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# CNOOC-UNOCAL AND THE WTO: DISCRIMINATORY RULES IN THE CHINA PROTOCOL ARE A LATENT THREAT TO THE RULE OF LAW IN THE DISPUTE SETTLEMENT UNDERSTANDING

Thomas P. Holt<sup>†</sup>

*Abstract:* In the summer of 2005, the Chinese state-owned oil company CNOOC, Ltd. (“CNOOC”) attempted to purchase American-owned Unocal Corporation on very favorable terms. There was a serious problem with the merger, however—the U.S. Congress was not about to let the People’s Republic of China (“China”) buy up an American company, no matter how much it was willing to pay. Following a period of increasingly heated rhetoric about the deal, the U.S. Congressman representing competitor Chevron Corporation’s home district inserted a provision in the Energy Policy Act of 2005 that was intended to, and did, scuttle the deal.

The U.S. Congress’ underlying concern that Chinese ownership of a U.S. oil company would threaten national security (whether justified or not) obscured a potentially larger issue. China had already agreed not to grant the type of subsidy that made CNOOC’s offer possible when it acceded to the World Trade Organization (“WTO”). Incorporated into the Protocol on the Accession of the People’s Republic of China (“China Protocol”) was a commitment that China would not use unprofitable “non-commercial” loans from its state-owned enterprises to further state policy. The Unocal acquisition was to be funded by precisely this type of subsidized loan. The unique WTO rules contained in the China Protocol do more than prevent China from buying U.S. companies, however. The rules are applicable *only* to China, and prevent conduct that would be allowed under any generally applicable WTO agreement. As such, they undermine the core nondiscrimination principles on which the WTO was founded. More seriously, unresolved interpretative conflicts between the China Protocol and the set of agreements into which it is putatively “integrated” will force the WTO’s panels and Appellate Body to make “WTO common law,” a function specifically forbidden to them. This will seriously undermine the legitimacy of the WTO’s crucially important Dispute Settlement Understanding, and call into question the continued efficacy of the organization as a whole.

## I. INTRODUCTION

On June 22, 2005, Chinese oil company CNOOC, Ltd. (“CNOOC,” a subsidiary of the state-owned China National Offshore Oil Corporation<sup>1</sup>) made an unsolicited offer to purchase the Unocal Corporation, an American

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<sup>†</sup> The author would like to thank Professor Craig H. Allen for his patience and insight. Any errors contained herein are a departure from the high standards to which he holds his students, and are solely attributable to the author.

<sup>1</sup> CNOOC Ltd. is 70% owned by its parent company, China National Offshore Oil Corporation, which is in turn owned by the government of the People’s Republic of China. The parent company is the country’s third-largest energy company. See Letter from Senators Conrad and Bunning to the Commerce Secretary Carlos Gutierrez (July 11, 2005). The China National Offshore Oil Corporation is also known by the moniker “CNOOC,” but here will be referred to by its full name to avoid confusion with its overseas subsidiary, CNOOC Ltd.

oil company based in California. CNOOC proposed to pay approximately sixty-seven dollars per share of publicly traded stock,<sup>2</sup> or just shy of \$20 billion after a payment of a \$500 million-plus break-up fee to rival bidder Chevron Corporation (“Chevron”). The proposed transaction was to be funded by low- and no-interest loans from CNOOC’s state-owned parent company and state-owned Chinese banks.<sup>3</sup> Due to political pressure from the United States Congress, however, CNOOC was not able to purchase Unocal despite the favorable terms that it offered.<sup>4</sup> Technically, CNOOC withdrew its bid for Unocal voluntarily.<sup>5</sup> In reality, the inclusion of a provision in the Energy Policy Act of 2005<sup>6</sup> (“Energy Policy Act”) specially designed to sink the CNOOC-Unocal merger (“CNOOC-Unocal”) was too serious an obstacle to the deal’s completion. This legislation, spurred by concerns of members of Congress regarding the security implications of Chinese competition for scarce world oil supplies (among other reasons) would have required substantially heightened security review of the deal, and caused prohibitive uncertainty and delay.<sup>7</sup>

This Comment will argue that Congress’ focus on the purported national security implications of the transactions obscured an issue of potentially longer-term significance: the funding package that CNOOC proposed for the deal was a violation of Chinese market economy obligations under the Protocol on the Accession of the People’s Republic of China (“Protocol” or “China Protocol”)<sup>8</sup> to the World Trade Organization (“WTO”). The People’s Republic of China (“China”) was required to make unique commitments as a precondition to membership in the WTO. These commitments make China subject to binding international legal obligations that could greatly affect the conduct of its overseas investment policy as a non-market economy. While the CNOOC-Unocal deal ran aground on other

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<sup>2</sup> See Paula Dittrick, *CNOOC Bid Raises Stakes in the Takeover of Unocal*, OIL & GAS J., June 27, 2005, at 25.

<sup>3</sup> See Lead Report, *Foreign Investment: Senators Charge CNOOC’s Unocal Bid Could Constitute WTO Violation*, 22 INT’L TRADE REP. 1148 (2005).

<sup>4</sup> See *infra* Part II; see also H.R. Res. 344, 109th Cong. (2005) (engrossed as passed) (expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States).

<sup>5</sup> See *Foreign Investment: China’s CNOOC Announces Withdrawal of Bid to Acquire Unocal, Citing Political Opposition*, 22 INT’L TRADE REP. 1286 (2005).

<sup>6</sup> Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 604 (2005).

<sup>7</sup> See *id.* § 1837; see also *Foreign Investment: Pombo Plans Amendment to Require Study of Chinese Oil Policy Before CNOOC Review*, 22 INT’L TRADE REP. 1202 (2005).

<sup>8</sup> See World Trade Organization, Protocol on the Accession of the People’s Republic of China, WT/L/432 (Nov. 23, 2001) [hereinafter Protocol].

rocky shores, its proposed funding package illustrates the latent problems posed by the growth of non-reciprocal obligations in the world trading system, especially between original WTO member-states and more recent additions.<sup>9</sup> The unique, stringent commitments of China in particular pose challenges for the WTO system. Such “WTO-plus”<sup>10</sup> obligations have the potential to throw the generally applicable system of international trade rules into turmoil, and to undermine the rule of law in the application of the Dispute Settlement Understanding (“DSU”).<sup>11</sup>

Part II of this Comment discusses the international legal constraints that the proposed merger between CNOOC and Unocal faced, and how the deal was ultimately aborted for other reasons. The Comment specifically addresses the fact that the terms of CNOOC’s proposed funding package for the acquisition did not meet China’s unique WTO requirement that loans from China’s state-owned enterprises be on a “commercial basis”. Rather, the loans that CNOOC sought included strategic interest rate subsidies from

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<sup>9</sup> The General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT 1947] laid the foundation for what would become the WTO. The WTO was formally established as an international organization by the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125 (1994), which serves as a “cover page” to the rest of the WTO agreements. See World Trade Organization, WTO Legal Texts, [http://www.wto.org/english/docs\\_e/legal\\_e/legal\\_e.htm](http://www.wto.org/english/docs_e/legal_e/legal_e.htm) (last visited May 4, 2006). States not party to the establishing agreement have the option of acceding to the WTO under Article XII of the Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994 33 I.L.M. 1125 (1994) [hereinafter WTO Agreement].

<sup>10</sup> See Julia Ya Qin, “WTO-Plus” Obligations and Their Implications for the World Trade Organization Legal System, 37 J. WORLD TRADE 483 (2003).

<sup>11</sup> Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125 (1994) [hereinafter DSU].

Perhaps no phrase in legal usage is more ambiguous than “rule of law.” As Judith N. Shklar points out in her essay *Political Theory and The Rule of Law*, “It would not be very difficult to show that the phrase ‘the Rule of Law’ has become meaningless thanks to ideological abuse and general over-use.” Judith N. Shklar, *Political Theory and The Rule of Law*, in *THE RULE OF LAW: IDEAL OR IDEOLOGY* 1,1 (Allan C. Hutchinson and Patrick Monahan eds., 1987). This paper, however, does not insert itself into the crossfire of legal philosophy with respect to the idea. See *id.* at 10 (comparing Friedrich von Hayek’s defense of the idea to Roberto Unger’s view of the concept as a “pure ideological cloak that must be ripped off to expose the fraudulence of the entire ideology of the Rule of Law.”).

Rather, the rule of law is defined here as a practical construct: a system under which decisions with respect to rights and obligations are made according to pre-defined set of generally applicable rules. Couched in the negative, the absence of the rule of law is demonstrated when rights and obligations are defined solely as result of the relative power of those affected by their application. In the words of the former Chairman of the WTO Appellate Body, James Bacchus, “The rule of law is, above all, not politics . . . . With the rule of law, the law is certain, not arbitrary. With the rule of law, the law is written beforehand, and the rules are defined and known in advance. With the rule of law, the law is written to apply to all equally, and all, in practice and in reality, are equal before the law. With the rule of law, no one is beneath the concern of the law or above it. Only this can rightly be called the rule of law.” James Bacchus, *Groping Toward Grotious: The WTO and the International Rule of Law*, 44 HARV. INT’L L.J. 533, 546 (2003).

the Chinese government, subsidies that China agreed not to use as a precondition to its membership in the WTO. Part III discusses how this commitment, as an “integrated” part of the WTO system of agreements, imposes on China trade rules not generally applicable to other WTO members, and how the financing package would have been legal under generally applicable WTO agreements. Part III further demonstrates how *any* WTO member could have utilized the WTO’s dispute settlement system to challenge or stall the proposed transaction, regardless of their level of involvement. Part IV argues that the asymmetry of rule obligations imposed on China by the Protocol threatens the rule of law in the world trading system’s dispute settlement mechanism, and could threaten the effectiveness of the WTO generally. Finally, this Comment closes with an argument that the imposition of unique burdens on acceding WTO members, illustrated by the China protocol, is antithetical to the mission of the WTO and should be discontinued in future accessions of transitional economy states.

## II. CNOOC’S PROPOSED FUNDING PACKAGE IMPLICATED CHINA’S WTO COMMITMENTS, BUT THE DEAL WAS SCUTTLED FOR OTHER REASONS

Protestations to the contrary aside,<sup>12</sup> CNOOC’s bid for Unocal was part of a strategic initiative by China to secure increased access to petroleum.<sup>13</sup> The attempted acquisition was part of a concerted effort to meet the country’s massive, and massively growing, demand for energy.<sup>14</sup> This was not, in itself, a problem. After all, the United States aggressively and actively promotes policies that result in greater control of energy infrastructure and greater access to petroleum<sup>15</sup> in order to meet what is indisputably the world’s greatest demand for fuel.<sup>16</sup> Similarly, the fact that China proposed to subsidize the transaction is wholly unremarkable; investment subsidies for key strategic enterprises, in one form or another, are

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<sup>12</sup> See Dittrick, *supra* note 2, at 25 (CNOOC stated that it sought to acquire Unocal because the “combined company would have a leading position in the Asian energy market . . .”)

<sup>13</sup> China has a stated policy of increasing the capacity of its strategic petroleum reserves. See, e.g., Letter from Senators Conrad and Bunning to the Commerce Secretary Carlos Gutierrez, *supra* note 1.

<sup>14</sup> For example, twelve days after the collapse of the merger, the state-owned China National Petroleum Corporation reached an agreement to acquire Canadian PetroKazakhstan. For an audio discussion regarding the issue, visit National Public Radio’s website and listen to Mike Shuster, China’s Oil Demand Complicates Relations with U.S., <http://www.npr.org/templates/story/story.php?storyId=4965017> (follow “Listen” link to download a radio report airing differing views on the extent to which the attempted acquisition represented part of an overarching government program to acquire increased access to oil assets) (last visited May 4, 2006).

<sup>15</sup> See generally Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 604 (2005).

<sup>16</sup> Measured either by volume or per capita. See, e.g., Canadian Broadcasting Corporation, Supply and demand: World oil markets under pressure, [http://www.cbc.ca/news/background/oil/supply\\_demand.html](http://www.cbc.ca/news/background/oil/supply_demand.html) (last May 4, 2006).

a common feature of the world commodity trade.<sup>17</sup> While it is certainly the prerogative of United States lawmakers to prevent foreign investment that they believe (correctly or not) threatens U.S. national security, it is equally China's prerogative to pursue policies that will give its citizens greater access to key resources.

What was problematic about the non-commercial motive for the Unocal acquisition, however, was the fact that China agreed as a precondition to membership in the WTO that its state-owned enterprises would not be the mechanisms by which such policy choices would be implemented.<sup>18</sup> Like any state, China acts with a multiplicity of different motives for every one of its official acts. Under the Protocol, however, its state-owned enterprises ("SOEs"), including its banks and oil companies, must make their decisions on the basis of factors associated with *commercial* considerations, i.e., the profitability of a given transaction. China's SOEs, in other words, are required to act as if they were private entities in their conduct in international trade. One way to conceptualize the distinction is to remember that *states*, not *lenders*, may have multiple motives. A lender, acting commercially, may only have one legitimate motive under the Protocol: to create profit. Therefore, securing greater energy security for the Chinese people, at the direction of the Chinese government, is *not* a commercial motive under the Protocol if the transaction through which that goal is effected is not one which will provide the financing SOE profit.

China made this commitment, as well as many others, as part of its negotiations with the WTO Working Party on the Accession of China ("Working Party") regarding accession to the world trading body, and is legally bound to them under international law.<sup>19</sup> Moreover, the Working Party Report on the Accession of China<sup>20</sup> ("Working Party Report"), with its record of unique commitments, is incorporated into the China Protocol, which in turn is made "an integral part of the WTO Agreement."<sup>21</sup>

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<sup>17</sup> The United States, for example, commonly gives tax and other relief to its giant (if privately-owned) energy companies with the understanding that benefits reaped in the form of greater competitiveness will ultimately accrue to the national interest. *See, e.g.*, Energy Policy Act § 1323. For a recent example of additional proposed legislation, see Refinery Investment Tax Assistance Act of 2005, S. 1781, 109th Cong. (2005); *cf.* H.R. 4420, 109th Cong. (2005) (to repeal tax subsidies enacted by the Energy Policy Act for the oil and gas industry).

<sup>18</sup> *See* World Trade Organization, Working Party on the Accession of China, Working Party Report on the Accession of China, WT/ACC/CHN/49 (Oct. 1, 2001) [hereinafter Working Party Report], para. 172.

<sup>19</sup> *See infra* Part II.B.

<sup>20</sup> Working Party Report, para. 172.

<sup>21</sup> Protocol § 1.2.

A. *China's Unocal Loans to CNOOC Would Not Have Been "On a Commercial Basis"*

China may have had both strategic and commercial interests in acquiring Unocal, but by directing its SOEs to make unprofitable loans in order to finance the deal, it was directing them to act in a non-commercial manner. It was to the strategic aspects of the transaction that the United States Congress reacted with the Energy Policy Act.

CNOOC instigated its "friendly"<sup>22</sup> bid for Unocal following the start of other negotiations for that company with Chevron. CNOOC's proffered explanation for its interest in acquiring the California company<sup>23</sup> was that it believed the combined companies would have a leading position in the Asian energy market and an expanded role in the development of China's liquefied natural gas market.<sup>24</sup> CNOOC expected the transaction to more than double its oil and natural gas production and to almost double its reserves.<sup>25</sup> As a preliminary gesture to calm worries in American political circles about the potential energy security implications of the transaction, CNOOC offered its "assurances" on a number of factors: that it would continue to sell all products of Unocal's U.S. properties in U.S. markets, that it would retain all of Unocal's employees and managers, if possible, and that it would divest Unocal's non-North American assets to the extent that such divestitures would not have a "material adverse effect on Unocal."<sup>26</sup>

The terms of the deal offered were considerably more favorable than those posed by Chevron in a deal that Unocal's Board of Directors had already recommended to Unocal stockholders. Compared to the \$67 in cash per share of stock that CNOOC offered, amounting to about \$18.5 billion, Chevron had previously agreed to offer Unocal stockholders an election between \$65 per share of stock, 1.03 shares of Chevron common stock, or some combination thereof<sup>27</sup>—an offer worth somewhere in the neighborhood of a billion dollars less to Unocal shareholders.<sup>28</sup> Moreover, unlike CNOOC, Chevron had already stated that it planned to make

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<sup>22</sup> See Dittrick, *supra* note 2, at 25.

<sup>23</sup> Both Chevron and Unocal are based in California. See Chevron, Company Profile, [http://www.chevron.com/about/company\\_profile](http://www.chevron.com/about/company_profile); see also Unocal, A History of Unocal, <http://www.unocal.com/about/ucl/history/index.htm> (last visited May 4, 2006).

<sup>24</sup> See Dittrick, *supra* note 2, at 25.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> See Kurt S. Abraham, *FTC Accepts Chevron's Unocal Plan, CNOOC Challenges*, WORLD OIL, July 1, 2005, at 11.

significant cuts in the Unocal workforce should the merger be approved.<sup>29</sup> CNOOC's superior commitments were not enough, however, to ease the fears of U.S. lawmakers.

In spite of terms that arguably amounted to overpayment for a struggling U.S. company embroiled in various liabilities<sup>30</sup> and guarantees that the merger would not impact American energy security,<sup>31</sup> CNOOC's bid for Unocal ignited an immediate firestorm of political opposition.<sup>32</sup> Fifty members of the U.S. House of Representatives asked the U.S. Treasury Department to review the transaction for economic and strategic implications under the oversight of the Committee on Foreign Investment in the United States ("CFIUS"),<sup>33</sup> citing security concerns. This provoked a response that the House members may not have expected. CNOOC responded by stating that the company "had planned for and want[ed] to participate in a CFIUS review of the transaction as soon as possible," going on to say that "we believe it is vital to the success of the possible merged company."<sup>34</sup> The company was willing for the merger to undergo security review. Hesitations about the deal, however, extended beyond the House of Representatives.

Across the Capitol rotunda, the transaction was stirring emotion in the U.S. Senate as well. Several members of the Senate Finance Committee also pressed for CFIUS review.<sup>35</sup> Ultimately, the rhetoric against China became so heated that Beijing responded, stating, "We demand that the U.S. Congress correct its mistaken method of politicizing economic and trade issues, and stop interfering in normal business dealings between enterprises of the two countries . . . ."<sup>36</sup> Not surprisingly, this diplomacy was poorly received in Congress. Not long after China's frustrated outburst, Senators Kent Conrad and Jim Bunning were emboldened to raise the question of

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<sup>29</sup> See Dittrick, *supra* note 2, at 25.

<sup>30</sup> See, e.g., Mark Lifsher, *Unocal Settles Human Rights Lawsuit Over Alleged Abuses at Myanmar Pipeline*, L.A. TIMES, Mar. 22, 2005, at C1.

<sup>31</sup> See Dittrick, *supra* note 2, at 25.

<sup>32</sup> See, e.g., H.R. Res. 344, 109th Cong. (2005).

<sup>33</sup> Letter from the United States House of Representatives to John Snow, Secretary of the Treasury, June 24, 2005.

<sup>34</sup> From an Open letter from Fu Chegyu to the United States House of Representatives, June 27, 2005. See *Foreign Investment: Fifty House Members Ask Snow to Review Chinese Bid for Unocal*, 22 INT'L TRADE REP. 1070 (2005). In addition, on June 30, Rep. Joe Barton, Chairman of the House Energy and Commerce Committee, announced that House hearings would be commenced on the deal in "the very near future." See *Foreign Investment: Barton Calls for Hearing on China Unocal Bid; CNOOC Seeks CFIUS Review*, 22 INT'L TRADE REP. 1119 (2005).

<sup>35</sup> See *Foreign Investment: Senators Press Administration for Review of Chinese Oil Firm CNOOC's Bid for Unocal*, 22 INT'L TRADE REP. 1070 (2005).

<sup>36</sup> *Id.*



China's WTO commitments. In a letter<sup>37</sup> dated July 11, 2005 to the Commerce Secretary Carlos Gutierrez and U.S. Trade Representative Rob Portman, the Senators alleged that China may have violated its WTO commitments by providing what the letter called a "direct subsidy" to CNOOC. The letter called for the two officials to raise the issue at the Joint Commission on Commerce and Trade ("JCCT") in Beijing that same day.<sup>38</sup> The concerns of the Senators were not addressed at the JCCT.<sup>39</sup>

Ultimately, the deal was doomed by competing amendments introduced in the House and the Senate that only tangentially implicated the WTO. Representative Richard Pombo introduced an amendment to the Energy Policy Act that ultimately required, beyond CFIUS review, an extensive additional "study of the growing energy requirements" of China and their implications for the United States.<sup>40</sup> This was perhaps not coincidental given the fact that CNOOC competitor Chevron has its headquarters in his California district.<sup>41</sup> Contemporaneously, Senator Charles Schumer of New York added yet another hurdle for CNOOC. He

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<sup>37</sup> The text of the letter reads:

The Chinese government holds a 70 percent stake in CNOOC, and this proposed acquisition is clearly intended to advance the Chinese government's stated policy of building strategic energy reserves. . . . Indeed, the proposed acquisition is not being conducted on commercial terms, and has little commercial justification. CNOOC's bid for Unocal will require CNOOC to secure \$16 billion in funding from outside sources. Of this \$16 billion, \$13 billion will be provided by entities owned by Chinese government; and \$7 billion of this funding will be in the form of no-interest or low-interest loans from its state-owned parent company. This below-market financing arrangement is a direct subsidy provided by the Chinese government to CNOOC, through a state-owned enterprise. In addition, the remaining \$6 billion will be provided by state-owned banks, which often do not seek repayment of their loans. Without this subsidy, it is clear that CNOOC's bid would be uncompetitive and unworthy of consideration by Unocal's shareholders. . . . The financing arrangement . . . appears to violate commitments that China made when entering the . . . WTO. For example, China assured members that its state-owned banks would only lend to state-owned enterprises on market terms. The CNOOC transaction illustrates that China has failed to abide by this commitment.

Letter from Senators Conrad and Bunning to the Commerce Secretary Carlos Gutierrez, *supra* note 1.

<sup>38</sup> See *Foreign Investment: Senators Charge CNOOC's Unocal Bid Could Constitute WTO Violation*, *supra* note 3.

<sup>39</sup> *Id.*

<sup>40</sup> See Energy Policy Act of 2005, Pub. L. No. 109-58, § 1837(a), 119 Stat. 604 (2005); see also *Foreign Investment: Energy Policy Act to Mandate China Energy Study; Inhofe Seeks to Toughen CFIUS*, 22 INT'L TRADE REP. 1242 (2005). The required review would have added months of uncertainty to the proposed deal or any similar transaction. As an added kick on the way out the door, the bill also included an "assessment of the extent to which investment in energy assets . . . has been on market-based terms and free from subsidies" from China. See Energy Policy Act § 1837(a)(4).

<sup>41</sup> Chevron is headquartered in San Ramon, California. See *supra* note 23. San Ramon is in the 11th California congressional district. See U.S. Representative Richard Pombo, 11th District, <http://www.house.gov/pombo/district/district.htm> (last visited May 4, 2006).

appended<sup>42</sup> to a State Department and Foreign Operations Appropriations bill<sup>43</sup> a requirement that when any state-owned company sought to acquire an American company, an additional study be performed on trade reciprocity.<sup>44</sup> The same day, the Unocal Board once again recommended to shareholders that the lesser Chevron offer be accepted.<sup>45</sup>

On August second, CNOOC withdrew its bid, citing “unprecedented political opposition” and asserting that, operating with purely commercial motives, it had been willing to “address any legitimate concerns” U.S. policy makers might have had.<sup>46</sup> The question of whether or not the proposed financing package violated China’s commitments under the Protocol was dropped. On August tenth, the shareholders of Unocal approved Chevron’s takeover.<sup>47</sup>

*B. China Agreed Not to Make Policy Loans from Its State-Owned Enterprises as a Precondition to Membership in the WTO*

While it is certainly not unusual for national governments to direct investment to certain areas which may increase either their economic or military security,<sup>48</sup> China’s situation is complicated by unique market economy obligations in the China Protocol. As a precondition to entry into the WTO, China was forced to make certain specific and unique commitments with regard to the intersection of its state-owned enterprises (“SOEs”) and its conduct in international trade.<sup>49</sup> Among those commitments was an agreement by China to forgo the strategic use of low- or no-interest loans by SOEs to strategically secure market share in the trade of goods, services, and commodities in a manner not available to more fully marketized nations.<sup>50</sup> Precisely why the original WTO members felt it necessary to impose numerous strictures on China is beyond the scope of this Comment. It is clear, however, that the strategic use of such loans by Chinese SOEs in acquisitions of overseas oil and energy services companies implicates China’s unique commitments under the Protocol.

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<sup>42</sup> S. Amdt. 1304, 109th Cong. (2005).

<sup>43</sup> H.R. 3057, 109th Cong. (2005).

<sup>44</sup> See *Foreign Investment: Sen. Schumer’s Amendment to Foreign Ops Bill Would Delay CNOOC Purchase of Unocal*, 22 INT’L TRADE REP. 1246 (2005).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> See Associated Press Release, *Unocal Shareholders Approve Chevron’s \$18 Billion Takeover Offer*, N.Y. TIMES, Aug. 10, 2005.

<sup>48</sup> See, e.g., Energy Policy Act of 2005, Pub. L. No. 109-58, § 1323, 119 Stat. 604 (2005).

<sup>49</sup> See Qin, *supra* note 10, at 505-06.

<sup>50</sup> *Id.*

Because the WTO is premised on free-market assumptions, the integration of China's "socialist market system"<sup>51</sup> creates problems. The potential trade-distorting effects of large scale state ownership of industry in China<sup>52</sup> spurred the WTO Working Party on the Accession of China ("Working Party") to require commitments by China to not make loans or set interest rates for non-commercial reasons. There is also significant cause to believe that the United States utilized the accession negotiation to put in place obligations as a check on Chinese economic growth.<sup>53</sup> These commitments were made specifically in Paragraphs 172 and 173 of the Working Party Report, explicitly incorporated into the Protocol by Paragraph 342 of the Working Party Report, and constitute international legal commitments binding China.

To address the concerns of the Working Party<sup>54</sup> about the integration of China's "socialist market system"<sup>55</sup> into the WTO, China confirmed that "all state-owned and state-invested enterprises would make purchases and sales based solely on commercial considerations . . . ."<sup>56</sup> In other words, China agreed not to direct the commercial decisions of its SOEs on the basis of strategic or policy considerations that are divorced from immediate profit and loss. Chinese SOEs under the socialist market model envisioned by the Protocol are to act in a manner effectively identical to private enterprises.<sup>57</sup> While the Chinese government may have multiple policy goals for any given sector, it agreed not to utilize subsidies to its SOEs to fulfill those goals.

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<sup>51</sup> See Julia Ya Qin, *WTO Regulation of Subsidies to State-Owned Enterprises (SOEs)—A Critical Appraisal of the China Protocol*, 7 J. INT'L ECON. L. 863, 872 (2004) (noting that a socialist market economy is defined as one "in which prices are set by the marketplace and public ownership dominates but coexists with private and other non-state sectors").

<sup>52</sup> See Working Party Report, para.171 ("Some members of the Working Party expressed concern that the special features of China's economy . . . still created the potential for a certain level of trade distorting subsidization . . ."). There continues to be a debate about whether or not certain SOEs investment measures actually significantly distort trade. See, e.g., Qin, *supra* note 10, at 503.

<sup>53</sup> See *infra* note 146.

<sup>54</sup> Many of the concerns of the Working Party could more accurately be characterized as the concerns of the United States. Simultaneous with the Working Party's negotiation with China regarding the terms of its Accession to the WTO, delicate bilateral negotiations were taking place with the United States. Much of the language of China's Working Party Report commitments was adopted verbatim from the results of the U.S.-China talks. See, e.g., Qin, *supra* note 51, at 913.

<sup>55</sup> China continues to maintain state ownership and control of major industries, and to manage them in manner consistent with a planned economy. The idea behind "market socialism" was that ownership of industry would continue to be held by the Chinese state, but that industry would be independently managed in response to market forces. See *supra* note 51.

<sup>56</sup> Working Party Report, para. 46.

<sup>57</sup> See Working Party Report, para. 43 ("The representative of China stated that the state-owned enterprises of China basically operated in accordance with rules of market economy. The government would no longer directly administer the human, finance and material resources, and operational activities such as production, supply and marketing.").

Presumably, this distinction between the actions of the government as *government* and the actions of government as *owner* was considered by the Working Party to be a necessary prerequisite to membership in the WTO club. Whatever the motivation of the Working Party, however, the Protocol clearly prohibits subsidies—whether in the form of direct payments or loan forgiveness—intended to direct the actions of SOEs for policy reasons.<sup>58</sup> The Protocol requires the decisions of SOEs to be made on the same bases that private industries use. That is, whether a given transaction will be profitable or not. Critically, if a transaction would not be profitable *without* subsidization, then that transaction is *not* being undertaken for commercial reasons.<sup>59</sup> Most importantly, in the context of below-market interest rate subsidies from SOEs for the purpose of acquiring energy assets, China made commitments, recorded in paragraphs 172 and 173 of the Working Party Report, that its financial institutions should be “run on a commercial basis,”<sup>60</sup> and that China would “reduce the availability of certain types of subsidies, in particular by . . . making government-owned banks operate on a commercial basis.”<sup>61</sup>

C. *The Working Party Report Amounts to a Treaty between China and the WTO, and Is an “Integral Part of the WTO Agreement”*

China’s Accession Protocol has a unique status in the WTO system that makes the restrictions on Chinese SOEs relevant outside the isolated circumstances of CNOOC-Unocal. First, each paragraph in the Working Party Report in which a commitment by China to the WTO is recorded is “noted” by the Working Party in Paragraph 342 of the Working Party Report.<sup>62</sup> The Working Party further “notes” that China’s commitments “are incorporated in paragraph 1.2 of the Draft Protocol,”<sup>63</sup> which entered into force as the China Protocol.<sup>64</sup> The Declaration of Accession<sup>65</sup> itself, in its

<sup>58</sup> See Working Party Report, paras. 172, 173. For discussion, see *infra* Part II.D.

<sup>59</sup> This is hardly an interpretive leap when it comes to the term “commercial.” The dictionary definition of the term is “Having profit, success, or immediate results as chief aim.” See American Heritage Dictionary of the English Language 267 (William Morris, ed., Houghton Mifflin, 1970). This interpretation is also supported by WTO jurisprudence. See Panel Report, *Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS161/R ¶ 757 (July 31, 2000) (“The list of variables that can be used to assess whether a state-trading action is based on commercial consideration [is comprised of] . . . prices, availability etc. . .”).

<sup>60</sup> Working Party Report, para. 172.

<sup>61</sup> *Id.* at para. 173.

<sup>62</sup> *Id.* at para. 342.

<sup>63</sup> *Id.*

<sup>64</sup> In standard WTO form, the Declaration of Accession serves as a “cover page” to the larger agreement contained in the Protocol. See World Trade Organization, Ministerial Declaration of 23 November 2001, Accession of the People’s Republic of China, WT/L/432 (2001).

preamble, also refers to “the results of the negotiations directed toward the establishment of the terms of accession of the [PRC] to the [WTO Agreement].”<sup>66</sup> In case there should be any mistake as to the import of this, the Protocol also makes note of the Working Party Report,<sup>67</sup> before declaring in one of its opening paragraphs that:

The WTO Agreement to which China accedes shall be the WTO Agreement as rectified, amended or otherwise modified by such legal instruments as may have entered into force before the date of accession. This Protocol, which shall include the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement.<sup>68</sup>

This agreement, incorporated into the greater system of WTO agreements, constitutes a binding treaty between China and the WTO. According to Article 2 of the Vienna Convention on the Law of Treaties between States and International Organizations<sup>69</sup> (“VCLT-IO”),<sup>70</sup> a treaty is an international agreement, in written form, between a state and one or more international organizations, whether that agreement is contained in one or multiple related instruments.<sup>71</sup> Here, the combined Working Party Report and Protocol clearly qualify and consequently are binding international law cognizable by the WTO’s dispute resolution bodies.

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<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> Working Party Report, pmb1.

<sup>68</sup> Protocol § 1.2.

<sup>69</sup> Vienna Convention on the Law of Treaties between States and International Organizations or Between International Organizations, Mar. 21, 1986, 25 I.L.M. 543 [hereinafter VCLT-IO]. In past decision of the WTO Appellate Body, the 1969 Vienna Convention on the Law of Treaties between States, May 23, 1969, 1155 U.N.T.S. 331, has been used as the guidepost for WTO agreement interpretation. *See, e.g.,* Appellate Body Report, *United States—Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R (Apr. 29, 1996), at 17 (Vienna Convention on the Law of Treaties between States forms “general rule of interpretation . . . [and] has attained the status of a rule of customary or general international law”); *see also* Claus-Dieter Ehlermann, *Experiences from the WTO Appellate Body*, 38 TEX. INT’L L.J. 469, 480 (2003). Dr. Ehlermann is former chairman of the Appellate Body.

In this case, the agreement at issue is arguably one between the WTO and China, rather than between the WTO member-nations and China, and the 1969 Convention is inapplicable. This is an academic distinction for interpretive purposes, however: Article 2, as well as Articles 31 and 32 of the two treaties, those governing interpretation of international agreements, are duplicative. *See infra* Part III.D.

<sup>70</sup> It is hoped that the use of this abbreviation does not create confusion with the similarly named 1969 Convention, but if it does, it will not be too great a tragedy for readers’ understanding. The operative language examined here is identical. *See supra* note 69.

<sup>71</sup> VCLT-IO, *supra* note 69, art. 2.

D. *Properly Interpreted, China's Unique Commitments Would Have Barred the Funding Package*

Article 31 of the VCLT-IO provides that, "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."<sup>72</sup> The context under which the agreement was entered is to be determined by the text itself, including its preamble and annexes, as well as any related agreements.<sup>73</sup> Together with the context, interpretation is based on subsequent agreements that address the interpretation of the primary agreement, as well as subsequent practice of the parties and any other relevant rules of international law.<sup>74</sup>

Under the "ordinary meaning" test generally given the greatest weight by the WTO Appellate Body,<sup>75</sup> Paragraph 172 of the Working Party Report states that SOEs, including banks, should be run on a commercial basis.<sup>76</sup> Immediately following, the Working Party notes that *this* is the commitment—that SOEs run on a commercial basis, and be responsible for their profits and losses.<sup>77</sup> Again, it is critical to make the distinction between the multiple goals allowed to the state when acting in its capacity as such, and the circumscribed conduct allowed to the state in its capacity as *owner* of SOEs. In its capacity as owner, the state may not utilize subsidies to its SOEs for the purpose of furthering conduct in a manner that would not be available to states where those same enterprises would be in private hands. Subsidies to SOEs, granted for the purpose of making an otherwise losing transaction profitable, in order to further a state policy goal are precisely those forbidden by the Protocol. Under the Protocol, the decisions of Chinese SOEs must be made on the basis of increasing profit and avoiding loss. Subsidies that alter this calculus are forbidden. This is the meaning of the "commercial basis" requirement. No reasonable ordinary-meaning interpretation would take this to allow for the provision of loans that return little or no interest, like those proposed for the Unocal acquisition, because there is simply no commercial rationale for such loans. Accordingly, the *only* rationale for them must be a strategic or policy one, and consequently a violation of the commitment.

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<sup>72</sup> VCLT-IO *supra* note 69, art. 31.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See Ehlermann, *supra* note 69, at 480.

<sup>76</sup> See Working Party Report, para. 172.

<sup>77</sup> *Id.*

Paragraph 173 presents a harder case under the ordinary-meaning test, but not by much. The sentence “The Working Party took note of this commitment” clearly modifies the preceding one—that “China would progressively work towards a full notification of subsidies, as contemplated by Article 25 of the SCM Agreement.”<sup>78</sup> The “SCM Agreement” is the Agreement on Subsidies and Countervailing Measures.<sup>79</sup> This notification requirement<sup>80</sup> commitment makes little sense, however, when read without reference to the preceding sentence, commenting that China was attempting to reduce the availability of subsidies, in particular those related to noncommercial bank loans. Seen from this perspective, it becomes clear that Paragraphs 172 and 173 must be read together to constitute a commitment on the part of China to forgo the use of investment subsidies from SOEs to achieve state economic or security policy goals—the precise type of subsidy at issue in CNOOC-Unocal. Whether or not China may have commercial, strategic, macroeconomic, *and* other policy goals when it subsidizes industries is irrelevant. The only allowable considerations from the perspective of the enterprise involved in the transaction at issue are commercial ones. It is precisely this separation of multiple and overlapping state interests from the operation of SOEs at which the Protocol attempts to strike.

This conclusion is supported by both the context<sup>81</sup> under which the Working Party agreements were made and the objects and purposes<sup>82</sup> of the negotiated commitments that are incorporated into the China Protocol through the Working Party Report.<sup>83</sup> China acceded to the WTO in the context of becoming integrated into the market system<sup>84</sup> and reducing and

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<sup>78</sup> See Working Party Report, para. 173.

<sup>79</sup> Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 33 I.L.M. 1226 (1994) [hereinafter SCM Agreement]; see Working Party Report, para. 172. Paragraph 172 then notes the Chinese representative’s belief that some subsidies would not confer a “benefit,” a definitional element under the SCM Agreement. Nonetheless, the representative pointed out that China’s objective was that “state-owned enterprises, including banks, should be run on a commercial basis and be responsible for their own profits and losses.” See *id.*

<sup>80</sup> Some context is required to understand why this is notable. Under the SCM Agreement, WTO members are required to notify the general council regarding the existence of subsidies, so they can be examined as to whether they fall under the definition of banned price supports. See SCM Agreement art. 25. In China’s case, the lack of notification is particularly relevant; China’s Accession Schedule requires that price supports of various kinds be reported and/or phased out at various points preceding or following accession. See Protocol § 10.1. Thus, failure to report prohibited subsidies could be a preface to renegeing on commitments to phase them out.

<sup>81</sup> See VCLT-IO, *supra* note 69, art. 31.1

<sup>82</sup> *Id.*

<sup>83</sup> See *supra* Part II.C.

<sup>84</sup> See Qin, *supra* note 10, at 504-7.

eliminating state behavior that distorts market outcomes.<sup>85</sup> The objects and purposes of agreements are the final major factors that the WTO Appellate body gives significant weight.<sup>86</sup> With respect to the objects and purposes of the China Protocol, it is equally clear that the Protocol was intended by the Working Party to serve as a restriction on China's use of its SOEs for non-market purposes.<sup>87</sup> Were this not the case, it is hard to see why the Working Party would have mentioned, repeatedly, its concerns regarding China's conduct via its SOEs.<sup>88</sup>

More importantly, had the Working Party and the General Council<sup>89</sup> not intended the Protocol to impose substantive disciplines on the conduct of the SOEs, it would not have imposed special subsidy notification requirements on China.<sup>90</sup> Neither would it have clarified that *all* subsidies to SOEs would be viewed as "specific" to an enterprise or industry under the SCM Agreement, and thus automatically be subject to the "Actionable Subsidies" provisions of Article 3 of that agreement.<sup>91</sup> The objects and purposes of the Protocol are, among other things, to impose market discipline on China as a world trading partner, and thus open to it the benefits of membership in the WTO.<sup>92</sup> These market disciplines would have barred the use of selective interest rate subsidies from SOEs to CNOOC.

The commitments in the Working Party Report were violated and are enforceable against China by any WTO member under the WTO Dispute Settlement Understanding. This was not by mistake; in order for China to accede to the WTO, it had to agree to special conditions enforceable against it but inapplicable against any other member. It is precisely these WTO-plus rules of decision that promise to create problems within the DSU in the future.

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<sup>85</sup> See Working Party Report, para. 6 (noting that China's reform measures tend toward "a separation of government from enterprise"); cf. Qin, *supra* note 51, at 895-96 (arguing that the Protocol's assumption that China's SOEs are particularly damaging to trade is misplaced).

<sup>86</sup> See VCLT-IO, *supra* note 69, art. 31.1; see also Ehlermann, *supra* note 69, at 480.

<sup>87</sup> See *supra* Part II.B.

<sup>88</sup> See, e.g., Working Party Report, paras. 43-50, 171-76.

<sup>89</sup> The General Council consists of all WTO member states acting in their "legislative" capacity (i.e., in the capacity of drafting agreements).

<sup>90</sup> See Protocol § 10.1.

<sup>91</sup> See Protocol § 10.2. This is an extremely important (and unique) provision. It provides that states that would seek to challenge SOE subsidies have a difficult threshold question—whether subsidies are intended for a specific policy purpose, already answered in the affirmative. Essentially, the provision considerably lightens the burden of a state that wishes to challenge PRC subsidies. For a thorough discussion of the "specificity" provision in the Protocol, see Qin, *supra* note 51, at 889-92.

<sup>92</sup> See *supra* note 55.



III. NO GENERALLY APPLICABLE SECTION OF THE WTO AGREEMENT WOULD HAVE BARRED CNOOC'S FUNDING PROPOSAL, BUT ANY MEMBER COULD HAVE STOPPED THE DEAL

China's unique commitments, as an integral part of the rules of decision under the DSU would have barred the CNOOC-Unocal funding package. At the same time, any other member of the WTO could have used its SOEs for precisely the same purposes that would have been barred to China. The deal was perfectly acceptable under the generally applicable rules of the WTO. The funding package would have been acceptable under the Uruguay Round Agreement on Trade Related Investment Measures<sup>93</sup> ("TRIMs") because that agreement is limited to certain types of investment measures not at issue in CNOOC-Unocal. Similar problems make the SCM Agreement inapplicable. Moreover, the Chinese interest rate subsidies at issue in CNOOC-Unocal would have been allowed under the Uruguay Round Amendments to the General Agreement on Tariffs and Trade<sup>94</sup> ("GATT 1994") and thus not amenable to challenge under the DSU. Under the China Protocol, however, the funding package could have hypothetically subjected China to everything from requests for burdensome consultations to outright countermeasures by any other WTO member.

A. *TRIMs Did Not Apply to CNOOC-Unocal Because the Deal Was Not Covered by the Agreement*

The first investigation to be made when confronted with a questionable investment measure by a WTO member-state is whether TRIMs bars the measure. The CNOOC-Unocal financing package would not have been so barred. While there is no decision by a competent WTO judicial body on the scope and application of Article 1 of TRIMs,<sup>95</sup> which defines the investment measures covered as those related to goods, the agreement is generally considered to be limited to a certain class of measures.<sup>96</sup> As the Dispute Settlement Panel clarified in *Indonesia—Autos*,

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<sup>93</sup> Agreement on Trade-Related Investment Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 33 I.L.M. 1226 (1994) [hereinafter TRIMs].

<sup>94</sup> General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 33 I.L.M. 1226 (1994) [hereinafter GATT 1994].

<sup>95</sup> See World Trade Organization, WTO Analytical Index: Guide to WTO Law and Practice—Agreement on Trade-Related Investment Measures, at [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/trims\\_01\\_e.htm#pB](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trims_01_e.htm#pB) (last visited May 4, 2006).

<sup>96</sup> See Kevin C. Kennedy, *A WTO Agreement on Investment: A Solution in Search of a Problem?*, 24 U. PA. J. INT'L ECON. L. 77, 135-41 (2003).

referring to TRIMs Article 2's definition of the scope of the agreement,<sup>97</sup> "In the case of the TRIMs Agreement, what is prohibited are TRIMs in the form of local content requirements, not the grant of an advantage, such as a subsidy."<sup>98</sup> The "illustrative list" appended to the TRIMs agreement confirms this interpretation of its scope. Covered measures are those "mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage," that require the use of domestic content in production by foreign-owned companies, or import restrictions on production components.<sup>99</sup> Accordingly, the investment at issue in CNOOC-Unocal is far outside the scope of TRIMs.

*B. The SCM Agreement Also Did Not Apply to the CNOOC Because the Subsidy Would Not Have Caused Adverse Effects to U.S. Industry*

In spite of the subsidized nature of the CNOOC-Unocal financing package, it was within the bounds of acceptable state conduct under the SCM Agreement. Although the China Protocol makes all subsidies to SOEs *de jure* "specific" to an industry for purposes of the SCM Agreement,<sup>100</sup> the subsidies at issue in CNOOC-Unocal would not have triggered any of the agreement's prohibitions or grounds for remedy. First, subsidies prohibited outright by the SCM Agreement are, like forbidden investment measures in TRIMs, those contingent on domestic content requirements or preferences for domestic products. Second, as to those subsidies that are "actionable" under Part III of the SCM Agreement, a subsidy must cause "adverse effects to the interests of other Members."<sup>101</sup> For example, subsidies that injure the domestic industry of another member, nullify another member's GATT 1994 Article II<sup>102</sup> benefits, or cause "serious prejudice" to the interests of another member are barred.<sup>103</sup> Simply put, the "actionable subsidies" of the SCM Agreement are those which would constitute export dumping to the

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<sup>97</sup> Article 2.1 of TRIMs states that the scope of the measures inconsistent with the agreement are those which violate the provisions of Articles III and XI of GATT 1994, discussing national treatment in taxation and regulation, and elimination of quantitative restrictions, respectively. TRIMs arts. 2.1, 2.2; see GATT 1994, *supra* note 94, arts. III, XI.

<sup>98</sup> Panel Report, *Indonesia—Certain Measures Affecting the Automobile Industry*, ¶ 14.50-14.52 WT/DS54/R (July 2, 1998) [hereinafter *Indonesia—Autos*].

<sup>99</sup> TRIMs Annex I.

<sup>100</sup> See *supra* note 91.

<sup>101</sup> SCM Agreement art. 5.

<sup>102</sup> Article II of GATT 1994 outlays members' concessions and commitments under the Agreement. Relevant to the inquiry of subsidies is the ability to impose countervailing duties in response to barred export dumping done for the purpose of gaining market power. See GATT 1994 art. II.2(b).

<sup>103</sup> SCM Agreement art. 5(a)-(c).

detriment of trading partners' specific industries. CNOOC-Unocal would thus not have been prohibited by the agreement because dumping issues were not implicated.

CNOOC-Unocal would have actually kept more workers employed at Unocal, as well as giving Unocal shareholders a significantly better return on their investment than the Chevron offer. Similarly, the proposed acquisition would not have impaired the United States' ability under Article II of GATT 1994 to challenge dumping practices. As for the argument that the acquisition might have caused "serious prejudice" to the interests of the United States, such prejudice is deemed to exist by Article 6 of the SCM Agreement when a specific *product* is subsidized, ad valorem, more than 5 percent, or when subsidies are granted to cover an industry's operating losses.<sup>104</sup> The only sense in which the United States could arguably have been said to have suffered serious prejudice as a result CNOOC-Unocal merger was that the "effect of the subsidy [would have been] an increase in the world market share of the subsidizing member in a particular subsidized . . . commodity . . ."<sup>105</sup> As the Panel pointed out in *Indonesia—Autos*, however, "serious prejudice may only arise . . . where there is 'displacement or impedance of imports of a like product from another Member' or price undercutting 'as compared with the like product of another Member . . .'"<sup>106</sup> In other words, the "serious prejudice" provision, like the rest of Article 6, is meant to provide a remedy for dumping, *not* subsidized overseas investments of the type at issue in CNOOC-Unocal.

C. *GATT 1994 Would Not Have Barred CNOOC-Unocal Because Neither China's Nondiscrimination nor Its National Treatment Obligations Were Implicated*

It is unlikely that any reasonable interpretation of GATT 1994 would be even remotely implicated by the CNOOC-Unocal transaction. GATT 1994, like its predecessor agreement,<sup>107</sup> is intended to serve two general purposes related to the trade in goods: (1) to provide a generalized most-favored nation (or nondiscrimination) obligation among WTO members, so that any trade advantages extended by one WTO member to another must be extended to all members,<sup>108</sup> and (2) to institutionalize the principle of

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<sup>104</sup> SCM Agreement art. 6.

<sup>105</sup> SCM Agreement art. 6.3(d).

<sup>106</sup> *Indonesia—Autos*, ¶ 14.201.

<sup>107</sup> GATT 1947.

<sup>108</sup> See GATT 1994 art. I; see also WORLD TRADE ORGANIZATION, UNDERSTANDING THE WTO, at 10 [hereinafter UNDERSTANDING THE WTO], available at World Trade Organization, What is the WTO?,

national treatment whereby members may not discriminate between domestic and imported goods either in taxation or regulation.<sup>109</sup> China, in attempting to subsidize the acquisition of Unocal, was almost certainly not doing so *because* Unocal was American, but simply because the acquisition served China's national interest. Accordingly, the nondiscrimination principle was not implicated. Similarly, China was not using its internal regulation to differentiate between domestic and foreign goods; rather, it was attempting to acquire greater access to a commodity traded on a global market. Such provisions of GATT 1994 which could be interpreted as barring the subsidization of state trading enterprises for noncommercial purposes are explicitly limited by the overarching goals of the agreement.<sup>110</sup>

*D. Any WTO Member Could Have Initiated Consultation Under the Dispute Settlement Understanding, and the Burden Would Have Been on China to Show an Absence of a Violation*

In spite of the fact that no generally applicable section of the WTO Agreement would have made CNOOC's financing plan illegal, any WTO member would have had standing to attempt to successfully challenge the merger under the Dispute Settlement Understanding.<sup>111</sup> Article XII of the WTO Agreement created a "loophole," under which the founding WTO members could impose additional WTO rules beyond those generally applicable on members acceding to the organization after the original entry into force.<sup>112</sup> This, of course, is the source of China's peculiar restrictions

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[http://www.wto.org/english/thewto\\_e/whatis\\_e/whatis\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm) (downloadable in text, Microsoft Word, or PDF format) (last visited May 4, 2006).

<sup>109</sup> See GATT 1994 art. III; see also UNDERSTANDING THE WTO, *supra* note 108, at 11.

<sup>110</sup> See, e.g., GATT 1994 art. XVII, para. 1. Article XVII, paragraph 1(b) states that state trading enterprises must make purchases or sales "solely in accordance with commercial considerations"; however, unlike the similar language in the China Protocol, this provision is intended simply as a modifier of paragraph 1(a), which requires state trading enterprises to follow the nondiscrimination and national treatment obligations. An argument could be made that a state trading enterprise which acquires access to a commodity for the putative purpose of directing it to the state in preference over other members would be acting in anticipation of discriminatory treatment. However, unless actual discriminatory treatment could be demonstrated, no violation of WTO norms would exist. The WTO, like any reasonable legal system, does not preemptively punish its subjects for *potential* violations of the law.

<sup>111</sup> DSU art. 3.8; see Qin, *supra* note 10, at 509-10 ("Under the DSU, the failure of a Member to carry out its obligations under a covered agreement is considered a *prima facie* case of nullification or impairment, meaning there is a presumption that a breach of the rules has an adverse impact on other Members . . . . Accordingly, should China fail to carry out any of its WTO-plus obligations . . . any other WTO Member may seek redress through the WTO dispute settlement system . . . .").

<sup>112</sup> WTO Agreement, *supra* note 9, art. XII. See generally Qin, *supra* note 10, at 487-491 (noting how the integration of the Working Party Report into the Protocol, and further integrated the Protocol into the WTO Agreement, created a separate and unique body of permanent WTO rules that are specific to China, and extend far beyond the terminable market access schedules required of either the original contracting parties to the agreement or any other acceding state.)

with regard to investment subsidies. As a result of these additional obligations, and because the China Protocol is “made an integral part of the WTO Agreement,”<sup>113</sup> any member of the WTO, whether founding or newly admitted, may challenge a violation of the Protocol by China.

China’s obligations under the Protocol, regardless of reciprocity from other members, are technically not unilateral commitments at all. Rather, they are rule obligations that “represent a common agreement among all members,” however counterintuitive this may seem.<sup>114</sup> As such, the Protocol becomes cognizable as part of the greater WTO Agreement for purposes of the DSU, and a charge of breach of the commitments invokes a *prima facie* assumption that the accused state has nullified its duties under the agreement.<sup>115</sup> In such a circumstance, the burden is on the accused state to prove that no impairment of commitments occurred.<sup>116</sup> As a result of this quirk in the intersection of the Protocol’s unique “WTO-plus” nature and the burdens of proof under the DSU, delicate commercial transactions by Chinese SOEs that would not otherwise offend the generally applicable provisions of the WTO agreements may be overshadowed by the threat of the compulsory jurisdiction of the Dispute Settlement Body.<sup>117</sup> A significant burden would be imposed by such a threat to China’s business, regardless of the merit of the challenging party’s underlying claims. This feature of the China Protocol promises to eventually bring to light the challenges to WTO legitimacy latent in CNOOC-Unocal.

#### IV. CNOOC-UNOCAL FORESHADOWS CHALLENGES TO THE RULE OF LAW IN THE WTO’S DISPUTE RESOLUTION UNDERSTANDING

Perhaps the greatest strength and innovation of the WTO system is that it transformed a power-based, diplomacy oriented system of world trade regulation into a mostly rules-based and principle-oriented system.<sup>118</sup> This

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<sup>113</sup> Protocol § 1.2.

<sup>114</sup> See Appellate Body Report, *European Communities—Customs Classification of Certain Computer Equipment*, WT/DS62, 67 and 68/AB/R, ¶ 109 (June 22, 1998) (holding that independent tariff schedules of each member collectively constitute a body of rules applicable to all members); see also Qin, *supra* note 10, at 509.

<sup>115</sup> See DSU art. 3.8.

<sup>116</sup> *Id.*

<sup>117</sup> The Dispute Settlement Understanding is a many-tiered process that begins with consultations between the parties, transitioning to mediation, the formation of Panels to address the disputes, and finally the jurisdiction of the permanent Appellate Body to review panel decisions. Apart from the general obligation of good faith under the Agreements, and the requirement that members exercise “good judgment” in bringing disputes to the fore contained in DSU art. 3.7, there is no guarantee that burdens of the process itself cannot be invoked as an obstacle to the culmination of politically sensitive transactions.

<sup>118</sup> See Qin, *supra* note 10, at 514.

was not by accident. A competitive, state-based system regulating tariffs and quotas results in overall greater restrictions on international trade.<sup>119</sup> This consequently nullifies many of the potential benefits of comparative advantage for *all* states, including the powerful. The rationale of the GATT/WTO system from Bretton Woods<sup>120</sup> onward has been to utilize negotiated agreements between state actors to create a system of rules that dismembers barriers to trade and thus increases the collective wealth of the entire world.<sup>121</sup> While the original incarnation of the GATT was based partially on the rule of law, the advent of the WTO institutionalized a universally applicable legal system as an indispensable feature of world trade.<sup>122</sup> Because one of the key components of the rule of law is that the law be generally applicable,<sup>123</sup> the China Protocol, as demonstrated by its possible application to the CNOOC-Unocal merger, threatens the rule of law in the WTO system.

The China Protocol creates discriminatory rules in the WTO system that are non-reciprocal and not applicable to any other country.<sup>124</sup> These obligations are the first WTO rules to shatter the uniformity of the trading system and thus significantly impair the rule of the law under the WTO agreements.<sup>125</sup> Moreover, the “integral” inconsistencies within the WTO Agreement created by the China Protocol, and demonstrated by the latent rule violation in CNOOC-Unocal, have the potential to give rise to substantive conflicts within the agreement itself as WTO member states use

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<sup>119</sup> See UNDERSTANDING THE WTO, *supra* note 108, at 25 (recording overall drop in tariff rates since institution of WTO).

<sup>120</sup> See Benjamin J. Cohen, Bretton Woods System, <http://www.polsci.ucsb.edu/faculty/cohen/inpress/bretton.html> (last visited May 4, 2006).

<sup>121</sup> See UNDERSTANDING THE WTO, *supra* note 108, at 13 (“The case for open trade”).

<sup>122</sup> See Qin, *supra* note 10, at 514; see also UNDERSTANDING THE WTO, *supra* note 108, at 23 (“The WTO is ‘rules based’”).

<sup>123</sup> See Qin, *supra* note 10, at 514.

<sup>124</sup> See *id.* at 515. It is important to reiterate that the rule obligations in the China Protocol are different in kind from the various custom-tailored market access requirements applicable to every WTO member-state. While the market access requirements are imposed according to individualized schedules, and are altered when necessary to conform to changed conditions, the obligations of the China Protocol are, as an integral part of the WTO Agreement, only subject to amendment via the formal amendment process prescribed by the Agreement itself. See WTO Agreement, *supra* note 9, art. X (describing structure for amendment of covered agreements). It has been observed that it is “nearly impossible” to amend the WTO Agreement, in that to do so requires a consensus of all WTO members. See Qin, *supra* note 10, at 485.

<sup>125</sup> See Qin, *supra* note 10, at 514. An argument could be made that the existence of free trade agreements and customs unions created non-uniform application of the WTO rules. Such an argument misunderstands the nature of the burdens imposed by the Protocol. The Protocol is not merely *applied* differently, it is a unique collection WTO *rules* that are specifically directed at one member and one member only. In other words, it is not a generally applicable rule that interacts differently with different members; rather, it is a discriminatory amendment of the actual governing WTO Agreements, and subject to the high hurdles of the covered agreements’ amendment process.

them for purposes outside the traditional scope of the WTO's governance. These conflicts, when they arise, will require the Dispute Settlement Body's Panels and the WTO Appellate Body to craft substantive rules of decision not currently present in the WTO Agreement. Because the Dispute Settlement Body "cannot add to or diminish the rights and obligation provided in the covered agreements,"<sup>126</sup> such substantive rulemaking will further impair the legitimacy of—and rule of law within—the WTO.

A. *China's Discriminatory Rule Obligations Undermine the Core Purposes of the WTO Agreement*

Among the WTO's stated purposes is the "elimination of discriminatory treatment in international trade relations."<sup>127</sup> It is difficult to reconcile this with singular obligations placed on China by the Protocol. Simply put, CNOOC-Unocal illustrates that China's unique WTO rule obligations bar behavior that would be acceptable if undertaken by any other state. Whether the type of policy-driven investment subsidies in the CNOOC-Unocal funding package are desirable or fair is not particularly relevant to the question of how they will affect the WTO system. What is relevant is that the special restrictions contained in the China protocol weaken the WTO as a whole.

The WTO Agreement states that "The WTO shall facilitate the implementation, administration and operation, and further the objectives, of this Agreement and of the Multilateral Trade Agreements . . . ."<sup>128</sup> The objectives of all the covered agreements, while tailored to their individual subject matters, are essentially the same: "raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources . . . ."<sup>129</sup> This is to be accomplished by "entering into *reciprocal* and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the *elimination of discriminatory treatment in international trade relations . . . .*"<sup>130</sup> These goals are echoed throughout all the covered agreements. Or rather, they are echoed throughout all the covered agreements except one.

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<sup>126</sup> DSU art. 3.2.

<sup>127</sup> WTO Agreement at pmb1.

<sup>128</sup> *Id.* at art. III.1.

<sup>129</sup> *Id.* at pmb1.

<sup>130</sup> *Id.* (emphasis added).

The China Protocol singles out China for dozens of highly specific, unique, and detailed disciplines not required of any other WTO member. China, of course, assented to the unique rule requirements contained in the Working Party Report, and by extension, in the China Protocol and the WTO Agreement.<sup>131</sup> That said, the fact that China is willing (currently) to shoulder the substantial obligations that the China Protocol imposes on it does not mean those obligations will not pose greater problems for the WTO system as a whole. Dismantling the uniformity of WTO rule application conflicts with the underlying goals of the organization.

The uniformity of the rule of law in the WTO system was one of the major advances in the world trade system when the transition from the GATT to the WTO occurred.<sup>132</sup> Under the GATT, inconsistent rule obligations led to inconsistent and high tariffs rates among member-states, albeit lower than those imposed without the GATT.<sup>133</sup> One of the major flaws in the GATT system was that states with greater negotiating power could impose more stringent trade disciplines on less powerful states, thus undermining the incentives for developing nations to join the GATT in the first place, or to perform on obligations after joining.<sup>134</sup> In essence, for all but a few GATT members, the balance between benefits and obligations under the agreement tilted perilously close to even, making the agreement less effective and less legitimate overall. The WTO sought to cure this defect by making the application of trade rules more uniform and thus creating greater incentive for states—particularly transitional and developing states—to join and perform on the obligations. This carrot is balanced by the stick of the compulsory jurisdiction of the Dispute Settlement Body in cases of nullification or impairment of obligations.<sup>135</sup>

CNOOC-Unocal illustrates the discriminatory nature of the China Protocol. No agreement on investment or subsidies, let alone any other generally applicable WTO agreement, bars strategic use of subsidies to promote greater overseas investment in particular market sectors. But, as U.S. Senators Conrad and Bunning correctly pointed out to the U.S.

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<sup>131</sup> China's trade delegation to the accession negotiations were obviously given broad latitude by the Chinese government as to the scope of the assorted negotiations that went into the crafting of the Protocol.

<sup>132</sup> Qin, *supra* note 10, at 515.

<sup>133</sup> *See id.* at 486.

<sup>134</sup> In distinguishing between the rules-based system of the WTO and the prior power-based system of individualized trade rules under GATT 1947, Professor Qin points out that the relative desirability of the two systems is subjective, and that a state's view of the system is necessarily influenced the degree of power wielded. *See id.* at 519-20.

<sup>135</sup> Including the presumption that where there is "infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment." DSU art. 3.8.



Commerce Secretary,<sup>136</sup> China took on obligations that would have allowed the United States to use the WTO to block the acquisition of Unocal by CNOOC. The motivation for doing so would have been irrelevant.

In other words, the very existence of the unique rule obligations under the China Protocol is at odds with the objectives of the WTO Agreement. Aside from directly contradicting the preambular language of the WTO Agreement,<sup>137</sup> and so lessening its legitimacy and consistent application, the Protocol also creates different classes of WTO members.<sup>138</sup> The greater the likelihood of being forced into such a class, the fewer the incentives for developing and transitional states to join the WTO. Perhaps more importantly, there are also fewer incentives to perform obligations in good faith after accession.<sup>139</sup> The greater legitimacy and applicability the WTO legal structure has among member-states, particularly with respect to its core principles of nondiscrimination and national treatment, the more effective the WTO will be as a legal system that draws its power from the active consent of its subjects.

The China Protocol poses a serious challenge to the legitimacy of and rule of law in the WTO because of its discriminatory nature. CNOOC-Unocal demonstrates a feature of the Protocol that is potentially even more problematic, however. Resolving the inconsistencies between the Protocol and the generally applicable WTO agreements may well put the Dispute Settlement Body in the position of crafting substantive rules of decision—a function that is expressly disallowed by its authorizing agreement. Because the dispute settlement mechanisms are at the heart of the WTO's effectiveness, such a challenge to them could seriously undermine the WTO as a whole.

*B. Non-Reciprocal "Integral" Obligations Will Necessitate Illegitimate Rulemaking by the Panels and Appellate Body*

The unique, non-reciprocal obligations in the China Protocol that posed latent challenges to the core principles of the WTO in CNOOC-Unocal also threaten the legitimacy the opinions by the Dispute Settlement

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<sup>136</sup> See *supra* note 37.

<sup>137</sup> See *supra* notes 129, 130.

<sup>138</sup> E.g., those that are only bound by the generally applicable agreements, and those that have numerous special and permanent obligations imposed on them individually by the accession process loophole under Article X of the WTO Agreement.

<sup>139</sup> Of particular note are the pending accessions of the Ukraine and the Russian Federation. See Qin, *supra* note 10, at 515.

Body.<sup>140</sup> In CNOOC-Unocal, the China Protocol would have barred the policy loans from China's state-owned enterprises to CNOOC, whereas no generally applicable WTO rule of law would have imposed similar obligations on China or any other WTO member.<sup>141</sup> The WTO panels and Appellate Body, however, are required to construe the China Protocol consistently with all other applicable provisions of the WTO Agreement.<sup>142</sup> At the same time, principles of interpretation of international agreements mandate that the panels and Appellate Body give force to the more specialized applicable agreements over the less specialized ones—the so-called *lex specialis derogat generalis* rule.<sup>143</sup> Because these fundamental provisions are in conflict—the China Protocol contradicts the fundamental principles of the WTO Agreement—the Appellate Body will be forced to choose between harmoniously construing the China Protocol with the rest of the WTO Agreement and giving effect to the Protocol. Such a choice will extend the range of Appellate Body action beyond the sphere of simple interpretation and into the sphere of substantive rulemaking.

There are specific provisions of the China Protocol—including the bar on “non-commercial” loans latent in CNOOC-Unocal—that cannot be harmoniously construed with the rest of the WTO Agreement. Moreover, while these provisions are more specialized, in the sense that they deal with China and China alone, they are often provide overly general prohibitions troubled by hazy and unclear language. Because of both latent conflicts between generally applicable provisions of the WTO and serious ambiguity within the specialized provisions in the Protocol, WTO Rules will be applied inconsistently between China and other WTO members. Even more striking, such conflicts presage inconsistent application of rules to China itself across similar situations. To resolve interpretative disputes regarding the actual content of the conflicting and ambiguous provisions of the China Protocol,

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<sup>140</sup> The Dispute Settlement Body is made up of all of the members of the WTO acting in an auxiliary capacity to their role as negotiating parties to the WTO Agreements. See, e.g., UNDERSTANDING THE WTO, *supra* note 108, at 56. Any member may request that a quasi-judicative panel be formed to rule on the dispute. DSU art. 6.1. Every disputing member has the right to appeal a panel's decision to the standing WTO Appellate Body for final disposition. DSU art. 17.

<sup>141</sup> See *supra* Part III.

<sup>142</sup> See, e.g., Appellate Body Report, *Argentina—Safeguard Measures on Imports of Footwear*, ¶ 81, WT/DS121/AB/R (Dec. 14, 1999) (WTO Agreements must be read “in a way that gives meaning to *all* of them, harmoniously”); see also Michael Lennard, *Navigating by the Stars: Interpreting the WTO Agreements*, 5 J. INT'L ECON. L. 17, 58-59 (2002) (noting that WTO jurisprudence puts an extremely strict “gloss” on this “effectiveness” principle that extends beyond that given by the International Law Commission. The Appellate Body does not recognize the possibility of inherent disharmony in treaty provisions or provide a means of resolving such conflicts).

<sup>143</sup> See Lennard, *supra* note 142, at 70 (noting that the Appellate Body indicated in dicta in *Indonesia—Autos* that it accepted the general legitimacy of the *lex specialis* rule).

the panels and the Appellate Body will be forced to craft “gap-filler” rules that have substantive effect. This will further erode the rule of law in the WTO system, because such rulings will directly contravene the DSU’s mandate that “[r]ecommendations and rulings of the [Dispute Settlement Body] cannot add to or diminish the rights and obligations provided” to members in the WTO Agreements.<sup>144</sup>

1. *Provisions in the China Protocol Invite Inconsistent Application of WTO Rules*

Because all of the specific rule commitments in the Working Party Report are incorporated into the WTO Agreement through the China Protocol, and because many of them conflict with the basic purposes of the WTO, it is likely that their application will result in inconsistent and confusing application of WTO rules to China. For example, in CNOOC-Unocal, Paragraphs 172 and 173 of the Working Party Report would have together banned the use of interest rates subsidies in the proposed financing package.<sup>145</sup> Putting aside for the moment the fact that no other WTO country has similar restrictions,<sup>146</sup> such a funding package would *not* have been a violation of the Protocol commitments if the loans could be demonstrated to have been for a legitimate commercial rationale. That is to say, if a provision was included in the funding package that provided that Unocal would repay loans at *above* market rates in the eventuality that it became particularly profitable, then the financing package could be characterized as based on commercial considerations, albeit on high risk terms.

It is not at all clear that there is any principled way to determine what such specific commitments in the China Protocol mean in practice. Does the Appellate Body have the final word on what constitutes a “commercial” rationale for a subsidy forbidden to China but available to all other WTO members? What means should the Appellate Body use to make such a determination? How do the China-specific and uniquely restrictive

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<sup>144</sup> DSU art. 3.2.

<sup>145</sup> See *supra* Part II.D.

<sup>146</sup> The “elephant in the room,” so to speak, in any discussion of the China Protocol, is why it was considered necessary to impose vast numbers of vague and non-reciprocal trade rules on China in the first place. Professor Qin hypothesizes that the “unspoken rationale” behind China’s is to adapt its economy to market terms, promote domestic rule of law, and liberalize investment. That said, she also points out that these “rationales,” when applied to specific provisions of the Protocol, are motivated by an underlying desire to put a break on China’s potentially vast influence in the world market system. See Qin, *supra* note 10, at 510-11.

provisions with regard to investment<sup>147</sup> interact with the other WTO Agreements, such as TRIMs? Do the extremely specific measures on state trading enterprises in the Working Party Report<sup>148</sup> incorporate the general exceptions in Article XX of GATT 1994?<sup>149</sup>

All these questions point to an overarching one: what, if any, safeguards are there to ensure that the WTO rules in the China Protocol are applied consistently and evenly both between different parties and across analogous situations? The simple answer is that there is no such guarantee—and it is highly unlikely that without one the provisions will be applied in consistent manner among China's different trading partners and across similar Chinese actions. The result of such inconsistent application will be a combination of lessened legitimacy of the rules themselves to all members, and pressure on the panels and the Appellate Body to provide clarification. This will result in the WTO's quasi-judicial organs<sup>150</sup> being put in the position of trying to fill the gaps between the inconsistent applications with increasingly substantive rules of decision.

## 2. *The Panels and the Appellate Body Will Be Forced to Make Substantive "Gap-Filler" Rules*

Canons of treaty construction are made to conflict by the China Protocol, and the resolution of those conflicts will amount to substantive rulemaking by WTO dispute settlement bodies. Specifically, three interpretive principles interact in unpredictable ways that will push the panels and Appellate Body in to the realm of filling the gaps between the Protocol and the other WTO Agreements with substantive rules of decision: 1) the principle of *lex specialis*,<sup>151</sup> which states that among competing terms

<sup>147</sup> For example, China must remove foreign equity limitations on joint ventures in automobile engine manufacturing. Working Party Report, para. 207. This restriction would not be mandated under TRIMs, because it has little or no effect on the provision of export or import of goods, but rather is merely a restriction on who profits from such trade. See *supra* Part III.A.

<sup>148</sup> See, e.g., Working Party Report, para. 212 (state-owned oil companies must provide that import allocations of petroleum to non-state trading companies are held over for the next year if not fully utilized).

<sup>149</sup> For example, the provision in GATT 1994 art. XX(j), which provides that resources essential to the provision of products temporarily in general or local short supply (oil, for example) are excepted from GATT disciplines, including those on state trading enterprise, provided certain criteria are met.

<sup>150</sup> See Ehlermann, *supra* note 69, at 470 ("Dispute settlement in the WTO is not a process that is entrusted in totality to an independent judicial branch. It would be wrong to qualify it as a purely judicial process. It is a quasi-judicial mechanism. It is a hybrid. And it will remain so for the foreseeable future.").

<sup>151</sup> See Professors Kurt Taylor Gaubatz and Robert Turner, "Beck's Law Dictionary": A Compendium of International Law Terms and Phrases, at <http://www.people.virginia.edu/~rjb3v/latin.html> ("Lex specialis derogat generali - specific law prevails over (abrogates, overrules, trumps) general law. One test that is applied in circumstances when (1) both customary and treaty sources of law exist and (2) these two sources cannot be construed consistently."); cf. WTO, Committee for Trade and the Environment, CTE on:

in international agreements the term which more specifically prescribes law is assumed to control, 2) the presumption of consistent use of the same terms across a single agreement or related agreements,<sup>152</sup> and 3) the principle that effect should be given to all the provisions of an agreement.<sup>153</sup>

Applied to the China Protocol, the principle of *lex specialis* gives inadequate guidance as to which potentially inconsistent terms present in the voluminous (and not very carefully drafted) Working Party Report would supersede apparently conflicting rights and obligations under the generally applicable WTO Agreements. For example, in CNOOC-Unocal, the ordinary meaning of “commercial considerations” applies broadly, arguably reaching into areas where there would be no conceivable distortion of trade caused by the forbidden act. In contrast, the “commercial considerations” provisions in Article XVII of GATT 1994, from which the language of the commitments was presumably lifted, only bar those subsidies to state trading enterprises that will distort trade.<sup>154</sup> In other words, by giving effect to the China Protocol under the *lex specialis* rule, it is necessary as a preliminary matter to disregard consistent application of the same terms through out the “integrated” WTO Agreements. If the agreements are indeed a single coherent whole, it is difficult to say in which circumstances the terms should be given one meaning over another. Should terms that appear in both the Protocol and other agreements always be given a more restrictive application when applied to China? That hardly jibes with the nondiscrimination principle. What if provisions of both the Protocol and the other agreements govern situations with equal authority? Should the harshest one be selected? Should the most lenient? Why? Because the broad strokes of the Protocol are more “specialized” than the carefully honed language of the major agreements?

Similarly, application of *lex specialis* to the China Protocol potentially nullifies the effectiveness of specific provisions of the WTO agreements.

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Trade Rules, Environmental Agreements and Disputes, [http://www.wto.org/english/tratop\\_e/envir\\_e/cte01\\_e.htm#lexspecialis](http://www.wto.org/english/tratop_e/envir_e/cte01_e.htm#lexspecialis) (last visited May 4, 2006) (“The principle of ‘lex specialis’ in public international law says that if all parties to a treaty conclude a more specialized treaty, the provisions of the latter prevail over those of the former. This . . . would likely be taken into account in the WTO.”).

<sup>152</sup> See Appellate Body Report, *European Communities—Measures Affecting Meat and Meat Products*, ¶ 164, WT/DS26/AB/R (Feb. 13, 1998) (different words are presumed to have different meanings; *ergo*, the same words are presumed to have the same meanings); see also Lennard, *supra* note 142, at 56-57 (“There is a presumption . . . that terms are generally used consistently in a treaty, so that different terms are intended to have different meanings.”).

<sup>153</sup> See Lennard, *supra* note 142, at 57.

<sup>154</sup> That is, import restrictions and domestic content requirements. See GATT 1994 art. XVII.1(a) (state trading enterprises must “act in a manner consistent with the general principles of non-discriminatory treatment prescribed in this Agreement for governmental measures affecting imports or exports by private traders.”).

For example, the provision in TRIMs which provides that all trade-related investment measures be subject to the exceptions of GATT 1994 may or may not be applicable to China under the Protocol, depending on the decisions of the Dispute Settlement Body.<sup>155</sup> Dozens (hundreds?) of similar interpretive puzzles will arise in attempts to reconcile China's obligations under the Protocol with the greater (though not longer) agreement into which it is putatively "integrated".

This is relevant not only because it will provide lifetimes of fodder for trade lawyers as China continues its ascent to prominence in the world trading system. It will also drastically expand the role of the Appellate Body and the panels from the somewhat workaday interpretative duties that they have had to date<sup>156</sup> to what is essentially common law rule making regarding the scope and application of the WTO Agreement to China. Moreover, the organs of the Dispute Settlement Body will be forced to determine the degree to which China's trading partners can impose novel restrictions on China's economic behavior via the Working Party Report.

For example, it hardly stretches the imagination to envision a circumstance in the near future in which a WTO member feels threatened by China's growing economic influence in the energy sector. Imagine that member using the Protocol to challenge the subsidization of a Chinese energy company under the DSU in order to prevent the consummation of a politically sensitive acquisition in a third state. Notwithstanding the injunction in the DSU that "a Member shall exercise its judgment as to whether action under these procedures would be fruitful,"<sup>157</sup> such a maneuver could be effective in casting a pall over a transaction to the extent that the outcome could be uncertain. Such uncertainty would require the Dispute Settlement Body to effectively decide the scope and coverage of the Protocol with relation to the other WTO Agreements. Such a decision could have a considerable effect on China's trade relations, and would most certainly "add to or diminish the rights and obligations provided" in the Protocol.<sup>158</sup>

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<sup>155</sup> TRIMs art. 3. Note that China made numerous investment commitments in the Working Party Report, such as forsaking technology transfer requirements, that are not mandated by TRIMs.

<sup>156</sup> Such basic interpretive duties are themselves the cause of significant controversy in defining the scope of the WTO. See, e.g., Appellate Body Report, *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, ¶ 149, WT/DS58/AB/RW (Oct. 22, 2001) [hereinafter *United States—Shrimp*] (holding that the chapeau of GATT 1994, art. XX prevented the use of endangered species preservation as a basis to except trade restriction from GATT 1994 disciplines).

<sup>157</sup> DSU art. 3.7.

<sup>158</sup> See DSU art. 3.2.

3. *Substantive Rulemaking by the Dispute Settlement Body Will Undermine the Rule of Law in the WTO*

The Dispute Settlement Body and its organs, the panels and the Appellate Body, are expressly forbidden by the DSU from adding to or lessening the rights and obligations on individual members as a result of deliberations.<sup>159</sup> Article 3.2 of the DSU reads, in its entirety:

The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the [Dispute Settlement Body] cannot add to or diminish the rights and obligations provided in the covered agreements.<sup>160</sup>

The DSU is at the heart of the WTO system<sup>161</sup> and is *only* authorized to make interpretive rulings on the WTO Agreements. The greater the substantive content of its decisions, the more likely it is that they, and the WTO system as a whole, will be viewed as illegitimate by both member governments and their citizens.

The WTO is, by its very nature, a consent-based organization.<sup>162</sup> Substantive rules that impose rights and obligations on members may only be crafted during the negotiating rounds by the WTO Ministerial Conference, consisting of all members.<sup>163</sup> The only legitimate basis for binding rules under the WTO consists solely of agreement by the participating member states on the basis of consensus, when possible, and

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<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> The DSU is the central innovation of the WTO Agreement compared to its predecessors—the provision of compulsory jurisdiction combined with the finality of rulings of the Appellate Body has transformed the loosely enforced, power-centered GATT into the structured, effective rules-based WTO. *See, e.g.*, UNDERSTANDING THE WTO, *supra* note 108, at 55. In fairness, this effectiveness in compelling state behavior is also very much at the root of criticisms directed at the WTO. *See, e.g.*, *United States—Shrimp*.

<sup>162</sup> *See* WTO Agreement art.IX.1 (“The WTO shall continue the practice of decision-making by consensus followed under GATT 1947(1). Except as otherwise provided, where a decision cannot be arrived at by consensus, the matter at issue shall be decided by voting.”).

<sup>163</sup> *See* WTO Agreement art. IX.2 (“The Ministerial Conference and the General Council shall have the exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements.”).

democratic voting when not. Any extension of the role of the panels and Appellate Body into the realm of substantively determining the rules of decision for members will severely undermine the rule of law in the WTO system. The latent problems posed by CNOOC-Unocal are only illustrative of a deeper problem: non-reciprocal agreements such as the China Protocol fundamentally undermine the rule of law in the WTO system.

Large states with transitional economies are poised for accession to the WTO.<sup>164</sup> The members of the WTO, particularly influential members like the United States, are thus faced with a decision: they can forbear from imposing conflicting rules like those in the China Protocol, or they use the WTO as a mechanism for stifling the economic growth of competing states. Should the current WTO members choose to create more “WTO-plus” agreements that codify non-reciprocal and discriminatory rules into the WTO Agreement, they will lessen the legitimacy and effectiveness of the entire organization. It remains to be seen whether the Protocol itself is sufficient to reduce the WTO from its rules-based ideal back to the power-based squabbling of the GATT. Should the flaws of the Protocol be replicated, however, the gains that the WTO has made for the rule of law in international trade will certainly evaporate.

## V. CONCLUSION

When China sought to acquire Unocal by providing loan subsidies to state-owned CNOOC, it violated commitments in its accession Protocol to the WTO. China agreed when it joined the WTO that it would not use subsidies to its state-owned enterprises to further government policies, like securing greater access to oil reserves. A key commitment in the China Protocol was that the decisions of China’s SOEs would be on a “commercial basis,” and that those decisions would be solely on the basis of profit and loss. Simply put, the low-interest loans proffered by China to CNOOC were unprofitable. Had the CNOOC-Unocal acquisition been completed with the proposed funding package, China would have been violating its WTO Commitments. This latent restriction is characteristic of a greater problem posed by the Protocol.

The non-reciprocal, “WTO-plus” rules contained in the Protocol mark a departure from the generally applicable, rules-based principles upon which the WTO was founded. This challenges the very legitimacy and effectiveness of the WTO. Moreover, inherent conflicts between the China Protocol and the generally applicable WTO agreements will force the panels

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<sup>164</sup> See *supra* note 139.



and Appellate body to make WTO “common law.” Because the Dispute Settlement Understanding specifically forbids such rule making, the Protocol will undermine the overall legitimacy and rule of law within the WTO. How much damage the Protocol will cause remains to be seen, but the potential harm is great. Whether or not the damage caused by the Protocol will spread depends on the choices made by current WTO members. They can either forbear from imposing discriminatory restrictions during future accessions, or they can watch the WTO crumble as they craft unique rules at the expense of transitional states.