

FROM CAPE TOWN TO THE HAGUE: HARMONIZATION HAS TAKEN WING

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1. Introduction

The harmonization of commercial law seems to be the flavor of our times. There has never been a greater zeal to create international laws that has been in evidence with the participation of so many. Within the space of less than twelve months, two conventions of tremendous significance have joined the burgeoning stable of international instruments that seek to achieve common solutions to the challenges of modern day international commerce. Although the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, 2002,² and the Cape Town Convention on International Interests in Mobile Equipment 2001,³ represent two different kinds of harmonization, their impact is similar. The Hague Convention achieves harmonization by tackling conflict of laws rules whereas the Cape Town Convention harmonizes substantive law. Both were driven by market imperatives and given the sheer size of the task involved were brought to fruition in a relatively short time. This article examines the state of harmonization as it stands today in the context of the Hague Convention and draws broad themes.

1.1. Burgeoning Internationalism

¹ The Queen's College, University of Oxford, England. I would like to express my gratitude to Joseph Wheatley and the entire editorial team of the Journal for their excellent editorial work.

² Adopted at a diplomatic conference at The Hague, Netherlands, on 13th December, 2002. The Convention was the progeny of the Hague Conference on Private International Law which is an intergovernmental organization consisting of 62 Member States. The Hague Conference specializes in the preparation of multilateral conventions in the private international law arena.

³ Adopted at a diplomatic conference in Cape Town on November 16, 2001. Although the Convention is really the progeny of the International Institute for the Unification of Private Law (UNIDROIT), the diplomatic conference was held under the joint aegis of UNIDROIT and the International Civil Aviation Organization (ICAO).

The end of the cold war and the corresponding explosion of commerce between nations have provided an impetus to internationalism in the law that has never been seen previously in human history. There is more curiosity about the different solutions offered by the various national laws to the common problems of international commerce than ever before.⁴ A simple testament to this curiosity and spirit of internationalism is the proliferation in efforts to harmonize the law that are currently in progress in areas as diverse as civil procedure,⁵ receivables financing,⁶ space asset financing,⁷ and insolvency law.⁸ More and more areas of the law are falling under the harmonizing lens. Only a decade ago, it would have been unthinkable to imagine that it would ever be possible to have international conventions in areas under the remit of property law or civil procedure.⁹ This was the product of a belief that these areas of the law embody aspects of national socio-political history and culture, and that national sensibilities may be so strong as to render any attempt at harmonization unsuccessful.¹⁰ That belief has given way today. Aspects of property law are

⁴ ROY GOODE, *COMMERCIAL LAW IN THE NEXT MILLENNIUM* 88 (1998) (noting that there is an increasing movement away from domestic international trade law to what has become known as “transnational commercial law”). This according to Professor Goode is that body of law that “results from the harmonization or convergence of national laws, whether by international conventions, conscious or unconscious judicial parallelism, uniform rules...” Professor Goode first defined the term in his article, *Usage and its Reception in Transnational Commercial Law*, 46 *INT’L & COMP. L.Q.* 1, 2 (1997), as: “Transnational commercial law” is conceived as law which is not particular to or the product of any one legal system but represents a convergence of rules drawn from several legal systems or even, in the view of its more expansive exponents, a collection of rules which are entirely anational and have their force by virtue of international usage and its observance by the merchant community. In other words, it is the rules, not merely the actions or events, that cross national boundaries.” See also, Roy Goode, *Insularity or Leadership? The Role of the United Kingdom in the Harmonization of Commercial Law*, 50 *INT’L & COMP. L.Q.* 751 (2001).

⁵ The American Law Institute and UNIDROIT are drafting procedural rules that a country may adopt for the adjudication of disputes stemming from international commercial transactions.

⁶ See UNCITRAL Convention on the Assignment of Receivables in International Trade, available at <http://www.uncitral.org/stable/res5681-e.pdf> (last visited Mar. 26, 2004).

⁷ UNIDROIT is currently in the advanced stages of transmitting a draft Space Protocol to the Cape Town Convention of 2001.

⁸ See UNCITRAL Model Law on Cross Border Insolvency, 1997, available at <http://www.uncitral.org> (last visited Mar. 26, 2004).

⁹ See, e.g., Ronald Cuming, *The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts UCC, Art 9 and its Progeny*, in *MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE* 499 (Ross Cranston ed., 1997): “Secured financing law has traditionally been viewed as an area which is ill suited to internationalization.”

¹⁰ Cf. ALI/UNIDROIT Draft Principles of Transnational Civil Procedure with Comments (April 2003), available at <http://www.unidroit.org/english/procedure/study/76-10-e.pdf> (last visited May 25, 2004). See also, Harold Burman, *Ten Years of the United Nations Sales Convention: Building on the CISG: International*

being attacked with great vigor and international instruments are rapidly being honed. The Cape Town Convention of 2001 is one instance.¹¹ Yet another is the recently concluded Hague Convention on conflict rules in respect of securities held by intermediaries.¹²

This level of activity is indeed the product of the modern era. For decades despite lofty ambitions there was nothing but paralysis. One instance of this can be seen in the case of the grand idea of crafting principles of international contract law. The Secretariat of UNIDROIT presented such an idea for the drafting of general principles of international contract law in its Report to UNCITRAL on the "Progressive Codification of the Law of International Trade" as far back as 1971.¹³ The Secretariat's ambition was as magnificent as it was unattainable:

[I]nternational trade needs its own ordinary law with its own particular role and full range of functions...The very fact that the legal relationships of international trade are international in character puts them outside the jurisdiction of municipal law and makes them governable by a law removed from any national contingencies, that is, an ordinary law of international trade, which alone can provide the legal framework which international trade needs in order to develop...Consequently, international trade now, as much as ever, needs...a material law that can govern international relations...It would be unthinkable...to allow international trade to continue to be governed by a host of national laws, since that places it in an impossible position, or to leave all legal problems arising in international trade to be solved simply by practice...so the first task will be to prepare a draft for the general section containing the basic principles which will form the foundations and the framework of the unification.¹⁴

This was to remain a pipe dream until the emergence of the UNIDROIT Principles on International Commercial Contracts, and the now raging debate on the European Civil Code.

Commercial Law Developments and Trends for the 2000's, 17 J.L. & COM. 355, 357 (1998), for a similar argument about insolvency law.

¹¹ The Convention on International Interests in Mobile Equipment, 2001, has been signed by 26 nations as of June 2003.

¹² Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, 2002, *available at* <http://www.hcch.net> (last visited Mar. 26, 2004).

¹³ The Report of the UNIDROIT-Secretariat on the "Progressive Codification of the Law of the International Trade," in U.N. Comm'n on Int'l Trade Law, Y.B. I (1968-1970), at 285, 286, *available at* <http://www.uncitral.org> (last visited Mar. 26, 2004).

¹⁴ *Id.* at 286. It stated that the first task was to prepare a draft for the general section containing the basic principles that would form the foundations and the framework of the unification effort. The Report called for a combined effort from all institutions such as UNIDROIT, UNCITRAL, and UNCTAD, and emphasized the impelling need for developing principles and rules of international contract law which could serve as a reference point for the construction of contracts and international conventions without recourse to domestic laws.

Similarly, when the United Nations Commission on International Trade Law ("UNCITRAL") asked Professor Ulrich Drobnig of the Max Planck-Institute to prepare a study on the legal principles governing security interests in the various legal systems of the world,¹⁵ with a view to determining whether it would be possible to harmonize the law in that area, there was very little room for optimism.

After analyzing the law of nineteen nations, the study found that the differences in the treatment of secured credit were great.¹⁶ Thereafter, the report tried to make assessments to "help to consider the necessity or desirability of framing rules in this field on an international level, especially for the international movement of goods subject to security interests."¹⁷ Despite the vast differences in national laws, Drobnig was not optimistic about the possibility of creating a convention:

It would seem that international legislation in the form of a convention providing uniform rules of substantive and conflicts law is not appropriate in this case. As against international sales or international transportation or the international circulation of negotiable instruments, transnational incidence of security interests is as yet relatively moderate. It would probably be difficult to obtain sufficient government support for an international conference dealing with the relatively technical topic of security interests; and even if the text of an international instrument could be agreed upon, national parliaments would probably be slow and perhaps even reluctant to ratify such a text.¹⁸

¹⁵ See Report of the Secretary-General: Study on Security Interests, [1977] U.N. Doc. A/CN.9/131, P 4.2.1, at 218, reprinted in 8 Y.B. Int'l Trade L. 171, 218 (1977); [1977] U.N. Doc. A/CN.9/SER.A/1977.

¹⁶ *Id.*

¹⁷ *Id.* As part of these assessments, Professor Drobnig chronicled prior attempts to achieve some degree of international uniformity with respect to security interests. These attempts included: (1) a uniform conditional sales act enacted by three Scandinavian countries (Norway, Sweden, and Denmark) during 1915-1917; (2) the UNIDROIT draft provisions of 1939 and 1951 concerning the impact of reservation of title in the sale of certain goods; (3) provisions in the draft European Economic Community Bankruptcy Convention of 1970 regarding the effect in bankruptcy of reservation of title in the sale of goods; and (4) model reservation of title clauses contained in several "General Conditions" elaborated by the United Nations Economic Commission for Europe. See *id.* at 210-211.

¹⁸ See Report of the Secretary-General: Study on Security Interests, *supra* note 15. This was despite the fact that there were proposals for the harmonization of secured credit law that had been submitted to the Council of Europe, made by UNIDROIT in 1968, and by the Service de Recherches Juridiques Comparatives of the Centre National Recherche Scientifique of Paris in 1972. These proposals put forth a range of possible unification efforts, including that of creating a uniform security interest for international cases. Professor Drobnig also noted the existence of a proposal to the European Community for the establishment of a central register for security interests. Professor Drobnig also took a negative view towards developing recommendations for nations to adopt rules that would promote uniformity: "Mere recommendations, even if emanating from an international organization of the highest repute, will not command sufficient moral or other support for adoption by any sizable number of States." *Id.* ¶ 4.2.3.

Drobnig's words would prove prophetic at least with respect to Model Laws: "Perhaps moral persuasion or intellectual insight into the virtues of the model rules will move some States to adopt them. Others may need persuasion by more effective means such as insistence on the part of international financing institutions."¹⁹ The imperatives of modern international commerce have in fact pushed these very areas of the law, once thought to be beyond the pale of harmonization, to the very fore front.

1.2. The Harmonization Process Explained

This section deals with the motivations for harmonization, and impetus thereto. It is clear that there is a distinct difference between harmonization endeavors that have followed the end of the cold war and those that occurred during or before its advent. This paper is not overly concerned with harmonization endeavors during and prior to the cold war, except in so far as they hold lessons for current efforts. One instrument which may hold such lessons is the Vienna Convention on the International Sale of Goods, 1980.²⁰ The reasons for dispensing with a detailed study of harmonization endeavors during and prior to the cold war are two fold: 1) much of the debate that characterized scholarship at the time was organized along ideological lines which have no relevance today; and 2) the extent of globalization that characterizes the modern world makes many of the concerns of the cold war era redundant. Thus, the harmonization of commercial law shall be studied from the perspective of factors that are in play in the modern world.

Perhaps the most important aspect of modern life is the idea that we live in a "global village." Although Professor Berger argues that "globalization" is an abstract term that has become a cliché rather than an idea with substantive content, he concedes that it has

¹⁹ *Id.* ¶ 4.2.2.

²⁰ The Convention has been ratified by sixty-three countries as of June 2004.

resulted in the “denationalization of the legal process.”²¹ He argues that because of the geopolitical and economic aspects of globalization at the beginning of the twenty-first century, associated with the decreasing significance of territoriality and the springing up of a "global civil society", a decentralized approach to law-making has become acceptable and even opens the door for the acceptance of the *lex mercatoria* as an autonomous legal order in international commerce.²² DiMatteo writes that “at the end of the twentieth century, globalization and the volume of international transactions has led to the idea of a new *lex mercatoria*,”²³ in no small measure because the continued development of international trade requires the internationalization of commercial law. Even if we do not accept the idea of a *lex mercatoria*, new or otherwise, it is impossible to deny that there is a great impetus to create international commercial law instruments. This is primarily because insularity is no longer possible as contacts with legal systems that are foreign are more common today than ever before.²⁴ Coevally, because of the similarity of transactions encountered across the legal system, problems encountered by lawyers in different countries are likely to have many similarities. To take just one example, that of the financing of aircraft, regardless of the airline involved, its lawyers will have to answer questions about registration requirements, the recording of security interests in the aircraft and its engines, the form that the transaction should take, among other things.²⁵ Similarly, creditors, regardless of the country they are from, are concerned primarily with the question as to how their interests can be protected in

²¹ Klaus Berger, *The New Law Merchant and the Global Market: A 21st Century View of Transnational Commercial Law*, INT. A.L.R. 3(4), 91, 98 (2000).

²² *Id.* at 100.

²³ Larry A. DiMatteo, *Reviewing the Historical and Practical Significance of the Principles of European Contract Law*, 43 HARV. INT'L L.J. 569, 570 (2002).

²⁴ Westbrook writes that more and more cases in United States bankruptcy courts have an important foreign connection—a resident alien debtor with assets in his country, or a foreign lender or a bondholder unfamiliar with the American law on bankruptcy. Jay Westbrook, *Creating International Insolvency Law*, 70 AM. BANKR. L.J. 563 (1996).

²⁵ Thatcher Stone, *In Flight Between Geneva and Rome: Abandoning Choice of Law Systems for Substantive Legal Principles in International Aircraft Finance*, 20 U. PA. J. INT'L ECON. L. 487, 490 (1999).

the event the debtor defaults in making payment.²⁶ This commonality of questions may provide the impetus for the pursuit of common solutions.

The move towards a global village brings with it several problems both for lawyers and legal systems. The former have to familiarize themselves with a vast array of legal systems to determine the legal position for issues raised by any given international transaction, while the latter has to evolve solutions for problems of an international nature. This is particularly difficult if the legal system in question has not encountered situations involving certain concepts before. One instance of this is the treatment of secured credit. Legal systems have widely varying attitudes towards secured credit. Even amongst those nations that have detailed secured credit laws, there are significant differences in the approach of civil law countries from that of the United States and even amongst each other.²⁷ Even in the European Union a recent study found that some security instruments for movable assets are unknown in some Member States and that in such cases the security interest fails if the secured goods are transferred across borders.²⁸ The study gave the example of the problems posed by the transfer of movable goods from Germany to Austria, and noted that the difficulties negatively affect the possibility of entering into cross-border leasing contracts.²⁹

Claps and McDonnell cite an Asian Development Bank Study which shows that private creditors in all countries—common law and civil law, industrial and transitional, north and south—worry primarily about repayment. According to the report, when the debtor offers collateral for a loan, private creditors offer larger loans, at lower interest rates, payable over longer periods of time. “Compared to a debtor who cannot offer good collateral, one with such collateral can anticipate receiving six to eight times more credit, taking two to ten times longer for repayment, and paying interest rates 30 percent to 50 percent lower.” See Guillermo A. Moglia Claps & Julian B. McDonnell, *Secured Credit and Insolvency Law in Argentina and the U.S.: Gaining Insight From a Comparative Perspective*, 30 GA. J. INT’L & COMP. L. 393, 399 n.19 (2002).

²⁷ Neil Cohen, *Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience*, 20 U. PA. J. INT’L ECON. L. 423, 431 (1999).

²⁸ Communication from the Commission to the European Parliament and the Council, A More Coherent European Contract Law: An Action Plan, 2003 O.J. (C 63) 14.

²⁹ *Id.*

The legal systems in developing countries do not have an adequate legal regime in place, and frequently do not accord enough importance to secured transactions law.³⁰ This may be explained in part by the fact that unfamiliarity with modern financing techniques has resulted in a lack of appreciation of the benefits of good secured credit laws. While this is the case, parties from these countries are unable to derive the full benefits of globalization, hamstrung as they are by the underdevelopment of their legal systems. This asymmetry in participation is a serious problem, and one that can easily be corrected by harmonization. The sheer extent and potential volume of international trade justifies the investment in harmonization for these countries.

1.2.1. Harmonization defined

While it is possible to get an intuitive idea as to nature of harmonization in the commercial law area, it may be useful to consider some definitions. Ziegel writes that “Harmonization in this field of law is a word with considerable elasticity. In its most complete sense it means absolute uniformity of legislation among the adopting jurisdictions.”³¹ According to Leebron, “Harmonization can be loosely defined as making the regulatory requirements or government policies of different jurisdictions identical or at least more similar.”³² Harmonization has also been described as an attempt to reduce the differences among national laws.³³ Glenn writes that the harmonization process is an evolutionary process that results in ever “greater levels of uniformity and correspondingly greater levels of supranational governance.”³⁴ According to Zamora,

³⁰ Cohen, *supra* note 27, at 432.

³¹ Jacob Ziegel, *Harmonization of Private Laws in Federal Systems of Government: Canada, the USA, and Australia*, in *MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE* 133 (Ross Cranston ed., 1997).

³² David Leebron, *Claims for Harmonization: A Theoretical Framework*, 27 *CAN. BUS. L.J.* 63, 66 (1996). He also argues that “the term “harmonization” is something of a misnomer insofar as it might be regarded as deriving from the musical notion of harmony, for it is difference, not sameness, that makes for musical harmony.” *Id.* at 67.

³³ ALI/UNIDROIT Draft Principles of Transnational Civil Procedure with Comments, *supra* note 10.

³⁴ H. Patrick Glenn, *Harmony of Laws in the Americas*, 34 *U. MIAMI INTER-AM. L. REV.* 223, 246 (2003).

Harmonization does not entail the adoption of a single, model set of rules, but instead implies a wide range of ways in which differences in legal concepts in different jurisdictions are accommodated. This accommodation can take place in many ways: by a process of law reform in one or more countries, reflecting influences beyond the jurisdiction's borders; by the mediation of private law concepts adopted by parties caught between two legal systems; or by a myriad of other contact points between legal regimes, from academic writings, the conceits of law professors, to visits by government officials to neighboring countries.³⁵

In his opinion, "harmonization should not be confused with unification of laws, or with the imposition of one legal model on all jurisdictions."³⁶ For Professor Boodman, "in a legal context harmonization is merely synonymous with the process of problem solving and is as infinite in its configurations as are potential problems in law."³⁷ According to Professor Goode, harmonization has two distinct objectives.³⁸ The first is to create a special regime for international transactions while retaining national laws for purely domestic transactions. The second is to facilitate a common market or political or economic grouping by harmonizing the national laws governing domestic transactions, so that state boundaries do not affect commerce within the grouping. Thus he draws a distinction between endeavors like the Vienna Convention, and the EEC Directive on Consumer Credit, based on their motivations.

While each of these definitions is debatable, it would suffice for the purposes of this paper to formulate a working definition of harmonization in the field of international commercial law: any attempt, by whatever instrument (international convention, model laws, restatements, model contracts, standard form contracts, codes of practice, or usages) to minimize or eliminate discord between national commercial laws as they apply to

³⁵ Stephen Zamora, *NAFTA And The Harmonization Of Domestic Legal Systems: The Side Effects Of Free Trade*, 12 ARIZ. J. INT'L & COMP. LAW 401, 403 (1995). According to him, the harmonization of law in an inter-jurisdictional and international transaction context is value neutral and cannot be justified in and of itself. Harmonization of any legal domain especially by "legislative reform requires specific justification as to the desirability of harmonization and model upon which it is based. The justification cannot be found in any attribute of harmonization." He recognized that due to the increasing contacts between citizens of different countries, the trend towards harmonization and accommodation of legal differences is likely to continue. *Id.* at 404-405.

³⁶ *Id.*

³⁷ Martin Boodman, *The Myth of Harmonization of Laws*, 39 AM. J. COMP. L. 699, 707 (1991).

³⁸ See Roy Goode, *Reflections on the Harmonization of Commercial Law*, in COMMERCIAL AND CONSUMER LAW: NATIONAL AND INTERNATIONAL DIMENSIONS 3-27 (Ross Cranston & Roy Goode eds., 1993).

international commercial transactions. That is the operating definition for this paper and must be borne in mind as the analysis progresses.

1.2.2. Historical context

Harmonization is not a new invention. Perhaps the clearest examples of formal harmonization in modern legal history have been the European national codifications of the 19th and 20th centuries.³⁹ These attempts may be better categorized as unification.⁴⁰ Thereafter, the growth of nationalism, and the corresponding nationalization of law in Europe accentuated European diversity. National laws emerged in many languages and in a variety of different forms. For instance, Germanic codes were very different from the codes of the other countries.⁴¹ Although the civil and common laws grew side-by-side, they diverged to such an extent that the differences were seen as insurmountable. While this may have been a mere European problem, and hence of little importance to the rest of the world, the impact of colonialism meant that the world's legal systems were divided along civil law and common law lines. Colonialism brought about a peculiar kind of harmonization with the colony acquiring laws based on those enacted in the mother country. In the nineteenth century, for example, French law was diffused through all continents via the French colonies.⁴² Likewise, English law dominated North America, Asia, Australia, and parts of Africa. It is true to say that most countries derived their current formal legal order from Europe during the nineteenth century and the early twentieth centuries. Despite the death of colonialism and the independence of the former colonies, however, most countries continue to retain the core

³⁹ See Glenn, *supra* note 34. The French pioneered the first comprehensive national civil, commercial and criminal codes between 1804 and 1811. The Napoleonic codes consolidated legislation operating before the French revolution and codified existing business practice in a systematic manner. Glenn points out that the other major codification of the nineteenth century was the German civil code which had been preceded by commercial, criminal, civil and criminal procedure codes. See also Daniel Berkowitz, *The Transplant Effect*, 51 AM. J. COMP. L. 163, 172 (2003)

⁴⁰ See *id.* at 225.

⁴¹ Daniel Berkowitz, *The Transplant Effect*, 51 AM.J. COMP. L. 163, 173 (2003).

⁴² Rodolfo Sacco, *One Hundred Years of Comparative Law*, 75 TUL. L. REV. 1159, 1161 (2001)

characteristics of the legal system they had received from their colonizers. One notable exception is the U.S., where the law has proceeded to develop independent of English law.⁴³

Harmonization under colonialism is not to be confused with modern notions of harmonization which are based on respect for all legal systems. Colonial harmonization disregarded indigenous legal systems and imposed the colonizers' law against the consent of the local populace.⁴⁴ In many cases, this kind of harmonization crept into the colonies slowly. At first, the transplanted European law applied only to the European population, while local people continued to be governed by local laws and customs. Criminal, tax, and administrative law were applied to the natives. However, in family, inheritance, and also commercial matters amongst themselves, municipal law prevailed. This was the practice in many English colonies, including India, and the jurisdiction of common law courts was only extended over time.⁴⁵ This brief historical context only serves to distinguish modern harmonization from its colonial counterpart, and to free it of any political taint. In the modern era, there is vigorous participation in the creation of international commercial law from all countries and, in many cases, such participation offers the opportunity to dispose of colonial laws.

2. Arguments for Engaging in the Process

Although it may seem that harmonization has innate intuitive virtues, it is important to understand the arguments advanced by its proponents. There is no consensus that indicates overwhelming appeal, and each argument must be individually examined and evaluated. This paper contains a brief analysis of the main arguments.

⁴³ See Berkowitz, *supra* note 39, at 174.

⁴⁴ Legal systems that were well developed included Hindu law, Islamic law and Chinese law.

⁴⁵ It was only after the British government took over control from the East India Company in 1858 that the general jurisdiction of the common law was established. Courts were created with the Privy Council as the highest court of resort. English common law was also codified which greatly accelerated the application of the common law to India and later to other parts of the empire.

2.1. Divergent national laws cause problems

Some scholars have argued that the mere existence of different national laws is a reason to engage in the harmonization process.⁴⁶ According to Ansel, “the disparity of national laws is contrary to the requirements of [the] modern economy and inimical to the development of international relations; a uniform law is superior to a system of conflicts of law, which allows the existence of those specific differences on which it is based.”⁴⁷ Ansel equates the diversity in national laws to diversity of local customs within a single country, and argues that it is undesirable because it “compromises the soundness, the general value, and the supremacy of the law.”⁴⁸ In his view, this diversity provokes stress, the elimination of which is imperative. It is difficult to agree with this extreme view.

Professor Stephan points out that divergences in national laws may cause “legal risk.”⁴⁹ In his view, such legal risk can encourage opportunism by commercial parties who may, for instance, race to litigate, in a forum that will suit their interests in case something goes wrong with the transaction.⁵⁰ One of the pitfalls of the existence of “legal risk” is that at the dividing line between risky and non-risky transactions many parties may desist from commercial activity.⁵¹ Accordingly, there may be merit in reducing “legal risk” to foster commerce.⁵²

Mere diversity in national laws is no reason to engage in the harmonization process. National laws are founded on different policy assumptions and there is no reason to eliminate differences that stem from them unless they impede international commerce. Where

⁴⁶ Marc Ansel, *From the Unification of Law to its Harmonization*, 51 TUL. L. REV. 108 (1976).

⁴⁷ *Id.*

⁴⁸ *Id.* at 110.

⁴⁹ Paul Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743, 746 (1999).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

differences in national commercial laws are an impediment, harmonization can facilitate an “interface” that helps parties across the divide conduct business.⁵³ In situations where differences in national laws are not material to the conduct of international commerce, there is little reason to create uniform law. It is important to emphasize this—in the absence of strong reason uniform laws stand very little chance of adoption and will result in wasted resources. Uniformity has very little innate value in this area, and has appeal only insofar as it eliminates or minimizes hurdles caused by disparity.

That divergent national laws are an impediment to international commerce was well demonstrated in the European context by the European Commission’s consultation exercise undertaken in 2001.⁵⁴ The joint response prepared by the Commission on European Contract Law (CECL), and the Study Group on European Civil Code (hereinafter referred to as the “Joint Response”), as expert a body on the state of European law as is likely to be found anywhere, painted a good picture of the difficulties posed even in a small economic region by disparities. The Joint Response was clear about the fact that there was diversity: “Contract laws across the EU show significant diversity on many fundamental points. Businesses cannot safely trade under the private law of another Member State in the supposition that it will be similarly to their own. The impossibility within reasonable conditions for participants in the internal market to acquire essential knowledge about foreign law always entails the danger of substantial loss of claims or unsuspected liabilities.”⁵⁵

They opined that differences between the contract laws of the Member States can have negative repercussions for participants in the internal market in at least four ways. First, they thought that differences effectively prevent certain kinds of commercial activity in the European market. Second, the Joint Response pointed out that the differences impose

⁵³ See Leebron, *supra* note 32, at 75.

⁵⁴ Communication on European Contract Law: Joint Response of the Commission on European Contract Law and the Study Group on a European Civil Code, 10 EUR. REV. PRIVATE L. 183 (2002).

⁵⁵ *Id.* ¶ 9.

additional costs because of the need to acquire knowledge about foreign law. These costs are either borne by businesses or, where possible, are passed on to consumers. If the costs are considerable, a business may decide that it would not be worth entering into international deals and may choose to forego otherwise profitable economic activity. This can also adversely affect competition in the common market. Third, the differences may mean that legal relationships are entered into without a proper understanding of the legal consequences. They point out that businesses do not always take into account the many peculiarities of foreign contract law, and are taken by surprise when rules of private international law come into play.⁵⁶ Fourth, the fear of adverse legal consequences in a foreign country may motivate businesses to not risk international trade. This may apply with great force to deter small or medium-sized enterprises (SMEs) which cannot bear the legal costs.

The Joint Response points out that in view of the many profound differences between the contract laws in the Member States such a concern can often be justified. Even if the fear is unfounded, it can still deter businesses from engaging in trade.⁵⁷ Further, in their experience, “it is difficult and often impractical for parties entering into agreements or already bound by contracts to obtain cost-effective information about foreign law relevant to rights and liabilities under transactions they are contemplating or have entered into. The problems are particularly acute in the area of the law of obligations and property law because even in many of the legal systems where this area of the law has been codified the legislation is relatively old and its meaning cannot be established without grasping the significance of

⁵⁶ “This difficulty in finding essential information about foreign law on a cost-effective basis creates the very real danger that participants in the European market will trade on the basis of false assumptions as to their legal position or be dissuaded from commercial activity because of the legal uncertainties involved.” *Id.*

⁵⁷ “The fact that substantially the same legal wine may be found in different shaped bottles as business activity moves from jurisdiction to jurisdiction is not enough to create the right environment for business in a continental market; apparent differences can be as damaging to confidence as real ones.” *Id.*

much judicial interpretation of its provisions. In relative terms the law is less apparent and more difficult to ascertain with assurance of its correctness.”⁵⁸

They concluded that there were substantial increases in costs for market participants that spring from the diversity both of mandatory contract law rules, and of dispositive contract law rules.⁵⁹ The parties also stood to incur additional costs if a legal dispute arose requiring them to take recourse to the courts. In the opinion of the authors, litigation in cases that invoke foreign law is particularly expensive, since foreign legal opinion has to be obtained, witnesses may have to be prepared, and so forth. Although the authors did not undertake any empirical study to assess the magnitude of any of these costs, they felt that it was a safe assumption, supported by anecdotal evidence, that significant cost is incurred in these situations. Furthermore, they also believed that private international law does not solve that problem.

The Joint Response also addressed the diversity of legal regimes that arises when some Member States sign an international convention and others do not. As is obvious, this results in harmonization for the signatory countries, but as regards the non signatories, within the EU it results in fresh legal diversity. The answer is simple – the non-signatories can accede to the convention, or the EU as a whole can enter into the convention. The authors wanted a coordinated approach of the international policy of Member States in signing, ratifying and implementing international agreements unifying private law, and thought that Member States should sign such conventions en bloc. One example of this is article 3 of Council Decision of 19th February 2002, authorizing Member States, in the interest of the Community to sign or ratify the 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage. This approach has great merit, would increase the number of signatories, and would be welcomed whole-heartedly by the harmonizing agencies.

⁵⁸ *Id.* ¶ 9.

⁵⁹ *Id.* ¶ 10.

In contrast to their counterparts in America, the authors were convinced that divergent contract law makes it impossible to engage effectively in Europe, and that businesses which do so are often burdened by costs which are either superfluous or unforeseeable. Furthermore, “risks of liability are extraordinarily difficult to gauge; often they are simply absorbed and may make business unprofitable or loss-making.”⁶⁰ From the Joint Response one gets the impression that very little trade takes place because of these problems. However, this is not so, as proven by the sheer magnitude of trade in the EU. The correct interpretation is perhaps that trade is conducted despite these great differences between the laws, and by incurring the costs that such differences impose. The elimination of these costs will immediately reduce legal costs and improve profit margins.

2.2. National laws may be inadequate for international transactions

There are situations in which national laws do not meet the demands of international commerce. This is not so much because of differences in solutions afforded by the different national laws that may come into play in relation to any given transaction, as it is due to the innate limitations of national laws as they apply to international transactions.⁶¹ As Rene David colorfully put it, the use of domestic tools to solve questions that are essentially international "is to square the circle."⁶²

⁶⁰ *Id.*

⁶¹ To quote the colorful words of Professor Goode, “The time has long passed when domestic legislation shaped for internal trade can provide sensible solutions to the problems of internal commerce...there may be substantial advantages in uniform law within a restricted field. The parties are able to sing from the same hymn sheet, to become familiar with the text, to read it in their own language, and to reduce their dependency on local experts in every jurisdiction in which they transact business.” Roy Goode, *Insularity or Leadership? The Role of the United Kingdom in the Harmonization of Commercial Law*, 50 INT’L & COMP. L.Q. 751, 752 (2001).

⁶² Rene David, *The International Unification of Private Law*, in 2 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, ch. 5, 7 (1969), reprinted in Friedrich Juenger, *Conflict of Laws, Comparative Law and Civil Law: The Lex Mercatoria and Private International Law*, 60 LA. L. REV. 1133, 1139 (2000). Juenger also quotes the Uruguayan private international law scholar Quint Alfons who believed that the domestic law of a state is designed to serve the needs of its society and cannot be applied in international transactions.

One glaring instance of this is the area of security interests in mobile equipment. Because of their very nature, mobile equipment will not be confined to any one jurisdiction, and it would be difficult, if not impossible, to keep track of the various security interests they may be subject to in the absence of an international register that records these interests. No single national law can create such an international register. In the absence of such an international register, parties will be forced to conduct searches in various national registries (where they exist) to determine issues of priority, and even then may not be adequately protected. This is a clear example of the need for an international solution.

2.3. Modernization and facilitation of international trade

This function of harmonization has long been neglected. UNCITRAL, founded in 1966 with a mandate to further the harmonization of the law of international trade, was motivated by the:

belief that the progressive harmonization and unification of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would contribute significantly to universal economic cooperation among all States on a basis of equality, equity and common interest and to the elimination of discrimination in international trade and, thereby, to the well-being of all peoples.⁶³

Due to the paralysis of the Cold War years, this has not assumed the importance it deserves.

In the current global environment, this is a very powerful motivation for harmonization. This is especially true for countries that are moving from planned or mixed economies to a free market economy. Such a movement inevitably requires legal reform that facilitates free enterprise. While these nations may see the need to reform their laws, that may be easier said than done due to the absence of expertise of law as it works in a free

⁶³ See Report of the UNCITRAL on the work of its thirty-fifth session, January 21, 2003, A/Res/57/17 available at <http://www.uncitral.org> (last visited Mar. 26, 2004).

market. One way out of this conundrum might be to copy the laws of a country or countries that have a free market.

This is a common practice. Legislators frequently and unwittingly bring about harmonization through the process of copying. Drafters in various countries examine laws in other countries and seek to implement them at home by copying from foreign legislations.⁶⁴ Professor Glenn points out that Mexico created a law for non-possessory security interests in moveable property that is substantially based on the laws of the U.S. and Canada.⁶⁵ The Chilean legislature has similarly borrowed from Quebec.⁶⁶

In the process of copying, legislators even seek to improve the foreign law by making changes.⁶⁷ The advantage may be that the legislator has a whole array of domestic laws to choose from and can choose the best law. Glenn calls this “legislative transnationalization.”⁶⁸ Although at first blush this looks like a process of unintended harmonization, in fact it is not so. The copying legislature is free to make whatever changes it deems fit, and harmony is lost as another version of the law springs up adding to the diversity. Even if the copy is identical, this kind of harmonization can at best be fragmented.

Copying is not an adequate solution for many reasons. First, the law of that country or countries may itself be crying out for reform. Second, the copying of another country's law results in an absence of participation in the legislative drafting process. In copying another country's law, there will also be the unnecessary copying of the political, financial, and interest group compromises that resulted in the adoption of that law. This baggage is not only unnecessary, but is also undesirable. Harmonization may provide the answer. It provides these nations with ready to adopt legal instruments that reflect the requirements of

⁶⁴ Glenn, *supra* note 34, at 242.

⁶⁵ *Id.* at 242.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* According to Glenn, the process of “legislative transnationalization” can be aided by the creation of Model Laws. In his view, this would at least provide a unity at the starting point as states would only diverge for good reason.

international commerce, while nevertheless allowing them to participate in the formulation of the instrument. The problem of many nations not possessing the expertise required to craft legal instruments on their own,⁶⁹ is also alleviated to some extent. The harmonization process allows them to draw upon a wealth of international expertise and build a body of scholarship for their own countries.

One recent example of modernization as a motivation for harmonization is the case of aircraft financing. With the enormous growth in civil aviation, demand for aircraft has skyrocketed. This is especially true in developing countries that did not have an extensive aviation industry even a decade ago. A concomitant development has been the privatization of many national carriers, with the result that these new private operators have to fend for themselves in obtaining financing. The law has been left behind and in the absence of a law that protects creditors' interests, the extension of credit to finance aircraft acquisitions is difficult.⁷⁰ The law has a direct impact on the availability of financing. The UNIDROIT Convention on International Interests in Mobile Equipment, 2001, and its Aircraft Protocol were adopted with a view to achieve this direct impact and countries with deficient legal regimes have a good reason to adopt it.⁷¹ The sheer proliferation in attempts to harmonize and hence modernize the law on secured credit is an eye-opener to the importance of harmonization; while the European Bank for Reconstruction and Development (EBRD) has

⁶⁹ Farnsworth notes that smaller and poorer countries often are unable to field experts even for meetings. While this may be because these countries do not consider a particular harmonization endeavour to be of sufficient political significance to justify the costs involved in sending experts to meetings, it is nevertheless a pointer to the disparity in distribution of expertise amongst nations. See Allan Farnsworth, *Unification and Harmonization of Private Law*, 27 CAN. BUS. L.J. 48, 59 (1996).

⁷⁰ See Terena Penteadro Rodrigues, *International Regulation of Interests in Aircraft: The Brazilian Reality and the UNIDROIT Proposal*, 65 J. AIR L. & COM. 279, 281 (2000). One indicia of the growth in the aircraft sector can be seen by the fact that over the next twenty years; Airbus Industrie and Boeing Company estimate a total delivery of 30,650 aircraft. See David Clancy & Gregory Voss, *Facilitating Asset-Based Financing and Leasing of Aircraft Equipment Through The Proposed UNIDROIT Convention: Manufacturers' Perspective*, 23 AIR & SPACE LAW 288 (1998).

⁷¹ *Id.*

spearheaded such attempts in Eastern Europe,⁷² in Asia it is under the umbrella of the Asian Development Bank (ADB).⁷³ The Organization of American States (OAS) has crafted a Model Inter-America Law on Secured Transactions, for Latin America.⁷⁴ This is vigorous activity by any standards.⁷⁵ It is a sure sign of the persuasiveness of harmonization as a tool for modernization, given the reality that the law of credit is directly related to the freeing up of markets and the expansion of trade.

An illustration of harmonization's modernization function can be seen in the Mexican experience with regard to secured transactions law. Before the enactment of the New Secured Transactions Law, Mexico's outdated law did not serve the purpose for which it was designed.⁷⁶ There were a number of security mechanisms and this caused confusion. There was no concept of a uniform security interest and the existence of this menu of instruments was a severe obstacle to the extension of credit. Even if credit was extended, litigation was rampant. Observers claimed that the reluctance of foreign entities to lend in Mexico was a

⁷² In 1993, the European Bank for Reconstruction and Development published a Model Law on Secured Transactions, designed to be a guide those states of Central and Eastern Europe that were interested in modernizing their securities and financial laws. It was also meant to spur harmonization of the law among these states. In the words of its drafters, the "principle which has guided the drafting of the Model Law has been to produce a text which is compatible with the civil law concepts which underlie many Central and Eastern European legal systems, and at the same time, to draw on common law systems which have developed many useful solutions to accommodate modern financing techniques." European Bank for Reconstruction and Development, *An Introduction to the European Bank's Model Law on Secured Transactions*, available at <http://www.ebrd.com/country/sector/law/st/modellaw/modlaw0.html> (last visited May 29, 2004).

⁷³ Guillermo A. Moglia Claps & Julian B. McDonnell, *supra* note 26, at 398.

⁷⁴ *Id.* at 399.

⁷⁵ This could be explained by Professor Goode's view that "Without an adequate legal regime for personal property security rights, it is almost impossible for a national economy to develop. Indeed, the World Bank considers the role of security so central in promoting economic growth that before making a loan to a developing country it will normally seek to establish to what extent a sound legal system for the creation and protection of security interests is or will be in place." He notes the impetus as stemming from the growth of the private sector in countries that had a predominant public sector, with the result that sovereign risk has been converted to enterprise risk, the growth in asset-based financing of high value equipment, the evolution of multinational syndicates to finance loans that are too large to be handled by the banks of any one country; the fact that collateral extended by multinational companies may not be in just one country, the growth of securitization, and the globalization of securities markets. See Roy E. Goode, *Security in Cross-Border Transactions*, 33 TEX. INT'L L.J. 47 (1998).

⁷⁶ Hale Sheppard, *Overcoming Apathetic Internationalism To Generate Hemispheric Benefits: Analysis Of And Arguments For Recent Secured Transactions Laws In Mexico*, 10 J. TRANSNAT'L L. & POL'Y 133 (2001). See also Boris Kozolchik, *What To Do About Mexico's Antiquated Secured Financing Law*, 12 ARIZ. J. INT'L & COMP. L. 523, 526-28 (1995).

foregone conclusion in light of such pervasive legal confusion.⁷⁷ According to Sheppard, “the overwhelming majority of small and mid-size businesses failed to obtain credit at a reasonable cost because they did not possess land, the only collateral acceptable to skeptical lenders.”⁷⁸ Mexican businesses were required to provide cash or property located in the United States as collateral before they were extended loans. If collateral was not available, “then the ability of a Mexican company to obtain credit [was] severely limited because of concerns by U.S. banks as to their ability to obtain enforceable security interests in Mexico.”⁷⁹ U.S. lenders were reluctant to extend credit to Mexican entities.⁸⁰ Professor Sheppard cites experts who state that “[t]here are numerous lenders in the United States and elsewhere who would like to come into Mexico to do business if the Mexican laws were more supportive to the lenders.”⁸¹ He also quotes other experts who claim that the legal deficiencies in terms of secured lending actually contradicted the spirit of NAFTA. Although the trade agreement allowed U.S. and Canadian institutions to take part in lending transactions in Mexico, “they are constantly rejecting otherwise viable requests for loans from Mexican companies because of the inability to create security interests in assets located in Mexico.”⁸²

The New Secured Transactions law is based on Article 9 of the UCC. The law is a kind of harmonization achieved by borrowing, and has served to modernize Mexico’s secured transaction laws. The experience with regard to secured transactions law is as good a case for the need for harmonization brought about by market forces as there is ever likely to be. There is virtually a consensus in opinion that a modern secured credit law is a *sine qua non*

⁷⁷ Todd C. Nelson, *Receivables Financing to Mexican Borrowers: Perfection of Article 9 Security Interests in Cross-Border Accounts*, 29 U. MIAMI INTER-AM. L. REV. 525, 546 (1998).

⁷⁸ *Supra* note 76, at 146.

⁷⁹ *See id.*

⁸⁰ Sheppard, *supra* note 76, at 176.

⁸¹ *Id.* at 175.

⁸² *Id.*

for the availability and the lowering of the cost of credit.⁸³ With credit being the life-blood of commerce, the flow-through benefits for international trade from harmonization are obvious. There is also a redistributive function to harmonization here – no less a body than UNCITRAL believes that “modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and those in developing countries, with the resultant improvement in the share of developing countries in the fruits of international commerce.”⁸⁴ Accordingly, modernization will not only be of legal systems, but also of other aspects of life, impacted as they are by the ability to afford high value equipment due to the extension of credit.

Harmonization serves the modernization function from a general systemic standpoint, too. Historically, the legal systems in developing countries have been criticized for numerous reasons. Their legal institutions are often congested, poor, corrupt, and in general, incapable of adequately performing the functions for which they exist. The legal systems are characterized by uncertainty derived from the ambiguity of the laws which is compounded by uncertain interpretation by the courts. Many of these problems are endemic to legal systems throughout the developing world. They are all characterized by insufficient resources to support courts and judges, inefficient and corrupt dispute resolution procedures, convoluted procedural laws, and outdated substantive laws. There may also be systemic inefficiencies

⁸³ UNCITRAL, Draft Legislative Guide on Secured Transactions, U.N. Doc. A/CN.9/WG.VI/WP.9, available at <http://www.uncitral.org/en-index.htm> (last visited Apr. 1, 2004). UNCITRAL noted that deficiencies in the law in this area could have major negative effects on a country’s economic and financial system, and observed that:

an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist the banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.

Id. ¶ 2.

⁸⁴ *Id.* ¶ 1. They cautioned, however, that “such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States.” *Id.*

that have crept in as a result of these factors, exacerbated by a lack of critical study and impetus to change. Almost without exception these legal systems are thought to need a thorough overhaul to bring them in line with modern requirements. There can be no better solution than harmonization, in any of its myriad forms, to achieve this modernization at a systemic level. It would be impossible for any system to acquire the knowledge and resources to take corrective action alone. Harmonization places the whole world's resources at the developing world's disposal, in terms of its intellectual capital, and would also carry with it the legitimacy afforded to it by the reputations of the world's foremost experts.

2.4. Reducing costs

Requirements imposed by various national legal systems can be extremely costly to business. These can range from the bare cost of legal advice to costs imposed by the law's inadequacy for international commerce. One illustration of the latter is easily discernible in the instance of the law regarding the extension of credit. The unpredictability and uncertainty caused by differing treatment by national laws will necessarily affect credit cost. As uncertainty increases, risk increases, and this risk is passed on to the debtor in the form of higher credit cost. In international transactions, this uncertainty appears at the very outset in the form of the uncertainty as to the applicable law governing the transaction. Even once the applicable law is determined, parties have to educate themselves about their rights and obligations under that law. There is, then, the substantive problem that the applicable law may not be creditor-friendly. For example, the creditor may not be able to repossess the assets in the event that the debtor defaults in making payment. In these circumstances, the existence of a single instrument that governs all aspects of the transaction can play a major

role in reducing risk, and thereby reducing costs, thus leading to a better use of resources.⁸⁵

Because the harmonized law subjects a transnational commercial transaction to a single set of rules, it reduces the legal costs associated with the transaction.⁸⁶

2.5. Providing a neutral choice of law

Parties in international commercial transactions may be loath to disavow reliance on their own laws, particularly when they happen to be government entities. This is quite logical given that they know their own legal systems best. There is also the fact that government entities may view the subjection of the contract to another national law as an affront to their sovereignty and prestige. This can result in a stalemate if both parties take the same position. This sort of situation is not uncommon and in many such cases the contract is subjected to vague notions such as “the general principles of law.” Professor Berger gives the example of two arbitral cases of this sort, where the contracts stated that they were subject to “Anglosaxon principles of law” and the “principles of natural justice.”⁸⁷ In such circumstances, the harmonized law can provide a way out of the impasse by allowing them to rely on a neutral law to govern the transaction, without requiring a compromise from either party. In the cases, the arbitrators applied the UNIDROIT Principles, trade usages, and the parties’ national laws, as a synthesized law that governed the contract.⁸⁸ In the Eurotunnel arbitration, the arbitrators and parties again applied the UNIDROIT Principles when the choice of law clause stated that:

⁸⁵ See Anthony Saunders et al., *The Economic Implications of International Secured Transactions Law Reform: A Case Study*, 20 U. PA. J. INT’L ECON. L. 309 (1999) (proclaiming advantages of UNIDROIT Convention on Mobile Equipment and Its Aircraft Protocol).

⁸⁶ Steven Walt, *Novelty And The Risks Of Uniform Sales Law*, 39 VA. J. INT’L L. 671, 672 (1999). He points out that uniform law is a mixed blessing for three reasons: (1) uniform law can increase the impact of inefficient rules; (2) despite uniformity there is the risk of differences in implementation; and (3) novelty in uniform law risks uncertainty in what the legal rule itself requires.

⁸⁷ Klaus Berger, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, 46 AM. J. COMP. L. 129, 143.

⁸⁸ *Id.*

[t]he construction, validity and performance of the contract shall in all respects be governed by and interpreted in accordance with the principles common to both English and French law, and in the absence of such common principles by such general principles of international trade law as have been applied by national and international tribunals. Subject in all cases, with respect to the works to be respectively performed in the French and in the English part of the site, to the respective French or English public policy (*ordre public*) provisions.⁸⁹

Although neutrality of choice as a reason is not as persuasive as it used to be for the creation of international conventions, it is significant that the Vienna Convention on the International Sale of Goods, 1980, met with much success, with neutrality as a major reason for adoption. Concerns of neutrality can only find more favor as international arbitration grows.

3. Arguments against Engaging in the Process of Harmonization

Not everyone is convinced that harmonization is desirable.⁹⁰ In recent years, there has been criticism both of the need for and the methods employed by harmonizing agencies.⁹¹ It has been argued that many of the products of harmonization endeavors were unnecessary, and in fact are detrimental to international commerce.⁹² Although Professor Stephan concedes that the reduction of “legal risk” may foster commerce, he argues that such a reduction is not without a cost.⁹³ He gives the example of a rule which voids all late deliveries, and has the virtue of certainty, but which may be less preferable to an ambiguous rule that recognizes extenuating circumstances.⁹⁴ This is a rather simplistic view of the harmonization process. Harmonization does not aim to provide a mechanical lowering of risk. In its pursuit of the best solution, it will take on board principles that might optimize risk, rather than its elimination.

⁸⁹ *Id.* at 144.

⁹⁰ “Many harmonization claims must be met with skepticism for it is unclear whether harmonization is the best solution to the underlying problem, and even if it is, it may impose unacceptable costs.” Leebron, *supra* note 32, at 64 (1996).

⁹¹ See J.S. Hobhouse, *International Conventions and Commercial Law: The Pursuit of Uniformity*, 106 LAW Q. REV. 530, 531 (1990).

⁹² Stephan, *supra* note 49, at 744 (1999).

⁹³ *Id.* at 747.

⁹⁴ *Id.* Stephan colorfully asserts that the taste for risk, like the taste for spicy food varies from person to person.

Stephan understandably takes a very dim view of the benefits of harmonization: “International unification instruments display a strong tendency either to compromise legal certainty or to advance the agendas of interest groups. In either case they offer no obvious gains as compared to rules produced through the national legislative process. In particular, we have no reason to expect these instruments to achieve substantial improvements in the law, if we may disregard what the interest groups get out of their adoption...And what reduction of legal risk the instruments achieve comes mostly, if not entirely, through conceding the field to specific interest groups, whether carriers, bankers, or other cohesive minorities.”⁹⁵ This conclusion will be examined in the light of some of the general criticisms considered below.

3.1. Diversity is a virtue

This school of thought holds that national laws are as much of a product as anything else and that because of the needs of international commerce, nations have an incentive to compete to craft the best law. According to them, harmonization acts as an impediment to innovation.⁹⁶ Daniels contends that it is not sufficient to assert that there are costs imposed by the diversity in national laws, but that it is necessary to show that these costs exceed the benefits.⁹⁷

This position follows from the belief that parties must have autonomy to choose whichever law they think is best to govern their transaction. This will result in countries competing to produce laws that may be more attractive. The fallacy in this line of thinking is manifest – it would result in a kind of perverse competition where some of the very fears

⁹⁵ *Id.* at 788.

⁹⁶ See R. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Market*, 36 MCGILL L.J. 130 (1991). Although Daniels’ criticisms are in the context of provinces in a federal structure, they apply in the international context as well. For a discussion of these criticisms, see Jacob Ziegel, *Harmonization of Private Laws in Federal Systems of Government: Canada, the USA, and Australia*, in MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE 136 (Ross Cranston ed., 1997).

⁹⁷ Daniels, *supra* note 96, at 140.

advanced by the skeptics, viz., dominance by powerful interest groups, magnified transaction risks, etc., are all heightened. Stephan and others advance the analogy of U.S. corporate laws, where different states have competed to attract companies to incorporate within their boundaries, dangling the carrot of better legal treatment.⁹⁸ This they argue has resulted in a race to the top with Delaware boasting the best climate for incorporation. This analogy wears thin when transplanted to the international context. First, corporate law is quite different from commercial law. The former, at least for the purposes of this argument, only concerns a voluntary choice to incorporate, and the obligations that flow from that are transparent. Commercial law brings problems that are not voluntarily subscribed to, and drags in third parties who may not know what the rules are. The other obvious difficulty is that it is impossible to compare states within the United States with poor countries. Most states would have greater resources than the majority of the nations of the world, and the kind of race to the top resulting from a move to create the “best law” is chimerical in the international context. Moreover, while it is true that some of the difficulties posed by different national laws in the international commercial context may be overcome by parties choosing the law that is to govern their transaction, this is not always the solution. This is particularly the case when third parties’ rights are involved. At its barest minimum, harmonization reduces transaction costs.⁹⁹ It reduces uncertainty and improves efficiency, which is more than can be said for the “competitive law-making” scenario.

There is also a systemic attack launched by Pistor which argues that instead of improving domestic legal systems, harmonization undermines the development of effective legal systems in developing countries.¹⁰⁰ Pistor’s thesis is based on the idea that legal rules are interdependent and that the transplanting of external rules, even though they may be best

⁹⁸ Stephan, *supra* note 92, at 790.

⁹⁹ Leebron, *supra* note 90, at 76.

¹⁰⁰ Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 98 (2002).

practices, sterilizes the process of lawmaking from political and socioeconomic development. Further, she contends that this also distances it from the process of continuous adaptation and innovation.¹⁰¹ Central to her argument is the idea that law is a living instrument that is contextual. Accordingly, the creation of law outside the domestic context deprives it of the organic quality of home-grown law. Pistor also points out problems with the distillation of the best legal rules from different legal systems without being tested in the laboratory of an actual system.¹⁰²

Another argument is that such rules may also be resisted in practice by courts and other institutions. She gives the example of the Vienna Convention on the International Sale of Goods to contend that in the few cases where courts have applied the Convention, both parties were apparently unaware that this Convention governed their transaction and that very frequently parties who realize that they might be subjected to it opt out of it by including a provision in the contract that explicitly denies the application of the CISG.¹⁰³

While it is true that law is a living instrument, her arguments lose much of their potency when one considers that most countries have laws that are part of the common law or civil law systems due to their imposition by colonial rule. Accordingly, the law has grown somewhat in tune in the former colonies, and the kind of harmonization that Pistor is talking about does not have the deleterious impact that she argues it does. Instead of stultifying organic growth, it can actually facilitate growth due the education function that harmonization serves to lawmakers.

3.2. Lack of representative capacity

¹⁰¹ *Id.*

¹⁰² *Id.* at 102.

¹⁰³ *Id.* According to Pistor, the reason for opting out is that the parties consider the uncertainties involved in interpretation of the new terms and concepts in the convention to be too high.

One of the criticisms against harmonization concerns the very nature of the bodies that play a role in this area. By their very nature, these agencies are bodies of experts, and cannot satisfy conventional democratic standards imposed on national legislatures. They are not accountable in the same way as are national bodies. Even more disturbingly, it is not clear if they are accountable at all, and if so to whom. This is an inherent weakness in the process.

Some check on the process and its legitimacy is provided by the simple fact that the harmonized law has to pass muster before national legislatures before they come into force. Once the legislature takes for consideration a harmonized instrument, it is no different from a piece of domestic legislation. Thus there is a kind of filtered accountability.

Criticism does exist that interest groups and lobbies may tilt the law in favor of themselves and those who are less powerful do not have much to say in the drafting process, with the result that, at least with international conventions, legislatures are saddled with a take-it-or-leave-it binary choice. Stephan asserts that the nature of the bodies that play a role in harmonization lead them to be unduly influenced by interest groups.¹⁰⁴ Critics of the Uniform Commercial Code (U.C.C.) have argued that Article 9 is creditor-centered because major financiers dominated the U.C.C. drafting process.¹⁰⁵ There is literature questioning the role of big banks, securities firms and major corporations in the U.C.C. drafting process.¹⁰⁶ Although there is some merit in this criticism, this is not unique to international law-making. Interest groups play a major role in the making of domestic laws as well, and one can only rely on the integrity of the legislators to ensure that laws reflect a balance of interests. It was

¹⁰⁴ Stephan, *supra* note 49, at 744.

¹⁰⁵ Guillermo A. Moglia Claps & Julian B. McDonnell, *supra* note 26, at 415. While noting that the UCC system accords primacy to the creditor's interest, they draw a contrast, to the "legal order" precautions which have the priority position in Argentine law, explained by the Argentinean imperative to prevent fraud, mistake or overreaching. This, according to them, could be because Argentina's current documentation requirements for registered pledges are heavily influenced by the perception that earlier legislation allowing registered pledges for agricultural machinery, crops and livestock was abused by creditors. This could be true of many other nations, in particular those which had a feudal and colonial history.

¹⁰⁶ *Id.*

difficult for smaller interest groups to be able to afford the resources required to participate effectively in international law-making. However, with the advance in modern technology, particularly the Internet, and telephone and video conferencing, the barriers have fallen significantly. One has only to look at the recent experience in the drafting of international conventions in the public law area to see the impact of non-governmental actors.¹⁰⁷

Thus this criticism must be met with skepticism, and in any event cannot be persuasive for the ceasing of harmonization efforts. At best, it can serve as criticism for improvement. Moreover, as Burman notes, in UNCITRAL, non-state actors have a role to play in the commercial law area. He does however observe that this is an area of tension as non-state actors believe that they should be as much involved with the formulation of law as sovereign states.¹⁰⁸

3.3. Inferiority of harmonized law

This is a more substantive concern, attacking the qualitative nature of the product of harmonization. The argument is that the national law is qualitatively superior.¹⁰⁹ Critics argue that by its very nature international draftsmanship requires compromises that severely enervate the resultant law.¹¹⁰ National sensibilities have to be balanced in order to obtain acceptability. The quest for uniformity uncovers the reality that where uniformity is not achieved, a “diplomatic uniformity” is sought to be hammered out, very often in clever guises.¹¹¹ One widely adopted tactic is that of a rule immediately emasculated by an equally

¹⁰⁷ This is particularly visible in the drafting of environmental conventions, and in the WTO process wherein NGOs have been included in the debate.

¹⁰⁸ Burman, *supra* note 10, at 362.

¹⁰⁹ To quote Professor Goode, once again, “there are those who consider that the English law in all its majesty is greatly superior to anything that could be devised at international level.” Goode, *supra* note 61, at 756.

¹¹⁰ See Hobhouse, *supra* note 91, at 533.

¹¹¹ See *id.* at 534 (arguing that uniformity achieved through diplomatic means, in practice, does not represent a freely chosen system of codes and ultimately interferes with parties’ contracts).

broad exception.¹¹² This was particularly true until the last decade when the divide between the common law and the civil law, and between capitalism and socialism, was pronounced. Such ideological concerns have given way to pragmatism and law makers are not particularly concerned with seeking a balance anymore as they are with arriving at the best solutions. There is no reason for international instruments to be inferior in quality to their nationally drafted counterparts. In fact, if one looks at the recently adopted conventions on International Interests in Mobile Equipment, and the Hague Convention on Security Interests held by Intermediaries, they illustrate the tremendously high quality of drafting – something that was achieved only due to the availability of international expertise. These are not likely to be isolated instances as ideological divides crumble and the pursuit is of the best solutions for given problems of international commerce.

3.4. The problem of amendment

Unlike domestic law which is capable of easy amendment, once a harmonized instrument has been achieved, signatories are locked into it until a new instrument comes into force. Given that international law-making is a time-consuming process, this problem becomes pronounced. The further problem is that unless all of the countries adopt the new instrument, there is even more discord than there was previously. This is definitely a problem that harmonizing agencies have to be alive to. They must ensure that harmonization does not result in petrification. There are two aspects to this problem: the first is the

¹¹² See *id.*; United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, S. Treaty Doc. No. 98-9 (1983), 19 I.L.M. 668 (1980) [hereinafter CISG] (entered into force on Jan. 1, 1988), available in 15 U.S.C.A. app. at 49 (West Supp. 1996), 52 Fed. Reg. 6262-80, 7737 (1987), U.N. Doc. A./Conf. 97/18 (1980). Note the following articles in the Convention: art. 16(1) (“Until a contract is concluded an offer may be revoked if the revocation reaches the offeree before he has dispatched an acceptance.”); art. 16(2) (“However, an offer cannot be revoked: (a) if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or (b) if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer.”); art. 43(1) (“The buyer loses the right to rely on the provisions of article 41 or article 42 if he does not give notice to the seller specifying the nature of the right or claim of the third party within a reasonable time after he has become aware or ought to have become aware of the right or claim.”); art. 43(2) (“The seller is not entitled to rely on the provisions of the preceding paragraph if he knew of the right or claim of the third party and the nature of it.”). These articles exemplify various instances where rules become enervated as a result of the broad exceptions made.

inordinate time taken to create international legal instruments. To an extent this is unavoidable given that experts from far flung corners of the globe have to collaborate in drafting. However, the time frame for the drafting of international conventions is rapidly shrinking due to the evolution of modern communication techniques which dispense with travel requirements. The Hague Convention is a classic case in point – it took two years from start to finish, and it is hardly imaginable that a domestic legislation could have been completed in a shorter time-frame. The second problem, which is really the heart of the matter, is the extremely long time it takes for countries to ratify the harmonized law. While the instrument sits in cold-storage before it secures the requisite number of ratifications for it to come into force, true harmonization is not achieved even then. It requires a critical mass of the world's major commercial players to adopt the instrument. This can sometimes take decades, and harmonizing agencies are loath to render such hard wrought harmony nugatory by amending the original text. The solution may lie in adopting innovative techniques that dispense with the cumbersome requirements of adopting a new instrument. In any event, it follows that if the area for harmonization is well chosen, there will be sufficient impetus from the industry to adopt the instrument, and hence some of the time problems may be overcome.

3.5. Parochialism

Many of the arguments against harmonization are motivated by thinly disguised parochialism. Lawyers and legal systems are reluctant to give up reliance upon their own familiar laws, and this reluctance is sometimes due to a view that their own laws are superior. There may also be the fear that their national laws would lose their pre-eminent position, and this would result in a reduction in business. As Forte points out with regard to the United Kingdom's reluctance to ratify the Vienna Convention on Contracts for the International Sale of Goods, 1980, "If the Convention were ratified by the UK and . . . came to be widely applied

to international sales, with or without a connection with this country, the role of English law in the settlement of international trading matters would obviously be diminished. A consequential effect might well be a reduction in the number of international arbitrations coming to this country.”¹¹³ This is definitely a legitimate concern and there is no need to denigrate the need for self-preservation. Legal services are as much a product as anything else and London being the pre-eminent commercial centre, is a huge market. English law is extensively relied on by parties in commercial transactions and this provides business for English lawyers.¹¹⁴ It is possible that the proliferation of international law may erode this dominant position that it enjoys.¹¹⁵

3.6. Interpretation

Another oft-repeated criticism is that it is not worth the effort to harmonize commercial law as any harmony that may have been crafted in the instrument is fleeting due to the possibility of divergent interpretations adopted by different national courts. Surprisingly enough, this concern has not manifested itself very powerfully. National courts have been more than willing to adopt an internationally oriented view towards the construction of international conventions and have accorded them great deference. Courts have even been willing to consider reference to *travaux preparatoires* in interpreting conventions. As Lord Diplock stated in *Fothergill v. Monarch Airlines Ltd*

The language of that convention (the Warsaw convention on the international air carriage of 1929, as amended by the Hague protocol 1955, and as scheduled, in its amended form, to the UK Carriage by Air Act 1961) that has been adopted

¹¹³ Angelo Forte, *The United Nations Convention on Contracts for the International Sale of Goods: Reason and Unreason in the United Kingdom*, 26 U. BAL. L. REV. 51, 58 (1997).

¹¹⁴ *Id.* Forte argues that “There is most definitely a self-perception that English law is a world brand-name and that those entrusted with its adjudication should be careful not to do anything which might jeopardize that position.” *Id.* at 59.

¹¹⁵ Forte points out that the 1989 Department of Trade and Industry Consultative Document asking for views on the desirability of accession by the United Kingdom to the Vienna Convention on the International Sale of Goods itself argued that accession would allow courts and arbitrators in the United Kingdom to have a market share in the resolution of disputes under the UN Convention and to participate in the evolution of its jurisprudence. *Id.*, at 62.

at the international conference to express the common intention of the majority of the states represented there is meant to be understood in the same sense by the courts of all those states which ratify or accede to the convention. Their national styles of legislative draughtsmanship will vary considerably as between one another. So will the approach of their judiciaries to the interpretation of written laws and to the extent to which recourse may be had to *travaux préparatoires*, doctrine and jurisprudence as extraneous aids to the interpretation of the legislative text. The language of an international convention has not been chosen by an English parliamentary draftsman...It is addressed to a much wider and more varied judicial audience than is an act of parliament that deals with purely domestic law. It should be interpreted, as Lord Wilberforce put it in *James Buchanan & Co. Ltd. v. Babco Forwarding and Shipping (UK) Ltd.*, [1978] A.C.141, 152, “unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptance.”¹¹⁶

This view has found support in the United States, too. In *El Al Israel Airlines v. Tsui Yuan Tseng*,¹¹⁷ where, in construing the Warsaw Convention, the U.S. Supreme Court relied on British decisions and held that to allow recourse to national law would undermine the uniform law that the Convention was designed to foster. It sent a clear signal that it would adopt an international approach to the construing of the convention, and explicitly stated that it would not like to upset the balance achieved between the competing interests in the Convention.

The next part will analyze the need for harmonization in the context of the Hague Convention, evaluating the claim put forward justifying the effort to determine if the claim is satisfied by the resultant product.

4. The Hague Convention

4.1. Background

The genesis of the Hague Convention was a joint proposal by Australia, the United Kingdom and the United States suggesting that a “short multilateral Convention clarifying applicable law rules for securities held through intermediaries” as “a basis for the world-wide

¹¹⁶ See *Fothergill v. Monarch Airlines Ltd.*, [1981] A.C. 251; *Sidhu v. British Airways plc.*, [1997] 1 All E.R. 192. See also, *Gatoil Int'l Inc. v. Arkwright-Boston Mfrs. Mut. Marine Ins. Co.*, 1985 S.C. (HL) 1.

¹¹⁷ 525 U.S. 155 (1999).

adoption of consistent principles” was necessary because of the inadequacy of the present legal regime.¹¹⁸ The proposal was based on the fact that transactions involving intermediaries who stand between the issuer and the holder of securities, wherein the latter’s interest is only recorded by the intermediary, are commonplace in modern markets.¹¹⁹ That such transactions are a common feature of the modern financial landscape is not controverted. As an International Monetary Fund research paper notes:

At present, it is very common to find a scenario where a collateral provider in country A provides to a bank, as collateral taker, in country B a pledge over securities issued by issuers of three different nationalities and booked to one account with a central securities depository (CSD) in country C and held physically in the vaults of a local depository or by nominee registration for this CSD in different countries.¹²⁰

The proposal came with the added support of the International Councils of Securities Associations (ICSA), which had “committed its members to urging their governments to support the consideration of an international Convention on this topic by the Hague Conference on Private International Law at its meeting on general affairs and policy in May 2000.”¹²¹

Following a presentation by the Australian delegate as to why harmonisation must be attempted in this area, many experts were of the view that such an endeavour was timely and

¹¹⁸ Hague Conference on Private International Law, Conclusions of the Special Commission of May 2000 on General Affairs and Policy of the Conference, Prel. Doc. No. 10, at 25-26 (June 2000), *available at* <http://www.hcch.net/e/workprog/genaff.html> (last visited Mar. 15, 2004).

¹¹⁹ Hague Conference on Private International Law, Proposal by the Delegations of Australia, the United Kingdom and the United States of America, Working Document No. 1 E (May 2000), *available at* <http://www.hcch.net/e/workprog/genaff.html> (last visited Mar. 15, 2004). The proposal argued that “The need for a Convention is urgent because of the systemic risk implications and because the existing legal uncertainty in the area has the potential to impede the growth internationally of financial services industry arrangements for the transfer of securities through multiple tiers of intermediaries.” Exposure is very high—European securitisation issuance alone was Eur. 157.8 billion for 2002 according to the European Securitisation Forum. *See* Steven Schwarcz, *Indirectly Held Securities and Intermediary Risk*, 6 UNIF. L. REV. 283, 285 (2001), referring to Roy Goode, *The Nature and Transfer of Rights in Dematerialized and Immobilized Securities*, in *THE FUTURE FOR THE GLOBAL SECURITIES MARKET, LEGAL AND REGULATORY ASPECTS* 107, 110 (Fidelis Oditah ed., 1996).

¹²⁰ Philippe Dupont, *Regulatory Aspects of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, at 4, *available at* <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/dupont.pdf> (last visited Apr. 1, 2004).

¹²¹ Hague Conference on Private International Law, Proposal by the Delegations of Australia, the United Kingdom and the United States of America, *supra* note 119.

even proposed that the Hague Conference attempt it on an unusually expedited basis.¹²²

Given that some experts were unconvinced, and in line with modern practice, a feasibility study was commissioned.¹²³ The feasibility study, a masterly exposition of the law, by Christophe Bernasconi of the Permanent Bureau of the Hague Conference, found, *inter alia*, that:

- 1) Direct Holding Systems, where there is a direct relationship between the issuer and owner, had given way to indirect holding systems.¹²⁴
- 2) Development of tiered relationships between the issuer and owner, characterised by the presence of intermediaries, who recorded interests relating to themselves.¹²⁵
- 3) There was a gap in the law not reflecting this evolution from direct to indirect holding systems in most legal systems.¹²⁶
- 4) The existing conflict of laws rule, the *lex situs* does not work well in indirect holding systems.¹²⁷

¹²² *Id.* Mr. Potok, the Australian delegate, emphasized that there was legal uncertainty as to the law applicable when intermediaries were involved, as was increasingly the case on account of computerization.

¹²³ Hague Conference on Private International Law, Conclusions of the Special Commission of May 2000 on General Affairs and Policy of the Conference, *supra* note 118, at 26.

¹²⁴ Christophe Bernasconi, First Secretary at the Permanent Bureau, Hague Conference on Private International Law, The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems, Prelim. Doc. No. 1 (Nov. 2000.), available at http://www.hcch.net/e/workprog/coll_sec_pd1.pdf (last visited Apr. 19, 2002) [hereinafter Bernasconi Report]. The reasons for moving away from the traditional direct holding systems according to Bernasconi are: (1) the cost, human, temporal, and financial; (2) risk of loss and forgery; and (3) “pipeline liquidity (or illiquidity) risk,” which was the unavailability of the securities as investment vehicles while the securities were in the postal pipeline. Dupont notes that “investors in securities realized quite some time ago that the transfer of certificated securities by way of physical transfer, which had been the method of transfer for centuries, carried substantial risks of loss, theft and liquidity costs which grew according to the distance between the buyer and the seller of a security. Disregarding existing legal frameworks that were still based on the existence and transfer of physical securities certificates, investors have set up a securities book-entry holding and transfer system that immensely facilitates the transfer of securities through a multi-tiered system of intermediaries without securities actually having to be physically moved.” Dupont, *supra* note 120, at 1.

¹²⁵ Such intermediaries may operate on several levels. As Potok points out, an example may be of an Australian Investor who holds securities of Illinois Corp, which are recorded by its intermediary, French Bank, which holds interests in respect of Illinois Corp., both for Australian Investor, and its other customers, which are recorded under its name in an omnibus account with a European International Central Securities Depository. The European CSD, in turn holds interests in respect of Illinois Corp., both for French Bank, and for other participants in the ICSD system in an omnibus account with its custodian in the United States, the Californian Sub-custodian. The last named also holds interests in respect of Illinois Corp., for the European ICSD and its other customers with the DTC. See generally, RICHARD POTOK, CROSS BORDER COLLATERAL: LEGAL RISK AND THE CONFLICT OF LAWS (2002).

¹²⁶ Bernasconi Report, *supra* note 124, at 3. According to the study, this situation was common to both the substantive law as well as the conflict of law rules.

- 5) Traditional property law concepts run into problems when confronted by the fungible nature of holdings in indirect systems. This is because under these principles, commingling alters the nature of the interests the depositor may have, effectively eliminating the direct proprietary interest that existed prior thereto.¹²⁸
- 6) There were a variety of national approaches to this commingling conundrum.¹²⁹
- 7) There were uncertainties with regard to the law to be applied to proprietary aspects of such transactions,¹³⁰ and the “look through” approach also created “severe practical difficulties.”¹³¹
- 8) This uncertainty translated to higher expense for market participants.¹³²
- 9) There were benefits to a convention that would resolve these uncertainties.¹³³
- 10) There was a need to develop a new approach, which in accordance with the reality that a record will only be present with the intermediary with whom the investor has a

¹²⁷ If the Investor in Australia decides to pledge its security interests in respect of Illinois Corp. shares, the creditor must make sure that its interests trump those of third parties by fulfilling the legal formalities of the appropriate law from amongst a host of competing laws, viz., Illinois law, which may be the law of the place of incorporation, New Jersey law, which may be the law of the place of the register of the underlying securities, New York law, as the law of the DTC, California law, as the law of the Sub-custodian, the law of the European ICSD, French law, as the law of the place of French Bank, or Australian law, which is the law of the place of the debtor. In addition, the law, if any that the parties have chosen in their agreement, and the law of the place of the creditor may also be implicated.

¹²⁸ Bernasconi Report, *supra* note 124, at 19. Under traditional rules common to both the common law and civil law, depositors retain property rights in respect of property held by a depository so long as it has not been commingled. In the event that the property is commingled, the depositor may have a contractual claim for the same amount and type of property, or may have a common, co-ownership interest in the commingled pool along with other depositors.

¹²⁹ These range from the antiquated no-commingling approach of some German intermediaries which hold certificates held together by a ribbon stating the name of the actual owner, to co-proprietary rights which may pertain to actual or notional pools of securities.

¹³⁰ Bernasconi Report, *supra* note 124, at 27-29. See Dupont, *supra* note 20, at 5.

¹³¹ The “look through” approach refers to the process whereby the law looks through the levels of intermediaries until it reaches the issuer, register, or actual certificates. Bernasconi Report, *supra* note 124, at 27. The problems that the “look through” approach runs into when confronted with fungible securities is obvious: it runs into a veritable brick wall, on account of the fact that there is no record on any interest of the investor, except with the intermediary with which it has a direct relationship. Thus, a movement through the levels of intermediaries will be frustrated. Further, the collateral taker may be forced to satisfy the perfection requirements of many jurisdictions. *Id.*, at 29. The study also found that “it is uncertain exactly what the legal rule is when applying the ‘look though approach’—is it the law of the place of the issuer, the place of the register or the place of the underlying securities?” *Id.*

¹³² Bernasconi Report, *supra* note 124, at 29.

¹³³ *Id.*

direct relationship, would be an approach that looks to the law of the location of that intermediary.¹³⁴

That there is need for law reform is clear. Dupont writes that “only a multi-national law reform will help cure the problem as local initiatives would always be subject to the risk of being challenged abroad.”¹³⁵ Industry bodies have repeatedly emphasized the fact that a problem exists. The International Swaps and Derivatives Association, Inc. recognized that “there are a number of weaknesses in the legal framework for indirectly held securities in many, if not most, jurisdictions around the world.”¹³⁶ The Securities Industry Association in its comments on the (then) proposed Hague Convention, noted that “Public trust and confidence in the capital markets, as well as market efficiency, are enhanced when national laws are harmonized to ensure legal certainty and predictability, so that parties’ expectations as to the applicable law governing their transactions are not frustrated. The Committee believes that the work on the Convention by the delegates to the Hague Conference will substantially advance these policy goals regarding transactions where securities are held as collateral.”¹³⁷

There were other expressions of the need to harmonize the law in this area. The Committee on Payment and Settlement Systems of the central banks of the Group of Ten in its report on Cross-Border Securities Settlements identified “legal risk, especially choice of law uncertainties, as one of the principal risks that differentiates cross-border securities transactions from domestic transactions.”¹³⁸

¹³⁴ *Id.* This was to become known as the “place of the relevant intermediary approach” or “PRIMA” a term that was reportedly coined by Richard Potok. See RICHARD POTOK, *supra* note 125.

¹³⁵ Dupont, *supra* note 120, at 8.

¹³⁶ Letter from Richard Metcalfe, Co-Head of the European Office of ISDA, to the Secretary General of UNIDROIT 2 (Sept. 6, 2002) (on file with the author).

¹³⁷ Letter from Michael Viviano, Chairman of the SIA Operations Committee, to Christophe Bernasconi (Dec. 7, 2001) (on file with the author).

¹³⁸ See Randall D. Guynn, *Modernizing Securities Ownership, Transfer and Pledging Laws*, at 9 (Capital Markets Forum of the International Banking Ass’n Section on Business Law 1996).

Randall Guynn’s masterly paper found that “[m]ost current laws do not allow investors or secured creditors to determine in advance - with sufficient certainty and predictability - the substantive law that will govern their rights and obligations or those of possible adverse claimants. Nor do most of them allow investors or secured creditors, once the governing substantive law has been ascertained, to be certain that they have a distinct package of rights that cannot successfully be attacked by adverse claimants.”¹³⁹ He also concluded that these uncertainties translate into a higher cost of capital, that they prevent market participants from making full use for securities, increase legal and operating costs, and contribute to systemic risk.¹⁴⁰ Guynn thought that internationally directed law reform was not only necessary to lower costs, but also to prevent a financial crisis.¹⁴¹ As Dupont noted, the consequences of uncertainty as to the law to be applied extends even to “putting at risk the capital base of banks as well as payment systems and the central banks that run these systems.”¹⁴²

Indeed, many of the arguments that were advanced as reasons for the harmonization of the law with regard to security interests in mobile equipment resonate very loudly in this area as well. Just as the inability to use movables as collateral was limiting the extension of credit, the uncertainty as to the applicable law, would act as a deterrent factor in creditors lending money. In fact, such systemic risk can have another adverse financial impact in the case of securities. By their very nature as risk instruments, any reduction in risk levels would enhance value that securities command in the market. If, because of systemic uncertainty, parties are prevented from entering into transactions that reduce risk, it has a depressing

¹³⁹ *Id.* at 12.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² Dupont, *supra* note 120, at 7.

effect on the securities' value.¹⁴³ In effect, the liquid nature of securities is compromised by this uncertainty as their free flow is hindered.

4.2. The Solution

Meeting the Need: The PRIMA Concept

Merely agreeing that the law of the principal residence of the intermediary approach is the most appropriate does not solve the problem. Even after the relevant intermediary is identified, there is still the important issue of determining where it is located. This is particularly important given that relevant records themselves may be in a location quite distinct from the principal offices of the intermediary.¹⁴⁴ The *Bernasconi Report* suggested a slew of approaches for determining the location of the relevant intermediary, including the place indicated in the address in the account agreement, the address in the account statement of the intermediary, the place of its statutory seat, the law of incorporation, or formation.¹⁴⁵ The *Report* showed that PRIMA was already accepted as the appropriate approach by a slew of jurisdictions, including France, Belgium, Luxembourg,¹⁴⁶ and the United States.¹⁴⁷

In just one manifestation of industry approbation of the PRIMA, the SIA “applauds the delegates to the Hague Conference for settling on the place of the relevant intermediary (“PRIMA”) as the applicable test for determining the applicable law. We think that this is a practical and wise approach. By focusing on the laws of the nation or state of the relevant intermediary, the Convention promotes legal certainty and the reasonable expectations of the

¹⁴³ See Guynn, *supra* note 138, at 13 (explaining that the value of a security is not just a function of the issuer's profitability or creditworthiness, but is also a function of its availability to be sold, traded, pledged, when desired.)

¹⁴⁴ For instance, the intermediary may be in San Jose, California, the data storage server may be located in Beijing, China, and whole tranches of data may be electronically located in Bangalore, India.

¹⁴⁵ Bernasconi Report, *supra* note 124, at 40.

¹⁴⁶ Dupont, *supra* note 120, at 8. Dupont notes that Belgium and Luxembourg have legislation that provides clear answers.

¹⁴⁷ Bernasconi Report, *supra* note 124, at 48-50. See, e.g., U.C.C. § 8-110 (2003). The Report also showed that similar legislation was under consideration in the Netherlands, the U.K., Japan, Australia, Canada, Bermuda, the British Virgin Islands, and the Antilles. Bernasconi Report, *supra* note 124, at 53-54.

parties.”¹⁴⁸

The *Comments* submitted by the Central Securities Depositories in the Americas and Africa on the (then) proposed Hague Convention supported the goal of such an effort, and noted that it “will reduce risk for pledgees. It will also benefit all in the industry, by squeezing uncertainty out of pledges that have cross-border components.”¹⁴⁹

The British Bankers Association in its August 2002 *Response to the European Commission’s Communication on Clearing and Settlement* stated that “[w]e fully support the implementation of PRIMA as a fundamental principle and encourage the Commission to examine the compatibility of EU law with the Hague convention, in order that the benefits PRIMA will bring are speedily applied to all types of securities transactions within the EU.”¹⁵⁰

The International Councils of Securities Associations (ICSA) was also supportive:

ICSA believes that the Hague Convention will bring much needed clarification in the application of conflict of law rules in determining the enforceability of a transfer or pledge of collateral. This is particularly true with regard to transactions that involve a number of intermediaries through which collateral passes (such as transactions involving the pledge of book-entry securities as collateral). In this regard, we fully support the “place of the relevant intermediary approach” (or “PRIMA”), which provides for a much improved standard for deciding upon the appropriate law for determining the rights of a collateral taker.¹⁵¹

¹⁴⁸ Letter from Michael Viviano, *supra* note 137, at 2.

¹⁴⁹ Letter from the Central Securities Depositories in the Americas and Africa (Oct. 15, 2002) (on file with author). The letter purported to be on behalf of fifteen Central Securities Depositories from fourteen countries: the CAJVAL & MERVAL of Argentina, the Canadian Depository for Securities, Ltd., Deposito Central de Valores, Chile, DECEVAL, Colombia, CEVAL, Costa Rica, CEDEVAl, El Salvador, Bolsa de Valores Nacional, Guatemala, S.D. INDEVAL, Mexico, CENIVAL, Nicaragua, LatinClear, Panama, CAVALI ICVL, Peru, STRATE, South Africa, The Depository Trust Company, United States, and Bolsa de Valores Montevideo, Uruguay.

¹⁵⁰ BRITISH BANKING ASSOCIATION, RESPONSE TO THE EUROPEAN COMMISSION’S COMMUNICATION ON CLEARING AND SETTLEMENT (2002), available at <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=684> (last visited July 1, 2004). According to its website, the British Banking Association (“BBA”) is the main financial services trade association in the UK with approximately 300 members, 85% of which are involved in providing wholesale banking services in the UK capital markets. 75% of the BBA’s members are of non-UK origin, representing 60 different countries.

¹⁵¹ Letter from the International Councils of Securities Associations (“ICSA”), to Christophe Bernasconi (Nov. 11, 2002) (on file with author). According to the letter, ICSA membership includes trade associations and self-regulatory bodies for the securities industry and many international trade associations: “ICSA members represent the overwhelming majority of the world’s equity, bond and derivatives markets.” *Id.*

4.3. The Hague Convention Solution

There was extensive debate as to what solution should be adopted. Given that PRIMA had attained wide acceptability a total jettisoning of the concept was not desirable. Yet the Convention makes a marked departure. The Hague Convention in Article 4 provides that the applicable law is the law which applies in the “State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law.” Thus, it is the agreement of the parties which determines the applicable law. The idea is that commercially sophisticated parties can look at the account agreement to know which law applies. However, the law designated by the parties in the account agreement will only apply if two conditions are satisfied:

1. The relevant intermediary has an office in that State which, either on its own or with other offices of the intermediary, effects or monitors entries to securities accounts; administers payments or corporate actions related to securities; or conducts the business of maintaining business accounts; or
2. The relevant intermediary is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.¹⁵²

The Convention excludes back-office operations maintained by the intermediary from being considered for the purpose of determining if it is engaged in conducting business in a State. The Convention provides fall-back rules for the determination of the applicable law if it is not possible to be determined under Article 4. According to Article 5, if it is expressly and unambiguously stated in the account agreement that the relevant intermediary entered into the account agreement through a particular office, the applicable law is the law in force in the State in which that office was then located if the office “satisfied the condition specified in the second sentence of Article 4(1).”¹⁵³ The Convention expressly excludes the consideration

¹⁵² Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, *supra* note 12, art. 4.

¹⁵³ *Id.* at art. 5(1).

of the following for the determination of whether the account agreement “expressly and unambiguously” states that the relevant intermediary entered into the account agreement through a particular office:

1. a provision in the agreement designating that office for the service of notices or other documents;
2. a provision designating a particular State or in a particular territorial unit of a Multi-unit State as the appropriate forum for the institution of legal proceedings;
3. a provision designating a particular office for the provision of any statement or other document;
4. a provision designating a particular office for the provision of any service;
5. a provision designating an office for the provision of any operation or function.

If this fails to provide an answer, the Convention provides that the applicable law is the “law in force in the State, or the territorial unit of a Multi-unit State, under whose law the relevant intermediary is incorporated or otherwise organised at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.”¹⁵⁴ If neither of the above solutions determines the applicable law, then the last fall-back rule is that the applicable law is the law of the State in which the relevant intermediary has its place of business. If the relevant intermediary has more than one place of business, the applicable law is that of “its principal place of business at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.”¹⁵⁵

4.4. Key Features of the Convention

¹⁵⁴ *Id.* at art. 5(2).

¹⁵⁵ *Id.* at art. 5(3).

The Hague Convention was adopted in December 2002 and will enter into force after three states have ratified it.¹⁵⁶

4.4.1. Scope

The Convention's scope extends to the determination of the law applicable to securities held with an intermediary¹⁵⁷ when there is a competition between the laws of different states¹⁵⁸ with respect to the legal nature and effects against the intermediary¹⁵⁹ and third parties, of the rights resulting from a credit of securities to a securities account, of a disposition¹⁶⁰ of securities, the requirements, if any, for perfection¹⁶¹ of a disposition of such securities, the question as to whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest, the duties, if any, of an intermediary to a person other than the account holder, who asserts in competition with the account holder or another person, an interest in securities held with that intermediary, the requirements, if any, for the realization of an interest in securities held with an intermediary, and the question as to whether a disposition of securities held with an intermediary extends to

¹⁵⁶ See Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, *supra* note 12, art. 19.

Article 19: Entry into force:

(1.) This Convention shall enter into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession referred to in Article 17. (2.) Thereafter this Convention shall enter into force – *a*) for each State or Regional Economic Integration Organization referred to in Article 18 subsequently ratifying, accepting, approving or acceding to it, on the first day of the month following the expiration of three months after the deposit of its instrument of ratification, acceptance, approval or accession; *b*) for a territorial unit to which this Convention has been extended in accordance with Article 20(1), on the first day of the month following the expiration of three months after the notification of the declaration referred to in that Article.

No reservations are allowed as per Article 21.

¹⁵⁷ *Id.* at art. 1(f) (explaining that securities held with an intermediary “means the rights of an account holder resulting from a credit of securities to a securities account.”).

¹⁵⁸ *Id.* at art. 4.

¹⁵⁹ *Id.* at art. 1(c) (defining “intermediary” as “a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity.”)

¹⁶⁰ *Id.* at art. 1(h) (defining “disposition” as “any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory.”)

¹⁶¹ *Id.* at art. 1(i) (defining “perfection” as the “completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition.”)

entitlements to dividends, income, or other distributions, or to redemption, sale or other proceeds.¹⁶² The Convention does not apply to purely contractual rights.¹⁶³ The Convention also applies regardless of the fact that the applicable law as determined by it may be that of a noncontracting state.¹⁶⁴

4.4.2. The Relevant Law

The Convention has a comprehensive approach and the applicable law¹⁶⁵ is the law of the State expressly agreed to in the account agreement as the State whose law governs the account agreement. However, if the account agreement explicitly provides that another law is applicable then that other law is the applicable law.¹⁶⁶ This can only happen if the relevant intermediary has (1) an office which alone or with other offices in that state, effects or monitors entries to securities accounts,¹⁶⁷ administers payments or corporate actions relating to securities held with the intermediary, or is otherwise engaged in a business or other regular activity of maintaining securities accounts; or (2) which has an office that is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.¹⁶⁸ The Convention provides a “fall-back rule” in case this fails to provide a solution.¹⁶⁹ Accordingly, in case the agreement unambiguously and expressly states that a particular office of the relevant intermediary entered into the agreement, then the law of the location of that office governs if (1) the office which alone or with other offices in that state, effects or monitors entries to securities accounts, administers payments or corporate actions relating to securities held with the intermediary, or is otherwise engaged in

¹⁶² *Id.* at art. 2(1).

¹⁶³ *Id.* at art. 2(3).

¹⁶⁴ *Id.* at art. 9.

¹⁶⁵ *See id.* at art. 10.

¹⁶⁶ *Id.* at art. 4(1).

¹⁶⁷ *Id.* at art. 1(b) (defining “securities account” as “an account maintained by an intermediary to which securities may be credited or debited.”)

¹⁶⁸ *Id.* at art. 4(1)(a)-(b). *See also id.* at art. 4(2) (excluding call centers, technology offices, mailing offices, and representative or administrative offices which do not have authority to enter into binding account agreements),

¹⁶⁹ *Id.* at art. 5.

a business or other regular activity of maintaining securities accounts; or (2) which has an office that is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.¹⁷⁰ If this fails to determine the applicable law, then the law is that of the place of incorporation of the intermediary at the time the account was entered into. If there is no such agreement, then the applicable law is that of the place of incorporation when the securities account was opened.¹⁷¹ If even this fails to determine the applicable law, then the applicable law is that of the intermediary's place of business, and if the intermediary has more than one place of business, it is that of the principal place of business, at the time the written agreement was entered into, or if there is no agreement, the time the securities account was opened.¹⁷² The applicable law as determined by the Convention applies regardless of the onset of any insolvency proceedings provided that the relevant events have occurred prior to the opening of the insolvency proceedings.¹⁷³

5. Uniformity or Best Solutions for Problems?

It is clear from the preceding discussion that the objective of harmonization is not just the attainment of uniformity; that would be too modest an aim. Harmonization endeavors

¹⁷⁰ See also *id.* at art. 5(1) (providing that “In determining whether an account agreement expressly and unambiguously states that the relevant intermediary entered into the account agreement through a particular office, none of the following shall be considered: a) a provision that notices or other documents shall or may be served on the relevant intermediary at that office; b) a provision that legal proceedings shall or may be instituted against the relevant intermediary in a particular State or in a particular territorial unit of a Multi-unit State; c) a provision that any statement or other document shall or may be provided by the relevant intermediary from that office; d) a provision that any service shall or may be provided by the relevant intermediary from that office; e) a provision that any operation or function shall or may be carried on or performed by the relevant intermediary at that office.”)

¹⁷¹ *Id.* at art. 5(2).

¹⁷² See *id.* at art. 5(3). See also *id.* art. 1(e) (defining “account agreement” as “the agreement with the relevant intermediary governing that securities account.”) See also art. 6 (explaining that in determining the applicable law, the place where the issuer of the securities is incorporated or has its statutory seat or registered office, central administration or place or principal place of business, the places where certificates representing or evidencing securities are located, the place where a register of holders of securities maintained by or on behalf of the issuer of the securities is located, or the place where any intermediary other than the relevant intermediary is located, are all to be ignored.).

¹⁷³ *Id.* at art. 8.

have frequently gone far beyond the mere attainment of uniformity and have resulted in the crafting of the best solutions to given legal problems. This is inevitable in any law reform project. When viewed in this light, apart from its obvious facilitative function, harmonization satisfies a development function too.¹⁷⁴

Professor Stephan raises pertinent questions here as well. While he does concede that because of the level of expertise available in the international harmonization process, and because of the fact that these experts undertake a rigorous study of various national laws, they might be in a position to fashion best solutions. Still, he wonders why this should not be the case in domestic law reform endeavors.¹⁷⁵ While the answer to this question is not obvious to him, there is one explanation as to why international harmonization is better placed to arrive at best solutions. This is a simple matter of resources available to domestic law makers. The majority of domestic draftsmen do not engage in rigorous comparative study before drafting their domestic laws. The scholarly investment at least in the developing nations is not comparable to that in international harmonization. Thus, at least speaking from the perspective of the vast majority of nations, international harmonization is more likely to result in the formulation of best solutions as compared to domestic efforts.

Harmonization is not an end in itself. It is at best a means to an end. That being the case, it is inevitable that harmonization must bear the burden of law reform and search for the best solutions to the problems of international commerce rather than content itself with achieving uniformity.

¹⁷⁴ See, e.g., Marc Ansel, *From the Unification of Law to its Harmonization*, 51 TUL. L. REV. 108, 109 (1976). According to Ansel, this distinguishes uniform law that may be derived by legislative unification from harmonized law. *Id.* at 111. In his words, “The aim to be pursued is therefore not necessarily the mechanical identity of normative law, but rather a meeting between systems in a functional apprehension of social and economic reality. This new conception, wider and more flexible, of unifying action entails two final consequences. First, it makes an important contribution to international legal cooperation, and, going beyond the bringing together of institutions, it assumes and calls for the bringing together of men. Second, it operates not so much on the level of legal analysis as on the level of legislative policy--a notion and a discipline that have been too long neglected.” *Id.* at 117.

¹⁷⁵ Stephan, *supra* note 49, at 749-750.