition” yields no results on the IOC’s international federation recognition process. Many of the documents referenced for the IOC recognition process are documents provided on an international federation’s website. The documents featured a heading with the IOC’s name, the Olympic rings, and words like “Recognition Procedure.” *See e.g., International Sports Federations Requesting IOC Recognition*, *supra* note 74. Criteria listed corroborated with other documents with similar features provided on the websites of other international federations. *See e.g., Evaluation Criteria for Sports and Disciplines*, INT’L OLYMPIC COMM., (2012), https://stillmed.olympic.org/Documents/Commissions_PDFfiles/Programme_commission/2012-06-12-IOC-evaluation-criteria-for-sports-and-disciplines.docx.pdf; Robert Rauch, Recognition by the International Olympic Committee: The Future of Ultimate and Flying Disc Sports (July 20, 2013), http://www.wfdf.org/about/congress-files/cat_view/56-wfdf-congress/124-wfdf-congress-2013 (click “WFDF Congress Presentation IOC recognition”). Criteria for the recognition process has since been changed. IOC, *IOC Annual Report 2016 (July 2017)*, IOC Annual Report, <https://www.olympic.org/documents/IOC-annual-report>.

¹⁰⁰ GAISF Statutes, *supra* note 3, at 5. The divisions are: the Association of Summer Olympic International Federations, the Association of International Olympic Winter Sports

which allows the applicant-organization to attend the General Assembly,¹⁰¹ while its application is pending if “no reasonable rivalry issues with an existing Member.”¹⁰²

A condition of membership for Full Members is that the organization “groups together the majority of the National Federations (or organisations) throughout the world practising its sport and regularly holding international competitions[.]”¹⁰³ A condition of membership for Associate Members is that the organization “groups together the activities of several Members generally for the purpose of organising competitions.”¹⁰⁴

The statutes explicitly lists its criteria for organizations interested in applying as a Full Member or Associate Member. Full Membership for GAISF requires, among other things:

- “a written declaration justifying that the sport or activity which [the applicant] control does not conflict with or is not in rivalry with an already existing Member of GAISF;”
- “a written declaration justifying that the IF is the only federation governing its sport on a world level. Provide, if any, the name of dissident organisations and explain how and which solutions were arranged;”
- “a copy of its constitution/statutes, regulations and directives which must comply with the World Anti-Doping Code. . . . The constitution/statute of the candidate must also contain a specific provision recognising the exclusive jurisdiction of the Court of Arbitration for Sport, in Lausanne, Switzerland;”
- “a list of its Member National Federations (where applicable), grouped by continents[.]”
- “at the national level, the sport – represented by the IF applying for GAISF membership – must include one of the disciplines recognised by the member NF. The National Federation must be a full member of the corresponding International Federation applying for GAISF membership. No categories other than the full membership to the IF will be taken into account;” and

Federations, the Association of IOC Recognized International Sports Federations, and the Alliance of Independent Recognized Members of Sport, and Associate Members. *Id.*

¹⁰¹ GAISF Statutes, *supra* note 3, at 12. “The General Assembly is the meeting of all GAISF Members. It is the supreme organ of GAISF.” *Id.*

¹⁰² GAISF Statutes, *supra* note 3, at 10.

¹⁰³ *Id.* at 5.

¹⁰⁴ *Id.*

- “a list of the National Olympic Committees (NOCs) or National Sport Authorities (NSAs) recognising its Member National Federations; A recognition certification signed and stamped by the NOC and/or NSA must be enclosed within the membership application for GAISF.”

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iii. Recognition for Sports and Disciplines Within a Sport

Both the Olympic Charter and the Statutes do not provide a definition of what a sport is. Similarly, the Olympic Charter and the Statutes do not define what constitutes a discipline of a sport. Neither set of governing documents describes criteria must be met to determine when activity constitutes a sport, nor do either set of governing documents provide criteria to determine whether an activity qualifies as a sport rather than a discipline of a sport.¹⁰⁶

D. *Parkour and FIG: A Live Dispute of the IOC's Recognition Process*

The absence of definitions for “sport” and “discipline” in the Olympic Charter and the Statutes, as well as the absence of readily-available international federation recognition criteria by the IOC, has led to struggles in authority between sports communities where no organization that has taken a clear lead in the sport and already-recognized international federations. The controversy between parkour practitioners and FIG is an example of the issues that may surface as a result.

i. Parkour

Parkour¹⁰⁷ is the “physical discipline of training to move freely over and through any terrain using only the abilities of the body, principally

¹⁰⁵ *Id.* at 6–7.

¹⁰⁶ Compare with Council of Europe, European Sports Charter (May 2001), https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=09000016804c9dbb (defining sport as “all forms of physical activity which, through casual or organised participation, aim at expressing or improving physical fitness and mental well-being, forming social relationships or obtaining results in competition at all levels.”)

¹⁰⁷ The terms “parkour,” “freerunning,” and “Art du Déplacement” are often used interchangeably among practitioners. See e.g., Letter from Eugene Minogue, Chief Executive, Parkour UK, & Stephen Mitchell, Independent Chair, Parkour UK, to Morinari Watanabe, President, Fédération Internationale de Gymnastique at unpag. 1 (Mar. 31, 2017), available at <http://parkour.uk/wp-content/uploads/2017/03/Letter-to-FIG-March-2017-FINAL.pdf>. David Belle, one of the nine people credited for founding parkour, first introduced the word “parkour” in 1998. *Id.* at 2. Parkour comes from the French word, “parcours,” which means “route” or “course.” *Id.* The other eight people credited for founding parkour are “Sabastien Foucan, Yann Hnautra, Chau Belle, Laurent Piemontesi, Guylain N’Guba Boyeke, Charles Perriere, Malik Diouf and Williams Belle.” *Id.* Guillaume Pelletier, one of several French practitioners, created the word “freerunning” to “describe the ethos of this new sport to an English-speaking audience.” *Id.* Some organizations distinguish between parkour and freerunning. For example, some describe parkour as “running, swinging, jumping, and

through running, jumping, climbing[,] and quadrupedal movement.”¹⁰⁸ Its practice includes “functional strength and fitness, balance, spatial awareness, agility, coordination, precision, control[,] and creative vision.”¹⁰⁹ Parkour practitioners are called “traceurs.”¹¹⁰ Since its founding in the 1980s,¹¹¹ community groups,¹¹² gyms¹¹³ and governing bodies¹¹⁴ have surfaced across the globe. Despite being recognized¹¹⁵ or described¹¹⁶ as a sport in some countries, parkour is not competitive.¹¹⁷ “Parkour is not

climbing from point A to point B in the quickest way possible,” in contrast to freerunning, which is “similar, but . . . emphasizes the flashy side of parkour, with . . . flips and stylistic acrobats. . . like an art of movement to express your creativity with your environment” Stephanie Lee, *The Difference Between Parkour and Freerunning*, LIFEHACKER VITALS (June 15, 2016), <https://vitals.lifehacker.com/the-difference-between-parkour-and-freerunning-1781827293>. See also Australian Parkour Association, *About the Australian Parkour Association*, AUSTRALIAN PARKOUR ASSOCIATION, <https://parkour.asn.au/about/> (last accessed Oct. 8, 2017). (featuring a freerunning class separate from its other activities). For this Comment, “parkour” treats parkour, freerunning, and Art du Deplacement as the same sport.

¹⁰⁸ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107, at 1.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at 2.

¹¹² For example, Newcastle Parkour is a parkour community in Newcastle, Australia, that offers classes and resources about parkour. Newcastle Parkour, *Classes*, NEW CASTLE PARKOUR, <http://newcastleparkour.com/classes/> (last visited Nov. 2, 2017). Concrete Foundation Crew is one of several groups in South Africa. Parkour South Africa, *Groups*, PARKOUR SOUTH AFRICA, <http://www.parkour.co.za/groups/> (last visited Nov. 2, 2017). ParkourONE is a parkour group in Switzerland. ParkourOne, *Region*, PARKOURONE, <https://parkourone.com/regionen/schweiz/> (last accessed Nov. 3, 2017).

¹¹³ See e.g., Apex, School of Movement, with gyms in Colorado, California, and Connecticut, *About*, APEX, <https://apexmovement.com/about/> (last visited Nov. 2, 2017); Pinnacle Parkour, a gym in New Jersey, Apex School of Movement, *About*, APEX, <https://apexmovement.com/about/> (last visited Nov. 2, 2017).

¹¹⁴ For example, New Zealand Parkour is recognized in New Zealand as the national governing body for parkour. New Zealand Parkour, *About*, NEW ZEALAND PARKOUR, <http://nzparkour.co.nz/about/#1> (last visited Nov. 2, 2017).. Fédération de Parkour is the recognized national governing body in France. Daniel Etchells, *New Zealand Parkour Association Back “Encroachment and Misappropriation Accusations Against FIG”*, INSIDE THE GAMES (May 11, 2017), <https://www.insidethegames.biz/articles/1050237/new-zealand-parkour-association-back-encroachment-and-misappropriation-accusations-against-fig>. See also New Zealand Parkour, *New Zealand Parkour*, NEW ZEALAND PARKOUR, <http://nzparkour.co.nz/> (last visited Oct. 8, 2017). Parkour UK is the recognized “National Governing Body (NGB)” in the UK. Parkour UK, *What We Do*, PARKOUR UK, <http://parkour.uk/what-we-do/> (last visited Sept. 29, 2017).

¹¹⁵ Parkour UK has been recognized by the UK Sports Councils as the national governing body for parkour in the United Kingdom. Letter from Eugene Minogue, *supra* note 107, at 2. Part of UK Sports Council’s recognition of an organization as a NF includes recognizing the activity practiced by the organization is a sport. *Sports Councils’ Recognition Policy 2* (2017), <https://www.sportengland.org/media/12132/uk-recognition-policy-2017.pdf>.

¹¹⁶ Rendao unknowingly took the textualist approach when describing parkour as a sport by referencing the Miriam-Webster dictionary, which defines sport as “physical activity engage in for pleasure . . . a particular activity (as an athletic game) so engage in[.]” Amos Rendao, Brandon Douglass, & Ryan Ford, *On Competition & Collaboration*, APEX SCHOOL OF MOVEMENT (Apr. 23, 2017), <https://apexmovement.com/blog/on-competition-collaboration/>.

¹¹⁷ Letter from Eugene Minogue, *supra* note 107, at 1. See also Max Bell, *Leaked Email Stating FIG’s Intent to Create Obstacle Course Competitions*, OBSTACLE RACERS NZ (May 17, 2017), <http://www.obstacleracersnz.co.nz/2017/05/17/obstacle-sport-federation-comments->

something you can win.”¹¹⁸ Furthermore, parkour is not governed by any international federation.¹¹⁹ At least one organization, the International Parkour Federation, has applied to be recognized by GAISF, but its application for recognition “has been pending for three years.”¹²⁰

While parkour as a sport is not competitive, parkour techniques “fit easily into competition culture.”¹²¹ Traceurs have recognized the benefits that competition brings to a sport.¹²² Accordingly, gyms and other community organizations have planned and executed obstacle course competitions that incorporate parkour movements. For example, Apex Movement, “a group of professional parkour coaches, athletes, and performers. . . . [with] multiple gym locations in Colorado, California, and Connecticut”¹²³ has hosted obstacle course competitions, called Obstacle Course Sprints, since 2009.¹²⁴ These competitions “are not exclusive to parkour practitioners but are inclusive to anyone who thinks they have the skills to go the fastest on short, dense, real-world based obstacle courses.”¹²⁵

While traceurs do not compete with each other, competitors can compare “who has the biggest jump the fastest time” and count the number of techniques executed over certain obstacles.¹²⁶ Amos Rendao, owner of Apex,¹²⁷ compared the potential for exposure of parkour in obstacle course competitions, stating that competitors

“get a lot of positive exposure in the same way a mixed martial arts . . . fighter gives exposure to their background martial arts. A[] . . . fighter may have a Muay Thai and Brazilian Jiu Jitsu background that makes up the bulk of their style of combat. In the same way, a course runner may have a track [and] field, [obstacle course

on-gymnastics-new-obstacle-sport/; Rendao et al., *supra* note 116. Some may describe parkour as a competition, but against yourself rather than against others. Amy Han, *Parkour: The Spectacle, the Practical, the Philosophical, and Where Competition Fits In*, FALLING LEAVES & A BIRD (Nov. 29, 2016), <https://fallingleavesandabird.com/>.

¹¹⁸ Rendao et al., *supra* note 116.

¹¹⁹ Max Bell, *Controversy Over New Gymnastics-based Obstacle Sport as Key Partner Pulls Out*, OBSTACLE RACERS NZ (May 14, 2017), <http://www.obstacleracersnz.co.nz/2017/05/14/controversy-over-new-gymnastics-based-obstacle-sport-as-key-partner-pulls-out/>.

¹²⁰ Max Bell, *Parkour Earth launches as International Federation for Sport of Parkour*, OBSTACLE RACERS NZ (Aug. 13, 2017), <http://www.obstacleracersnz.co.nz/2017/08/13/parkour-earth-launches-as-international-federation-protecting-the-sovereignty-of-parkour/>.

¹²¹ Han, *supra* note 117.

¹²² Rendao et al., *supra* note 116. Rendao noted that his obstacle course competitions foster: (1) the development of skills “to maintain control under high pressure,” (2) community, (3) a sense of humility. *Id.*

¹²³ Apex School of Movement, *About*, APEX, <https://apexmovement.com/about/> (last visited Dec. 19, 2017).

¹²⁴ Rendao et al., *supra* note 116.

¹²⁵ *Id.*

¹²⁶ Han, *supra* note 117.

¹²⁷ Amos Rendao, *The Story*, AMOS RENDAO, <http://www.amosrendao.com/the-story/> (last visited Feb. 21, 2019).

racing], parkour, and speed climbing background as they compete in [Obstacle Course Sprints].”¹²⁸

Rendao explains that, like skiing, climbing, and surfing, parkour should not “be recognized as [a] competitive sport[.]” in its entirety.¹²⁹ Parkour, skiing, climbing, and surfing are all similar because training methods for these sports predates and goes beyond what a specific event focuses and showcases.¹³⁰ Thus, obstacle course competition competitors may borrow parkour techniques like vaults to traverse an obstacle, but the library of parkour techniques includes more than just vaults.¹³¹ A new competition can be created without encompassing the sport as a whole.¹³²

ii. The International Extreme Sports Festival¹³³

In late 2016, Rendao and others learned of the opportunity to bring obstacle course competitions to an international audience.¹³⁴ Discussions became serious around February and March of 2017 when FIG and a group, the International Extreme Sports Festival Association emerged as key partners for Apex’s Obstacle Course Sprint.¹³⁵ The International Extreme Sports Festival Association organizes the International Extreme Sports Festival, “a staple event in the action sports calendar” involving “over 25 competitions that bring together the most popular action sports: skateboard, BMX, mountain bike, wakeboard, [and] inline skate.”¹³⁶ Rendao agreed to work with FIG under certain conditions. First, he sought “significant control over ongoing development, presentation, format, etc. of the [Obstacle Course Sprint] by having two spots on the highest committee that would have final say.”¹³⁷ Second, as an extension of the control process, Rendao agreed to move forward if he was “assured that important off-limit terms like parkour, gymnastics, freerunning, art du déplacement, and parcours were never to be used in the naming of [the] competition format.”¹³⁸ Lastly, Rendao proceeded under the premise that governance of parkour was not on

¹²⁸ Rendao et al., *supra* note 116.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *See id.*

¹³² *See id.*

¹³³ This is an English translation of the contest’s title, “Festival Internal des Sports Extrêmes.” *About Us*, FESTIVAL INTERNAL DES SPORTS EXTRÊMES, <http://fise.fr/en/about-us-0> (last visited Feb. 21, 2019).

¹³⁴ Amos Rendao, et al., *APEX Ends Collaboration with FIG & Cancels APEX INTL in France*, APEX SCHOOL OF MOVEMENT (May 13, 2017), <https://apexmovement.com/blog/apex-intl-canceled>.

¹³⁵ *Id.*

¹³⁶ Philippe Sirech, *FISE 2017, the 20th Anniversary was a Blast*, UNLEASHED (May 31, 2017), <https://unleashedwakemag.com/fise-2017-20-th-anniversary-blast/>.

¹³⁷ Rendao et al., *APEX Ends Collaboration*, *supra* note 134.

¹³⁸ *Id.*

the table for consideration. Rendao recalls that, “[t]here was zero mention of any interest in FIG governing parkour.”¹³⁹

iii. FIG Debuts a New Discipline

On February 24, 2017, FIG issued a press release on the development of a FIG discipline based on parkour¹⁴⁰ “[f]ollowing the presentation and research into parcours d’obstacles (obstacle course competitions) and parkour, already part of the work of many national gymnastics federations including Sweden, The Netherlands and Belgium[.]”¹⁴¹ FIG President Watanabe stated that he “deeply respects the development of parkour as a non-competitive training methodology, based on obstacles that were not created as such, and with a particular philosophy emphasizing efficiency, usefulness and personal development.”¹⁴²

While the development of FIG’s creation of a parkour-based discipline was ongoing, news spread that FIG planned to appoint a FIG Parkour Committee, chaired by Belle and include Perriere, other parkour experts, and two athletes “which shall work in three areas, education, development and competitions.”¹⁴³

iv. The Parkour Community Responds to FIG’s Announcement

Beginning March 31, 2017, parkour communities across the globe began issuing open letters to FIG President Watanabe to protest the development of FIG’s new discipline.¹⁴⁴ The following shows how sports communities with no international federation respond to an international federation’s attempt to adopt a discipline with “completely different histories, cultures, and purposes[,] [where] [a]ny overlap” between the two sports community to be annexed as a discipline and the international federation trying to annex the sport is superficial.¹⁴⁵

¹³⁹ *Id.*

¹⁴⁰ *Parkour UK Issues Open Letter to Fédération Internationale de Gymnastique (FIG) Re: The Encroachment and Misappropriation of Parkour/Freerunning*, PARKOUR UK, <http://parkour.uk/parkour-uk-issues-open-letter-to-federation-internationale-de-gymnastique-fig-re-the-encroachment-and-misappropriation-of-parkourfreerunning/> (last visited Feb. 21, 2019) [hereinafter “Parkour UK’s Open Letter to FIG”].

¹⁴¹ Press Release, FEDERATION INTERNATIONALE DE GYMNASTIQUE, *First Meeting, First Key Decisions from the New FIG Executive Committee* (Feb. 24, 2017), <http://campaign.r20.constantcontact.com/render?m=1104002974775&ca=3514ded5-82cd-4788-8249-b3807e822f52> [hereinafter “Feb. 24, 2017 FIG Press Release”].

¹⁴² *Id.*

¹⁴³ Rebecca Johnson, *Update On Development Of Parkour As New FIG Discipline*, FLO GYMNASTICS (June 9, 2017), <https://www.flogymnastics.com/articles/5066562-update-on-development-of-parkour-as-new-fig-discipline>.

¹⁴⁴ See generally Parkour UK’s Open Letter to FIG, *supra* note 140.

¹⁴⁵ Aaron Gordon, *How Gymnastics is Trying to Take Over Parkour and Make it an Olympic Sport*, VICE SPORTS (July 11, 2017, 12:47 pm), https://sports.vice.com/en_us/article/qvp395/how-gymnastics-is-trying-to-take-over-parkour-and-make-it-an-olympic-sport.

a. *Parkour UK's Response*

Parkour UK, a parkour organization recognized in the United Kingdom as the national governing body for parkour,¹⁴⁶ was one of the first parkour organizations to respond to FIG's February 24, 2017 press release. A letter from Parkour UK Chief Executive, Eugene Minogue, and Stephen Mitchell, Independent Chair, stated FIG's decision to create new discipline was "encroachment and misappropriation" of their sport.¹⁴⁷ Minogue and Mitchell highlighted one of the Fundamental Principles of Olympism:

"Recognising that sport occurs within the framework of society, sports organisations [within the Olympic Movement] shall have the rights and obligations of autonomy, which include freely establishing and controlling the rules of sport, determining the structure and governance of their organisations, enjoying the right of elections free from any outside influence and the responsibility for ensuring that principles of good governance be applied."¹⁴⁸

The letter also mentions Parkour UK's previous experience with similar events at the national level when British Gymnastics, Britain's national federation for gymnastics, developed a program that imitated parkour.¹⁴⁹ Parkour UK "addressed this with British Gymnastics [and] the UK Sports Councils [in] March 2013, to ensure that [parkour] is not misappropriated and/or encroached upon."¹⁵⁰ Parkour UK's letter also reiterated its position that Parkour UK is the national recognized governing body for parkour as a sport in the UK.¹⁵¹ Minogue and Mitchell wrote that parkour is not gymnastics, that traceurs are not gymnasts, and that parkour is its own "sovereign sport with independently recognised distinct uniqueness and cultural status."¹⁵² Minogue and Mitchell invited other national communities to "issue letters of support for Parkour UK's position to FIG . . . to ensure[,] protect[,] and promote the integrity of our sport, the rights, freedoms and interests of [t]raceurs . . . internationally[.]"¹⁵³

Parkour UK provides two main arguments. First, FIG lacks the competence to govern over a discipline based on parkour.¹⁵⁴ Parkour is different from gymnastics, featuring different environments that require different techniques. For example, many gymnasts perform routines on

¹⁴⁶ *What We Do*, PARKOUR UK, <http://parkour.uk/what-we-do/> (last visited Feb. 21, 2019).

¹⁴⁷ Parkour UK's Open Letter to FIG, *supra* note 140.

¹⁴⁸ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107 (emphasis removed) (quoting Olympic Charter, *supra* note 13, at Fundamental Principles of Olympism).

¹⁴⁹ See Parkour UK's Open Letter to FIG, *supra* note 140.

¹⁵⁰ *Id.*

¹⁵¹ See *id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107.

spring-board floors.¹⁵⁵ Parkour, by contrast, is performed in outdoor environments¹⁵⁶ which often require traceurs to interact with concrete, asphalt, grass, brick, and other less impact-absorbent structures. Thus, how a gymnast would perform a front flip and how a traceur perform a front flip are different. Second, Parkour UK argues, FIG lacks the authority and legitimacy to develop a parkour-related discipline.¹⁵⁷

The letter concludes by welcoming a meeting with FIG, to be memorialized in a Memorandum of Understanding, “to formally acknowledge and [recognize] sovereignty of Parkour[.]”¹⁵⁸ Minogue and Mitchell requested that the meeting be “prefaced with an agreed and binding arbitration agreement referring any dispute” to CAS’ jurisdiction.¹⁵⁹ Minogue and Mitchell proposed that if FIG failed to act in 60 days,

“any dispute arising from and/or related to the binding arbitration agreement will be submitted exclusively to [CAS] . . . and resolved definitively in accordance with the Codes of sports-related arbitration.”¹⁶⁰

b. Response from Others Parkour Communities and Organizations

Soon after Parkour UK published its letter, other communities issued open letters of their own to FIG. The International Parkour Federation¹⁶¹ stated FIG lacked any “organic understanding of [p]arkour”¹⁶² and compared FIG’s announcement of its new discipline as “someone breaking into our home and saying, ‘Just give us two of your four children and we’ll leave you alone to raise the other two as you wish.’”¹⁶³ New Zealand Parkour and the Australian Parkour Association echoed Parkour UK’s sentiment that FIG’s announcement represented encroachment and misappropriation.¹⁶⁴ The Australian Parkour Association and other

¹⁵⁵ *Women’s Artistic Gymnastics Event Descriptions*, USA GYMNASTICS, <https://usagym.org/pages/gymnastics101/women/events.html> (last visited Mar. 6, 2019).

¹⁵⁶ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ At the time of writing this Note, International Parkour Federation has not been recognized by either the IOC or GAISF.

¹⁶² Letter from Victor Bevine & David Thompson, Co-Founders, International Parkour Federation/WFPF, to André Gueisbuhler, Secretary General, Fédération Internationale de Gymnastique at unp. 1 (May. 31, 2017), <https://web.archive.org/web/20171102173734/https://www.wfpf.com/message-wfpf-ipf-re-attempt-fig-federation-international-de-gymnastique-take-competitive-parkour>.

¹⁶³ *Id.*

¹⁶⁴ Letter from Damien Puddle, CEO, New Zealand Parkour, and Nigel Elvidge, Chairman, New Zealand Parkour, to Morinari Watanabe, President, Fédération Internationale de Gymnastique (May 11, 2017), <http://nzparkour.co.nz/wp-content/uploads/2015/05/Parkour-NZ-Open-Letter-to-FIG.pdf>; *See also*, Letter from Eliot Duffy, President, Australian Parkour Association, to Morinari Watanabe, President, Fédération Internationale de Gymnastique (May 12, 2017), <https://web.archive.org/web/20180914150918/http://parkour.asn.au/open-letter-to->

communities¹⁶⁵ stated that FIG Secretary General Andre Gueisbugler's understanding of parkour's history was inaccurate and ill-informed.¹⁶⁶ The Australian Parkour Association also rejected Gueisbugler's comment that the parkour community was not organized in its development of parkour.¹⁶⁷ Other geographically-based communities began collaborating to create new, national federations "to prevent the encroachment and misappropriation of our sport nationally."¹⁶⁸

On May 13, 2017, Rendao updated Apex Movement's website announced its formal termination with FIG in the development of the obstacle course competition.¹⁶⁹ Rendao stated that he and the rest of the Apex Movement community, as defenders of the parkour community, "do not stand for FIG governing parkour."¹⁷⁰ Rendao said the opportunity to collaborate with FIG for the obstacle course competition "as it was presented to us is no longer aligned with surfacing information, and key assurances over the naming of our competition format were neglected publicly in statements made by FIG."¹⁷¹ "FIG's interests do not coincide with what we perceive to be a step forward for the international parkour

the-federation-internationale-de-gymnastique-on-the-encroachment-and-misappropriation-of-parkour.

¹⁶⁵ The open letter from German-based parkour groups Ashigaru, Parkour Movement, ParkourONE, and Parkour Stuttgart also "reject[ed] the assertions of FIG Secretary General, André Gueisbuhler, regarding the history of [p]arkour as inaccurate and ill-informed." Letter from Enis Maslic, Ashigaru, Maren Baufeld, Parkour Stuttgart e.V., Giulio Hesse, Parkour Movement, e.V., and Ben Scheffler, ParkourONE, to Morinari Watanabe, President, Fédération Internationale de Gymnastique at unp. 1 (May 19, 2017), <https://www.facebook.com/parkourone/posts/10154898023314177> [hereinafter "Letter from Ashigaru, et al."].

¹⁶⁶ Letter from Eliot Duffy, *supra* note 164.

¹⁶⁷ *Id.* In a separate update by Rendao on Apex's website, he quoted Secretary General Gueisbugler, who stated,

"At the moment [parkour practitioners] are not organized. Their basic spirit is to be free, not to be organized. Yet they want to have competitions. But if they want to do competitions, obviously they need minimum rules and environment to make attractive competitions. I'm sure FIG is the international federation most qualified to further develop parkour."

Rendao et al., *APEX Ends Collaboration*, *supra* note 134 (internal quotation marks omitted) (citing Vestnik Kavkaza, *Andre Gueisbuhler: "Azerbaijan is helping the world gymnastics"*, VESTNIK (May 4, 2017), http://parkour.uk/wp-content/uploads/2017/05/Appendix-14-Andre-Gueisbuhler_-_Azerbaijan-is-helping-the-world-gymnastics_-_Vestnik-Kavkaza.pdf).

¹⁶⁸ For example, four German-based parkour groups reached an accord to create a new national federation. Letter from Ashigaru, et al., *supra* note 167.

¹⁶⁹ Letter from Eliot Duffy, *supra* note 164.

¹⁷⁰ Rendao et al., *APEX Ends Collaboration*, *supra* note 134.

¹⁷¹ *Id.*

community.”¹⁷² Across all open letters were the same theme: parkour is its own sovereign, culturally independent from gymnastics.¹⁷³

E. *Development and Events After the Open Letters*

Despite the open letters from members in the parkour community, FIG continued pursuing the new discipline and proposed its “full inclusion at Tokyo 2020.”¹⁷⁴ On May 10, 2017, FIG issued another press release stating its approval of “the key stages for the discipline’s formal inclusion, with a view to organizing World Cup series in 2018 and 2019 and World Championships from 2020.”¹⁷⁵ FIG’s parkour experts, who remained unnamed, sought to include two obstacle course formats: an obstacle course sprint, in which participants would race through a course against the clock, and a freestyle, in which participants would be judged.¹⁷⁶ The courses would be “based on real-world shapes found in urban and natural environments.”¹⁷⁷ President Watanabe again stated that FIG was developing its new discipline “with the desire to respect the philosophy that drove the founders of parkour, and to empower them.”¹⁷⁸

On May 19, 2017, FIG’s Secretary General André Gueisbuhler sent an email to Minogue reading “[i]t is not FIG’s policy to correspond with ‘open letters’ and we do not wish to interfere in any National

¹⁷² *Id.*

¹⁷³ See Letter from Ashigaru, et al., *supra* note 167 (supporting stances of Parkour UK, Fédération de Parkour, Australian Parkour Association, and the New Zealand Parkour Association that FIG’s development of a parkour-based discipline is encroachment and misappropriation); “*Invasión y apropiación indebida*” del Parkour por parte de la FIG, INONDER (May 20, 2017), <https://web.archive.org/web/20180423145056/https://inonder.com.mx/invasion-apropiacion-indebida-parkour-fig>; *Carta a la Federación Mexicana de Gimnasia por parte de la comunidad de Parkour*, INONDER (May 20, 2017), <https://web.archive.org/web/20180207160436/http://inonder.com.mx/carta-federacion-mexicana-gimnasia-parkour>.

¹⁷⁴ Nick Butler, *Exclusive: International Gymnastics Federation Present Parkour for Olympic Inclusion at Tokyo 2020*, INSIDE THE GAMES (May 5, 2017), <https://www.insidethegames.biz/articles/1050020/exclusive-international-gymnastics-federation-present-parkour-for-olympic-inclusion-at-tokyo-2020>. FIG’s proposal for the Tokyo 2020 Olympic Games was denied at an IOC Executive Board meeting in June 2017. Michael Pavitt, *FIG to Launch Parkour World Cup Series in November*, INSIDE THE GAMES (Aug. 1, 2017), <https://www.insidethegames.biz/articles/1053511/fig-to-launch-parkour-world-cup-series-in-november>.

¹⁷⁵ *FIG Decision-Making Bodies Greenlight Inclusion of a New Discipline*, AROUND THE RINGS (May 10, 2017), http://aroundtherings.com/site/A_60083/Title__FIG-Decision-Making-Bodies-Greenlight-Inclusion-of-a-New-Discipline/292/Articles [hereinafter “May 10, 2017 FIG Press Release”].

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

recognition procedures.”¹⁷⁹ Gueisbuhler also clarified that FIG is an international organization and that it invited the other international federations representing parkour that they were aware of.¹⁸⁰

FIG’s first event featuring its new discipline was scheduled for debut in May 28, 2017, during the International Extreme Sports Festival in Montpellier, France.¹⁸¹ The event would serve as a model for “a proposed urban cluster at the Tokyo Olympics and future games[.]”¹⁸² IOC Representatives were at the event “to observe the new trends in view of the Tokyo Olympic Games.”¹⁸³ Belle stated that the “weekend was a very big step forward for parkour[.]”¹⁸⁴

On July 4, 2017, several national parkour federations “reached an accord . . . to establish Parkour Earth as the International Federation for Parkour[.]”¹⁸⁵ In its announcement, Parkour Earth stated that it intended to be parkour’s only international governing and administering body “to protect the rights, freedoms[.]” and sought to “promote the interests of traceurs[.]”¹⁸⁶

By July 26, 2017, sixty days after Parkour UK wrote its open letter to FIG, Parkour UK did not receive a response to meet.¹⁸⁷ FIG “remained[] on track with their plans to bring parkour into gymnastics[.]”¹⁸⁸ From November 3–5, FIG hosted their first Parkour World Cup in Chengdu.¹⁸⁹ President Watanabe and members of Parkour Earth met on November 7, 2–17 in hopes to “formalise the clarification, understanding[,] and recognition of the sovereignty of” and “to demonstrate [Parkour Earth’s] goodwill and intention to bring the prevailing uncertainty of the FIG’s proposals and intention to an amicable and swift resolution.”¹⁹⁰ On December 14, 2017, Parkour Earth wrote a letter to FIG which concluded that the meeting, while

¹⁷⁹ E-mail from André Gueisbuhler, Secretary General, Fédération Internationale de Gymnastique, to Eugene Minogue Chief Executive, Parkour UK (May 29, 2017, 10:46 BST), <http://parkour.uk/wp-content/uploads/2017/05/FIG-email-29.05.2017.pdf>.

¹⁸⁰ *Id.*

¹⁸¹ May 10, 2017 FIG Press Release, *supra* note 177.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ Daniel Etchells, *FIG President Admits He Has Been Excited by Parkour Since First Seeing It Seven Years Ago*, INSIDE THE GAMES (May 31, 2017), <https://www.insidethegames.biz/articles/1050993/fig-president-admits-he-has-been-excited-by-parkour-since-first-seeing-it-seven-years-ago>.

¹⁸⁵ *Parkour Earth Launches*, NZ PARKOUR (Aug. 4, 2017), <http://nzparkour.co.nz/parkour-earth-launches/>. These organizations are Parkour UK, Fédération de Parkour (France), New Zealand Parkour – Tauhōkai Aotearoa, Australian Parkour Association, Parkour South Africa, and Polska Federacja Parkour i Freerun (Poland). *Members*, PARKOUR EARTH, <https://parkour.earth/#members> (last visited Mar. 7, 2019).

¹⁸⁶ Bell, *supra* note 120.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ Pavitt, *supra* note 176.

¹⁹⁰ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107.

appreciated, failed to address any of Parkour Earth's "fundamental, legitimate[,] and substantiated concerns."¹⁹¹

F. *Similar Developments in Other Sports*

The parkour community is not the first to experience the struggle over the governance of its own sport from a seemingly arbitrary organization. Developments in other sports shows a pattern in IOC's disregard for consideration of existing governing bodies.

i. Snowboarding

In 1998,

"the IOC included snowboarding for the first time in the Winter Olympics, but under the International Ski Federation's . . . umbrella, rather than ushering in the burgeoning International Snowboard Federation," effectively making snowboarding a subdiscipline of skiing.¹⁹² "Terje Haakonsen, one of the most influential snowboarders ever and the best in the world at the time," stated that International Ski Federation's absorption of snowboarding hindered the International Snowboard Federation's development.¹⁹³ Haakonsen accused International Ski Federation of "using its leverage to prevent the [International Snowboard Federation] from getting lucrative television contracts," thereby leading to its downfall.¹⁹⁴ "The [International Snowboard Federation] shut down in 2002."¹⁹⁵

Predictions of whether International Snowboard Federation would not have shut down for economic reasons if IOC instead recognized the International Snowboard Federation over International Ski Federation are only speculative. The cultural effects, however, have been recognized. "Olympization of snowboarding [has] fractured the community as some competitors perfected their skillsets for Olympics-style competition, while others like Haakonsen adhered to previous ideals of creativity and expression."¹⁹⁶ Haakonsen believes Olympization of snowboarding has made it worse, "and many view the standardization of competitions as detrimental to its founding values of riding whatever the terrain provides."¹⁹⁷

¹⁹¹ *Id.*

¹⁹² Gordon, *supra* note 146.

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ Gordon, *supra* note 146.

ii. BMX

Union Cycliste Internationale is the international federation for “all other Olympic cycling events[.]”¹⁹⁸ Union Cycliste Internationale absorbed BMX, allegedly only because BMX practitioners also happen to use bicycles, thus completely failing to consider other factors like independent cultural heritage.¹⁹⁹ If BMX practitioners wish to take action, they would “have little sway in what funding they receive from their national governing bodies because they’re a small fish in a big pond.”²⁰⁰

iii. Skateboarding

Skateboarders have experienced a fate similar to the BMX practitioners. “[M]any skaters don’t want to be in the Olympics at all[.]”²⁰¹ The International Roller Sports Federation is the IOC-recognized international federation for all roller skating.²⁰² Its disciplines include inline freestyle, inline hockey, roller derby, and others.²⁰³ The IOC requested for the International Roller Sports Federation, despite the existence of the International Skateboarding Federation,²⁰⁴ a separate organization “established to provide direction and governance ... of skateboarding worldwide[.]”²⁰⁵ While the International Roller Sports Federation and the International Skateboarding Federation have “agreed to jointly run the Tokyo 2020 Skateboarding Commission,” some argue that the collaboration is only a short-term fix for “what promises to be a protracted legal fight over who owns skateboarding.”²⁰⁶

III. ANALYSIS

IOC has exhibited an ongoing pattern of filing sports that have their own unique history, culture, techniques, teaching structures, and other logistical infrastructure in the cabinet of existing, international federations as a new discipline rather than recognizing organizations with existing, long-standing leadership and involvement of the sport, to govern new sports or new disciplines. To remedy these issues, the Olympic Charter and the Statutes should be revised to (1) provide a means of due process by

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* (citing Damien Puddle, *Why We Need to Fight FIG: Lessons From Other Action Sports*, DAMIEN PUDDLE (May 28, 2017), <https://web.archive.org/web/20180825073144/http://damienpuddle.com/2017/05/28/why-we-need-to-fight-fig-lessons-from-other-action-sports>).

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *International Roller Sports Federation (FIRS)*, SKATE LOG, <http://www.skatelog.com/firs/> (last visited Mar. 9, 2019).

²⁰³ WORLD SKATE, <http://www.worldskate.org/> (last visited Mar. 9, 2019).

²⁰⁴ Gordon, *supra* note 146.

²⁰⁵ *Skateboarding in the Olympics, International Olympic Committee Announces Street and Park Events Will Debut in Tokyo 2020*, TOKYO 2020 SKATEBOARDING COMM’N (Aug. 3, 2016), <http://skateboarding2020.com/>.

²⁰⁶ Gordon, *supra* note 146.

presenting mandatory criteria for both international federation recognition and the adoption new disciplines by an international federation; (2) provide for increased transparency its major executive body and of its parts; and (3) require public involvement. While these suggestions may not provide the exact relief aggrieved organizations and athletes would seek, sports proceedings would better mimic existing processes from government's that already show deference for the IOC and CAS. In some instances, these topics overlap and thus providing revising the Olympic Charter and/or the Statutes in one area will address several issues at once.

A. *Issues with the Current Approach to International Federation Recognition*

IOC's behavior of allocating sports to already-recognized international federations rather than non-government organizations that have invested resources and years' worth of time and experience in a sport is problematic. First, IOC's pattern is contrary to a statement it made in its 2016 Annual Report in which the IOC said that one of its aims is to give "full transparency on our operations."²⁰⁷ Despite this declaration to strive for transparency, IOC does not make the international federation criteria for recognition readily available on its site, nor does it clearly define what activities constitute a sport or what how an activity would constitute a discipline in a sport. Further, the Olympic Charter is silent on any specific criteria for consideration, save for the requirement that the international federation's statutes be consistent with the Olympic Charter and the Olympic Movement in its entirety.

Second, any organization wishing to challenge the IOC's decision to recognize one organization as the international federation for a new sport or discipline faces unique challenges because of IOC's structure and deference for IOC's operations. For example, in *Martin v. International Olympic Committee*, the U.S. judicial branch showed deference for IOC's operations by refusing to apply U.S. law to an IOC decision.²⁰⁸ Similarly, in *Liang Ren-Guey v. Lake Place 1980 Olympic Games Inc.*, the U.S. Department of Justice stated that the U.S.

"has repeatedly committed to the IOC that the United States would be bound by the list of invitees and the conditions of participation set by the IOC . . . based on our 'recognition of the private character of the [IOC] and the games.'"²⁰⁹

Thus, suits brought by, say, organizations that claim to "have been sidelined by [a different international federation] and [the IOC]" may have

²⁰⁷ IOC ANNUAL REPORT, *supra* note 11, at 5.

²⁰⁸ *Martin v. Int'l Olympic Comm.*, 740 F.2d 670, 677 (9th Cir. 1984).

²⁰⁹ *Ettinger*, *supra* note 12, at 108–09 (internal citation omitted).

limited access to judicial relief because of the deference towards IOC decisions “despite investing money and resources into preparations.”²¹⁰

This limited access to judicial relief is exacerbated by CAS’ limited jurisdiction. Recall that CAS has jurisdiction over appeals only where both parties have consented to its jurisdiction. A non-government organization that has functioned as an international federation but has not been recognized as an international federation by the IOC or GASIF, or where one party feels aggrieved by a recognized international federation’s decision to adopt another sport as a discipline, is limited in where to seek relief should IOC decides against the interests of that non-government organization.

Further, “[t]he IOC answers to no higher authority and it is free to make decisions without appeal to any other body.”²¹¹ Decisions made by the Session are final.²¹² The Olympic Charter offers no mechanism for appeal from a decision by the IOC to the Court of Arbitration for Sport.²¹³

Third, the Olympic Charter and the Statutes lack any opportunity for public involvement or commenting. Neither document requires a forum for organizations and athletes interested in the outcome of the decisions from the IOC or GAISF to be heard. Additionally, if a recognized international federation choose to adopt a sport as a new discipline, nothing in the Olympic Charter nor the Statutes requires, or even suggests, that the international federation seeking to adopt a new discipline receive any public input on the matter.

Fourth, even if the Olympic Charter and the Statutes had provisions for public involvement or comment, and even if both parties have consented to CAS’ jurisdiction, there are no criteria for CAS to apply regarding the adoption of a new discipline or recognizing a new sport. Parkour Earth has unsuccessfully requested for FIG to consent to dispute resolution through CAS for misappropriation.²¹⁴ Even if FIG agreed to subject itself to CAS’ jurisdiction, CAS lacks any rules that directly apply to FIG’s adoption of parkour as a discipline. The silence of the Olympic Charter and the Statutes on criteria for adopting a new discipline can lead to almost arbitrary results if left unchecked. For example, FIG could, if it wanted to, adopt kite flying as a discipline, against the interests of groups like the International Kite Federation, because nothing in the either the Olympic Charter nor the Statutes offers requirements when international federations seek to adopt a new discipline.

²¹⁰ Nick Butler, *World Skateboarding Federation Sue Rivals on Eve of Decision to Admit Sport into Tokyo 2020*, INSIDE THE GAMES (Aug. 1, 2016), <https://www.insidethegames.biz/articles/1040187/world-skateboarding-federation-sue-rivals-on-eve-of-decision-to-admit-sport-into-tokyo-2020>.

²¹¹ Ettinger, *supra* note 12, at 116 (internal citation omitted).

²¹² OLYMPIC CHARTER, *supra* note 1.

²¹³ See generally *id.*

²¹⁴ Letter from Eugene Minogue & Stephen Mitchell, *supra* note 107.

B. *Revising the Olympic Charter and the Statutes*

Self-governance of and by these organizations has led to negative criticism. Critics have highlighted that the undemocratic nature of self-governance by the IOC and GAISF “consider the organization’s deliberations to be the ‘machinations of a fascist-like clique’ and that the IOC consists of ‘arrogant old aristocrats.’”²¹⁵ The lack of transparency, availability of judicial remedies, and opportunity to be heard are surprising given the United States’ constitutional requirements for due process and the availability of the Swiss judicial system if an appellant seek appeals from a decision by CAS.

The issues of self-governance in international sports is important because international sports organizations influence international governance. For example, the Helsinki Accords reads,

“to expand existing links and co-operation in the field of sport the participating [s]tates will encourage contacts and exchanges on this kind, including sports meetings and competitions of all sorts, on the basis of the established international rules, regulations and practice.”²¹⁶

Some have argued that the Olympic Charter are rules of customary international law because they are the basis of international rules, regulations, and practice for sports²¹⁷ as described in the Helsinki Accords. Though the Helsinki Accords are not legally binding, “they provide a ‘morally compelling, comprehensive expression of norms to guide the behavior of the signatory states.’”²¹⁸

If sports are so highly revered to be recognized and included in an international agreement signed by 35 states, their regulation should be subject to the same standards that courts and other dispute resolution methods are subject to. Increased regulation may lead to increased costs borne by the IOC, GAISF, international federations, and all parts of international sports. But balancing costs for the sake of due process is not impossible, as judicial systems are faced with this problem have already shown.²¹⁹ CAS already shows deference for international policy.²²⁰ CAS

²¹⁵ Ettinger, *supra* note 12, at 117. Others have referred to the IOC as the “most exclusive club in the world.” *Id.* Critics have also stated self-governance of these organizations is open to acts of nepotism. *Id.*

²¹⁶ Conference on Security and Co-operation in Europe, *Helsinki Final Act*, 45 (Aug. 1, 1975), <https://www.osce.org/helsinki-final-act?download=true>.

²¹⁷ See Ettinger, *supra* note 12, at 104.

²¹⁸ *Id.* at 104–05.

²¹⁹ See *Matthews v. Eldridge*, 424 U.S. 319, 347 (1976) (“In striking the appropriate due process balance the final factor to be assessed is the public interest. This includes the administrative burden and other societal costs that would be associated with requiring, as a matter of constitutional right, an evidentiary hearing upon demand in all cases prior to the termination of disability benefits.”).

also recognizes the importance of due process because it recognizes the right to be heard as part of international public policy. Since CAS already shows respect for international policy and due process, this counters the cost concerns against amending international sports' governing documents to further due process and transparency.

i. Due Process

A clear authority over the actions of sporting federations is necessary.²²¹ An important part of clear authority over sport involves the process that sports-governing organizations use to adopt new regulations. In *USA Shooting Union (UIT)*, CAS “refused to imply a strict liability rule into the rules and practice of a sporting federation.”²²² A sports governing body’s decision to implement a new rule may affect the “careers of dedicated athletes.”²²³ Rules must be “adopted in constitutionally proper ways. They should not be the product of an obscure process of accretion.”²²⁴

Just as CAS held that a governing body’s rules should be adopted in a constitutionally proper way, so too should a sports governing body’s decision to create a new discipline be adopted in a constitutionally protected way. The Olympic Charter, the Statutes, and international federations self-governing statutes, including those of FIG’s, do not provide procedures nor criteria that must be used by international federations to decide when it may to adopt a new discipline.²²⁵ Yet according to FIG’s February 24, 2017 press release, FIG’s decision to create a new discipline resulted from the Executive Committee’s mandate to the Presidential Commission to continue the development of the discipline.²²⁶

Further, CAS has regularly pronounced that “decisions of sporting federations can be challenged for various reasons that constitute an unfair procedure or an unfair hearing.”²²⁷ For example, in *AEK Athens & SK Slavia Prague v Union of European Football Ass’n*,²²⁸ CAS stated that “the

²²⁰ *Federación Panameña de Judo et al. v. Int’l Judo Fed’n*, CAS 2007/A/1392, ¶ 31 (Sept. 9, 2008), <http://jurisprudence.tas-cas.org/Shared%20Documents/1392.pdf> (“[T]he respect of the right to be heard has also to be considered as being part of international public policy, at least under the conception adopted under the *Lex arbitri*, that is to say Swiss law.”).

²²¹ Foster, *supra* note 54, at 5-6 (citing *R. v. Int’l Olympic Comm.*, CAS OG Nagano 98/002, ¶¶ 26-27 (Feb. 20, 1998), <http://jurisprudence.tas-cas.org/Shared Documents/129.pdf>).

²²² *Id.* at 6.

²²³ *Id.* (quoting *USA Shooting & Q. v. Int’l Shooting Union*, CAS 94/129, ¶ 34 (May 22, 1995), <http://jurisprudence.tas-cas.org/Shared Documents/129.pdf>).

²²⁴ *Id.* (quoting *USA Shooting & Q.*, CAS 94/129, ¶ 34).

²²⁵ See generally FIG, *Statutes* (2017), MAIN RULES, http://www.fig-gymnastics.com/publicdir/rules/files/en_Statutes%202017.pdf.

²²⁶ Feb. 24, 2017 FIG Press Release, *supra* note 141.

²²⁷ Foster, *supra* note 54, at 8.

²²⁸ CAS 98/200 (Aug. 19, 1999), <http://jurisprudence.tas-cas.org/Shared Documents/200.pdf>.

principle of procedural fairness is . . . among the unwritten principles of sports law to be complied with by international federations.”²²⁹

Ideally, the Olympic Charter and the Statutes would create minimum standards that an international sports federation must “observe to avoid legal challenges before national courts.”²³⁰ Example protections would include due process considerations like a notice and comment period, “proper and precise notification of the charge; an opportunity to present their case; cross-examination of witnesses; legal representation; . . . reasons for decisions; and a right of appeal.”²³¹

On the issues of international federation recognition and adopting a new discipline faced by the parkour and other sports communities not yet governed by a recognized international federation, the Olympic Charter and the Statutes could adopt some of the criteria provided by UKSport in its recognition process. UKSport is an organization in the United Kingdom that established a recognition process for national federations.²³² One of the several considerations for its recognition process includes an applicant-organization’s influence in the community, in which the applicant-organization

“must demonstrate it is the *leading body* for the sporting activity . . . , that it has influence throughout the sporting activity[,] and that it is working in co-operation with other organisations within its sport, or that other organisations have minimal influence within the sport.”²³³

Where several organizations exist for a sport, “the applicant should demonstrate that it is better placed than others to govern and develop its sport.”²³⁴ Providing this language would address issues of governance by providing notice to those interested in becoming a recognized international federation and would address what to do if more than one organization is interested in becoming a recognized international federation.

ii. Transparency

The Olympic Charter and the Statutes should be revised to require more transparency within its own process by, for example, requiring that the IOC, the Council, and international federations to describe its decision and its rationale for that decision. This would improve transparency and accountability of the IOC and its parts, including international federations

²²⁹ Foster, *supra* note 54, at 8 (quoting *AEK Athens*, CAS 98/200, ¶ 158).

²³⁰ *Id.*

²³¹ *Id.* (citing Philip Morris, et al., *Challenging Sports Bodies’ Determinations*, 17 Civ. J. Q. 128 (1998)).

²³² *Sports Councils’ Recognition Policy*, SPORT ENGLAND 3 (2017), <https://www.sportengland.org/media/12132/uk-recognition-policy-2017.pdf>.

²³³ *Id.* at 13 (emphasis added).

²³⁴ *Id.*

and those governed by international federations such as national federations, athletes.

A requirement provided in the Olympic Charter and the Statutes that international federations be transparent in the decision-making process would allow those who may be impacted by a decision of the IOC or an international federation to better understand when and how a decision was made. It would help to address issues like those experienced by Rendao who was blindsided by FIG's idea to govern parkour. Alternatively, organizations seeking to become part of the IOC by becoming a recognized international federation would benefit if the IOC was transparent about its international federation recognition requirements by knowing how to conduct activities towards recognition. Organizations like Parkour Earth would then be able to take the initiative to seek inclusion and involvement in the Olympic Movement.

CAS has arbitrated on the issue of transparency several times. In *Chiba v. Japan Amateur Swimming Federation*,²³⁵ a swimmer "challenged her non-selection for the Sydney Olympics" on grounds that she had swam a qualifying time and finished first in the qualifying trials[.]" the two announced criteria to qualify for the Olympics.²³⁶ CAS accepted JASF's use of a third, unannounced criteria used only for the "few but best" like Chiba.²³⁷ In doing so, however, CAS also

"issue[d] a strong statement that selection criteria should be announced in advance; that professional athletes have a right to know the criteria; and that federations 'should pursue a policy of transparency and open information.'"²³⁸

Similarly, in *Beashal & Czisowski v Australian Yachting Federation*, the Court of Arbitration for Sport referred a selection for the Olympics back to the AYF

"because it had failed to follow its procedures for nomination and, because it was a close sporting call, it was possible that this may have made a difference to the outcome."²³⁹

While these proceedings relate only to the "selection of athletes to compete in the Olympic Games[.]"²⁴⁰ the IOC has shown signs of its

²³⁵ CAS 2000/A/278 (Oct. 23, 2000), <http://jurisprudence.tas-cas.org/Shared Documents/278.pdf>.

²³⁶ Foster, *supra* note 54, at 7 (citing *Chiba*, CAS 2000/A/278).

²³⁷ *Id.* (citing *Chiba*, CAS 2000/A/278).

²³⁸ *Id.* (citing *Chiba*, CAS 2000/A/278, ¶ 10).

²³⁹ *Id.* (citing *Beashal & Czisowski v Australian Yachting Fed'n*, CAS 2000/A/260 (Feb. 1, 2000), <http://jurisprudence.tas-cas.org/Shared Documents/260.pdf>).

²⁴⁰ *Id.*

willingness to become transparent where no law requires it do so.²⁴¹ Similarly, GAISF already emphasizes transparency of operations in its own statutes. For example, one of the requirements listed in its Application Procedure for Full Membership are “copies of audited financial statements, together with a detailed description of sources of income and a transparent report on expenses[.]”²⁴² GAISF is also “competent to enact guidelines implementing the provisions on admission, and to determine transparent and objective criteria for admission into GAISF.”²⁴³

iii. Public Involvement

Revising the Olympic Charter and the Statutes to include public involvement in the international federation recognition process and the adoption of a discipline process would supplement the aforementioned due process and transparency improvements. The new provision on international federation recognition could include language similar to the following: the IOC (Council) must publish a press release when it wants to recognize a new international federation. The press release shall describe the time, place, and manner for other international federations to provide input on the IOC’s decision. The press release shall also describe how those that may be impacted by this decision, but are not part of the Olympic Movement or GAISF, can provide input on the IOC’s decision. The press release shall summarize why the international federation should be recognized for the sport according to the criteria provided by the Olympic Charter (Statutes).

New provisions on the adoption of a new discipline would contain language similar to: an international federation must publish a public press release when it seeks to adopt a new discipline. The press release shall also provide information on how those who may be impacted by this decision, but are not part of the Olympic Movement or GAISF, can provide input on the IOC (Council)’s decision. The press release shall summarize why the international federation is adopting the new discipline according to the criteria provided by the Olympic Charter (Statutes).

Both provisions would feature a discrete window for involvement, using language similar to: the input period for those from those who may be impacted by this decision, but are not part of the Olympic Movement or the Global Association of International Sports Federation, must remain open for at least two months before the IOC, Council, or the international federation decides.

²⁴¹ See IOC ANNUAL REPORT 2016, *supra* note 11, at 5 (stating that the IOC “aim[s] to give full transparency on [its] operations, including all [its] financial figures and [its] indemnity policies for IOC Members.”).

²⁴² GAISF Statutes ch. II, art. 7.A.4, § 14, <http://oomfgjxh.preview.infomaniak.website/wp-content/uploads/sportaccord-statutes-2017-eng.pdf>.

²⁴³ GAISF Statutes, *supra* note 244, art. 7.A.8.

Providing the opportunity for input would help those who may be impacted by a decision of the IOC, the Council, or an international federation an opportunity to voice their concerns over adopting a discipline or recognizing an international federation beforehand. By adding a provision similar to the one suggested, the IOC, the Council, and an international federation would provide more opportunity for organizations that have functioned as international federations but have not yet been recognized a chance to be involved in the process, ideally resulting in the reduction of the type of controversies experienced by the parkour, snowboarding, BMX, and skateboarding communities.

In addition to allowing organizations that function as international federation to be heard or to dispute a decision, other organizations that lack resources for a global reach, but are otherwise enthusiastic about international involvement and the mass exposure international competitions provide, would have an opportunity to give valuable input to an international federation seeking to properly administer and govern over a sport or adopt a new discipline.

Further, CAS has already recognized that

“[i]t is a general principle of sports law, constantly recognized by the CAS jurisprudence, that the right to be heard has to be respected, even if there is no applicable rule expressly providing for such principle[.]”²⁴⁴

“Furthermore, the respect of the right to be heard has also to be considered as being part of international public policy, at least under the conception adopted under the *Lex arbitri*, that is to say Swiss law.”²⁴⁵

C. *Maintaining the Status Quo*

IOC is a respected international organization comprised of representatives to ensure the development of their own sports. It has been recognized as an international personality and its role in promoting peace has been recognized by the UN. Though IOC and GAISF provides some kind of independent relief in the form of CAS and by allowing constituents to govern themselves, it provides no relief for those who may be impacted by decisions made by itself or by its constituents through CAS.

From a legal standpoint, even if FIG fully committed to and absorbed parkour as, both the competitive obstacle sprint and the non-competitive parts such as education, as its own discipline, nothing in

²⁴⁴ Federación Panameña de Judo et al. v. Int’l Judo Fed’n, CAS 2007/A/1392, ¶ 31 (Sept. 9, 2008), <http://jurisprudence.tas-cas.org/Shared%20Documents/1392.pdf>.

²⁴⁵ *Id.*

Olympic Charter, nor do any regulations, or other laws prevent FIG from governing over parkour.

The question that surfaces, then, is whether CAS' involvement in the development of a new discipline by an international federation need to even be addressed by the IOC or GAISF at all. Participation in the Olympic Movement is a private effort, wherein participation is voluntary. Thus, organizations and communities unhappy with how FIG develops its new discipline need not apply to be an organization, club, or any part of FIG. An international federation's newfound authority, even if self-made, to govern a sport does not mark the end of the non-competitive community of the sport. For example, after snowboarding became "one of the most popular winter sports" since its Olympic debut in 1998, the non-competitive snowboarding culture and community continued to exist, albeit with tension from both the competitive and non-competitive communities.²⁴⁶ Foucan echoed the same sentiment when he asked, "Who is going to stop me [from practicing parkour] my own way, on my own?"²⁴⁷

The need for the IOC and GAISF to provide a remedy, or at least that the Olympic Charter and the Statutes provide for and require due process from its constituents for organizations that suddenly find their sovereignty encroached upon by another organization, however, does not disappear just because organizations can continue practicing separately. The IOC and international federations and control licensing for their sports. This level of control over exposure has real effects. For example, "when BMX racing lost its television coverage with ESPN, its popularity and participation rates experienced a significant decline."²⁴⁸

IV. CONCLUSION

The IOC and several international federations recognized by the IOC have exhibited recurring patterns of disengaging existing sports governing bodies and communities from the sports they influence despite the existence of independent technique, culture, and appreciation. IOC should offer these unrecognized sports' governing bodies the opportunity to be recognized by the IOC, thus allowing such organizations to continue cultivating an activity with its existing constituents. Alternatively, the IOC should offer opportunities for these communities to provide input to the already recognized federations propose adopting an already existing activity as its own sport or discipline. The parkour community, along with other sports communities, has felt the effects of Olympization of their sports.

²⁴⁶ DEFINING SPORT: CONCEPTIONS AND BORDERLINES 137, (Shawn E. Klein eds., 2016).

²⁴⁷ Sebastien Foucan (@sebroucan), FACEBOOK (May 21, 2017, 2:20 PM), https://www.facebook.com/permalink.php?story_fbid=437455053284680&id=100010605671158.

²⁴⁸ DEFINING SPORT: CONCEPTIONS AND BORDERLINES 139, (Shawn E. Klein eds., 2016).

While some of those communities thrive, those that do not have little recourse against IOC or the IOC-recognized international federation they seek to challenge. A revision in the Olympic Charter to require a more transparent decision-making process, complete with due process considerations could provide a means of relief for these organizations unrecognized by the IOC.