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International Law Practicum

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Practicing the Law of the World from New York

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PRACTICUM: FORM AND POLICY

The *International Law Practicum* is a semi-annual publication of the International Section of the New York State Bar Association. The *Practicum* welcomes the submission of articles prepared by practicing attorneys. The length of an article, as a general rule, should not exceed 3,500 words, footnotes included. Shorter pieces, notes, reports on current or regional developments, and bibliographies are also welcomed. All manuscripts must be sent either (i) in laser printed triplicate accompanied by a CD formated in Microsoft Word or WordPerfect to: The *Practicum*, c/o Daniel J. McMahon, Esq., New York State Bar Association, One Elk Street, Albany, N.Y. 12207-1096; or (ii) by e-mail in Microsoft Word or Wordperfect format to either the Editor-in-Chief (david.detjen@alston.com) or the Senior Executive Editor (amber.wessels@alston.com). Both text and endnotes must be double-spaced. Endnotes must appear at the end of the manuscript and should conform to *A Uniform System of Citation* (the Harvard Bluebook). Authors are responsible for the correctness of all citations and quotations. Manuscripts that have been accepted or published elsewhere will not be considered. The *Practicum* is primarily interested in practical issues facing lawyers engaged in international practice in New York. Topics such as international trade, licensing, direct investment, finance, taxation, and litigation and dispute resolution are preferred. Public international topics will be considered to the extent that they involve private international transactions or are of general interest to our readership.

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Deadlines

Manuscripts intended for publication in the Spring and Autumn issues must be received by the Editor-in-Chief by the preceding 1 December and 1 June, respectively.

Reprints

Each author will receive three complimentary copies of the *Practicum* issue in which the author's material is published. Additional copies may be ordered at cost before an issue goes to press by communicating with Daniel J. McMahon, Esq., at the New York State Bar Association, One Elk Street, Albany, N.Y. 12207-1096 (telephone (518) 487-5582).

Back Issues and Advertising

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Back issues (2000 to present) of the *International Law Practicum* are available, in pdf format, online to Section members on the New York State Bar Association's Web site at www.nysba.org/IntlPracticum. A searchable index is also available.

Editor's Note

You hold in your hands the fiftieth issue of the *International Law Practicum* published by the International Section of the New York State Bar Association during the 25-year existence of this publication.

It has been my very great pleasure, and indeed honor, to have served as either Executive Editor or Editor-in-Chief through all twenty-five volumes of the *Practicum*. Over the years it has been great fun for me to correspond with colleagues all over the world, as we worked to prepare their articles and commentaries for publication in this journal.

During those twenty-five years we have remained true to the stated purpose of the *Practicum*: As its name suggests, this journal has been designed to publish news, information, and insights of value to practicing lawyers, to assist those lawyers in the international practice of private and public law.

Nevertheless, as enjoyable as the experience has been for me, I have concluded that, with the publication of this issue 2 of volume 25, it is time for a younger generation of members of the International Section to assume management of the *Practicum*.

Accordingly, with issue 1 of volume 26, my colleague, Amber Wessels, will take over as Editor-in-Chief of the *Practicum*. I am sure that the *Practicum* under Amber's leadership will continue to be of interest and value to the over two thousand members of the International Section of the New York State Bar Association, as well as the many other readers of the *Practicum* around the world.

My sincere thanks to the small but dedicated team of staff members who worked with me over the years to help edit the various articles, commentaries and transcripts that have appeared in the *Practicum*. Indeed, we have in the course of twenty-five years published nearly four hundred pieces! And, of course, I wish to express my appreciation to the many authors, located all over the world, who have contributed their work effort to the *Practicum*, as well as my gratitude to Lester Nelson, who for many years has served as the Editor-in-Chief of the sister publication of the *Practicum*, the *New York International Law Review*.

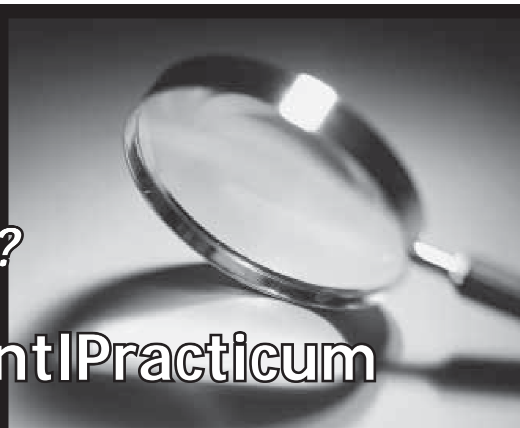
Finally, my thanks to the Executive Committee of the International Section, which afforded me the opportunity for so many years to lead the *Practicum* and the Section's Publications Committee.

David W. Detjen

LOOKING FOR PAST ISSUES

OF THE

INTERNATIONAL LAW PRACTICUM?



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"Canada" Immigration Trusts for U.S. Persons

By Gwen Benjamin and Glenn G. Fox

I. Introduction

U.S. citizens and non-citizen domiciliaries of the U.S. ("resident aliens") may immigrate to Canada for career advancement, retirement, or to be closer to friends and relatives, etc. If, before becoming a resident of Canada or during the sixty-month period after becoming a resident of Canada, the immigrant to Canada settles a trust that is a non-resident trust for Canadian tax purposes and meets certain other requirements set forth below, the trust's income from its non-Canadian source assets will be exempt from tax in Canada until the taxation year in which the taxpayer has been resident in Canada for more than sixty months, after which time the trust is taxed like any other trust in Canada.

This concept of a Canadian immigration trust is an excellent planning opportunity for U.S. citizens and resident aliens who plan to immigrate to Canada. (U.S. citizens and resident aliens are sometimes referred to in this article as "U.S. persons.") The key, from a U.S. perspective, is to structure the trust to have minimal impact from a U.S. gift tax and estate tax perspective and avoid state-level income taxation. Avoiding U.S. federal income taxes is usually not one of the goals behind such a trust.

II. Canada Perspective

A. Residency at Common Law

At common law in Canada, generally a trust is resident where central management and control exists. This will often, but not always, be determined by the residency of the trustees and where they make decisions—it may depend on whether the trustees are actually "controlling" the trust decision making. This is a relatively new test established in a case called *Garron Family Trust v. Canada.*[1]

A trust resident in Canada will generally be taxed on its worldwide income, while a non-resident trust is taxed only on dispositions of taxable Canadian property and on Canadian source income.

B. Deemed Residency

Even if a trust is not resident of Canada based on central management and control, it may be *deemed* to be a resident of Canada for taxation purposes under the "non-resident trust rules" in Section 94 of Canada's Income Tax Act (ITA). Under the current rules, a non-resident trust would be caught by this section if two tests are met: a beneficiary test and a contribution test. Since many non-resident trusts do not name a Canadian beneficiary (but allow amendments that could do so), many trusts were able to avoid these rules. These rules have been in flux since 1999, and Canada has draft legislation pursuant to which the Canada Revenue Agency (CRA) administers the rules. The latest draft was issued in August 2010, with technical notes issued in September 2010. These latest provisions apply to taxation years after 2006.

Under the draft legislation, the determination of deemed residency is based on the existence of a "resident contributor" at the end of the taxation year of the trust. Deemed residency is also based on having a "resident beneficiary," together with a "connected contributor," at the end of the taxation year of the trust.

A "resident contributor" is an entity which at the time of contribution is a resident of Canada for income tax purposes and a contributor to the trust. The definitions of contribution and contributor are extremely broad and indicate that the intention is to "catch" every type of way in which property can be contributed. For example, there are many indirect transfers which are contributions under the draft legislation. Further, the issuance of shares to a trust can, in some cases, be a contribution. There are exceptions for "arm's length transfers," which is a defined term.

Under the most recent draft legislation, a trust which is deemed to be resident will have its property divided, notionally, for Canadian tax purposes, into a taxable Canadian resident portion and a non-taxable non-resident portion. The resident portion is the property acquired from residents and former residents of Canada and property substituted for such property. Each person who is a resident contributor or resident beneficiary is generally jointly and severally liable for the non-resident trust's Canadian tax arising on the resident portion. The income on the resident portion will be attributed to its electing resident contributors in proportion to their relative contributions. The trust will be entitled to deduct amounts of income distributed to beneficiaries and income attributed to electing resident contributors. There are rules which determine how to allocate income to the resident and non-resident portion.

An individual who has never been a resident of Canada for a total of sixty months is excluded from the definition of resident contributor, even if he or she was resident at the time of making the contribution.

A "resident beneficiary" includes a beneficiary who may only be a contingent beneficiary. A "beneficiary" includes a person who is "beneficially interested" in the trust. There are rules to determine when a contingent beneficiary or a "successor beneficiary" who is not a resident beneficiary at a specific time becomes a resident beneficiary.

Because this definition would deem any trust which has even a contingent beneficiary who is resident of Canada in certain cases as a resident of Canada, it is nec-

essary also to have a "connected contributor" for the trust to be a deemed resident under the draft legislation. This excludes contributions made at a "non-resident time," which is generally within a window of time that begins sixty months prior to the contribution and ends sixty months subsequent to the contribution. Also excluded from "connected contributor" is an individual who has not been resident in Canada for an aggregate over one or more periods of sixty months. In the case of contributions made by an individual that arose as a consequence of his or her death, if he or she was not resident of Canada throughout the eighteen-month period before death, the contribution will be made at a "non-resident" time.

There are also rules under the ITA which tax certain foreign investment entities, referred to as offshore investment fund property. If a trust is a deemed resident, a beneficiary's interest in the trust will not be an interest in an offshore investment fund property. This is a property defined in Section 94.1 of the ITA. This section applies where an investor invests in such a fund, the investment derives its value primarily from "portfolio investments," and it can be reasonably concluded, having regard to all the circumstances, that one of the main reasons is to reduce or defer liability to tax in Canada which would have arisen if the income had been earned directly by the taxpayer. If the section applies, the taxpayer must include an amount in income based on the "designated cost" of the fund and based on prescribed rates of interest. These rules are also in flux and amendments to the current rules were contained in the August 2010 draft legislation. Among other things, it is proposed that the prescribed rate of interest used to compute the deemed income be increased by two percent.

The Income Tax Conventions Interpretation Act (ITCIA) contains rules which govern the interpretation of Canada's tax treaties. It is proposed that an amendment be made which will provide that if a trust is deemed resident under Section 94, the trust will be deemed to be a resident of Canada and not a resident of another country for the purposes of applying the relevant tax treaty.

C. The Immigration Trust

An immigration trust is not defined as such under the ITA. An immigration trust is a non-resident trust settled by a person who is a non-resident of Canada and who will remain non-resident (such as a parent of the immigrant) or by the person who has immigrated or will immigrate to Canada and who has not previously been a resident of Canada for income tax purposes for an aggregate of sixty months during his or her lifetime (draft subsection 94(3) of the ITA). As noted, in these situations the immigrant is excluded from being a resident contributor or a connected contributor during this period. If the only contributor to the trust remains a non-resident, provided that central management and control remains outside of Canada, the deemed residency rules would not apply.

An immigration trust can be established either before or after becoming a Canadian resident, but the tax exemption period cannot extend beyond sixty months from the date the person became a resident of Canada. It is advantageous to immigrate early in the year to maximize the exemption period. The trust's income from its non-Canadian source assets will be exempt from tax in Canada until the taxation year in which the taxpayer has been resident in Canada for more than sixty months, after which time the trust is taxed like any other trust in Canada.

As noted above, an immigration trust must be a non-resident trust for common law purposes. Thus the new test in *Garron* will apply to consider where central management and control rests. This will not necessarily be where the trustees reside, but where control resides. In *Garron,* for example, the trustee was resident of Barbados, but control was found to reside in Canada. Thus, the majority of the trustees of such an immigration trust should be non-residents of Canada and such trustees should control.

Generally, the immigrant and members of his or her family will be the beneficiaries of the trust. To shelter the trust income from Canadian income taxation during the sixty-month period, the trustees should have complete discretion with respect to whether trust income should be distributed to the immigrant or his family members as beneficiaries. Since the immigrant is now a resident of Canada, he or she will be taxed on his or her worldwide income. Any income that is in fact paid to the beneficiary, or that is required to be paid, will be subject to Canadian income tax in his or her hands.

The trust should provide that the income can be accumulated and added to capital. Capital can, however, be distributed to the beneficiary without Canadian tax in his or her hands. Since a person who immigrates to Canada will be subject to Canadian tax on his or her worldwide income, the immigration trust shelters the person's non-Canadian source income from Canadian taxation during the sixty-month period. The income of the trust will be subject to taxation in the jurisdiction where the trust is established. However, foreign jurisdictions, such as the U.S., have lower income tax rates than Canada and some, such as offshore tax havens, have no income taxation.

If the immigrant creates or contributes to the trust, he or she may be a capital beneficiary without income attribution. Subsection 75(3) of the ITA provides that the trust will be exempt from rules that attribute income and taxable capital gains to the contributor to the trust during the sixty-month period. If the trust is still in existence on the expiry of the sixty-month period, then subsection 75(2) will apply. If subsection 75(2) ever applies to a trust, there will be other issues arising on the distribution of property from the trust to beneficiaries.

The trust can be "migrated" to Canada prior to the expiration of the sixty-month period. This can be done by replacing the non-Canadian resident trustees with Canadian trustees (again, assuming that central management and control will now migrate to Canada). The trust will obtain a Canadian basis for tax purposes equal to the fair market value of its assets at time of migration other than taxable Canadian property.[2] If the immigrant wishes to wind up the trust, he or she may do so. Generally, assets can be distributed to a Canadian resident beneficiary without taxation in the trust if it is in partial or full satisfaction of the beneficiary's capital interest in the trust.

The most recent draft legislation is unclear as to whether the offshore investment fund rules apply to immigration trusts. The explanatory notes issued in September 2010 do, however, state that an immigration trust will be excluded from the application of these rules. It is understood that Finance will clarify this in the next round of draft legislation.

III. United States Perspective

A. General Background

This discussion assumes knowledge of the general U.S. estate and gift tax rules applicable to U.S. citizens, resident aliens, and non-resident aliens. Based on the discussion of immigration trusts set forth above, a U.S. resident who plans to immigrate to Canada, or who has already done so, should consider settling an immigration trust to take advantage of the sixty-month "tax holiday" available for non-Canadian source income discussed above, if he or she has not previously been a resident of Canada for income tax purposes for an aggregate of sixty months during his or her lifetime.

It should be understood that a non-citizen of the U.S. who is considered a "resident alien" of the U.S. for income tax purposes is either a person who is a lawful permanent resident of the U.S. at any time during the year (i.e., a so-called "green card holder") or a person who meets the so-called "substantial presence test."[3] The substantial presence test is satisfied if a non-citizen is present in the U.S. for at least thirty-one days during the year and the sum of the days present in the current year, one-third of the days present in the preceding year, and one-sixth of the days present in the second preceding year equal or exceed 183 days.

Before the U.S. person settles an immigration trust, he or she must consider the following from a U.S perspective, while taking the Canadian immigration trust rules into account:

- Whether the trust should be a U.S. trust or a non-U.S. trust.
- The jurisdiction in which the trust should be settled.
- If the trust will be a U.S. trust, whether the trust should be settled in a state that does not impose income taxes on trust income and, if so, how to accomplish this.
- Whether the trust should be structured to provide asset protection for the settlor.
- Consider who the trustees should be and whether the settlor can/should be one of the trustees.
- Whether the transfer to the trust should be structured as a complete or incomplete gift for U.S. gift tax purposes.
- What the trust provisions should be after the expiration of the sixty-month period.
- What trust provisions should be included to plan for the possibility of the settlor dying before the sixty-month period has expired.

Each of these points will be considered below.

B. U.S. Trust or Non-U.S. Trust for U.S. Tax Purposes

As already established, an immigration trust must be a non-resident trust of Canada for common law purposes. In making this determination, the focus is on where central management and control rests. In order for control to rest outside Canada, the majority of the trustees should be non-residents of Canada and these trustees should control the trust.

In order to confirm that there are no indicia of residency in Canada, the immigration trust is usually established under the law of a jurisdiction other than Canada. The U.S. person who is immigrating to Canada therefore has a choice as to whether to create the immigration trust under the laws of one of the states of the U.S. (commonly referred to as a "domestic trust" or "U.S. Trust" for U.S. tax purposes), or under the laws of a non-U.S. jurisdiction other than Canada (commonly referred to as a "foreign trust" or "Non-U.S. Trust" for U.S. tax purposes).

The term "domestic trust" refers to a trust that is taxed as a U.S. person under the Code. A trust is taxed as a U.S. person if (i) a court within the U.S. is able to exercise primary supervision over the trust's administration (the "court test"), and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "control test").[4] If a trust does not satisfy both of these requirements, it is treated as a foreign trust for U.S. tax purposes.[5]

Before determining whether to create a domestic trust or foreign trust, the U.S. person should understand that U.S. citizens and resident aliens are subject to U.S. income taxation on their worldwide income, regardless of where they may live. In this connection, see Sections 1 and 61 of the U.S. Internal Revenue Code (Code), which effectively tax the worldwide income of *all* individuals, since

neither U.S. citizens nor resident aliens are specifically mentioned in these sections. However, special restrictive rules for nonresident aliens are provided in Code Section 871, which effectively taxes only their U.S. source income. Therefore, Code Sections 1 and 61 effectively tax only U.S. citizens and resident aliens.

Generally speaking, the income of a trust is computed in the same manner as that of an individual and for this purpose a foreign trust is treated as a nonresident alien individual who is not present in the U.S. at any time.[6] Therefore, the U.S. taxable income of a foreign trust is limited to U.S. source income, while the worldwide income of a domestic trust is subject to U.S. income tax.

Since U.S. persons and domestic trusts are taxed on their worldwide income, there may be an incentive for a U.S. person to transfer his or her assets to a foreign trust for U.S. tax purposes when settling an immigration trust. However, before reaching the conclusion that a foreign trust may be a viable solution when structuring an immigration trust, the U.S. person immigrating to Canada must understand the following:

- If the trustee of the trust is a nonadverse party (i.e., has no interest in the trust) and the income of the trust may be distributed to the settlor in the discretion of the trustee or accumulated for future distribution to the settlor or his spouse, the settlor will be treated as the owner of the trust and its income will still be taxable to him even though it is a foreign trust.[7] Such a trust is referred to as a "grantor trust."
- Even if the settlor has no beneficial interests in the foreign trust, if another U.S. person, such as the settlor's child, has a beneficial interest in the trust, the settlor will still be treated as the owner of the trust and its income will still be taxable to him even though it is a foreign trust.[8] Again, such a trust is referred to as a "grantor trust."
- If the settlor retains no beneficial interests in the trust and no power to control the beneficial enjoyment thereof (See Code § 674(a)), the transfer to the foreign trust will result in the recognition of unrealized gain and will result in gift tax. See Code Sections 684(a) as to the recognition of gain, and see Code Section 2501 as to the gift tax. Code Section 684(b) provides for nonrecognition gain upon the transfer to a foreign trust when the grantor is treated as the owner thereof under the above rules.

Due to the above rules, there is little incentive for a U.S. person to use anything but a domestic trust as the immigration trust. Although the income of the trust will continue to be subject to U.S. income tax, since the U.S. has lower income tax rates than Canada (assuming that in Canada both federal and provincial rates will apply, while in the U.S. only federal income tax will apply, since the trust can be settled in a state without any income taxes, as discussed below), the taxpayer will still be better off creating the immigration trust as a U.S. domestic trust. The combined Canada federal income tax rate and Ontario income tax rate is forty-six percent, while the top U.S. federal income tax rate is 39.6%.[9]

C. U.S. Jurisdiction Where Trust Should Be Settled, Trust Income Tax and Asset Protection

Having determined that the immigration trust for a U.S. person immigrating to Canada should be settled in the U.S., the next question is in which state within the U.S. should the trust be settled. Since the U.S. person will no longer reside in the U.S., he or she will no longer be subject to state level income tax, even if he or she formerly resided in a state that imposed income tax. The U.S. person should take steps to structure the immigration trust so that it too is not subject to state level income tax.

New York imposes income tax on non-resident trusts with respect to any items of income or gain from state sources that are not distributed or credited to the beneficiaries.[10] New York imposes income tax on resident trusts with respect to any income or gain received by the trust and not distributed to or credited to its beneficiaries,[11] so long as the trust has a nexus to New York. If a resident trust does not have a nexus to New York, it is taxed in the same manner as a non-resident trust. (See more on nexus below.)

New York Tax Law §605(b)(3) defines a resident trust as follows:

> (2) a trust, or portion of a trust, consisting of property transferred by will of the decedent who at his death was domiciled in this State, or
>
> (3) a trust, or portion of a trust, consisting of the property of:
>
> (a) a person domiciled in this State at the time such property was transferred to the trust, if such trust, or portion of a trust, was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (b) a person domiciled in this State at the time such trust or portion of a trust became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

Based upon the above definition of resident trust for New York income tax purposes, any irrevocable trust created under the law of *any* jurisdiction that is settled

by a New York domiciliary will be a New York resident trust for New York income tax purposes. This essentially means that, if a current New York domiciliary is immigrating to Canada, and he or she settles an immigration trust (which by its very nature must be irrevocable) while he or she is still domiciled in New York, the trust will be a New York resident trust. However, the analysis of whether a trust is subject to New York income tax on all of its income does not stop with the determination that it is a New York resident trust.

In the New York case of *Mercantile Safe Deposit and Trust Co. v. Murphy*,[12] the Appellate Division of the New York Supreme Court held that New York lacked jurisdiction to tax the income of a trust established by a New York domiciliary, where the trust was administered in Maryland, the trustee was domiciled in Maryland, and the intangibles constituting the trust corpus were in the trustee's exclusive possession and control in Maryland.[13] As a result of this decision, New York amended its tax regulations to state that no personal income tax will be imposed on a resident trust if all the following conditions are satisfied: (i) all the trustees are domiciled in a State other than New York; (ii) the entire corpus of the trust, including real and tangible property, is located outside New York; and (iii) all income and gains of the trust are derived from and connected with sources outside New York, determined as if the trust were a non-resident.[14]

Since a U.S. person domiciled in New York may be creating the immigration trust before immigrating to Canada or just after he or she has immigrated to Canada, New York will very likely take the position that he or she was still domiciled in New York when the trust was settled, making the trust a New York resident trust. Therefore, it would behoove the U.S. person to structure the trust so that it does not have any nexus to New York by making sure that none of the trustees are domiciled in New York, that the corpus is located outside of New York, and that all of the income is non-New York source income.

The trust can be created under, and subject to, New York law and still not have a nexus to New York under the above rules. Therefore, the trust can be created under New York law and still avoid New York income tax.

Nevertheless, New York law does have some drawbacks outside the income tax area. For instance, a trust created for the benefit of the settlor, a so-called "self-settled" trust, is subject to the claims of the settlor's creditors under New York law, even if it is irrevocable.[15] Therefore, if the settlor wishes to have the trust assets protected from the claims of his or her creditors while the trust is in place, and also wishes to avoid state level income tax, he or she should consider establishing the trust in a state (i) whose laws protect the trust assets from the claims of the settlor's creditors that arise after the trust is settled and (ii) which does not impose state level income tax on trusts.

There are many states that provide self-settled trust creditor protection and no state level income tax for trusts. Just one example is Delaware.[16] Under Delaware law, in order for a self-settled trust to be sheltered from the claims of the settlor's creditors, the trustee must be a Delaware resident or corporate trustee recognized by Delaware and the settlor may not act as a trustee. If an immigrant to Canada does not have a particular family member or other trusted individual suited to be trustee, and he or she must therefore choose a corporate trustee, it may make sense to settle the trust in a state like Delaware, with a Delaware corporate trustee, to get the added creditor protection.

D. Choosing a Trustee

For purposes of Canadian immigration trust law, a majority of the trustees should be non-residents of Canada and the settlor should not be a trustee. As noted above, for asset protection purposes the settlor should also not be one of the trustees, so for two separate goals (asset protection and the Canada tax holiday) these rules are aligned. For both U.S. and Canada law purposes the trustee or trustees may be a family member or a bank or trust company, so long as the majority are not residents of Canada.

E. Complete or Incomplete Gift for U.S. Gift Tax Purposes

A U.S. person creating an immigration trust will very likely not want the transfer to the trust to be considered a completed gift, since a completed gift would result in a forty-five-percent gift tax. The donor may be particularly averse to incurring such a tax since, ultimately, after the sixty-month period, the trust assets may revert to him or her. However, as discussed below, there are cases where a completed gift may be desirable.

The U.S. imposes a gift tax on the transfer of property by gift, and the gift tax applies whether the transfer is in trust or otherwise.[17] A gift will be considered complete, and gift tax will be imposed, if the donor has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another.[18] For example, if a donor transfers property to another in trust to pay income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his or her other descendants, no portion of the transfer is a completed gift and the gift tax will not apply.[19]

In addition, if the exercise of the trustee's power is limited by a fixed or ascertainable standard (such as a power to distribute for the donor's education, support, maintenance, or health), enforceable by or on behalf of the

donor, then the gift is incomplete to the extent of the ascertainable value of any rights retained by the donor.[20] A gift is incomplete whenever the donor reserves the power to revest title to the property in himself or herself, if the donor reserves the power to name new beneficiaries, or if the donor reserves the power to change beneficial interests in a nonfiduciary capacity and not subject to ascertainable standards.[21]

If a donor transfers property to an irrevocable trust and an independent trustee has the sole and absolute discretion to distribute trust income or corpus to the donor and, under state law, the donor's creditors cannot reach the assets of the trust to satisfy their claims, the gift is complete because the donor has not retained an interest in the property.[22] If, however, the creditors of the settlor may satisfy their claims from the property of the trust, the transfer may not be complete for gift tax purposes.[23] In *Paolozzi v. Commissioner* the donor was the sole beneficiary of a trust that she settled and the trustees had the sole and absolute discretion to distribute income to the donor. The court held that, since under state law the donor's creditors could attach the income of the trust to satisfy their claims, the transfer was incomplete for purposes of the gift tax and no gift tax applied to the transfer. The theory behind this position was that the donor could still control whether she benefited from the trust by incurring debt.

Since the immigration trust must be irrevocable and the trustee must have full discretion as to whether to distribute income and principal to the settlor in order to shelter the trust assets from Canada income tax for the sixty-month period, to avoid a completed gift it is recommended that the U.S. person settling the trust reserve a testamentary power to appoint the trust property among his or her descendants. Even if the settlor creates the trust in a state like New York that allows creditors to attach trust assets, it is not recommended that the settlor rely on this power to make the transfer to the trust an incomplete gift.

In 2013, U.S. gift tax/estate tax exemption is $5,250,000 (the exemption is indexed for inflation each year). A U.S. person establishing an immigration trust may want the first $5,250,000 ($10,500,000 for a married couple) to be considered a completed gift. In that case, the settlor would not retain a testamentary power of appointment over the trust, would settle the trust in a state like Delaware that does not allow creditors who arise after the transfer to attach trust assets, and provide that the trust will remain in place with an independent trustee even after the sixty-month tax holiday expires. In this case the trust would be subject to Canada income tax, but at least it will be sheltered from U.S. estate tax upon the death of the U.S. person.

F. Income Tax Considerations

As noted above, if the trustee of the trust is a non-adverse party (*i.e.*, has no interest in the trust) and the income of the trust may be distributed to the settlor in the discretion of the trustee or accumulated for future distribution to the settlor or his or her spouse, the settlor will be treated as the owner of the trust and its income will still be taxable to him or her.[24] Since an immigration trust is not established for the reduction of U.S. income taxes, the fact that the income continues to be taxable to the settlor under this rule should not be a concern.

Even if the trust is structured as a completed gift under the above rules, the income will still be taxable to the settlor under Section 677(a) of the U.S. Internal Revenue Code. Generally, this is beneficial since the settlor's payment of the trust's income taxes is in essence a gift-tax-free gift to the trust remaindermen (most likely the settlor's children), since more of the trust assets will be preserved for them.

G. Provisions of Immigration Trust After Sixty-Month Tax Holiday

If the settlor structures the trust to be considered an incomplete gift, the trust should simply provide for the trust assets to pass to the donor once the sixty-month period expires. If the settlor structures the trust to be a completed gift, as discussed above, the trust could provide for it to continue after the expiration of the sixty-month period.

H. Provisions of Immigration Trust if Settlor Dies During Sixty-Month Tax Holiday

If the settlor dies during the sixty-month tax holiday, consideration should be given to the same issues that are considered in general U.S. estate planning. Therefore, consideration should be given to including a credit shelter trust for the surviving spouse to take full advantage of the estate tax unified credit and possibly a marital trust for the balance of the trust assets. Consideration should also be given to how the trust assets should be distributed upon the settlor's death beyond credit shelter planning. If the settlor is married at that time, presumably the assets would pass to his or her spouse. If he or she is not married at that time, alternative beneficiary provisions should be considered and set forth in the trust.

Endnotes

1. [2010] 2 C.T.C. 2346, *aff'd*, 2010 FCA 309. The taxpayer in the *Garron* case appealed to the Supreme Court of Canada. The appeal was heard on 16 March 2012. Judgment was reserved.
2. Section 128.1 of the ITA.
3. Internal Revenue Code (the "Code") Section 7701(b)(1)(A).
4. Code § 7701(a)(30)(E).
5. Code § 7701(a)(31)(B).
6. Code § 641(b).
7. See Code § 677(a).

8. See Code § 679.
9. See Code §1(e).
10. New York Tax Law §601(e)(1).
11. New York Tax Law §601(c).
12. 19 A.D.2d 765, 242 N.Y.S.2d 26 (2d Dept., 1963), *aff'd*, 15 N.Y.2d 579, 255 N.Y.S.2d 96 (1964).
13. *Id.*, 242 N.Y.S.2d at 28.
14. New York Reg. §105.23(c).
15. New York Estates, Powers and Trusts Law § 7-3.1(a).
16. *See* Del. Code Ann. Tit. 12, § 3570.
17. Code §§ 2501(a) and 2511(a).
18. Treas. Reg. § 25.2511-2(b).
19. *Id.*
20. *Id.*
21. Treas. Reg. § 25.2511-2(c).
22. *Holtz Estate v. Commissioner*, 38 T.C. 37, 42 (1962), *acq.* 1962-2 C.B. 4; Regs. § 25.2511-2(b); Rev. Rul. 77-378, 1977-2 C.B. 347.
23. *Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958); *Outwin v. Comr.*, 76 T.C. 153 (1981), *acq.* 1981-2 C.B. 2; *Hambleton v. Comr.*, 60 T.C. 558 (1973), *acq. in result*, 1974-1 C.B. 1; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), *acq.* 1962-1 C.B. 4; Rev. Rul. 76-103, 1976-1 C.B. 293.
24. *See* Code § 677(a).

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The Irish Intellectual Property Regime and the Treatment of Intellectual Property Licenses Under the Bankruptcy Laws of Ireland

By Carol Plunkett

I. Introduction: The Growing Importance of Intellectual Property in Ireland

Ireland has for many years been the European headquarters location of choice for the world's leading pharmaceutical, technology and financial institutions. This can be credited in large part to Ireland's attractiveness as a location for intellectual property. In order to sustain this position, substantial efforts have been made, first, to ensure that Ireland has the necessary legislative framework in place to offer sufficient legal protection for intellectual property rights and, second, to offer tax incentives to encourage and foster growth of intellectual property rights in Ireland.

A. Favorable Corporate Tax Rate[1]

A general corporate tax rate of 12.5 percent applies to all companies operating in Ireland, as well as non-resident companies who trade through a branch or agency in Ireland. In order to qualify for the 12.5-percent rate, the income earned must be active "trading income," and not passive investment income such as interest or dividends. It is also required that an essential part of the trading function (for example, a sales function) be carried out in Ireland. Issues can arise as to whether royalty income from the licensing of intellectual property is eligible for the 12.5-percent rate. A company whose only activity is licensing the rights of intellectual property is unlikely to be regarded as trading for the purposes of qualifying for the 12.5-percent rate. However, provided that sufficient management, sales and/or enforcement activities are carried out in Ireland, an intellectual property holding company can technically qualify for the 12.5-percent rate. Where the holding of intellectual property can be combined with research and development work carried on in Ireland, the licensing of the intellectual property will generally be viewed as a trading activity, which qualifies for the 12.5-percent tax rate. In such circumstances, Ireland becomes a very tax-efficient jurisdiction for licensing intellectual property.

Generally dividends received by Irish companies from non-Irish companies are subject to a corporation tax of percent. However, "qualifying dividends" received by Irish companies from foreign companies are subject to a corporation tax at 12.5 percent. Qualifying dividends are dividends received by a company out of the trading profits of a non-resident company that is resident for tax purposes in either an EU member state or a country with which Ireland has a Double Taxation Treaty.

B. Registration of Licenses

Substantial efforts have been made at a government level to introduce measures to ensure that Ireland has the necessary legislative framework in place to offer sufficient legal protection for intellectual property rights. Ireland's intellectual property law can be split into four principal categories: (i) trademarks; (ii) patents; (iii) copyright; and (iv) designs. Except for copyright, in which rights subsist automatically and there is no statutory system of regulation, all intellectual property rights can be registered in Ireland.

The majority of intellectual property license agreements entered into will contain a clause which stipulates that the agreement be governed by and construed in accordance of the laws of a particular country. It will also often specify that both parties submit to the jurisdiction of the courts of that country in relation to any disputes or proceedings arising out of or in connection with the agreement. Since the licensor to a contract is often in the stronger bargaining position, it is the licensor who usually decides which jurisdiction's law will govern the agreement. Most intellectual property agreements entered into in Ireland are governed by Irish law. This is advantageous for a number of reasons, primarily because disputes concerning intellectual property are dealt with in a division of the High Court known as the Commercial Court.

C. Irish Commercial Court

The Commercial Court was established in 2004 to provide efficient and effective dispute resolution in commercial cases. It is governed by Order 63A of the Rules of the Superior Courts in particular. The Commercial Court consists of the Commercial List, as it is termed. The objective of the Court is the determination of the proceedings in the Commercial List in a manner which is "just, expeditious and likely to minimize the costs of those proceedings." It is a list which comprises proceedings in respect of which the Commercial Court has exercised its discretion to accept for consideration and which are conducted pursuant to Order 63A. The Commercial List is managed by Mr Justice Kelly.[2] There are two other judges permanently assigned, with other High Court judges assigned where the demand warrants it.

Litigation admissible to the Commercial List falls into three categories.[3] As a starting point the dispute must be commercial in nature and that should be plain from the facts. For the most part the dispute must have a value of in excess of One Million Euros and invariably it is a multiple of that figure.

The Court does have jurisdiction to deal with disputes related to intellectual property, and there is no monetary lower limit in such cases. In reality, though, one would only make an application to have a case entered in the Commercial List where it was a dispute of significant value. The exception made for intellectual property disputes reflects Ireland's drive towards becoming a highly skilled "*Smart Economy*"[4] as opposed to an agrarian one.

The other types of commercial dispute accepted into the Commercial List are public law disputes which have a substantial commercial aspect. Such public law disputes are invariably in the form of a judicial review or statutory appeal against a decision of the various regulators, whether of energy, electronic communications or airport charges.

Unlike other High Court cases, the power of the Commercial Court judges to control the course of pre-trial procedure in the Commercial Court is enshrined in Order 63A Rule 5. It empowers a Commercial Court judge to

> at any time and from time to time, of his own motion and having heard the parties, give such directions and make such orders, including the fixing of time limits, for the conduct of proceedings entered into the Commercial List, as appears convenient for the determination of the proceedings in a manner which is just, expeditious and likely to minimize the costs of proceedings.

The rule gives Commercial Court judges wide discretion as to the directions they can make and the sanctions they can order for non-compliance. This power is used in a diverse number of ways, such as to require parties to redraft pleadings where the Court considers them deficient or to provide them in a particular form such as a joint issues statement or a statement of agreed facts, or to direct what matters will be admissible as evidence, or to direct that expert witnesses meet to seek to agree on issues. If a case is particularly complex and involves a number of pretrial issues, then it may have a specific Commercial Court judge assigned to it before whom there will be regular Directions Hearings to ensure that the case remains managed despite its complexity. This procedure has proved effective. The most recent statistics[5] indicate the average waiting time from the entry of a case to conclusion of a hearing is twenty-two weeks.

Despite this rapid time frame the statistics show that two-thirds of cases settle prior to the full hearing of the case, thus demonstrating that it has achieved its objective: "the determination of the proceedings in a manner which is just, expeditious and likely to minimize the costs of the proceedings."

The experience of the Irish Commercial Court demonstrates that the judge-directed case management given effect by Mr Justice Kelly in his management of the Commercial List in Ireland is a success when measured as a procedure which facilitates the efficient and effective resolution of commercial disputes, irrespective of complexity.

II. Patents, Trademarks, Copyright and Designs

A. Patents

The Patents Act 1992, governs the law relating to patents. There are two types of patents in Ireland. Long-term patents allow the applicant protection for up to twenty years. A number of criteria must be satisfied for a long-term patent to be granted, most notably those of novelty and inventiveness. Alternatively, a short-term patent may be applied for, to cover a period of up to ten years. Since there are fewer conditions to satisfy in order to apply successfully for a short-term patent, the process is a simple and efficient one. Official costs associated with applying for a short-term patent are also 50 percent less than those costs associated with applying for a full-term patent. Ireland is also a signatory to the Paris Convention, pursuant to which each convention country must grant, in regard to intellectual property rights, the same protection to nationals of all other convention countries as it grants to its own nationals.

Under the Patents Act, a proprietor of a patent may decide at any time to apply to the Controller of Patents, Trade Marks and Designs, also known as "The Patents Office," to indicate that licenses as of right are available in respect of the patent.[6] In this way the proprietor can enjoy such advantages as attracting potential licensees and a fifty-percent reduction in the renewal costs of the patent in question. When a license of right becomes entered on the register, any person may obtain a license on terms to be agreed by the parties. If terms cannot be agreed between the parties, they will be settled by the Patents Office, who will make a final decision. The licensor must also be aware that acceptance of these terms by the applicant does not preclude the possibility of an appeal, nor does it prevent the applicant from challenging the validity of the patent in a defense to infringement proceedings further down the line.

The Patents (Amendment) Act 2006 has substantially changed the provisions under which a person may compel the granting of a license.[7] Before the 2006 amendment, a compulsory license was available on the basis that the demand for the patented product was being met purely by importation. It is now the case that, provided the patentee imports the invention from a member country of the WTO or manufactures it here in Ireland, no compulsory license may be granted. It was also previously the case that a compulsory license could be sought to satisfy an export market. However, as previously explained, compulsory licenses are now only available in WTO countries to satisfy a demand in that country itself. Prior to the 2006 amendment, food and medical inventions were afforded special public interest considerations when royalty rates for compulsory licenses were being considered. This is no longer the case, since the TRIPs agreement requires equal treatment for

all fields of technology. It is also now required that a person seeking a compulsory license must first approach the patentee with a view to agreeing on reasonable terms of a license agreement.

There are other grounds for a compulsory license, including:

- Insufficient Domestic Working[8]—where a patented invention, capable of being worked commercially in Ireland, is not being worked to the fullest extent that is reasonably practicable.
- Failure to meet demand or to meet such demand on reasonable terms or doing so by importation other than from a member of the WTO.[9]
- Unfair prejudice to the establishment or development of commercial or industrial activities in Ireland.[10]

B. Trademarks

Registered Irish trademarks are governed by the Trade Marks Act 1996. A registration lasts for a period of ten years and can be renewed indefinitely for successive ten-year periods. Unregistered trademarks may be protected under the common law tort of passing off. This, however, can be uncertain, since it places the burden of proof on the owner to establish reputation, and is consequently difficult and expensive to enforce. A Community trademark may also be sought from the Office of Harmonisation in the Internal Market ("OHIM") in Alicante, which provides one single registration for a trademark throughout the twenty-seven members of the European Union. Ireland also ratified the Madrid Protocol in 2001, which allows the applicant to protect its mark in most countries worldwide which are also party to the protocol by filing an application in the Irish Patents Office, known as the "Office of Origin."

In Ireland, a trademark license may be granted in respect of some or all of the goods and services covered by the registration. A limited license may apply in relation to the goods and services covered by the registration, or the use of the mark in a particular manner or location. It is also possible, where the license allows, for a sublicense to be granted by the licensee.[11] The grant of a license is also a registrable transaction under the Trade Marks Act, 1996. Failure to do so will make the license vulnerable for a number of reasons. First, the license will be ineffective against someone acquiring a conflicting interest in the mark or in ignorance of it.[12] Second, the licensee will not have the right to bring infringement proceedings in its own name.[13] Third, the licensee will not be entitled to recover damages or an account of profits arising from infringement of the registered trademark.[14]

C. Copyright

Ireland introduced the Copyright and Related Rights Act 2000 to govern and modernize the law relating to copyright and address the enormous technological changes that have taken place in recent years. The statutory period of protection for most works is 70 years after the death of the author. There is no formal system for registering copyright claims in Ireland. Therefore licenses are also not registrable by the copyright owner. Similar to trademarks, copyright may be licensed wholly or partially with respect to the copyrighted material.[15] Exclusive licenses may also be agreed between the owner of the copyright and the licensee. Under Irish Law an exclusive licensee has the same rights against a successor in title bound by the license as it has against the person granting the license.[16]

D. Designs

Ireland's Industrial Designs Act 2001 substantially updated Irish law with respect to the protection and registration of industrial designs. Registered designs are protected for up to twenty-five years, renewable at five-year periods. Ireland also benefits from the Registered Community Design Right (community-wide legal protection for designs) and Unregistered Community Design Right, both introduced into Ireland in 2000.

Similar to trademarks above, the grant of a license in respect of a design is a registrable transaction. Failure to register a license will render it ineffective as against someone acquiring a conflicting interest in the registered design, and removes any entitlement to the rights and remedies provided for by the Act in case of infringement.[17] Licenses, including exclusive licenses, must be signed on behalf of the grantor in order to be effective and are binding on a successor-in-title to the grantor's interest in the design.

III. Liquidation

According to Murdoch's Dictionary of Irish Law, liquidation, or "winding up," is:

> The process whereby the end is put to the carrying on of the business of a company or partnership. The assets are collected and realised, the resulting proceeds are applied in discharge of all its debts and liabilities, and any balance (surplus) which remains after paying the costs and expenses of winding up is distributed among the members according to their rights and interests, or otherwise dealt with as the constitution of the company or partnership directs.

There are three methods by which a company may be wound up:

- A compulsory or "official" liquidation occurs when the High Court is petitioned to have a company wound up.[18] Persons entitled to petition the court to have a company wound up are: the company itself; a creditor of the company; a contributory; a member; the Director of Corporate Enforcement and the Registrar of Companies.[19] Those listed may only bring a petition on certain grounds. Compulsory

winding up is often resisted by the company petitioned.

- A members' voluntary liquidation is commenced by the members (shareholders) of a company. A members' voluntary liquidation differs from the other forms of winding up in that the company must be solvent. There are two grounds under which the members can voluntarily wind up a company by way of a members' voluntary liquidation.[20] The first ground is where the articles of association of a company provide that the company is to be dissolved after a certain period of time and that period has expired: in that case the company may pass an ordinary resolution that the company be wound up voluntarily. The second and most common ground for a members' voluntary liquidation is where the company resolves by special resolution that the company be voluntarily wound up. Members may wish to wind up the company on this basis in order to transfer assets out of the company by means of a distribution in specie.
- Creditors' voluntary liquidation can occur on the conversion of a member's voluntary liquidation (where it transpires that the company is insolvent) or it may be resolved by the members (shareholders) in a general meeting that, because of its liabilities, the company cannot continue as a business and it must be wound up.[21] The creditors have an opportunity at a creditors meeting to appoint a liquidator in place of the members appointed.

Ireland is a party to the EU Insolvency Regulation, which came into effect in 2002 and applies to all EU member states except Denmark. This Regulation established a regime for the improved efficiency and effectiveness of the conduct of cross-border insolvencies. This is achieved by providing for cross-border recognition and enforcement of basic orders such as the appointment of liquidators and other insolvency officeholders, and of remedies typically invoked in insolvency proceedings. It also establishes a regime for the management of asset realization and the processing of creditor claims in multi-jurisdictional cases. The regulation applies only to entities that have their center of main interests ("COMI") within an EU member state. The Regulation provides that the applicable jurisdiction for insolvency proceedings is the court of the member state where the debtor's COMI is located. Ireland is not a party to the United Nations Commission on International Trade Law (UNCITRAL), to which countries such as the USA and Australia are members.

B. Consequences of a Winding-Up

If a licensee company is wound up, and is at that time party to an intellectual property licensing agreement, generally the terms of the license will provide for the termination of the agreement on appointment of the liquidator. For example:

> The Licensor may terminate this Agreement immediately by notice in writing if the Licensee is unable to pay its debts or enters into **compulsory or voluntary liquidation** (other than for the purpose of effecting a reconstruction or amalgamation in such manner that the company resulting from such reconstruction or amalgamation if a different legal entity shall agree to be bound by and assume the obligations of the relevant party under this Agreement) or compounds with or convenes a meeting of its creditors or has a **receiver** or manager or an **examiner** appointed over its assets or ceases for any reason to carry on business or takes or suffers any similar action which in the opinion of the party giving notice means that the other may be unable to pay its debts.

If the licensor is wound up, the license agreement will be an asset of the licensor entity that is being wound up and a liquidator will try to sell this asset. Therefore, it is important that there be assignment provisions in the license in the event of the licensor going into any insolvency process. In respect of a licensee, in order to maintain its rights, it must fulfill its obligations as per the license agreement by paying the licensing fees to the entity that is the subject of the insolvency proceedings. If the liquidator sells the IP to a third party with the benefit of the licenses, the obligations on the licensee will be assigned to the IP's new owner.

C. Disclaimer of Onerous Contracts

If the license agreement does not contain such a termination provision, a liquidator appointed to a licensee company can apply to court to disclaim the license agreement. Such an application can be made where the licensee is party to an unprofitable agreement binding the company to the performance of any onerous acts or payments of any sums of money, and the liquidator may, with permission of the court, disclaim the agreement as onerous property.[22] The effect of this would be to terminate the rights, interests and liabilities of the company with respect to the property. Any person suffering loss as a result of the disclaimer will then become a creditor of the company to the amount of the damages and may prove the amount as a debt in the winding up.[23] The court may make an order rescinding the contract on such terms as to payment of damages for the non-performance of the contract as the court deems appropriate.[24]

D. Examinership

Examinership in Ireland is where the court places the company under its protection in order that a court appointed examiner may investigate the company's affairs and report the company's likelihood of survival to the court.[25] If the examiner finds that survival can be achieved,

the court may sanction a scheme of arrangement which allows the company to pay its creditors in part, enabling the company to continue in business. In the short term this process allows the company breathing space, since there is an automatic stay imposed for a period of 70 days. This process is unique to Ireland but has some similarities to the Chapter 11 procedure in the USA. If a license agreement is not terminated on its own terms by the appointment of an examiner, the company in examination has the power to disclaim onerous agreements.

E. Receivership

Receivership normally occurs when a company defaults on a contract to repay loans or outstanding debts. When this happens, a receiver is appointed by the creditor to gather up and take the debtor's assets into the receiver's possession for the purpose of selling them and applying the proceeds in satisfaction of the debt owed to the creditor. A receiver can be court appointed or appointed on foot of a deed. This differs from liquidation, which means the company is in the process of being wound up. The objective of receivership is realizing a company's assets in order that debts outstanding to the creditor that appointed the receiver can, subject to the payment of any preferential creditors, be met. The appointment of a receiver in itself does not automatically terminate license agreements unless, of course, individual contracts are expressed to terminate on the appointment of a receiver.

F. Personal Bankruptcy

Bankruptcy is the process in Ireland whereby natural persons who cannot or are unwilling to pay their debts have their assets realized and distributed among their creditors under the supervision of the High Court. Once a debtor has been adjudicated bankrupt by the High Court, all of the bankrupt's assets will be vested with an Official Assignee, who will then set about realizing and distributing the bankrupt's assets among the debtor's creditors in accordance with the law. A new Personal Insolvency Bill published by the Irish Government seeks to bring major reform in this area and is expected to become law late in 2012. The new bill will bring Ireland more in line with personal insolvency laws in other EU member states.[26] Significant provisions of the new Bill include:

- A reduction in the automatic discharge period in bankruptcy from twelve to three years, subject to certain conditions.[27]
- The establishment of an independent body corporate called "The Insolvency Service," tasked with overseeing three new debt settlement systems introduced under the Bill.[28]
- The appointment of "Personal Insolvency Practitioners" to advise debtors and act on their behalf.[29]

Endnotes

1. Section 71 of the Finance Act, 1999.
2. It should be noted that there is no automatic right of entry to the Commercial List of the High Court. Entry to the List is at the discretion of Mr Justice Peter Kelly of the Irish High Court.
3. The Commercial Court deals with the following types of disputes:
    - Disputes concerning intellectual property (including proceedings under the Patents Act, 1992; the Trade Marks Act, 1996; the Copyright and Related Rights Act, 2000; the Industrial Designs Act, 2001; or any proceedings instituted for relief in respect of passing off;
    - Disputes of a commercial nature where the value of the claim is at least €1 million;
    - Any other case where the Judge considers that the application is, having regard to the commercial or any other aspect thereof, appropriate for entry in the Commercial List.
4. *Building Ireland's Smart Economy, A Framework for Sustainable Economic Renewal*, http://www.taoiseach.gov.ie/attached_files/BuildingIrelandsSmartEconomy.pdf.
5. Commercial Court Statistics—1 January 2004 to 4 October 2011:

	Total
Cases Entered into List	1506
Cases Disposed of	1363
Cases Outstanding	143

6. Patents Act 1992, §68.
7. Patents Act 1992, §70, as amended by the Patents (Amendment) Act 2006.
8. Patents Act 1992, §70(2)(a), as amended by the Patents (Amendment) Act 2006.
9. Patents Act 1992, §70(1)(b), as amended by the Patents (Amendment) Act 2006.
10. Patents Act 1992, §70(1)(b), as amended by the Patents (Amendment) Act 2006.
11. Section 32 of the Trade Marks Act 1996.
12. Trade Marks Act, 1996, §29(3)(a).
13. Trade Marks Act, 1996, §29(3)(b).
14. Trade Marks Act 1996, §29(4).
15. Copyright and Related Rights Act 2000, §120(2).
16. Copyright and Related Rights Act 2000, §122.
17. Industrial Designs Act 2001, §78.
18. Companies Act 1963, §212.
19. Companies Act 1963 §215, as amended by the Companies Act 1963, Sch1, para 18, and C(A)A 1983, Sch and by CLEA 2001, §94.
20. Companies Act 1963, §251(1).
21. Companies Act 1963, §251(1)(c).
22. Companies Act 1963, §290.
23. Companies Act 1963, §290(9).
24. Companies Act 1963, §290(6).
25. Companies (Amendment) (No 2) Act 1999.
26. Personal Insolvency Bill 2012 Explanatory Memorandum.
27. Personal Insolvency Bill 2012, §143.
28. Personal Insolvency Bill 2012, §8.
29. Personal Insolvency Bill 2012, §144.

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The Treatment of Intellectual Property Licenses Under U.S. Bankruptcy Law

By Eric Stenshoel

I. Introduction

Intellectual property assets have characteristics that set them apart from other classes of assets. They consist of rights of exclusive use that exist by virtue of the laws of particular jurisdictions, making them territorial, but these rights are the subject of international conventions that allow their extension to other jurisdictions, giving them potentially international scope. They are intangible and therefore inherently portable, but their value derives from their physical embodiment in patented inventions or processes, copyrighted works (including software), and trademarked products, all of which are commercialized in particular jurisdictions. Finally, they come into existence as exclusive rights, but their owners may exploit them by licensing them to others without losing their right to control how they are used.

Taken together, these features of intellectual property tend to confound the process of marshaling assets in bankruptcy, since licensed intellectual property can be viewed as an asset of both the licensor and the licensee. Where the debtor is a licensor of intellectual property, it will want to maximize the value of the intellectual property by terminating unprofitable licenses, if this course of action is legally available, in order to enable it to enter into licenses on more profitable terms or to exploit the intellectual property itself. Where the debtor is a licensee, it will want to retain rights under any profitable licenses, either to continue its own exploitation or to assign them to a purchaser. The question is how these two related assets—the owner's right to control the intellectual property and the licensee's right to exploit it—are treated in bankruptcy. The question becomes even more complicated when the license and the bankruptcy are international in scope.

II. The Legal Landscape in the United States

A. Generally

Under U.S. law, the filing of a voluntary petition for bankruptcy creates a bankruptcy estate consisting of all of the debtor's interests in property as of the filing, any proceeds of such property, and any additional interests in property that the debtor acquires in the case.[1] It also triggers an automatic stay, which prevents other parties from bringing actions to collect money from the debtor or to take possession or control over property of the estate.[2] Furthermore, clauses that purport to modify or terminate either contracts or the debtor's interest in property upon bankruptcy, so-called "ipso facto clauses," are not enforceable.[3]

In addition to protecting the debtor from actions by others, the filing of a voluntary petition relieves the debtor-in-possession of the obligation of performance under executory contracts entered into prior to the filing, allowing the trustee or debtor-in-possession to formulate a plan of reorganization. The trustee or debtor-in-possession may reject burdensome executory contracts[4] and may generally assume and assign executory contracts despite anti-assignment clauses in them.[5] In order to (i) assume or (ii) assume and assign a contract, the debtor must cure its defaults, compensate the other party for its actual losses, and provide adequate assurances of future performance.[6] An executory contract must be either assumed or rejected in its entirety[7] unless it contains separate agreements that are severable under applicable non-bankruptcy law.[8] Severability is "primarily a question of intention of the parties."[9]

The term "executory contract" is not defined in the Bankruptcy Code. The definition most commonly adopted by the courts is the "Countryman definition," formulated by Professor Vernon Countryman, who defined an executory contract as one under which "the obligations of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[10]

B. Intellectual Property Licenses as Executory Contracts

Although there is some disagreement on the definition of executory contract, licenses of intellectual property typically contain mutual obligations sufficient to categorize them as executory, such as a licensee's continuing obligation to account for sales and pay royalties[11] and, in the case of a trademark license, to maintain the character and quality of the goods sold[12] or the reputation of the licensor[13] and a licensor's obligation to maintain the licensed property in effect.[14] Other executory obligations sometimes cited are the duties of indemnification[15] and product marking,[16] and the licensor's forbearance from selling products itself when it has granted an exclusive license.[17] Professor Countryman proposed that the grant of a patent license, even in the absence of any other express obligations, gives rise to an implicit warranty of validity, making nearly every patent license an executory contract.[18] Similarly, it has been held that, since a non-exclusive license is "a mere waiver of the right to sue" the licensee for infringement,[19] it includes an executory obligation on the licensor to refrain from such a suit.[20] By

this reasoning, all licenses of intellectual property would necessarily be executory.

Notwithstanding the general rule that intellectual property licenses are executory contracts, they have sometimes been held to be non-executory. For example, in the case of *In re Stein and Day Inc.*,[21] where an author granted his publisher exclusive licenses to publish two books and the agreement was fully performed on the part of the author except for certain warranties, such as non-infringement, and the books had been published over a decade earlier, the court held that the contracts were not executory as to the author and denied a motion to compel the debtor to assume or reject the contracts.[22]

A similar analysis fact pattern arose in the context of a trademark license in *In re Exide Technologies.*[23] In this case, the debtor, Exide Technologies, sought to reject a trademark license arising from the sale to EnerSys, over a decade previously, of substantially all of its industrial battery business. The manufacturing assets were sold outright but, since Exide wanted to be able to continue using the trademark outside the industrial battery business, it retained ownership of the trademark but granted EnerSys a perpetual, exclusive, royalty-free license to use the mark in connection with the transferred industrial battery business. In 2000, Exide sought to re-enter the industrial battery market. It negotiated with EnerSys for an early termination of its ten-year period of non-competition and acquired another battery company. It also sought to reacquire the trademark from EnerSys but EnerSys refused. After facing direct competition for two years from EnerSys, which was selling Exide-branded batteries, Exide filed for Chapter 11 protection and obtained permission of the bankruptcy court to reject the Exide trademark license. After the decision was affirmed by a memorandum order of the district court, EnerSys appealed to the Third Circuit Court of Appeals, arguing that the license agreement was not executory and that rejection of the contract failed to terminate its license rights.

The majority opinion held that the license agreement was not an executory contract, notwithstanding the obligations imposed on EnerSys not to use the mark outside the industrial battery business, to maintain the licensor's quality standards, and to provide indemnification and further assurances. The Third Circuit found that the restriction on the licensee's use was a non-material condition subsequent, that the licensor had not provided the licensee with any quality standards, that the warranty related to representations and warranties under the asset purchase agreement had expired eight years earlier, and that there was no evidence that any further assurances arising from the asset purchase transaction were required.[24]

Both *Stein and Day* and *Exide* indicate that when a license agreement looks more like a sale than a true license, a court may be more inclined to treat it as a non-executory contract in order to avoid an inequitable result. But the *Exide* case also opened the door to a more fundamental shift in the treatment of intellectual property licenses in bankruptcy. Judge Ambro concurred in the *Exide* result but argued that the district court had erred in holding that rejection of the trademark license terminated EnerSys's rights under the agreement. His argument was recently adopted by the court in the Seventh Circuit Court of Appeals in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[25] which is discussed below in the context of the effect of rejection of license agreements by debtor licensors.

1. The Debtor as Licensor

As noted above, a debtor licensor may either assume or reject a license agreement that qualifies as an executory contract. In order to assume the license agreement, the debtor must cure its defaults, compensate the licensee for its actual losses, and provide the licensee with adequate assurances of future performance by the debtor or, if the license agreement is assigned, by a prospective assignee.[26] Although the option of assumption and assignment may be restricted for debtor licensees, as discussed below, a debtor licensor may generally assume and assign an intellectual property license even if the terms of the agreement prohibit it from doing so.[27]

(a) Rejection under *Lubrizol*

The situation is much murkier when it comes to the effect of rejection of an intellectual property license. In the *Lubrizol* case, the debtor had licensed technology for a metal process to Lubrizol on a non-exclusive basis a little over a year before filing its petition for bankruptcy. The bankruptcy court approved the rejection of the technology license as an executory contract[28] and Lubrizol appealed to the district court, which reversed on the grounds that the contract was not executory and that rejection could not reasonably be expected to benefit the bankrupt debtor substantially, based partly on the assumption that rejection of the contract would not deprive Lubrizol of all its rights to the technology.[29]

On appeal from the district court ruling, the Fourth Circuit Court of Appeals held that the debtor's obligation under a most-favored-licensee clause, as well as the obligations to notify, defend and indemnify the licensee against possible suits, made the license agreement an executory contract and that rejection did in fact terminate Lubrizol's rights to use the technology.[30] The decision was based upon the well-established proposition that the non-debtor party to an executory contract is not entitled to specific performance from the debtor following rejection.[31] Framing the issue in this way, however, treats the grant of license as if it were a stream of goods to be delivered rather than a promise of forbearance from suing for infringement during the license term.

The Fourth Circuit acknowledged the harsh effect that its ruling would have on the licensee, noting that allowing rejection in such circumstances could have "a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty."[32] Nevertheless, it concluded that the bankruptcy law did not allow courts to alter the result based upon equitable considerations and added that it was in the power of Congress to ameliorate the consequences if it desired to do so, as it had with respect to collective bargaining contracts.[33]

The same reasoning was applied in the context of a trademark license in the case *In re Chipwich, Inc.*[34] In that case, the debtor had granted exclusive licenses to Farmland Dairies to produce eggnog, flavored milk and a dairy shake product under the trademark CHIPWICH in exchange for one-time license fees totaling $90,000 and continuing royalties. The terms ran for fifty years under the first license and ninety-nine years under the second, with an option for Farmland to renew for another ninety-nine years. The court rejected Farmland's argument that the license agreements were non-executory and approved the debtor's rejection of the license agreements, finding that it was in the debtor's best interests to terminate Farmland's licenses and seek more lucrative contracts with other licensees.[35]

(b) Congressional Response to *Lubrizol*: Section 365(n)

In response to the *Lubrizol* decision, Congress enacted the Intellectual Property Protection Act of 1988, which created statutory protections for intellectual property licensees whose licenses were rejected by a debtor-licensor. These protections, which were codified as Section 365(n) of the Bankruptcy Code, apply both before and after rejection by the debtor.

Prior to rejection, on receiving a written request from the licensee, the debtor-licensor must perform the license agreement and provide the licensee with access to the licensed intellectual property in accordance with the terms of the agreement, and may not interfere with the contractual rights of the licensee to such intellectual property.[36]

Upon rejection by the debtor-licensor, the licensee has two options. It may treat the license agreement as terminated, in which case any claim for damages would be treated as a general unsecured claim against the bankruptcy estate.[37] Alternatively, the licensee may elect to retain its existing rights in the licensed intellectual property.[38] In the latter case, the licensee must continue to make royalty payments[39] and waive any right of set-off it may have under the agreement and any administrative claim allowable under Section 503(b) of the Bankruptcy Code arising from the performance of such contract.[40] The licensor-debtor is relieved of any further obligations, other than allowing the licensee to exercise rights under the license agreement.

(c) Treatment of Trademark Licenses in Bankruptcy

The protections granted under Section 365(n) apply only to licensees of "intellectual property," as defined in the Bankruptcy Code. The definition includes (i) trade secrets; (ii) inventions, processes, designs, or plants protected under U.S. patent law; (iii) patent applications; (iv) plant varieties; and (v) works of authorship protected under U.S. copyright law, or mask works (used in the production of semiconductor chip products).[41] Conspicuously missing from this list are trademarks and service marks. In enacting Section 365(n), Congress explained the omission as follows:

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of section 365 by the Lubrizol court and others ..., such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[42]

Notwithstanding this statement of Congressional intent, courts have generally reasoned by negative inference that the omission of trademarks from the definition of intellectual property means that Congress intended *Lubrizol*'s holding to control when a debtor-licensor rejects a trademark license.[43] Judge Ambro's concurrence in *Exide*, however, focused judicial attention on the extensive scholarly criticism that followed the *Lubrizol* decision[44] and argued that, by allowing debtor-licensors to revoke licensed rights that it bargained away, *Lubrizol* confuses rejection with termination, which "makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve."[45]

(d) Rejection under *Sunbeam*

The argument planted by Judge Ambro in *Exide* came to full flower in *Sunbeam Products, Inc. v. Chicago American Manufacturing*, decided 9 July 2012 by the Seventh Circuit Court of Appeals.[46] The contract at issue was a trademark license not protected under Section 365(n) and the facts of the case seem designed to illustrate the danger contemplated by both *Lubrizol* and *Chipwich*—that allowing the termination of license agreements in bankruptcy could

have "a general chilling effect" upon the willingness of prospective licensees to contract at all with financially troubled businesses.[47] The debtor, Lakewood Engineering & Manufacturing Co., manufactured and sold a variety of products, including box fans. It was losing money on its sales of box fans and so contracted with Chicago American Manufacturing (CAM) to produce 1.2 million box fans under Lakewood's patent and authorized CAM to put Lakewood's trademarks on the finished box fans for shipment to retailers on orders from Lakewood. In view of Lakewood's financial situation, CAM was concerned about recouping the cost of gearing up for production and so negotiated the right to sell the trademarked box fans for its own account if Lakewood failed to purchase them.

Three months after executing the contract with CAM, Lakewood was put into bankruptcy by its creditors. Sunbeam Products bought Lakewood's assets, including its patents and trademarks, but did not want to buy the box fans manufactured by CAM and did not want CAM to sell them in competition with its own products. Lakewood's trustee rejected the executory portion of the agreement with CAM and brought an adversary action alleging patent and trademark infringement by CAM. The bankruptcy judge cited Judge Ambro's concurrence in *Exide* but, rather than reaching the issue of whether rejection of a trademark license ends the licensee's right to use the trademark, decided to allow CAM to continue using the Lakewood marks "on equitable grounds."[48]

On appeal, the Seventh Circuit found the bankruptcy judge's reliance on equitable grounds untenable,[49] but affirmed the judgment in favor of CAM on the grounds that the trustee's rejection of the trademark license did not terminate the trademark license. In so ruling, the Seventh Circuit relied on the Bankruptcy Code provision that provides that a rejection constitutes a breach of the contract, not a termination. The court explained that, outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use the intellectual property and thus, by classifying a rejection as a breach, the Bankruptcy Code allows the other party's rights to remain in place if the debtor or trustee decides to reject an executory contract.[50] The court explicitly adopted Judge Ambro's argument and rejected the *Lubrizol* decision, noting that no other court of appeals had either agreed or disagreed with it since it was issued.[51] Since the opinion creates a conflict among the federal circuits, it was circulated to all active judges on the circuit and none of them favored a hearing *en banc*.[52]

(e) After *Sunbeam*

The reasoning of *Sunbeam* would appear to apply equally well to trademark licenses and to licenses of patents, copyrights and other intellectual property as defined in the Bankruptcy Code. If so, and if the *Sunbeam* analysis prevails in the other circuits, it is not clear what will become of Section 365(n), which was intended as a statutory overruling of *Lubrizol*. The language of the section is permissive. It states that the licensee "may" elect to treat the contract as terminated or to retain its rights to the intellectual property licensed under the contract, but that it must then waive any set-off rights under the contract and any administrative claims. After *Sunbeam*, a non-debtor licensee may therefore have a third option. It may perhaps choose not to avail itself of its rights under Section 365(n) and to retain not only the right to use the licensed intellectual property but also any contractual right of set-off that it may have.

2. The Debtor as Licensee

When the debtor is the licensee rather than the licensor, another special provision of the Bankruptcy Code comes into play. A debtor or trustee may normally assume executory contracts[53] and the debtor or trustee may normally assign executory contract rights to third parties notwithstanding contract provisions or applicable law prohibiting or restricting assignment.[54] But Section 365(c) creates a narrow exception to these general rules:

> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
>
> > (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor-in-possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
> >
> > (B) such party does not consent to such assumption or assignment, either as the debtor-in-possession or for the purpose of assigning them to a third party purchaser.

Sub-clause (B) does not require that the licensor consent to the assignment in the context of the bankruptcy. Where the license agreement itself permits assignment under certain conditions, the licensor is deemed to have consented to assignment within the bankruptcy in accordance with those conditions.[55]

The term "applicable law" is not defined in the Bankruptcy Code. It is interpreted as "any law applicable to a contract, other than bankruptcy law."[56] Where the issue is the assignability of license rights under a patent, copyright or federal trademark, the courts will apply federal common law even when the parties have chosen the law of a state to govern the contract.[57] Although it has been established since *Erie v. Tompkins* that there is no federal general common law,[58] federal common law has never-

theless developed in particular areas "within which the policy of the law is so dominated by the sweep of federal statutes that legal relations which they affect must be deemed governed by federal law having its source in those statutes, rather than by local law…."[59] In the area of federally registered intellectual property rights, the federal policy of encouraging creation of inventions and original works of authorship by granting limited monopolies to inventors and authors has been held to bar the free assignability of patent licenses and copyright licenses, which would undermine the licensor's ability to control the identity of its licensees.[60]

Unlike the grant of rights under patent and copyright law, trademarks rights do not have a constitutional basis and their purpose is not to encourage creativity in the naming of products, but rather to protect consumers from confusion about the source of the trademarked goods or services. Where the owner of a trademark chooses to license the mark for use by others, it must therefore exercise quality control of the goods or services sold under the mark or risk losing its rights in the mark.[61] The requirement that a licensor control the quality of the goods or services sold by its licensee has generally been taken to imply that trademark licenses are inherently non-assignable.[62] Indeed, where a trademark license failed to specify the governing law, and the facts might have supported the application of the laws of Washington State or Canada, the Seventh Circuit recently stated: "None of this matters, though, because as far as we've been able to determine, the universal rule is that trademark licenses are not assignable in the absence of a clause expressly authorizing assignment."[63]

(a) The Effect of Exclusivity

The grant of an exclusive license in intellectual property is akin to assignment in that the licensor does not retain the right to exploit the property. Where the licensor does not retain a reversionary interest and fails to exercise any control over the licensee's use of the licensed property, as with the irrevocable exclusive trademark license in *Exide*, the license agreement may be treated as a de facto assignment. The result in *Exide* was that the agreement was held to be non-executory and not subject to rejection by the debtor licensor.[64] When the debtor is the licensee, it has been suggested that exclusivity may make the license agreement assignable in bankruptcy like other contracts, notwithstanding a non-assignment provision.[65] The precedent is somewhat ambiguous, however.

(i) Copyright Licenses

The assignability of an exclusive copyright license was at issue in *Gardner v. Nike, Inc.*[66] The case arose from a 1992 license agreement between Nike and Sony involving Nike's cartoon character MC Teach. In exchange for a fifteen-percent royalty, Nike granted Sony the exclusive, perpetual, worldwide right to use MC Teach in connection with phonograph records, in television programs and motion pictures using music from the records, and on educational materials and clothing. The agreement also stated that Nike would own the copyright in the licensed materials and that the materials would bear a notice of Nike's copyright. The agreement was silent with respect to Sony's right to assign the exclusive license.

In 1996, Sony assigned all of its rights in the exclusive license to Gardner in exchange for a share of the proceeds derived from use of the MC Teach character. Nike threatened legal action against Sony and Gardner, and Gardner brought a declaratory judgment action seeking declaratory relief. The district court granted Nike's motion for summary judgment, finding that Sony could not assign the exclusive copyright license without the consent of Nike.

On appeal, the Ninth Circuit affirmed the district court's decision. The court reasoned that the amendment of the definition of "transfer of ownership" in Section 101 must be read together with Section 201(d)(1), allowing the transfer of ownership, and 201(d)(2), which specifically permits the subdivision and separate ownership of the rights granted by copyright and states that "[t]he owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by this title."[67] Sony was thus entitled to sue in its own name for infringement of the licensed copyright but was not entitled to assign the license without Nike's consent. The court bolstered its conclusion with a discussion of policy considerations, citing the copyright licensor's need to control the identity of licensees and to monitor the use of the copyright as "strong policy reasons" in favor of requiring the licensor's consent, adopting the reasoning used by the *CFLC* case in the context of a patent license.[68]

However, the *Gardner* decision has been severely criticized in subsequent cases and scholarly commentary. In the case of *In re Golden Books Family Entertainment, Inc.*, the debtor sought to assume and assign a licensing agreement relating to the character Madeleine. The bankruptcy court held that the license was exclusive rather than non-exclusive and that, because of the Copyright Act's inclusion of exclusive licenses in the definition of transfer of ownership, the debtor could assign the license notwithstanding a contractual prohibition of assignment. It criticized the *Gardner* decision as being in contradiction to the leading cases and commentary[69] and concluded that including the right of assignment in the rights of an exclusive licensee is a more natural reading of the Copyright Act.[70] Subsequent cases have echoed this criticism.[71] It may be noted that, under this line of authority, it would appear to be impossible for a copyright licensor to grant its licensee the right to bring infringement suits in the licensee's own name while retaining for itself the right to control the identity of the licensee in the event of the licensee's bankruptcy.

(ii) Patent Licenses

The statutory language used to support the free assignability of exclusive copyright licenses is not relevant to patents. Most cases addressing assignability have arisen in the context of non-exclusive licenses and some have expressly limited their holdings to this context, leaving open the possibility that exclusive patent licenses should be freely assignable in the absence of a contractual limitation.[72] However, one court that has examined the issue has held that the analysis that applies to non-exclusive patent licenses applies equally to exclusive patent licenses, and that neither is assignable.[73]

(iii) Trademark Licenses

The underlying purpose of trademark protection is the protection of the public from confusion rather than rewarding inventors and artists for their creative contributions. But trademarks "are also used by trademark owners to protect themselves from unauthorized use of their mark, and they are used by trademark owners to preserve the value of their business name and products."[74] Since quality control is at the heart of a trademark license, the issue of controlling the identity of a licensee would be expected to weigh in favor of treating all trademark licenses as non-assignable. This appears to be the trend in recent cases.[75]

(b) A Note on Nomenclature

The *XMH* case, which endorsed the position that trademark licenses are inherently not assignable, involved a contractual relationship that had begun as a trademark sublicense but had been converted into a services agreement without an explicit license. Since the substantive obligations of the parties were similar under the sublicense and the services agreement, the licensor argued that the service agreement should be construed as an implied sublicense which could not be assigned. The court rejected this argument, however, noting that the agreement expressly provided that, at the end of the license term, the trademark rights and trademarked goods reverted to the licensor, who assumed sole control over sales, pricing and production going forward. Under the circumstances, the parties' choice of the description "services agreement" rather than "trademark sublicense" rendered the agreement assignable.[76]

(c) Effect of Non-Assignability

There is a split among the federal circuits on the effect of non-assignability on the ability of a debtor in bankruptcy to assume a contract. As stated above, Section 365(c) provides that an executory contract may not be assumed if applicable non-bankruptcy law excuses the counterparty from accepting performance from, or rendering performance to, an entity other than the debtor, and such party does not consent to such assumption or assignment. In order to assign an executory contract, the contract must first be assumed. The Ninth Circuit applies the "hypothetical" test, which allows the debtor to assume an executory contract only if, hypothetically, it could assign that contract to a third party, even if the debtor does not actually intend to assign the contract.[77] This test has also been adopted by Third Circuit,[78] the Fourth Circuit[79] and, apparently, the Eleventh Circuit.[80] The "actual" test prevents assumption if the debtor actually intends to assign the contract that is non-assignable pursuant to applicable non-bankruptcy law and the counterparty does not consent. This prevents a licensor from being forced to accept performance from a party other than the debtor with whom it originally contracted. This test is applied by the courts of appeal in the First Circuit[81] and the Fifth Circuit[82] and has also been applied by bankruptcy courts in the Sixth Circuit[83] and the Eighth Circuit.[84]

The Bankruptcy Court for the Southern District of New York developed a third approach in its 2005 decision in *In re Footstar, Inc.*[85] It is based on a new reading of the Bankruptcy Code which distinguishes between references to the trustee and to the debtor or debtor-in-possession. Under the *Footstar* test of applying the plain language, Section 365(c) only applies with respect to the trustee's assumption or assignment of an executory license agreement. The debtor-in-possession may therefore assume such contracts.

III. Implications for Cross-Border Bankruptcy Proceedings

In order to promote a uniform and coordinated legal regime for cross-border insolvency cases, the United States adopted the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law ("UNCITRAL") in a new Chapter 15 added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Because of the UNCITRAL source for Chapter 15, the U.S. interpretation must be coordinated with the interpretation given by other countries that have adopted it as internal law.

A. Procedural Harmonization

Chapter 15 is intended to provide effective mechanisms for dealing with insolvency cases in which debtors, assets, claimants, and other parties involved are located in more than one country. It permits the representative of a debtor who is subject to a primary proceeding outside the United States to bring an ancillary proceeding in the United States. Alternatively, where the assets in the United States are extensive enough to warrant it, the debtor or a creditor may commence a full Chapter 7 or Chapter 11 case in the United States.[86] Chapter 15 also permits a U.S. court to authorize a trustee or other entity to act in a foreign country on behalf of a U.S. bankruptcy estate.[87]

To commence an ancillary case under Chapter 15, the foreign representative files a petition for recognition

of a foreign proceeding.[88] After notice and a hearing, the court may recognize the foreign proceeding as either a "foreign main proceeding" (a proceeding pending in a country where the debtor's primary interests are located) or a "foreign non-main proceeding" (a proceeding pending in a country where the debtor carries out long-term economic activity but that is not its primary location).[89] Recognition of a foreign main proceeding activates the automatic stay and other provisions of the Bankruptcy Code within the United States. The U.S. court may issue preliminary relief as soon as the petition for recognition is filed.[90] The law requires court and estate representatives to "cooperate to the maximum extent possible" with foreign courts and foreign representatives and authorizes direct communication among the U.S. court, authorized estate representatives, the foreign courts and foreign representatives.[91] In addition, the U.S. court is directed to "grant comity or cooperation to the foreign representative."[92]

B. The Public Policy Exception

In general, Chapter 15 requires the recognition of foreign proceedings and the enforcement of foreign judgments in the ancillary U.S. proceeding. This requirement is limited, however, by a public policy exception:

> Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.[93]

The use of the word "manifestly" in the formulation of the exception makes the exception a narrow one. In *In re Ephedra Products Liability Litigation*, the debtor was the defendant in numerous actions for personal injury and wrongful death arising from its marketing of ephedra.[94] It eventually filed for bankruptcy in Canada and the Canadian proceeding was recognized as a foreign main proceeding under Chapter 15. The foreign representative obtained approval in the main proceeding for an expedited procedure to evaluate the claims of the creditors, including the U.S. plaintiffs. When the foreign representative sought to enforce the evaluation procedure with respect to the U.S. plaintiffs, four plaintiffs objected on the grounds that they were being deprived of due process and the right to a jury trial. In rejecting their argument, the court explained:

> In adopting Chapter 15, Congress instructed the courts that the exception provided therein for refusing to take actions "manifestly contrary to the public policy of the United States" should be "narrowly interpreted," as "[t]he word 'manifestly' in international usage restricts the public policy exception to the most fundamental policies of the United States."… This is the standard meaning accorded the word "manifestly" in international law when it refers to a nation's public policy. Indeed, the official Guide to the Enactment of the Model Law on Cross-Border Insolvency (from which Chapter 15 derives) expressly states that [t]he purpose of the expression "manifestly," used also in many other international legal texts as a qualifier of the expression "public policy," is to emphasize that public policy exceptions should be interpreted restrictively and that article 6 is only intended to be invoked under exceptional circumstances concerning matters of fundamental importance for the enacting State.…This takes on even added relevance when one recognizes that the House Judiciary Committee, in enacting Chapter 15, specifically indicated that the Guide "should be consulted for guidance as to the meaning and purpose of [Chapter 15's] provisions."[95]

Notwithstanding the high standard stated in *Ephedra*, the public policy exception has been applied in Chapter 15 cases. In the case of *In re Toft*, the insolvency administrator in a German proceeding sought *ex parte* relief in the form of an order authorizing the administrator to intercept the debtor's postal and electronic mail pursuant to a "Mail Interception Order" issued by the Munich District Insolvency Court.[96] The debtor had no assets in the United States, but the administrator claimed that the debtor's evasive tactics made it necessary to investigate his e-mail, which was stored on servers located in the U.S. Such an order had previously been issued by the English High Court of Justice, granting recognition and enforcement of the Mail Interception Order. The U.S. bankruptcy court held that the comprehensive statutory protection afforded to electronic communications meant that the relief sought would be manifestly contrary to U.S. public policy. The court acknowledged that application of the exception could not be grounded on the mere fact that U.S. law differs from German law with respect to the disclosure of e-mail communications, but noted that the relief sought was banned under U.S. law and would lead to criminal liability for those who carried it out.[97]

Another case applying the exception, *In re Gold & Honey, Ltd.*, arose in connection with a Chapter 15 petition for recognition brought by receivers in Israel who were appointed after commencement of a Chapter 11 case in the U.S. involving the same debtor.[98] Since the creditor who commenced the proceedings in Israel had previously appeared in the U.S. case, the court refused to recognize the Israeli proceeding on the grounds that doing so would reward the creditor for violating the automatic stay in the U.S. proceeding.[99]

C. Substantive Dissonance

A disparity in the treatment of intellectual property licenses under the bankruptcy laws of the United States and Germany has led to another dispute over the public policy exception with respect to the recognition of foreign judgments under Chapter 15 in the case of *In re Qimonda*.[100] Qimonda was a leading German manufacturer of semiconductor chips. Between 1995 and 2008, Qimonda and its predecessors[101] had entered into perpetual and irrevocable cross-licensing agreements covering thousands of patents with international electronics and semiconductor manufacturers, including Infineon, Samsung, IBM, Hynix, Intel, Nanya and Micron.[102]

In January 2009, Qimonda commenced insolvency proceedings in Munich, Germany, which automatically rendered all of Qimonda's executory contracts unenforceable, subject to the debtor's right under the German Insolvency Code, Section 103, to confirm non-performance or to elect performance. Under German law, unenforceability means that the right of intellectual property licensees to exploit the licensed property is terminated, leaving the licensee with an unsecured claim against the bankrupt estate. The effect is similar to rejection as interpreted by *Lubrizol*.

The insolvency administrator in the German proceeding filed for recognition of the German proceeding in a U.S. bankruptcy court. The bankruptcy court recognized the German insolvency proceeding and appointed the German insolvency administrator as the foreign representative in the Chapter 15 proceeding. At the same time, acting *sua sponte*, it issued an order making the entirety of 11 U.S.C. Section 365 applicable to the proceeding, including Section 365(n), which allows licensees of the debtor's intellectual property to retain their licenses under certain conditions, as discussed above. When the foreign representative attempted to confirm non-performance of patent licensing agreements pursuant to the German Insolvency Code, the licensees objected, asserting their rights under Section 365(n) to continue exercising its rights under the licensing agreements notwithstanding the debtor's rejection in bankruptcy. The foreign representative then filed a motion asking the bankruptcy court to remove the reference to Section 365(n) from its order or to limit its application so as to enable the representative to confirm non–performance of the licenses in accordance with German insolvency law.

The bankruptcy court granted the foreign representative's motion, accepting the foreign representative's arguments that the application of Section 365(n) would undermine the German Insolvency Code, that ancillary proceedings should supplement but not supplant the foreign proceeding, and that the application of the laws of different jurisdictions to the patent licenses would lead to inconsistent results, potentially splintering Qimonda's patent portfolio and diminishing its value.[103]

Qimonda's licensees appealed to the District Court for the Eastern District of Virginia, arguing that the bankruptcy court had erred (i) in its balancing of the debtors' and the creditors' interests under Section 1522(a)[104] in agreeing to amend its original order, (ii) in applying Section 365(n) discretionarily rather than mandatorily, and (iii) in deferring to the application of German insolvency law under comity principles.[105] The district court upheld the discretionary treatment of Section 365(n) but remanded the case to the bankruptcy court for further consideration of the other two issues.[106] The district court identified three principles to guide the bankruptcy court on remand:

(1) The mere fact of conflict between foreign law and U.S. law, absent other considerations, is insufficient to support the invocation of the public policy exception.

(2) Deference to a foreign proceeding should not be afforded in a Chapter 15 proceeding where the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections.

(3) An action should not be taken in a Chapter 15 proceeding where taking such action would frustrate a U.S. court's ability to administer the Chapter 15 proceeding and/or would impinge severely a U.S. constitutional or statutory right, particularly if a party continues to enjoy the benefits of the Chapter 15 proceeding.[107]

On remand, the bankruptcy court held a four-day evidentiary hearing on the impact of allowing termination of the patent licenses pursuant to the German insolvency law, both on the parties and on the semiconductor industry and the U.S. economy as a whole. The bankruptcy court concluded that the balancing of the interests of parties, as required by Section 1522(a), weighed in favor of making Section 365(n) applicable to the administration of the debtor's U.S. patents and that limiting the applicability of Section 365(n) was manifestly contrary to the public policy of the United States under Section 1506.

The foreign representative appealed the bankruptcy court's decision and, on 7 May 2012, the district court certified the bankruptcy court's order for direct appeal to the Fourth Circuit Court of Appeals.[108] On 10 October 2012, the U.S. Justice Department submitted an amicus brief arguing that Section 365(n) is irrelevant to the ancillary proceeding before the U.S. bankruptcy court and that the effectiveness of the action of the German insolvency proceeding could be settled later if Qimonda were to bring an infringement suit against the licensees under the U.S. patents included in cross-license agreements.

IV. Conclusion

Licenses of intellectual property serve two fundamental contractual expectations: the licensor expects to be able to exercise control on the identity and behavior of the licensee with respect to its unique property and the licensee expects to be able to build a business by exploiting the same property. To the extent that a bankruptcy proceeding allows a licensor to terminate license rights or enables a licensee to assign the agreement beyond or in violation of the terms of the contract, it frustrates one of these expectations. Recent cases such as *Exide Technologies*, *XMH* and *Sunbeam* suggest a certain judicial antipathy toward such a result. As the court in *Sunbeam* puts it, "nothing about this process [of rejection of executory contracts] implies that any rights of the other contracting party have been vaporized," comparing the rejection of a license to the rejection of a lease, which does not end the tenant's right of possession.[109]

At its core, the position adopted in these cases appears to reflect a judgment on the fairness of the bankruptcy process, exemplified in Judge Ambro's observation that treating rejection of a license as a termination of licensed rights "put[s] debtor-licensors in a catbird seat they often do not deserve."[110] This judgment may have its roots in the basic principle of *pacta sunt servanda*, in that it disfavors the use of bankruptcy proceedings to rewrite the debtor's contracts except as necessary to shield it from affirmative executory obligations and the claims of creditors.[111] The one notable exception to this overall picture is the treatment of exclusive licenses of copyright, where the statutory definition of "transfer of ownership" may deprive the licensor of the right to control the identity of its licensee in the event of the licensee's bankruptcy. This exception will not be applicable in bankruptcies in the Ninth Circuit, however, unless the *Gardner* decision is overturned.

The implications of the recent developments for international disputes such as *Qimonda* are not yet clear. Under the standard stated in *Ephedra*, the public policy exception may be invoked "only under exceptional circumstances concerning matters of fundamental importance."[112] Both *Toft* and *Gold & Honey* dealt with procedural remedies that were held to contravene fundamental public policy concerns of the United States. *Sunbeam* suggests that a bankruptcy process that terminates licensed rights is inherently inequitable, but it does so in the context of interpreting the U.S. Bankruptcy Code. Given the continuing split of judicial authority in the United States and Congress's failure to deal with trademark licenses in Section 365(n), a judicial rejection of *Lubrizol* cannot by itself support an argument that Germany's insolvency procedure violates the fundamental public policy of the United States.

Under the guidelines of the district court in *Qimonda*, the public policy exception may apply where a requested action "would impinge severely a U.S. constitutional or statutory right."[113] This more relaxed standard opens the door to a wider understanding of public policy, such as was enunciated in the legislative history of Section 365(n):

> The court decisions on Section 365 that have stripped intellectual property licensees of their right to continue to use the licensed property…threaten an end to the system of licensing of intellectual property…that has evolved over many years to the mutual benefit of both the licensor and the licensee and to the country's indirect benefits.... Because of the instability that Section 365 has introduced into the licensing relations, parties who would have formerly accepted licenses—the right to use another's intellectual property—are now forced to demand assignments—outright transfer of ownership of the intellectual property. This change in basic format is wasteful and cumbersome and is especially chilling to small business technologists. It is not an overstatement to say that the change is a fundamental threat to the creative process that has nurtured innovation in the United States.[114]

On the remand of *Qimonda*, the bankruptcy court considered this sort of substantive public policy concern, delving into the impact of termination of the licensed rights on the parties, the semiconductor industry, and the U.S. economy as a whole.

The ultimate question to be answered in the appeal of *Qimonda* is whether substantive differences in the treatment of debtors and creditors, such as those reflected by Section 365(n) of the U.S. Bankruptcy Code and Section 103 of the German Insolvency Code, are enough to trigger the public policy exception. If so, then disputes such as *Qimonda* are likely to recur unless and until there is harmonization of substantive bankruptcy law.

Endnotes

1. 11 U.S.C. § 541.
2. 11 U.S.C. § 362.
3. 11 U.S.C. §§ 365(e)(1) and 541(c)(1).
4. 11 U.S.C. § 365(a).
5. 11 U.S.C. § 365(f)(1).
6. 11 U.S.C. §§ 365(b)(1) and 365(f)(2).
7. *See Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996).
8. *Mirant Corp. v. Potomac Elec. Power Co.* (*In re Mirant*), No. 05–10038, 2006 WL 2034612, 2006 U.S. App. LEXIS 18129 (5th Cir. 19 July 2006) (*per curiam*).
9. *Holiday Homes v. Briley*, 122 A.2d 229, 232 (D.C. 1956).

10. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).
11. *In re Chipwich, Inc.,* 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985).
12. *In re Interstate Bakeries Corp.,* 447 B.R. 879, 886 (Bankr. W.D. Mo. 2011), *aff'd*, 690 F.3d 1069 (8th Cir. 2012).
13. *In re Rovine Corp.*, 6 B.R. 661, 665 (Bankr. W.D. Tenn. 1980).
14. *In re Chipwich, Inc.,* note 11 *supra*, 54 B.R. at 430.
15. *Lubrizol Enters, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1046 (4th Cir. 1085); *Chipwich,* note 11 *supra*, 54 B.R. at 430.
16. *In re CFLC, Inc.*, 89 F.3d 673, 677 (9th Cir. 1996).
17. *Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.)*, 625 F.2d 290, 292 (9th Cir. 1980).
18. Countryman, *Executory Contracts in Bankruptcy: Part II*, 57 Minn. L. Rev. 479, 501–502 (1974).
19. *De Forest Radio Tel. Co. v. United States*, 273 U.S. 236, 242 (1927) (quoting *Robinson on Patents* §§ 806, 808).
20. *CFLC*, 89 F.3d at 677.
21. 81 B.R. 263 (Bankr. S.D.N.Y. 1988).
22. *Id.* at 266.
23. 607 F.3d 957 (3d Cir. 2010), *as amended* (24 June 2010), *cert. denied*, 131 S. Ct. 1470 (U.S. 2011).
24. *In re Exide Techs.*, note 23 *supra*, 607 F.3d at 963–64. *Cf. In re Interstate Bakeries Corp.,* 447 B.R. 879, 886 (Bankr. W.D. Mo. 2011), *aff'd*, 690 F.3d 1069 (8th Cir. 2012) (finding a perpetual, royalty-free, exclusive license granted in connection with the sale of a business in a portion of the territory covered by the trademark to be an executory agreement and distinguishing *Exide* on the grounds that the agreement contained substantive quality control standards).
25. 686 F.3d 372 (7th Cir. 2012), *cert. den.* __ U.S. __, 81 USLW 3217, 2012 WL 4812510 (Dec. 1, 2012).
26. 11 U.S.C. § 365(b)(1).
27. 11 U.S.C. § 365(f)(2).
28. *In re Richmond Metal Finishers, Inc.*, 34 B.R. 521, 526 (Bankr. E.D. Va. 1983).
29. *In re Richmond Metal Finishers, Inc.*, 38 B.R. 341, 345 (E.D. Va. 1984).
30. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).
31. *See N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 531 (1984).
32. *Lubrizol,* note 30 *supra*, 756 F.2d at 1048.
33. *Id.*
34. *Chipwich,* note 11 *supra*, 54 B.R. 427.
35. *Id.* at 431.
36. 11 U.S.C. § 365(n)(4).
37. 11 U.S.C. § 365(n)(1)(A).
38. 11 U.S.C. § 365(n)(1)(B).
39. 11 U.S.C. § 365(n)(2)(B).
40. 11 U.S.C. § 365(n)(2)(C)(i), (ii).
41. 11 U.S.C. § 101(35A).
42. S. Rep. No. 100–505, at 5 (1988), *reprinted in* 1998 U.S.C.C.A.N. at 3204.
43. *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) (trademarks are not "intellectual property" under the Bankruptcy Code, so "rejection of licenses by licensor deprives licensee of right to use trademark") (internal citations omitted); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademarks stops on rejection").
44. *See, e.g.*, Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1, 11 (1991); Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 Am. Bankr. Inst. L. Rev. 463, 470–72 (1997); Douglas G. Baird, Elements of Bankruptcy 130–40 & n.10 (4th ed. 2006).
45. *In re Exide Techs.,* note 23 *supra*, 607 F.3d at 967–68 (Concurrence by Judge Ambro).
46. 686 F.3d 372 (7th Cir. 2012), *cert. den.* __ U.S. __, 81 USLW 3217, 2012 WL 4812510 (Dec. 10, 2012).
47. *Lubrizol*, note 30 *supra*, 756 F.2d at 1048; *Chipwich,* note 11 *supra*, 54 B.R. at 431 (quoting *Lubrizol*).
48. *In re Lakewood Eng'g Mfg. Co., Inc.*, 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011).
49. *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, note 46 *supra*, 686 F.3d at 375–76.
50. *Id.* at 376–77.
51. *Id.* at 376.
52. *Id.* at 378.
53. 11 U.S.C. § 365(a).
54. 11 U.S.C. § 365(f)(1).
55. *In re Midway Airlines, Inc.*, 6 F.3d 492, 496 (7th Cir. 1993).
56. *In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011).
57. *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996) (patent); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) (copyright); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 311 (Bankr. D. Del. 2001) (copyright); *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005), *aff'd,* 279 Fed. App'x 561 (9th Cir. 2008), *cert. denied*, 129 S. Ct. 1577 (2009) (trademark); *In re XMH Corp.*, 647 F.3d 690, 695–696 (7th Cir. 2011) (trademark).
58. *Erie R. Co. v. Tomkins*, 304 U.S. 64, 78 (1938).
59. *Unarco Indus. Inc. v. Kelley Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (federal law rather than state law applied to the issue of licensee estoppel in view of federal antitrust policy).
60. *In re CFLC, Inc.*, note 57 *supra*, 89 F.3d at 679; *In re Patient Educ. Media, Inc.*, note 57 *supra*, 210 B.R. at 243.
61. *XMH,* note 56 *supra,* 647 F.3d at 695–96.
62. *Tap Publ'n, Inc. v. Chinese Yellow Pages (New York) Inc.*, 925 F. Supp. 212, 218 (S.D.N.Y 1996).
63. *In re XMH*, note 56 *supra*, 647 F.3d at 695 (7th Cir. 2011).
64. *In re Exide Techs.,* note 23 *supra*, 607 F.3d at 964.
65. *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999).
66. 279 F.3d 774 (9th Cir. 2002).
67. 17 U.S.C. § 201(d)(2).
68. *Gardner v. Nike* , note 66 *supra*, 279 F.3d at 780–81.
69. *In re Golden Books Family Entm't*, note 57 *supra*, 269 B.R. 311 at 317.
70. *Id.* at 318.
71. *See Traicoff v. Digital Media, Inc.*, 439 F. Supp. 2d 872, 877–78 (S.D. Ind. 2006) (collecting authority).
72. *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999).
73. *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002).
74. *In re N.C.P. Mktg. Group*, note 57 *supra*, 337 B.R. at 236.

75. *Id.; In re Wellington Vision, Inc.*, 364 B.R. 129, 136 (S.D. Fla. 2007) (inclusion of trademark license in franchise agreement rendered it unassignable); *Tap Publ'ns, Inc. v. Chinese Yellow Pages (New York) Inc.*, 925 F. Supp. at 218 (exclusive trademark license not assignable); *Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 988 (9th Cir. 2006) (*per curiam*); *In re XMH Corp.*, note 56 *supra*, 647 F.3d at 695.
76. *In re XMH Corp.*, note 56 *supra*, 647 F.3d at 697–98.
77. *Catapult Entm't,* note 65 *supra*, 165 F.3d at 749–50.
78. *Cinicola v. Scharfggenberger*, 248 F.3d 110, 121 (3rd Cir. 2001).
79. *In re Sunterra Corp.*, 361 F.3d 257, 266–67 (4th Cir. 2004).
80. *In re James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994), *rehearing en banc denied*, 38 F.3d 575 (11th Cir. 1994).
81. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), *cert. denied,* 521 U.S. 1120 (1997).
82. *Bonneville Power Admin. v. Mirant Corp* (*In re Mirant Corp.*), 440 F.3d 238, 249 (5th Cir. 2006).
83. *In re Cardinal Indus., Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990).
84. *In re GP Express Airlines, Inc.*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996).
85. *In re Footstar, Inc.*, 323 B.R. 566, 570–74 (Bankr. S.D.N.Y. 2005).
86. 11 U.S.C. § 1520(c).
87. 11 U.S.C. § 1505.
88. 11 U.S.C. § 1504. A "foreign proceeding" is a "judicial or administrative proceeding in a foreign country…under a law relating to insolvency or adjustment of debt in which proceeding the [debtor's assets and affairs] are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation." 11 U.S.C. § 101(23). A "foreign representative" is the person or entity authorized in the foreign proceeding "to administer the reorganization or liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."
89. 11 U.S.C. § 1517.
90. 11 U.S.C. § 1519.
91. 11 U.S.C. §§ 1525–1527.
92. 11 U.S.C. § 1509(b)(3).
93. 11 U.S.C. § 1506.
94. 349 B.R. 333 (S.D.N.Y. 2006).
95. *Id.*, 349 B.R. at 336 (internal citations omitted).
96. *In re Toft*, 453 B.R. 186 (Bankr. S.D.N.Y. 2011).
97. *Id.* at 198.
98. *In re Gold & Honey, Ltd.*, 410 B.R. 357 (Bankr. E.D.N.Y. 2009).
99. *Id.* at 372–73.
100. *In re Qimonda AG*, No. 09–14766, 2009 WL 4060083 (Bankr. E.D. Va. 19 Nov. 2009), *aff'd in part and remanded in part*, 433 B.R. 547 (E.D. Va. 2010), *on remand*, 462 B.R. 165 (Bankr. E.D. Va. 2011), *cert. granted*, 470 B.R. 374 (E.D. Va. 2012).
101. Qimonda had its roots in Siemens, which spun off Infineon in 1999. Infineon spun off Qimonda in 2006.
102. *In re Qimonda*, note 100 *supra*, 470 B.R. at 377.
103. *Id.*, 470 B.R. at 378–79.
104. The applicability of 11 U.S.C. § 1522(a) in *Qimonda* hinges upon the fact that the bankruptcy court first chose to apply the whole of § 365 to the proceeding, forcing the foreign representative to seek an amendment of the court's order.
105. *In re Qimonda*, note 100 *supra*, 470 B.R. at 379–80.
106. *Id.*, 470 B.R. at 381.
107. *In re Qimonda*, note 100 *supra*, 433 B.R. at 570.
108. *In re Qimonda*, note 100 *supra*, 470 B.R. at 390 (granting certification to the Fourth Circuit Court of Appeals directly).
109. *Sunbeam Prods.*, note 46 *supra*, 686 F.3d at 377.
110. *In re Exide Techs.,* note 23 *supra*, 607 F.3d at 967–68 (Concurrence by Judge Ambro).
111. This principle appears in the contract clause, article I, § 10, cl. 1 of the U.S. Constitution, prohibiting the states from passing any law impairing the obligation of contracts.
112. *In re Ephedra Products*, note 94 *supra*, 349 B.R. at 336.
113. *In re Qimonda*, note 100 *supra*, 433 B.R. at 570.
114. S. Rep. No. 100–505, at 3 (1988), *reprinted in* 1988 U.S.C.C.A.N. at 3200, 3202.

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The Challenges of eDiscovery and Cloud Computing

By Jonathan P. Armstrong, Eric Sinrod, and Philip J. Favro

I. Introduction

One of the major developments in business over the last few years has been the rise in cloud computing. Often, however, the compliance aspects of moving data have been ignored. When moving data into the cloud, it is clear that careful planning will be needed. In this article we will try to make some sense of these issues and suggest practical ways forward. We will look at some of the early regulatory pronouncements on eDiscovery in the cloud and some of the wider issues corporations are likely to face when going through eDiscovery touching Europe.

II. Data Protection and Privacy Issues

A. Code of Practice

The UK data protection regulator, the Information Commissioner's Office (ICO), gave some advice on putting data into the cloud in its Personal Information Online Code of Practice, which it published in July 2010. The Code recognizes the increasing use of cloud computing, but reminds data controllers that the primary responsibility when data is passed into the cloud remains with them.

The Code sets out two very helpful checklists. The first is for data controllers who are thinking of putting data into the cloud and the second is for vendors to check their own services. The questions in the data controller questionnaire include:

- Can the vendor confirm in writing that it will only process data in accordance with the data controller's instructions and will maintain an appropriate level of security?
- Can the vendor guarantee the reliability and training of its staff, wherever they are based, and does the vendor have any form of professional accreditation?
- What capacity does the vendor have for recovering from a serious technological or procedural failure?
- What are the vendor's arrangements and record regarding complaints and redress: does it offer compensation for the loss or corruption of data entrusted to it?
- If the vendor is an established company, how good is its security track record?
- What assurances can the vendor give that data protection standards will be maintained, even if the data is stored in a country with weak, or no, data protection law or where governmental data interception powers are strong and lacking safeguards?

The ICO says that, if the answers to any of these questions raise concerns about a vendor's ability to look after your information, you should not use the provider concerned and should seek alternatives. Whichever jurisdiction is involved, it would seem that the ICO's checklist would be a good start. Care should also be taken in eDiscovery to make sure that other basic principles are followed as well, such as the following:

- The data being uploaded should be minimized: only store in the cloud what you need and only store it for as long as you need it.
- Data should only be processed fairly and lawfully: the rights of data subjects, even if they are suspects in an investigation or have been guilty of wrongdoing themselves, must always be respected.
- Ideally, consent should be obtained to the uploading of data in the cloud. However, consent is unlikely to be the whole story, since the basic principles of data protection must also be followed, even with consent, and consent can generally be withdrawn at any time.
- The data must be kept securely: a data processor will remain liable for the security of the data, whether it is in his hands or not.

B. Where Should Data Reside?

As a general rule, it is best for personal data to stay local. In an internal investigation or discovery exercise, the least-risk solution is almost always to look at the data in country. For example, in Europe if the data you need to examine relates to Spanish individuals, it is best to do at least the first examination of that data in Spain. If that is not possible, the second best option would be to do the first cut of the data in another European Economic Area (EEA) country. Ideally that data would stay in the EEA. However, given the realities of multinational business, that is often not possible: for example, the data may be required for an investigation by authorities based in the United States or eDiscovery in litigation there. If that is the case, then the first cut review of data should strip out any personal data which does not need to be transferred. The transfer of data should be proportionate to the purpose for which it is needed. For example, if the eDiscovery relates only to events between 1998 to 2000, then the first assumption should be that data outside those dates should not leave the EEA.

Bear in mind, however, that even this approach can cause difficulties. Moving data from one country to another could result in a submission to the laws of that country if the data is not simply in transit. In the UK, for example, under Section 5 of the Data Protection Act 1998 (DPA), if a data controller is not established in the EEA but uses equipment in the United Kingdom for processing the data other than "for the purposes of transit through the United Kingdom," they will be subject to the DPA's provisions. It is proposed that these requirements are widened under the proposed new EU Regulation: for example, the behavioral monitoring of EU citizens will be sufficient to submit to the jurisdiction.

C. Data Security

It is important to check the security of the data—both in transit and at its location. Increasingly data regulators across Europe have been concerned to secure personal data: the ICO, for example, has been involved in a number of regulatory actions concerning the transmission of data by post, email and fax, and those investigations have resulted in fines of up to £325,000.[1] Of assistance in assessing whether security procedures are adequate may be the work done in November 2009 by the European Network and Information Security Agency (ENISA). ENISA was set up by the European Union (EU) to focus on information security issues in Europe. Its role is to carry out specific technical scientific tasks in the field of European security as a European Community Agency. Their cloud computing risk assessment is a worthy piece of work stretching to around one hundred twenty-five pages. It does not have the force of law, but the report did include contributions from various academics and representatives of industry, including Symantec.

In addition to the ICO's and ENISA's work, many other data protection regulators in Europe have looked at some of the issues involved. For example, in June 2010 the Data Protection Commissioner of the German *Land* of Schleswig-Holstein issued his opinion on the legal issues around cloud computing. Germany has a split system of data protection regulation, with the regulation of private companies conducted by a Data Protection Commissioner in each *Land* (roughly equivalent to a U.S. state). The Schleswig-Holstein Commissioner, Thilo Weichert, said that clouds located outside the EU which hold data on Schleswig-Holstein citizens are *per se* unlawful, even if the European Commission has passed an adequacy decision in favor of the country in question (as it has for Canada, for example). Dr. Weichert also cast doubt on whether the cloud provider's self-certification to the U.S. Department of Commerce's safe harbor program could of itself provide an adequate level of protection when putting data into the cloud. In February 2011 the Sedona conference reprinted Dr. Weichert's thoughts and in July 2012 he updated his guidance.[2]

In an effort to bring some uniformity across Europe, the Article 29 Working Party (WP29), a representative body made up of the data protection authorities in each EU member state, issued its own Opinion on cloud computing in July 2012.[3] The Opinion comments on EU law rather than any additions to that law in each individual country. It follows Dr. Weichert's concerns on adequacy and safe harbor. It reminds those putting their data in the cloud that they must "choose a cloud provider that guarantees compliance with data protection legislation" and provides a list of issues that the contract with the provider should address, which are in many respects similar to those we have already discussed.[4]

III. Data Export Legislation

While the issues created by data protection law in Europe are challenging, it would be wrong to think that that is the end of the story. In addition to data protection legislation, data export laws exist in some parts of Europe to try to curb "le fishing expedition." The French authorities have looked to legislate against French documents being used in foreign proceedings since 1968. In 2007 the French Supreme Court upheld the conviction of French lawyer for violating a Penal Law that provides that:

> Subject to international treaties or agreements and laws and regulations in force, it is forbidden for any person to request, seek or communicate in writing orally, or in any other form, documents or information of an economic, commercial, industrial or financial nature leading to the constitution of evidence with a view to foreign judicial or administrative procedures or in the context of such procedures.

The lawyer concerned was fined ten thousand Euros.

Regrettably, courts in the United States have often been unwilling to consider the need to accommodate foreign data export laws when limiting eDiscovery. This has led to considerable concerns among the legal profession on both sides of the Atlantic. For example, the Sedona Conference, the American Bar Association, and the New York State Bar Association have all highlighted the issue as problematical. In 2012 the American Bar Association passed its Resolution 103, where it urged that "where possible in the context of the proceedings before them, US Federal, State, Territorial, Tribal and Local Courts consider and respect, as appropriate, the data protection and privacy laws of any applicable foreign sovereign and the interest of any person who is subject to or benefits from such laws with regard to data sought in discovery in civil litigation." Disappointingly, however, U.S. courts continue to regard U.S. litigation as supreme. Just this year, in *TruePosition, Inc. v. LM Ericsson Telephone Co.*,[5] a U.S. court felt that the "strong national interest of the United States"

would override the "weak national interest of France in prohibiting disclosure of information." For most organizations, the challenge is which law they will break—since the choice seems to be the rock of disobeying an American court or the hard place of acting unlawfully in Europe.

IV. Works Councils and Employee Rights

In addition to the data protection and data export issues, those with substantial numbers of employees in Europe may need to consult with or inform their respective Works Council. Works Councils in Europe are bodies set up to protect employees' interests against the employer. The law on what a Works Council can and cannot do varies across Europe, although it is possible for some employers with more than one thousand employees to have a European Works Council with whom they could negotiate for all of their facilities. A company's obligations when launching an eDiscovery project, or putting any data into the cloud, may include the obligation to notify or consult with Works Councils.

Works Councils across Europe—including those in Germany, France, Netherlands and Austria—have objected to the way in which their members' data is handled. In France, for example, you may be legally obliged to tell your Works Council if you start any significant project for the introduction of new technology if that project is likely to have consequences for the employment, the classification, the pay, the training or the working conditions of your employees. Although it may not be a legal requirement to tell your Works Council about any movement of data into the cloud (since your installation may not meet the test set by Article L.2323-13 of the French Labor Code), it is good practice to tell your Works Council, and this transparency generally increases acceptance. Traditionally negotiations with Works Councils have been challenging—especially for any organization reducing its workforce in Europe. Often Works Councils have used their rights to be consulted or informed about changes to data handling practices to extract concessions from employers in other areas. The courts in some countries, notably France and Germany, have been prepared to back employees against employers, both in the implementation of schemes and also in halting schemes or investigations where the correct procedures were not followed. Europe does not recognize the concept of employment at will, and employees often additionally have protection from dismissal save for cause and the right to a fair procedure even when cause is shown.

Having said that, there is at least some evidence that the tide in France may be turning slightly. In May 2012 a French regional court[6] upheld the dismissal of an employee who had sent confidential work-related data to his personal email account. The employee had sent two hundred sixty-one confidential technical files, and he argued that the employer had violated his workplace privacy rights by examining his work emails to get the proof. The court disagreed and said that emails sent by an employee using a computer provided by his employer for work purposes could be presumed to be professional mail that the employer could access without the employee's presence, unless the employee had identified the messages as personal.

Employee and Works Council rights must always be factored in to any governance and eDiscovery process. The law across Europe tends to be granular, with additional laws prohibiting interference with email communications. This category of law often carries heavier criminal sanctions than data protection legislation. Improperly collected evidence could be inadmissible in any subsequent proceedings and, in extreme cases, could land the collector with a criminal conviction. To address these concerns, those leading the eDiscovery process will want to establish a list of the relevant countries involved in the process, and the number of individuals involved in each of those countries, at an early stage in the project. Armed with that information, a proper assessment, using local counsel familiar with the legislation in each country, can be undertaken.

V. Contracting with Your Cloud Provider

It is obviously important when putting data into the cloud to make sure that you do proper due diligence on the cloud solution vendor and put in place a proper written agreement with that vendor. Under data legislation in Europe, a written agreement will be needed. In addition, it is important to be clear in the contract with the vendor what you are buying. Among the issues to review with special care would be the following:

- **Limits on the vendor's liability.** It is common for vendors to seek to cap their liability at an unrealistically small amount—maybe even at the level of fees paid to them. Will this be adequate? Given that a security breach may cost over one million dollars, does the vendor have enough of a share of the risk? Bear in mind that this is not just an issue of risk tolerance. If the vendor has only limited responsibility, can the legal requirement that the vendor is complying with "obligations equivalent to those imposed on a data controller" be met?
- **Termination provisions.** It is important that the agreement contains proper termination provisions, including addressing the vendor's insolvency, given that it is predicted that there will be substantial fallout in this industry as cloud computing matures.
- **The jurisdiction of the agreement.** Is it a jurisdiction with which you are familiar and to which you are willing to go in a hurry if there is an issue with

the vendor that requires you to take emergency proceedings to secure your data?

- **Uptime.** All cloud providers are not equal. What commitments will they give you to make your data available when you need it? Look also at how uptime will be calculated. Some vendors will only guarantee uptime and provide support during their business hours. If your main operations are based in Europe but the vendor is only committing to provide a service during business hours in California, how much use will that be to you? Will you be prepared to wait eight or nine hours until the support provider wakes up?

- **Third party requests.** A good contract will put in place a contractual protocol which will detail how the cloud vendor will respond to any third party requests for information (such as a subpoena) and whether the vendor is obliged to notify the company of those requests prior to producing the requested information. Be aware of the fact that the answer to this question is not always as simple as it may sound. Some countries (including the United Kingdom) have provisions in some pieces of legislation against tipping off. This could mean that the vendor would be committing a criminal offense if it complied with any contractual requirement to notify you before delivering up the requested information.

- **The scope, type and purpose of the processing, the type of data and the category of data subjects.** This is an area which is unlikely to be controversial but seems to be specifically required by the Schleswig-Holstein opinion.

- **Subcontracting.** Some almost virtual operations exist which sell cloud computing, but then subcontract any contracts that they have won. It is important that you know with whom you are contracting. You will need to do due diligence and credit checks on your proposed vendor and its subcontractors. You should also try to find out where the facilities that will hold your data are located. If the data is held overseas, using corruption indices like those produced by Transparency International would also be wise. Anti-corruption law is toughening throughout the world (for example, with the U.K. Bribery Act 2010), but regrettably some outsourcing locations of choice still score poorly in corruption indexes. If those with the ability to access your data are poorly paid and are from a country where corruption is rife, it stands to reason that the chances of your data being compromised are greater. A wise default position may be for the agreement to prohibit subcontracting of any kind without your prior written consent. The Schleswig-Holstein opinion also highlights this risk saying that, "[D]ue diligence should be done on subcontractors as well…At minimum, an independent entity must perform an outside audit and submit a report for the Cloud user's review. Because there are so many potential Cloud participants, the user must be informed as to which providers are actually processing the data at any given time…."

- **Timing and Assistance on Security Breaches.** Most reported security breaches these days seem to be vendor related. Dealing with the security breach is a fraught process and you will need co-operation from everyone involved. Your contract should make it clear that the vendor has to respond quickly. Remember that under the new EU proposals you may only have twenty-four hours to make multiple breach reports, and so vendors are going to have to be able to assist you to prepare those reports promptly.

- **Location.** You should also try to find out where the facilities that will hold your data are located. With many clients we have developed something we call for convenience the "Tripadvisor test." As the start in any data relocation exercise, you should look up on Tripadvisor the location where your data will reside. If you are not comfortable going there on a business trip, then consider whether it would be wise to send your data there.

- **Data Transfer Agreement.** Any contract must include the minimum provisions of a data transfer agreement (DTA), even if all of the parties involved have signed up to the U.S. Department of Commerce's Safe Harbor scheme to protect the flow of data from the EU and or Switzerland to the U.S. They should also include the ability to change the DTA elements of the agreement if the law changes. Also bear in mind that if you are moving data, DTAs need to be specific in some countries such as Spain and Germany: The EU model terms will not always work. Watch out also for strange provisions of U.S. or local law. For example, is there an export control prohibition on the type of encryption technologies that you are using to protect your data? If an investigation involves allegations of obscenity, do you increase the risks by moving the data to another country which may be less tolerant of these issues?

VI. The USA PATRIOT Act and Related Laws

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act), while expanding some government access to data in certain respects, did not create an entirely new regime of U.S. governmental access to information that greatly threatens

data in the cloud. Moreover, a recent comparative study indicates that it is inaccurate to assume that access by the U.S. government to data stored in the cloud is greater than the access of governments in other advanced countries, since they also have anti-terrorism laws that afford similar expedited access.

A. Additional Laws Impacting Government Access

The FBI and other U.S. government agencies have previously been able to utilize a National Security Letter (NSL), as a type of administrative subpoena, to seek records and data relating to government investigations. At the time the USA PATRIOT Act was enacted, there already were in place several U.S. federal statutes, including the Electronic Communications Privacy Act (ECPA), authorizing the issuance of NSLs. The realm of NSLs was expanded in various respects by the USA PATRIOT Act, and subsequent to this expansion the use of NSLs increased. NSLs gave rise to certain criticisms, some of which were abated by the USA Patriot Act Improvement and Reauthorization Act of 2005 (the Reauthorization Act). Nevertheless, while NSLs still are used, the data that can be sought from cloud providers is generally limited to identification information, such as name, address, and length of service, but *not* the actual content of communications.

Often, the ECPA governs access to data maintained by a cloud service provider. If U.S. authorities seek customer data from a cloud provider, under the ECPA a judge must issue a search warrant or an ECPA court order, or the government must issue a proper subpoena to the provider. When dealing with a court order or subpoena, notice usually is provided to the customer allowing for potential opposition, but this is not the case when it comes to search warrants.

B. The True Impact of the USA PATRIOT Act

The aftermath of the USA PATRIOT Act does not necessarily mean that data needs to be stored on Cloud servers outside of the United States or with non-U.S. providers to prevent the data from being accessed by U.S. governmental authorities. Indeed, the United States and a number of European governments have entered into Mutual Legal Assistance Treaties (MLATs). Pursuant to an MLAT, two countries usually agree to the most expansive level of mutual assistance with respect to investigations or criminal offense proceedings. And in 2003, the United States and the EU entered into an MLAT containing a data protection provision. According to the comments to this MLAT, this data protection provision is designed to ensure that assistance will generally be provided and only will be refused on data protection grounds in exceptional cases. As a result, even if data were stored in the cloud on European servers, European governmental authorities likely would cooperate with respect to a U.S. investigation. And even though the European Commission recently proposed a new Regulation and new Directive relating to personal data privacy, the proposed new Directive appears to maintain significant law enforcement access to personal data.

C. Approach of Other Countries

In addition, a recent review of the laws of the Australia, Canada, Denmark, France, Germany, Ireland, Japan, Spain, the United Kingdom and the United States reveals that the U.S. is not alone, and that even countries that have strict privacy protections also have anti-terrorism laws that could allow for expedited government access to data stored in the cloud.[7] Thus, "it is not possible to isolate data in the Cloud from governmental access based on the physical location of the Cloud service provider or its facilities."[8]

VII. Conclusion

It is likely that in the years ahead we are going to see the need for investigations to be done in a more culturally astute manner. That might mean that companies have to use eDiscovery providers who have the ability to collect data in-country, and do the first analysis of it in-country before sending selected data back to the U.S. It might include seconding people from the United States to Europe to help manage these investigations. And it will almost certainly mean using local counsel who understand the issues in the particular jurisdiction concerned, and who can act as a critical friend to the corporation in the investigation, questioning them on whether it has become overbroad in approach or whether the investigation is simply out of proportion to the wrong that is being investigated.

While we all know that a serious allegation of the type that Enron suffered will have to be investigated in a very comprehensive manner, and while we all know that taking three packets of post-it notes home should not be investigated in the same way as the Siemens investigation, the challenge for most corporations is that whole big area in the middle. When is an investigation serious enough to warrant the troops being mobilized? These areas are likely to continue to be difficult, and wise counsel will be at a premium.

An eDiscovery exercise involving data in the cloud will generate the following issues that will need to be addressed:

- The need to limit the scope of the discovery exercise.
- The need to keep data in-country where possible.
- The need to restrict circulation: corporations need to get out of the habit of unintelligently copying people in "for information only," especially where those people are in a different jurisdiction. In discovery, consideration should also be given to apply

to a U.S. court for a protective order. With investigations and regulatory inquiries, consideration should be given to seeking to agree on the scope of the discovery exercise and the possibility of steps like the anonymization of data.

- The need for arrangements in each relevant jurisdiction with outside counsel who can direct an investigation.
- The need to manage employee expectations before an incident: this could include sending a reminder to employees that their emails could be read where legally permitted.
- The need to do due diligence on suppliers.
- The need to check data protection registrations.

The need then for law firms and eDiscovery consultants to know the culture in those countries where data is collected, as well as local law, will become ever more important. Data collection procedures will have to be tailored to suit each occasion, in order to try to ensure both compliance with local law and the expectations of the court or regulator. Litigation teams will need to include data privacy specialists in all aspects of the investigation and may even need to include independent counsel to lay down ground rules on behalf of those being investigated.

While this article has attempted to map out some of the challenges involved, more will be encountered. Regrettably, there is no one-size-fits-all approach. With that in mind, the need for specialist assistance, proper resources and a clear mind is self-evident.

Endnotes

1. The £325,000 monetary penalty was levied on 1 June 2012 against Brighton and Sussex University Hospitals NHS Trust. Details are at http://bit.ly/Jy9hVm. Details of other ICO enforcement activity can be found at www.ico.gov.uk.
2. See www.bit.ly/kmyh95. The Schleswig Holstein revised guidance appears at https://www.datenschutzzentrum.de/presse/20120713-datenschutzkonformes-cloud-computing.htm.
3. A copy of the Opinion is at http://bit.ly/TbcXmn.
4. The French data regulator CNIL also issued a paper on cloud computing in June with similar recommendations. It can be found at http://bit.ly/MfwwcO. Also in June the Spanish data regulator AEPD issued guidance to law firms on the use of cloud technologies. It can be found at http://bit.ly/MXVYOg.
5. Case No. 11-4574 2012 U.S. Dist LEXIS 29294 (E.D. Pa. 6 March 2012).
6. *Pierre B. Epsilon Composite*, No. 4164, *Cour d'Appel*, Bordeaux (2 October 2001). Here the *Cour de Cassation* established the general rule that employees have the right to workplace privacy and that an employer cannot search an employee's personal messages stored on the company's computer without breaching that right to privacy. In a 2005 decision, the court ruled that an employer could only search files identified as personal on a work computer in the presence of the employee, unless there was a particular threat to the company. *Philippe Ex v. Société Cathnet-Science*, No. 04.40017, *Cour de Cassation* (17 May 2005).
7. Maxwell & Wolf. *A Global Reality: Governmental Access to Data in the Cloud* (Hogan Lovells: 23 May 2012), at http://bit.ly/MIY5rK.
8. *Id.* at 2.

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International Trade Commission: The Real Rocket Docket

By James A. Johnson

I. Introduction

A. Leahy-Smith America Invents Act

The Leahy-Smith America Invents Act was signed into law on 16 September 2011.[1] The sweeping patent reform law is the biggest change to intellectual property law in 175 years. One of the purposes of the Act is to bring America's patent system in line with those of other countries and to create a faster and more stable process for the patentee. The America Invents Act shifts the United States from a system where a patent is awarded to the first person who comes up with an invention to one where patent is awarded to the first person who files a patent application. The first-to-file procedure takes effect on 16 March 2013.

Also note that the United States Patent and Trademark Office opened on 16 July 2012 its first satellite office, named after Elijah J. McCoy, at 300 River Place Drive in Detroit. The building, listed on the National Historic Registry, was the former home of Parke-Davis Laboratories and the headquarters of Stroh's Brewery. As an interesting aside, Elijah J. McCoy, an African American, born in Colchester, Ontario, Canada, invented an automatic lubricator for oiling the steam engines of locomotives and ships. On 12 July 1872 he obtained his first patent for an "Improvement in Lubrication for Steam Engines" (U.S. Patent 129,843). McCoy worked his magic in a home-based machine shop in Ypsilanti, Michigan. The saying "the real McCoy," meaning the real thing, has been associated with Elijah McCoy's invention of an oil-drip cup, for which he was well known.

B. Review Procedures

Under the America Invents Act, there are four rules that create new procedures for reviewing patents after they have been issued: inter partes review; post-grant review; the covered business methods programs; and supplemental examination.

The new inter partes review system will replace the current inter partes re-examination process. Under the new system, a *third party* can request that the PTO take a second look at an issued patent to determine its validity. The new and different standard requires a "reasonable likelihood that the requester will prevail with respect to at least one the claims challenged in the request." Under the statute, inter partes reviews must be completed within twelve months, subject to the director's discretion to extend the process up to eighteen months.

The supplemental examination will allow *patent holders* to request that the PTO review an existing patent to consider, reconsider or correct relevant information. This proceeding might be used by patent holders to preempt an inter partes review or as a way to head off potential charges of inequitable conduct if relevant prior art surfaced after a patent was granted. For example, someone sued for infringing a "covered" business method patent will be able to ask the PTO to review the patent for invalidity without having to demonstrate the likelihood of success up front.

Inter partes and post-grant review may dramatically reduce the cost of determining patent validity issues. Both forms are initiated by the filing of a petition by any person who is not the patent owner. The filing or grant of a petition for either form of review could stay pending litigation and avoid broad district court discovery that is pursued concurrently on infringement, invalidity or damages.

II. Jurisdiction

A. Background

A provision in the America Invents Act bars the bringing of a single patent case against numerous unrelated defendants, in the context of foreign companies importing products that infringe on a U.S. patent. This has enhanced the attractiveness and importance of the International Trade Commission.

The United States International Trade Commission (ITC) is an administrative agency for patent enforcement. Jurisdiction over importers is invoked by the mere act of importation.[2] This makes jurisdiction over foreign companies much easier than in the United States district courts, where venue and personal jurisdiction rules can often deny jurisdiction. After a finding of patent infringement, the ITC has the power to enlist U.S. Customs and Border Protection to bar entry of the infringing products into the United States. In addition, pursuant to statute, ITC actions must end within a defined time period.[3] Thus, patent actions before the ITC have dramatically increased. It is estimated that the ITC's commissioners handle approximately a quarter of all patent trials in the United States. Moreover, the number of investigations in 2011 increased substantially.

B. Fast Track Adjudication

Section 1337 gives the ITC power to exclude products that are found to infringe a U.S. patent and to issue cease and desist orders.[4] The procedure commences when a patent holder files a complaint with the ITC, requesting that the ITC investigate the alleged infringement of a U.S. poatent, with resulting harm to a domestic industry.[5] The number of investigations in 2011 increased substan-

tially. An administrative judge determines questions of infringement and validity and this is reviewed by the ITC commissioners and the President and is then appealable to the Federal Circuit.[6] A parallel action for patent infringement can be pursued in the United States district court.[7]

C. ITC Proceedings

One of the unique advantages of the ITC is the speed of the proceedings. The ITC is required to complete an investigation "at the earliest practicable time after the date of publication of the notice of such investigation."[8] This time period is usually about fifteen months, as compared with years for federal district courts.[9] The Federal Circuit in *Kyocera Wireless Corp v. International Trade Commission* determined that the ITC's statutory authority is confined to limited exclusion orders (LEOs) to named respondents only.[10]

The LEO is limited to excluding those infringing products imported by respondents and is very similar to an injunction in district court.[11] The general exclusion order (GEO) applies to all importers of the infringing product, regardless of whether they are a party to the litigation.[12] As an alternative to naming more respondents in the complaint in order to expand the scope of the available LEO, a complainant can seek to obtain a GEO. A GEO excludes all infringing products, regardless of whether that product's importer is named in the ITC action. Moreover, a GEO is another way to obtain an effective remedy against downstream importers. However, GEOs are granted only upon a showing of a widespread pattern of infringement, together with evidence that others besides the respondent are attempting to enter the U.S. market with infringing devices.

The ITC will issue injunctive relief following a finding of infringement, as distinguished from the Supreme Court's decision in *eBay v. MercExchange*.[13] *eBay* has limited the availability of injunctions in district court patent infringement cases to the four-factor test for permanent injunction relief.[14] Further, the Federal Circuit has held that the four-factor equity test for injunctions, as set out in *eBay*, does not apply in Section 337 actions.[15] Thus, the ITC is an extremely attractive venue for patent infringement enforcement, particularly in electronic- and computer-related patent disputes.

III. Conclusion

The ITC is already a major part of the patent enforcement landscape in the United States. The ITC will become an even more important forum for patent litigation because of the America Invents Act bar against bringing a single patent case against numerous unrelated defendants. Another major reason the ITC has risen to prominence is its ability to issue automatic injunctions in the form of exclusion orders. Automatic injunctions immediately bar a foreign company from shipping goods into the United States. A patentee can shut down a foreign company for the life of the patent. The ITC's speed in deciding patent cases, usually about fifteen months, compared with years for federal district courts, has made the ITC the venue of choice and the real "Rocket Docket."

Endnotes

1. H.R. 1249. 112 Cong. (2011).
2. 19 U.S.C. § 1337(a) (1).
3. 19 U.S.C. § 1337(b) (2006).
4. 19 U.S.C. § 1337 (d).
5. 19 U.S.C. § 1337 (b) (1).
6. 19 U.S.C. § 1337 (b) (c).
7. *Texas Instruments, Inc. v. U.S. Int'l Trade Comm'n*, 851 F.2d 342, 344 (Fed. Cir. 1988).
8. 19 U.S. C. § 1337 (b) (1).
9. Hahn and Singer, *Assessing Bias in Patent Infringement Cases: A Review of International Trade Commission Decisions*, 21 Harv. J. L & Tech 461 (2008).
10. 545 F.3d 1340, 1355-56 (Fed. Cir. 2008) (citing 9 U.S.C. § 1337(d)).
11. *Id.*, 545 F.3d at 1356 (citing 19 U.S.C. § 1337(d) (2) (A) & (B)).
12. 19 U.S. C. § 1337 (d) (1).
13. 547 U.S. 388 (2006).
14. *Id.* The four factors are: (1) The plaintiff has suffered an irreparable injury; (2) the remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) considering the balance of hardships between plaintiff and defendant, a remedy in equity is warranted; and (4) the public interest would not be disserviced by a permanent injunction.
15. *Spansion, Inc. v. Int'l Trade Comm'n*, 629 F.3d 1331, 1359 (Fed. Cir. 2010).

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Third-Party Funding in International Dispute Resolution

By Aren Goldsmith

I. An Introduction to TPF and Some Key Features and Associated Risks

While the subject of Third-Party Funding (TPF) is appearing in the arbitration press and on agendas for conferences with ever increasing frequency, the phenomenon has not yet become a common feature of arbitral practice. That said, the relevance of TPF for international arbitration appears likely to grow. Relevant factors that appear likely to contribute to the growth of TPF in international arbitration include the relaxation of regulations that once prohibited such financing in the common law jurisdictions where many funders are organized today, the rapid accumulation of capital in search of uncorrelated returns in the sizable global market for commercial disputes, serious challenges posed in many cases by the rising costs of prosecuting and defending international arbitrations today, and the increasing openness toward TPF of many law firms involved in the practice of international arbitration.[1] When used appropriately and with a full understanding of its potential pitfalls, the author believes that TPF may have a salutary impact in many cases by expanding access to arbitral justice and leveling the playing field for parties that might otherwise lack the means necessary to put forward the best possible case.

Nonetheless, it is important not to overstate the impact of this phenomenon. Instead, the author submits that a prudent posture for practitioners today would be to study the phenomenon in order to be in a position to spot appropriate opportunities to explore TPF with clients, or to exploit an opposing party's reliance upon TPF. The background discussion and substantive reflections below aim to support such a "watching brief."

A. The Origins of TPF

While discussion of its potential relevance for international arbitration may be new, the availability of TPF for domestic court litigations is not. The origins of TPF have been tied back to certain practices in ancient Rome and Greece, but are most often associated with feudal practices in medieval England, when powerful noblemen lent their support to parties involved in litigation in order to advance interests of their own unrelated to the merits of the underlying claim, such as to weaken rivals or as a source of income.[2] Such behavior led to the criminal prohibition of champerty and maintenance, as well as related civil torts and doctrines of contractual nullity in the common law world.[3]

In recent times, age-old rules regarding champerty and maintenance have been relaxed or largely eliminated in many common law jurisdictions,[4] creating an opportunity for litigation funding where its practice previously would not have been possible. In particular, after first emerging in Australia about twenty-five years ago, dedicated third party sources of funding expanded to other parts of the common law world, as well as to a number of civil law jurisdictions.[5] The funds, which were estimated early last year by one leading industry player to number around twenty (a number which the author can confirm has since increased), represent (along with one-off funders) a capital supply valued approximately in the single-digit billions of dollars, and typically invest both domestically and abroad.[6] The phenomenon of TPF is therefore international in nature and represents, particularly in light of what many industry analysts believe is a level of demand for TPF that is many times greater than the supply currently available, a market that is likely to increase significantly in size over time.[7]

The market we are describing now is what will be called below the "standard" form TPF. Of course, when the definition of TPF is expanded to include other sources of funding in relation to litigation claims, such as after-the-event (ATE) insurers, the size of the market and the number of players implicated increases substantially. In the future, it is likely that the lines between "classic" TPF and other related sources of funding will blur, since funds investing in claims are already offering insurance products as part of the funding package, such as insurance for adverse or the party's own costs.[8] Similarly, we are not counting brokers like, "The Judge," who work with both providers of classic TPF and insurance underwriters, serving as intermediaries to align parties in search of funding with funding solutions.

B. The Forms and Nature of TPF

As the preceding discussion suggests, there is no universally agreed definition of TPF. Certain authors have defined the concept to include only the predominant claimant-side model. Others, including the author, would view contingency fee legal arrangements as a form of TPF. The status of respondent-side funding is also open to debate.[9] Whatever the definitional approach, a fairly standard conception would qualify TPF as present in any case in which a third-party, *other* than the litigant itself, plays a role in part or all of the funding for the prosecution or defense of claims.

In this article, we will focus on "standard" TPF.

1. "Standard" Claimant-Side TPF

(a) Basic Product Features

Modern TPF typically involves the provision of non-recourse financing to cover all or part of the costs and disbursements necessary for pursuing a claim (such as legal fees, expert fees, arbitrator and administrative costs and, in some cases, even operating costs to support the existence of the claimant entity so that the claim may be pursued), in exchange for a financial interest in the proceeds collected based upon the enforcement of any award that recognizes the claim.

For example, in their November 2011 *Code of Conduct for Litigation Funders* (the "England and Wales TPF Code"),[10] the Association of Litigation Funders of England and Wales defines TPF in the following functional terms:

> A Funder has access to funds immediately within its control or acts as the exclusive investment advisor to an investment fund which has access to funds immediately within its control, such funds being invested pursuant to a Litigation Funding Agreement (LFA) to enable a Litigant to meet the costs of resolving disputes by litigation or arbitration (including pre-action costs) in return for the Funder: (a) receiving a share of the proceeds if the claim is successful (as defined in the LFA); and (b) not seeking any payment from the Litigant in excess of the amount of the proceeds of the dispute that is being funded, unless the Litigant is in material breach of the provisions of the LFA.[11]

This definition both orients TPF toward the prosecution, as opposed to the defense of claims, and excludes from the definition brokers who match funders to claims and do not invest funds.

The terms of TPF products available for the financing of complex commercial claims are not standardized. Instead, funding terms will usually reflect the give and take of contractual bargaining between the funder and funded party. While it is difficult to generalize, funders often seek to fund in exchange for the greater of (i) the return generated by multiplying funded costs by a pre-designated multiplier (often based upon a three-to-one ratio), or (ii) a percentage interest in any recovery achieved (often in the range of twenty percent to forty percent of amounts recovered, but at times a greater percentage).[12] Funders may also set a minimum guaranteed return, set as a function of the amount invested by the funder. Unsurprisingly, the amount of compensation required by the investor will vary, based upon the level of risk associated with the investment, including the probability of success (including as to enforceability/solvency of the future judgment debtor) and length of time required to achieve a litigation outcome (by outright victory or settlement).[13] Where a party expects to realize non-monetary relief, such as the restitution of property or an injunction ordering the performance of an obligation, the parties may agree on a mechanism to monetize such a remedy. For instance, in one funding of which the author is aware, the funded entity agreed to sell the property that was the object of the litigation upon recovery and satisfy the funding "debt" out of the resulting proceeds.

(b) Due Diligence

Like pricing, the nature of the diligence process that typically precedes funding will vary. Many funders provide, through their websites, a high-level description of the funding process that a party can expect to experience. Such processes often involve an initial screening, followed by more intensive due diligence, to be undertaken if the claim yields sufficient interest. Because of the large supply of claims seeking funding, funders report that they typically fund only a very small percentage of claims that are presented to them.[14] In this sense, funders are quite selective.

Factors considered by funders during diligence include analysis of the size of the claim, *i.e.,* whether it falls within the range that is within the funder's mandate, the subject matter of the claim (a number of funds exclude claims in certain substantive areas, such as consumer claims and defamation actions, or limit their funding to claims arising under legal systems familiar to them), the complexity and enforceability of the claim (some funders consider investment treaty claims to be more difficult to fund because of the complexity of the legal issues involved and potential obstacles to enforcement),[15] and the nature of the legal team associated with the claim.[16] For example, one of the world's largest funders, IMF (Australia) Ltd., lists the following factors as relevant to its diligence: "(a) the strength of [the] claim; (b) the type of claim; (c) when [the] claim arose; (d) the jurisdiction in which [the] claim will be heard; (e) the amount of [the] claim; (f) any legal or factual difficulties; (g) the ability of the proposed defendant to pay…; [and] (h) how much documentary evidence there is to support [the] claim."[17]

When substantial funding is sought in connection with a complex dispute, the due diligence process may take several months to complete, involve significant costs for both the party seeking funding and the funder (which may or may not require the funded party to cover its diligence costs),[18] require exclusivity undertakings (to preclude the party seeking funding from continuing to "shop around"), and necessitate the involvement of key client representatives.[19] Diligence may also involve vetting by outside advisors to the funder, including legal advisors, auditors, and experts on quantum/valuation.[20] Because

the quality of counsel associated with a claim is often a key factor for funders in deciding whether to invest,[21] some funders may require the funded party to accept a new legal team as a condition for funding or reserve a right to participate in the naming of the legal team that will be associated with a claim for which arbitration counsel has not yet been named.[22]

Because the diligence process may involve a discussion of the merits of the claim to be funded, the fact that a party has participated in funding-related diligence may create a risk of exposure to subsequent attempts by adversaries to obtain disclosure of the information exchanged during that process (for instance, based upon arguments that the disclosure waived any otherwise applicable legal privilege). In view of this risk, certain funders seek to perform their diligence exclusively on the basis of non-privileged information.[23] Others may seek to limit the type of information provided based, for example, upon the belief that while certain privileges could be waived by a sharing of information (such as the attorney-client privilege), other protections, such as work product privilege, would not be.

(c) Sensitive Terms: Control Rights

A particularly sensitive area for the structuring of any funding agreement involves the issue of control rights. Some providers of TPF, particularly those located in common law jurisdictions that have not completely done away with public policy considerations related to the doctrines of champerty and maintenance, may seek to avoid the acquisition of actual or constructive "control" rights, for fear that excessive interference could render their funding agreements unenforceable. For example, the England and Wales TPF Code provides explicitly that the funder will "not seek to influence the Litigant's solicitor or barrister to cede control or conduct of the dispute to the Funder."[24]

In addition to direct control rights, a form of indirect control may be seen in contractual provisions regulating the parties' relationship in the event a conflict should arise between the funder and funded party, for example, over an important strategic decision. In anticipation of the risk of a divergence of opinion as to how a claim should be managed, funding agreements may provide for rights securing a return on investment to the funder, should the funded party opt for a course of action that is contrary to the one recommended by counsel or a neutral expert called in to assess the best course of action to pursue. Two common scenarios in which such provisions may be triggered arise in connection with debates over whether a particular settlement offer should be accepted or whether a claim should be discontinued.[25]

By contrast, some funders are less reluctant to secure control or influence rights, whether in terms of the outright authority to make key decisions or through the provision of what certain funders describe as "enhancement" services in relation to the claim. Such "enhancement" can take the form, for example, of strategic advice in connection with the choice of counsel and the management of proceedings.[26] In jurisdictions like Australia, where case law has upheld extensive control rights and appears largely to have set aside concerns related to champerty and maintenance, an even stronger form of TPF appears to have emerged.[27]

While the issue of "control" remains sensitive in certain common law jurisdictions, local jurisdictions do not always extend their own public policy rules or rules of legal ethics to international arbitration proceedings (or may limit the extension of such rules to arbitration proceedings taking place within their own territory).[28] Similarly, concerns under domestic policy designed to protect local litigants from abusive behavior may be viewed under the same public policies as less relevant in the context of international proceedings among sophisticated commercial entities. Thus, international arbitration has been targeted by certain funders seeking to exercise greater influence than might be permissible in domestic court litigations within their own jurisdictions.

Similarly, as noted above, funders that are organized in civil law jurisdictions may be less encumbered by control-related concerns in structuring the terms of their products. For example, in Germany, significant control rights appear to be possible.[29]

(d) Sensitive Terms: Termination

One additional area of potential concern associated with the structuring of funding relationships is the question of termination. In recognition of this concern, the England and Wales TPF Code regulates both capital adequacy (requiring immediate access to funds) and the terms on which funding may be withdrawn (enumerating the conditions and excluding unrestricted discretionary termination).[30] While capital adequacy could be seen primarily as a problem for the party seeking funding, opposing parties in an international arbitration may also have reason to be concerned when the funder behind a claim lacks sufficient capital or may enjoy liberal termination rights.

For example, the England and Wales TPF Code allows for the termination of funding when the funder "reasonably ceases to be satisfied about the merits of the dispute" or "reasonably believes that the dispute is no longer commercially viable."[31] Where the funded party relies upon the funder for the financing of his claim, such provisions may expose the opposing party to costs risks (*i.e.,* the risk of being unable to collect costs from a defaulting entity no longer supported by TPF) in the event the funder should decide to withdraw funding because the claim appears to have weakened over time.

2. Alternative Varieties of TPF

While space constraints preclude exploring alternative forms of TPF in greater detail, it is worthwhile to note that the following may also arguably be considered forms of TPF: (i) contingency fee legal arrangements; (ii) insurance products indemnifying against exposure to liability and/or costs (both before- and after-the-event); (iii) "strategic" funding, *i.e.,* cases in which an interested third party funds not for any particular return on the specific claim funded but instead to advance a larger interest (financial or non-pecuniary, such as human rights); (iv) respondent side (a discussion earlier this year at a roundtable with leading funders suggested that it is unlikely that any such funding has ever actually been underwritten).

C. Disclosure Risks

As noted above, the exchange of sensitive information regarding a claim or defense may form part of the due diligence process preceding the provision of TPF and/or of communications between the litigant and funder during the course of the proceedings being funded. Parties may view such information as of a legally privileged nature.

1. Scenarios in Which Disclosure Risk Arises

There are two primary procedural frameworks under which questions of legal privilege in relation to communications with providers of TPF would appear likely to become relevant in the context of international arbitration. Both are of general interest for arbitration practitioners, whatever the seat of the arbitration proceeding in connection with which TPF is to be sought or has been obtained.

The first scenario may arise before the arbitral tribunal, which may be called upon to decide whether information shared with a TPF funder should be shielded from disclosure on the basis of a claim of legal privilege. When called upon to decide whether the communications with TPF funders must be disclosed, arbitral tribunals will presumably treat the issue of disclosure as they would any other question of legal privilege. Under common practices, one factor likely to be considered by arbitral tribunals in such a context would be the question of whether the party communicating confidential legal information to a funder had a basis to expect that such information would be protected from disclosure under any privilege available under applicable law in relation to the communication. In this context, where the communication takes place in the United States or touches that jurisdiction, United States privilege rules may become a relevant factor.

The second scenario in which questions of privilege in relation to communications between a party and funder are likely to become relevant for international arbitration proceedings (again, wherever the seat of arbitration) is in the context of satellite litigation before the domestic courts resulting from attempts by parties to obtain the production of such information for use in international arbitration proceedings against the opposing funded party. While a number of laws offer support to arbitral tribunals seeking information from third parties, the forum in which such disputes most likely will become relevant to international arbitration is before the United States federal courts, certain of which have found authority under 28 U.S.C. Section 1782 to grant full American-style discovery from subjects (*i.e.* those in possession of information regarding the claim) within their reach for use in international arbitration proceedings around the world.[32] The Eleventh Circuit, for example, recently held that arbitral tribunals are "tribunals" for purposes of the discovery statute.[33] Many federal district courts have taken a similar view of the statute.

2. Privilege Rules Applicable

Assuming for purposes of discussion the Section 1782 scenario, it is important to understand how the United States court seized of any application for assistance would analyze whether information shared with a TPF should be protected by legal privilege.

Unfortunately, there is very little law on this important question. Caution is therefore of paramount importance. Indeed, the Association of the Bar of the City of New York, commonly called the New York City Bar Association, in a June 2011 Opinion regarding ethical issues created by TPF under the New York Rules of Professional Conduct, declared that "a lawyer may not disclose privileged information to a financing company unless the lawyer first obtains the client's informed consent, including by explaining to the client the potential for waiver of privilege and consequences that could have in discovery or other aspects of the case."[34] What is possible at this time is to present the forms of privilege likely to be implicated in this context.

The first rule of privilege that may be relevant for analysis of communications with TPF providers is known as the "attorney-client privilege." "The attorney-client privilege covers communications made between privileged persons, in confidence, for the purpose of obtaining or providing legal assistance for the client."[35] Privileged persons are generally held to include counsel and certain agents or technical advisors who facilitate attorney-client communication.[36] However, the disclosure of privileged communications to anyone other than a privileged person generally waives the privilege and subjects the relevant communication to disclosure.[37] United States courts tend to take a strict approach to waiver.[38]

While room for debate exists, in the absence of the availability of an exception to the rules of waiver, there is a real risk that courts in the United States could find that the voluntary communication of otherwise privileged

information regarding a claim to a source of TPF should be deemed to result in a waiver of the attorney-client privilege.[39]

One leading candidate to serve as an "exception" in the context of TPF is known as the "common interest" doctrine. Under this doctrine, a court may allow material to remain privileged despite disclosure to a third party, as long as that third party has a sufficiently close "common interest" with the disclosing party, the disclosure is made in confidence, and the disclosure is made within the context of that common interest. It is not always easy to define exactly what will qualify as a "common interest" sufficient to maintain privilege in the face of a disclosure.

The only reported decisions of which the author is aware to have considered the availability of the "common interest" doctrine in the context of communications with a third party regarding funding have denied its availability and, as a result, compelled production to the opposing party of the information that had been given to the TPF provider.[40] Thus, while some commentators are confident that the "common interest" exception provides sufficient comfort to shield discussions with sources of TPF behind privilege,[41] significant caution appears to be warranted, both due to the paucity of reported decisions in this area and the significant harm that can result when the attorney-client privilege is lost.

A final protective principle that may become relevant in the context of TPF is known as the "work product" doctrine.[42] The doctrine protects the "thoughts, mental impressions, and strategies of attorneys from being discovered by opposing parties in litigation" and extends to "documents and tangible things…prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent).[43]

The waiver of work product protection through disclosure to a third party is analyzed differently than the waiver of the attorney-client privilege. In particular, the waiver of work product protection has been held to require a showing that the disclosure of otherwise protected materials "substantially increase[d] the likelihood of documents falling into the hands of an adversary in litigation."[44] In other words, even where work product materials are disclosed to a third party who lacks a "common interest" with the disclosing party, there may well be no waiver of the protection as long as the disclosure occurs in circumstances that make it unlikely the materials would land in the hands of the disclosing party's opponent.

The work product doctrine, which may ultimately offer the greatest hope in efforts to resist disclosure under United States law,[45] is likely to become a fertile battleground in future discovery disputes related to TPF. The reason why "work product" may be of great interest to litigants is due to the very nature of "work product," which often consists of legal analysis prepared by counsel of the strengths and weaknesses of the claim for which funding is sought. It is unlikely that the disclosure of any such memo, even if phrased in cautious lawyerly terms, would be seen as a positive development for the party being funded.

Very few reported decisions have considered the question of whether work product shared with a funder, such as the memorandum in the example above, could be protected under the work product doctrine. In one of the few cases to have considered this question in the context of TPF, the district court upheld a claim of work product protection invoked by a party that shared documents prepared by its lawyer (containing legal strategy information) in connection with discussions with investors.[46] The court allowed the document to be withheld, based upon the finding that the disclosure to investors did not substantially increase the likelihood of documents falling into the hands of the opposing party.[47] However, other courts have reached the opposite conclusion on comparable facts. Applying principles from the common interest doctrine to consider whether work product protection has been waived, other courts have found waiver of work product protection where information has been disclosed to a third-party sharing only a commercial rather than a legal interest with the disclosing party.[48]

Again, in view of the great uncertainty surrounding these questions, caution is warranted.

II. Select Issues of Relevance for Arbitration Practice and Procedure

Two key procedural problems likely to arise with increasing frequency as a result of the emergence of TPF on the arbitration scene should be addressed: (1) security for costs; (2) conflicts of interest.

A. Security for Costs

Security for costs is a form of interim or conservatory relief that may be awarded, when the arbitral tribunal has the authority to do so, based generally upon a showing of (1) *fumus boni iuris, i.e.*, that the party seeking security has a *prima facie* chance of succeeding on the merits of its claims or defenses, and (2) *periculum in mora, i.e.,* that there exists an imminent danger facing the applicant absent the award, such as its inability to satisfy a future award of costs against the assets of its adversary due to a degradation of the financial condition of that adversary.[49] Although by no means a routine form of relief, circumstances may arise where it is appropriate for equitable reasons to protect the respondent against the risk that a claimant will lack sufficient assets to satisfy an award of costs against it.

In claimant-funding scenarios, the availability of TPF often will enable a party that would not otherwise be able to support the costs of pursuing its claim (either at all or in the manner made possible with the support of outside funding) nonetheless to proceed and thereby to generate costs for the respondent where such costs would not otherwise exist (either at all or at the level generated as a result of funding).

The power of a party to externalize costs exceeding its own financial resources may become particularly problematic in the context of international arbitration proceedings. While the claimant may, in theory, be assigned liability for its opponent's costs if unsuccessful, TPF may enable a party to generate greater costs than the respondent could satisfy against the claimant's assets in enforcement proceedings. For example, a party with limited or no means of its own may, through access to TPF, retain world class counsel, submit sophisticated expert evidence and embark upon an aggressive arbitration strategy. Such behavior in many cases will increase the respondent's costs beyond those which the respondent would incur in the absence of TPF. In such a scenario, the costs incurred by the respondent could easily exceed the claimant's capacity for reimbursement. The funder would not be liable for such costs within the arbitration because it would remain a third party[50] to the procedure.

Thus, in the absence of the availability of a remedy against the funder in the domestic courts (*e.g.,* through a cause of action under local law seeking to hold the funder liable for the costs generated as a result of the arbitration), TPF may create a particular risk in relation to international arbitration proceedings that claimants will be incentivized to generate and externalize excessive costs, leaving respondents to bear the related default risk.

B. Arbitrator Independence / Impartiality

It is generally recognized that arbitrators must be impartial and independent of the parties and interests involved in any arbitration. The obligation of independence is often analyzed objectively, in light of both direct and indirect relationships.[51]

Arbitrators (or the law firms with which they are affiliated) may perform any number of professional services on behalf of funders, including representing funders for purposes of due diligence or as counsel retained at the request of the funder to litigate an unrelated claim (with or without a shared financial interest). Similarly, arbitrators may serve on advisory committees commonly established by funders or hold financial interests in funders (including common shares). Finally, certain arbitrators may become "preferred" arbitrators for certain funders. Where this should occur and where the arbitrator should become aware of his or her status in relation to the particular funder, the known presence of the funder may create questions of independence and impartiality.

Under the IBA Conflicts Guidelines, which, while not of universal application, are often consulted for purposes of considering problems of conflicts of interest in international arbitration, disclosure obligations may arise under a variety of circumstances that go well beyond the arbitrator's (or his law firm's) existing legal representation of a party or its affiliate. These include factors such as repeat prior appointments by a party or counsel, the existence of a financial interest in a party or its affiliates, or possession of a position of management or control in any party or its affiliate.[52] Whether similar ties between an arbitrator and a particular funder would give rise to a valid basis for a challenge under those standards remains an open and (to the author's knowledge) untested question.[53]

While much debate surrounds the questions of what arbitrators should disclose and the standards that should govern any disclosures made, it would appear relatively uncontroversial to observe, in relation to existing practices surrounding TPF and the contacts that can be imagined between arbitrators and funders, that relationships between arbitrators and providers of TPF could give rise to serious questions of independence and impartiality.

Performing the necessary analysis of independence and impartiality in any given case would require disclosure regarding both the terms of the funding relationship (including key elements such as the funders' right to control or influence the claim) as well as disclosure regarding any relationship (direct or indirect) between the funder and the arbitrator or his or her law firm. The challenge of course lies in developing standards for assessing (i) at what time such disclosure would be appropriate and (ii) who should provide it.

One answer would be that TPF (assuming acceptable definitions can be agreed or provided under applicable rules) should always be disclosed. While such an approach would maximize the probability of detecting potential conflicts, many would respond that such an approach would create issues where none might otherwise have existed. What the arbitrator does not know cannot influence the arbitrator's decision-making. It is not clear that the absence of knowledge—particularly where knowledge can be obtained through diligent inquiry—will suffice to clear objective conflicts of interest in all jurisdictions. Moreover, because the presence of a funder may be disclosed at any stage of the proceedings (for example, during an evidentiary hearing or during debates over who may access documents disclosed during the production phase), the failure to provide for full disclosure upfront could increase the risk of costly disruptions at a later stage, including where the revelations result in recusal. While disclosure and analysis at the outset may entail additional costs and create delay as the parties debate the significance of any disclosures made, the loss of a

member of the tribunal during the course of the proceedings (particularly, at a late stage) may create even greater costs and delay for the parties.

A second practical question is: Who should disclose links to sources of TPF? Different possibilities have been suggested.[54] One is to place the initial disclosure obligation upon the arbitrator. However, requiring arbitrators to disclose all existing direct and indirect ties to funders may be unrealistic and unduly burdensome, particularly for arbitrators affiliated with large law firms. It may also place the arbitrator in the awkward position of being required to disclose confidential information—the very fact of having been engaged to provide legal services to a particular funder may be subject to a confidentiality obligation—in the presence of a conflict that may in reality not exist.

Alternatively, the parties could be required to make initial disclosures regarding reliance upon TPF. Such an approach would allow the arbitrators to exercise discretion as to whether to offer additional disclosure (or to step down) on the basis of the parties' disclosures. However, as noted above, this approach may create issues where none might otherwise have existed, giving rise to possible objections based on the simple fact that TPF is involved and making the resolution of the dispute unnecessarily more complicated.

A final possibility would be to ask the parties and members of the tribunal to submit lists of funders with whom any relationship believed to warrant disclosure exists, to a neutral third party. The third party could then act as a form of "clearing agent," commissioned with responsibility for identifying any potential conflicts. The disadvantage of such an approach is that it would delay the process of constitution of the arbitral tribunal and it would, in many instances, once again place a heavy burden upon arbitrators (particularly those affiliated with a large law firm), and possibly require the disclosure of confidential information to avoid what might be a purely theoretical conflict. Moreover, it is not self-evident that an acceptable third party could be found that would be willing to assume the responsibility and potential liability that such a role could entail.

Of course, before anyone will be able to assess when disclosure should be made at all, it will be necessary to develop definitions as to the meaning of "TPF" and as to the standards that should govern when TPF must be disclosed. To state the obvious, if there is no commonly understood framework for defining the phenomenon, it would be unfair to fault a party or arbitrator for having failed to disclose a relationship the party did not understand to constitute TPF or to involve circumstances rising to a level warranting disclosure. Thus, arbitral institutions may wish to consider the viability and desirability of developing standards to assist the parties in assessing when disclosure would be appropriate.[55] Such efforts would no doubt proceed from relevant definitions. Accomplishing either of the above would be easier said than done. At a minimum, the development of well considered and clearly defined practices and/or guidelines would assist users in deciding where to arbitrate and forming an understanding of whether disclosure would be appropriate in any given case.

III. Conclusion

The limited set of issues addressed above does not begin to do justice to the myriad procedural and substantive complexities that may arise from the involvement of TPF in an arbitral proceeding. Additional issues that warrant consideration include: (i) problems of extension of the arbitration agreement; (ii) problems of assignment, particularly of a *de facto* nature, resulting from the acquisition of "control" by the funder over the claim or a dominant financial interest in the claim; (iii) confidentiality; (iv) public policy issues in jurisdictions that have strong public policies prohibiting TPF, where the enforceability of any award obtained through TPF may be called into question.

The discussion above shows that TPF, while of clear utility and interest for many parties, particularly in a world of rapidly escalating arbitral costs and financial crisis, presents a number of challenges for the institution of international arbitration. None appears in and of itself to warrant urgent intervention or regulation. Like other challenges that have engaged the arbitral community over time, it is hoped that ongoing reflection will yield answers and new approaches that will recognize the place for TPF in arbitration, while safeguarding the interests of those who may be affected when it is misused.

Endnotes

1. *See, e.g.* Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 Minn. L. Rev. 1268, 1281 (2011) (quoting a 2008 *Wall Street Journal* article reporting that as of March 2008, "[E]ight out of 10 of London's top law firms [were] already using or assessing external funding for litigation and arbitration cases… Even [the U.S.-based firm] Skadden [was] getting into the action, reportedly using third-party funding in an arbitration case."); *Funds Spring Up to Invest in High-Stakes Litigation*, Wall Street Journal, 3 October 2011 (referring to "cautious backing" for TPF from partners at a number of major United States law firms).
2. *See, e.g.*, Lyon, *Revolution In Progress: Third-Party Funding of American Litigation*, 58 UCLA L. Rev. 571, 581 (2010) (discussing the role of the "sycophant" in ancient Greece (an individual or parade of individuals, often paid, who would appear at proceedings to argue on behalf of parties) and "calumniator" in ancient Rome (one "who without authorization brings actions in the name of another with which [he has] no concern or otherwise brings false, vexatious litigation"); Steinitz, note 1 *supra*, at 1286-1287 (describing feudal origins of champerty in the Old French "*champart*," a form of land grant scheme).
3. In basic terms, maintenance and champerty are, respectively, the meddling in litigation involving a third-party in which one has no *bona fide* personal interest and the sharing in the proceeds resulting from such involvement. *See* Lyon, note 2 *supra*, at 579; Steinitz, note 1 *supra*, at 1286-1287. A related tort is that of barratry, which

involves inciting vexatious litigation claims. *See* Kantor, *Third-Party Funding in International Arbitration: An Essay About New Developments*, 24 ICSID Rev. 65, 75 (2009).

4. For a discussion of the relaxation of maintenance and champerty and related growth of TPF in the United States, *see* American Bar Association Commission On Ethics 20/20, *White Paper on Alternative Litigation Finance* (released for public comment in October 2011), at 10-13 (providing overview and noting that one recent survey found that twenty-nine out of fifty-one jurisdictions, including the District of Columbia, permit some form of champerty); *Formal Opinion 2011-2: Third Party Litigation Financing*, (issued by New York City Bar Association) (noting absence of any decision finding non-recourse funding arrangements champertous in New York); Seidel, *Investing in Commercial Claims; New York Perspectives*, 4 NYSBA New York Dispute Resolution Lawyer (Spring 2011) (citing restriction in New York statutory law, which excludes from scope of champerty prohibition claims exceeding $500,000). For a discussion of relevant Australian case law, where a strong form of TPF, under which funders exercised extensive control rights, has been upheld (albeit in *obiter dicta*), *see* W. Attrill, *Ethical Issues In Litigation Funding* (February 16, 2009) (paper prepared by IMF (Australia) Ltd.) (discussing the Australian High Court's decision in the landmark case, *Campbells Cash & Carry Pty Limited v. Fostif Pty Limited* [2006] HCA 41 (majority decision)). For an overview of the relevant law in England and Wales, *see Third Party Funding—Case notes on third-party funding*, 3 Global Arb. Rev. 1 (2008), available at http://www.globalarbitrationreview.com/journal/article/15965/third-part-funding-case-notes-third-party-funding. In England and Wales, a key question has been how to define the outer limits of TPF under public policy. In particular, courts apply a flexible and pragmatic analysis that seeks to tease out whether the funding arrangement "has a tendency to corrupt public justice." D. Jones, *Third Party Funding of Arbitration*, presented at SJ Berwin's *Hot Topics in International Arbitration* (London, 22 September 2009) (citing the exercise of control by the funder as a danger zone increasing the risk of unenforceability). *See also* Freshfields Bruckhaus Deringer, *Class Actions and Third Party Funding of Litigation—An Analysis Across Europe* (June 2007) (England and Wales report, noting, "It is not inconceivable that professional funders will want to take control of proceedings where a lot of their money is at stake and this is the outstanding issue where champerty and maintenance may bite to limit the spread of such funding.").

5. *See* S. Seidel, Fulbrook Management Nutshell Primer at 3 (2d ed. 2011). In Europe, Germany has had an active market for over ten years. *See Roundtable on Third Party Funding of International Arbitration Claims: The Newest "New New Thing"* (presentation paper prepared by Calunius Capital LLP for Fordham University School of Law conference regarding TPF, 15 June 2011); *Third Party Funding—Angels or Dragons*, 3 Global Arb. Rev. (2008), *available at* http://www.globalarbitrationreview.com/journal/article/15963/third-party-funding-angels-dragons (describing creation of first fund in Germany by FORIS AG in 1998 and entry into the German market of Allianz in 2002). In the United Kingdom, an active market for TPF of commercial disputes has existed since about 2007. *See Third Party Funding—Case notes on third-party funding*, note 4 *supra* (note on England and Wales). In Switzerland, draft legislation by the Zurich Cantonal Council in 2003 seeking to prohibit TPF was struck down by the Federal Supreme Court on 10 December 2004. *See Third Party Funding—Case notes on third-party funding*, note 4 *supra* (note regarding Switzerland, prepared by N. Radjai). France has recently seen the recent launch of La Française AM International Claims Collection, a funder associated with a substantial French asset management group. Omni Bridgeway has also advertised a presence in France. Nonetheless, the actual funding of litigations or arbitrations in France appears to remain somewhat limited. One report observes that private capital funding of disputes is neither expressly permitted nor customary in France. Freshfields Bruckhaus Deringer, *Class Actions and Third Party Funding of Litigation—An Analysis Across Europe*, note 4 *supra*. For a discussion of the situation in Spain, where funding appears to be limited, but not non-existent, *see* C. Hendel, *Third Party Funding*, 9 Spain Arb. Rev. 67 (2010) (offering a helpful overview of TPF and discussion of practices in the Spanish market). For discussion of a number of additional European jurisdictions, *see* Freshfields Bruckhaus Deringer, *Class Actions and Third Party Funding of Litigation—An Analysis Across Europe*, note 4 *supra*.

6. *See* Seidel, *Investing in International Arbitration Claims*, note 4 *supra*. In addition to dedicated funders, banks, hedge funds, insurance companies and wealthy individuals have been known to finance claims on a one-off basis. *Id.* Some examples of funders are: La Française AM International Claims Collection (a French funder, formerly known as UFG International Claims Collection); Calunius Litigation Risk Fund LP (a private Guernsey fund with approximately £40 million in capital); Burford Capital Ltd. (an AIM-listed fund, which is the largest funder in the world with approximately US$310 million in capital); Juridica Investments Ltd. (also an AIM-listed fund, and the second largest in the world, with US$210 million in capital); IMF Australia Ltd. (a listed Australian fund, with approximately AUD 87 million in assets); Harbour Litigation Funding Ltd. (a UK fund which reportedly raised £60 million in funding in 2010); Arca Capital Ltd. (Arca is a private equity group active in Central and Eastern Europe); Omni Bridgeway (based in the Netherlands); Juris Capital (based in the United States); Woodsford Litigation Funding (a UK fund); Therium Capital Management Limited (a UK fund); and Vannin Capital (Isle of Man). In late 2011, Allianz Litigation Funding, which had been active in Germany, Austria and Switzerland, exited the claimant-oriented funding business. In addition to funders, certain firms provide brokerage services, matching parties in need of TPF with sources of funding. One well known broker is The Judge (based in the UK). Among the newest funds are: Fullbrook Management, LLC (which is now in the process of forming what its founder, S. Seidel, the co-founder and former Chairman of the Burford Group, describes as a "serious fund" interested in investing in cases with a potential recovery of $25 million or more based upon investments of $1 million to $10 million); BlackRobeCapital Partners LLC; and Bentham Capital LLC. *See Funds Spring Up to Invest in High-Stakes Litigation*, Wall Street Journal, 3 October 2011. Based upon reports of arbitrations involving funders and publicly available information, it appears that most of the foregoing funds are either interested in or have been directly involved in the funding of international arbitrations.

7. Market participants cite a shortfall of capital supply relative to demand. Demand is perceived to be great based in part upon the size of the commercial litigation market. *See, e.g.*, *Funds Spring Up to Invest in High-Stakes Litigation*, note 6 *supra* (referring to spending of about US$15.5 billion during 2011 on U.S. commercial litigation alone).

8. One recent example of such fusion is seen in the acquisition by Burford Group (a leading funder) of the U.K. after-the-event insurer FirstAssist in December 2011. *The Lawyer* reports that the insurer was acquired for $11.5 million net of cash. K. Dowell, *Litigation funder Burford hires Time Inc. associate GC*, The Lawyer, 31 July 2012.

9. *See, e.g.,* Cremades, *Third Party Litigation Funding: Investing In Arbitration*, 8 TDM (October 2011) (distinguishing assignment, after-the-event legal expense insurance and contingent fee agreements).

10. This voluntary Code, applicable to the funding of disputes *within* England and Wales, was prepared by a number of major funders based in England and Wales. The Code was launched pursuant to Lord Justice Jackson's recommendation that industry participants seek to develop such a voluntary normative framework. In particular, Lord Justice Jackson highlighted three particular areas of concern that should be addressed: (1) proper provisions for capital adequacy; (2) restrictions on ability of the funder to terminate the funding mid-stream in the absence of acceptable reasons; and (3) restrictions as to ability of the funder to influence

the litigation funded. Lord Justice Jackson, *Third Party Funding or Litigation Funding*, Sixth Lecture by Lord Justice Jackson in the Civil Litigation Costs Review Implementation Programme, Delivered at the Royal Courts of Justice (23 November 2011) ("Jackson Report"). Upon the recent release of the Code, Lord Justice Jackson made favorable comments, anticipating "that solicitors will be advising their clients only to enter funding agreements with litigation funders who sign up to the code and comply with its provisions." Alison Ross, *New era for third-party funding in the UK—and beyond?*, Global Arb. Rev. (23 Nov. 20110 published online accessed Dec. 20: http://www.globalarbitrationreview.com/b/29983/. It is not clear whether funders adhering to this Code would adhere to the same principles in connection with the funding of disputes outside England and Wales.

11. England and Wales TPF Code, Article 2. This claimant-oriented definition of TPF tracks the definition adopted in the Jackson Report, which also referred to the payout of proceeds "of any amounts recovered as a consequence of the litigation." Jackson Report, note 10 *supra* (definitions).

12. *See, e.g. Investment In Commercial Claims* in Fulbrook Management Nutshell Primer, note 5 *supra*, at 11; Addelshaw Goddard, *Litigation funding—Understanding the Strategies and Attitudes of Corporate UK*, online publication, available at http://www.fundingcontrol.co.uk/ipsosmori.htm at 12 (October 2008) (reporting results of a survey and indicating funding typically for a three-to-one return on costs or for an interest of twenty-five percent to forty percent of amounts recovered).

13. *Id.*; *Third Party Funding—Angels or Dragons*, note 5 *supra* (Allianz reporting typically taking a twenty-percent to thirty-percent interest in the claim funded, with the possibility of lower rates for claims considered to have a high probability of success and higher percentages associated with claims expected to be costly to prosecute); Kantor, *Third-Party Funding in International Arbitration*, note 3 *supra*, at 68-70 (describing policies and expected returns at a number of funds, including Juridica Investments, Juris Capital, Credit Suisse and Burford Capital).

14. *See, e.g.*, *Litigation Funding*, 2 The Hedge Fund Law Report No. 25 (2009) (the CEO of Juridica Capital Management reported: "We're pretty selective. If we like a case and it meets our parameters, then we'll go outside and get a third law firm to rip the case apart and find the flaws. We're not afraid to walk away if we find problems.").

15. On the other hand, one leading funder has described enforceability concerns against sovereigns as near the bottom of his list of risk factors relevant to valuation.

16. *See, e.g.*, *Investment In Commercial Claims* in Fulbrook Management Nutshell Primer, note 5 *supra*, at 15-19. The CEO of Juridica Capital Management, a major funder, has noted that his firm "has a very deep due diligence process that takes into account the substantive merits of the lawsuit, the nature of the claim and the magnitude of potential damages, as well as risk factors beyond the substantive legal merits, such as the ability to collect, the potential for appeals and political influence." *Litigation Funding*, note 14 *supra*.

17. *See* IMF (Australia) Ltd., *Combined Financial Services Guide and Product Disclosure Statement* (18 January 2010).

18. The author is aware of provisions requiring the party seeking funding to commit to a substantial minimum fee as a condition precedent to entering into more advanced stages of diligence.

19. *See, e.g. Investment In Commercial Claims* in Fulbrook Management Nutshell Primer, note 5 *supra*, at 15-19; 5 April 2011 presentation by Therium Capital Management Limited14; Hendel, *Third-Party Funding*, note 4 *supra*, at 77 (describing anecdotal evidence of 2-3 month diligence processes and related expense of approximately US$100,000). Indeed, many funders work with panels of legal advisors to provide necessary expertise to assess claims in particular jurisdictions or dispute contexts (*e.g.,* for treaty arbitration claims).

20. *See* A. Charlton (FTI Consulting), *Kicking (all) the Tyres*, Kluwer Arbitration Blog (2 December 2010) (referring to anecdotal evidence of factual and economic diligence, including relating to quantum/valuation issues, involving investments of between US$100,000 and US$1 million by funders).

21. A number of funders have already established preferred panels of advisors, including some well known arbitration practices.

22. In jurisdictions in which "control" raises issues of public policy, attempts to designate counsel may be less common.

23. *See, e.g., Litigation Funding*, note 14 *supra* (interviewing representatives of the Juridica and Juris funds, which reported efforts to avoid receiving privileged communications from counsel in connection with due diligence or otherwise).

24. England and Wales TPF Code, Article 7(c).

25. An interesting example of this problem is seen in recently revealed documents produced in litigation related to a lawsuit formerly funded by Burford Group, one of the world's largest funders. An exhibit filed in the litigation was a presentation by Burford Group described as requiring that the plaintiffs obtain the consent of Burford Group to settle for less than $900 million or, in the event of a lower amount of settlement in the absence of consent, pay out to Burford Group as if the matter had been settled for $900 million. This proposed arrangement was later superseded by terms that appeared even more favorable to Burford Group in the event of any unauthorized settlement. *See* V. Li, *Burford Didn't Want Chevron Plaintiffs To Settle for Less than $900 Million, According to Internal Report*, The AmLaw Litigation Daily, 31 July 2012.

26. *See, e.g.*, Seidel, *Control*, Commercial Dispute Resolution at 61-63; BlackRobe Capital press release dated 3 October 2011 ("BlackRobe is pioneering the application of private equity principles to investments in legal claims . . .").

27. Attrill, note 4 *supra* (discussing extensive control rights upheld by Australia's High Court in the *Fostif* decision).

28. Some jurisdictions have limited the application of these doctrines to proceedings either before their own domestic courts or international arbitration proceedings taking place in the same territory. *See, e.g.*, M. Willems, *Third Party Funding—A paper for the Society of Construction Arbitrators*, Howrey LLP (October 2009), noting that "since *Bevan Ashford v Geoff Yeandle* [1998] 3 WLR 172 it has been clear that champerty does extend to arbitration," but noting further that "the common law has never had any difficulty with accepting that these principles do not apply to litigation or arbitration abroad, as English public policy is not applied extraterritorially," citing *Mansell v Robinson* [2007] EWHC 101 (QB) (in the author's understanding of English law, it would be unlikely for an English court to extend public policies related to champerty and maintenance to an international arbitration proceeding seated in England, except under egregious circumstances that would clearly offend local public policies). *See also* Ng, *The Role of the Doctrines of Champerty and Maintenance in Arbitration*, 76 Arbitration 208 (2010) (contrasting Hong Kong, where champerty has not been extended to arbitration proceedings, to Singapore, where it has been so extended). A similar example is seen in relation to the treatment of contingency legal fees in certain jurisdictions. While pure results-based contingency fee agreements (a form of TPF provided by lawyers themselves) are generally impermissible under French rules of legal ethics, certain influential French commentators have suggested that such agreements may be less restricted in relation to international arbitrations. *See* Pinsolle, *Le financement de l'arbitrage par les tiers*, 2 Revue de l'arbitrage 385, 396 (2011).

29. R. Mohtashami, *Third party funding: emerging ethical problems*, Delivered at IBA Annual Conference, Dubai (31 October 2011), slide 7 (describing Germany as a jurisdiction where a third-party funder "may take charge of the full rights of the claim").

30. *See* England and Wales TPF Code, Art. 2 (requiring immediate access to funds) and 9(b) (requiring that the funding agreement state whether [and, if so, how] the relationship may be terminated in the event that the funder "(i) reasonably ceases to be satisfied about the merits of the dispute; (ii) reasonably believes that the dispute is no longer commercially viable; or (iii) reasonably believes that there has been a material breach of the LFA by the Litigant"). Article 10 of the Code further provides that "The LFA shall not establish a discretionary right for a Funder to terminate a LFA in the absence of the circumstances described in clause 9(b)." The Jackson Report found that "the funder should be obliged to continue to provide whatever funding it originally contracted to provide unless there are proper grounds to withdraw."

31. England and Wales TPF Code, Article 9(b).

32. Whether this federal statute may be relied upon in connection with an arbitration proceeding seated in the United States is an unsettled question. *See* G. Born, 2 International Commercial Arbitration 1936 (2009) (noting that, while the statute speaks of "foreign or international tribunals," certain awards made in the United States will not be considered to be "domestic" awards for purposes of the New York Convention, raising the possibility that assistance under 28 U.S.C. Section 1782 may be available in connection with such proceedings). Based on recent precedents, United States courts increasingly have been willing to apply Section 1782 to international arbitration. *See* text of Part II *infra*. However, the trend is not without exceptions. *See* Beckett, Glasser, Suskin, *District Court Rejects Use of Section 1782 in Aid of ICC Arbitration*, 26 Maeley's Int'l Arb. Rep. 33 (September 2011).

33. *See Consorcio Ecuatoriano de Telecomunicaciones S.A. v. JAS Forwarding (USA), Inc.*, No. 11–12897, 2012 WL 2369166, at *1 (11th Cir. 25 June 2012).

34. New York City Bar Association—*Formal Opinion 2011-02*, note 4 *supra*, at 5. *See also* Philadelphia Bar Association Ethics Opinion 99-8 (February 2000) (noting in relation to discussions between a lawyer and TPF: "The importance of consultation with the client about the possible risk of loss of not only client confidentiality but also of the attorney-client privilege as a result of supplying assessment-type information to the potential lender cannot be underestimated."). Other bar associations have also sounded notes of caution over the question of privilege in the TPF context. A helpful overview and analysis of privilege problems under United States federal law and California law in relation to TPF is found in E. Weiner, *Price and Privilege*, Los Angeles Lawyer (April 2012), *available at* http://www.lacba.org/Files/LAL/Vol35No2/2913.pdf.

35. Commission On Ethics 20/20, *White Paper on Alternative Litigation Finance*, note 4 *supra*, at 35-38.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* Drawing an analogy to the treatment of liability insurers by certain courts as "privileged persons," arguments could also be made that the TPF provider should be analyzed as a privileged person for the purpose of the attorney-client privilege, along with attorney and client. *See* Commission On Ethics 20/20, *White Paper on Alternative Litigation Finance*, note 4 *supra*, at 35. However, like the status of the "common interest" exception, such arguments are untested in the context of TPF and therefore subject to uncertainty.

40. *See Leader Technologies, Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373 (D. Del. 2010); *Abrams v. First Tennessee Bank National Association*, No. 3:03-cv-428, 2007 WL 320966, at *1 (E.D. Tenn.) (30 Jan. 2007).

41. *See, e.g.*, Warren, *Preserving Attorney-Client Privilege: How Companies Maintain Confidentiality of Documents and Communications When Using a Third-Party Litigation Funder*, Directorship (published in online version on 9 March 2011). For an opposing viewpoint, *see* Frischknecht and Schmidt, *Privilege and Confidentiality in Third Party Funder Due Diligence,* 8 TDM 8 (No. 4: October 2011) (concluding that the joint-interest privilege likely would not be upheld in connection with information shared with a funder).

42. Technically, this doctrine is not a rule of "privilege," but instead a procedural doctrine offering qualified protection from discovery in support of the litigation system.

43. Commission On Ethics 20/20, *White Paper on Alternative Litigation Finance*, note 4 *supra*, at 37. Work product is divided into two general forms. "Opinion work product" includes legal interpretations and thought processes and receives the highest degree of protection. "Ordinary work product," which receives a lower degree of protection, includes all materials that do not contain "opinion work product," *i.e.,* materials not containing an attorney's opinions, conclusions, interpretations or impressions, but instead things like data collected as part of litigation effort.

44. *Id.* For the avoidance of confusion, the common interest doctrine has also been applied to work product protection, allowing the sharing of work product between parties who share the same interest in a matter (such as a common adversary). *See, e.g.*, Restatement (Third) of the Law Governing Lawyers §91, comment b; *Mainstreet Collection, Inc. v. Kirkland's, Inc.*, 270 F.R.D. 238 (E.D.N.C. 2010). Some courts have found that disclosure of work product to a non-party, even when in furtherance of a shared interest in relation to a pending litigation, waives work product protection. *See, e.g., Marciano v. Atlantic Medical Specialties, Inc.*, No. 08-CV-305-JTC, 2011 WL 294487 (W.D.N.Y. 27 Jan. 2011) (finding a waiver of work product protection on grounds that: The common interest doctrine does not "encompass a joint business strategy which happens to include as one of its elements a concern about litigation") (quoting *Bank Brussels Lambert v. Credit Lyonnais (Suisse) S.A.*, 160 F.R.D 437, 447 (S.D.N.Y. 1995)).

45. The work product doctrine may offer the greatest hope for security from compelled production of materials provided to a TPF provider. The main reasons for this are that the work-product doctrine applies specifically in the context of litigious disputes and that the standard for when a disclosure amounts to a waiver is less stringent than under the attorney-client privilege. Furthermore, courts generally limit any waiver of the work product protection to the documents actually disclosed, meaning the risk of an all-encompassing subject-matter waiver is lower than with the attorney-client privilege. Thus, this doctrine is likely to become a fertile battleground.

46. *Mondis Technology Ltd. v. LG Electronics, Inc.*, Nos. 2:070CV-565-TJW-CE, 2:08-CV-478-TJW, 2011 WL 1714304 (E.D. Tex. 4 May 2011). *See also* Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, note 2 *supra*, at 605 ("It seems likely that courts will ultimately find that communications with third-party litigation lenders are protected by the work product rule, but not by attorney-client privilege.").

47. *Id.*

48. *See, e.g., Marciano*, note 44 *supra*, 2011 WL 294487. While the formal analysis for waiver of the attorney-client and work product privileges are distinct in theory, courts often blur the boundaries and find work product waivers where the conditions required for the common interest doctrine have not been satisfied, *i.e.,* where work product is shared by a party that does not have an identical legal interest. A good example of such blurring is seen in one of the few cases to have considered objections based upon claims of legal privilege in relation to requests for the production of information provided by a litigant to a TPF funder, *Leader Technologies*, note 40 *supra*, 719 F. Supp. 2d at 375-76. In that case, the district court rejected objections to production based upon both the attorney-client and work product doctrine based upon an analysis that discussed only the attorney-client privilege. While certain commentators have noted that such a decision may be of questionable precedential value due to the ambiguous nature of its reasoning, *see* Frischknecht and Schmidt, note 41 *supra*, 8 TDM at 11, the same authors observe, correctly in the author's view, that

such decisional practices (which are not uncommon) highlight the real risks of disclosure in this area. It is worth pointing out that an additional impediment to the claims of privilege in the *Leader Technologies* case was the fact that the litigant who made the disclosure and funder who received it never entered into a funding relationship. It will be interesting to follow case law as it evolves on this issue to see whether other courts also exclude privilege where the funding relationship is inchoate in nature. Such developments will be of particular interest and relevance because documents provided to potential funders early in a relationship may contain some of the most (potentially) interesting material that opposing parties will fight the hardest to obtain (and that disclosing litigants will fight the hardest to withhold).

49. For more detailed discussion of these factors, *see* Draetta, *Short Practical Notes on Security for Costs in Arbitration*, 2011-1 Les cahiers d'arbitrage 77 (2011). As Professor Draetta notes, a threshold question for any application is whether the tribunal has the legal authority to grant such relief. A division of opinion exists over the question of whether such authority is inherent or must be specifically conferred upon the tribunal, for instance, by operation of national laws, arbitral rules or the agreement of the parties. Professor Draetta reviews various provisions under major arbitral institutional rules related to security, noting that among leading rules, the Rules of Arbitration of the London Court of International arbitration are one of the few that explicitly recognize the power to grant security for costs. As Redfern and Hunter note, "This is a somewhat special form of interim measure of relief, since…the tribunal must weigh the cost to a respondent of defending a claim, with the possibility of not recovering those costs even if successful, against the risk of stifling a genuine claim by a claimant who is short of funds, possibly because of the conduct of the respondent which is the reason for the arbitration." *See* Redfern and Hunter on International Arbitration §5.31 (5th ed.). Such relief may be sought by a respondent against a claimant or by a claimant against the respondent-counterclaimant. Security for costs is generally more difficult to obtain outside of England and some common law jurisdictions. In other jurisdictions, tribunals may fear that the award of security for costs could unduly interfere with the parties' right to be heard. *See* G. Born, 2 International Commercial Arbitration, note 32 *supra*, at 2005.

50. *See, e.g.* Pinsolle, note 28 *supra*, 2 Revue de l'arbitrage at 400-01 (2011) (analyzing the possibility of an extension under French law and concluding that it is doubtful, absent unusual circumstances, that the funder's interest in the litigation, as opposed to involvement in the negotiation or performance of the contract giving rise to arbitration, would be sufficient to treat the funder as a party to the arbitration clause).

51. *See generally*, Cohen, *Indépendence des arbitres et conflits d'intérêts*, 3 Revue de l'arbitrage 611 (2011). For a discussion of the standards applied by one leading arbitral institution, the LCIA, in deciding arbitral challenges, *see* Walsh and Teitelbaum, *The LCIA Court Decisions on Challenges to Arbitrators: An Introduction*, 27 Arb. Int'l 283 (2011). In LCIA practice, arbitral independence is assessed on an objective basis; by contrast, impartiality is assessed subjectively for the presence of bias. Both have been assessed by Divisions of the LCIA Court on the basis of "whether the fair-minded and informed observer, having considered the facts, would conclude that there [i]s a real possibility that an arbitrator appears to be dependent on a party or is partial to a party." *Id.* (internal citations and quotation marks omitted). The IBA Guidelines on Conflicts of Interest in International Arbitration ("IBA Conflicts Guidelines"), which are widely applied in international arbitration, also speak of "independence and impartiality." *See* International Bar Association, *The IBA Guidelines on Conflicts of Interest in International Arbitration*, General Principle 1 (2004) ("Every arbitrator shall be impartial and independent of the parties at the time of accepting an appointment to serve and shall remain so during the entire arbitration proceeding until the final award has been rendered or the proceeding has otherwise finally terminated."). For further general discussion of independence and impartiality obligations under numerous sources of law and normative guidelines, including national curial laws and institutional rules, *see* G. Born, 1 International Commercial Arbitration, note 32 *supra*, Chapter 11.E.

52. The IBA Conflicts Guidelines deal with these various relationships (and others) in a specific fashion, depending upon the nature and depth of the relevant links, treating some as triggering disclosure obligations and others as rising to the level of non-waivable conflicts.

53. If such ties were found to provide a valid basis for challenge, due diligence obligations upon arbitrators would likely increase in tandem. In particular, some diligence in identifying information warranting disclosure is often expected of arbitrators. Indeed, it is common practice to consider the arbitrator's failure to disclose information that arguably should have been disclosed as a circumstance that may support a challenge. *See, e.g.*, Walsh & Teitelbaum, *The LCIA Court Decisions on Challenges to Arbitrators: An Introduction*, note 51 *supra*, 27 Arb. Int'l at 289 (describing LCIA practices in this respect: "The failure by an arbitrator to disclose circumstances likely to give rise to any justifiable doubts as to his impartiality or independence is not likely to be a sufficient ground to sustain an arbitrator challenge. However, such a failure may be considered by the LCIA Court as one of a number of factors that in the aggregate may be sufficient to warrant the removal of an arbitrator." (internal quotation marks omitted)).

54. The distinguished arbitrator, Professor Albert Jan van den Berg, expressed the view that it is important to avoid conflicts between arbitrators (and their firms) and a funder behind a party appearing before the arbitrator. According to Professor van den Berg, the "surest" solution would be to always require disclosure by the parties of their funding. This solution, however, was seen as difficult to justify legally. A second option, according to Professor van den Berg, would be the "reverse conflict check," in which the arbitrator discloses ties to the parties. Such an approach would, as noted above, generate significant burdens for arbitrators. A final solution, according to Professor van den Berg, would be to require the funded party to ensure during the course of the proceeding that no conflict exists. The difficulty of such an approach would of course be policing. *See* Perry, *Third-Party Funding: An Arbitrator's Perspective*, Global Arb. Rev. (http://www.globalarbitrationreview.com/b/29981) (23 November 2011).

55. For the case in favor of institutional involvement, *see* Bertrand, *The Brave New World of Arbitration: Third-Party Funding*, 29 ASA Bull. 607, 615 (2011).

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Commentary: The Rise of an Asian Monetary Fund?

By Narun Popattanachai

I. Introduction

While the rest of the world was severely hit by the global financial crisis in 2007 and 2008 and has continued to suffer from its aftershock, Asia remained and continues to remain largely unaffected by what has gone on elsewhere. Consequently, its major cities, particularly Shanghai, Hong Kong and Singapore, are set to overtake New York and London as the premiere world financial centers, owing to more favorable tax regimes, industry-friendly regulation, and sustained economic growth.

This apparent shift in economic power between developed and emerging economies has caused the Western leaders to call for the international community to correct "global imbalance." That is generally understood to mean that big emerging economies, such as China, India and Indonesia, should share more of the burden and make a larger contribution toward global economic recovery.[1] While these Asian countries agree with the existence of a global imbalance, they are of the view that their current representation and power on the world stage understate their growing economic and financial muscle.

The difference in perception between the two camps translates into a discrepancy in post-crisis regulatory reform agendas. While Euro-American policymakers are focusing on overhauling the regulation of financial markets, at the same time emerging economic blocs, particularly East Asia, are concentrating on laying down the foundation for a more united regional economy, independent from foreign meddling both in boom times and during crises. One major development in 2012 was the direct currency exchange agreement between China and Japan. Direct yuan-yen trades on the inter-bank foreign exchange markets will reduce not only their dependency on U.S. dollar risk but, more importantly, U.S. monetary authorities' influence on the Asian economy.[2] China is currently pursuing a similar policy with other neighboring countries, such as Thailand.

However, the most important financial cooperation in Asia in the past decade is arguably the Chiang Mai Initiative Multilateralisation (CMIM). CMIM represents the multilateral swap facility agreed upon among members of the Association of Southeast Asian Nations (ASEAN) and their three affiliated East Asian nations, namely, China, Japan and South Korea.[3] Many view CMIM as a prototype for an Asian Monetary Fund (AMF), necessary to counterbalance the influence of the IMF. This line of thought stems from deep frustration over the latter's destructive handling of the Asian economic crisis in 1997 and 1998.[4] While the idea of having an independent regional monetary authority is not unrealistic, it has been argued that CMIM, as it currently exists, will not be able to fulfill such a prophecy. Moreover, rather than creating a regional body to compete with the IMF, East Asian nations are better off with an organization possessing a more flexible structure and tasked to assume the role of being the coordinating anchor in pre-empting future crises. The proposed setting has already been implemented by the European Bank of Reconstruction and Development (EBRD) under the Vienna Initiative.

II. What Is the Chiang Mai Initiative Multilateralisation (CMIM)?

A. Background

The Chiang Mai Initiative Multilateralisation (CMIM) was initially established to be merely a series of bilateral swap arrangements "to supplement the existing international facilities."[5] In other words, East Asian nations hoped that the Initiative would supplement the IMF. Even though it was established as a direct response to the Asian financial crisis in the late 1990s, the underlying importance of CMIM was once again highlighted by the recent financial meltdown and the European sovereign debt crisis. CMIM is supported by an independent macrosurveillance unit, ASEAN+3 Macroeconomic Research Office (AMRO), responsible for identifying region-wide and country-specific vulnerabilities.[6] Furthermore, AMRO assumes the role of providing an objective assessment of a swap-requesting country and a recommendation to CMIM parties.

The CMIM demonstrates East Asia's resolution to prevent a repeat of the 1997 economic collapse by giving the more vulnerable economies in the region a safety net against unexpected liquidity shortfalls, thereby reducing the contagion risk. However, the recent financial crisis had also exposed the gross inadequacy of the size of the pool available to the members. After serious doubts were raised about the ability of the South Korean and Singaporean economies to withstand the global systemic shock,[7] both countries sought liquidity guarantee from the U.S. Federal Reserve as opposed to relying on the CMIM. Even though the ASEAN+3 nations agreed to increase the CMIM's pool to $240 billion in 2012, the amount is unlikely to be sufficient if bigger members or several small nations apply for assistance at the same time.

B. Governance

At present, the CMIM has no governance structure worthy of a fully established regional monetary agency. The decision-making framework consists of political and technocratic forums. The former allows the ASEAN+3 finance ministers to make fundamental decisions regard-

ing the total size of CMIM and contribution of respective member states on consensus. The latter, populated by representatives of central banks and relevant regulatory authorities, makes executive decisions, such as the granting of drawing requests and renewal of drawing on the basis of a two-thirds majority.[8] Furthermore, the ASEAN+3 nations co-founded the AMRO primarily as an independent research office responsible for keeping the CMIM decision-making apparatus informed about the current state of financial and economic well-being of the region.[9] This system, while appropriate for the region where financial cooperation is still in its fledging stage,[10] does not represent real progress towards establishing the AMF.

III. Crisis Management

East Asian countries are eager to put in place a regional system that can ameliorate extreme economic cycles and effectively preempt the contagious effect of the crisis. However, to replicate the IMF's crisis management policy may not be the best idea. The IMF has long pursued its one-size-fits-all structural assistance program to any members that are facing severe liquidity shortfall or insolvency crisis. Such a policy has proved to be fruitless in the past, as demonstrated by the Asian economic crisis of the 1990s. The IMF policy in 1990s is almost the perfect case of an international crisis being unsuccessfully handled by a country-specific approach.[11]

The region started to show the first glimpse of structural weakness in January 1997, when Hanbo Steel, the gigantic Korean industrial conglomerate, collapsed after amassing $6 billion in debt. Yet the IMF decided against intervention until July 1997, when Thailand's local currency, the baht, crumbled under speculative attacks by foreign currency traders. By then, isolated shocks had already become highly contagious. Instead of changing its tactics, the IMF persisted in its assistance policy of providing multibillion support packages to Indonesia in October 1997 and South Korea in December. Not only did such country-focused strategy contribute nothing to reclaim market confidence in the region, but also it was widely blamed for subsequent protests and social unrests in all of these financially stricken countries.[12] With hindsight, many commentators put the IMF's relentless pursuit of its rigid supporting package down as another major culprit for the largely ineffective rescue plan.[13]

IV. The Anchor-Tenant Model—An Example of the Vienna Initiative

Having demonstrated the weaknesses of the IMF's assistance program, this commentary proposes an alternative model that has already proved hugely successful among Central and Eastern European countries (CEE), namely, the anchor-tenant model.

During the Eastern European liquidity crisis, literally no single transnational organization was willing to guarantee credit supply to the CEE's banking entities after all Western European parent banks redirected their capital to protect their core units in response to the financial crisis. Severe liquidity shortages in the private sector could have metamorphosed into insolvency and subsequently a full-blown economic crisis, had the EBRD not stepped in. Unlike the IMF's strategy in East Asia a decade earlier, the EBRD treated the task as a regional crisis from the very beginning and was thus able to mediate a series of negotiations between home and host countries, international financial organizations, and private sector stakeholders. In other words, the EBRD acted as "anchor-tenant" for the CEE bloc.

This series of dialogues eventually yielded strong concerted commitments from all sides to ensure adequate financial support to banking institutions throughout the region.[14] The EBRD greatly benefited from local knowledge and the trusting relationship it has long cultivated with national governments as well as the private sector.[15] Both factors were not enjoyed by the IMF during the Asian crisis.

The Vienna Initiative should provide interesting food for thought to Asian policymakers. An obvious solution is to turn AMRO from a research office into a coordinating headquarters of the CMIM. It can further be tasked to liaise with regional banking and financial institutions as well as relevant government authorities in order to help prevent any liquidity problem from developing into a solvency crisis or economic meltdown. Additionally, all decisionmaking processes can be subsumed under its auspices. However, rather than acting unilaterally, AMRO should become a facilitator that helps balance often polarized interests of both lending and borrowing nations. This approach will allow decisions to be reached with real consensus in a timely manner.

V. New Approach Towards Harmonization of Financial Regulation in ASEAN

Related to the new monetary regime discussed above is the issue of harmonization of financial regulation. Currently, the international community has received no guidelines to assist the countries which are planning to pursue regulatory convergence via mutual recognition. This could potentially result in so-called "regulatory arbitrage," since only countries with similar financial development would agree to mutually recognize each other's authority. On the other hand, the EU adopted the maximum harmonization policy, forcing member states to uniformly implement EU financial law under a strict timetable. But such a policy could potentially be viewed as insensitive to the fact that the affected countries are at different levels of financial development.

This is where ASEAN's approach can be a role model for other regions and for the international community as well. ASEAN members are mindful of the fact that they

are at an extremely variable degree of economic development and financial sophistication.[16] Furthermore, unlike the European Union, ASEAN was founded upon a much weaker institutionalized framework, without central rulemaking or judicial and administrative institutions. As a result, the ASEAN Capital Markets Forum (ACMF) takes a phased approach towards mutual recognition. In other words, ASEAN's mutual recognition initiatives are implemented bilaterally—first among the more advanced economies of the region (Malaysia, Singapore and Thailand) and multilaterally as other countries are ready to join in.[17] As a prerequisite for integration, the less developed jurisdictions are encouraged to raise their regulatory regime up to the regionally recognized standards.[18] The pragmatic approach of ASEAN, standing in sharp contrast with the EU's insistence on maximum harmonization, offers fresh food for thought for the international community.

VI. Conclusion

Asia has experienced the latest financial crisis differently from the Western developed world. Rather than enduring a moment of panic, Asia enjoyed an opportune moment to build a regional system free and independent from foreign interference. This sentiment is manifested in the development of the CMIM. As opposed to the time of austerity, the economy of emerging Asia on average continues to expand at an impressive rate. ASEAN's harmonization of financial regulation thus epitomizes an innovative approach to constructing an integrated financial market that can compete with the rest of the world. Nevertheless, when it comes to the question of whether Asia needs its own monetary fund, the answer is less obvious. Instead of creating the Asian Monetary Fund, or "AMF," Asia should concentrate on constructing a regional system better suited to monitor its members' economic activities and deal with crises in the region. Since the CMIM will soon approach a crossroads, a wise turn would be toward an anchor-tenant model similar to the Vienna Initiative, rather than an Asian Monetary Fund.

Endnotes

1. *See, e.g.*, Drysdale, *Can Asia Help Power World Recovery?*, East Asia Forum, 8 June 2012, available at <http://www.eastasiaforum.org/2012/06/18/can-asia-help-power-world-recovery/>.
2. Takahashi, *Japan, China Bypass US in Currency Trade*, Asian Times Online, 2 June 2012, available at <http://www.atimes.com/atimes/Japan/NF02Dh01.html>.
3. Collectively known as the "ASEAN+3."
4. Sohn, *East Asia's Counterweight Strategy: Asian Financial Cooperation and Evolving International Monetary Order*, United Nations Conference on Trade and Development G-24 Discussion Paper Series, *No. 44*, March 2007, at 2.
5. *The Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting*, 6 May 2000, Chiang Mai, Thailand, available at <http://www.aseansec.org/>.
6. *The Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers Meeting*, 2 May 2010, Tashkent, Uzbekistan, available at <http://www.asean.org/documents/JMS_13th_AFMM+3.pdf>.
7. This resulted in South Korea, Singapore, and eleven other countries around the world entered into bilateral swap agreements with the U.S. Federal Reserve. *See* Matthews and Sim, *Fed Opens Swaps With South Korea, Brazil, and Mexico*, Bloomberg, 30 October 2008, available at <www.bloomberg.com/apps/news?pid=newsarchive&sid=aViXCrX8Ikms>.
8. *Joint Ministerial Statement*, note 5 *supra*, Annex 1.
9. *Joint Ministerial Statement*, note 5 *supra*, Paragraph 9.
10. Winkler, *The Financial Crisis: A Wake-Up Call for Strengthening Regional Monitoring of Financial Markets and Regional Coordination of Financial Sector Policies?*, ADBI Working Paper Series, No.199, February 2010, at 28 (observing that the lack of financial integration in Asia can be partly attributed to the skeptical attitude of the major regional players toward capital liberalisation).
11. Beeson and Rosser, *The East Asian Economic Crisis: a brief overview of the facts, issues and the future*, Murdoch University Working Paper Series No. 86, June 1998, at 1-2 (where the authors neatly summarised how the events chronologically unfolded).
12. Lowenfeld, *The International Monetary System: A Look Back Over Seven Decades*, Journal of International Economic Law 575, at 594-95 (2010); Sohn, note 4 *supra*, at 2.
13. Hagan, *Reforming the IMF*, in M. Giovanoli and D. Devos (eds), Int'l Monetary and Financial Law at 2.46 (2011). *See also* J. Stiglitz, Globalization and its Discontent (2002).
14. Pistor, *Governing Interdependent Financial Systems: Lessons from the Vienna Initiative*, J. of Globalization and Development at 13 (Issue 2: 2011).
15. See <http://www.ebrd.com/pages/about/what.shtml>.
16. ASEAN's most prosperous and highly developed nation is Singapore (per capita income of $59,900; market value of publicly traded shares of $569 billion) while Myanmar is a closed economy still more or less managed by a military junta (per capita income of $1,300; no recognized national stock exchange). Data from the CIA factbook, available at < https://www.cia.gov/library/publications/the-world-factbook/>.
17. ASEAN Capital Markets Forum, Implementation Plan Endorsed at the 13th ASEAN Finance Ministers Meeting, 9 April 2009, at 9, available at <http://www.theacmf.org/ACMF/report/ImplementationPlan.pdf>.
18. Verdier, *Mutual Recognition in International Finance*, 52 Harvard Int'l L.J., at 106.

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A Portuguese Overview of Stolen Masters: The Sale of Stolen and Plundered Art

By António Sampaio Caramelo

I. Introduction: The Fact Pattern

Set forth below is the hypothetical fact pattern on which this article's legal analysis is based:

> *The Museum of Modern Stuff in New York ("MoStuff") engaged a nefarious New York dealer to bid for it on two paintings, one by Ernst Ludwig Kirchner and one attributed to Max Ernst, being auctioned by Kristibies in Lisbon in 1965 from the estate of a Lisbon collector, Paolo Oliveira. At the auction MoStuff was the successful bidder and purchaser of both works.*
>
> *In the late 1930s the Vienna art collector Heinrich Schauinsland had purchased both paintings from an art dealer in Berlin, Germany. In 2012 it appeared that the Kirchner painting had been plundered by the National Socialist Government in Berlin, where the painting was on exhibition. Schauinsland was subsequently forced to leave Vienna and ended up fleeing to Lisbon. In 1944 Schauinsland decided to leave Lisbon and go to New York. To pay for the voyage to New York, Schauinsland sold the painting attributed to Max Ernst to Paolo Oliveira in Lisbon. Oliveira bought the Kirchner painting from a dealer working with the German government. After Oliveira's death, Oliveira's heirs engaged Kristibies to carry out the 1965 auction sale of both paintings.*
>
> *The Max Ernst painting now appears to be a forgery. Schauinsland's heirs intend to sue MoStuff for the return of the Kirchner. MoStuff wants to sue Kristibies for repayment of the purchase price of the Max Ernst forgery.*
>
> *What are the rights and remedies of the parties if either case is brought in Portugal?*

II. Assessing the Merits of the Claims

A. Conflict of Laws

Portuguese law might come into play as applied by the court adjudicating the claims, if the rules of the conflict of laws which that court must apply would select Portuguese law as the law governing the dispute.

Such a court might be a Portuguese court, which might well conclude, in accordance with Portuguese conflicts rules, that the dispute should be governed by substantive Portuguese law. On the other hand, a court in another country might also find, pursuant to its own rules of the conflict of laws,[1] that this dispute should be decided in accordance with the substantive provisions of Portuguese law.

One should note that the Portuguese conflicts rules in force at the date when the auction sale was carried out, in Lisbon, namely, 1965, were not the same as those in force today. In fact, before a new Portuguese Civil Code, containing a comprehensive conflict of laws system, was enacted in 1966 (and entered into effect on 1 June 1967), the Portuguese system of conflict of laws consisted of a fragmented and incomplete set of rules partly based on statutory provisions and partly developed by the teachings of scholars and the jurisprudence of courts.

For instance, the issue of the possible material invalidity of the sale/purchase, notably because the seller did not have the right to sell the object (and, consequently, because of his inability to confer title to the item to the purchaser), was governed by the law of the place where the sale/purchase agreement was entered to, if the parties had not selected a specific law to govern that agreement.[2]

It is worth mentioning that the corresponding rule contained in the 1966 Civil Code led to the same conclusion.[3] However, after the entry of Portugal into the European Community, this rule was replaced by the provisions of the 1980 Rome Convention on Law Applicable to Contract Obligations, which sets forth that, absent a choice of the parties to this effect, the validity of an agreement is governed by the law of the country with which the agreement is most closely connected.

Be that as it may, the application of any of the aforesaid conflicts rules points to Portuguese law as the one which governs the material validity of the 1965 auction sale, including its possible nullity for lack of title of the seller (or lack of authorization for him to sell the object in question).

Whenever there is a succession of conflicts rules potentially applicable to an act or situation connected with several systems of law, one must determine their respective scope of application. The prevailing view among private international law scholars and in the jurisprudence of courts[4] is that conflicts rules are not, in principle, to be applied retroactively. Therefore, if there is not a statutory provision stating otherwise, the validity of an agreement is to be assessed in accordance with the rule (of conflict of laws) in force at the date when the agreement was made.

It flows from the above that, should the issue be submitted to Portuguese courts, the possible nullity of the 1965 auction sale, because of the hypothetical lack of title of the seller (Paolo Oliveira's heirs) is governed by the Portuguese conflicts rule in force at relevant date, that is, Article 4.º(1) of the 1888 Commercial Code, which set forth that such an issue is governed by the law of the country where that sale agreement was made—in this instance, Portugal—so that the provisions of 1867 Portuguese Civil Code apply to this case.

B. Substantive Legal Principles

After having determined that the validity of 1965 auction sale, whereby the Museum of Modern Stuff in New York (MoStuff) acquired the two paintings sold by Paolo Oliveira, is governed by Portuguese law, one should now answer the question raised: Were these sales/purchases valid or invalid and, in the latter case, which remedies has the buyer against the seller?

1. The Kirchner Painting

Let us consider, first, the sale of the Kirchner painting. According to the narrative in the fact pattern, Paolo Oliveira bought this painting (most probably, before 1945) from some German entity which had acquired it by means of plunder occurring some years before (affecting Shauinsland).

The sale/purchase of this painting by the German entity to Paolo Oliveira was undoubtedly null and void, pursuant to article 1555º of the 1867 Portuguese Civil Code, because the seller had no title and no legitimate right to sell this object of art. The nullity of this transaction could have been declared by the Portuguese courts, at the request of any interested party, in principle, without a time limit.

We assume that the painting in question was located in the territory of Portugal when Paolo Oliveira purchased it from the German entity. If, on the contrary, it was located in Germany at that time, the material validity of that acquisition would be assessed by Portuguese courts in accordance with German law (as the *lex rei sitae*).[5] However, in such a case, the provisions of German law applied by Portuguese courts would be those of the German Civil Code (*Bürgerliches Gesetzbuch*, or *BGB*) according to which such a sale/purchase would certainly be null and void—and not the so-called "Aryanization laws" in force at that time in Germany, which would be disregarded by the Portuguese courts because they violate the "public policy" (*ordre public*) of the Portuguese legal system.[6]

Regarding the sale of goods carried out by anyone who is not their owner or is not empowered to sell them on behalf of the owner, Portuguese law is one of the few continental European legal systems which do not provide specific protection to a good faith acquirer.[7] Under Portuguese law, a sale made by someone who is not the owner (and is not authorized by the owner to make the sale on its behalf) is null and void.[8] In such a case, the buyer must return the "bought" thing to its owner, but is entitled to claim the reimbursement of the paid price from the unlawful and unauthorized seller. Indeed, under Portuguese law, such a "buyer" does not have, in principle, a lawful claim against the *real* owner, who is entitled to the return of the goods without having to make any disbursement.[9]

However, an important concession to the goal of protecting the good faith acquirer could be found in Article 534.º of the Portuguese Civil Code of 1867, which provided that anyone who demanded the return of a movable thing of his property[10] from a *bona fide* third party who had purchased it in a market or public sale or had purchased it from a trader who traded in goods of the same or similar kind,[11] would be required to pay to the good faith purchaser the price that the latter paid for it, without prejudice to the demanding party's right of recourse against the author of the theft or against the person who had found the lost property and sold it to the *bona fide* third party purchaser.

The Civil Code of 1966 has a similar provision, Article 1301.º, with a slightly narrower scope: it covers "…*immovable things bought by a bona fide purchaser, from a trader who trades in the same or similar kind of goods*…"

Although no court decision was found on this matter, I believe that Article 534.º of the Civil Code of 1987 (and possibly also Article 1301.º of the Civil Code of 1966) may apply to the purchase by a good faith acquirer, made at an auction sale conducted by a reliable auctioneer. In this connection, see the last paragraph below of this Part II.B.1.

Despite the fact that the sale/purchase was absolutely null and void, the legal position of the acquirer, Paolo Oliveira, came to be "healed" due to *usucapio. Usucapio* (in Portuguese, "*usucapião*"), as general grounds for the acquisition of rights to property, is under Portuguese law (like under many other legal systems) the ultimate basis of the law of property (whether movable or immovable).

It unquestionable that the concept of *usucapio* in regard to the ownership of these paintings by Paolo Oliveira was governed by Portuguese law, because Portugal was the *lex situs* of the objects in question, since they were located in Portugal during the time required for the *usucapio* to become effective.[12]

Under Portuguese law, *usucapio* is a form of acquisition of title to material things as a consequence of long-lasting possession of them. This possession must be effective, public and uninterrupted to give rise to *usucapio.* The duration of time of possession required for *usucapio* to be established varies according to the nature of the possession. Naturally, possession in good faith and with good

acquisition title requires a shorter time to consolidate than possession in bad faith and without good acquisition title.

According to Article 532.º of the 1867 Civil Code, *usucapio* of movable things took place after ten years of possession by Paolo Oliveira, irrespective of good faith (of the acquirer) and of good title.[13]

Consequently, although he acquired the Kirchner painting by means of a null and void purchase, Paolo Oliveira (and, by succession, his heirs) ended up becoming the lawful owner of that painting, because he held it peacefully as the owner for more than twenty years. Since he had, in 1965, lawful title on that painting, his heirs could later lawfully sell and confer valid title on it to MoStuff.

If, before Paolo Oliveira could acquire that painting by means of *usucapio*, Schauinsland's heirs had applied to Portuguese courts seeking a declaration of nullity of the sale/purchase of the Kirchner painting made between Paolo Oliveira and the German entity, because of lack of title of the seller, they would most probably have prevailed in such a suit. However, after the *usucapio* of the painting became effective, Schauinsland's heirs have no remedy available under Portuguese law, either against MoStuff or against anyone else.[14]

If Paolo Oliveira had been in possession of the paintings for a period shorter than the time period legally required for *usucapio* to be effective, Schauinsland's heirs might have had a viable claim, before the Portuguese courts, against MoStuff, provided it was presented before the end of time period necessary for the latter to have acquired the painting by means of *usucapio* or some equivalent legal institution under New York law.[15] But, in that case, the eventual nullification of the 1965 auction sale by decision of the Portuguese courts would go together with the application of Article 534.º of the Portuguese Civil Code of 1867. As a consequence, MoStuff would have been ordered to return the painting to Schauinsland's heirs, but, at the same time, MoStuff would have been entitled to be reimbursed for the price paid in the auction sale.

2. The Max Ernst Painting

Regarding the Max Ernst painting, which was recently found to be a forgery, the purchase made by MoStuff from Paolo Oliveira's heirs in the 1965 auction sale may be challenged, under Portuguese law, on grounds of an *essential* error.

Pursuant to Article 661.º of the 1867 Civil Code, anyone could apply to the courts to void a contract entered into, if that person's consent was vitiated by an error in regard to a quality of the object of the contract which was *essential* to the decision to buy, provided that the other party knew or should have known that the buyer had entered into the agreement because it thought the relevant object of the contract had that quality.

Obviously, the authenticity of a painting is a quality which is determinant of the buyer's decision to enter into a purchase contract, except when the parties have stated otherwise.

The time period for the filing of a legal suit aimed at voiding the contract on grounds of error on an essential quality of the object of the contract would be one year, counted from the day when the party whose consent was vitiated by error knew about the error.

Assuming that this suit is timely filed with Portuguese courts and these courts consider themselves competent to adjudicate it,[16] MoStuff would most probably succeed in having the 1965 auction sale/purchase avoided.

This suit should be filed against Paolo Oliveira's heirs,[17] who were the sellers in the challenged sale.

Kristibies, since it acted merely as an auction agent and organizer (i.e., as an intermediary), would not be a defendant in respect of the claim to have the sale/purchase contract avoided. However, Kristibies could be a defendant, in that same suit, with respect to its possible liability for having breached its professional duty of diligence to assess and certify the authenticity of the painting sold in an auction conducted by this company. If found then to have been negligent, Kristibies would be liable to compensate MoStuff for any damages, material and moral, which the latter may have incurred because of the unfortunate purchase made in 1965. The material damage would be the portion of the purchase price paid in excess of the portion of the purchase price which MoStuff was able to collect from Paolo Oliveira's heirs.

III. The International Competence of the Portuguese Courts

What was said above applies irrespective of the fact that Portuguese courts may or may not consider themselves as competent to adjudicate the claims mentioned in the case submitted. These seem to be the solutions given by the provisions of Portuguese law applicable to the merits of the claims contemplated in the case submitted. However, these provisions could be applied not only by the Portuguese courts but also by the courts of another jurisdiction whose conflicts rule might also lead to a determination that Portuguese law is the proper law governing the dispute *sub judice*.

One must now address the requirements to be met for Portuguese courts to accept jurisdiction to decide the claims mentioned in the case submitted. These requirements are set by the rules of the international competence of Portuguese courts in force at the date when the legal suits are filed, i.e., with the rules now in force.

Having regard for the nature of claims considered in the case submitted, the applicable rules governing the jurisdiction of Portuguese courts are (i) those set out by the Council Regulation (EC) nº 44/2001 of 22 December 2000 (which became the applicable rules applicable to this matter in all member states of the European Union), if the defendant has his domicile within the European Union, or (ii) the applicable provisions of the Portuguese Civil Procedure Code (Articles 65.º, (1), b), 74.º (1) and 85.º(1)), if that is not the case.

Under both sets of rules, the primary connection for the establishment of a court's jurisdiction is the domicile of the defendant.

In the event the defendant does not have his domicile in the territory of Portugal, the Portuguese courts would only consider themselves competent if the sold/purchased goods were delivered or should have been delivered into Portuguese territory.[18]

Consequently, with respect to a suit filed by Schauinsland's heirs against MoStuff seeking the return of the Kirchner painting, taking into account that the defendant (MoStuff) does not have its domicile in Portugal, Portuguese courts could only accept jurisdiction if under the terms of the 1965 auction sale the place of delivery of the painting to the buyer should have been within Portuguese territory (for instance, Lisbon). Although there is no mention to this particular point in the case submitted, it is plausible that, in the terms of sale of the 1965 auction, a covenant existed stating that the sold paintings were to be delivered by the seller to the buyer in Lisbon.

As for the suit which MoStuff may bring before the Portuguese courts against Paolo Oliveira's heirs, seeking repayment of the purchase price paid for the Max Ernst painting, Portuguese courts may accept jurisdiction based on the fact that the defendants have their domicile in Portugal. Regarding the possible accumulation, in the same suit, of MoStuff's claim against Paolo Oliveira's heirs (for the repayment of the purchase price) with its possible claim against Kristibies (on grounds of its alleged negligent participation in the auction sale, as explained above) the EC Regulation No. 44/2001 has no provision applicable to this question, but the Portuguese courts might apply, by analogy, the provisions of Article 87. (1) of the Civil Procedure Code, which states that, in the event there is more than one defendant, they can all be sued at the place of domicile of the majority of them.

If, as assumed above, within the terms of the 1965 auction sale there was a covenant stating that the painting sold was to be delivered to the buyer in Lisbon, this would be an additional fact supporting a decision of the Portuguese courts to accept jurisdiction to entertain such legal suit.

IV. The UNIDROIT Convention on Stolen or Illegally Exported Goods[19]

Taking into consideration that, when it comes to international claims in respect of cultural objects, neither the common law nor the civil law system offers satisfactory solutions, and the existing International Conventions texts related to this subject matter either do not cover, or do so only in part, the private law aspects of cultural property protection, UNESCO asked UNIDROIT to draft a new instrument that would that would take its cue from the 1970 UNESCO Convention, but would also incorporate twenty-five years of reflection on the subject of illicit trafficking in cultural objects.

This UNIDROIT Convention underpins the provisions of the 1970 UNESCO Convention, supplementing them by formulating minimal legal rules on the restitution and return of cultural objects. It guarantees the rules of private international law and international procedure that make it possible to apply the principles set down in the UNESCO Convention. The two conventions are compatible and complementary.

It took six years of hard negotiations to harmonize the contrary views that confronted one another in the context of negotiations, since from the beginning one group of States supported the free movement of cultural objects worldwide,[20] while the other campaigned for national protection of the cultural heritage.[21] In the end, a Convention was produced that was adopted at the diplomatic conference held in Rome on 24 June 1995 and attended by over seventy states.

The UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects entered into force on 1 July 1998 and has currently thirty-three Contracting States, including Portugal.

The real purpose of this Convention is not to enable or trigger a certain number of restitutions or returns through the courts or by private agreement, but to reduce illicit trafficking by gradually, but profoundly, changing the conduct of all buyers and all other actors in the art market.

If a cultural object has been stolen, it must be returned: restitution is an absolute duty unless the limitation period has expired. The only question that arises is when the compensation must be paid.

Probably the most important provision in the entire Convention is its Article 3(1), which enshrines the principle that the possessor of a cultural object that has been stolen must return it, whatever the circumstances. This principle, coupled with the possibility of compensation for the buyer who can prove that he acted "with due diligence,"[22] constitutes one of the most important legal rules in the fight against illicit trafficking in cultural objects. The effect of this provision on the art market, where

dealers have tended to be reluctant to reveal the origin of cultural objects and buyers have tended not to be overly curious, should be immediate.

This Convention, when it has gained wide acceptance, will make it possible to shift the responsibility onto the only person likely to be caught: the final purchaser.

The need for legal security is met by the provision of a relatively short limitation period. Pursuant to Article 3(3) of the Convention, the time limitation is three years from the time when the claimant knew the location of the cultural object and the identity of its possessor.

On the other hand, the Convention text takes into account the material and moral interests of "exporting" states and, more generally, those of public collections (as defined in Article 3(7) of the Convention), religious and cultural institutions, and the protection of the archaeological heritage and historic monuments. It does so by creating a group of cultural objects subject to a very long limitation (seventy-five years) and, in some cases, no time limitation at all. That same special regime extends to sacred objects or objects of significant cultural importance for indigenous communities. These provisions reflect a concern for a more balanced dialogue of cultures.

A very important provision of this Convention is the non-retroactivity clause in Article 10. The drafters of Convention opted for a solution resting on a general principle set forth in Articles 10(1) and (2), which state that the Convention will apply solely to cultural objects stolen after the Convention entered into force in respect of the state where the request was brought, as well as the objects illegally exported after the entry into force of the Convention in respect of the requesting state and of the state where the request was brought. However, paragraph 3 specifies that the Convention "does not in any way legitimize any illegal transaction of whatever nature which has taken place before the entry into force of this Convention" and does not "limit any right of a State or other person to make a claim under remedies available outside the framework" of the Convention.

V. The Portuguese Legislation Against the Illicit Trafficking of Cultural Objects

Although not directly applicable to the hypothetical case outlined above, it is worth mentioning Portuguese legislation pertaining to the fight against the illicit trafficking of cultural objects, because that legislation pioneered the adoption of legal solutions that only much later were enshrined in international law instruments.

A Portuguese statute enacted in the first half of the preceding century, Decree-Law nº. 27.633, of 3 April 1937, adopted a remarkably forward-looking stance in the fight against the illicit trafficking of cultural objects and, therefore, in the efforts to protect the cultural heritage of all nations and peoples of the world.

Its article 1.º provided as follows:

> Transactions made in the Portuguese territory over objects having an artistic, archeological, historic and bibliographic value, proceeding from a foreign country, are null and void when they are made in breach of the provision of the respective internal legislation which regulates its alienation or exportation.

Article 2. established:

> A good faith acquirer is entitled to be compensated on the following terms:
>
> 1. By the transferor, except if it is also a good faith acquirer;
>
> 2. By the State interested [in the return of the object] if the original alienor is not found in the Portuguese territory or, if he is found, has become insolvent.
>
> §1. Good faith cannot be alleged by the acquirer, if the disappearance of the objects and their description enabling its identification, have become public, by means of announcement in two Portuguese newspapers, among those with larger readership.
>
> §2. The amount of compensation will be set by the Minister of Education and can never exceed the acquisition price plus conservation expenses made in respect of the object.

And Article 3. added:

> The objects in article 1 which may be found in the Portuguese territory will be apprehended by the police or customs authorities, who will be their faithful custodians until the appropriate destination is determined for them.

Enacted much later, Law No. 13/85, of 6 July 1985, which set out the guidelines for the protection of the Portuguese cultural heritage, contains a provision which is in line with the principle set forth in Article 1. of the above-mentioned Decree-Law 27.633. Article 31. (2) provides: "Transactions involving cultural objects in the Portuguese territory proceeding from foreign countries are null and void, when they are made in breach of such foreign country's internal legislation regulating their alienation or exportation. That 1985 law was replaced by Law No. 107/2001, of 8 September 2001 (setting the principles for the protection and enhancement of Portuguese cultural heritage).

This law has provisions in line with the quoted provisions of the abovementioned statutes. As matter of fact, its Article 69.º (1) states: "On condition of reciprocity, transactions made in the Portuguese territory, with respect to objects belonging to the cultural heritage of another State and which were brought to the Portuguese territory in breach of their respective protecting legislation, are null and void." Paragraph 2 of this article provides: "The objects mentioned in the foregoing paragraph may be returned in accordance with the European law or international law binding the Portuguese State."

This provision (as well as several other provisions of the same law) should be construed and applied in conjunction with the provisions of the UNIDROIT Convention referred to above as well as in conjunction with numerous UNESCO Conventions related to this subject matter, to which Portugal is a party.

Endnotes

1. Directly or through the private international law mechanism of *renvoi*.
2. *See* art. 4 (1) of the 1888 Commercial Code, applied by analogy. *See also* Isabel Magalhães Collaço, Lições de Direito Internacional Privado at 243-244 (1963).
3. In case the parties had failed to select a law to govern the contract and these parties had their residences in different countries, the contract would be governed by the law of the place where it was made.
4. This is the solution adopted by the jurisprudence of Portuguese courts, as quoted in Luís de Lima Pinheiro, I Direito Internacional Privado at 412-418 (2009).
5. It is worth noting that the majority of scholars (in Germany, Italy and Portugal) hold the opinion that the *lex rei sitae* does not have, in this particular instance, absolute precedence over the *lex contractus*. In accordance with this view, if the *lex rei sitae* requires the making of a valid contract for the ownership of the goods to be transferred, the validity of that contract must be assessed in accordance with the *lex contractus*. (On this subject matter, *see* Luís de Lima Pinheiro, Direito Internacional Privado at 442 (2009)). However, as in both hypothetical fact patterns considered above, the result under *lex rei sitae* and *lex contractus* would be the same (pursuant to the Portuguese rules of conflict of laws): Portuguese law or German law, as the case may be, the conclusion would not be different from that stated in the text.
6. *See* art. 22.º of the current Portuguese Civil Code.
7. In this respect, Portuguese law is similar to English law and both laws are in line with the principle of Roman law "*nemo dat quod non habet*." *Cf.* António Menezes Cordeiro, A Posse—Perspectivas Dogmáticas Actuais at 116-122 (1997).
8. *See* art. 1555.º of Civil Code of 1867 and art. 892.º of the Civil Code of 1966.
9. The case of immovable property purchased from a non-owner is somewhat different, due to the effects of registering real estate transactions.
10. That is, the *real owner* of that thing.
11. Provided that such demand (by the real owner) was made before the time has passed for such goods to be acquired by someone else, on grounds of *usucapio*. Regarding the effects of *usucapio*, *see* note 12 *infra* and accompanying text.
12. Under Portuguese conflicts rules, the regime of possession, ownership and other rights *in rem* (freehold, leasehold, liens and encumbrances, etc.) on movables and immovables is governed by the *lex rei sitae*. This was the solution prevailing under the 1867 Civil Code (*see* Isabel Magalhães Collaço, note 2 *supra*, at 270-271) and it is also the solution adopted by art. 46.º (1) of the 1966 Civil Code. Pursuant to a basic imperative of legal security, once the acquisition of a thing becomes lawfully effective under the law of the country where it was then located at that time, this acquisition must be acknowledged and respected by law of any other country into which such thing would be later transported. On this issue, *see* António Ferrer Correia, A Venda Internacional de Objectos de Arte, at 15, 44 (1994), as well as the foreign legal doctrine quoted in this study.
13. Under art. 1299 of the 1966 Civil Code, the corresponding required possession time would be six years.
14. Not even against Paolo Oliveira's heirs, on ground of unlawful purchase from the German entity. Paolo Oliveira did not incur any legal liability by making a purchase from a non-owner: he may have made a "risky" transaction, which could be declared null and void by the courts, but the transaction was not one that gave rise to civil or criminal liability.
15. Since this was the subsequent *lex situs* of the painting.
16. This issue is addressed in Part III of this article.
17. In accordance with Portuguese Law, Paolo Oliveira's obligation *vis-a-vis* MoStuff for the refund of the price of the voided sale/purchase would be transmitted by inheritance to his heirs.
18. Arts. 65.º, (1), b) and 74.º(1) of the CPC.
19. The contents of this paragraph are composed of extracts taken from the document issued by UNIDROIT, *The 1995 UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects—an Overview*, available at UNIDROIT 's website.
20. Therefore, they were intent on limiting the future Convention's scope of application to the utmost and on safeguarding the protection afforded to the good faith buyers within their jurisdictions
21. Therefore, they wished to extend the principle of restitution of stolen or illegally exported cultural objects as far as possible, thereby ensuring optimal protection of national cultural heritage on the international stage.
22. 1995 UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects Art. 4(1).

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Stolen Masters: The Sale of Stolen and Plundered Art—An Austrian Perspective

By Otto Waechter and Petra Fizimayer

I. Introduction

Between 1933 and 1945 the National Socialists looted more than six hundred thousand artworks from their (mainly Jewish) European owners. Many stolen works were never recovered. Although many looted works remain in public and private ownership, there may still be a chance for victims of National Socialism[1] to recover their artworks. Under the law of some European countries, a thief cannot pass good title, regardless of how many subsequent owners buy in good faith. But what if the artworks were never stolen, confiscated or looted by the National Socialism regime? What if—instead—the owner sold the painting to protect it from impending seizure by the National Socialism regime or to generate income for his family because the National Socialists stripped him of his livelihood? Is this a "forced sale" amounting to theft? The answer may well depend on which country's law might apply to the sale: the country where it took place seventy-five years ago; the current residence of the heirs; or the residence of the original owners.

II. Historical Background

In March 1938, Austria was occupied and annexed into the German Third Reich (an event known as the *Anschluss*). Immediately after the National Socialists came to power in Austria, the systematic disenfranchisement and persecution of mainly Jewish families began. Therefore, shortly after the annexation, all Austrian Jewish property, valued at more than Five Thousand Reichsmark, was registered with the National Socialist Jewish Property Declaration Office and subsequently confiscated by the National Socialist authorities. As a result, the National Socialist authorities obtained access to all assets of the Jewish community and deprived the victims of any basis of existence even before their expulsion and deportation. Less forceful, but with the same result, victims of National Socialism were also forced to sell their works of art for prices far below their true value.

Various actions or mechanisms used by the National Socialists to confiscate property lurk behind the terms "art theft" and "looted art." As mentioned above, many victims of National Socialism were forced to sell their possessions on the art market at knockdown prices. This massive expropriation was administered through ordinances[2] and National Socialist laws and carried out through various means: assets were seized by the *Gestapo* (*Geheime Staatspolizei*), the Secret State Police; assets were prevented from being taken abroad by the Institute for Monument Preservation; and assets were confiscated by the tax authorities or secured by the Municipality of Vienna. After the war, survivors who returned to recover their art had to negotiate with museum directors as to which items they could export in exchange for "gifts" that would remain in the museums.

The variety of possibilities for expropriating works of art and the large number of people involved have made it difficult to retrace the history of expropriated objects today. Research efforts to determine the origin and whereabouts of looted art and cultural assets are being carried out by the Commission for Provenance Research (*Kommission für Provenienzforschung*), established in 1998. To comply with this statutory mandate, it is necessary to examine systematically and comprehensively the holdings of the Austrian federal museums and collections from 1933 to the present.

III. Restitution and Compensation Procedure After the End of World War II

A. Historical Background

After the end of World War II Austria denied any responsibility for the National Socialist regime's crimes. Although until 1949 several restitution acts were promulgated and published in the Federal Law Gazettes, the return of confiscated assets was limited to certain circumstances and did not compensate many victims. The period for submitting applications was quite short, and the potential applicants (mostly not living in Austria) were not informed directly about their rights. Additionally, the law did not take into consideration that the victims' loss of property was difficult to prove by documents, since the evidence was usually left behind.

In 1991, several decades after the end of World War II, Federal Chancellor Vranitzky recognized the complicity of Austria in the Nazi regime's crimes.

To try to track down looted artworks, many institutions were established. On the basis of these initiatives, commissions were established in the occupation zones of the Nazi regimes, with the goal first to take inventory and finally to return the artworks to the corresponding governments of these countries where expropriations took place. Since most of the artworks have not been returned directly to the individuals, but instead to the respective government, there were numerous legal proceedings—even decades after the end of the war.

B. Statutes

Until 1946 there was no clear concept on whether and how the looted works of art should be returned or compensated. As a consequence, seven Restitution Acts (1946-1949) on the restitution of seized assets were enacted in Austria. The most important was the third Restitution Act,

passed on 6 February 1947, on the nullity of asset seizures. However, the seven Acts of Restitution did not establish a continuous system. Indeed, it was quite the reverse: the Acts were a complex, partially contradictory structure of a vast number of laws and ordinances. For the victims it was inscrutable which of the laws were applicable. Furthermore, potential claimants generally were only able to file claims within a year after the specific Act entered into force. This was a serious obstacle for potential claimants living abroad.

Although Austria had these restitution laws in place immediately after the end of war, it made little effort to assist claimants trying to retrieve their artworks. With the expiration of the validation periods, the restitution of works of art came to a temporary end. The situation changed with the 1996 Mauerbach Auction, at which the remaining looted artworks kept by the Austrian State were auctioned by Christie's for the amount of $9.2 million, for the benefit of the National Socialist victims.

In December 1998 the Federal Act on the Restitution of Art from Austrian Federal Museums and Collections was promulgated.[3] Decisive for that was the seizure of two *Schiele* paintings from the collection of Leopold at the Museum of Modern Art in New York.[4] These two paintings, *Portrait of Wally* (from the former Lea Bondi-Jaray Collection) and *Dead City III* (from the former Fritz Grünbaum Collection), had been expropriated from their owners during the National Socialist era and after the war bought by a collector. Subsequently, this legal case elicited a long-term change in the approach to the issue of Nazi looted art, not only in Austria, but also internationally.[5]

The objective of this artwork restitution legislation was to carry out the restitution of works of art and cultural objects from the Austrian federal museums and collections that had become the property of the Austrian federal government in the process of or as a result of the National Socialist regime to their original owners or legal successors. Therefore, various organizations—the Historical Commission, the Commission for Provenance Research, and the Restitution Committee—were established to decide on specific restitution cases.

Since 1999 the City of Vienna and most of Austria's federal provinces have passed corresponding legal provisions and have retained experts to carry out provenance research for their collections.

After implementation of the Art Restitution Act of 1998 approximately 4,170 objects have been returned, including several paintings of Gustav Klimt. A remarkable restitution of artwork was, for example, the return of the Rothschild collection in 1999: two hundred twenty-four objects were sold by auction at Christie's, achieving a record total of approximately $91.6 million.[6]

As mentioned below in Part XI, in 2001, on the basis of the Washington Agreement, the General Settlement Fund (*Allgemeiner Entschädigungsfond*) was founded.

The amendment of the Art Restitution Act in November 2009[7] specified and modified the provisions of restitution. Restitution is carried out *ex officio*, meaning there is no need to submit an application and therefore no status of a party to the procedure. Legally obtainable rights cannot be based on the Art Restitution Act.

Today it is still not known how many artworks actually were confiscated under the National Socialist regime. Since 1949 at least thirteen thousand objects have been returned to the legitimate owners or descendants. However, at present purchasers from major auction houses can safely assume that works have been vetted with the Art Loss Register prior to sale.[8]

IV. Legal Basis of the Restitution Procedures

The following analysis always refers to restitution of works of art. The act of restitution is, basically, a combination of international law, private international law, and law of inheritance.

In addition to the aforementioned legal precepts, the *ordre public* reflects the basic fundament of the Austrian legal system. The meaning of the *ordre public* cannot be precisely determined and is subject to change from time to time, but there are some common sources of the *ordre public*. Thus, one principle of *ordre public* is to ensure a fair decision (in the sense of a concept of justice). Besides this moral precept, the *ordre public* consists of fundamental principles of the Austrian Federal Constitution, European law, criminal law, private and public law as well as general constitutional principles. Legislative provisions prohibiting racial discrimination and providing for compensation are fundamental principles of the Austrian legal system. The elimination of all Nazi-related ideology in the areas of politics, economics and culture is in particular anchored in the Treaty of Austria of 1955 (*Staatsvertrag 1955*).

V. The Jurisdiction of Austrian Courts

As a rule, cases are initiated in the place of general jurisdiction of the defendant. The place of general jurisdiction of a natural person is based on the person's legal or habitual residence. In some cases, actions can be initiated not only in the defendant's place of general jurisdiction, but also optionally in another jurisdiction, in an elective venue (*Wahlgerichtsstand*). The Austrian jurisdictional rules (*Jurisdiktionsnorm* or *JN)* recognize more than twenty different elective venues for civil proceedings alone, for dealing with contractual and statutory relationships under the law of obligations, or various claims under the law of property, as well as elective venues of a procedural kind. These might include: the forum of the place of performance; the place named on the invoice; the forum *rei sitae* (jurisdiction at the place where the subject matter in

controversy is situated); the place where damage was inflicted; or the forum of a cross-action.

The rules of jurisdiction for actions against defendants not domiciled in an EU member state are determined by Section 27a paragraph 1 of the JN in conjunction with Sections 65 *et seq.* of the JN. Apart from the stipulation of Section 27a paragraph 1 of the JN, which determines the international jurisdiction of Austrian courts in general, specific rules under international law prevail.[9] Moreover, if one party has its domicile in a member state of the European Union ("EU"), it is possible to set up a contractual agreement on jurisdiction of a court within the EU.[10]

Besides, the claimant can bring a case to a court in Austria and await further action by the defendant (and the court), since international jurisdiction of an Austrian court is accepted if the other party does not claim lack of jurisdiction but continues to proceed in the Austrian court. Thus, the Austrian court may have jurisdiction by acknowledgment of the defendant.[11] The right of the court to reject the claim *in limine litis* expires with its first official act concerning the claim, such as with the order to file a claim of defense.[12]

Furthermore, a settlement under Section 104 paragraphs 1 and 2 of the JN allows the parties (whether with or without any connection to Austria, such as through citizenship) to agree on the international jurisdiction of Austrian courts concerning a certain lawsuit or legal relationship, such as if jurisdiction was agreed when deeds were set up. As a consequence, in such a case claimants would need a valid deed with the defendant to get international jurisdiction of Austrian courts.

VI. Acquisition of Ownership Under the Austrian General Civil Code[13]

A. Generally

Ownership is generally obtained by fulfilling the prerequisites of title, e.g., a valid contractual agreement or last will or valid transfer, such as a physical handover of movable property.

In addition, there is a difference between derivative and original acquisition of property:

- With respect to derivative acquisition of property, the previous owner or possessor passes the ownership to another person, meaning the previous owner is legally entitled to dispose of property.
- In the case of original acquisition of property, the ownership arises regardless of the previous person, i.e., the acquirer obtains a "completely new" ownership of property, which is not derived from anyone else (such as a good faith purchaser).

B. Good Faith Acquisition

A possessor who has reasonable cause to believe that the property he possesses is his own is a good faith (*bona fide*) possessor pursuant to Section 326 of the Austrian *Allgemeines B*ürgerliches Gesetzbuch (ABGB), or General Civil Code. Where it is proved that the new possessor should reasonably have questioned the good faith of his possession, either from the nature of the object he had acquired, from the strikingly low price thereof, or from the known personal qualities of his predecessor etc., good faith cannot be presumed. However, pursuant to Section 328 ABGB, good faith is generally presumed under Austrian law in the absence of these or other unusual or suspicious circumstances.

C. Acquisition of Title by Acquisitive Prescription (*Ersitzung*)

Acquisition by prescription is the obtaining of a right by qualified possession during a period stipulated by law. Acquisitive prescription may lead to acquisition of title after a legally determined lapse of time. The previous proprietor loses the right of ownership, while the "following" possessor obtains the ownership. Acquisitive prescription of movable goods is effective after three years of possession in good faith; immovable goods after thirty years.[14] But a possessor will be found not to have had the requisite confidence for prescription if, at any time during the prescription period, the possessor had any objective reason to doubt his claim, or if he was negligent in maintaining his belief of lawful possession.

D. Auctions

Another effective way under Austrian law to acquire property is by auctions, allowing purchasers at the sale to acquire good title, no matter who the former owner might be.[15] Section 367 of the General Civil Code includes the judicial auction as well as the administrative or private (i.e., voluntary) auction, such as through an auction house. In all these auctions the purchaser acquires original ownership.

E. Inheritance

For the acquisition of property through inheritance and estate matters, legal title is constituted by testamentary dispositions (e.g., last will or codicil), contract of inheritance, or intestate succession.

VII. Limitation Period

In general, damage claims (against the state and private persons)—even with respect to *in rem* restitution—are subject to a statutory limitation period. Pursuant to Section 1489 of the General Civil Code, the absolute statute of limitation for damage claims is thirty years. However, the prevailing academic opinion[16] is that claims with respect to restitution of objects deprived due to a void act of National Socialist State or force (e.g., robbery, extortion) are not subject to any limitation. This is derived by inter-

preting Section 1459 of the General Civil Code in such a way that property rights do not become time-barred.[17] In order to be successful on these claims, the claimants must prove valid ownership.[18] Therefore, in the case of where a third party acquired title by acquisitive prescription (as described in Part VI.C.), a loss of right (*Rechtverlust*) occurs even in this case.

Additionally, the Nullification Act of 1946 states that any transaction classified as a seizure of property is null and void. Thus, no acquisition of ownership was possible by acts of aryanization (*Arisierung*). Hence, even nowadays it is possible to claim ownership of looted artworks under the general provision of the General Civil Code via *rei vindicatio*.[19] However, a good faith purchase initiates the limitation period, as mentioned above in Part VI.B.

VIII. Restitution Against Private Persons

The Act on the Restitution of Art from Austrian Federal Museums and Collections does not apply to private persons.[20] So far, it seems there are impossible barriers to recover artworks, especially because of the claimant's burden of proof. However, Section 1 of the Nullification Act of 1946 contemplated the nullity of all transactions representing deprivation of property, combined with a lessening of the burden of proof, in the sense that the *de facto* impossibility of preservation of evidence may not lead to the National Socialist victims' disadvantage. Therefore, basically, there is still the option to reclaim ownership via *rei vindicatio* pursuant to Section 366 of the General Civil Code (as long as there is no acquisitive prescription).

IX. Restitution and Arbitration

The Austrian Arbitration Court for Restitution—applying Austrian law, especially the Austrian Law on Restitution of Art Objects of 1998[21]—has competence to facilitate the return to the rightful owners (or their heirs) of those items which are still unlawfully in the possession of Austrian federal state. Arbitral awards of the Austrian Arbitration Court are legally binding pursuant to Section 607 of the Austrian Code of Civil Procedure. Only the claim of annulment of the award (e.g., there is no valid agreement for an arbitration court or the arbitral award contradicts the *ordre public*) is a valid remedy which must be filed in the competent regional court.[22]

X. Cases

A. *Amalie Zuckerkandl* by Gustav Klimt[23]

Pursuant to Section 1 of the Nullification Act, every transaction classified as a seizure of property is null and void if it was caused by political or economic prosecution in order to divest property rights. As a consequence, claims under the Nullification Act require evidence of political persecution and a causal connection between dispossession and abuse of force, thereby reversing the burden of proof concerning causal connection. The Act of Restitution shifted the burden of proof to the detriment of the possessor. In the event the possessor is able to provide evidence that there is no causality between dispossession and seizure of NS power, there will be no restitution.

The arbitration court in the *Amalie Zuckerkandl* matter found that the prerequisites of restitution did not exist, on the ground that the painting was handed over voluntarily without any kind of dispossession. The Austrian Supreme Court (*Oberster Gerichtshof* or *OHG*) confirmed this opinion, and could not see a violation of the *ordre public* (as claimed in the appeal). Therefore, the painting remained in the Austrian gallery Belvedere.

B. *Egon Schiele* Painting[24]

In a case where the suit does not comply with the requirements for Austrian jurisdiction, the Austrian Supreme Court is able—under certain circumstances—to grant Austrian jurisdiction pursuant to Section 28 paragraph 1 (2) of the JN. This practice is allowed in cases where the claimants are Austrians or have their legal or habitual residence in Austria if prosecution in a foreign country is unduly burdensome.

In 2006, the OGH determined in the case of a painting by Egon Schiele that the term "unduly burdensome" is a high standard to meet, such as if the decision of a foreign court is not accepted or enforceable in Austria or if the proceedings take an extraordinarily long time abroad. However, international jurisdiction of Austrian courts is barely acknowledged by the Austrian Supreme Court. In the case of the *Egon Schiele* painting, Austrian jurisdiction was rejected because merely reasons of economy of cost for filing the claim in Austria represented no valid argument.

C. *Republic of Austria v. Altmann*[25]

Maria Altmann was a Jewish refugee from Austria, noted for her successful legal campaign to reclaim five family-owned paintings[26] by the artist *Gustav Klimt* from the Government of Austria, stolen by the Nazis during World War II. After an Austrian researcher questioned the Austrian state's ownership of the paintings in 1998, Maria Altmann experienced years of fruitless negotiations and efforts to litigate in the Austrian court system. In 2000 Altmann filed a lawsuit in the United States District Court for the Central District of California under the United States Foreign Sovereign Immunities Act (FSIA). The case, *Republic of Austria v. Altmann*, ended up in the Supreme Court of the United States, which ruled in 2004 that Austria was not immune from such a lawsuit. After this decision, Altmann and Austria agreed to binding arbitration by a panel of three Austrian arbitrators.[27] In January 2006, the arbitration panel ruled that Austria was legally required to return the artworks to Altmann and the other family heirs. The paintings were estimated to be collectively worth at least $150 million when returned. In monetary terms this represented the largest single return of NS looted art in Austria.

Just months after the Austrian government finally returned the paintings to Maria Altmann, she consigned the Klimts to the auction house Christie's to be sold on her behalf. *Portrait of Adele Bloch-Bauer I* sold for $135 million and *Portrait of Adele Bloch-Bauer II* for $88 million, with the five paintings fetching a total of over $327 million.[28]

Adele Bloch-Bauer I was ultimately bought by Ronald Lauder and now can be seen in the Neue Galerie in New York City.

XI. Excursus: Compensation Programs

Restitution and compensation is split up into two different areas, including (i) restitution, meaning actual return of deprived property; and (ii) law, ensuring certain benefits to victims of National Socialism.

In addition to restitution, since 1995 in Austria numerous compensation programs have been in place to obtain some compensation for damages caused by the National Socialist regime, although a few of these have expired.

A. General Settlement Fund

Applications for monetary settlement for compensation could be submitted to the General Settlement Fund (which had a total of $210 Million) in the following asset categories: liquidated companies; licenses and other company assets; real estate; bank accounts; equities; bonds; mortgages; movable assets; insurance policies; losses related to occupation or education; and other losses. Victims of National Socialism and their heirs were entitled to file a claim. The application deadline expired on 28 May 2003, and final payments are currently being processed: one hundred twenty thousand claims were filed.

B. National Fund of the Republic of Austria for Victims of National Socialism

Heirless property, as defined in the Federal Art Restitution Law, is to be transferred to the National Fund of the Republic of Austria for Victims of National Socialism.[29] There is no deadline for applications for a one-time payment (in the amount of approximately $7,000) as a symbolic gesture to Holocaust survivors, as well as applications for a second and third payment for social needs. From 1995 until 2000 the Fund paid about $182 Million to the victims in total. At the end of 2000, the Fund was increased by another $150 million. In 2006, the National Fund posted an online database[30] of some of the heirless objects to allow additional claimants to come forward. Currently, about nine thousand objects are listed.

C. Social Security Benefits

Austrian National *Socialist* regime victims/survivors are entitled to the following social benefits (if the statutory criteria apply):

- Beneficiaries' pension by the Austrian Social Security Administration Sections 500 *et seq.* of General National Insurance Act provides a surcharge (since expatriation) for pensions, ranging from approximately €740 to €3,900, for persons sustaining disadvantages in the period from March 1933 till May 1945 for reasons of origin or political and religious reasons.
- Care benefits of up to €1,655.80 per month, depending on degree of care needed, from the Social Security Administration.
- Victim's pension *(Opferrente)*, of up to €1,451.20 per month for those victims of National Socialism who suffered damage to their health, if damage was directly caused by the National Socialist regime.
- Widows or widowers of Austrian victims of National Socialist persecution are able to file a claim with the Social Security Administration for a widow's/widower's pension, which is usually forty to sixty percent of the beneficiaries' pension described above in the first bullet of this Part XI.C.
- In addition to their widow's/widower's pension, widows or widowers of deceased recipients of victim's pensions are also entitled to a survivor's pension up to EUR 969.90 per month under the Victim Welfare Act.
- Austrian citizens are entitled to claim benefits up to EUR 37.00 monthly if they were in war imprisonment during World War I or II, depending on duration of imprisonment.

Endnotes

1. For purposes of this article, the term "victims of National Socialism" means those individuals persecuted by the National Socialist Regime for political reasons, or reasons of national origin, religion, nationality, sexual orientation or due to a physical or mental disability.
2. Ordinance on the Registration of Jewish Property, *RGBl* [*Reichsgesetzblatt*, or in English Reich Law Gazette] I No. 887, 26 April 1938.
3. *Bundesgesetzblatt* (in English Federal Law Gazette) 141/1998
4. Faber, *Restitution–ein "schwieriges Thema": Von der Opferthese zur Mitverantwortung*, 2010 JBl 569.
5. http://www.restitution.or.at.
6. Kunth, Die Rothschild'schen Gemäldesammlungen in Wien 106-107 (2006).
7. Federal Law Gazette I 117/2009.
8. Bloom, *Buyers Beware—Protecting Against the Risk of Purchasing Stolen Art*, 13 Entertainment, Arts and Sports Law Journal 9 (Summer 2002).
9. Section 27a paragraph 2 JN.
10. Article 23 par 1 EuGVVO. *See also* Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.
11. Article 24 EuGVVO.
12. §§ 43, 104 par 3 JN.
13. *Allgemeines Bürgerliches Gesetzbuch (ABGB);* Federal Law Gazette I 68/2012.

14. §§ 1466 ABGB.
15. § 367 ABGB.
16. Wilhelm, *Arisiertes Eigentum verjährt nicht*, ECOLEX 161 (2003).
17. OGH 20.04.2010, 1 Ob 38/10k.
18. Graf, *"Arisierung" und Restitution. Anmerkungen zum Entschädigungsfondsgesetz*. JBl 746 (2001); Wilhelm, note 16 *supra*.
19. § 366 ABGB.
20. Ortner, *Wiedererlangung arisierter Kunst von Privaten auf Grundlage des allgemeinen bürgerlichen Rechts*, JURIDIKUM 34 (2003).
21. *Kunstrückgabegesetz* 1998; Federal Law Gazette 117/2009.
22. §§ 611, 615 ZPO.
23. Pitkowitz, *Ordre-public widriger Klimt-Schiedsspruch. Kann der armen Amalie geholfen werden?* ECOLEX 663, 664 (2007).
24. OGH 23.11.2006, 8 Nc 25/06b.
25. *Republic of Austria v. Altmann*, 541 U.S. 677 (2004).
26. The works were: Adele Bloch Bauer I (*Goldene Adele*); Adele Bloch Bauer II; *Apfelbaum*; *Birkenwald/Buchenwald*; *Häuser in Unterach am Attersee.*
27. *See* Kodek, *Der Streit um die Klimt-Bilder*. 2 Zak 25 (2006).
28. http://en.wikipedia.org/wiki/Portrait_of_Adele_Bloch-Bauer_I.
29. Noll, *Fortschritt und Versäumnis. Kunstrückgabe in Österreich*, JURIDIKUM 31 (2003).
30. www.kunstrestitution.at.

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Overview of the Madrid System and the United States Perspective

By L. Donald Prutzman

I. Introduction: An Overview of the Madrid System

The "Madrid System," named for the two multilateral international treaties through which it is administered—The Madrid Agreement and The Madrid Protocol—is one of the three separate methods by which a brand owner may obtain international protection for a trademark. Because not all countries are signatories to one or both of these treaties, the Madrid System is not available for all trademarks in all countries.

Where it is applicable, it permits a trademark owner in a member country to extend the protection of a trademark to other member countries through one "international" application, filed through the trademark owner's home country trademark office and administered by the World Intellectual Property Organization ("WIPO"), which is headquartered in Geneva. As described in more detail below, an application made through the Madrid System is not truly an international application, but is in many respects more like a bundle of individual country applications. It is, however, a useful tool that is sometimes available and should always be considered as part of an international trademark protection program.

Although the Madrid System offers many benefits, it also has some drawbacks. These advantages and disadvantages will be explored below. The best, and most cost-effective, way to protect trademarks internationally will most often involve a combination of the Madrid System and the other methods of protecting trademarks outside the mark owner's home country, devised after careful consideration by an experienced trademark lawyer. However, the Madrid System is growing in importance and availability as more countries, particularly in regions traditionally hostile to the concept, choose to participate in it.[1]

II. The "Territorial" Theory of International Trademark Protection

International protection of trademarks is based on a "territorial" theory of international law. Since the world is made up of individual jurisdictions, each with sovereignty over its own territory, any efforts to harmonize or set standards or norms for international trademark protection must be pursuant to treaties, typically multilateral treaties among groups of nations that can agree on standards or methods of protection. Territoriality is one of the two competing general theories under which international protection of intellectual property operates. The competing theory is called "universality."

The "territoriality" theory postulates that intellectual property rights exist separately under each country's law and run only to the borders of that country. Under the territoriality principle, use or protection of intellectual property outside a country does not give the user any rights to use that intellectual property, or to stop others from using it, in that country. Under territoriality, a trademark has a separate legal existence under each country's laws. Thus, trademark owners who wish to expand the protection of their marks outside their home country must take some steps to obtain protection in other countries, or at least other jurisdictions or groups of jurisdictions.

The countervailing theory to the territoriality principle is called "universality." Under that theory, intellectual property protected in accordance with one country's law should be afforded protection in all countries, or at least all countries that have agreed to give it that protection. Although the universality principle has not found much favor in connection with international protection of trademarks, this concept, or rather a version of it, is the animating force behind international protection of copyrights under another international multilateral treaty known as The Berne Convention. Universality is not the optimum theory for trademark protection, primarily because numerous trademarks are either not used in more than one country or are used in only a limited number of countries and their use is not likely to expand significantly. To protect a trademark used in one country throughout the world more or less automatically is unnecessary and would unduly limit the availability of trademarks. Due to the often local nature of trademark use, similar marks can often be used in different countries without any confusion of consumers or detriment to mark owners.

III. The Three Methods of International Trademark Protection

As noted, in general three separate methods of securing international trademark protection are available, although each method in not available in every jurisdiction.

A. Individual Country Registrations

The one method of protection available in virtually all countries is registration with the individual country's trademark office. It is the only method currently available for some important countries, including, for example, Canada and most Latin American countries, although that is undergoing a process of change. The primary benefits

of individual country registration are that (i) only existing registrations in that country can potentially interfere with the registration sought, and (ii) it is generally the fastest method of obtaining protection in a country. The drawbacks include the need for counsel in each country and the need to renew the registration in each country periodically, with the attendant costs of both.

B. International Registration

The Madrid System provides for the filing of an "international" registration with the mark owner's home country trademark office. This application is then forwarded to and administered by the WIPO in Geneva. The applicant can seek protection in any combination of jurisdictions that subscribe to the treaty involved. In many, but not all, cases, the mark owner's counsel in the home country can handle the entire protection process without the need to involve counsel in the jurisdictions where the protection is sought.

C. Supranational Registrations

A supranational registration grants protection in a particular group of countries that have agreed to offer group protection through a single registration. The most important supranational registration is the Community Trademark ("CTM"), which offers protection in all European Union ("EU") countries through one registration. Other supranational registrations are available for the Benelux countries (which actually no longer have individual country trademark offices), and two groups of approximately sixteen African nations, known as the African Intellectual Property Organization ("OAPI") and the African Regional Industrial Property Organization ("ARIPO"). Each is somewhat different from the CTM, but the general considerations are similar. Several Andean countries, Peru, Colombia, Ecuador and Bolivia, also have a "common regime on intellectual property" known as the Andean Pact or Decision 486, which has some similarities to a supranational registration, but does not go quite as far.

IV. The Madrid System

The Madrid System comprises two international treaties administered by WIPO, known as the "Madrid Agreement" and the "Madrid Protocol." Both treaties provide for the international protection of trademarks in member countries by filing a central application administered by WIPO. However, individual countries must examine and approve each country registration based on their own national laws, and oppositions can be filed in each individual country. In this respect, an "international" registration under the Madrid System is really a hybrid between a truly international registration (which, in truth, does not exist) and a bundle of national applications. One huge benefit, however, is that successful opposition in any one country (other than the home country) does not vitiate protection in other countries.

A. The Underpinning of the Madrid System: The Paris Convention for the Protection of Industrial Property

Any discussion of the Madrid System must begin with an understanding of the basic tenets of an earlier effort to establish international principles of trademark protection known as the Paris Convention for the Protection of Industrial Property. The Paris Convention of 1883 was the first broad-based international agreement concerning recognition of the trademark rights of foreigners in signatory countries. Unlike the two Madrid System treaties, which are only gradually gaining widespread international adherence, virtually all countries of commercial significance are contracting states under the Paris Convention, also referred to as members of the "Paris Union."

The basic tenets of the Paris Convention have continued to this day as the fundamental principles of all international trademark recognition and protection, and it is on these principles that all subsequent efforts, including the Madrid System, build. These tenets are the following:

1. National Treatment

The principle of "national treatment" is basically that each member country will afford the same trademark rights to foreigners that it affords to its citizens. Article 2(1) of the Paris Convention provides that:

> Nationals of any country of the Union shall, as regards the protection of industrial property, enjoy in all the other countries of the Union the advantages that their respective laws now grant, or may hereafter grant, to nationals, all without prejudice to the rights specially provided for by this Convention. Consequently, they shall have the same protection as the latter, and the same legal remedy against any infringement of their rights, provided that the conditions and formalities imposed upon nationals are complied with.

Note that "national treatment" does not require reciprocal treatment. A country need not provide foreigners any trademark protection if it provides its own citizens none. This has been considered a significant weakness in the Paris Convention.

2. No Domicile Requirement

The Paris Convention prohibits any contracting country from requiring that a foreign entity establish a domicile or permanent presence in a country as a condition to enjoying the protection of its trademark laws. Absent this underlying provision, the Madrid System would be of little utility.

3. Right of Priority

The Paris Convention created the very important right of priority for foreign trademarks. Under the right of priority, the filing date of a duly filed trademark application in one of the countries of the Union can be claimed as a right of priority in another country any time within six months after the original filing date. Under this right, for example, a Portuguese trademark owner who files an application in another signatory country within six months after the Portuguese filing has priority in that country over anyone else who filed for the same mark after the Portuguese filing date.

4. Registration

Under the Paris Convention, each country may determine by its own laws the conditions for filing and registration of trademarks. There is no centralized filing under the Convention. Thus, in the absence of other agreements (for example, the Madrid System treaties) a trademark owner must file and register in each country where protection is needed. This underlying right of each country to determine the conditions for filing and registration thus placed some constraints on future efforts to implement "international" registration systems that have shaped the design of the Madrid System.

5. Protection of "Well-Known" Marks

The one effort at some semblance of truly international protection that the Paris Convention made was the "well-known" or famous mark protection that Article 6*bis* offers, even to marks that are not registered in a particular country. Member countries are required "to refuse or to cancel the registration, and to prohibit the use, of a trademark which constitutes a reproduction, an imitation, or a translation, liable to create confusion, of a mark considered by the competent authority of the country of registration or use to be well known in that country as being already the mark of a person entitled to the benefits of this Convention and used for identical or similar goods." Owners of well-known marks must be afforded at least five years from the registration of the offending mark in which to request cancellation, but the time in which prohibition of use of the offending mark must be requested is in each country's discretion. Article 6*bis* is the sole intrusion of something approaching the "universality" theory discussed above in the prevailing international scheme of trademark protection.

Interestingly, even though the United States is a signatory to the Paris Convention and Congress has ratified the treaty, a very influential United States Court of Appeals, the Second Circuit, has held that Article 6*bis* does not apply in the United States because the Paris Convention is not a "self-executing" treaty, *i.e.*, does not become U.S. law without some internal implementing legislation and Congress has never passed any internal trademark legislation implementing Article 6*bis*.[2] Thus, the availability of Article 6*bis* protection in the United States is questionable and the U.S. Congress should act to bring the country into conformity with its treaty obligations.

B. The Madrid Agreement Concerning the International Registration of Marks

As noted, the Paris Convention did nothing to establish a centralized or uniform system for international filing and registration of trademarks. In 1891, some of the Paris Union countries made an effort to do that in the Madrid Agreement, but still retained the principle of trademark territoriality—that trademarks and trademark protection only exist in individual countries—under the constraint of the Paris Convention's "registration" requirement.[3]

The Madrid Agreement allows trademark registrants in member countries to secure registration in any other member countries they wish by filing an international application through the home country trademark office, with the International Bureau, today WIPO. Individual countries must, however, approve each country registration based on their own national laws, and oppositions can be filed in each individual country. However, successful opposition in any one country does not vitiate registrations in other countries resulting from the application. Thus, the Madrid Agreement provides a single place to file for multiple national registrations, but the filing alone does not confer any substantive rights. The mere existence of an "international" registration does not mean that it provides protection anywhere. That must be determined through further action, or lack of action, by the member countries' trademark offices.

Today, fifty-six countries participate in the Madrid Agreement. However, it has some perceived flaws that kept key countries from joining. The drawbacks to the Madrid Agreement that kept it from attaining wide adherence include the following:

- It requires that a home country *registration* have issued before the international application can be filed. This disadvantages applicants from countries with more rigorous, longer examination processes by delaying their ability to use the treaty to gain international protection, and favors applicants from countries with minimal scrutiny of applications.
- Under the Madrid Agreement, individual countries have only twelve months in which to reject a registration requested in the international application. The process simply takes longer in some countries, such as the United States. If applications in such countries had to be examined within twelve months, resources would have to be diverted from the prompt examination of domestic applications.
- The Madrid Agreement allows "central attack" with drastic consequences. Under its provisions,

if the home-country registration (on which the international registration is based) is successfully attacked, in whole or in part, within five years after registration, all the protection resulting from the international application ceases completely. This is unfair to trademark owners in countries offering relatively more grounds for a central attack.

- The Madrid Agreement does not require any use of, or intent to use, a trademark before filing for registration. Use-based protection of trademarks is a fundamental tenet of United States trademark law, although most countries protect trademarks based on mere registration.

C. The Madrid Protocol

The Madrid Agreement could never establish a very extensive international trademark protection system because it was not acceptable to the United States and other important countries. WIPO continued to look for a solution that would bring these countries into the fold. A promising 1973 attempt called the Vienna Trademark Registration Treaty was acceptable to the United States, but failed to gain enough support to be viable.

Finally, in 1989, almost one hundred years after the Madrid Agreement, a treaty called a "Protocol Relating to the Madrid Agreement Concerning the International Regulation of Marks," known as the "Madrid Protocol" was agreed upon. The Madrid Protocol is actually a separate treaty, not merely an addendum to the Madrid Agreement. It was thought to be acceptable to virtually all the major countries that resisted the Madrid Agreement, and the international trademark community thought that a true international trademark system might finally be at hand.[4]

The Madrid Protocol treated a number of perceived problems with the Madrid Agreement. The principal differences, or "improvements," between the Madrid Agreement and the Madrid Protocol are:

- The Madrid Protocol allows an international application to be based on the *filing* of a national trademark application, rather than the perfected national *registration* that the Madrid Agreement requires. This helps ameliorate the disadvantage at which the Madrid Agreement placed trademark owners from countries with more extensive examination of application.
- The Madrid Protocol gives each country named in an international application eighteen months in which to review and refuse registration, rather than the twelve months the Madrid Agreement affords. This more fairly allocates the resources of the trademark offices that typically take more time to examine applications.
- Under the Madrid Protocol, if the basic national registration (or application) supporting the international application is successfully attacked, then the international registrations that stemmed from it may be converted into separate national registrations with an effective filing date as of the original international application's filing date. Under the Madrid Agreement, these international registrations are simply wiped out. This diminishes the draconian effect of "central attack."
- The Madrid Protocol allows each national trademark office to charge its national filing fee for examining applications made via an international application.

The Madrid Protocol has gained significant acceptance, is gaining more every year, and is on the verge of growing significantly. Today it has eighty-six contracting countries, up from eighty-four last year. Colombia is the most recent country to join, and Mexico appears poised to be the next.[5]

The member countries include the United States, although the United States was quite late in joining. Efforts throughout the 1990s to have Congress ratify the Madrid Protocol repeatedly failed. This was not due to any substantive problem the United States had with the trademark provisions of the treaty. Until 2000, the failure to ratify was based on the State Department's opposition to a treaty provision that gave the European Union, as an entity, a vote in future debates over the treaty in addition to the votes of the constituent EU countries. The United States objected on principle to this "extra" vote for a non-country. Compromise on this issue was reached when the EU agreed that it would never vote against the United States on any matter. Two years later, in 2003, the United States finally ratified the Madrid Protocol.

V. The Madrid System Compared to Other International Trademark Protection Methods

Each of the international trademark protection methods referred to above—individual country applications, the Madrid System and the supranational registrations—have relative advantages and disadvantages that need to be taken into account in deciding how to structure an international trademark protection program. Most often, the best choice will involve a combination of these methods. The key considerations are summarized below.

A. Madrid System Registrations

1. Advantages

- Most cost-effective way to obtain protection in a large number of countries where many non-EU countries are involved

- Lower maintenance burden than national registrations because a single renewal or single assignment will be effective for all countries included.

2. Disadvantages

- Very costly in the event that problems arise in a few countries because of the need for local counsel and separate proceedings in each country.
- The description of goods and services from the home country application or registration must be used.
- Results in a bundle of national rights rather than a unitary right.
- Mark must be used in each country at some point to maintain protection in each country.
- Mark must be enforced in each country separately.
- Limited coverage in Western Hemisphere and spotty coverage in Asia.

B. National Registrations

1. Advantages

- Fastest way to obtain protection in individual countries (depending somewhat on the country in question).
- Cost advantage if protection in only one or two countries is needed.

2. Disadvantages

- Most costly alternative for protection in most or all of the EU countries.
- Greater burden of maintenance and renewal for individual marks.
- Can obtain enforcement in only one country.

C. The CTM (Other Supranational Registrations May Differ)

1. Advantages

- Relatively inexpensive to obtain for coverage in a number of EU countries, compared to national registrations or international application (after payment of filing fees in each country).
- Currently covers twenty-seven countries and may soon include six additional countries that have applied for membership.
- Use in one country sufficient to maintain the CTM mark in all EU countries.
- Long term cost advantage because there is only one mark to maintain and renew.
- Can be enforced through a pan-European injunction not available with individual country registrations or Madrid System.

2. Disadvantages

- Relatively slow proceeding—registration takes thirteen to sixteen months, even when no problems come up.
- Enforcement not available before registration.
- Relatively high risk of failure—rejection by one country dooms CTM application; can be converted to national applications, but with disadvantages noted above.
- Does not include Switzerland or Norway.

VI. Conclusion

One of the disadvantages of the Madrid System—the limited coverage in Latin America and Asia—is starting to change. For a variety of reasons, more countries formerly disinclined to join Madrid are reconsidering. Traditionally, Latin American countries have been hostile to the idea of joining Madrid. However, Colombia has joined effective August 2012 and Mexico is soon expected to join. The United States, WIPO and the International Trademark Association, a private association of trademark owners and trademark attorneys, are all making efforts to encourage countries to join Madrid.

Despite the potential benefits, United States trademark owners and trademark lawyers have not been making as much use of the Madrid System as might be expected. This may to some extent be due simply to a lack of knowledge of the system or simply resistance to any departure from established practices. However, the requirement for Madrid applications to use the same descriptions of goods and services as the home country application may also be a contributing factor. The United States Patent and Trademark Office ("PTO") requires more specific descriptions of goods and services than the vast majority of countries. Accordingly, use of those descriptions in Madrid applications may lead to narrower trademark protection in other countries than would otherwise be available.

For example, the PTO typically requires applicants for apparel trademarks to specify the specific garments on which the mark is used, *e.g.,* trousers, skirts, shirts, etc. In many other countries the description "apparel" or even the description of the entire relevant international class (Class 25) is acceptable. Accordingly, the protection for a United States owner's trademark in such a country would be narrower under a Madrid application than if a separate application had been filed in that country. Depending on the mark and the goods or services, this factor may or may not be significant.

Nonetheless, the Madrid System is growing in popularity and acceptance, and is likely to play a greater role in international protection of trademarks. The traditional objections of some countries to joining the Madrid System are gradually giving way, and more countries will likely be joining. Although not the correct choice in every circumstance, the Madrid System is, and deserves to be, an important part of the mix in determining how best to protect trademarks internationally.

Endnotes

1. In this connection, see the article by Federico González Peña, *The Madrid System from a Mexican and Broader Latin American Perspective*, 25 INT'L L. PRACTICUM ___ (2012).
2. *ITC Limited v. Punchgini, Inc.*, 482 F.3d 135 (2d Cir.), *cert. denied,* 128 S. Ct. 288, *certified questions answered,* 9 N.Y.3d 467, 850 N.Y.S.2d 366 (2007), *certified questions conformed to,* 518 F.3d 159 (2d Cir. 2008).
3. The text and member countries of the Madrid Agreement can be found at http://www.wipo.int/treaties/en/registration/madrid/.
4. The text of the Madrid Protocol and the list of countries adhering to it are available at http://www.wipo.int/treaties/en/registration /madrid_protocol/.
5. *See* González Peña, note 1 *supra.*

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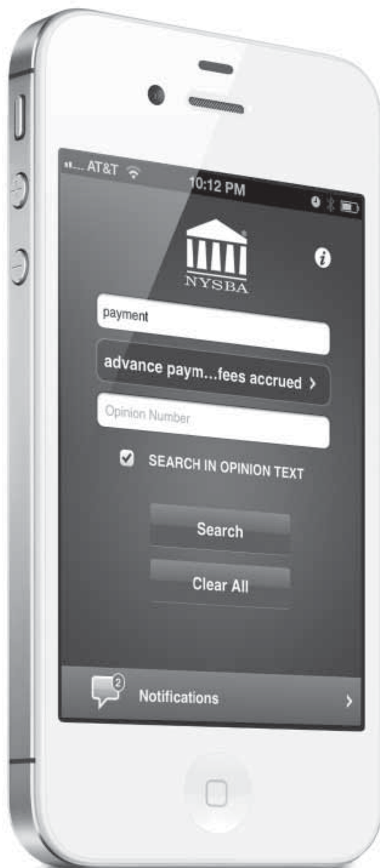

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The Madrid System from a Mexican and Broader Latin American Perspective

By Federico González Peña

I. Reason for Historical Resistance in Latin American Countries

Latin America is often mistakenly viewed as a single standardized region, with identical economic, political and social backgrounds and for perspectives and ambitions.

In fact, Latin America is a region comprising thirty-four countries with different languages and substantially different levels of development—despite the fact that some countries, such as Brazil, Argentina, Chile, Colombia and Mexico, show clear economic growth advantages. Latin America is actually a complex and diverse region. Therefore, it is difficult to generalize the position of all Latin American countries regarding the Madrid Protocol.

Nevertheless, historically there has been significant resistance in Latin America to the Madrid System, and it is important to point out that currently Cuba, Antigua, Barbados and Colombia are the only countries in Latin America that are members of the Protocol.

In spite of some Latin American countries accepting the Madrid Protocol, several Latin American practitioners, trademark owners and IP associations such as ASIPI (Inter-American Industrial Property Association), AMPPI (Intellectual Property Protection Mexican Association), and ABPI (Brazilian Intellectual Property Association), among others, have asserted that further study on the impact of the Protocol should be carried out before Latin American countries make a decision to accede to the Protocol.

Some of the common concerns among all Latin American countries are discussed below.

A. Negative Experiences

History shows that Brazil, Argentina and Chile had problems with international trademark cooperation in conducting export and import operations. Thus, it was very difficult to obtain trademark registrations outside such jurisdictions. Consequently, the adherence to the Madrid System was and is not considered by those countries as a good commercial approach.

Brazil was a member of the Madrid Agreement until 1934, when it formally resigned, based on its experience that the international trademark registration system was detrimental to local companies.

Since Brazil's main items of export were and still are to a great extent either agricultural products or goods manufactured by subsidiaries of foreign companies, there was an imbalance between the overwhelming inflow of foreign trademarks and the outflow of local trademarks. The local marks were confronted with a huge number of international registrations, while few Brazilian marks were protected internationally.

Furthermore, since Brazil's main trade partners were and are in Latin America, the countries targeted by Brazilian companies were outside the system anyway. This experience has had an enduring impact, not only in Brazil but in the neighboring countries as well.

The Madrid Protocol could become a more acceptable option once Latin American countries increase their international commerce and are able to benefit more fully from the treaty's advantages. The negotiation of special concessions in trade agreements meant to promote industrial development in Latin America is a necessary prerequisite to promoting adherence to the Protocol.

B. Language Barrier

Another significant obstacle for adoption of the Madrid System was the exclusion of Spanish as an official language of the treaty. A few years ago, the only two official languages of the Protocol were English and French.

Yet in Latin America 400 million people speak Spanish and 180 million speak Portuguese. Moreover, in many Latin American countries, use of the official language is an unavoidable constitutional requirement. For instance, publication in the domestic language is fundamental for the validity of certain rights.

One practical incentive favoring accession would be the adoption of Spanish, which is in fact anticipated. In fact, studies have been presented to the World lntellectual Property Organization (WIPO) Assembly showing the importance of the adoption of Spanish to overcome constitutional barriers.

However, the inclusion of Spanish in the Madrid Protocol would not be the perfect solution for all Latin American countries, since Brazil is a Portuguese-speaking nation.

C. Dual Registration Systems

Another concern with regard to the implementation of the Madrid Protocol for Latin American countries is the duality of trademark registration protection systems. This

is considered to be a latent intrusion on domestic governmental procedures, and is also viewed as the enforcement of foreign law in violation of a nation's sovereignty.

Under the Madrid Protocol, if the designated country fails to examine the mark within certain time limits, the international registration is automatically granted. In contrast, for nationals the failure of examination by the trademark offices will result in a lack of protection. This inconsistency of rights between nationals and foreigners raises constitutional issues. Furthermore, the fact that many Latin American trademark offices are understaffed, under-budgeted and badly equipped contributes to the reluctance to accept dual systems in practical terms. Input from WIPO is necessary to address these concerns and to help these countries reorganize and improve their trademark offices. Some countries propose that the possibility of implementing a regional office should also be considered.

Thus, prior to the Protocol's implementation in Colombia, and now in Mexico, the effect of granting a trademark registration eighteen months after the corresponding publication, without any official action or notice form the local authority, was extensively discussed.

D. Opposition and Litigation Costs

Another relevant topic for discussion, not because of the executing nations, but in light of the trademark owners involved, is the opposition as part of the registration system.

Although WIPO has issued diverse criteria to be considered in the granting or denial of a trademark registration, it is within each nation's prerogative to include or not to include such criteria, either by an opposition procedure prior to the granting of each registration, or by including such criteria as trademark registration nullity grounds.

There is a broad concern that the Madrid System may increase the number of oppositions and litigation. Nationals generally fear the risk of costly Central Attacks and multi-jurisdictional disputes. It is therefore important to introduce some guarantees to ensure that these disputes will not be used to impose a financial defeat—as opposed to a legal victory based on the merits. In litigation, there should be mechanisms for service of process without the need of expensive letters rogatory. At present, the Protocol does not resolve these concerns.

E. FTAA Negotiations

The economic frontiers of the Americas are being redefined as the countries enter the final stages of negotiations for the Free Trade Area of the Americas (FTAA). A harmonized IP regime is one of the topics under consideration. Mandatory adherence to the Madrid Protocol has been proposed.

For Latin American countries, an IP regime is not a primary issue in the FTAA negotiations and will be considered in the context of reciprocal concessions, since market access for agricultural products and specific industries are Latin America's higher priorities. Yet in the U.S. the Congress has restricted its government's negotiating ability in discussing agricultural barriers as well as a reduction of certain industries' subsidies, and it is possible that such discussions might be transferred to the Doha Round of the WTO. This has prompted some countries to propose moving the IP issues to the Doha Round as well. To enhance the Protocol's chances in the negotiations under the FTAA, the developed countries of the region must be prepared to make concessions in the agricultural field and to cut subsidies to their less competitive industries.

The debate on whether to join the Protocol has recently intensified in Latin American countries, where the discussions have been focused on the conflict between multinationals wishing to reduce costs and the local practitioners in their efforts to preserve jobs. Some government officials are also concerned that their functions may be significantly altered as a consequence of the Protocol's reduction of the autonomy of the local trademark offices.

However, these positions fail to address fully the advantages and disadvantages of the Madrid System for the Latin American economies. Thus there are benefits in the Madrid Protocol for companies exporting branded goods, but there are also critical disadvantages for small businesses and companies involved only with internal markets.

In identifying the Protocol's benefits and disadvantages, the economic impact on local companies must be considered. In any event, it is clear that this subject matter will be on the agenda as the ongoing FTAA negotiations evolve. Trade concessions, as well as solutions to the above-mentioned objections, are necessary for the Protocol to become an attractive alternative for Latin American countries.

II. The Historical Resistance Is Abating

In this highly competitive global economy, Latin American countries need to take advantage of all available tools to assist trademark owners in meeting the challenge to grow not only their businesses domestically, but also to find new markets for their products and services. A key tool to boost such expansion is an international system, such as the Madrid System, that greatly eases the burden of obtaining protection of trademark rights. Mexico should further its leadership in the promotion of intellectual property rights, particularly in Latin America, by enacting legislation to clear the way for joining the Madrid System and it is likely to do so.

A. The Madrid System Adopted by Colombia

Thanks to this international procedural mechanism, the Madrid System offers a trademark owner the possibility to have the owner's trademark protected in several countries by simply filing one application directly with the owner's own national or regional trademark office. An international mark so registered is equivalent to an application or a registration of the same mark effected directly in each of the countries designated by the applicant. If the trademark office of a designated country does not refuse protection within a specified period, the protection of the mark is the same as if it had been registered by that office. The Madrid System also greatly simplifies the subsequent management of the trademarks, such as recording changes, adding designated countries, and renewing the registration through a single procedural step.

B. Recent Incorporation of Mexico to the Madrid System

The Madrid System is of great importance to trademark owners entering the international commercial arena. It creates meaningful access to international trademark protection for all companies, regardless of size, by substantially reducing costs, and providing a streamlined registration process. Without the Madrid System, smaller enterprises wishing to offer their products and services on the global stage, but without the means to seek trademark protection on a country by-country basis, take the prospect of foregoing overseas markets. Larger corporations also will benefit from Mexico's adherence to the Madrid Protocol and its ease of administration and cost-saving features.

Although joining the Madrid Protocol would entail some administrative changes within Mexico's Intellectual Property Office (IPO), the minimal administrative costs will be more than offset by additional revenue from filing fees.

C. Principal Obstacle to Be Resolved in Mexico

The trademark granting process in Mexico is, in some ways, restricted in comparison with most of the other countries worldwide, since the Mexican process does not allow any third party who believes that its rights and interests could be affected by the granting of the corresponding registration to intervene in said process. In other words, Mexico is the only country of Latin America that does not have an established opposition procedure.

Under the provisions of the Mexico Industrial Property Law, each trademark registration application is subject to (i) a formal or administrative exam and (ii) a novelty exam. In the first one, the IPO will check if all legal requirements are met, while in the second one, the IPO will determine if the proposed trademark can be registered attending to the restrictions provided by law: the IPO has the maximum periods of four and three months, respectively, to issue any official demands or requirements with which the applicant must comply.

Nevertheless, as commonly happens in international practice, a trademark registration is usually subject to an opposition system, which requires the local office in charge of registration to publish all trademark applications before the corresponding granting, with the purpose of allowing any affected third party, if the proposed trademark registration is granted, to file arguments aimed at persuading the authority to deny said registration in accordance to law.

Opposition procedures can be defined as those which offer any third party the opportunity to prevent the granting of a trademark registration within a reasonable period of time, by claiming at least one legal impediment for registration, as recognized by local legislation.

Such opposition procedures are intimately bound up with the registration process, and it is possible to include them in the initial part of the process, prior to the grant of trademark registration in the form of an opposition prior to registration, or initiated as an opposition after registration is granted.

In addition to the opposition system, or even as an alternative (as in the Mexican case), national trademark laws may offer to any affected third party the chance to oppose an already registered trademark by commencing a nullity or cancellation action. These administrative procedures are conducted once the trademark has been granted an official registration, allowing the corresponding plaintiff to claim any legal impediment or prohibition, be it absolute or partial.

In those systems offering both opposition and nullity procedures, it is possible to find similarities between the two procedures, in regard to both allowed grounds for opposition and ways to file evidence. However, these procedures can have different purposes. On one hand, the opposition may turn into a fast, low-cost and superficial procedure, in order to solve simple matters through agile resolutions, but with very restricted opposition grounds and ways to file arguments and evidences, while, on the other hand, nullity procedures are usually more ample, including a wider scope of nullity grounds and options of acceptable evidence.

Likewise, there is the option in some countries to prepare and file so-called "observations" and "letters of protest." In connection with the first, such may be filed by third parties in opposition procedures or simultaneously.

The main purpose of the "observations" is to provide the examining office, at any time, with any such information as may lead to denying a specific trademark registration. The person or entity who files the observations does not become part of a procedure and, in general, the examining offices do not respond directly to such observations.

In regard to letters of protest, these can be filed during the corresponding application's exam period. Nevertheless, such a letter is not directly analyzed by the examining officer, but rather by an independent assessment officer, who determines if the evidence submitted with such letter is binding for interested parties. If the evidence filed is of a descriptive nature, and it is clear that the corresponding examiner did not previously assess such information, it will be included in the relevant trademark file or dossier.

In Mexico the trademark authority has a specific code in its trademark database system to identify observations filed by third parties, without the same being part of a trademark opposition process. However, this arrangement lacks a legal basis, since such observations are not included in the Industrial Property Law. Consequently, intellectual property specialists must file such observations based on the constitutional right of petition.

Importantly, membership in the Madrid Protocol will contribute to the progressive internationalization of Mexico's economy, providing additional products and services to consumers, and creating new jobs. This two-way facilitation of obtaining trademark protection will help stimulate both the export of Mexican products and services and promote foreign investment in Mexico.

D. Expected Benefits for Trademark Owners

Accession to the Madrid Protocol would permit Mexican companies to reduce greatly their administrative costs and paperwork by only having to file:

- One application;
- In one place;
- With one set of documents;
- In one language (which could be in Spanish);
- With one fee;
- Resulting in one registration;
- With one number;
- And one renewal date;
- Covering more than one country.

The costs savings to trademark owners would be significant. For example, a trademark owner wishing to register a mark in ten different countries currently needs to file ten separate applications. The costs of these ten applications, which include official and attorney fees, would be exorbitant. Under the Madrid Protocol, the fee, depending on the amount that the national office has agreed with WIPO to charge, would be preset.

For a basic application and based on WIPO schedule of fees in 2008, the fees correspond to (i) a base fee of around US$710 (for three classes) and (ii) an additional fee of around US$100 for each designated country, providing trademark protection for ten years.

An even greater economic benefit would be realized after an international registration has been obtained. If a company has one thousand trademark registrations in ten countries and needs to make an amendment due to a simple change in address, without the Madrid Protocol that would require ten thousand amendment applications at a cost in the thousands of dollars. Under the Protocol, only one amendment application needs to be filed with WIPO at a cost of about US$163.

E. Coexistence of the Two Systems

The procedures for registering trademarks are governed by the rules and regulations of national and regional IP offices. Trademarks can be applied for by filing an application with the relevant national or regional IP office(s), or by filing an international application through the Madrid System. Even when countries decide to adopt this system, through the Madrid Protocol, the decision of whether to issue a trademark registration remains at the discretion of the competent national or regional authority, and trademark rights are limited to the jurisdiction of the authority that issues the trademark.

III. The Efforts to Encourage Wider Membership in the Madrid System

A. Efforts by WIPO

WIPO encourages countries to optimize their trademark office operations under the harmonized registration procedures in order to reduce costs and other burdens for both local and international trademark owners. In many countries, a registration through the national office can take up to four years, in effect denying trademark protection in this age of global communication and rapidly changing markets. Under the Madrid Protocol, an application for a registration to be extended must be examined and acted upon within eighteen months.

WIPO has become a fundamental entity in promoting a wider membership in the Madrid System, due to its ongoing efforts by means of regular basis seminars and conferences, as well as its constantly improving web-based tools and services.

B. Efforts by the International Trademark Association ("INTA")

The International Trademark Association has exposed the need for Latin American countries to participate in the Madrid System. There are currently fifty-eight Contracting Parties that are members to the Madrid System, but, as noted above, only a very few from Latin America.

Through its advocacy strategy launched in 2006, INTA, in partnership with the United States Patent and Trademark Office (USPTO), WIPO and other IP associations, has played a leading role in promoting the Madrid Protocol in Latin American countries. In recent years, many developments in the region have paved the way for adoption and implementation of the Madrid Protocol:

- Local government efforts to implement modern IP systems.
- The rising activity of SMEs in the region's economies.
- The signing of trade agreements.

INTA policy seminars conducted throughout the region have championed the advantages of joining the Madrid System:

- A simple and time- and cost-effective registration system (savings calculated to be sixty-seven percent in total fees)
- Multiple registrations using one application in one language that can be in English, French or Spanish and one application fee.
- Streamlining of office procedures.
- Coexistence with national trademark systems, providing an alternative route for registering marks.

INTA is also working with local authorities and IP stakeholders to identify and address some of the challenges that must be overcome before the Protocol is implemented.

Since 2006, INTA has taken a leading role in educating governments and legislatures through seminars and workshops in Latin America, to promote the advantages of the Protocol and to assist through providing support for preparing trademark operations to take on the additional tasks and requirements of the Madrid System. In the process, INTA has facilitated a dialogue with authorities, the legal community, and the private sector. It is INTA's assessment that the net result of the awareness campaign is a growing interest and recognition by governments in Latin America that the Protocol is a valuable trading tool.

C. United States Inclusion of Membership in the Madrid System as Part of New Free Trade Agreements

The U.S. has contributed to the expansion of the Madrid Protocol membership through the different Free Trade Agreements it has executed in the recent years, since this ensures that Americans will have a faster, simpler and more cost-effective tool to protect their intellectual property globally.

U.S. trademark owners are able to file a single on-line application with the USPTO in English, pay the fees in U.S. dollars, and potentially obtain protection for its mark in any or all of the fifty-eight Madrid Protocol member countries. Consequently, the U.S. Government has established the Protocol's adherence as one of the fundamental requisites for its trade partners around the globe, which, of course, turns into a "must-do" requirement in view of the indisputable benefits for those countries seeking to engage in deeper commercial relationships with the U.S.

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The Madrid System from a Portuguese and Broader European Perspective

By João Paulo Mioludo

I. Introduction

The Madrid System is currently composed of two important international agreements, the Madrid Agreement and the Protocol to the Madrid Agreement. Both are managed by WIPO, but the trademark registry officials within each Contracting Party play an important role within the Madrid System, as reflected by the fact that the national trademark registration procedures and rules within each Contracting Party are also applied in the course of protecting trademarks under the Madrid System—sometimes with important consequences in the international registration, such as the results arising from a "central attack" or arising from provisional refusal decisions, among many others.

II. Historical background

The Madrid Agreement was established in 1891, and was revised on several occasions: in Brussels (14 December 1900); Washington (2 June 1911); The Hague (6 December 1925); London (2 June 1934); Nice (15 June 1957); and Stockholm (14 July 1967). More recently, the Madrid Agreement was modified in 2007.

The Agreement resulted from the efforts, at the end of the nineteenth century, to establish a system of international protection of trademarks. History can tell us something about the changes and developments of world trade in the nineteenth century, and this trend had continued until the current globalization we are experiencing, even with the interruption of the two world wars.

At the end of the nineteenth century, the industrialized countries felt the need to overcome the difficulties that had arisen in obtaining trademark registrations on a country-by-country basis (the so-called "territoriality principle"), including very different rules and procedures from one country to the next and above all very high costs. At that time regional systems for protection of industrial property rights were not conceivable, since the local interests of each state were most of the time very strong. The new proposed system would respect the different interests of the states that were looking for an international protection system, offering them the freedom to establish either more liberal or protectionist measures.

The Paris Convention, established on 20 March 1883, was probably one of the most important agreements, which has created a Union that currently comprises more than 150 countries and has the distinction of being the first effort to effect harmonization in terms of industrial property legislation. Thus, the Madrid Agreement was the first international agreement that established the possibility of extending trademark protection granted in one country (country of origin) to other country members through a single registration, with relatively simple formalities.

More recently there have been two significant steps in response to challenging times. For one, there was the authority of the Madrid Protocol to the International Registration of Marks, on 27 June 1989, and for another, there was the implementation of the Community Trademark System (CTM) within the European Union. It is not by chance that both the Protocol and the CTM went into force in 1996.

The Madrid System now comprises eighty-eight countries. Of these, fifty-six are party to both agreements. With no doubt, the Protocol was in fact an important lever to have important states and regions join the Madrid System, including, among others, the United Sates and the European Union. However, important countries like Indonesia and Taiwan are not covered yet, nor are important regions, like most of Latin America.

III. The Madrid System

A. The Madrid Agreement

As noted above, the Madrid Agreement has played an important role in the protection of trademarks. The main features can be summarized as follows:

- There is one single application.
- International Registration (IR) is based on a home trademark registration (Country of Origin).
- Each contracting party may provide for examination in accordance with its respective national rules, with the possibility of refusing protection for the international registration.
- Costs are composed of a basic fee, an extra fee for each class beyond the third class, and a supplementary standard fee for each designation.
- French was adopted as the only language of procedure.
- There was dependency on the home registration for a period of five years, which could result in the revocation of the international registration if the home registration was declared void or cancelled.
- Validation period was for ten years (initially twenty years), with a centralized renewal procedure in Geneva.

- In each designated country the protection of the IR was to be identical to the protection granted marks submitted pursuant to the country's national rules.

B. The Protocol

In 1989 the Madrid Agreement Community comprised only twenty-nine countries. Many states had shown interest in becoming members, but for various reasons, such as the insufficiency of fees or the strictness of the rules, they gave up. In any case, it was seen that the system had to be improved before many other countries and regions would become part of the Madrid System.

The Madrid Protocol, adopted on the 27 June 1989, contained more flexible rules:

- The international registration can be based on a trademark application (as opposed to registration) filed in the Country of Origin.
- The deadline to notify the applicant of a possible refusal of protection is now eighteen months rather than the original twelve months, as provided in the Madrid Agreement;
- A basic fee is maintained, but each state is free to establish its own individual fee, in order to balance the loss of official fees that would have resulted from national applications.
- Languages of procedure are now French and English, and, more recently, Spanish.
- There is now the possibility of converting an international registration into a national registration in the event the IR is declared void or cancelled through a "central attack" during the dependency period of five years.

With these new rules, some important countries have joined, such as the United Kingdom and the Scandinavian countries, as well as Japan, South Korea, Australia and the United States.

However, the most important achievement was the fact that the Protocol was also a gateway for intergovernmental organizations, like the European Union, which joined the Protocol on 1 October 2004.

C. The Safeguard Clause

The Protocol itself has already been the subject of two amendments (3 October 2006 and on 12 November 2007), due to the "safeguard clause" as originally set forth in article 9*sexies* of the Protocol.

As noted above, the Madrid System is composed of two agreements, where some Contracting Parties are bound by the Madrid Agreement only, while other Contracting Parties are bound by both the Agreement and the Protocol, and yet a third group are Contracting Parties exclusively bound by the Protocol. When the Protocol was approved, it was necessary to establish which agreement should be applied when. For instance, in an international application there were countries that were Contracting Parties to both the Agreement and the Protocol, and others that were only members of the Agreement or of the Protocol.

This was in fact a very sensitive question, due to several issues, such as questions like fees, the term within which to notify provisional refusals of protection, the basis of the international application (a home registration or a home application), the election of the administration of origin, and the language regime. There are in fact many questions around these issues, but the strict scope of this article does not allow us to go much further.

Yet, it should be kept in mind that article 9*sexies* of the Protocol, commonly known as the "safeguard clause," had established that where Contracting Parties are bound by both the Agreement and the Protocol, the provisions of the Agreement would prevail in the mutual relations between those Contracting Parties. Currently, article 9*sexies* of the Protocol, as amended and in force from 1 September 2008, repeals the "safeguard clause." Consequently and as from that date, it will be the Protocol which will apply in the mutual relations between the Contracting Parties bound by the Agreement and the Protocol.

There are only a few situations where the Agreement will continue to apply:

(i) when the country of origin is a country bound exclusively by the Agreement; or

(ii) the country of origin is bound by both the Agreement and the Protocol and some or all of the designated Contracting Parties are bound exclusively by the Agreement.

In any event, it should be stressed that article 9*sexies*, as amended, limits the effects of the repeal of the safeguard clause in two aspects that are related to the extension of the time limit for notifying a provisional refusal and to individual fees.

In sum, despite all the problems raised with the implementation of the Madrid System, it has turned out to be a great success in terms of international protection of trademarks.

IV. Portugal and the Other Portuguese-speaking Countries and the Madrid System

A. Portugal

Portugal is one of the oldest members of the Madrid System, having been a member of the Madrid Agreement since 31 October 1893. Later on, Portugal adopted the Stockholm revision in 29 April 1988 and became a member of the Protocol on 20 March 1997.

Over the years Portugal has had a very positive experience with the Madrid System, although Portugal cannot be cited as one of the largest users of the System. As the statistics show, the Madrid System is clearly an instrument that benefits countries with a strong industrial base. Thus Germany was by far the greatest user of the Madrid Agreement, followed by France. In the Protocol years, and above all with the entry of the United States and the EU, the situation has changed a little, but even so, perhaps with Japan (and China in terms of territorial designations), these are with no doubt the top users of the Madrid System.

As for Portugal, the available data (on the Portuguese Patent and Trademark Office website) reveal that Portugal has declined in importance in terms of international designations, since in 2010 Portugal was designated in 2258 applications, 15.6% fewer than in 2009.

In the same period the number of International Registrations has increased 6.6%, and in this regard Portugal was the country of origin of 151 international applications, representing an increase of 11.9% in comparison to 2009.

It is not likely that the situation will change in the near future. In fact, due to the financial problems Portugal is experiencing, companies and economic agents in general are suffering from severe investment restrictions, together with a very significant increase in taxes, which will in all likelihood bring Portugal into an economic recession for quite a few years.

B. Brazil

As we all know, Brazil, as well as the large majority of Latin America, are still not part of the Madrid System. After the accession of the United States in 2003, and given the political and economic influence of the U.S. all over the South American continent, some have said that it was only a matter of time before all Latin America countries would join the Madrid System. But, with the exception of Cuba, only Colombia has joined so far, last August, and Mexico is about to join.

Brazil is by far the most important country in Latin America, and one of the biggest economies of the world. In recent years we have been witnessing impressive economic growth and development in Brazil that, among many other factors, gave rise to a greater distribution of wealth and a growing and stronger middle class, bringing Brazil closer to western standards of living.

Nevertheless, several factors may explain this delay in Brazil adopting the Madrid System.

First, the Brazilian export industry is not very strong, and most of Brazil's production is being absorbed by internal demand. Therefore, Brazilian companies and economic agents in general are not desperate to look for international protection of trademarks. Furthermore, Brazil's big preferential markets are the United States, the European Union, and more recently, China. Thus, it would not be all that expensive to file trademark applications in two big countries, like the U.S. and China, and in the EU under the CTM, with the possibility of obtaining registration in twenty-seven countries at the same time.

Moreover, the Brazilian Patent and Trademark Office suffers from a huge backlog, and trademark procedures can last for a few years. The situation has improved in recent years, but it is far from being satisfactory. In order to accomplish the deadlines established in the Protocol, in particular the term for notification of refusal, decisions would have to be more timely notified and issued, and this can only work with a more regular situation in terms of national applications decisions, which must be rendered more rapidly.

Another issue is related to the fact that the Brazilian Industrial Property Law contemplates a single-class system, while the Madrid System adopted the multi-class system. Thus Brazil's internal law would have to be amended in this regard if the Madrid System were adopted by Brazil.

And the fact that the international application would have to be filed before the Brazilian Office in English, French or Spanish has been considered more onerous for Brazilian applicants, since they have to turn to more qualified trademark attorneys with broader language skills.

Finally, the question of costs is, as always, a sensitive question, and how to decide on the adoption of an individual fee or the participation in an annual fee resulting from the complementary fees distributed by WIPO may provoke a large discussion.

Brazil was originally part of the Madrid Agreement, but left it in 1934, since it was considered "harmful" for Brazilian national interests. The situation has changed, and winds blow much more in favor of a Brazilian accession to the Madrid System.

C. Portuguese-Speaking Africa

The Portuguese-speaking African countries are Angola, Cape Verde Islands, Guinea Bissau, Mozambique and Sao Tome and Principe.

Angola is by far the most important country and its recent economic growth is remarkable. Furthermore, it is a very rich country in terms of natural resources. However, an interested party must file trademark applications directly in Angola, since this country so far has not subscribed to any international trademark agreement, such as those of the Madrid System. The situation is identical for Cape Verde Islands.

Guinea Bissau is a member of the African Intellectual Property Organization (AIPO), which is essentially a regional and unitary system for protection of trademarks.

The only Portuguese-speaking African countries taking part in the Madrid System are currently Mozambique and Sao Tome and Principe.

Mozambique joined both the Madrid Agreement and the Protocol on 7 October 1998, and Sao Tome and Principe joined more recently, on 8 December 2008, but only in regard to the Protocol. Mozambique, as do all the above-mentioned countries, has a civil law heritage. Although the author does not have detailed information, he is aware that Mozambique does not have specific rules concerning International Registrations. However, International Registrations are being processed, since the National Patent and Trademark Office officially recognizes IRs.

The situation is similar in Sao Tome and Principe where, previous to its accession, it was announced well in advance that the National Services of Industrial Property would comply with the obligations of the Madrid Protocol. In this regard, the national Industrial Property Law established that "the terms of any international agreement relating to patents, industrial models or designs, collective trademarks and indications of provenance or names of origin to which Sao Tome and Principe is a contracting party are applicable [to Sao Tome and Principe], and in the event of divergence between them and this law, they shall prevail." In our opinion, the omission of "trademarks" in the above-mentioned rule seems to be accidental. In spite of the above, protecting international registrations in these countries may be inefficient and ineffectual, since internal procedures are not clear. It is the opinion of some that, to be on the safe side, trademark owners should file national applications to better secure their rights!

V. Community Trademarks and International Trademarks

As mentioned above, the Protocol foresees the possibility of supranational organizations becoming part of the Madrid System. The European Union was the first supranational organization to join, and since its accession, it has become possible to designate the EU in an international application, since the EU has a regional Office (the OHIM) administrating a trademark valid across the whole territory of the European Union—the Community Trademark.

By designating the EU in an international application (or in a subsequent designation), one can obtain a protection with the same effects as a direct Community Trademark application. It is not the purpose of this article to give and analyze statistics, but as far as we know there is little doubt that the Madrid System and the Community Trademark System have successfully coexisted. Thus the OHIM website states:

> WIPO has recently revealed that 2011 was the best year ever for trade marks filed under the Madrid System for the International Registration of Marks, with a total of 42,270 applications. This represents an increase of 6.5% on the figure for 2010.
>
> And in times of global uncertainty and worldwide financial instability, the total of 21,754 international trade mark renewals also filed at WIPO in 2011 was a demonstration of the importance the business community places on their IP rights as a way of weathering the storm in times of hardship.
>
> In terms of the geographical origin of international trade mark filings, more than half of all international trade mark applications came from member states of the European Union (57.4%), while China remained the most designated country for protection.
>
> And for the first time OHIM has knocked Germany off the top spot, filing a total of 5,859 international applications in 2011—nearly 25% up on the previous year.
>
> German applicants come second in the ranking of top ten filers with 5,000 IAs, almost 12% of the total amount filed, followed closely by the USA in third place with 4,791 filings, though the fastest growth rate belongs to Russia, with an increase of more than 35% in comparison to 2010.
>
> As far as designations for extension of protection to other contracting parties was concerned, the number rose by 8% in 2011 compared to the previous year with a total of 323,855. And topping the list of favourite designated parties were China (18,724 designations), the EU, the United States of America, the Russian Federation, Switzerland, Japan, Australia, Republic of Korea, Turkey, and Ukraine.
>
> As with filings of CTMs at OHIM, computer hardware and software goods in class 9 and business services in class 35 were the top two areas of activity in international trade mark filings for the year 2011, representing 9% and 7.3% respectively. Following on were services in class 42, goods in class 25 and services in class 41, closely matching the filing trends in national and CTM filings.

As established in its founding treaties, one of the main objectives of the European Union was to establish an internal market. Although in force since only 1996, discussions over the creation of a community trademark had begun many years before, as a result of the understanding that a unitary trademark, valid in the whole territory of the EU, would be a necessary and fundamental step to achieve and strengthen the proposed internal market.

This is probably the first distinction we have to make when we compare the Community Trademark with the International Registration. The Community Trademark results from an integration system as outlined in the programmatic treaties of the EU, providing for an economic union as a first step, but nowadays consisting also of a political union, while the international registration as established by the Madrid System results from the cooperation between states (and regions) in order to obtain and facilitate trademark protection in other states and territories.

As a compromise, there are some significant differences in the two systems, as we can see through the following chart comparing the two regimes:

Community Trademark	International Registration
A single registration creates a single unified right throughout the EU. In the case of refusal the CTM is refused for the whole territory, even if the refusal is grounded in a national prior right. Conversion is possible.	An international application creates rights in the Contracting Parties that grant protection though registration. In case of refusal in some countries, the IR can proceed for registration in the remaining countries.
CTM applications are examined (ex officio) on absolute grounds only.	Grounds for refusal in member countries are more extensive as a result of their own national laws. Refusals may result from relative grounds, such as likelihood of confusion.
A CTM applicant does not need to be established in the EU.	An applicant for an IR must be a national of or domiciled in one of the member countries of the Madrid System or at least have an industrial or commercial establishment.
The CTM is filed directly at OHIM (it does not need a "home" application and/or registration).	The Madrid System requires the existence of a home application and/or registration in the applicant's home country.
Filling fees covers all the 27 countries of the EU.	Filling fees depend on the number of countries sought for registration.
CTM is valid for ten years from the date of application, and can be renewed for identical periods of time.	IR is valid for periods of ten years from the date of registration. However, refusal or cancellation of the home application and/or registration during the first five years may result in the cancellation of the whole IR, including all the member country designations (conversion into national application is possible).
CTM registration procedure is usually longer than in individual countries of the EU (with a few exceptions).	Applications filed under the Madrid System are sometimes granted more quickly in some countries than if individual applications had been filed.
Genuine use in only one country of the EU may be sufficient to protect the CTM against a cancellation action for non-use.	The IR is subject to use requirements in each member country. Use in one country is not sufficient to oppose cancellation proceedings filed in another country.
CTM is automatically valid in all 27 countries after granting registration.	IR protection (registration) can be extended to other countries (territorial extension).
Injunctions are possible for the whole territory of the EU in the event of CTM infringement.	Injunctions and legal procedures in general are only possible on a country-by-country basis.

The differences between the two regimes are clear from the above chart, but it might be worthwhile to stress that, for the users or applicants in general, other factors and practical questions are important when a decision has to be made concerning issues such as in which territories to protect my trademark and what is likely on the total cost.

The possibility of designating the EU in an international registration and obtaining a CTM through the Madrid System is in fact a great advantage, since through a single designation in an application of an IR one can obtain protection in twenty-seven countries by using a single procedure. The fact that other territories have meanwhile joined the Madrid System—and above all the Protocol—has enlarged the possibility of achieving protections in other markets, while filing on a country-by-country basis would certainly result in increased costs and multiple efforts.

However, one should keep in mind that some countries are very restrictive in the evaluation of International Registrations. Besides, the Madrid System provides that the Contracting Parties may use the System in accordance with their own interests, and this may result in some shortcomings.

Another important issue about International Registrations is related to costs: one should carefully review costs to avoid unpleasant surprises.

Consider the following situation as an example. A Portuguese applicant wishes to protect its trademark internationally, including all the countries of the EU, and chooses the Madrid System as the right tool to do it. His mark is a single mark, with no color claim and intended for wines in class 33 of the International Classification of goods and services. Portugal is a member of both the Madrid System and of the EU, and therefore an IR may be based either on a national application or on a CTM application. However, in terms of costs, there is a significant difference. In terms of official fees, to choose filing the IR based on a Portuguese application represents a saving of 1284 Swiss francs. Furthermore, the official fees due for the transmission of the international application from the Office of Origin to the Bureau may diverge substantially. In Portugal, fees are in the amount of €10.00, but at OHIM the fees are of €300.00.

In fact there is no special guide to follow in terms of the best solution to adopt when one seeks international protection. A case-by-case analysis should be undertaken, since many factors must be considered. It may happen that in some cases the Madrid System does not offer the best solution, nor the most cost effective one.

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