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PRACTICUM: FORM AND POLICY

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Practical Aspects of The Hague Service and Evidence Conventions

By Birgit Kurtz

I. Introduction

This article is designed to provide practical information for the practicing lawyer on the use of the Hague Service and Evidence Conventions.

II. The Hague Service Convention

A. Background

The full title of the Hague Service Convention is "The Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters."[1] It applies in all civil and commercial cases in which there is a need to transmit judicial or extrajudicial documents for service abroad where two signatory countries are involved. [2] The Hague Service Convention was signed on 15 November 1965 by Members of the Hague Conference on Private International Law and entered into force on 10 February 1969. The full text and a list of the current signatory countries can be found on the official website of the Hague Conference on Private International Law: http://www.hcch.net.[3]

The purpose of the Hague Service Convention is to accomplish the following:

- Create appropriate means by which judicial and extrajudicial documents served abroad shall be served on an addressee in sufficient time.
- Improve international mutual judicial assistance by simplifying and expediting the process for service abroad.[4]

B. Procedure Before the Enactment of the Hague Service Convention

Before the enactment of the Hague Service Convention, service was generally made by use of "letters rogatory." A letter rogatory is a formal request from a court in the country where the proceedings are underway to a court in the country where the party on whom service is desired is a resident.

In order to use this method, the court in which proceedings are underway transmits the document(s) to be served to its own country's Ministry of Foreign Affairs (in the United States, the State Department), which forwards the request to its counterpart in the country of destination. The latter then transmits the document(s) to its local court, which arranges for the party to be served. Once completed, a certificate of service is sent back, using the same process in reverse.

Letters rogatory are still used in cases where the country of destination has not ratified the Hague Service Convention.

C. Operation of Hague Service Convention

Each signatory country designates a "Central Authority" to accept incoming requests for service.[5] In the United States, that is the Department of Justice in Washington, D.C.

A "Judicial Officer" who is authorized to serve process in the country of origin may send the request for service directly to the "Central Authority" of the country in which service is to be made.[6] In the United States, any attorney admitted to the bar is a "Judicial Officer."

Once the request is received, barring any objections,[7] the receiving state's "Central Authority" arranges for service to be made, generally in accordance with that country's laws.[8]

Once service has been effected, the "Central Authority" transmits back to the original "Judicial Officer" a certificate that is evidence of proper service (not unlike those used in U.S. state and federal courts).[9]

D. Forms

There are three forms, two of which must be completed by the party seeking to effect service in order for a country's "Central Authority" to serve the documents. The three forms are available online.[10]

The forms should be completed in English or French.[11] The Central Authority of each signatory country may, however, require that the documents to be served be translated into that country's official language.[12]

(1) The first form is the "Request for Service Abroad of Judicial or Extrajudicial Documents." This document formally requests service by one of three methods:
   - "by a method prescribed by its internal law for the service of documents in domestic actions upon persons who are within its territory";
   - "by a particular method requested by the applicant, unless such a method is incompatible with the law of the State addressed"; or
   - voluntary acceptance by the person to be served.

(2) The second form is the "Summary of the Document to Be Served." The form requires the serving party to provide a concise description of the action, for example:
   - Name and address of the requesting authority;
   - Identities of the parties in the action;
   - Nature and purpose of the document;

- Nature and purpose of the proceedings and amount in dispute, if any.

(3) The third form is the "Certificate." The "Central Authority" transmits a certificate of service back to the applicant or his/her counsel. The "Central Authority" certifies:

- Whether the document has been served;
- If so, the date, time and place of service;
- Method by which service has been effected;
- Identity of the individual to whom the documents were delivered;
- If the document was not served, notation of that fact and explanatory facts.

E. Cost of Using the Hague Service Convention

Although the "Central Authority" may not ask to be reimbursed for the services it rendered, it may ask for remuneration of the costs associated with the employment of a process server as well as costs occasioned by the use of some specific method of service requested by the applicant.[13]

F. Service by International Registered Mail

The Hague Service Convention generally does not interfere with a party's ability to send judicial documents directly to persons abroad via the postal service.[14] The Federal Rules of Civil Procedure allow for service abroad via registered or certified mail, return receipt requested,[15] where the destination country has not specifically prohibited such service.[16] The following countries do *not* allow service via mail:

Argentina	Lithuania
Bulgaria	Norway
China	Poland
Czech Republic	Russian Federation
Egypt	San Marino
Germany	Slovak Republic
Greece	Sri Lanka
Hungary	Switzerland
Japan	Turkey
Korea	Ukraine
Kuwait	Venezuela.[17]

G. Benefits of the Hague Service Convention

The use of the Hague Service Convention has several benefits. First, service is generally accomplished faster: requests for service pursuant to the Hague Service Convention generally are procured within two to four months, while service with letters rogatory often takes up to twelve months. Second, standardized forms simplify the process and are recognized by judicial authorities in those countries that have ratified the Hague Service Convention. Third, generally service via the Hague Service Convention is cheaper, since it avoids the involvement of a foreign local attorney.

H. Miscellaneous

The address of the U.S. "Central Authority" is as follows:

Office of International Judicial Assistance
Civil Division
Department of Justice
Room 11006
1100 L Street, N.W.
Washington, D.C. 20530[18]

Because, as noted above, in the United States, a party's attorney is designated as a "Judicial Officer" for the purposes of the Hague Service Convention, any American attorney may transmit a request for service directly to a receiving nation's "Central Authority."[19] There are also companies in the U.S. that can help with service pursuant to the Hague Service Convention.[20] Nevertheless, some countries will not honor a request for service unless it is executed by a judge or clerk of the court in which the matter is pending.[21]

The U.S. Supreme Court has indicated, albeit in *dictum*, that service via the Hague Service Convention is mandatory when the Convention applies.[22] Nevertheless, the use of the Hague Service Convention is unnecessary when the foreign litigant is on U.S. soil and, thus, subject to a court's *in personam* jurisdiction under the so–called "tag jurisdiction."[23]

III. The Hague Evidence Convention

A. Background

The full title is the "Hague Convention on Taking of Evidence Abroad in Civil or Commercial Matters."[24] It applies where, in a civil or commercial matter, a government authority of one contracting state requests the help of another to "obtain evidence, or to perform some other judicial act."[25] The Hague Evidence Convention may not be used to obtain evidence not intended for use in a judicial proceeding. The term "other judicial act" does not encompass service of process or the execution or enforcement of judgments.

The Hague Evidence Convention was signed on 18 March 1970 and entered into force on 7 October 1972. The full text of the Convention and a list of the current signatory countries can be found on the website of the Hague Conference on Private International Law at http://www.hcch.net.[26]

The purpose of the Hague Evidence Convention is to accomplish the following:

- Facilitate the transmission and execution of requests for the taking of evidence.
- Improve international cooperation in civil and commercial matters.[27]

B. Procedure Before the Enactment of the Hague Evidence Convention

Before the enactment of any treaties[28] for the taking of evidence, governments resorted to the use of "Letters of Request," which are very similar to Letters Rogatory. The term "Letter of Request" was adopted by the Hague Evidence Convention and is based on the same concept as the standard forms used by the Hague Service Convention. As with Letters Rogatory, Letters of Request are still used in cases where evidence is located in a non–signatory country.

C. Operation of the Hague Evidence Convention

As with the Hague Service Convention, each signatory country designates a "Central Authority" to receive Letters of Request and transmit them to the local authority with the power to execute the request.[29] A model Letter of Request can be found online.[30] The Letter of Request must specify:

- the authority making the request and the authority being asked to comply with it;
- the names and addresses of all parties to the proceedings;
- a short description of the nature of the proceedings;
- the evidence to be obtained, or judicial act performed, *e.g.*, the name and address of a person to be examined, questions a witness is asked to answer and/or documents or property sought to be inspected; and
- any special instructions, *e.g.*, the prescribing of an oath prior to examination.

The Letter of Request should be in the language of the country to which it is being transmitted, but English or French will suffice unless a signatory country has expressly made a reservation to the contrary.[31] Upon application, the requesting authority may ask to be informed of the time and place where the request will be executed so that the parties concerned or their representatives may be present.[32]

The judicial authority executing the Letter of Request will apply its own law as to the methods and procedures to be followed.[33] The requested authority will also apply the appropriate compulsory measures against a non–willing party as are provided by its own laws.[34] Nevertheless, the party that is being asked to give evidence may refuse insofar as it may possess a privilege or duty under *either* the law of the state where execution is taking place *or* the law of the state where the request was made.[35] Once the Letter of Request has been executed, the evidence obtained must be transmitted through the same channel—in reverse—as it was originally made.[36]

D. Cost of Using the Hague Evidence Convention

The execution of the Letter of Request is free of charge except in instances where, *inter alia*, the state of execution paid fees to experts or interpreters.[37] In countries where the parties themselves are required to secure evidence without governmental involvement, and the government itself is unable to secure the evidence and must appoint a person to do so, such costs may, with the consent of the requesting party, be passed on.[38]

E. Diplomatic Assistance

Articles 15 through 22 of the Hague Evidence Convention deal with the taking of evidence by diplomatic officers of the country of origin, *e.g.*, U.S. diplomatic officers in the country where the witness or other evidence is located. In most cases, such officers may not use compulsory measures to obtain evidence.

F. Other Methods Used to Obtain Evidence

1. 28 U.S.C. § 1782

For requests made to parties *in* the United States, the Hague Evidence Convention has largely been replaced by 28 U.S.C. § 1782, "Assistance to foreign and international tribunals and to litigants before such tribunals,"[39] commonly referred to as "1782 Discovery." This statute permits foreign parties to apply to the U.S. District Courts to obtain evidence for use in foreign proceedings, including possibly international arbitration proceedings.[40] The statute is rather liberal in its application and allows the requesting party freedom to determine the manner in which the discovery is obtained. If no specific manner is requested, the evidence will be obtained in accordance with the Federal Rules of Civil Procedure. 1782 Discovery is somewhat more advantageous than the Hague Evidence Convention because it: (1) may allow for pre–trial and even pre–litigation discovery; and (2) the requesting party need not make a preliminary application to the foreign tribunal.[41]

2. EU

Within the European Union, the Hague Evidence Convention has been replaced by Council Regulation (EC) No. 1206/2001 on Cooperation Between the Courts of the Member States in the Taking of Evidence in Civil or Commercial Matters.[42] This provision greatly simplifies the taking of evidence by allowing the courts of the various EU member states to interact directly via the use of a standardized form attached to the regulation. The use of telephone and videoconferencing is encouraged.

G. Miscellaneous

A signatory country may declare that it will not execute Letters of Request issued to obtain pre–trial discovery of documents as known in common law countries.[43] The only countries, aside from the U.S., that have not excluded such Letters of Request are the Czech Republic, Israel and the Slovak Republic.[44]

Contrary to the Hague Service Convention, the Hague Evidence Convention has been held by the U.S. Supreme Court to be *non–exclusive*.[45] The Court has cautioned, however, that foreign litigants should be protected from discovery abuses:

> American courts, in supervising pretrial proceedings, should ***exercise special vigilance to protect foreign litigant***s from the danger that unnecessary, or unduly burdensome, discovery may place them in a disadvantageous position. Judicial supervision of discovery should always seek to minimize its costs and inconvenience and to prevent improper uses of discovery requests. When it is necessary to seek evidence abroad, however, the district court must ***supervise pretrial proceedings particularly closely to prevent discovery abuses***.[46]

Endnotes

1. 20 UST 361, TIAS 6638.
2. Hague Service Convention, Art. 1. Note that the Convention does not apply where the address of the person to be served is unknown. *Id.*
3. List at: http://www.hcch.net/index_en.php?act=conventions.status&cid=17. Text at: http://www.hcch.net/index_en.php?act=conventions.text&cid=17.
4. Hague Service Convention Preamble.
5. Hague Service Convention, Art. 2.
6. *Id.* Art. 3.
7. *See, e.g., id.* Art. 13. If the Central Authority believes that the request fails to comply with some aspect of the Convention, it will notify the applicant and state its objections to the request. *Id*. Art. 4.
8. *Id.* Art. 5.
9. *Id.* Art. 6.
10. Forms at: http://www.usmarshals.gov/forms/usm94.pdf.
11. Hague Service Convention, Art. 7.
12. *Id.* Art. 5.
13. *Id.* Art. 12.
14. *Id.* Art. 10(a).
15. Fed. R. Civ. P. 4(f)(2)(C)(ii).
16. Fed. R. Civ. P. 4(f)(2)(C).
17. *See* http://www.travel.state.gov/law/info/judicial/judicial_680.html.
18. The telephone number is 202–514–7455, and the telefax number is 202–514–6584. The "Central Authority" can be reached under the following e–mail address: Robert.Hollis@USDOJ.gov. http://hcch.e–vision.nl/upload/wop/2008usa14.pdf at 7–8.
19. *Id.* at 11.
20. For example, such services are offered at http://www.hagueservice.net and http://ushagueservice.org/Home.htm.
21. See http://www.hcch.net/index_en.php?act=conventions.publications&dtid=33&cid=17 for a list of country questionnaires and the various restrictions some have put on the operation of the Hague Service Convention.
22. *See Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694, 699 (1988).
23. *See, e.g., Burnham v. Sup. Ct. of Cal.*, 495 U.S. 604 (1990).
24. 23 UST 2555, TIAS 7444.
25. Hague Evidence Convention, Art. 1.
26. List: at: http://www.hcch.net/index_en.php?act=conventions.status&cid=82. Text at: http://www.hcch.net/index_en.php?act=conventions.text&cid=82.
27. *Id.*, Preamble.
28. One of the predecessors to the Hague Evidence Convention was the 1905 Civil Procedure Convention, also signed at The Hague. This Convention, however, proved unpopular and was only ratified by twenty–two states, most of which were the original signatories. The 1905 Civil Procedure Convention was replaced in 1954 with one bearing the same name. Certain portions of the latter 1954 Convention are still in effect, although not widely used.
29. Hague Evidence Convention, Art. 2.
30. Model at: http://www.hcch.net/index_en.php?act=publications.details&pid=3309&dtid=2.
31. Hague Evidence Convention, Art. 4. Any signatory country may reject the Letter of Request for failure to comply with the requirements of the Hague Evidence Convention, but must specify its objections. *Id.* Art. 5.
32. *Id.* Art. 7.
33. *Id.* Art. 9.
34. *Id.* Art. 10.
35. *Id.* Art. 11.
36. *Id.* Art. 13.
37. *Id.* Art. 14.
38. *Id.*
39. 28 U.S.C. § 1782(a) provides, in pertinent part:

    > The district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal,… The order may be made pursuant to a letter rogatory issued, or request made, by a foreign or international tribunal or upon the application of any interested person.…
40. *See, e.g., La Comision Ejecutiva Hidro–Elecctrica del Rio Lempa v. El Paso Corp.*, 617 F. Supp. 2d 481 (S.D. Tex. 2008) (holding that 1782 does not apply to arbitral tribunals); *In re Application of: Roz Trading Ltd.*, 469 F. Supp. 2d 1221 (N.D. Ga. 2006) (holding that 1782 applies to arbitral tribunals).
41. For a discussion of the use of 1782 Discovery, see Alcott, *Obtaining Evidence from U.S. Courts for Use in Cross–Border Disputes*, 21 Int'l L. Practicum 118 (2008).
42. Text at: http://ec.europa.eu/justice_home/judicialatlascivil/html/te_information_en.htm.
43. Hague Evidence Convention, Art. 23.
44. Thus, Germany is one country that has objected to Article 23. *See generally* Gebhardt, *Practical Aspects of U.S.–Style Discovery Within Germany*, 22 Int'l L. Practicum 42 (2009).
45. *Societe Nationale Industrielle Aerospatiale v. U.S. District Court.*, 482 U.S. 522, 534, 539 (1987).
46. *Id.* at 546 (emphasis added). *See also Volkswagen, A.G. v. Valdez*, 909 S.W.2d 900, 901–02 (Tex. 1995) (applying balancing–of–interests test and holding that trial court abused its discretion in ordering German company to produce telephone directory of all its employees, in violation of German data protection laws).

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International Intellectual Property Protection: The Berne Convention, The Madrid Agreement and Protocol, and Other International Agreements

By L. Donald Prutzman

I. Three Types of Intellectual Property Often Encountered in International Transactions

A. Introduction

Transactions between or among international parties often relate, in whole or in part, to the ownership or protection of intellectual property. Although there are some other specialized types of intellectual property, the types most likely to be encountered are trademarks, patents and copyrights. At the outset, it will be helpful to recap the distinctions among each of these three types of intellectual property.

B. Trademarks

A trademark is a word, name, symbol or device, or combination thereof, used to distinguish one person's goods or services from those manufactured or sold by others and to indicate the source of goods or services, even if that source is unknown.[1] It is often a brand name (e.g., TIDE for detergent), but it can also be a lot of other things: a logo, a pure design with no literal element (e.g., the Nike swooch), a slogan (e.g., TAKES A LICKING AND KEEPS ON TICKING for Timex watches), a sound (e.g., the NBC chimes), in certain circumstances a color, and sometimes even a smell or fragrance. However, not all countries protect these more esoteric types of trademarks.

A service mark is the same as a trademark, but it is used to identify services instead of goods. The term "trademark" is sometimes used specifically for a mark for products but is also used as an overall term for trademarks (in the narrower sense) and service marks.

Trademarks are typically legally protectable indefinitely, so long as the mark continues to be used to identify a person's goods or services.

C. Patents

A patent is a limited monopoly granted by a government to an inventor that typically gives the inventor the right to exclude others from making, using or selling a claimed invention within the territory administered by that government. In return, the inventor typically must disclose the complete invention to the public so that the progress of science and technology is promoted.

Typically, patents are available for inventions that are useful, novel and non-obvious. Also, patents typically grant their limited monopoly for relatively short periods, such as twenty years for a United States patent.

D. Copyrights

A copyright protects an original work of authorship fixed in a tangible medium of expression. Such a work can be textual (e.g., a book), graphic (e.g., a photograph or artwork), musical (e.g., a song or a performance) or audiovisual (e.g., a movie or a video game). Copyrightable subject matter also includes computer software code and choreography that is reduced to some form of notation. A copyright protects these original works by granting the author a bundle of exclusive rights in a work, typically including the right to make and distribute copies and, for visual or audiovisual works, the right to display and perform the works publicly.

Depending on the context, the term "copyrighted" can mean simply that the material is protected by applicable copyright law whether or not that involves registration, or that the copyright is "registered." As is discussed in more detail below, registration is a concept of importance in the United States, but much less so internationally. The verb "to copyright" usually refers to registering a copyright with the United States Copyright Office or a similar office in the handful of countries that maintain copyright registries.

Copyrights are typically protected for long periods of time. Today, the typical period in most countries is the author's life plus between fifty and seventy years, or, for corporate "authors," a period of seventy to ninety years. (Interestingly, the copyright in J.M. Barrie's *Peter Pan* is, by special statute, protected perpetually in the U.K.) Previously, the United States and a few other countries maintained a system of copyright protection based on an initial term (twenty-eight years in the U.S.), with a renewal term (also twenty-eight years in the U.S.) available to those who acted to renew the copyright. This system is still applicable in some cases, but is of decreasing relevance since the U.S. now uses the internationally typical "author's life plus" formula.

E. Other Forms of Intellectual Property

There are some other less-encountered forms of intellectual property that can be important in international transactions. These include industrial designs, maskworks, phonorecords or phonograms, geographical indications and some others. Details of these are outside the scope of this article. It is, however, important to mention moral rights, or "author's rights," which are related to, but not included in, copyrights. Generally, moral rights are inalienable rights of an author to control the use of his or her name as an author of the work if the work is changed or mutilated, or to prevent change or mutilation in some cases. Moral rights are a European concept that was long resisted in the United States. As discussed below, this non-acceptance of moral rights protection is a primary reason why international copyright protection took so long to harmonize effectively. Today, moral rights are protected in the United States, but only to a limited extent.[2]

F. Intellectual Property Provisions in International Contracts

Intellectual property derives its value from protection in particular countries and jurisdictions. If the owner or licensee cannot control use of the intellectual property by others in a particular country it has limited value there. Accordingly, drafting and evaluating international contracts that deal with intellectual property requires lawyers to understand how each type of intellectual property is protected internationally. For example, license agreements, asset purchase agreements for business assets or stock purchase agreements involving international transactions typically identify intellectual property in schedules and contain representations and warranties, often complex, concerning the intellectual property in the agreement, including warranties that it is valid and subsisting, duly registered, valid and enforceable, etc. in the jurisdictions where the agreement contemplates it will or may be exploited.

To evaluate whether a client can give, or reasonably rely upon, such warranties and representations, the practitioner needs to have at least a general understanding of how international protection of intellectual property works. Even with that understanding it may still be necessary to perform some searches or consult counsel in various other jurisdictions. However, the basic understanding will assist in helping the lawyer identify what he or she needs to know.

II. Theories of International Protection of Intellectual Property

A. Introduction

Since the world is made up of individual jurisdictions, each with sovereignty over its own territory, all efforts at harmonizing or setting standards or norms for international intellectual property have to be pursuant to treaties, typically multilateral treaties among groups of nations that can agree on standards of protection. Several of these are discussed below. There are, however, two competing general theories under which international protection of intellectual property operates: "territoriality" and "universality."

B. Territoriality

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, the 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, intellectual property has a separate legal existence under each country's laws. As further discussed below, international intellectual property protection for patents and trademarks generally proceeds under a territoriality theory. As a consequence, the applicable international agreements generally provide that some action in, or with respect to, each jurisdiction where protection is desired is required. There are some exceptions—for example, there is a Community Trademark Registration and a European Patent available that covers the entire European Union, and some other country group trademark registrations.

C. Universality

A 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 in all countries that have agreed to give it that protection. The universality principle has not found much favor in connection with international protection of trademarks and patents. However, as further discussed below, a version of it is the animating force behind international protection of copyrights under the Berne Convention.

III. International Protection of Trademarks and Patents

A. Introduction

Because of the dichotomy between the two principles discussed above, it is useful to discuss the international protection of trademarks and patents separately from the protection of copyrights. The former are generally protected under a territoriality theory, while the latter are protected under a version of the universality theory.

The discussion must begin with the Paris Convention for the Protection of Industrial Property (the "Paris Convention").[3] We then consider the Madrid Agreement,[4] the Madrid Protocol,[5] and the Pan American Convention,[6] which concern international protection of trademarks, and finally the Patent Cooperation Treaty,[7] which concerns patents. These are not the only international agreements covering these types of intellectual property. However, they are the major ones. Some reference to others is made below, but, in general, these other agreements are outside the scope of this article.

B. The Paris Convention for the Protection of Industrial Property

The first broad-based international agreement concerning recognition of the intellectual property rights of foreigners in signatory countries was the Paris Convention of 1883.[8] It has been revisited and reconsidered six times since then, most recently at Stockholm in 1967, and it was amended most recently in 1979. Approximately 172 countries, including virtually all those of commercial significance, are contracting states under the Paris Convention, or members of the "Union."

The basic tenets of the Paris Convention have continued to this day as the fundamental principles of all industrial property recognition and protection. The term "industrial property," as used in the Paris Convention, includes patents, trademarks, industrial designs, utility models (a kind of "small patent" provided for by the laws of some countries), trade names, geographical indications and unfair competition protection.

The following are the basic principles of the Paris Convention:

(a) **National Treatment—**The principle of "national treatment" is basically that each member country will afford the same intellectual property rights to foreigners that it affords to its citizens. Article 2(1) of the Convention provides the following:

> 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 or patent protection if it provides its own citizens none. It merely is not permitted to discriminate against foreigners. This has been considered a significant weakness of the Paris Convention.

(b) **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.

(c) **Right of Priority—**The Paris Convention created the very important right of priority for foreign trademarks and patents. Under the Convention, the filing date of a duly filed application in one of the countries of the Union can be claimed as a right of priority in another country any time within a specified time from the original filing date. The priority period for trademarks is six months and for patents it is one year. Under this right, a United States trademark or patent applicant who files an application in another signatory country within the priority period of the U.S. filing has priority in that country over anyone else who filed for the same mark or invention after the U.S. filing date.

(d) **Common Rules—**The Paris Convention also establishes a few common rules for intellectual property protection that all members must follow.

For patents, these include the following:

(1) Patents granted in different member countries for the same invention are independent of each other. This means that one country's grant of a patent does not obligate other countries to grant a patent. Conversely, a patent cannot be refused, annulled or terminated in any member country because it has been refused, annulled or has terminated in any other country.

(2) The inventor has the right to be named as such in a patent.

(3) Certain restrictions on compulsory licenses under patents.

For trademarks, these common rules include:

(1) Each country has the right to regulate the conditions for filing and registration of marks by domestic law. Consequently, one country's registration or refusal of registration is not binding on any other country.

(2) 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 Paris Convention. Thus, in the absence of some other agreement, a trademark owner must file and register in each country where protection is needed.

(e) **Protection of "Well-Known" Marks—**One other important provision of the Paris Convention is found in Article 6*bis*, which requires the protection of "well-known" trademarks, even if they are not registered in a particular country. 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.

Interestingly, even though the United States is a signatory to the Paris Convention and Congress has ratified the treaty, the United States Court of Appeals for the Second Circuit, in *ITC Limited v. Punchgini, Inc,*[9] recently held that Article 6*bis* does not apply in the United States because the Paris Convention is not a "self-executing" treaty, that is, it does not become U.S. law without some internal implementing legislation, and Congress has never passed any internal trademark legislation implementing Article 6*bis.* This was a rather surprising decision, to say the least.

C. 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.[10] 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 the World Intellectual Property Organization (WIPO) located in Berne. 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. Thus, the mere existence of an "international" registration does not mean that it provides protection anywhere. That must be determined through further inquiry.

Today, fifty-six countries participate in the Madrid Agreement, but the United States has never been one of them. The United States has, however, acceded to the Madrid Protocol, discussed below.

There are several reasons why the United States has refused to join the Madrid Agreement, and they are important points for those involved in international trademark protection to understand:

(1) It requires that a home country registration be issued before the international application can be filed. This disadvantages U.S. trademark applicants because the registration process in the U.S. is more rigorous, and takes longer, than in most countries.

(2) 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 the U.S. If the U.S. undertook to examine Madrid Union applications in twelve months, it would have to give them priority over applications from its own citizens.

(3) The Madrid Agreement requires that "central attack" be allowed. This means that, if the home-country registration (on which the international registrations are based) is successfully attacked, in whole or in part, within five years of registration, all the protection resulting from the international application ceases completely. This is unfair to United States trademark owners because there are many more grounds to attack a registration available in the U.S. than in most other countries.

(4) 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.

D. The Madrid Protocol

The Madrid Agreement could never establish a truly international trademark system because it was not acceptable to the United States and a handful of other important countries, including the United Kingdom, Ireland, Denmark and Greece. The 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, a "Protocol Relating to the Madrid Agreement Concerning the International Regulation of Marks," known as the "Madrid Protocol," was agreed upon. The Madrid Protocol was thought to be acceptable to virtually all the major players and the international trademark community thought that a true international trademark system was finally at hand.[11]

The Madrid Protocol treated a number of the problems that the United States had with the Madrid Agreement. The principal differences between the Madrid Agreement and the Madrid Protocol are as follows:

(1) **Application Based on Filing—**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 United States trademark owners.

(2) **More Time to Refuse Registration—**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 Unites States Patent and Trademark office.

(3) **"Central Attack" Less Drastic—**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."

(4) **Fees in Each Country—**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 gained significant acceptance and today has seventy-five contracting countries, including the United States. The U.S. was quite late in joining, however. 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.

Although the Madrid Protocol is now available to U.S. trademark owners it has not become as widely used as expected. The reasons are not clear. Perhaps it has just not caught on yet. One drawback to use of the Madrid Protocol for U.S. trademark owners is the requirement that the U.S. description of goods and services be used in the international application. The U.S. Patent and Trademark Office typically requires a more specific description than many other countries. This means that international protection based on a U.S. application or registration may give narrower international protection than could be obtained by filing individual country applications or a European Community trademark application covering the entire European Union. However, this is not relevant in every case and is not sufficient to explain why the Madrid Protocol is less used than expected.

It must be noted that the Madrid System (as the Madrid Agreement and the Madrid Protocol, together, are known) is not the only way to protect trademarks internationally. Marks may also be protected through individual country registrations and multi-country registrations such as the Community Trademark covering the entire European Union. Sometimes the Madrid System is simply not available. For example, almost no American countries other than the United States, and few Asian countries, participate in the Madrid System. Where more than one method of international registration is available, the proper choice requires an evaluation of many factors by an experienced trademark practitioner. These factors are beyond the scope of this article.

E. The Pan American Convention

Although it applies to only a handful of Latin American countries, the Pan American Convention of 1929[12] contains some important special trademark rights applicable to member countries that practitioners should know about. The Pan American Convention consists of two separate agreements: the "Convention for Trade Mark and Commercial Protection" and a "Protocol on Inter-American Registration of Trade Marks." Fourteen Western Hemisphere countries, including the United States, but notably not Canada, participated in this convention. The United States renounced the Protocol portion of the Convention in the mid-1940s.

The "Convention for Trade Mark and Commercial Protection" agreement remains in force and has gained new significance for trademarks as a result of the *ITC*[13] decision referred to above, which held that the well-known mark protection of Article 6*bis* of the Paris Convention does not apply in the United States because Congress never passed any implementing legislation. Articles 7 and 8 of the Pan American Convention provide some potentially very important protection not only for "well known" marks, but also for other marks used in a signatory country, but not yet in actual use, or otherwise protected, in the United States.

If the *ITC* decision is followed by other Circuit Courts of Appeals, and Article 6*bis* of the Paris Convention does not apply in the United States, then the little-known provisions of Articles 7 and 8 of the Pan American Convention will assume far greater importance for trademark owners in the United States and the Latin American countries that are parties to the treaty. The latter countries are Columbia, Cuba, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay and Peru. The protections of the treaty are available not only to nationals of these countries, but also to "domiciled foreigners who own a manufacturing or commercial establishment or an agricultural development in any" of these countries.[14] In addition, the benefits of Article 7 are available to "[a]ny owner of a mark protected in one of the contracting states." Thus many trademark owners that are not nationals of a party to the treaty, but have protected their mark in a country that is a party, will be able to invoke the treaty provisions in another country that is a party.

Article 7 of the Pan American Convention provides as follows:

> Any owner of a mark protected in one of the Contracting States in accordance with its domestic law, who may know that some other person is using or applying to register or deposit an interfering mark in any other of the Contracting States, shall have the right to oppose such use, registration or deposit and shall have the right to employ all legal means, procedure or recourse provided in the country in which such interfering mark is being used or sought, and upon proof that the person who is using such mark or applying to register or deposit it, had knowledge of the existence and continuous use in any of the Contracting States of the mark on which opposition is based upon goods at the same class, the opposer may claim for himself the preferential right to use such mark in the country where the opposition is made or priority to register or deposit in such country, upon compliance with the requirements established by the domestic legislation in such country and by this Convention.

Article 8 of the Pan American Convention states the following:

> When the owner of a mark seeks the registration or deposit of the mark in a Contracting State other than that of origin of the mark and such registration or deposit is refused because of the previous registration or deposit of an interfering mark, he shall have the right to apply for and obtain the cancellation or annulment of the interfering mark upon proving, in accordance with the legal procedure of the country in which cancellation is sought, the stipulations in Paragraph (a) and those of either Paragraph (b) or (c) below:

(a) That he enjoyed legal protection for his mark in another of the Contracting States prior to the date of the application for the registration or deposit which he seeks to cancel; and

(b) that the claimant of the interfering mark, the cancellation of which is sought, had knowledge of the use, employment, registration or deposit in any of the Contracting States of the mark for the specific goods to which said interfering mark is applied, prior to the adoption and use thereof or prior to the filing of the application or deposit of the mark which is sought to be cancelled; or

(c) that the owner of the mark who seeks cancellation based on a prior right to the ownership and use of such mark, has traded or trades with or in the country in which cancellation is sought; and that goods designated by his mark have circulated and circulate in said country from a date prior to the filing of the application for registration or deposit for the mark, the cancellation of which is claimed, or prior to the adoption and use of the same.

The protections that these Articles grant are, in fact, somewhat broader than, or at least different from, the protection of well-known marks under Article 6*bis* of the Paris Convention. The availability of protection is based not on the fame of the foreign mark, but on the usurper's knowledge of that mark. Thus, even if the foreign mark is not well known to the public, the foreign owner would be entitled to protection if the usurper knew of the mark. It is arguable that Articles 7 and 8 leave a gap in famous-mark protection because, in theory, they would not apply to a famous mark that the usurper did not happen to know about before he or she adopted it. In practice, however, the probability of any such gap is doubtful. Decisions applying these articles typically rely, at least in part, on a mark's fame within the jurisdiction as circumstantial evidence that the usurper knew of the mark's use outside the jurisdiction.

Furthermore, Articles 7 and 8 are not vulnerable to the reasoning used by the Second Circuit to preclude application of Article 6*bis* of the Paris Convention in the *ITC* case, i.e., that the treaty is not self-executing and Congress has never enacted implementing legislation. The U.S. Supreme Court has expressly held that the Pan American Convention is self-executing and became U.S. law upon ratification without the need for implementing legislation.[15]

F. The Patent Cooperation Treaty

The Patent Cooperation Treaty,[16] or PCT, established in 1970, amended in 1979 and modified in 1984 and in 2001, does not grant any international protection for patents. Rather, it facilitates filing for patent protection for an invention simultaneously, or during a specified period, in a number of countries through the filing of an "international" patent application. Anyone who is a national or resident of a PCT-member country may file an international application under the PCT. The application can be filed with the individual national patent offices where protection is sought or with the International Bureau of the WIPO in Geneva, which will transfer it to each national office.

If the applicant is a national or resident of a country that is a party to the European Patent Convention, the international application may also be filed with the European Patent Office (EPO). The same is true for certain African and other multi-country patent agreements, which have their own centralized patent offices.

After a PCT application is filed, it undergoes a so-called international search by the patent office of one of the member countries. The results are provided to the applicant, along with a preliminary opinion on patentability. The applicant may then revise his or her application accordingly or withdraw it. If it is revised, the applicant can obtain further review of the application as amended through an international preliminary examination.

If the PCT application is not withdrawn, it is then published by the International Bureau. The applicant has a period of thirty months (with some exceptions) in which to decide the particular countries from which he or she wants to seek a patent. The patent is then prosecuted in each such country by local counsel or patent agents.

The advantages of using the PCT include the following.

- An extra period of time of up to eighteen months over what the Paris Convention provides to decide whether to seek protection in particular countries.
- A uniform format for applications that will not be rejected for failure to comply with a particular local requirement.
- The benefits of the international search report and opinion to evaluate the chances for success generally.
- The opportunity to amend and reevaluate the application at the International Bureau level before it goes to national patent offices.
- Worldwide notice of the claimed patent through international publication.

IV. International Protection of Copyrights

The principal international agreement that governs protection of copyrights is the Berne Convention for the Protection of Literary and Artistic Works (the "Berne Convention").[17] It was first adopted in 1886. It has been revised and amended a number of times, most recently in 1979. Almost all countries of any importance for purposes of international copyright exploitation are signatories to the Berne Convention. In addition, under the Agreement on Trade-Related Aspects of Intellectual Property (the "TRIPS Agreement"), the basic principles of the Berne Convention also apply to those countries that are members of the World Trade Organization but not party to the Berne Convention.

As noted above, the Berne Convention approaches international copyright protection by attempting to follow the universality theory as much as possible. In other words, unlike trademarks and patents, which must, in some fashion, be protected in each country where protection is desired, copyrights are automatically protected internationally without any specific registration or other action in individual countries.

The Berne Convention establishes three basic principles and addresses the minimum period of protection that each member country must give. The three principles are:

(a) **National Treatment** (as we saw above in regard to the Paris Convention)—Under the Berne Convention, works originating in one member country, meaning that the author is a national of that country or the work is first published in that country, must (with one exception noted below) be given the same protection in each of the member countries that that country grants to the works of its own nationals.

(b) **No Formalities—**Protection under the Berne Convention cannot be conditioned on compliance with any formalities, such as inclusion of a copyright notice or registration.

(c) **Independent Protection—**Protection in member countries other than the country of origin is independent of protection in the country of origin (note the territoriality theory creeping in). The only exception is that, if a member country provides a longer period of protection than the country of origin does, then the member country may, but is not required to, cease protecting a work when protection in the country of origin ceases.

The standards of protection that the Berne Convention establishes relate to the types of works and the rights in them that must be protected, and the minimum duration of protection. Pursuant to Article 2(1) of the Berne Convention, protected works must include "every production in the literary, scientific and artistic domain, whatever may be the mode or form of its expression." The rights that must be recognized as exclusive rights of the author include:

(i) the right to make translations;

(ii) the right to make adaptations and arrangements;

(iii) the right to public performance of dramatic, dramatic-musical and musical works;

(iv) the right to recite literary works in public;

(v) the right to communicate to the public the performance of a work;

(vi) the right to broadcast, provided that a member country may provide for a compulsory license with equitable remuneration;

(vii) the right to make reproductions in any manner or form, provided that a member country may in certain circumstances provide for unauthorized reproduction if it does not conflict with the normal exploitation of the work and does not unreasonably prejudice the legitimate interests of the author, and further provided that a member country may permit the reproduction of sound recordings of musical works with only a right to equitable remuneration;

(viii) the right to use the work as a basis for an audiovisual work, and the right to reproduce, distribute, publicly perform or communicate to the public any such audiovisual work.

The Berne Convention also provides for "moral rights," which, as noted above, include a personal, inalienable right of the author to claim authorship of the work, disclaim authorship of an altered version of the work, and to object to any mutilation, deformation or other modification of the work that would prejudice the author's honor or reputation.

The Berne Convention, as a general rule, provides that copyright protection must be granted for a minimum of the author's life plus fifty years, with some special rules for anonymous or pseudonymous works. One other exception is that photographic works and works of applied art need only be protected for a minimum of twenty-five years.

The Berne Convention also has some special provisions for developing countries under United Nations' standards. In some cases, they may authorize translations into their local languages or reproduce copies of works if the copyright owner is not exploiting the work in that country.

As with the Madrid Agreement relating to trademarks discussed above, the United States was long unable to accept the Berne Convention due to profound disagreement with some of its principles. These include the moral rights provisions, which did not exist under U.S. law; the "no formalities" provision, which conflicted with the U.S. requirement for inclusion of a copyright notice; and the unitary term requirement, which conflicted with the U.S.'s initial term and renewal system. As a result, an additional, but not exactly competing, international agreement called the Universal Copyright Convention (the "UCC")[18] came into existence in 1952. The UCC embodied principles similar to those of the Berne Convention but allowed the U.S. and a few other countries to keep their formalities and two-tier term system. The desire to secure the benefits of both the Berne Convention and the UCC led to the common practice of publishing works simultaneously (defined as within thirty days of each other) in the United States and a Berne Convention member, often Canada.

On 20 October 1988, however, the U.S. Senate ratified the Berne Convention. It then passed the Berne Convention Implementation Act of 1988[19] to bring U.S. copyright law into compliance with the Berne Convention. The implementation act, as well as U.S. membership in the Berne Union, became effective on 1 March 1989. To join the Berne Convention, the United States had to give up its longstanding requirement of the formality of a copyright notice as a condition to copyright protection. Use of a copyright notice is, however, still beneficial and is a best practice for copyrighted works.

Endnotes

1. *See, e.g.,* 15 U.S.C. § 1127.
2. *See* Visual Artists Rights Act of 1990, codified at 17 U.S.C. § 106A.
3. 20 March 1883, as revised, 21 U.S.T. 1583, 828 U.N.T.S. 305 (hereinafter, the "Paris Convention").
4. Madrid Agreement Concerning the International Registration of Marks of 14 April 1891, as revised, 828 U.N.T.S. 389 (hereinafter, the "Madrid Agreement").
5. Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, 27 June 1989 (hereinafter, the "Madrid Protocol"), available, together with the Madrid Agreement, as WIPO Pub. No. 204.
6. General Inter-American Convention for Trade-Mark and Commercial Protection, 20 Feb. 1929, 46 Stat. 2907 (the "Pan American Convention").
7. 19 June 1970, 1160 U.N.T.S. 231.
8. *See* note 3 *supra*. The text of the treaty, as well as a list of the member countries of the Union, is available at http://www.wipo.int/treaties/en/ip/paris/, last visited on 27 July 2009.
9. 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).
10. The text and member countries of the Madrid Agreement can be found at http://www.wipo.int/treaties/en/registration/madrid/, last visited on 28 July 2009.
11. The text of the Madrid Protocol and the countries adhering to it are available at http://www.wipo.int/treaties/en/registration/madrid_protocol, last visited on 28 July 2009.
12. *See* note 6 *supra.*
13. *See* note 9 *supra.*
14. Pan American Convention art 1.
15. *Bacardi Corp. of Am. v. Domenech*, 311 U.S. 150 (1940).
16. *See* note 7 *supra.* The text of the PCT and a list of its member countries is available at http://www.wipo.int/treaties/en/registration/pct, last visited on 3 August 2009.
17. Berne Convention for the Protection of Literary and Artistic Works, September 9, 1886, as last revised at Paris on July 24, 1971, 1161 U.N.T.S. 30, and as amended in 1979, S. Treaty Doc. No. 99-27 (1986). The text of the Berne Convention and a list of member countries is available at http://www.wipo.int/treaties/en/ip/berne/ (last visited on 8 September 2009).
18. 6 U.S.T. 2731 (1952 Geneva text); 5 U.S.T. 1341 (1971 Paris text).
19. Pub. L. No. 100-568, 102 Stat. 2853 (1988).

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Litigating in Canada: Five Things U.S. Lawyers Might Find Surprising

By Stephen J. Maddex

I. Introduction

Although the United States and Canada enjoy perhaps the closest economic, cultural, and political ties of any neighboring countries in the world, they can also be very different in many important ways. This is particularly true with respect to the U.S. and Canadian legal systems: although they share much in common, they are also fundamentally different. The following discussion describes five key aspects of the Canadian legal system that some U.S. lawyers might find surprising.

II. Attorneys' Fees Are Generally Recoverable in Almost Every Action in Canada

Unlike in the U.S., where attorneys' fees generally are not recoverable unless specifically permitted by statute or contract, in Canada, where the guiding principle is that "costs follow the event," attorneys' fees are awarded to the prevailing party in almost every action. In other words, the prevailing party at trial or on appeal can expect the opposing party to be ordered to pay anywhere from fifty to ninety percent of the prevailing party's actual legal costs. Attorneys' fees can also be awarded to the prevailing party on a motion. For instance, if a defendant brings a motion for summary judgment that is denied by the court, the defendant can be ordered to pay the plaintiff's legal fees incurred in responding to the motion.

As a result, because of the significant consequences that can result from losing at trial or even being denied relief on a motion, litigants in Canada tend to be more cautious when filing pleadings with the court. Moreover, because judges have broad discretion in determining whether to award costs, some judges may be reluctant to award attorneys' fees against a sympathetic plaintiff, even if the plaintiff's claim lacked merit. In any event, these cost-shifting rules have a tremendous impact on litigation strategy in Canada, both with respect to whether suit should be filed and what claims should be asserted, and with respect to what strategies should be employed to bring the suit to resolution.

III. Personal Jurisdiction in Canada Is Determined Based on the Forum's Connection to the Claim

Canadian courts take a very different approach to personal jurisdiction from that under the Due Process analysis familiar to U.S. litigants. There are ten provinces in Canada and, like each of the fifty states of the United States, each province is a distinct judicial jurisdiction. However, unlike in the U.S., where suit can only be brought in a state where the defendant has sufficient minimum contacts, lawsuits in Canada are to be heard in the province that has the most "real and substantial connection" to the matter in dispute. The appropriateness of filing suit in the jurisdiction of the defendant's residence or where the defendant maintains contacts depends on the forum's overall connection to the claim.

In determining whether a jurisdiction has a real and substantial connection to the dispute, courts take into account a variety of factors, including the parties' connection to the forum, where the witnesses are located, where the dispute arose, and where the substance of the dispute is located. However, Canadian courts take a considered interest in protecting the legal rights of their residents and therefore will afford an injured plaintiff generous access to courts in the plaintiff's home jurisdiction to recover its damages. Thus, if the defendant has engaged in any activity within the jurisdiction that bears upon the plaintiff's claim, Canadian courts will be more likely to assume jurisdiction over the defendant.

In this regard, Canadian courts tend to take a much more plaintiff-oriented approach to jurisdiction. For instance, because damage is an essential element of any tort, if the damages complained of occurred in the forum, the tort is deemed to have been committed in the forum, regardless of whether the actual tortious conduct occurred somewhere else. Therefore, if an Ontario resident were injured in a car accident in New York with a New York driver and then returned to Ontario where she incurred pain and suffering and received medical treatment for her injuries, an Ontario court likely would conclude it has jurisdiction over the New York driver, regardless of whether the driver had any contacts with Ontario whatsoever. Accordingly, the Canadian approach to personal jurisdiction can lead to extremely surprising results for U.S. litigants.

IV. There Is Less Pre-Trial Discovery in Canada Than in the U.S.

The rules of discovery in the Canadian legal system are much more restrictive than the rules of discovery in the U.S. system. Unlike in the U.S., where information is considered discoverable as long as it is reasonably calculated to lead to the discovery of admissible evidence, to be discoverable in Canada, information must be actually relevant to material facts at issue in the dispute. As a result, the volume of information exchanged between the parties quite often is significantly less than what normally would occur in the U.S.

Furthermore, litigants in Canada have an affirmative duty to determine on their own what documents in their possession or under their control are relevant to the matters at issue. Litigants then must disclose those documents and provide an affidavit that describes each document. Unless the other side takes issue with the substance of the disclosure, as a practical matter, the parties' own determination of what should be disclosed often stands.

Generally speaking, each side is only entitled to one deposition of the opposing party, which usually involves taking the deposition of a designated party representative. The party representative must make an affirmative effort to compile information at his or her disposal for purposes of disclosing it to the other side if requested and must be prepared to testify regarding all relevant facts, including any expert evidence the party intends to rely on. However, retained expert witnesses are not subject to deposition, and therefore there is a great deal less expert witness discovery before trial in Canada than in the U.S.

In addition, obtaining documents and testimony from non-parties is much more restricted. To be entitled to examine or obtain documents from a third-party witness, litigants must obtain leave of court and must show a compelling need for the information. Accordingly, the scope of pre-trial discovery in Canada is considerably narrower than in the U.S.

V. Jury Trials in Civil Cases Are Relatively Rare in Canada

The right to a jury trial for litigants in civil cases in Canada is much more restricted than the constitutional rights enjoyed by litigants in the U.S. Although, generally speaking, courts in Canada regard the right to a jury trial in civil cases as a "substantial" right, it is not absolute. For instance, in Ontario, claims for injunctive relief, the partition of real property, foreclosure of a mortgage, specific performance, declaratory judgment, and claims against municipalities are *prohibited* from being tried to a jury.

Moreover, even when the claims at issue are permitted to be tried to a jury, courts have broad discretion to strike the jury and proceed with a bench trial. The determination of whether to strike the jury is generally based on whether "justice will be better served" by proceeding with or without a jury. As long as the court's decision is not arbitrary or capricious, an appellate court will not second-guess the court's determination.

It is generally accepted that cases involving complex legal or factual disputes are not appropriate to be decided by a jury but rather are more appropriately decided by a judge. For instance, a case that involves scientific or medical testimony, voluminous documents, multiple parties, or a case that would require a lengthy trial may not be appropriate for a jury in many Canadian courts. Because judges have the opportunity to reflect upon the evidence at their leisure, even marginally complicated cases normally will be tried without a jury in Canada. Accordingly, given that all but the simplest of cases could be described as "complex" to at least some degree, the right to a jury trial in a civil case is far more elusive in Canada than is typically the case in the U.S.

VI. Courtroom Demeanor Is Much More Formal and Most Civil Trials Are Held Only in Provincial Court

Generally speaking, courtroom proceedings in Canada tend to be somewhat more formal and more cordial than what might be the case in some U.S. courts. For instance, in most circumstances, the judges, lawyers, and some court personnel all wear formal black robes and white collars. Until relatively recently, appellate court judges were addressed as "My Lord" or "My Lady." Nowadays, however, as in the U.S., all judges are addressed as "Your Honor." It is also common practice to bow to the court when entering and leaving the courtroom when the judge is sitting.

As in the U.S., there is a federal court system and a provincial court system in Canada. Federal courts have limited jurisdiction—much more limited than U.S. federal courts. Generally speaking, federal trial courts in Canada only have authority to hear matters involving the Canadian federal government. There is no such thing as "diversity jurisdiction" for federal courts in the Canadian system. In addition to federal trial courts, there is also a federal court of appeal. The Supreme Court of Canada is Canada's highest court. Similar to the U.S. Supreme Court, the Supreme Court of Canada has discretionary authority to hear an appeal and exercises that discretion in only a small percentage of cases.

Provincial courts in Canada have trial courts of general jurisdiction, as well as courts of limited jurisdiction, such as small claims courts, municipal courts, family courts, juvenile courts, and criminal courts. All criminal matters are tried in provincial courts only—never in federal courts. Each province also has a court of appeal of last resort. There are no provincial intermediate courts of appeal.

VII. Conclusion

Even though Canada and the U.S. are close neighbors, when disputes arise that may spill over the border, it would be a mistake to assume that procedural rules and substantive rights fundamental to the U.S. legal system would necessarily apply in Canada. Although the two systems share much in common, they are also profoundly different. Accordingly, understanding some of the important features of the Canadian system can go a long way to developing a winning strategy in the event a U.S. litigant is forced to resolve a dispute in a Canadian court.

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A National Infrastructure Development Bank for the United States: Lessons from the Brazilian Model

By Andrew J. Dell'Olio

I. Introduction

This article analyzes two recent legislative proposals to create a federal infrastructure development bank in the United States and compares these proposals with the legal structure and practical experiences of a similar institution that has existed in Brazil for almost sixty years. The article focuses exclusively on proposals to improve federal contributions to infrastructure financing, which are often combined with state and local funding.

II. Background

A. The State of U.S. Infrastructure

One of the few points of consensus in Congress today is the need for substantial improvement to our nation's infrastructure. Less agreement exists on the means of funding such improvements. In a 2005 study, the American Society of Civil Engineers (ASCE) gave the overall state of U.S. infrastructure a grade of "D" and estimated a need for investments totaling $1.6 trillion over a five-year period in order to bring the nation's infrastructure into "good working order."[1]

Federal contributions to infrastructure spending have declined, proportionally, over the last several decades. In the 1960s, federal spending was nearly equal to that of state and local governments. Today, states and localities spend nearly three times as much as the federal government.[2] Without sufficient federal financing, overburdened states and localities have neglected essential maintenance and modernization projects, while increased user demand, particularly on roads, bridges and electrical and water distribution systems, has stretched the physical plant to its limits.

B. Current Funding Methods for U.S. Infrastructure

Most federal infrastructure financing is currently done via block grants to states, cities and local public authorities. These block grants are often earmarks included in general spending bills. Local entities lobby for funding of general needs and specific projects and are granted wide discretion in spending the funds. Although they were built under a federal program, interstate roads are owned by the states (often via turnpike and thruway authorities). Where they cross state lines, bridges and tunnels carrying interstate roads are usually owned by bi-state authorities (e.g., Delaware Memorial Bridge, George Washington Bridge). Maintenance costs are shared between the federal government and the local authorities, which rely on local taxes and toll revenues for their portions. States, cities and public authorities also issue bonds to supplement their capital budgets.

Transportation funding has a dedicated federal revenue stream from excise taxes on motor fuels, heavy vehicles and truck tires. These taxes are pooled into the Highway Trust Fund (HTF), a creation of the 1956 Highway Revenue Act.[3] Although such excise taxes had existed before the creation of the Interstate Highway System, they were deposited in the general treasury, not dedicated for transportation funding. The 1956 Act assessed taxes at three cents per gallon for gasoline and diesel, and raised existing taxes on heavy vehicles and truck tires. The 1956 Act's taxes were set to expire in 1972, but subsequent legislation in the 1980s and 1990s renewed, expanded and increased the taxes. The taxes currently stand at 18.4 cents per gallon for gasoline, 24.4 cents for diesel and 13 cents for gasohol (gasoline containing at least ten percent alcohol).

Tax proceeds are primarily allocated among the HTF's two principal component accounts: the Highway Account and Mass Transit Account, as well as to two smaller accounts: the Leaking Underground Storage Tank Trust Fund and the Aquatic Resources Trust Fund. The Mass Transit Account, created in 1982, receives 2.86 cents per gallon for gasoline, diesel and gasohol, and lower amounts for natural gas.[4] The Storage Tank Trust Fund, created to clean up fuel-related environmental contamination, receives 0.1 cents per gallon from most liquid fuels. The Aquatic Resources Fund receives 13.5 cents per gallon from motorboat and small engine fuel sales. Finally, the Highway Account receives the majority of fuel taxes as well as all revenues from truck and tires taxes. The summary chart in Appendix 1 gives a more complete explanation of user taxes and revenue distribution.

From 1 October 1993 to 1 October 1997, 4.3 cents per gallon of gasoline taxes were deposited into the general treasury for deficit reduction, temporarily depriving the transportation infrastructure of a portion of its dedicated funding source. Today, only a portion of gasohol taxes is directed to the general treasury.

The pooled funds are redistributed to the states by a complex formula of percentages. A redistribution formula necessarily means that some states are net donors and others net recipients of excise tax revenues, as is the case with most taxation regimes. However, the geographic distribution of revenue transfers can be deceiving. Since many federal fuel taxes are paid by the oil companies at their headquarters, and simply passed on to consumers at the pump, revenue collection appears to be concentrated in certain states. Additionally, most U.S. tire manufacturing is based in Ohio, which records most tire sales taxes.

A similar Airport and Airway Trust Fund pools revenue from aviation fuel taxes and departure taxes and allocates those funds for the development and maintenance of air traffic control and communications systems.[5]

Local public housing authorities rely on allocations from the Department of Housing and Urban Development (HUD), which are divided into budgets for operating expenses and those for capital improvements. School facilities are locally built and managed and school districts do not cross state lines, although school districts can receive federal operating and capital funds.

III. The National Infrastructure Bank Act of 2007

A. Legislative History

A Bill to establish a "National Infrastructure Bank," or NIB, as an independent establishment of the U.S. Government was introduced in the Senate on 1 August 2007 by Senators Christopher Dodd (Democrat from Connecticut) and Chuck Hagel (Republican from Nebraska) (the "2007 Bill").[6] An identical House version was introduced on 3 August 2007 by representatives Barney Frank (Democrat from Massachusetts) and Keith Ellison (Democrat from Minnesota).[7] The House version, referred to the Committee on Transportation and Infrastructure (Subcommittee on Water Resources and Environment), was never acted on and died in committee. The Senate Banking, Finance and Urban Affairs Committee held several hearings on the Senate version in mid-2008, without taking further action toward passage. However, the 2007 Bill gained important supporters during its consideration, including as a co-sponsor then-Senator Barack Obama (Democrat from Illinois), who has promised to sign similar legislation as President. The 2007 Bill received support and endorsements from various industry and commercial associations, such as the National Construction Alliance, the ASCE and Goldman Sachs and was the subject of a favorable article by former Undersecretary for Commerce Everett Ehrlich and financier and former Ambassador Felix G. Rohatyn.[8]

Largely modeled on legislation governing the Federal Deposit Insurance Corporation (FDIC), the 2007 Bill mirrors and/or refers to many FDIC regulations.

B. Scope of Projects and Financing Mechanisms

Included in the NIB's "qualified infrastructure projects" are mass transit systems, roads, bridges, public housing properties and drinking water or wastewater systems.[9] Only publicly sponsored projects in a minimum amount of seventy-five million dollars having a "regional or national significance" may qualify for NIB financing.[10] The NIB will be able to provide financial assistance for qualified infrastructure projects by means of direct subsidies, direct loans, and loan guarantees to state or local governments issuing debt securities to finance qualified infrastructure projects.[11]

To raise the necessary capital, the NIB may issue the following types of securities:

- General purpose infrastructure bonds, the proceeds of which may be used for any qualified infrastructure project; and
- Project-based infrastructure bonds, the proceeds of which may only be spent on the specific project for which they were issued, similar to revenue bonds.

In consultation with the Treasury Department, the NIB, will promulgate its own regulations with regard to issuance of such general purpose and project-based bonds.[12]

C. Criteria and Procedure for Evaluation of Projects

The NIB will evaluate the various types of qualified projects (transit, roads, public housing, and water systems) based on certain factors specified in the legislation. Those factors are:

– promotion of economic growth;

– reduction of traffic congestion (for transit and road projects);

– environmental benefits;

– urban land use policies;

– health benefits (for water projects), including those that reduce the cost of health care; and

– poverty reduction and economic empowerment (for public housing residents).[13]

The ratings system and evaluation processes for infrastructure projects will be developed by personnel with experience in public procurement on detail to the NIB from the Department of Transportation, HUD, the Army Corps of Engineers and other relevant agencies.[14] Infrastructure projects receiving federal aid from the NIB will still be subject to their applicable current regulations, but the NIB will now determine the appropriate share of federal funds to a project.[15]

D. Administrative Structure

The NIB's board of directors will consist of five presidential appointees, who are subject to Senate approval. Similar to FDIC regulations, no more than three directors may be members of the same political party.[16] At least one director must have "demonstrated expertise" in mass transit, roads or bridges, public housing, water infrastructure or public finance.[17] The chair and vice chair will serve six-year terms, and the initial terms of the three remaining directors shall be staggered in five, four and three year terms, with subsequent terms to be the full six years.[18] Vacancies occurring during a director's term are to be filled only for the remainder of the original member's term, although holdover directors may continue in service beyond their terms until a successor is appointed.[19] As per conflict of interest regulations, directors are prohibited from holding other public office during their service. They may not accept employment with or own the stock of private companies engaged in projects financed or considered by the NIB.[20] Directors are also barred from employment with such private companies for two years after their service, except when a director has served a full term.[21]

Subject to the board's confirmation, the chair may appoint an executive director of the NIB, who must also have "demonstrated expertise" in mass transit, road or bridge projects, public housing, water infrastructure or public finance.[22] The board may also employ such support staff as is necessary to operate the NIB, which may include employees of other federal agencies on secondment to the NIB, and for which the NIB shall reimburse those agencies.[23]

The board will have the authority to hold investigative hearings and issue subpoenas for witnesses and documents, noncompliance with which may be punishable by contempt of federal court.[24]

E. Reports

The NIB must report its evaluation of each project to the Senate Committee on Banking, Finance, Housing and Urban Affairs within sixty days of its determination and must file annual reports with the committee regarding all evaluations and financing packages granted by the NIB over the preceding fiscal year.[25] The NIB will maintain a publicly accessible database containing a description of each qualified project, including information as to its location, sponsor(s) and total cost, as well the amount and means of financing received from the NIB.[26] Within two years after enactment, and every three years thereafter, the Board must undertake a study of the effectiveness of the federal infrastructure financing system and submit this study to the Senate committee. The study must compare the financing mechanism used by the NIB with those used by other federal agencies and contain recommendations to improve effectiveness.[27]

F. Capitalization—Limits

The outstanding debt limit for bonds is set at sixty billion dollars with all obligations backed by the full faith and credit of the U.S. government.[28] The NIB's operations will be funded by the general federal budget until its initial bonds are issued.[29] Thereafter, no more than one percent of funds raised via bond issues may be used toward administrative costs of the NIB.[30] Interest on all bonds is, of course, exempt from state and local taxation.[31]

IV. The National Infrastructure Development Bank Act of 2009

A. Legislative History

A bill to create "The National Infrastructure Development Bank," or NIDB, was introduced on 20 May 2009[32] (the "2009 Bill") by Representative Rosa DeLauro (Democrat from Connecticut). Representative DeLauro has sponsored similar legislation for the past fifteen years. The NIDB would be a wholly owned "government corporation," similar in structure to the Pension Benefit Guarantee Corporation, and not an independent federal agency, as the NIB would be under the 2007 Bill.

B. Scope of Projects and Financing Mechanisms

Written in broader language than the 2007 Bill, the 2009 Bill's scope encompasses four types of infrastructure projects: transportation, environmental, energy and telecommunications. As in the 2007 Bill, eligible projects must be of a "regional or national significance." Most importantly, the 2009 Bill authorizes the NIDB to assist both private firms and government entities. The NIDB can fund covered projects by means of direct subsidies, loans and loan guarantees, and may "monitor and oversee" those projects.[33] The NIDB may also borrow on global capital markets in order to re-lend to state or local governments, as well as to commercial banks, and will also be able to purchase, pool and re-sell infrastructure-related loans and securities on the capital markets.[34]

C. Criteria and Procedure for Evaluation of Projects

In evaluating proposals for financing, the NIDB will consider such factors as the economic and social benefits of a project, as well as its overall costs, and will give priority to those projects that maximize economic growth and job creation and to those of regional or national scope.[35] Such evaluation criteria are not markedly different from those of the 2007 Bill. The NIDB will also consider whether its financial assistance will result in an accelerated project schedule with lower overall costs than would be the case without NIDB assistance. The NIDB must also evaluate the extent to which its assistance maximizes the level of private investment in the project.

Unlike the 2007 Bill, the 2009 Bill does not set a minimum threshold for a project. The 2009 Bill lists evaluation criteria for the four types of covered infrastructure projects. Job creation and reduction of poverty and economic inequality are criteria common to all four types. In addition, transportation projects will be judged on potential reductions in carbon emissions and in ground and air traffic, control of urban sprawl and the usage of smart tolling and congestion pricing. Environmental projects will take into account their public health benefits and pollution reduction. Energy projects will focus on the use of renewable energy, development of a smart grid and energy-efficient building modernization. Public housing projects will focus on improvements to structural layouts and resident mobility. Telecommunications projects will be oriented toward increasing broadband and wireless service to rural and underserved areas.[36]

D. Administrative Structure

The President of the United States will appoint the five members of the board of directors, who are subject to Senate confirmation, and will select the chair and vice-chair. Directors serve six-year terms and positions are considered part-time, compensated on a per-diem basis.[37] Directors are restricted from reviewing a project if they or a person with whom they are "affiliated" has a financial interest in the project.[38] Similar to the 2007 Bill, the chair and vice chair will serve full terms, and the initial terms of the three remaining directors will be staggered. Also similar to the 2007 Bill, vacancies are filled for the remainder of the original director's term, and directors may continue in service beyond their terms until a successor is appointed. Two of the directors must have public sector experience and three must have experience in the private sector. Directors must be chosen from diverse regions of the United States.[39] Three directors constitute a quorum.

Only the board, subject to the approval of the U.S. Treasury Secretary, has the authority to issue public benefit bonds and to purchase and sell the NIDB's debt securities.[40] Board meetings are generally open to the public, except when the board determines that the disclosure of certain information would adversely affect a project or create speculation in the financial or securities markets.[41]

The executive committee will be a division of the board that establishes the procedures by which applicants will submit proposals for NIDB financing. The executive committee will also evaluate and pre-screen proposals and create a list of those accepted for further consideration by the board.[42] The executive committee is headed by an executive director, who serves as the NIDB's CEO and who is appointed by the board. The executive director's full powers and duties are yet to be defined by the by-laws. In addition to the executive director, the executive committee will be comprised of the following eight members:

- chief compliance officer (see below);
- chief financial officer;
- chief asset and liability management officer;
- chief loan origination officer;
- chief operations officer;
- chief risk officer (see below);
- chief treasury officer; and
- general counsel.[43]

Executive committee members shall be chosen for their experience and expertise in the following areas:

- transportation infrastructure;
- environmental infrastructure;
- energy infrastructure;
- telecommunications infrastructure;
- economic development;
- workforce development;
- public health; and/or
- private or public finance.[44]

The five-member risk management committee will be headed by a chief risk officer (CRO), who will manage the NIDB's compliance-related risks and who is also appointed by the board. The CRO reports directly to the board and is responsible for establishing guidelines for the NIDB's lending activities to ensure diversification by both project type and regional distribution. The CRO will also monitor the NIDB's credit exposure.[45] The CRO and other members of the risk management committee must have experience in asset and liability management, investment and securities regulations, the insurance industry, credit risk management and credit evaluations, and or "related disciplines."[46]

The NIDB's Audit Committee also consists of five members, including a chief compliance officer (CCO), who is appointed by the board and reports directly to it. The audit committee is responsible for internal controls and auditing, issuing the NIDB's financial statements and coordinating with external auditors and accountants.[47] The CCO and other committee members are to be drawn from persons experienced in internal corporate audits and investigations, as well as in accounting and financial practices.

The members of the executive, risk management and audit committees are full-time employees of the NIDB and may not hold other public office. All members of these committees, including the executive director, CRO and CCO, serve six-year terms, renewable by the board, and may be removed at the board's discretion. Conflict-of-interest rules prohibit members of any of these committees from having any financial interest in any project, company or financial institution seeking NIDB financing, or from obtaining such an interest within two years after separation from service.[48]

The NIDB is authorized to indemnify its directors and officers for actions arising out of their duties.[49] Similar to the 2007 Bill, the NIDB may employ personnel on secondment from other federal agencies, on a reimbursable basis.[50]

E. Reports

Recipients of assistance are required to file annual reports with the NIDB detailing their use of the funds and their compliance with the criteria on which their proposals were evaluated. These annual reports must also identify all entities with an ownership, development or operational interest in the project (i.e., developers, construction firms, and the like).[51]

The NIDB's financial records must be maintained pursuant to generally accepted accounting principles. The board must file an annual report to Congress and the President containing a summary of the NIDB's operations, a schedule of obligations and outstanding capital securities, and the status of all projects in the construction phase.[52] Every five years, the U.S. Government Accountability Office must file a report with Congress assessing the impact and benefits of all projects, focusing on how effectively each project has met the NIDB's goals and project criteria.[53]

F. Capitalization—Limits

The NIDB has an authorized capital subscription of five billion dollars, per year, from fiscal 2010-2014. This aggregate capital of twenty-five billion dollars represents ten percent of the total subscribed capital of $250 billion, with the remaining $225 billion callable at the option of the U.S. Treasury.[54] The 2009 Bill contains a fifteen-year sunset clause, and will require additional legislation to continue in operation.[55]

As with most government bonds, all securities issued by the NIDB are exempt from state and local taxation and from SEC registration requirements. All bonds are backed by the full faith and credit of the federal government.[56]

Projects receiving NIDB funding must comply with Davis-Bacon Act requirements to pay prevailing wages to construction trades, as is the case with all federally financed building projects.

V. The BNDES System in Brazil

A. Legal Structure and History—The BNDES

The Brazilian *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES) was created in 1952 as an independent federal agency.[57] A 1971 amendment to the BNDES's regulations converted it into a "government corporation," wholly owned by the Brazilian government, and under the supervision of the Ministry of Development, Industry and Foreign Trade.[58] Although the same 1971 amendment authorized the Brazilian President to later convert the BNDES into a "mixed capital" corporation, which would be partially privatized but still majority-owned by the government, the BNDES remains a government corporation, with the federal government as sole equity shareholder.[59]

The 1971 amendment also allowed the BNDES to open subsidiaries abroad and to enter into all necessary contracts to effectuate its purposes, including contracts to borrow money or issue debt securities in Brazil or abroad. These contracts can contain terms and conditions customarily included in private international contracts, including dispute resolution and arbitration clauses.[60] Contractual obligations may be backed by the full faith and credit of the Brazilian federal government.[61] Headquartered in Rio de Janeiro, the BNDES has branch offices in São Paulo, Brasília and Recife. As of the time of this writing, the BNDES is in the process of opening a representative office in Montevideo and has incorporated a new subsidiary, BNDES Limited, for a future London office.

B. Scope of Projects and Financing Mechanisms

The BNDES provides the following type of assistance:

- financing of investments by Brazilian companies abroad;
- export financing;
- grants for research and development in high-technology industries;
- grants for social development, including those directed toward employment, housing and health;
- studies and technical support, provided at no cost to private companies; and
- capitalization of private companies, through direct investment in their securities, which can be sold on capital markets.[62]

The BNDES finances not only public infrastructure projects, but private investments in such strategic sectors as mining, steel, shipbuilding and aerospace. This support was present from the 1950s through the 1980s, when the Brazilian state pursued a more developmentalist and protectionist economic policy, and has continued during the past 20 years with the opening and privatization of the Brazilian economy. In fact, the BNDES's budget, loan/grant portfolio and profits have reached record levels in the past several years.[63]

The BNDES assists a wide range of private entities, including individual persons, small or medium companies (with less than sixty million Reais in annual revenues), and larger firms. One of the principal means of support for sole proprietors and small/medium companies is the *Cartão BNDES*, or BNDES credit card. By partnering with private banks and with Visa® and Mastercard,® the BNDES facilitates the purchase of needed business supplies and services through a network of accredited suppliers, such as suppliers of construction materials. In 2008, twenty-four percent of assistance went to small and medium businesses, a percentage consistent with the average of the past decade.

Seventy-three percent of all BNDES loans were made to the private sector in the first half of 2009, a percentage consistent with those of recent years.[64] Much of the private-sector assistance indirectly benefits public infrastructure projects insofar as it aids the construction industry.

The BNDES's revenues stem from several sources, including:

- the issuance of bonds and notes in international markets and debentures in the Brazilian markets;[65]
- the sale of capital assets;
- operating revenues (interest collected);
- borrowing from multilateral banks (e.g., World Bank, Inter-American Development Bank);
- borrowing from private sources (usually syndicated financing);
- budget contributions from the Brazilian government;
- dedicated revenue streams from payroll taxes, the primary of which is the "Workers' Assistance Fund"; and
- fees charged for banking services (usually for the management of other government funds).[66]

In response to the credit crisis of 2008-2009, the BNDES has received special allocations to augment its budget and increase the amount of credit available to private parties. In January 2009, the Brazilian government loaned the BNDES one-hundred billion Reais from funds raised through a sovereign debt issue.[67] During late 2008, the BNDES also received special contributions as investments from various public funds in Brazil and the World Bank.[68]

C. Criteria and Procedure for Evaluation of Projects

Compared with the procedure as proposed by the two U.S. bills, the BNDES procedure is somewhat lengthy and cumbersome. Upon receiving a request for financing, the BNDES will evaluate a proposal in terms of its financial and technical qualifications, including its environmental and social impact. When a proposal receives loans, the BNDES will conduct an appraisal of the project's collateral. Where grants are made, an evaluation of collateral is inapplicable.[69] This initial evaluation is performed by the "Department of Priorities," or DEPRI. The DEPRI then makes its recommendation to the Credit Department and Operations Department, which in turn route the proposal through the Risk Evaluation Committee.

Following this, the most important step in the process is the review by the Categorization and Credit Committee, which informs the applicant whether or not the proposal will proceed. If it does move forward, and if the officers approve the proposal, the Operations Department negotiates the structuring of the operation and the contractual documents to be signed by the parties.[70] Companies in arrears for taxes or social welfare contributions, or those in bankruptcy protection, will generally not be approved.

D. Administrative Structure

The BNDES is governed by an eleven-member board of directors, all appointed by the Brazilian president, upon the recommendations of the Brazilian Ministries of Finance, Labor, Planning and Budget, Foreign Affairs, and Development, Industry and Foreign Trade. Directors serve three-year terms, renewable once consecutively and renewable again after a one-year absence.[71] The Brazilian President may fill vacancies, with replacements serving out the original director's term. The board is headed by its chair, whose decision-making powers are defined by the larger board. The board reviews the BNDES's annual financial statements and may create reserve funds for the deposit of profits. Board approval is necessary for an increase of capital shares as well as any incorporation, closure or merger of any subsidiary, or the formation of any joint venture by a subsidiary.[72] Six of the eleven directors constitute a quorum, with meetings occurring at least once per calendar quarter or when called by the chair or at least two other directors.[73]

The BNDES's day-to-day operations, including administration, procurement and personnel matters, are overseen by the corporate officers, which include the BNDES president, vice president and six officers at-large, all of whom are appointed and serve at the pleasure of the Brazilian President.[74] The six officers-at-large are granted their respective titles and functions by the BNDES president.[75] The BNDES president and vice president have indefinite terms of office and the remaining six officers have three-year terms, renewable once. The officers govern the internal bureaucratic structure, with personnel and job titles, and can create branches and representative offices. Subject to any authority granted or limited by the board, the officers may enter into contracts obligating the BNDES and may grant the forms of financial assistance that are the core of the BNDES's operations.[76]

Officers' meetings are held weekly or when called by the BNDES president, with a quorum of five present, and take action by simple majority vote. Officers' decisions may be vetoed by the BNDES president, whereupon the board has the authority to resolve such disputes.[77]

The "Fiscal Council," or *Conselho Fiscal*, is comprised of three members (and their respective alternates). Two are nominated by the Ministry of Development, Industry and Foreign Trade and one by the Finance Ministry, and all are appointed by the Brazilian President. They serve two-year terms, renewable once consecutively and renewable again after a one-year absence.[78] The Fiscal Council reviews financial statements and delivers semi-annual financial reports to the Board. The BNDES's Fiscal Council also fulfills the same role that fiscal councils serve in private Brazilian corporations.[79]

The BNDES also has an audit committee, or *Comitê de Auditoria*, whose function is to recommend the independent auditors hired by the BNDES and to review and revise the auditors' semi-annual accounting statements.[80] The audit committee can have up to six members, all appointed by the board, to which the audit committee reports. Members have indeterminate terms, but can be removed by the board without cause.[81] The audit committee meets at least once per quarter with the officers, independent auditors and internal auditors to review financial records. The audit committee must present its own reports as of 30 June and 31 December of each year.[82]

The BNDES ombudsman's office is a means of communications between the BNDES System and its clients, and can mediate conflicts. The ombudsman is appointed by and serves at the pleasure of the BNDES president.[83]

Brazilian labor law applicable to private employment governs BNDES employees, and jobs are filled via open competitive exams.[84] Mid-level management must be chosen from existing BNDES employees, although senior management and their advisers may be hired from the outside.[85] The BNDES will defend and indemnify all employees and management from lawsuits against them for actions taken in the course of their official duties.[86]

Major changes in corporate structure, such as the following, must be approved by the Brazilian Finance Ministry:

– the sale of shares of the BNDES, BNDESPAR or FINAME;

– increase in capital via issue of new shares;

– wavier of options to purchase shares or convert debt instruments to shares in private companies it may control;

– sale of convertible debt instruments;

– merger, split-off or incorporation of subsidiaries or controlled companies;

– exchange of shares of subsidiaries or controlled companies; and

– entering into or abrogating shareholder agreements.[87]

The BNDES's profits are distributed as follows:

1. Five percent of net profit to a mandatory capital reserve, but not in excess of twenty percent of paid-in capital;

2. A minimum of twenty-five percent adjusted net profit (calculated after the five percent capital reserve is funded) as dividends to the sole shareholder, the Brazilian government;

3. Fifteen percent to a "reserve for future capital increase," but not in excess of twenty percent of paid-in capital; and

4. All of the remaining net profit to an "operations reserve," but not in excess of fifty percent of paid-in capital.

The reserve for future capital increase and the operations reserve are destined to fund increased BNDES lending to a growing Brazilian economy.[88] These two reserve funds were created in late 2008 to permit the BNDES to redirect a greater percentage of its profits to lending. Prior to this, the Brazilian government received a higher percentage of BNDES profits (forty percent in 2007 and sixty-six percent in 2006).[89]

E. BNDESPAR

A wholly owned subsidiary of the BNDES, *BNDES Participações, S.A.*, or BNDESPAR, "participates" in private companies by purchasing equity and/or convertible debt securities, usually in a minority position and for a temporary period. BNDESPAR can assist private companies in several ways:

– direct purchase of stock from an issuer, although preferably not a controlling share thereof;

– a guarantee to purchase an issuer's stock, bonds, or debentures; and

– the acquisition and sale of a company's securities in the secondary market.[90]

Normally, only Brazilian domestic companies qualify for such financial assistance. Brazilian domestic companies are those incorporated under Brazilian law with headquarters and administration in Brazil, including Brazilian subsidiaries of multinationals. Multilateral lending organizations or foreign companies in which multilaterals are shareholders may, in exceptional circumstances, qualify.[91]

BNDESPAR has its own board of directors, consisting of the BNDES president and five other members chosen by the BNDES. Directors serve three-year terms, renewable once. BNDESPAR's board meets quarterly or when called by its chair and takes action by majority vote, with a quorum of four.[92] The chair has the tiebreaker vote. The board elects BNDESPAR's officers and oversees all policy matters. There are seven officers, all of whom are chosen from BNDES's employees. BNDESPAR's officers are its director-president and director-superintendent, who are the BNDES president and vice president, respectively, and up to five additional officers.[93] Officers must meet twice monthly or when called by the director-president. A quorum is two officers, one of whom must be the director-president or the director-president's designee.[94] Actions are taken by majority present, with the director-president having the tiebreaker vote. BNDESPAR's officers govern the subsidiary's day-to-day operations and make decisions regarding financial support and investments made in private companies.[95]

BNDESPAR has its own fiscal council, comprised of three members chosen by the BNDES with the approval of the Brazilian president, serving two-year renewable terms. There is one representative each from the Finance Ministry, the Brazilian Treasury and the BNDES.[96]

F. FINAME

The third leg of the BNDES System triad is FINAME. Also a wholly owned subsidiary of the BNDES, FINAME is a fund dedicated to financing the industrial and machinery sectors.[97] Headquartered in Rio de Janeiro, FINAME can receive its funding from a variety of sources, including the BNDES, multilateral financial organizations, the Brazilian federal government and/or profits from its own activities.[98] FINAME finances the purchase and sale of Brazilian-manufactured machinery, as well as the importation of necessary machinery or machine tools not manufactured in Brazil.[99] Assistance can take the form of credit extended to manufacturers and to purchasers of Brazilian-made machinery. FINAME is also authorized to purchase and sell the shares of Brazilian manufacturers, in the same manner as BNDESPAR, although this is a role it leaves to BNDESPAR.

FINAME is managed directly by its ten-member board of directors, eliminating the level of officers present in the BNDES and BNDESPAR. FINAME's board members are:

- the BNDES president;
- one additional BNDES officer;
- one BNDES director;
- one representative each from the Ministries of Finance, Planning and Budget, and Development, Industry and Foreign Trade;
- one representative from the industrial sector;
- one representative from Brazilian regional and state development banks;
- one representative from the commercial banking sector; and
- one representative from the investment banking sector.[100]

Directors serve three-year terms, renewable once, and act by majority vote, with the chairman having the tiebreaker vote. The chair and the chair's alternate are chosen by the Ministry of Development, Industry and Foreign Trade.[101] A quorum consists of five directors present. The board meets during the last week of each calendar quarter, as well as when called by the chair or at least two other directors.[102] The chair runs the day-to-day operations of FINAME and is assisted by an executive secretary, who does not have a vote.[103] The board regulates and approves FINAME's lending practices and other means of financial assistance.[104]

FINAME can employ staff from throughout the Brazilian government, including employees of the various ministries, independent agencies and "mixed capital" government corporations.[105] FINAME can carry out its program through public or private intermediary institutions, such as regional and state development banks throughout Brazil, and private banks and investment companies, provided that these intermediaries adhere to the criteria set by FINAME.[106]

VI. Comparison and Discussion

A. Relative Strengths of the Two U.S. Bills and Recommendations

The two U.S. bills are structured similarly and contain many provisions in common. An improved draft would ideally adopt the best provisions from both. However, in its current version the 2009 Bill is the better of the two, for reasons explained in this section. The scope of eligible projects and their evaluation criteria are largely similar in both the 2007 and 2009 Bills. Fortunately, the 2009 Bill expands the scope of covered projects to include energy and telecommunications, which were omitted from the 2007 Bill. In light of the need to modernize our electric grid after the 2003 blackout and to reduce carbon emissions in a nation that generates one-half its electricity from coal, energy projects are an important addition. However, the most significant advantage of the 2009 Bill is that it also permits assistance to private entities involved in public infrastructure projects, whereas under the 2007 Bill only "public sponsors" are eligible.[107]

The administrative structures and personnel regulations of the two bills are also substantially similar, although the 2009 Bill envisions an executive committee with a wider array of special expertise. The 2009 Bill contains more rigorous accountability and reporting requirements in that it requires an annual report from the NIDB to Congress and an independent evaluation by the GAO every five years. The 2009 Bill also provides a better risk-management regime, with a qualified and experienced CRO dedicated solely to this function, and better accounting controls, with the addition of an audit committee. Unfortunately however, the 2009 Bill omits the 2007 Bill's public database requirement, which is an advantageous feature.

The final legislation should set a minimum threshold for funding requests, which the 2009 Bill does not, but one possibly lower than the seventy-five million dollars set in the 2007 Bill. A threshold is important to avoid overwhelming the infrastructure bank with insignificant projects which can distract it from its core mission of funding larger-scale projects with a national or regional impact.

I also favor the provision of the 2007 Bill limiting administrative costs to one percent of bond issues. The 2009 Bill does not delineate between funds for administrative expenses and those for infrastructure financing. After initial government budgeting for start-up costs, the infrastructure bank could become partially self-financing. Much of the opposition to the legislation will be rooted in opposition to increased government spending, for both administrative and building costs. In any event, the current method of outlays leaves taxpayers shouldering the entire budgetary burden. An infrastructure bank may even be able to lower taxpayers' overall exposure by attracting increased private investment via revenue bonds (which could be repaid with user fees, such as toll revenues or a percentage of fuel taxes currently deposited in the HTF). Even if such revenue bonds were backed by the full faith and credit of the general treasury, this would signify no greater exposure for taxpayers than the current system creates. The fifteen-year sunset clause contained in the 2009 Bill may also allay some opponents' long-term fiscal concerns.

Opposition to the establishment of a national infrastructure bank may also come from influential lawmakers with the ability to direct capital funds to their constituents by including earmarks in general spending bills. Such earmarks might attend to local needs (or exaggerate them) but often neglect regional and national priorities.[108] These lawmakers will therefore favor the status quo.

In fact, I would go a step further than what both bills have proposed and advocate redirecting some of the funds spent under the current system and funneling them through the infrastructure bank. The savings realized through a more efficient coordination of policy and the elimination of wasteful earmarks will free funds for larger projects under the infrastructure bank's purview. This will signify an obvious concentration of decision-making power. Proponents will view it as a "professionalization" of infrastructure policy, concentrated in a small panel of technocratic specialists.

As Erhlich and Rohatyn note, an infrastructure bank could replace the current "uni-modal" approach to transportation funding with a more comprehensive method that could integrate various modes.[109] Instead of the fractured system whereby different agencies (Federal Highway Administration, Federal Aviation Administration, Maritime Administration, local mass transit authorities, and the like) vie for funding to fulfill their narrow mandates, the infrastructure bank could fund multi-modal projects, such as an airport expansion project coupled with an urban rail link, and connected to an existing metro and suburban rail network.

Another recommendation of mine is that a U.S. infrastructure bank also issue true project-specific revenue bonds, i.e., those not backed by the full faith and credit of the U.S. Treasury. Private investors should be willing to accept a certain amount of risk in exchange for potential returns, with concomitant protections for taxpayers. At a time when investors are wary of private-sector securitized assets, we may see increased demand for seemingly secure government bonds, which would lower the interest rates and transaction costs of bond issuances.

B. Lessons from the BNDES System

U.S. lawmakers drafting and revising legislation for any eventual infrastructure bank can learn much from the successful Brazilian model. The BNDES System has an extensive and comprehensive legal and administrative structure, the product of nearly 60 years of evolution during which that structure has been altered and augmented by subsequent legislation and administrative rulings. Should a U.S. infrastructure bank meet with initial success, the Brazilian legislation can also serve as one of several models for regulations to accommodate the expansion of its mandate, which could include increased assistance to the private sector. As an example, BNDESPAR is authorized to purchase the equity shares of companies in need of financing. It is unclear whether the 2009 Bill envisions this as an option. Its language states that the NIDB may "purchase, pool and sell infrastructure-related *loans and securities* on the global capital market."[110] It is unclear as to whether this will encompass purchases of *equity and debt* securities directly from the issuers, as BNDESPAR does, or whether this is only intended as a conduit for securitized loans. To effectuate loan securitization, a U.S. infrastructure bank may consider incorporating special purpose vehicles (SPVs) to serve as such facilities. Neither bill contains a provision specifically authorizing the creation of subsidiary entities, nor does either bill affirmatively prohibit them.[111]

In any scenario, a U.S. infrastructure bank should be careful to avoid mirroring the complex and excessive administrative structure into which the BNDES System has grown. The BNDES System currently employs a staff of 2,275.[112] There is no need for specialized subsidiaries, since the SPVs could hold the securities (debt or equity), nor for the myriad committees or multi-step evaluation process that the BNDES requires. As with all governmental agencies, we must aim for a lean and efficient staff and a streamlined process for the approval of projects.

C. Conclusion

This author advocates the creation of a federal infrastructure bank in the U.S. In a time when the current and long-term fiscal restraints on all levels of government limit traditional sources of funding, we must be more efficient in their use and inventive in seeking new sources. Infrastructure improvements are not only a question of safety, but also create much-needed, well-paying jobs that add to the American workforce's technical skill set and stimulate production in the building-material industry. Although some foreign architectural, engineering and construction firms may participate in public projects and some materials may be imported, the majority of the work and manufacturing cannot be outsourced. Infrastructure funding is true public investment, not consumption-oriented government spending, and it leaves lasting, tangible assets that benefit both industry and the public, both in their use of the systems and the collateral benefits of productive economic activity, along with new technologies and know-how.

One must be aware of the potential pitfalls of adding administrative and budgetary burdens and growing the federal bureaucracy. If, however, the infrastructure bank were to largely *replace*, rather than merely supplement, the current infrastructure financing system, we could achieve both administrative efficiencies and a more sensible allocation of resources.

Endnotes

1. *See Guiding Principles for Strengthening America's Infrastructure*, Center for Strategic & Int'l Stud., 27 Mar. 2006, at 1, available at http://csis.org/files/media/csis/pubs/060327_infrastructure_principles.pdf (last visited on 12 Jan. 2010).
2. *Id*. at 2.
3. P.L. 84-627, codified at 26 U.S.C. § 9503.
4. The Mass Transit Account was instituted by the Surface Transportation Assistance Act of 1982. P.L. 97-424, codified at 26 U.S.C. § 9503(e).
5. 26 U.S.C. § 9502.
6. S. 1926, 110th Congress.
7. H.R. 3401, 110th Congress.
8. *See* Everett Ehrlich and Felix G. Rohatyn, *A New Bank to Save Our Infrastructure*, N.Y. Rev. of Books, 15 Oct. 2008.
9. S. 1926, 110th Congress, § 3(7).
10. *Id.* § 202(b).
11. *Id.* § 203(b).
12. *Id.* § 203(c).
13. *Id.* § 202(d).
14. *Id.* § 202(f)(2).
15. *Id.* § 202(g) and (h).
16. *Id.* § 102(a). *See also* 12 U.S.C. § 1812(a)(2).
17. *Id*. § 102(a).
18. *Id.* § 102(c).
19. *Id.* § 102(c)(3), (4).
20. *Id.* § 102(e)(1).
21. *Id.* § 102(e)(2)
22. *Id.* § 103(a).
23. *Id.* §§ 103(d) and 202(f).
24. *Id.* § 201.
25. *See id.* §§ 203(a) and 301(a).
26. *Id.* § 301(b).
27. *Id.* § 302.
28. *Id.* § 203(d) and (e).
29. *See* § 4 (The NIB shall receive from the federal government "such sums as may be necessary" for administrative expenses until its bond issuances can adequately finance its operations.).
30. *Id.* § 203(f).
31. *Id.* § 205.
32. H.R. 2521, 111th Congress.
33. *Id.* § 5(k).
34. *Id.* § 5(k)(1)(G).
35. *Id.* § 10(b).
36. *See Id.* § 10(c).
37. H.R. 2521, 111th Congress, § 5(i).
38. *Id.* § 5(j).
39. *Id.* § 5(b) and (c).
40. *Id.* § 5(k).
41. *Id.* § 5(l).
42. *Id.* § 6(f).
43. *Id.* § 6(d).
44. *Id.* § 6(e).
45. *Id.* § 7.
46. *Id.* § 7(e).
47. *Id.* § 8(d).
48. *Id.* §§ 6(k), 7(j) and 8(k).
49. *Id.* § 5(k)(1)(L).
50. *Id.* § 5(k)(5).
51. *Id.* § 10(g).
52. *Id.* § 15.
53. *Id.* § 15(b).
54. *Id.* § 16.
55. *Id.* § 17.
56. *Id.* §§ 11, 12.
57. Brazilian Law 1.628 of 20 June 1952 created the *Banco Nacional de Desenvolvimento Econômico* (BNDE), which was renamed the BNDES pursuant to Decree-Law 1.940 of 25 May 1982.
58. Brazilian Law 5.662 of 21 June 1971, art. 1.
59. *Id*. art. 8.; *see also* Brazilian Decree-Law 200, of 25 Feb. 1967, § II and § III, for descriptions of "government corporations" and "mixed capital corporations," respectively, in Brazil. Petrobrás and Banco do Brasil are examples of "mixed capital corporations."
60. *Id*. art. 5.
61. *Id*. art. 6.
62. BNDES by-laws, Law 4.418 of 11 Oct. 2002, art. 9.
63. Irany Tereza, *BNDES faz desembolso recorde em 7 meses.*, O Estado de S. Paulo, 17 Aug. 2009.
64. *See* Vania Maria da Costa Borgerth**,** BNDES Presentation, Aug. 2009, http://inter.bndes.gov.br/english/bndes/AF_DEPCO_english.pdf (last visited on 12 Jan. 2010).

65. Debt securities issued on international markets are normally issued in compliance with Rule 144A and Regulation S. Debt securities issued by the BNDES are not convertible into equity shares.

66. BNDES by-laws, Law 4.418 of 11 Oct. 2002, art 7. The *Fundo de Amparo de Trabalhador,* or Workers' Assistance Fund, is one of several employer payroll tax contributions that fund the BNDES.

67. Lu Aiko Otta, *BNDES terá R$ 100 bi para "PAC privado,"* O Estado de S. Paulo, 23 Jan. 2009.

68. Irany Tereza, *BNDES libera amnahã R$ 10 bi para capital de giro*, O Estado de S. Paulo, 30 November 2009. Among these public funds was the FGTS-FI, an investment fund comprised of the surplus in the Brazilian federal unemployment insurance system. For a more complete explanation of the FGTS-FI, *see* Andrew J. Dell'Olio, *New Sources of Infrastructure Financing in Brazil: An Update*, 21 Int'l Law Practicum 28-38 (2008).

69. *Id.* art. 10.

70. BNDES Presentation 17 Sept. 2009, *Fluxo de tramitação de projetos.*

71. BNDES by-laws, art. 11.

72. *Id.* art. 12.

73. *Id.* art. 13.

74. *Id.* art. 14.

75. *Id.* art. 19.

76. *Id.* art. 15, V and IX.

77. *Id.* art. 16.

78. *Id.* art. 21.

79. *Id.* art. 22. A requirement of the Brazilian Corporations Law (*Lei das S.A.*) is that a *Sociedade Anônima* (S.A.) have an oversight body known as the *Conselho Fiscal*, a sort of statutory audit council, whose functions are to supervise officers' actions, verify corporate accounts and financial statements and give its opinions regarding amendments to the by-laws, issuance of debentures and/or distribution of dividends. *See* Law 6.404 of 15 Dec. 1976, as amended by Law 9.457 of 5 June 1977 and Law 10.303 of 31 Oct. 2001.

    A corporation's by-laws will determine whether the *Conselho Fiscal* will operate on a permanent basis. If it does not, it will only operate in those fiscal years in which ten percent of the voting capital or five percent of the non-voting capital so request. The *Conselho Fiscal* is composed of a minimum of three and a maximum of five individual members, with an equal number of alternates, all of whom must be resident and domiciled in Brazil and all of whom are elected by the General Shareholders' Meeting. No officer, director or employee of the company or any other company of the same corporate group, nor any relative of such persons, may serve on the *Conselho Fiscal*. Compensation of members is determined by the Annual Shareholders' Meeting and may not be less than ten percent of the officers' average compensation, excluding profit sharing. *See* generally, Law 6.404 of 15 Dec. 1976, art. 163. In most publicly traded U.S. corporations, an audit committee fulfills the roles of both the *Conselho Fiscal* and the *Comitê de Auditoria*.

80. *Id.* art. 22-C.

81. *Id.* art. 22-A.

82. *Id.* art. 22-A, V II and IX.

83. *Id.* art. 22-D.

84. *Id.* art. 27.

85. *Id.* art. 27-A.

86. *Id.* art. 29-A.

87. *Id.* art. 30., N.B.: The BNDES does not presently own a controlling share in any private company.

88. *Id.*; Amendments enacted in Dec. 2008 created the "Reserve for Future Capital Increase" and "Operations Reserve" and permitted the BNDES to keep more of its profits for additional lending. Prior to this, the Bank distributed as dividends to the government 40% of its 2007 profits (2.8 billion Reais) and 66% of its 2006 profits (3.97 billion Reais). *See* Nicola Pamplona, *BNDES altera estatuo para emprestar mais*, O Estado de S. Paulo, 31 Dec. 2008.

89. Nicola Pamplona, *BNDES altera estatuto para emprestar mais*, O Estado de S. Paulo, 31 Dec. 2008.

90. BNDESPAR by-laws, art.5. *See*, Decisão de Diretoria nº 149/2002–BNDES, 11 Mar. 2002, as amended.

91. *Id.* arts. 6 and 6-A.

92. *Id.* art. 14.

93. *Id.* art. 15.

94. *Id.* art. 18.

95. *Id.* art. 17.

96. *Id.* art. 22.

97. FINAME is the *Agência Especial de Financiamento Industrial,* or the "Special Agency for Industrial Finance."

98. Decree 59.170 of 2 September 1966, art. 3; s*ee also*, Decree 4.648 of 27 Mar. 2003.

99. *Id.* art. 4.

100. *Id.* art. 6.

101. *Id.* art. 10.

102. *Id.* art. 8.

103. *Id.* art. 9.

104. FINAME Instruction, 48/98, 29 Sept. 1998. Art. 9, as amended, Instruction No. 49, 31 Mar. 2003 and Instruction No. 50, 22 Dec. 2003.

105. Decree 59.170 of 2 Sept. 1966, art. 11.

106. *Id.* art. 12.

107. S. 1926, § 202(b).

108. *Guiding Principles for Strengthening America's Infrastructure,* note 1 *supra*, at 2.

109. *See* Everett and Rohatyn, note 8 *supra,* at 4.

110. *See* H.R. 2521, § 5(k)(1)(G).

111. § 5(k)(1)(N) of H.R. 2521 grants the Board of Directors the power "to exercise all other lawful powers which are necessary or appropriate to carry out, and are consistent with, the purposes of the Bank." I would argue that even a moderately expansive interpretation of such a provision would permit the incorporation of subsidiaries.

112. Vania Maria da Costa Borgerth, BNDES Presentation, Aug. 2009, http://inter.bndes.gov.br/english/bndes/AF_DEPCO_english.pdf (last visited on 12 Jan. 2010).

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Appendix 1

Federal Highway User Taxes

Fuel Type	Effective Date	Tax Rate (cents per gallon)	Distribution of Tax			
			Highway Trust Fund		Leaking Undrground Storage Tank Trust Fund	General Fund
			Highway Account	Mass Transit Account		
Gasoline	10/01/1997	18.4	15.44	2.86	0.1	-
Diesel	10/01/1997	24.4	21.44	2.86	0.1	-
Gasohol (10% ethanol)	10/01/1997	13	6.94	2.86	0.1	3.1
	01/01/2001	13.1	7.04	2.86	0.1	3.1
	01/01/2003	13.2	7.14	2.86	0.1	3.1
	01/01/2005	13.3	7.24	2.86	0.1	3.1
Special Fuels						
General Rate	10/01/1997	18.4	15.44	2.86	0.1	-
Liquefied petroleum gas	10/01/1997	13.6	11.47	2.13	-	-
Liquefied natural gas	10/01/1997	11.9	10.04	1.86	-	-
M85 (from natural gas)	10/01/1997	9.25	7.72	1.43	0.1	-
Compressed natural gas (cents per thousand cu. ft.)	10/01/1997	48.54	38.83	9.70	-	-
Truck Related Taxes — All Proceeds to Highway Account						
Tire Tax	0-40 pounds, no tax Over 40 pounds - 70 pounds, 15¢ per pound in excess of 40 Over 70 pounds - 90 pounds, $4.50 plus 30¢ per pound in excess of 70 Over 90 pounds, $10.50 plus 50¢ per pound in excess of 90					
Truck and Trailer Sales Tax	12 percent of retailer's sales price for tractors and trucks over 33,000 pounds GVW and trailers over 26,000 pounds GVW					
Heavy Vehicle Use Tax	Annual tax: Trucks 55,000 pounds and over GVW, $100 plus $22 for each 1,000 pounds (or fraction thereof) in excess of 55,000 pounds (maximum tax of $550)					

Taxes for Aquatic Resources Trust Fund

Fuel Type	Effective Date	Tax Rate (cents per gallon)	Distribution of Tax		
			Aquatic Resources Trust Fund	Leaking Underground Storage Tank Trust Fund	General Fund
Motorboat and Small Engine Fuel	10/01/1997	18.4	11.5	0.1	6.8
	10/01/2001	18.4	13	0.1	5.3
	10/01/2003	18.4	13.5	0.1	4.8

Source: Federal Highway Administration
See http://www.fhwa.dot.gov/tea21/factsheets/htf.htm (last visited on 12 Jan. 2010).

Dual Citizenship: Living on Both Sides of the Global Fence

By Jan H. Brown

I. Introduction

Dual citizenship exists when a person is a citizen of two countries at the same time. This can be achieved by choice, such as through marriage to a foreign citizen. A person may also obtain dual nationality involuntarily, such as when a child is born to a U.S. citizen in a foreign country, and that country's laws recognize that child as a U.S. citizen as well as a citizen of that country.

Dual citizenship has become increasingly common as foreign countries have relaxed laws to involve successful emigrants in their financial growth, and as the global fences are increasingly crossed. In this era of a global society, how does the U.S. define and clarify dual citizenship rights?

U.S. law does not directly address dual nationality or require a person to choose one citizenship only or to discard another.[1] Still, the U.S. government has generally discouraged maintaining dual nationality.[2] The courts have expressed that the dual claims of both countries of nationality may create a conflict.[3]

The Department of State ("DOS") takes the position that "[t]he country where a dual national is located generally has a stronger claim to that person's allegiance."[4] Nonetheless, a dual national owes allegiance to both the foreign country and the U.S. Both countries have the ability to enforce their laws, and so the dual citizen must remain mindful to follow the laws of the two countries.

The DOS states that most U.S. citizens must use a U.S. passport to travel in and out of the U.S.[5] Dual citizens should check with the foreign country of citizenship to determine whether its passport is required for travel to and from that country. If a foreign passport is used by U.S. citizen for travel, it does not jeopardize his or her U.S. citizenship.[6]

II. A "Citizen" or a "National"?

The U.S. Customs and Border Protection *Inspector's Field Manual* states that "[t]here is a technical distinction between a citizen of the U.S. and a national of the U.S. All citizens of the U.S. are nationals, but all nationals are not citizens."[7] The Immigration and Nationality Act ("INA")[8] provides the following definitions: The term "national" means a person owing permanent allegiance to a state. The term "national of the United States" means (A) a citizen of the U.S., or (B) a person who, although not a citizen of the U.S., owes permanent allegiance to the U.S.[9]

Regardless of these distinctions, "dual citizenship" and "dual nationality" are used interchangeably in U.S. regulations and therefore in this article to describe an individual who is a citizen of two or more countries.[10] Distinctions in foreign law must be addressed on a case-by-case basis, as the definitions of these terms vary from country to country.

According to the *Inspector's Field Manual*, as of March 2001, American Samoans (including Swains Islanders) are the only U.S. non-citizen nationals.[11] When entering the U.S., they should present a Certificate of Identity showing U.S. nationality, a U.S. passport, or a birth certificate.[12] The Commonwealth of the Northern Mariana Islands provides another exception to the rule: although a former territory, it provides U.S. citizenship to its born nationals. All persons born in the Commonwealth after 3 November 1986 (when a Covenant was made with the U.S.) are citizens at birth under Section 301 of the INA.[13]

III. Conditions for Acceptable U.S. Dual Nationality

Pursuant to the doctrine of *jus sanguinis*, a child born abroad to U.S. citizens will acquire not only U.S. citizenship but perhaps the citizenship of the country in which the child was born, which is referred to as *jus solis*. [14] Similarly, a child born in the U.S. to foreign parents may acquire both U.S. citizenship (*jus solis*) and the citizenship of the parents (*jus sanguinis*).[15] The *Foreign Affairs Manual* states that the country where a dual national resides has the "paramount" right to that individual's allegiance.[16]

A U.S. citizen ("USC") is not precluded from dual nationality when it is obtained by the following methods:

1. Through naturalization in the U.S. when the foreign state does not divest its citizens of their citizenship upon naturalization in a foreign country;
2. Through birth in the U.S. to nationals of a country that follows principles of *jus sanguinis*; or
3. Through naturalization of a USC in a foreign state that does not require the USC to renounce his or her U.S. citizenship or where the USC was found not to expatriate him or herself.

There is no requirement that the dual national choose one nationality or the other when she becomes an adult.[17]

IV. Potentially Expatriating Acts

A. Overview

There are, however, acts which will be considered expatriating acts by the DOS when accompanied by the person's intent to expatriate. Section 349 of the INA states that U.S. citizens will lose citizenship if they perform certain *specified* acts voluntarily *and* with the intention to relinquish U.S. citizenship. These acts include:

1. Obtaining naturalization in a foreign state;[18]
2. Taking an oath, affirmation or other formal declaration to a foreign state or its political subdivisions;[19]
3. Entering or serving in the armed forces of a foreign state engaged in hostilities against the U.S. or serving as a commissioned or noncommissioned officer in the armed forces of a foreign state;[20]
4. Accepting employment with a foreign government if (a) one has the nationality of that foreign state or (b) an oath or declaration of allegiance is required in accepting the position;[21]
5. Formally renouncing U.S. citizenship before a U.S. diplomatic or consular officer outside the U.S.;[22]
6. Formally renouncing U.S. citizenship within the U.S. (but only under strict, narrow statutory conditions);[23]
7. Conviction for an act of treason.[24]

The actions listed above can cause loss of U.S. citizenship only if performed voluntarily and with the intention of relinquishing U.S. citizenship. The U.S. Supreme Court established in *Afroyim v. Rusk*[25] that intent is needed to lose one's citizenship when performing such acts. The Supreme Court has since reaffirmed that the onus is on the government to prove that the person in question had intent to expatriate.[26]

The DOS has a uniform administrative standard of evidence based on the premise that U.S. citizens intend to retain U.S. citizenship when they obtain naturalization in a foreign state, subscribe to a declaration of allegiance to a foreign state, serve in the armed forces of a foreign state not engaged in hostilities with the U.S., or accept non-policy level employment with a foreign government[27].

B. Disposition of Cases When Presumption of Retention Is Applicable

Since the DOS assumes a U.S. citizen's intent to retain citizenship, a dual national usually does not need to provide a statement of this fact. The DOS has stipulated that, in light of the administrative premise discussed above, a person who:

(1) is naturalized in a foreign country;

(2) takes a routine oath of allegiance to a foreign state;

(3) serves in the armed forces of a foreign state not engaged in hostilities with the U.S.; or

(4) accepts non-policy level employment with a foreign government; and in so doing wishes to retain U.S. citizenship need not submit prior to the commission of a potentially expatriating act a statement or evidence of his or her intent to retain U.S. citizenship since such an intent will be presumed.[28]

When, as the result of an individual's inquiry or an individual's application for registration or a passport, it comes to the attention of a U.S. consular officer that a U.S. citizen has performed an act made potentially expatriating by subparagraphs (1), (2), (3) or (4) of INA Section 349(a),[29] the consular officer will simply ask the applicant if there was intent to relinquish U.S. citizenship when performing the act. If the answer is no, the consular officer will certify that it was **not** the person's intent to relinquish U.S. citizenship and, consequently, find that the person has retained U.S. citizenship.

The premise that a person intends to retain U.S. citizenship is not applicable when the individual:

(1) formally renounces U.S. citizenship before a consular officer;

(2) serves in the armed forces of a foreign state engaged in hostilities with the U.S.;

(3) takes a policy level position in a foreign state;

(4) is convicted of treason; or

(5) performs an act made potentially expatriating by statute accompanied by conduct which is so inconsistent with retention of U.S. citizenship that it compels a conclusion that the individual intended to relinquish U.S. citizenship. (Such cases are very rare.)

Cases in categories 2, 3, 4 and 5 will be scrutinized carefully by U.S. consular officers to ascertain the individual's intent toward U.S. citizenship. Those individuals wishing to relinquish their U.S. citizenship should consult the guidelines set out on the DOS's Web site.[30]

C. Applying the Presumption of Retention

The premise established by this administrative standard of evidence is applicable to cases adjudicated previously. Persons who previously lost U.S. citizenship can have their cases reconsidered in light of this policy. To do so, the individual in question should submit a request to the nearest U.S. consular office or by writing directly to the following address:

If by express mail, then to:
Director
Office of Policy Review and Inter-Agency Liaison
(CA/OCS/PRI)
Overseas Citizens Services
Bureau of Consular Affairs
U.S. Department of State
4th Floor
2100 Pennsylvania Avenue, N.W.
Washington, D.C. 20037
Phone: 202-736-9110
Fax: 202-736-9111
Email: ASKPRI@state.gov

If by first-class mail, then to:
Director
Office of Policy Review and Inter-Agency Liaison
(CA/OCS/PRI)
Overseas Citizens Services
Bureau of Consular Affairs
U.S. Department of State
SA-29, 4th Floor
Washington, D.C. 20520

The DOS states that each case will be reviewed on its own merits taking into consideration, for example, statements made by the person at the time of the potentially expatriating act.[31]

Additionally, an individual may request reconsideration of prior expatriations by contacting the State Department at the following address:
Director
Office of Policy Review and Interagency Liaison
U.S. Department of State
2201 C Street, N.W.
Washington, D.C. 20520[32]

D. Cases in Which U.S. Citizens May Want to Relinquish Other Citizenships

1. Dual Taxation

The U.S. collects tax on a citizen's worldwide income unless there is a treaty to the contrary. There are numerous tax treaties among the nations to avoid double taxation or to apply tax credits for taxes paid to another nation.[33] For instance, Ireland and the U.S. share two treaties.[34] An individual who is a dual citizen of a nation not so covered may wish to consider voluntary expatriation.

2. Military Service

Foreign military service can be considered an expatriating act. A multilateral Protocol Relating to Military Obligation in Certain Cases of Double Nationality, to which the U.S. is a party, states that "[a] person possessing two or more nationalities who habitually resides in one of the countries whose nationality he possesses, and who is in fact most closely connected with that country, shall be exempt from all military obligations in the other country or countries."[35] This Protocol defines dominant nationality as the country in which the national resides and with which he or she has the strongest ties.

Thus, a U.S. dual citizen could be exempt from military service in his or her foreign country should such country be party to the Protocol, and if he or she has dominant U.S. nationality. To gain this exemption, a dual citizen may have to lose his or her nondominant nationality.[36] Claiming exemption from service in the U.S. military in favor of obligations to another country could be considered evidence of an intent to relinquish U.S. citizenship. Therefore, a dual citizen may have to relinquish one citizenship in order to avoid or accept military service in the other country.

3. Service in an Elected Position in a Foreign Country

Serving in an elected position in a foreign country does not in itself expatriate a U.S. citizen unless such service is accompanied by an expressed intent to do so. There have been notable cases where an individual returning to his or her country of origin for public service has relinquished his or her U.S. citizenship to appease the foreign electorate. One such case involved Valdas Adamkus, the President of Lithuania, who was a naturalized U.S. citizen who had fled his native country more than fifty years ago. After his election in Lithuania, he renounced his U.S. citizenship to honor a campaign promise.[37] As dual citizens often return to their countries of origin to aid in restructuring and other tasks,[38] each case should be carefully researched as to whether foreign laws or oaths could affect U.S. citizenship, and vice versa.

4. In the Case of Foreign-Government Harassment

Article 4 of the Hague Convention on Certain Questions Relating to the Conflict of Nationality Laws of 1930 provides that "a State may not afford diplomatic protection to one of its nationals against a state whose nationality such person also possesses."[39]

Consular standards view U.S. citizens residing abroad with dual or multiple nationalities as owing their paramount allegiance to the country in which they reside.[40] Thus, dual nationals living in other countries may not count upon the intervention of the U.S. government in the event of foreign government harassment. However, this does not preclude intervention by the U.S. government on the dual national's account if the person's allegiance to the U.S. has been established through U.S. residency over a period of years.[41]

IV. Countries Where Dual Citizenship Is Recognized

A. Overview

As of 2005, the countries allowing dual citizenship in some form numbered 151, including the U.S.[42] Allowance, however, does not equal official recognition in a country's laws. A list of countries and details as to whether each recognizes dual citizenship as of March 2001 can be found in *Citizenship Laws of the World*.[43] Appendix A contains a list of countries and indicates whether or not they recognize dual citizenship as of March 2001.

According to *Citizenship Laws of the World*, dual citizenship is not particularly desirable in many countries for the same reason it is discouraged in the U.S.: A dual citizen's obligation to the country can sometimes be in conflict with the laws of the other country.[44] A conflict may arise when there are conflicting military obligations, or when a person's dual citizenship hampers efforts to provide diplomatic or consular protection when the person is abroad. *Citizenship Laws of the World* states, "The majority of countries do not recognize dual citizenship. That is, their governments do not recognize a person's prerogative to the rights, privileges, or immunities that may be the prerogatives of citizens of the other nation."[45]

Countries have various means of restricting dual nationality. First, children of diplomatic representatives are prevented by international law from acquiring the *jus solis* citizenship of the country in which their parents are serving. Thus, a child of a diplomat born in the U.S. is considered a lawful permanent resident ("LPR")[46] unless such child abandons LPR status to return to his or her home country with his or her parents.[47] The "majority divestiture" option allows a person with dual citizenship, upon reaching the age of legal adulthood, to decide which citizenship to keep. Many countries have this provision in their constitution, charter, or in their citizenship laws.[48] This option can be used in dual nationality cases which arise due to adoption. In countries where non-native children must be registered after birth at the consular office of their parent's country's, a lack of registration documentation can make it impossible or difficult for the child later to acquire citizenship in either country.[49]

Below are several examples of the unique nature of foreign nationality laws.

B. Mexico

The Nationality Law passed by Mexico in 1998 and, based upon a constitutional reform approved unanimously by the Mexican Congress in December 1996, went into effect on 20 March 1998.[50] This law declares that any persons born in Mexico, or born to Mexican nationals wherever they reside, can claim Mexican citizenship even if they are citizens of another country.

This law allows Mexicans who live abroad and decide to adopt a foreign nationality or citizenship to keep their Mexican nationality. It also allows those individuals who were originally Mexicans and are now citizens of another country to regain Mexican nationality. U.S./Mexican dual citizens can vote in Mexican elections and even hold office. Juan Hernandez, who was born in Dallas, became the first Mexican American to hold a Mexican Cabinet position, heading the presidential Office for Mexicans Abroad under Mexican President Vicente Fox.

Mexican legislation establishes a distinction between nationality and citizenship. Nationality is based on one's birth country and on familial origins. Citizenship implies nationality, yet includes the exercising of political rights which are acquired upon reaching legal age and residence, among other requisites. The Mexican constitutional reform modified only those provisions related to nationality.[51]

According to Article 37 of the Mexican Constitution, a Mexican cannot lose his or her nationality. Anyone who has renounced his or her Mexican nationality to acquire another nationality can recover it. Those wishing to recover their Mexican nationality must be at least eighteen years of age and of sound mind, and must complete an application at a Mexican Consulate.

C. Canada

The Canadian Citizenship Act, passed in 1977, allows a Canadian citizen to acquire foreign nationality without automatically losing Canadian citizenship.[52] Since 15 February 1977, a Canadian citizen may retain Canadian citizenship in such cases, unless he or she voluntarily applies to renounce it and the application is approved by a citizenship judge. The present Act thus makes it possible to have two or more citizenships and allegiances at the same time for an indefinite period. Like the U.S., Canada requires specific acts to give up citizenship.

On 17 April 2009, Bill C-37 amended the Citizenship Act to restore citizenship by descent to children of parents who were themselves born in Canada or obtained citizenship through naturalization.[53] This bill allows many so-called "lost Canadians" to have their Canadian citizenship restored. Bill C-37 summarizes that it shall:

> (a) permit certain persons who lost their Canadian citizenship for specified reasons to have their citizenship restored from the time it was lost;
>
> (b) permit certain persons who, born outside Canada to a Canadian parent, did not acquire Canadian citizenship for specified reasons to become Canadian citizens from the time of their birth;
>
> (c) provide that certain persons born outside Canada to a Canadian parent who was himself or herself born outside Canada do not acquire Canadian citizenship; and
>
> (d) provide for a grant of citizenship, on application, to persons who have always been stateless and meet other specified conditions.[54]

D. United Kingdom

A British citizen will still not lose his or her citizenship should he or she obtain citizenship elsewhere, including the U.S. The War of 1812 began over a controversy concerning dual citizenship. British warships were stopping American merchant ships and placing U.S. sailors into the Royal Navy. The British still considered them British subjects, even though they had taken an oath of allegiance to the U.S.[55]

Since 1948, there has been no general restriction in United Kingdom law against a British national being a citizen of another country.[56] If a British national acquires another nationality, he or she will not automatically lose British nationality. A person does not need to give up any other nationality to obtain British nationality. However, U.K. law details several categories of nationality and citizenship, due to its historical colonization. When considering questions of U.K. citizenship, a practitioner should first ascertain which type of U.K. citizen or national a person is. These categories include:

- British citizens (usually all prior citizens of "United Kingdom and Islands")[57]
- British Overseas Territories citizens (most are now British citizens in accordance with the British Overseas Territories Act)[58]
- British Nationals (overseas)[59]
- British Overseas citizens[60]
- British subjects[61]
- British protected persons[62]

For those persons who wish to renounce British citizenship or request that it be reinstated, forms and instructions can be found on the Web site of the British Home Office.[63]

E. Germany

Germany recognizes the concept of multiple nationalities. A child born to an American parent and a German parent acquires both American and German citizenship at birth, regardless of place of birth, if the parents satisfy the *jus solis* or *jus sanguinis* requirements of their respective countries.

In May of 1999 the German parliament ratified a new nationality law that came into effect on 1 January 2000.[64] Under this law, a child born to a German citizen parent automatically acquires German citizenship at birth through *jus sanguinis*, regardless of the place of birth. There are exceptions under present law, however. Beginning 1 January 2000, a child born in Germany to non-German parents acquires German citizenship by *jus soli* only if: (1) at least one parent had lived legally in Germany for at least eight years prior to the birth; and (2) at the time of the birth, that parent had a permanent residence permit (either an *Aufenthaltsberechtigung* or, for the three years prior to the birth, an *unbefristete Aufenhaltserlaubnis*.)

The DOS Web site for the U.S. Embassy in Germany points out these exceptions within the *Bundesregierung* law implemented in 2000:

> The child must choose between German nationality and the nationality of his/her parents before he/she turns 23 years of age, unless it is legally impossible for him/her to give up his/her parents' nationality, in which case he/she must apply to the German authorities for dual nationality before turning 21.… Those born in Germany to non-German parents before February 2, 1990, have no claim to German citizenship under this law.[65]

V. Conclusion

Dual citizenship will likely continue to rise as travel, economics, the internet and other phenomena render our world symbolically fenceless. Although U.S. law is comparatively relaxed in its restrictions against dual citizenship, the wise practitioner should carefully study both foreign and U.S. law for guidelines and prohibitions regarding everything from citizenship to military service to travel.

Endnotes

1. *Mandoli v. Acheson,* 344 U.S. 133 (1952). *See also* http://atravel.state.gov/travel/cis_pa_tw/cis/cis_1753.html (last visited on 6 Jan. 2010).
2. *Roger v. Bellei*, 401 U.S. 815, 831-32 (1971) ("Congress has an appropriate concern with problems attendant to dual nationality.").
3. *Kawakita v. U.S.*, 343 U.S. 717, 733 (1952); *see also Kennedy v. Mendoza-Martinez,* 372 U.S. 144, 187 (1963) (Brennan, J. concurring).
4. *See* http://travel.state.gov/travel/cis_pa_tw/cis/cis_1753.html (last visited on 6 Jan. 2010). *See also* 8 U.S. Dep't of State Foreign Affairs Manual (FAM) 253.2.
5. See the reference at http://travel.state.gov/travel/cis_pa_tw/cis/cis_1753.html (last visited on 6 Jan. 2010).
6. *Id*.
7. U.S. Customs and Border Protection *Inspector's Field Manual,* ch. 12, § 12.8, at 40 (American Immigration Lawyers Association (AILA) Publications, 2008) (hereinafter "Inspector's Field Manual"). This document was made available due to a successful Freedom of Information Act petition by Charles M. Miller and can be found at http://www.ilw.com/immigdaily/News/2008,0513-cbp.pdf (last visited on 6 Jan. 2010).
8. Codified at 8 U.S.C. §§ 1481 *et seq.* (1988) (hereinafter "INA").
9. INA, note 8 *supra*, § 101(a)(21-22).
10. 7 FAM 1113 (e) defines "dual national" as a person who owes permanent allegiance to more than one country.
11. Section 308 of the INA, note 8 *supra,* provides for acquisition of nationality at birth outside the U.S. or American Samoa for a child born to a national of the U.S. Prior to 1986 there was no provision for a child born to one national and one alien parent. Pub.L. 99-

396 (27 Aug. 1986) amended INA § 308 by adding Section 308.4, which provides for acquisition at birth to those born outside of the U.S. or an outlying possession with one alien parent and one national parent. The amendment made the change retroactive and provided that nationality regardless of date of birth was acquired when the applicant established that the requirements of the statute were met. Therefore, any person born before 27 Aug. 1986 who claims nationality through one parent must present a U.S. passport showing he or she is a "national."

12. *Inspector's Field Manual*, note 7 *supra.*
13. *Inspector's Field Manual*, note 7 *supra*, § 12.9.
14. 8 FAM 253.2.
15. *Id.*
16. 8 FAM 253.2.
17. *Mandoli v. Acheson*, 344 U.S. 133 (1952).
18. INA, note 8 *supra*, § 349(a)(1).
19. *Id.* § 349(a)(2).
20. *Id.* § 349(a)(3).
21. *Id.* § 349(a)(4).
22. *Id.* § 349(a)(5).
23. *Id.* § 349(a)(6).
24. *Id.* § 349(a)(7).
25. *Afroyim v. Rusk*, 387 U.S. 253 (1967). *See also* G. Endelman, *How to Prevent Loss of Citizenship: Part 1*, 89-11 Immigr. Briefings (Nov. 1989).
26. *Vance v. Terrazas*, 444 U.S. 252, 260-1 (1980).
27. *See* http://travel.state.gov/law/citizenship/citizenship_778.html# (last visited on 6 Jan. 2010).
28. *Id.*
29. *See* the text at notes 18 through 21 *supra*.
30. http://travel.state.gov/law/citizenship/citizenship_778.html# (last visited on 6 Jan. 2010).
31. *See* note 27 *supra.*
32. Sample inquiry letters can be found in the following article: R. Mautino, *Dual Citizenship: How Do You Know? What Do You Do?*, 1997-98 INL Handbook Citizenship (AILA Books/Conference Publications/INL Handbooks 2008).
33. For a comprehensive listing of treaties, please see Kurzban's Immigration Law Sourcebook (11th Edition), available from AILA Publications, whose Web site can be found at www.ailapubs.org . For DOS information prior to 1997, see Dep't of State, Office of Treaty Affairs, *Treaties in Force: A List of Treaties and Other International Agreements of the United States in force as of Jan. 1, 1997* (1997) [hereinafter "Treaties in Force"], available at http://www.state.gov/s/l/treaty/treaties/2009/index.htm (last visited on 6 Jan. 2010). *See also* Bowman & Harris, Multilateral Treaties: Index and Current Status 85 (1984) (treaty 129).
34. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estates of Deceased Persons, 13 Sept. 1949, 2 U.S.T. 2294, T.I.A.S. 2355, 127 U.N.T.S. 119; and Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 13 Sept. 1949, 2 U.S.T. 2303, T.I.A.S. 2356, 127 U.N.T.S. 89. U.S. tax credit laws for foreign taxes paid can be found at 26 U.S.C.S. §§ 27, 642, 841, 874, and 901 *et seq*. (1997).
35. 12 Apr. 1930, 50 Stat. 1317, 2 Bevans 1049, 178 L.N.T.S. 227.
36. *Id.* art. 1.
37. "Richard C. Paddock, *Lithuania's President-Elect Gives up U.S. Citizenship; Inauguration: Former EPA Bureaucrat from Chicago Is to Be Sworn in Today as Leader of His Native Land,* L.A. Times, 26 Feb. 1998, at A4; *President-to-Be Gives up U.S. Citizenship*, News & Observer, 26 Feb. 1998, at A11; *Lithuanian Returns U.S. Passport*, Wash. Post, 26 Feb. 1998, at A18; Judy Pasternak, *American Trades Retirement for Chance to Lead Lithuania*, L.A. Times, 9 Feb. 1998, at A5.
38. Robert C. Toth, *New Ties to the Old Country; Ethnic Pride Has Surged Among Americans of East European Descent; Assistance Has Gone Beyond Financial Support; Some Have Taken Jobs with the New Governments*, L.A. Times, 14 May 1991, at A1.
39. Hague Convention on Certain Questions Relating to the Conflict of Nationality Laws, The Hague, 12 Apr. 1930, 723 U.N.T.S. 450.
40. 8 FAM 253.2.
41. *Id.*
42. S. Renshon, *Reforming Dual Citizenship in the United States* (Center for Immigr. Stud. Oct. 2005).
43. U.S. Office of Personnel Management, Investigations Service, *Citizenship Laws of the World* (U.S. Dep't US-1, Mar. 2001), available at http://www.opm.gov/extra/investigate/IS-01.pdf (last visited on 6 Jan. 2010).
44. *Id* at 6.
45. *Id.*
46. 8 C.F.R. §§ 101.3, 1101.3; *In re Chu,* 14 I&N Dec. 241 (R.C. 1972) *In re Huang,* 11 I&N Dec. 190 (R.C. 1965).
47. *Nikoi v. Attorney General*, 939 F.2d 1065 (D.C. Cir. 1991).
48. *Id.* at 7.
49. *Id.*
50. Const. arts. 30, 32, and 37, parts A and B, amended 20 Mar. 1998 (Mex.).
51. *Citizenship Laws of the World*, note 43 *supra.*
52. Citizenship Act (R.S. 1985, c. C-29), available at http://laws.justice.gc.ca/eng/C-29/index.html (last visited on 6 Jan. 2010).
53. Bill C-37: An Act to Amend the Citizenship Act (R.S. 2008, c. 14), available through the Web site of the Canadian Parliament at http://www.parl.gc.ca (last visited on 6 Jan. 2010).
54. *Id.*, Summary.
55. http://www.post-gazette.com/nation/20020515dual0515p4.asp (last visited on 6 Jan. 2010).
56. British Nationality Act, 1948, 11 & 12 Geo. 6, c. 56.
57. British Nationality Act, 1981, c. 61, as amended.
58. British Overseas Territories Act 2002, c. 8.
59. Hong Kong Act 1985 and the British Nationality (Hong Kong) Order 1986.
60. British Nationality Act 1981, c. 61, as amended.
61. *Id.*
62. *Id.*
63. at www.ind.homeoffice.gov.uk/britishcitizenship (last visited on 6 Jan. 2010).
64. *Deutsche Bundesregierung*, 1999: Gesetz zur Reform des Staatsangehörigkeitrechtes, in Bundesgesetzblatt Teil I Nr. 38. Bonn 23, July 1999 (G 5702), at 1618-1624.
65. http://germany.usembassy.gov/acs/dual_nationality.html (last visited on 6 Jan. 2010).

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Appendix A

Countries That Recognize Dual Citizenship

Key:
Y: Yes
N: No
C: Country recognizes dual citizenship with extended conditions
NA: Information not available

This information has been culled from *Citizenship Laws of the World*.[1]

Citizenship Laws of the World provides contact information for some countries listed below as "NA."

Afghanistan	N	Ashmore and Cartier Islands	NA	Belarus	N
Albania	NA	Australia	Y	Belgium	N
Algeria	N	Austria	N	Belize	Y
Andorra	N	Azerbaijan	N	Benin	Y
Angola	N	Bahamas, The	N	Bermuda	NA
Antigua and Barbuda	Y	Bahrain	N	Bhutan	N
Argentina	N	Bangladesh	N	Bolivia	N
Armenia	N	Barbados	Y	Bosnia and Herzegovina	NA
Aruba	NA	Bassas da India	NA	Botswana	N
Bouvet Island	NA	Cocos (Keeling) Islands	NA	El Salvador	Y
Brazil	N	Colombia	Y	Equatorial Guinea	N
British Indian Ocean Territory	NA	Comoros	NA	Eritrea	N
British Virgin Islands	NA	Congo, Democratic Republic of the	N	Estonia	N
Brunei	N	Congo, Republic of the	N	Ethiopia	NA
Bulgaria	Y	Coral Sea Islands	NA	Europa Island	NA
Burkina Faso	Y	Costa Rica	Y	Falkland Islands	NA
Burundi	N	Cote d'Ivoire	Y	Faroe Islands	NA
Cambodia	N	Croatia	N	Fiji	N
Cameroon	N	Cuba	N	Finland	N
Canada	Y	Cyprus	Y	France	Y
Cape Verde	Y	Czech Republic	N	French Guiana	NA
Cayman Islands	NA	Denmark	N	French Polynesia	NA
Central African Republic	Y	Dhekelia	NA	French Southern and Antarctic Lands	NA
Chad	NA	Djibouti	N	Gabon	N
Chile	N	Dominica	NA	Gambia, The	N

China	N
Christmas Island	NA
Clipperton Island	NA
Gibraltar	NA
Glorioso Islands	NA
Greece	N
Greenland	NA
Grenada	Y
Guadeloupe	NA
Guam	NA
Guatemala	N
Guernsey	NA
Guinea	N
Guinea-Bissau	N
Guyana	N
Haiti	N
Heard Island and McDonald Islands	NA
Honduras	Y
Hong Kong	NA
Hungary	Y
Iceland	N
India	N
Indonesia	N
Mayotte	NA
Mexico	C
Micronesia	N
Moldova	N
Monaco	N
Mongolia	N
Montserrat	NA
Morocco	Y

Dominican Republic	N
Ecuador	N
Egypt	N
Iran	N
Iraq	NA
Ireland	Y
Isle of Man	NA
Israel	Y
Italy	Y
Jamaica	Y
Jan Mayen	NA
Japan	N
Jersey	NA
Jordan	Y
Juan de Nova Island	NA
Kazakhstan	N
Kenya	C
Kiribati	N
Korea, North	N
Korea, South	N
Kuwait	N
Kyrgyz Republic	N
Laos	N
Niue	NA
Norfolk Island	NA
Northern Mariana Islands	NA
Norway	N
Oman	N
Pakistan	N
Palau	N
Palestine	NA

Georgia	NA
Germany	C
Ghana	N
Latvia	N
Lebanon	Y
Lesotho	N
Liberia	N
Libya	N
Liechtenstein	NA
Lithuania	N
Luxembourg	N
Macau	NA
Macedonia	NA
Madagascar	N
Malawi	N
Malaysia	N
Maldives	Y
Mali	Y
Malta	N
Marshall Islands	N
Martinique	NA
Mauritania	N
Mauritius	Y
Russian Federation	Y
Rwanda	N
Saint Helena	NA
Saint Kitts and Nevis	Y
Saint Lucia	Y
Saint Pierre and Miquelon	NA
Saint Vincent and the Grenadines	Y
Samoa	N

Mozambique	N	Panama	N	San Marino	NA
Namibia	N	Papua New Guinea	N	Sao Tome and Principe	N
Nauru	N	Paracel Islands	NA	Saudi Arabia	N
Navassa Island	NA	Paraguay	Y	Senegal	N
Nepal	N	Peru	Y	Serbia and Montenegro	NA
Netherlands	N	Philippines	N	Seychelles	N
Netherlands Antilles	NA	Pitcairn Islands	NA	Sierra Leone	N
New Caledonia	NA	Poland	N	Singapore	N
New Zealand	Y	Portugal	Y	Slovak Republic	Y
Nicaragua	N	Qatar	N	Slovenia	N
Niger	N	Reunion	NA	Solomon Islands	N
Nigeria	Y	Romania	Y	Somalia	NA
South Africa	Y	Thailand	N	United Arab Emirates	N
Spain	N	Timor-Leste	NA	United Kingdom	Y
Spratly Islands	NA	Togo	Y	Uruguay	Y
Sri Lanka	N	Tokelau	NA	Uzbekistan	N
Sudan	N	Tonga	N	Vanuatu	N
Suriname	NA	Trinidad and Tobago	Y	Venezuela	N
Svalbard	NA	Tromelin Island	NA	Vietnam	N
Swaziland	N	Tunisia	Y	Virgin Islands	NA
Sweden	N	Turkey	Y	Wake Island	NA
Switzerland	Y	Turkmenistan	NA	Wallis and Futuna	NA
Syria	Y	Turks and Caicos Islands	NA	Western Sahara	NA
Taiwan	N	Tuvalu	Y	Yemen	N
Tajikistan	NA	Uganda	N	Zambia	N
Tanzania	N	Ukraine	N	Zimbabwe	N

Endnote

1. U.S. Office of Personnel Management, Investigations Service, *Citizenship Laws of the World* (U.S. Dep't US-1, Mar. 2001), available at http://www.opm.gov/extra/investigate/IS-01.pdf (last visited on 6 Jan. 2010).

Key U.S. Distribution Contract Provisions

By Andre R. Jaglom

I. Introduction

Distribution of goods into a market can be accomplished using a variety of methods: direct distribution; commercial agents; independent distributors; private label goods; franchising; and licensing of manufacturing rights, among others. Each of these options raises different legal issues, both regulatory and contractual, which vary widely from nation to nation and region to region.

This paper will examine the principal areas of regulation and key contract provisions applicable for distribution of goods in the United States.

II. Areas of Regulation

A. Advertising and Consumer Protection

Advertising in the United States is regulated at both the federal and state levels. The authority of the Federal Trade Commission ("FTC"), under § 5 of the Federal Trade Commission Act,[1] to regulate unfair and deceptive practices has made the FTC the principal federal advertising enforcement agency. State unfair and deceptive practices acts and other consumer protection laws give similar authority to the attorneys general of the various states.

Both federal and state authority to restrict unfair and deceptive practices is broad, and can encompass a wide variety of practices. The FTC will act against advertising that it determines is likely to mislead a consumer interpreting the message reasonably and is likely to affect the consumer's purchasing decision.[2] The 1994 amendments to Section 5 of the FTC Act permit the FTC to prosecute unfair practices "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[3] In recent years, the FTC has focused its efforts on advertising claims that are more difficult for consumers to verify, such as environmental benefits, health benefits (particularly in the area of drugs, devices, weight loss products, and dietary supplements), and food claims. Its enforcement priorities also include alcoholic beverages, infomercials and telephone numbers with the charge-bearing "900" prefix.

Many states, however, continue with a broader approach to deceptive advertising enforcement, using the standard of protecting "the ignorant, the unthinking and the credulous, who, in making purchases do not stop to analyze but are governed by appearances and general impressions."[4] Intent is not an element of an offense, and hiding critical disclosures in the "fine print" will not save an advertisement whose overall impression is misleading. The case law under state consumer protection laws makes clear that, unlike a common law fraud action, intent to deceive, reliance, and damages are not required elements of an action under consumer protection laws.[5]

The basic rule for advertising is that facts, demonstrations, tests, endorsements, surveys, guarantees and other methods used by advertisers to sell their products to consumers must be substantiated by hard data. If a claim is objectively provable (in contrast to mere "puffery," such as "world's best coffee"), whether the claim is explicit or implied, substantiation is required and must be in hand before the claim is made, not generated after the fact.

B. Unfair Competition

Unfair competition, like most private party litigation for false advertising, is often based on Section 43(a) of the Lanham Act. The elements of a Lanham Act claim include (i) a false representation of fact, including claims which have a tendency to mislead even if literally true,[6] (ii) that is material, i.e., likely to influence purchasing decisions; (iii) misleads a substantial segment of the target audience,[7] (iv) affects interstate commerce; and (v) is likely to be injure the plaintiff. Again, state unfair competition laws are similar, covering conduct that amounts to a "passing off" of one firm's goods for another or a misappropriation of another firm's goodwill. Although most unfair competition cases involve claims of this nature, the coverage of unfair competition law is broad, and not necessarily so limited.

C. Antitrust/Competition Law

1. Resale Price Maintenance

In general, U.S. antitrust laws, in the absence of monopoly power, are concerned with concerted action, not unilateral conduct. Moreover, concerted action among competitors—"horizontal" conduct—is generally considered *per se* unlawful, meaning that economic or other justifications will not be heard. Until 2007, the same was true for vertical agreements—that is, agreements between buyer and seller—that set a minimum resale price for the affected product. The Supreme Court overturned that rule in the landmark decision, *Leegin Creative Leather Products, Inc. v. PSKS, Inc*.[8] Now all vertical agreements, whether related to pricing or to non-price matters such as territorial restrictions, are judged under federal law by the "rule of reason," under which the court must determine whether the anticompetitive harm from the conduct is outweighed by potential competitive benefits.[9] The proof required of a plaintiff in a rule of reason case is generally much greater, as are the costs of litigation.

State antitrust laws vary, however. Some states follow federal law, others view federal law as relevant, but not controlling, authority, and in some states, among them New York and California, state antitrust laws are entirely independent of federal law and continue to apply a *per se* rule against resale price maintenance.

Moreover, even under federal law, the Supreme Court in *Leegin* stressed several situations in which resale price maintenance could be found to be anticompetitive, such as where resale price maintenance is initiated by dealers rather than suppliers; where most suppliers in an industry use resale price maintenance; and where either the supplier or dealer involved has market power. Note, however, that where distribution is accomplished through a true agent, who does not take title to the product, sales are therefore made directly by the supplier to the customer procured by the agent, and the supplier is free to control that price, because it is a unilateral act of the supplier, not an agreement with the agent.

2. Territorial and Customer Restrictions

Customer and territory restrictions, such as exclusive territories pursuant to which a distributor is allocated a specific territory outside of which it may not sell and within which no other distributor may sell the supplier's goods, are governed by the rule of reason. Exclusive territories, by definition, reduce intrabrand competition between distributors of the same products. But by eliminating one distributor "free-riding" on the promotional and service efforts of another and undercutting its price, and thus making it feasible for the distributor to sustain those efforts, exclusive territories enhance interbrand competition among suppliers of competing products, and so are usually viewed as procompetitive on balance.[10] This is in sharp contrast to the situation in Europe, in which such territorial restrictions are viewed as antithetical to the common market.

3. Predatory Pricing—Below-Cost Sales

A supplier's sales below cost are unilateral in nature, and so do not violate the antitrust laws except in the context of monopolization or an attempt to monopolize under § 2 of the Sherman Act. To constitute such a violation, predatory pricing must be at a level below marginal or average variable cost.[11] In addition, market structure must be such that the alleged monopolist will be able to recoup its losses by increasing prices to above-competitive levels after driving its competitor out of business. A market with low barriers to entry, for example, is an unlikely candidate for a predatory pricing claim, because a new entrant could readily prevent supra-competitive pricing.

4. Refusals to Deal

Again, in the absence of monopolization under § 2, only joint refusals to deal are actionable under the antitrust laws. In general, suppliers are entirely free to select those with whom they wish to do business, even if that decision is based upon compliance with pricing policies.[12] Decisions not to do business with certain customers must, however, be made unilaterally, and never jointly with competitors. Even a decision not to deal with a distributor made at the behest of another distributor carries potential antitrust risks, and should be undertaken only after consultation with counsel.

Accordingly, suppliers should avoid circumstances in which they terminate a distributor in response to the request of a number of that distributor's competitors. In those circumstances the claim might be asserted that the supplier was acting as a member of a horizontal conspiracy of the competing dealers.[13]

In general however, the antitrust laws are designed to protect competition, not individual competitors, and in the absence of concerted action, a supplier's decision to replace one distributor with another does not implicate the antitrust laws.[14]

5. Price Discrimination

Broadly speaking, under the Robinson-Patman Act,[15] price discrimination is prohibited. A supplier cannot sell the same product to different competing purchasers at different prices if the effect is anticompetitive. The big purchaser may not be favored over the small one. Any quantity discounts must be cost-justified, and, because this defense is particularly difficult to establish, should be approved by counsel. Prices may be lowered to meet, but not beat, a competitor's price, but only if there is a good-faith basis for believing that the competitor actually made a lower offer. The lower price must not, however, be confirmed with the competitor.[16]

The Robinson-Patman Act also requires promotional programs, services and allowances to be available to customers on a proportionally equal basis. In general, to the extent possible, suppliers should consult with counsel on price-discrimination and promotional program issues because of the complexity of the law and the importance of the factual context.

6. Franchising

Franchising is heavily regulated in the United States, both by the Federal Trade Commission and by the individual states. Many states have business franchise laws or other dealer protection statutes that restrict termination and non-renewal (notwithstanding the terms of an agreement) or impose disclosure or registration requirements. Some three-quarters of the states have general statutes regulating franchises, business opportunities or both.[17]

(a) Types of Statutes

Many of these state laws require specified detailed disclosures and sometimes registration with state authorities.[18] (The Federal Trade Commission Rule on franchising, 16 C.F.R. Part 436, is similar.) Some statutes restrict the supplier's right to terminate the relationship or otherwise regulate the substantive nature of the relationship, such as the supplier's right to prohibit transfers or assignments and the supplier's freedom to increase prices without notice.[19] In addition to these general laws, many states have laws applicable to specific industries, such as petroleum products, motor vehicles, farm equipment, alcoholic beverages and office equipment. Petroleum products and automobile dealers are also protected by federal statutes.[20] The legislative motivation behind the franchise laws is much the same as that behind securities laws: the franchisee is viewed as an investor entitled to certain information and safeguards. Violation of these statutes is usually a criminal offense and gives rise as well to civil liability of the franchisor to injured franchisees.

The statutes take one or both of two general forms: (1) disclosure and registration requirements; and (2) restrictions on termination and other substantive aspects of the distribution relationship. The theory of the disclosure and registration laws is that the franchisee should be given essential information regarding what is considered to be his business "investment." The theory underlying the anti-termination laws is that a distributor who has invested in a supplier's brand and has built up a market should be protected from a supplier's decision to yank the rug out from under him by giving the now established market to another distributor or taking it over directly.

(b) Applicability

(i) *"Franchise" Laws.* The definitions of a "franchise" under state statutes and the FTC Rule follow a general pattern. First, there is usually a trademark element—either a license to use the franchisor's trademark, service mark or the like,[21] or substantial association with such a mark,[22] or, in some cases, the mere right to sell goods or services using the mark.[23] Second, there is usually a marketing element—either a community of interest between franchisor and franchisee in the marketing of goods or services,[24] or a marketing plan prescribed by the franchisor.[25] And third, there is often, but not always, a franchise fee element.[26]

(ii) *"Business Opportunity" Laws.* Another set of definitions applies to "business opportunity" laws, generally involving suppliers who (i) provide or help find locations for vending machines, racks or displays; (ii) purchase all products which the purchaser makes using supplies sold by it to the purchaser; (iii) guarantee that the purchaser will derive income exceeding the price paid or the seller will return the purchase price or repurchase any products, equipment or supplies; *or* (iv) will provide, upon payment of some minimum sum, a sales or marketing program which will enable the purchaser to derive income from the business opportunity. Unlike franchises, where the involvement of the franchisor's trademark is usually a necessary element, the business opportunity laws often *exempt* sales of business opportunities in conjunction with the licensing of a registered trademark.[27]

(iii) *Exemptions.* Various state statutes have a variety of exceptions for fractional franchises, suppliers with large net worth, and other situations too varied to explore here.

(c) Disclosure Requirements

The FTC Rule and many state laws require that a very extensive disclosure document be provided to prospective distributor franchisees. Among the information that must be provided are the franchisor's audited financial statements, information about the franchisor's history, including litigation and bankruptcy history and operating experience, a description of the franchisor's termination rights, and restrictions on the business that the franchisee may conduct. There are also very specific restrictions on earnings claims. As a result of these restrictions, such claims or projections are generally not made. The states with franchise disclosure laws generally require that similar documents not only be provided to prospective franchisees, but also be filed with, and often approved by, state authorities.

(d) Substantive Restrictions

Most state franchise laws also regulate certain substantive provisions of the relationship between franchisor and franchisee, particularly with respect to termination. Of the states with franchise laws restricting termination rights, a few, such as Mississippi, merely require that a specified minimum notice be given.[28] Most, however, require not only minimum notice and opportunity to cure, but also that "good cause" or "just cause" exist, not only for termination but also for non-renewal of a franchise. The statutory definition, if any, of such cause is often very narrow and generally does not include poor sales performance *per se*.[29] A number of definitions do define good cause to include the franchisee's failure to comply with reasonable requirements of the franchise agreement, and performance standards might qualify as such a requirement.

Moreover, many states require that, before termination occurs, the franchisee or distributor be given a specified period—often sixty or ninety days—in which to cure any deficiency.[30] "Curing" has been held not necessarily to require correction of a breach, but merely the taking of steps to avoid a recurrence. Thus a distributor who made out-of-territory sales in breach of a contractual provision was held to have cured the deficiency by ensuring that such sales did not recur.[31]

Some state laws not only restrict termination and non-renewal but other diminutions of a franchise, such as the addition of other distributors or franchisor-owned outlets in the franchisee's area.[32] Some state laws also restrict other aspects of the franchise relationship, such as restrictions on changes in management or ownership, requirements that goods or services be obtained from the franchisor, discrimination among franchisees in price, credit terms, services and the like, unreasonable performance standards, or increases in prices without notice.[33]

Many statutes prohibit any waiver by the franchisee of its statutory rights.[34]

6. Dealer Termination

While termination of distributors and dealers will generally be permitted in accordance with contractual provisions, such termination is one of the most frequent sources of litigation under the antitrust laws and related state statutes and common law. It is thus important that company records adequately and accurately reflect the reasons for termination, but such documentation should be reviewed by counsel. Inconsistent application of standards for termination will lend support to a distributor's claim that the stated ground for termination was pretextual and that the actual reason was some unlawful one. It is also important that termination not be threatened, explicitly or implicitly, without legal investigation and advice.

Terminations that are performed in an unconscionable or unfair manner may be actionable as well. For example, the United States Court of Appeals for the Fourth Circuit has held that, under South Carolina law, even where a contract provides a broad right to terminate without cause, such a termination is actionable "if the manner of termination is contrary to equity and good conscience," such as where it is unconscionable or causes needless injury.[35] In contrast, where clear notice was given of the reasons for termination and the steps needed to be taken by the dealer to cure its defaults, the manner of termination was proper and the termination upheld.[36]

Similar concerns militate against the pre-termination gathering of customer and sales data or inappropriate customer contacts, which could lead to a claim of misappropriation of trade secrets, unfair competition or defamation.

A number of states apply the doctrine of recoupment to prohibit termination of a contract of indefinite duration until the distributor has been given a reasonable period of time to recoup its investment in the distributorship.[37] This suggests that suppliers may want to include a representation by the distributor that it already had all the resources necessary to perform the agreement, or an acknowledgment that termination is permitted at any time and that any "investment" is made voluntarily by the distributor with that understanding.

It is worth noting that under some circumstances, a terminating supplier may find itself liable for a business tort or tortious interference with contract or with prospective economic advantage.[38] In addition, some courts have invoked the doctrines of fraud, breach of fiduciary duty or unconscionability in the termination context.[39] Moreover, some courts have held written contractual provisions to be superseded by oral representations.[40]

In light of the variety of state law restrictions on termination, nonrenewal, and modification—such as the appointment of additional dealers—of certain distributor arrangements, it is particularly important not to act without counsel. State "franchise" and "business opportunity" statutes often are far broader in scope than their names might indicate, and care should be taken to consider their impact before initiating or altering distributor arrangements. Special dealer protection laws exist in some states for certain industries. Legal advice is desirable even for the addition of distributors, so that the client is fully aware of the consequences of that step in the particular state and so that efforts, including careful contract drafting and perhaps restructuring of the details of the relationship, can be made to avoid falling within any state distributor protection laws.

III. Key Contract Issues

A. General Concerns

Except for the franchise and special industry situations referred to above, distribution relationships in the United States are generally governed by contract. The distribution agreement is the critical document defining the rights and obligations of the parties, and thus must be drafted carefully, with a full understanding of the business relationship intended and each party's objectives.

1. Supplier Objectives

In general, the supplier will want to establish a structure that will ensure satisfactory performance or allow the supplier to end the relationship. This will involve specifying as fully as possible exactly what it wants the distributor to do and trying to quantify acceptable performance levels, so that the supplier will be satisfied so long as the agreement's terms are met. All possible reasons for dissatisfaction should be determined, so that adequate termination rights can be provided. The supplier's expectations in areas like advertising, promotion and service should be specified.

2. Distributor Objectives

In turn, the distributor will want to define exactly what sort of support it will receive from the supplier in terms of advertising and promotion, delivery, and any support services, such as accounting or training. It will want to determine what performance levels are reasonable and appropriate to its market, so that it is not held to unreasonable levels of performance and will be protected so long as reasonable standards are achieved. It will want to consider what quantity and price guarantees it will need. Finally, it may want compensation for the value of its distribution rights in the event of termination or non-renewal by the supplier, at least in the absence of material breach by the distributor.

The most important distribution agreement provisions are addressed below.[41]

B. Definitions of Product

The contract should specify whether the distributor has the right to buy the supplier's entire line or only specified products. The supplier may be given the right to reduce the range of products sold to the distributor, under certain specified circumstances. It is important to consider how broadly or narrowly to define the products, as well as the extent to which product characteristics may be changed. For example, a product definition tied to a trademark may leave a distributor without a product if the trademark is changed or a separate one adopted for new products. It is also necessary to decide whether to give the distributor an option or right of first refusal with respect to any new products the supplier may introduce in the future, or to require the distributor to handle such products. In addition, it may be important to specify whether different products or product lines are part of a single distribution agreement or are separable. In one case in which different product lines were included in separate product addenda, they were held to constitute separate franchises, so that the termination of one product line violated a state franchise law. This might not have been the case had the various product lines been part of a single franchise, since a substantial portion of the franchise would have continued.[42]

C. Definition of Territory

1. Where May This Distributor Sell?

The territory must be clearly defined if the areas in which the distributor may sell or the customers to whom it may sell are limited. As noted above, the permissibility of territorial and customer restrictions is governed by a rule of reason, taking into account such factors as the supplier's market power, any anticompetitive effect on intrabrand competition (between distributors of the supplier's product), which must be compared with any alleged positive effect on interbrand competition (with products of other suppliers), and the importance of interbrand competition as a source of competitive pressure on price.[43] If such restrictions are imposed, not only should out-of-territory sales be prohibited, but also sales to those the distributor knows or has reason to believe will resell outside the territory (or those the supplier notifies the distributor it believes will do so), to prevent transshipping.

2. May Others Sell in This Territory?

The distributor may be granted exclusive rights in the territory, or the supplier may sell to others.[44] The distributor may require the supplier to provide protection against "gray market" imports from other distributors outside the territory. Another option is to require distributors selling outside their principal territory to pay a portion of their profits over to the distributor in whose territory the sale was made. The supplier may reserve the right to sell to certain types of customers (for example, "national accounts," governmental customers or military bases) directly. Some national retailers insist on purchasing directly from the manufacturer, so reserving the right to make such sales may be critical. In such situations, the distributor may receive compensation for those sales in the form of a per unit "invasion fee."

The supplier should consider its own long-term goals before granting an exclusive territory to a distributor, particularly in relation to the supplier's possible plans for direct marketing on the internet. One American Arbitration Association decision held that the establishment of a franchisee's exclusive territory precludes internet sales by the franchisor to customers located within the franchisee's territory.[45] Another arbitration panel came to the opposite conclusion, finding H&R Block's internet offering of its tax preparation services did not unreasonably intrude on the franchisee's operations and so did not violate the exclusive territory provisions of the franchise agreement.[46] Some state statutes for specific industries also preclude direct sales by suppliers on the internet, and the supplier should be aware of these state regulations when determining exclusive territories.[47]

It is similarly noteworthy that a California court held that, despite the absence of an exclusive territory in a franchisee's franchise agreement, the franchisor's placement of other franchises in close proximity to the existing franchisee created a triable issue of fact as to whether the franchisor breached the implied covenant of good faith and fair dealing.[48]

D. Internet Distribution

As internet distribution becomes more prevalent, suppliers need to make sure they are protected against unintended or unforeseen distribution of their product by providing for internet distribution methods and standards in their agreements with distributors. Suppliers who do not yet want their product marketed over the internet, but do not want to foreclose the possibility entirely for the future, may include a provision requiring their prior approval for a distributor to sell or advertise online, or to sell to those whom the distributor knows or has reason to believe will resell online. Without such a provision, a supplier wishing to limit internet distribution of its products is left to less direct alternatives, which may or may not be available depending on the circumstances, such as announcing a general policy of not dealing with dealers who distribute through the internet, refusing advertising support for internet sales, restricting the use of the supplier's intellectual property to print or traditional broadcast media, and limiting its warranty to exclude internet sales. Some products that can be transferred digitally may be distributed directly over the internet, such as software, audio and video materials, information databases and the like. In such cases, the supplier may readily choose to avoid distributors entirely.

If a supplier accepts distribution through online channels, it should set standards for internet distribution in its distribution agreements. Depending upon their concerns and their product, suppliers may limit internet distribution to products that do not require service or, alternatively, require distributors to arrange for a bricks and mortar distributor to provide any service needed. Products requiring extensive pre-sale education or demonstration may benefit from limitation of internet distribution, to avoid discount online sellers from free-riding on the efforts of bricks and mortar dealers who invest in such pre-sale efforts. Standards for website operation and customer service, such as a twenty-four hour hotline or response time standards for online inquiries, might be prescribed. A supplier should consider restricting the use of any domain name that makes use of or might be confused with the supplier's trademark. Another option is to require a distributor to maintain a link to the supplier's website, with a disclaimer that the supplier is not in any way responsible for representations made by the distributor's website.

By permitting its distributors to use the inherently borderless internet, a supplier may thereby enable distributors who are limited to specific geographic territories to sell into another's territory. In order to inhibit such activity a supplier may require internet distributors to collect consumer's postal codes before proceeding and to refuse or redirect any consumer who is not located within the distributor's territory.

The internet also creates virtually endless possibilities for the collection and analysis of consumer data. Information obtained from customers through internet transactions can be used to market through highly targeted advertising campaigns. If a supplier wishes to have access to and control over customers' data collected by a distributor through its website, there should be a provision in the agreement explicitly stating that all data collected regarding customers of the product shall be deemed to be the supplier's property and shall not be used by the distributor or sold, licensed, disclosed or transferred to any party other than the supplier without the supplier's written permission. In contrast, distributors generally will want to safeguard such information from disclosure to, or at least use by, the supplier, as free use of detailed customer data will greatly facilitate the transition to a replacement distributor.

Moreover, a supplier should specify guidelines for the collection of consumer data. An internet distributor should be explicitly required to comply with all applicable privacy and consumer protection laws, to post and comply with its own privacy policy and to disclose to consumers that their information will be shared with the supplier and obtain their consent when necessary.[49] Note that the European Union, Canada and other countries strictly regulate the collection and use of consumer data in their territory or from their citizens.

E. Pricing, Payment Terms and Execution

Pricing methods should be specified, whether as determined from time to time by the supplier, or restricted in some fashion. Restrictions can include minimum notice of changes, limitations on frequency of changes, and limitations on the amount of increases, whether pegged to cost increases, consumer price indices, industry market prices, specified percentages, or otherwise. Whether prices are to be F.O.B. supplier's facility, ex works, C&F, C.I.F. or otherwise, should be specified, or the matter expressly left to supplier's specification by invoice. Note that these terms may have different meanings under the Uniform Commercial Code applicable in most states and the International Chamber of Commerce's Incoterms, often used in international transactions. The distribution contract should make clear what is intended.

Payment terms should be addressed as well, although suppliers will want the freedom to reduce terms for valid credit reasons. If the supplier desires payment by electronic funds transfer or has an electronic data interchange system for ordering and payment, the distribution agreement should provide for the distributor's participation and for the formation of a contract upon receipt of an order from the distributor's computer and acceptance by the supplier's computer, with a procedure for resolving discrepancies between the supplier's and the distributor's computer records.

It is important that the parties adopt a commercially reasonable authentication procedure for such electronic transactions. In international transactions, the United Nations Commission on International Trade Law (UNCITRAL), Model Law on E-Signatures, which was adopted on 5 July 2001, states that "[w]here the law requires a signature of a person, that requirement is met in relation to a data message if an electronic signature is used that is as reliable as was appropriate."[50] The federal Electronic Signatures in Global and National Commerce Act[51] ("E-SIGN") imposes no specific requirements on electronic documents and signatures, which under E-SIGN are given equal validity to paper contracts and signatures. Rather, it leaves it to the market to determine what types of electronic signatures will succeed and be accepted. Nevertheless, prudence dictates that a form of signature be used which can be authenticated and ensures the integrity of the document to which it is affixed.

F. Restrictions on Competition

If the supplier will be providing valuable competitive information to the distributor, including information regarding customers and their needs, a restriction on competition by the distributor with the supplier during and after the agreement may also be advisable, particularly if trade secrets are to be disclosed to the distributor. Otherwise, a knowledgeable distributor could do substantial damage by selling competing products to the supplier's customers. A review of state law is important here, because the states differ widely in their treatment of such clauses, with some states holding such restrictions to be entirely unenforceable.[52]

To be enforceable, such clauses generally must be "ancillary" to the agreement and in furtherance of the agreement's lawful purposes.[53] Courts have applied a reasonableness standard in assessing whether a noncompete clause is enforceable, taking into consideration (i) the length of time,[54] geographic area, and activities restricted; (ii) the hardship to the distributor; and (iii) the public interest.[55] As an alternative to the typical geographic restriction, the supplier may want to consider imposing a restriction on selling to specified customers or to customers purchasing the supplier's products during a specified period.

In the franchise relationship certain interests not present in the usual buyer-seller relationship may exist and these interests may be protectable through noncompete clauses, for example, integrity of the franchise, marketability of the franchise, and protection of shared confidential business information. For these reasons, competition might be restricted not only near the franchisee's location but also near the location of any franchisee.[56] Some states, however, prohibit or limit such post-term noncompete clauses by statute.[57] And other states have invalidated overbroad restrictions in franchise agreements on public policy grounds.[58]

It may be prudent to recite that the noncompete clause is a separate agreement from the overall contract, supported by separate consideration, such as the supplier providing training and access to valuable confidential information, and fully vests upon the provision of that consideration. Otherwise a rejection of the entire contract by a bankrupt distributor under section 365 of the Bankruptcy Code might be held to render the noncompete clause unenforceable.[59]

The agreement should also provide that breach of the noncompete agreement will cause the supplier irreparable injury for which money damages are neither adequate nor fully ascertainable, and that injunctive relief is therefore to be available as a remedy for any such breach.

G. Restrictions on Transfer, Changes in Ownership, Control and Management

The supplier may wish to restrict assignment or transfer of the agreement. The distributor may wish to be able to sell his business and assure the purchaser of a right to keep the distributorship. If assignability of the distribution agreement is to be restricted, the transfer provision should cover stock sales and asset sales, mergers and consolidations, as well as changes in management or control. The distributor might require that the supplier's consent to a change not be unreasonably withheld. Standards to be met by transferees might be established. Some state franchise laws may limit restrictions on assignment or transfer, and should be reviewed.[60]

H. Use of Trademarks

The agreement should specify whether and to what extent the distributor has the right to use the supplier's trademarks. For example, the distributor may be permitted to use the trademark in its business name or it may be limited solely to identifying the goods or services it sells. The scope of any license should be spelled out clearly. Any limitations on trademark use in websites or otherwise online, including use of trademarks in metatags (visible to search engines but not to users) or their incorporation in domain names, also should be detailed.

Note that a license limited to use of the trademark within a specific territory, or limited to use in the sale of goods as permitted in the agreement, may convert extraterritorial sales or transshipment from a simple breach of contract to a trademark infringement claim.

If a trademark license is granted, the licensor should provide for procedures to maintain quality control or its trademark rights may be jeopardized.[61] It is typical to require all advertising or other materials incorporating the supplier's marks to be approved in advance by the supplier. Note also that the extent to which the distributor's business is associated with the supplier's trademarks may affect the applicability of state franchise laws.[62]

It is also important to spell out the distributor's obligations regarding the protection of the trademarks. Regardless of how responsibility for enforcement is divided, the contract should specify how any recovery for damages from infringement is to be divided between supplier and distributor. The same is true for any other intellectual property that may be licensed.[63]

I. Limitation of Warranties; Indemnification; Insurance

A supplier, if it is not the manufacturer, will not want to give a warranty or assume any liability greater than that of the manufacturer. A manufacturer will seek, consistent with applicable law and business considerations, to limit its warranty and liability. Such a limitation was held effective in a Massachusetts case holding Mack Trucks' disclaimer of the implied warranty of merchantability enforceable as against a subsequent purchaser without notice.[64]

The distributor, on the other hand, will want protection against third party claims, in the form of an indemnification, insurance or both. Third party claims can include claims under a product warranty, product liability, and infringement of patents, trademarks or copyright, or claims by a prior distributor of interference. To the extent that the distributor also fabricates or assembles the product, incorporates it into another product or services it, it can be required to take some responsibility for third party claims arising out of those activities.

In examining this issue it is necessary to consider the nature of the product and the use (industrial vs. consumer), as well as the service or assistance which is given to a customer by the manufacturer or distributor. The scope of indemnification should be spelled out, as well as whether the indemnification includes attorneys' fees and either the right or the duty to assume the defense of any claims, and whether it includes only proven claims or all allegations of covered claims. If insurance will be required of either party, the amount should be specified and the other party should be named as an additional insured.

J. Duration

The contract may be for a specified term, or indefinite until terminated. Note that some state franchise laws place stricter limits on termination during the contract term than on nonrenewal after expiration.[65] If a specific duration is provided for, consider whether renewal is to be automatic if no notice is given, or whether it requires a notice of renewal or the execution of a new agreement. The decision will depend in part on the existence of a systematic procedure for the client to assure that notice will be given. A distributor may want the guaranteed right to renew if certain performance standards are met.

In many states, a contract with no specified duration is terminable at will, on reasonable notice, but if the contract provides for termination upon the occurrence of specified events, it is not of indefinite duration and may not be terminated except when such events occur.[66] Other states disfavor perpetual agreements, at least in the absence of a specifically stated intent. Thus, a contract with defined terms, but subject to automatic renewal, was held to be for fixed terms renewable only if both parties consented, in the absence of an unequivocal statement of an intent to create a perpetual agreement.[67]

In one case under Puerto Rico's restrictive Dealer Contract Act, a distributor's failure to give written notice of renewal as required by contract was held good cause for non-renewal.[68] The court stressed that the non-renewal there was occasioned by the *distributor's* non-renewal, not the supplier's. This suggests the inclusion of such a renewal requirement, although if the requirement is ignored for years and then suddenly enforced, the courts are likely to be unsympathetic to the supplier.

K. Termination

1. Grounds

The parties will generally wish to specify the basis on which the agreement may be terminated. State laws may restrict these grounds. [69] Among the issues to be considered are the following:

(a) Without Cause

May either party terminate without cause? If so, this should be explicitly stated. [70]

(b) Performance Standard

The inclusion of mandatory performance standards appropriate to the product, industry and territory may be desirable. They can be stated in dollar terms, unit terms, as a percentage of average regional or national performance, in terms of market share, or on some other basis. Sales figures are generally better for the supplier and worse for the distributor than purchase requirements; the latter, if they force a dealer to buy more product than it can sell, might be deemed a franchise fee. Moreover, if achievement of standards results in automatic renewal, standards based on purchases rather than sales allow the dealer to obtain a renewal by buying into inventory without genuinely building a larger market for the product. If the intent is to allow the supplier to terminate or not renew if minimum standards are not met, this should be explicitly set forth. Distributors will wish to make clear that termination is the only remedy for failing to meet the standard and that there is no liability for damages as a result of any shortfall. Similarly, the supplier may wish to provide for a right to terminate if the parties cannot agree on new minimum standards for a renewal term, while distributors should resist such a provision.

Courts may examine the reasonableness of performance standards.[71] The supplier, in setting the standards, thus should be prepared to exercise the right to terminate consistently among those who do not meet the standard.[72] An alternative is to provide for the right to add additional distributors (i.e., to terminate the distributor's exclusivity) if performance levels are not reached.[73]

(c) Other Breaches

Other breaches of contract may occur. The parties should specify whether any breach justifies termination and, if not, which do. In addition, the contract should specify when, if ever, the party in breach is to be afforded an opportunity to cure, and in what period. It may be prudent to stipulate that certain breaches are agreed to be noncurable.

(d) Changes in Ownership and Control

The supplier may provide that a change in ownership, management, or control of the distributor justifies termination. Some conditions might be included. For example, termination might be permitted upon a transfer of some percentage of the ownership of one or the other party or upon the replacement of specified officers.

(e) Financial Problems

The supplier may wish to terminate if the distributor is financially unstable. The triggering event can include liens (other than routine financing liens), insolvency, the inability to pay debts as they become due, or bankruptcy. Note that if the agreement has not been terminated before a bankruptcy filing, section 365 of the Bankruptcy Code will allow the distributor the option to reject the contract or to affirm it and so prevent termination unless independent grounds for termination exist apart from the bankruptcy.[74] This suggests providing for a right to terminate for insolvency prior to bankruptcy, although to terminate for insolvency, the supplier may be required to have had knowledge of the insolvency at the time of termination.[75] Any such provision should provide that insolvency includes both balance sheet insolvency (value of liabilities exceeding value of assets) and the common law test of inability to pay debts as they come due.[76] Note that defaults by the distributor after bankruptcy may provide independent grounds for termination.[77]

In the context of intellectual property licenses, special rules apply. If a bankrupt licensor rejects a license agreement for patent, copyright or trade secret rights, the licensee may elect either to retain its rights to the intellectual property (including any exclusivity) for the duration of the agreement, including any period for which the licensee has the right to extend the agreement, or to treat the agreement as terminated by the rejection.[78] If the licensee elects to continue the license, it is not entitled to any maintenance or support services that might be called for under the license agreement, nor is it entitled to receive updates of the intellectual property at issue. In short, the licensee gains only the right to continue to use the intellectual property "as is."

(f) Other Circumstances

The supplier may desire the right to terminate in a variety of other circumstances. For example, if the distributor acts so as to injure the business reputation of the supplier or the products, or if there is a violation of law in connection with the business, termination may be warranted. The supplier may also want the right to terminate if it decides to withdraw from the product or geographic market or to convert to a direct or other distribution channel. State laws may restrict termination in these circumstances.[79]

2. Notice

The drafter should consider how much notice is required and whether the distributor may cure. The reasonableness of this provision will depend on the circumstances. Note that state franchise laws may require minimum notice and an opportunity to cure. It may be prudent to provide for what, if anything, will be considered a cure of such deficiencies as a failure to meet performance standards or the making of prohibited out-of-territory sales.

3. Effect on Non-Compete

The effect of termination on any restrictions on competition by the distributor should be considered. Different grounds for termination might have different effects. For example, termination by the supplier without cause might free the distributor to compete.

4. Inventory Repurchase

Consideration should be given to whether the supplier should have either the right or the obligation to repurchase unsold inventory on termination. Generally the supplier will want the right to repurchase, so as to prevent the terminated distributor from dumping the product on the market at distress prices. Moreover, if the supplier has such a right, but not the obligation, to buy back inventory, the agreement to do so can serve as consideration for a release from the distributor; if the contract required the repurchase, the supplier's performance of that requirement would not constitute consideration. Distributors will prefer to have the option to sell off inventory, or at least to have the supplier's repurchase be mandatory, not optional, so as to avoid allowing a supplier to leave the distributor with slow-moving products. Note that some state laws require such an inventory repurchase; obviously, in such states the repurchase would not be consideration for a release.

5. Compensation

Finally, the distributor may wish to be compensated upon termination for the value of its lost distribution rights. Even in the case of a termination for cause, it may seek compensation, less any damages resulting from the cause. Suppliers will generally resist such compensation, although they should consider the benefit of an increased incentive for the distributor to invest in the brand if it knows it will be fairly compensated for the value of its distribution rights on termination, especially given that the incoming distributor should ordinarily be willing to pay fair value for the rights it is obtaining. The practice varies from industry to industry and from state to state. Beer distribution rights are regularly paid for on termination, and indeed such compensation is required by law in some states.[80] In contrast, such compensation is atypical for wine and spirits, a distinction perhaps lacking in any internal logic.

Assuming compensation is to be provided, the parties may wish to define the basis upon which it is determined. Fair market value, whether based on appraisal or economic analysis, or formulae based upon multiples of sales, gross profits, net profits or other factors, are all possibilities. If the distributor does not pay for the distribution rights initially, then compensation on termination might be based only on increases in value, sales or profits over the life of the distributorship.

L. Arbitration

Counsel should consider whether a provision for arbitration is desirable. If included, such a provision will generally be enforced, even in the face of state law to the contrary.[81] Although domestic antitrust claims were at one time considered not to be arbitrable, courts are now enforcing arbitration agreements even in this area.[82] Note, however, that where state franchise law requires a disclosure that a choice of law or choice of forum provision may not be enforceable in that state, a question arises as to whether the parties really agreed to the contractual choice. The Ninth Circuit has held in such circumstances that a contractual choice of forum for arbitration was unenforceable in light of such a mandated disclaimer, finding that the franchisee had no reasonable expectation that it had agreed to an out-of-state forum.[83]

Care should be taken in drafting arbitration clauses not to overreach. For example, the Ninth Circuit held an arbitration clause unconscionable, and so unenforceable, where franchisees were required to arbitrate, but the franchisor could proceed in court.[84]

1. Limitations on Awards

Suppliers should consider limiting the relief the arbitrators may award to actual compensatory damages in the amount of ascertainable injury, expressly precluding punitive damages,[85] injunctive relief or specific performance. The Supreme Court has held that the central purpose of the Federal Arbitration Act is to ensure "that private agreements to arbitrate are enforced according to their terms," so that the parties' decision as to whether arbitrators may award punitive damages will supersede contrary state law as to the scope of arbitrators' authority.[86] In addition, suppliers should consider including language denying preclusive, or collateral estoppel, effect to issues resolved by arbitration with one distributor in later proceedings with other distributors.

2. Choice of Forum

Courts generally will also enforce a provision for a particular arbitration forum.[87] Such a provision for a "hometown" forum may be of benefit to a supplier, because it may impose significant cost on a distributor forced to contest a termination. Another alternative is to provide that the arbitration is held in a neutral city, or in the home city of the party *not* commencing the proceeding, although the latter may disfavor the distributor, who is more likely to need to arbitrate.

3. Potential Disadvantages

One disadvantage of arbitration is the tendency of arbitrators to "split the baby" and arrive at a compromise decision. This tends to disadvantage the party with the stronger legal basis for its position. Thus a supplier who fears unwarranted termination disputes by dealers may wish to avoid arbitration. Discovery will generally be more limited in arbitration than in litigation: More often than not this will disadvantage the distributor, who may wish discovery of the supplier's reasons for termination or treatment of similarly situated distributors elsewhere. Preliminary injunctive relief may be less readily available in arbitration, thus precluding a distributor from forestalling a termination while the dispute is resolved.

Finally, an arbitral award generally cannot be overturned other than for fraud or dishonesty. Thus there is little recourse from a poorly reasoned or otherwise incorrect decision of a bad arbitrator. In court, obviously, a right of appeal is generally available. Arbitration thus may work to the disadvantage of the party with the stronger legal position.

M. Choice of Forum

The parties can provide for all litigation arising under the agreement or its termination to be brought in a court located in a particular state and can waive their right to seek a transfer. These clauses are sometimes enforced and sometimes not.[88] The Supreme Court, in *Burger King Corp. v. Rudzewicz*,[89] enforced a contractual choice-of-forum clause requiring a Michigan franchisee to litigate Burger King's action for breach of contract in Florida, Burger King's home state. *Burger King* merely holds that a franchisor can constitutionally enforce a forum-selection clause against its franchisees in an action commenced by the franchisor.

The supplier also should make certain that the requirements of state long arm statutes and state constitutional due process requirements are met. It is possible that courts in the distributor's home state will refuse to enforce a forum-selection clause on the ground that the public-policy interests of the distributor's state outweigh the parties' choice.[90] Note also that state franchise laws may expressly prohibit the choice of another state as a forum.[91] Federal courts, however, will apply federal law to determine whether to enforce such a clause, notwithstanding any such state view; the forum clause is not dispositive, but should be considered together with the other private and public interest factors normally weighed in a transfer motion pursuant to 28 U.S.C. § 1404(a),[92] at least where the choice is between two federal districts.

A showing of state policy sufficient to outweigh a forum clause may be difficult to make. The Supreme Court has held enforceable a fine print forum selection clause printed on the back of a cruise line's passenger ticket, requiring a Washington resident to sue in Florida for injuries sustained on a cruise off Mexico.[93] The Maryland courts have similarly held that a forum selection clause favoring the franchisor's home state was enforceable despite being incorporated into a form contract where the franchisor had superior bargaining power, reasoning that there was no fraud involved.[94] Similarly, the Sixth Circuit has enforced a choice of law and choice of forum clause contained in a contract allegedly signed in reliance on the defendant's fraud.[95] And the Western District of New York upheld a one-sided forum clause that restricted venue in actions by a franchisee, but not in actions by the franchisor.[96] The District of New Jersey has recently relied on federal law in granting a motion to transfer to the forum identified in the parties' forum selection clause.[97]

On the other hand, the District of Puerto Rico declined to transfer a dispute to California courts as called for by a contractual forum clause, because it was unchallenged that Puerto Rico was more convenient for witnesses, and there was no evidence justifying transfer other than the contract clause.[98]

In drafting forum selection clauses, counsel should make clear both that jurisdiction in the chosen forum is consented to and that venue in that forum is mandatory.[99] Arbitration clauses calling for a particular forum are highly likely to be enforced. The Seventh Circuit reversed a district court opinion and ordered arbitration in Poland pursuant to contract in a case under the Illinois Beer Industry Fair Dealing Act, holding that while the state's public policy expressed in that statute required Illinois law to apply notwithstanding the contract's choice of Polish law, that public policy could not overcome the federal policy in favor of arbitration embodied in the Federal Arbitration Act.[100]

N. Choice of Law

The parties should include a choice of law provision. Suppliers may wish to select the law of a jurisdiction that does not have a franchise or dealer protection law, in an effort to avoid the impact of such law on their termination rights and other aspects of the dealer relationship. Such an effort may succeed, if the jurisdiction chosen bears a reasonable relationship to the transaction, *e.g.*, the supplier's home state. While a number of courts have disregarded such choice of law provisions in deference to the public policy of states with franchise laws,[101] or because the validity of the contract containing the clause was questioned,[102] some courts in recent years have honored the parties' choice, at least in the absence of oppressive use of superior bargaining position, although the overall trend has been mixed.[103] In response to one such decision, Minnesota amended its franchise statute in May 1989 to invalidate any contractual choice of law clause.[104] It remains to be seen whether courts outside of Minnesota will give effect to this provision.

The Michigan courts have found that a Florida choice of law provision in a contract between a Florida franchisor and Michigan franchisee was unenforceable because the choice of law provision significantly eroded the franchisee's protection under the Michigan Franchise Investment Law.[105] Moreover, at least one court, the First Circuit, has not only held that Maine's public policy expressed in its wine franchise law voided a contractual choice of law provision, but went so far as to award sanctions against the supplier and its counsel for what it termed a "frivolous" appeal.[106]

The Eighth Circuit has held both ways, suggesting at one point that the determining factor may be whether the federal court faced with the question is being asked to apply the law of the forum state or of another forum.[107] This suggests that a race to the courthouse in the preferred forum may be worth the exercise.

The chosen law should have some relationship to the parties or the performance of the contract. A federal district court in New York has held invalid a choice of law provision that bore no reasonable relation to the parties or contract, applying New York law instead.[108] In selecting a particular state's law, note that this may result in the application of either a more or less restrictive state franchise law than might otherwise be the case.[109] Counsel for suppliers should consider seeking to carve such statutes out of the choice of law selection.

In addition, care should be taken that references in the contract to the provisions of "applicable law" do not result in the application of a state franchise law notwithstanding the contrary choice of law. The Ninth Circuit held that a contract provision applying California law "[e]xcept as otherwise required by applicable law" did not preclude application of an Arizona franchise law, since that was the only other possible "applicable law."[110] Another trap for the unwary drafter was laid by the Ohio Court of Appeals, which decided to enforce an arbitration clause in a contract with a severability clause that provided "any provision of this Agreement which in any way contravenes any law of any relevant jurisdiction shall be deemed not to be a part of this Agreement in such jurisdiction." This language was held to require application of California's state law giving a state motor vehicle board authority to determine whether there was good cause for termination.[111]

A better practice that addresses both these decisions would be to refer only to provisions of applicable law that cannot be waived and that are necessarily applicable notwithstanding a contractual choice of other law. Note also the importance of drafting a broadly applicable clause governing the rights of the parties, and not merely governing the agreement.[112]

Note that unless the parties provide otherwise, the United Nations Convention on Contracts for the International Sales of Goods[113] will govern contracts for sales of goods between parties who have their places of business in different Contracting States.[114] Significant differences from the terms which U.S.-based parties might expect include the inapplicability of a Statute of Frauds requirement of a signed writing,[115] unless the parties so require by contract,[116] the rejection of the parol evidence rule,[117] "battle of the forms" issues,[118] and the payment of the prevailing party's attorneys' fees.[119]

Combining a choice of favorable law with an arbitration clause will enhance the likelihood of the choice of law being enforced. The strong federal policy in favor of arbitration, embodied in the Federal Arbitration Act,[120] has been held to support the parties' explicit choice of law to be applied in arbitrations, even in the face of explicit state law to the contrary,[121] although there have been decisions requiring arbitration, even in foreign countries, but still requiring the application of local law that forbade parties from opting out of its terms.[122]

Endnotes

1. 15 U.S.C. §§ 45 *et seq.*
2. *See Kraft Inc. v. FTC*, 970 F.2d 311 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 1254 (1993); *Int'l Harvester Co.*, 104 F.T.C. 949, 1056 (1984).
3. FTC Unfairness Policy Statement, appended to *Int'l. Harvester Co.*, 104 F.T.C. 949, 1070 (1984).
4. *Florence Mfr. Co. v. J.C. Dow & Co.*, 178 F.2d 73, 75 (2d Cir. 1910) (L. Hand).
5. *See, e.g.*, *Fletcher v. Security Pacific National Bank*, 23 Cal. 3d 442, 451 (1979); *People v. Superior Court (Olson)*, 96 Cal. App. 3d 181, 190, 198

(1979), *cert. denied*, 446 U.S. 935 (1980); *Ball v. American Trial Lawyers Ass'n*, 14 Cal. App. 3d 289, 310 (1971); *People ex rel. Mosk v. Lynam*, 253 Cal. App. 2d 959, 965-66 (1967); *People v. Wahl*, 39 Cal. App. 2d Supp. 771, 773 (1940).

6. *See, e.g.*, *William H. Morris Co. v. Group W Inc.* 66 F.3d 255 (9th Cir. 1995); *American Home Products Corp. v. Johnson & Johnson*, 577 F.2d 160, 165 (2d Cir. 1978)

7. *See, e.g.*, *McNeilab, Inc. v. American Home Products Corp.*, 501 F. Supp. 517, 528 (S.D.N.Y. 1980) ("not insubstantial number of consumers receive a false or misleading impression" (23%)).

8. 551 U.S.877 (2007). It remains to be seen how lower courts will interpret *Leegin*, for the Supreme Court took pains to observe that there were circumstances in which resale price arrangements would be found to be anticompetitive and unlawful.

9. *See generally Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

10. *See Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977); *Graphic Products Distributors Inc. v. Itek Corporation*, 717 F.2d 1560 (11th Cir. 1983).

11. *See, e.g.*, *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014, 1041 (9th Cir. 1981), *cert. denied*, 459 U.S. 825 (1982). ("If the plaintiff does prove pricing below average variable cost, the burden shifts to the defendant to establish a legitimate business justification for its conduct.").

12. *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919); *Russell Stover Candies, Inc. v. Federal Trade Commission*, 718 F.2d 156 (8th Cir. 1983).

13. *E.g.*, *Lovett v. General Motors Corp.*, Bus. Fran. Guide (CCH) ¶ 9860 (D. Minn. 1991). S*ee also Denny's Marina v. Renfro Productions, Inc.*, 8 F.3d 1217 (7th Cir. 1993) (boat show's exclusion of marina in response to complaints by marina's competitors of price-cutting was horizontal price-fixing conspiracy and so a *per se* violation); *Malley-Duff v. Crown Life*, 734 F.2d 133 (3rd Cir. 1984) (termination of insurance agent was horizontal group boycott, and so *per se* violation, where insurance carrier officer who made termination decision was behind-the-scenes principal in new agency that took over the territory, so termination decision was horizontal decision of competitor, not independent vertical decision of carrier).

14. *E.g.*, *Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors Ltd.*, 416 F.2d 71 (9th Cir. 1969), *cert. denied*, 396 U.S. 1062 (1970).

15. 15 U.S.C. §§ 13, 13a, 13b, 21a.

16. *See United States v. United States Gypsum Co.*, 438 U.S. 422 (1978).

17. For a broader discussion of franchise regulation, see Jaglom, *The Broad Scope of Franchise Laws: Traps for the Distribution Contract Drafter*, available at http://www.thshlaw.com/documents/ALIABA_Materials_Jaglom_Franchise2008.pdf.

18. *See, e.g.*, Calif. Corporations Code §§ 31000 *et seq.*; N.Y. Gen. Bus. Law §§ 680 *et seq.*

19. *See, e.g.*, Calif. Bus. and Professions Code §§ 20000 *et seq.*; N.J. Rev. Stats. §§ 56:10-1 *et seq.*

20. 15 U.S.C. §§ 1221 *et seq*. (automobile dealers); 5 U.S.C. §§ 2801 *et seq*. (motor fuel).

21. *See*, *e.g.*, Hawaii Rev. Stat. Tit. 26, § 482E-2.

22. *See*, *e.g.*, Calif. Corporations Code § 31005(a)(2).

23. *See*, *e.g.*, Mich. Comp. Laws § 445.1502(3)(b).

24. *See*, *e.g.*, Minn. Stat. § 80C.01(4). An ordinary buyer-seller relationship, if of a continuing nature, may satisfy the "community of interest" requirement.

25. *See*, *e.g.*, Calif. Corporations Code § 31005(a)(1).

26. *See*, *e.g.*, California Business and Professions Code § 20001; Haw. Rev. Stat., Tit. 26, § 482E-2.

27. *See*, *e.g.*, California Civil Code § 1812.201; Florida Statutes, 1981, § 559.801.

28. *See*, *e.g.*, Miss. Code §§ 75-24-51 to 75-24-61.

29. *See*, *e.g.*, Minn. Stat. § 80C.14(b).

30. *See*, *e.g.*, Minn. Stat. § 80C.14(3); 47 Pa. Stat. § 4-492 (19).

31. *McKeesport Beer Distributors, Inc. v. All Brand Importers, Inc.*, 390 Pa. Super. 627, 569 A.2d 951 (1990).

32. *See*, *e.g.*, Hawaii Rev. Stat. § 482E-6(2)(E); Ind. Code, Tit. 23, art. 2, Ch.2.7, § 1(2).

33. *See*, *e.g.*, 1981 Rev. Code of Wash. § 19.100.180; N.J. Rev. Stat. § 56:10-7; Rev. Stat. Neb. § 87-406; Ind. Code, Tit. 23, art. 2, Ch.2.7, § 1(2).

34. *See*, *e.g.*, Mich. Comp. Laws § 445.1527(d); Wis. Stat., Tit. XIV-A, § 135.025(3).

35. *deTreville v. Outboard Marine Corp.*, 439 F.2d 1099 (4th Cir. 1971). *But see Puretest Ice Cream, Inc. v. Kraft, Inc.*, 806 F.2d 323 (1st Cir. 1986) (no implied good cause or good faith requirement for termination when contract permits termination without cause); *Keeney v. Kemper Nat'l Ins. Cos.*, 960 F. Supp. 617 (E.D.N.Y. 1997) (same); *Premiere Wine & Spirits of South Dakota, Inc. v. E. & J. Gallo Wines*, 644 F. Supp. 1431 (E.D. Cal. 1986) (same).

36. *Haagen-Dazs v. Masterbrand*, Bus. Fran. Guide (CCH) ¶ 9570) (S.D.Ga.1989) (S.C. law).

37. *See, e.g., Sofa Gallery, Inc. v. Stratford Co.*, 872 F.2d 259 (8th Cir. 1989); *Ag-Chem Equipment Co., Inc. v. Hahn, Inc.*, 480 F.2d 482, 486 (8th Cir. 1973). *See also Bartolomeo v. S.B. Thomas, Inc.*, 889 F.2d 530 (4th Cir. 1989); *Tractor and Farm Supply, Inc. v. Ford New Holland, Inc.*, 898 F. Supp. 1198 (W.D. Ky. 1995).

38. For the elements of these torts, *see*, *e.g.*, *Unijax, Inc. v. Champion Int'l, Inc.*, 683 F.2d 678, 687 (2d Cir. 1982) (tortious interference with prospective business relations); *Halebian v. Roppe Rubber*, 718 F. Supp. 348 (D.N.J. 1989) (introduction of policy against transshipping might be tortious interference with relationship with customers distributor previously dealt with but was forbidden to sell to under new policy); *Shaitelman v. Phoenix Mut. Life Ins. Co.*, 517 F. Supp. 21, 24-25 (S.D.N.Y. 1980) ("prima facie tort" under New York law); *Robbins v. Ogden Corp.*, 490 F. Supp. 801, 810 (S.D.N.Y. 1980) (tortious interference with contracts).

39. *Carter Equip. v. John Deere Indus. Equip.*, 681 F.2d 386, 388-90 (5th Cir. 1982) (fiduciary duty); *Call Carl, Inc. v. BP Oil Corp.*, 554 F.2d 623 (4th Cir.), *cert. denied*, 434 U.S. 923 (1977) (fraud). *Cf. Arnott v. Am. Oil Co.*, 609 F.2d 873, 883-84 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (fiduciary duty); *Koehler Enterprises, Inc. v. Shell Oil Co.*, Bus. Fran. Guide (CCH) ¶ 10,252 (D. Md. 1993) (franchise relationship alone does not create fiduciary duty, but additional dealings between parties may do so; where franchisee was less sophisticated and "vulnerable," existence of fiduciary duty is question of fact); *Pickering v. Pasco Marketing, Inc.*, 303 Minn. 442, 228 N.W.2d 562 (1975) (applying the principle of unconscionability to limit a contractual termination right, focusing on circumstances surrounding the termination); *Shell Oil Co. v. Marinello*, 120 N.J. Super. 357, 294 A.2d 253 (Super. Ct. Law Div. 1972), *modified and aff'd*, 63 N.J. 402, 307 A.2d 598, *cert. denied*, 415 U.S. 920 (1974) (same); *Ashland Oil, Inc. v. Donahue*, 159 W. Va. 463, 223 S.E.2d 433 (1976) (same). *See generally* Restatement (Second) of Torts §§ 762-774A (1977) (where refusal to deal and intentional interference with contractual relations are present). *But see Crim Truck & Tractor Co. v. Navistar Int'l Transportation Corp.*, 30 Tex. Sup. Ct. J. 647 (1991) (no fiduciary duty in franchise relationship); *Power Motive Corp. v. Mannesman Demag Corp.*, 617 F. Supp. 1048 (D. Colo. 1985) ("vast majority" of jurisdictions hold no fiduciary duty in franchise context) and cases cited therein.

40. *See, e.g., Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Development Corp.*, 38 Cal. App. 4th 985 (1995) (permitting fraud claim notwithstanding merger clause disclaiming any representations, warranties or inducements beyond those in the written agreement); *Century 21 v. Home Town Real Estate Co.*, 890 S.W.2d 118 (Tex. App. 1995) (grant of second franchise in territory, as permitted by written agreement, but contrary to oral policy, was unconscionable under Texas Deceptive Practices Act); *McEvoy Travel Bureau, Inc. v. Norton Co.*, 408 Mass. 704, 563 N.E.2d 188

(Mass. 1990) (giving effect to oral assurances that contractual termination provision was meaningless and relationship was long-term). *See also Commercial Property Investments, Inc. v. Quality Inns International, Inc.*, 938 F.2d 870 (1991) (finding oral representations supported claim of fraud despite contractual disclaimer of reliance on any such representations); *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 162 Misc. 2d 941, 618 N.Y.S.2d 155 (Sup. Ct., N.Y. Co. 1994), *aff'd*, 214 A.D.2d 473, 625 N.Y.S. 904 (1st Dep't 1995), *modified on other grounds*, 87 N.Y.2d 574, 640 N.Y.S.2d 849 (1996) (oral representations supported claim of violation of franchise disclosure law despite contractual disclaimer of reliance on any such representations). *But see, e.g., Traumann v. Southland Corp.*, 842 F. Supp. 386 (N.D. Cal. 1993) (refusing to enforce oral promise that was contradicted by express written provision, but permitting good faith and fair dealing claims to proceed); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, 815, 817, 829-30 (D. Minn. 1989) (N.Y. law) (barring oral modification of contract with provision prohibiting oral modification; parol evidence admissible to clarify ambiguous contract terms or to show fraud in inducement of contract, but reliance unreasonable where contradicted by express written disclaimer); *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1152-53 (S.D.N.Y. 1989) (Mass. law) (similarly).

41. This is not intended to be a comprehensive treatment of all of the provisions of a distribution contract. For a more complete discussion, see Jaglom, *Distribution Contracts*, available at http://www.thshlaw.com/documents/ALIABA_Materials_Jaglom_Franchise2008.pdf.

42. *General Motors Corp. v. Gallo GMC Truck Sales, Inc.*, 711 F. Supp. 810 (D.N.J. 1989). *But see Central GMC Inc. v. General Motors Corp.*, 946 F.2d 327 (4th Cir. 1991).

43. *See, e.g., Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977); *Graphic Products Distributors, Inc. v. Itek Corp.*, 717 F.2d 1560 (11th Cir. 1983). Note that state antitrust authorities often take a harder line on what territorial restrictions are permitted. *See, e.g., Abrams v. Anheuser-Busch, Inc.*, 673 F. Supp. 664 (E.D.N.Y. 1987), in which the New York Attorney General attacked territorial restrictions in the beer industry.

44. A supplier's express reservation of rights to sell to others has been held to defeat Puerto Rico dealers' claims that the supplier's sales to others had impaired its existing relationship in violation of Law 75, Puerto Rico's strict Dealers' Act. *Graphics Supply, Inc. v. Polychrome Corp.*, Bus. Fran. Guide (CCH) ¶ 11,192 (1st Cir. 1997) (not for publication); *Vulcan Tools of Puerto Rico v. Makita USA, Inc.*, 23 F.2d 564 (1st Cir. 1994).

45. *Emporium Drug Mart., Inc. of Shreveport v. Drug Emporium, Inc.*, AAA Case No. 71-114-00126-00(2000), *reported at* Bus. Franch. Guide (CCH) ¶ 11,966.

46. *In re Arbitration between Franklin 1989 Revocable Family Trust and H&R Block, Inc.*, Bus. Fran. Guide (CCH) ¶12,473 (31 December 2002).

47. *See, e.g.*, *Ford Motor Co. v. Texas Department of Transportation*, 106 F. Supp. 2d 905 (W.D. Tex. 2000) (operation by Ford Motor Company of website allowing prospective purchasers within the state of Texas to view previously owned vehicles and arrange for them to be viewed at a local dealer brought Ford within the statutory definition of a dealership, thereby violating the Texas law prohibiting a manufacturer from operating or controlling a dealership).

48. *Foodmaker, Inc. v. Quershi*, Bus. Fran. Guide (CCH) ¶11,780 (Cal. Sup. Ct. 1999).

49. For further discussion of such privacy issues, as well as other internet distribution issues, *see* Jaglom, *Internet Distribution and Other Computer Related Issues: Current Developments in Liability On-Line, Business Methods Patents and Software Distribution, Licensing and Copyright Protection Questions*, http://www.thshlaw.com/documents/ALIABA_Materials_Jaglom_Internet_Distribution2008.pdf.

50. *UNCITRAL Model Law on Electronic Signatures*, U.N. Comm'n on Int'l Trade Law, 34th Sess., Art. 6.1 (2001).

51. Pub. L. 106-229 (2000).

52. *See, e.g., Cottman Transmission Sys., Inc. v. Melody*, 851 F. Supp. 660 (E.D. Pa. 1994) (Calif. law); *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Cal. 1990).

53. *See United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 282 (6th Cir. 1898), *modified and aff'd*, 175 U.S. 211 (1899) ("[N]o conventional restraint of trade can be enforced unless the covenant embodying it is merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by the other party.").

54. A case in New York held that a one year non-compete clause was unreasonable in duration as applied to an editor for a technology information publication, because of the speed at which the Internet industry moves. In that context, the court held, one year is "several generations, if not an eternity." *Earth Web, Inc. v. Schlack*, 71 F. Supp. 2d 299, 316 (S.D.N.Y. 1999).

55. *See*, *e.g.*, *Interstate Automatic Transmission Co. v. W.H. McAlpine Co.*, 1981 WL 2193, 1982-1 Trade Cas. (CCH) ¶ 64,538 (N.D. Ohio 1981). *See generally* Restatement of Contracts § 514 (1932). Post-term noncompete clauses have been upheld if they are short in duration and in a limited geographic area. *See*, *e.g.*, *Wilkinson v. Manpower, Inc.*, 531 F.2d 712 (5th Cir. 1976) (in a six-county area; for two years); *Meineke Discount Muffler Shops, Inc. v. Bleier*, Civ. Act. No. H-80-2495 (S.D. Tex. 1981) (25-mile radius of former shop; for one year); *Shakie's, Inc. v. White*, No. 77-106, slip op. (E.D. Mo. 1977) (within 30 miles of the franchised location; for one year); *Snelling & Snelling, Inc. v. Dupay Enters., Inc.*, 125 Ariz. 362, 609 P.2d 1063 (1980) (within 35 miles of franchised location; for three years).

56. *See, e.g., Casey's General Stores, Inc. v. Campbell Oil Co., Inc.*, 441 N.W.2d 758 (Iowa Sup. Ct. 1989). *See also Physicians Weight Loss Centers of America v. Creighton*, 1992 WL 176992, Bus. Franchise Guide (CCH) ¶ 10,248 (N.D. Ohio 1992) (noncompete clause unenforceable in the absence of actual competition by franchisor within the specified geographic area).

57. *See*, *e.g.*, Ind. Code Ann. § 23-3-2.7-1(9) (Burns 1982); Mich. Stat. Ann. § 28.61 (Callaghan 1981). *But see* Fla. Stat. Ann. § 2.33(2)(b) (West 1981) (expressly allowing noncompete covenants in franchise relationship).

58. *Gandolfo's Deli Boys, LLC v. Holman*, 490 F. Supp. 2d 1353 (N.D. Ga. 2007) (restrictive covenant unenforceable under Georgia law where prohibition barred interest "in any capacity" in broad category of restaurants, within ten miles of any franchised location, so restricted territory could not be determined until contract terminated).

59. *See In re JRT, Inc.*, 121 B.R. 314, 323 (Bankr. W.D. Mich. 1990); *Silk Plants, Etc. Franchise Systems, Inc. v. Register, 95* B.R. 73 (Bankr. M.D. Tenn.), *aff'd*, 100 B.R. 360 (M.D. Tenn. 1989). *But see In re Hirschhorn*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993) (rejection of executory contract does not render covenant not to compete unenforceable); *In re Audra-John Corp*., 140 B.R. 752 (Bankr. D. Minn. 1992) (remedy for breach of contract caused by rejection in bankruptcy is governed by state law, but franchisor did not meet state law injunction standards); *In re Don & Lin Trucking Co., Inc.*, 110 B.R. 562 (Bankr. N.D. Ala. 1990) (enforcing noncompete clause after rejection of contract on ground that rejection terminated mutual performance obligations but did not affect provisions dealing with termination).

60. *See*, *e.g.*, Mich. Comp. Laws § 445.1527(g).

61. *See, e.g., Kentucky Fried Chicken v. Diversified Packaging,* 549 F.2d 368, 387 (5th Cir. 1977); *Sheila's Shine Products, Inc. v. Sheila Shine, Inc.*, 486 F.2d 114, 123-24 (5th Cir. 1973).

62. *See*, *e.g.*, Cal. Bus. & Prof. Code § 20001; Mich. Comp. Laws § 445.1502(b).

63. *See, e.g., Original Appalachian Artworks v. S. Diamond Associates, Inc.,* 911 F.2d 1548 (11th Cir. 1990) (holding licensee of copyright, if

injured, is entitled to share in settlement proceeds from third party infringer).

64. *Theos & Sons, Inc. v. Mack Trucks, Inc.*, 729 N.E.2d 1113 (Mass. 2000).

65. *See* Cal. Bus. & Prof. Code §§ 20021, 20025 (West 1986 Supp.); Minn. Stat. Ann. § 80C.14(b), (c) (West 1986).

66. *See, e.g., Zee Medical Distributor Association, Inc. v. Zee Medical, Inc.*, 94 Cal. Rptr. 2d 829 (2000).

67. *Armstrong Business Services v. H&R Block*, 96 S.W.3d 867 (Mo. App. W.D. 2002).

68. *Nike Int'l Ltd. v. Athletic Sales, Inc.*, 689 F. Supp. 1235 (D.P.R. 1988).

69. *See*, *e.g.*, Cal. Bus. & Prof. Code §§ 20020 *et seq*.

70. But see notes 4 and 5, *supra*, and accompanying text.

71. *See*, *e.g.*, *R&R Assocs. of Connecticut, Inc. v. Deltona Corp.*, Bus. Fran. Guide (CCH) ¶ 7526 (D. Conn. 1980). *See generally* Spalty and Dicus, *Risky Business: Franchise Terminations for Failure to Meet Performance Quotas*, Franch. L.J., Spring 1987, at 1.

72. *See*, *e.g.*, *Marquis v. Chrysler Corp.*, 577 F.2d 624, 632-33 (9th Cir. 1978) (selective enforcement of an unrealistic quota may violate the federal Automobile Dealer's Day in Court Act).

73. This option may not be available in some industries in some states where the practice of "dualing" may be prohibited. *See, e.g.,* Ga. Regs. § 560-2-5.02 (Alcohol Beverage Control regulations).

74. 11 U.S.C § 365. A termination notice given before the bankruptcy filing, but effective afterward, generally will be given effect, so long as only the passage of time is necessary for the termination to become effective, *i.e.,* there is no right to cure remaining after the time of filing. *See Atlantic Richfield Co. v. Herbert*, 806 F.2d 889 (9th Cir. 1986); *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1212-13 (7th Cir. 1984). *But cf. In re Krystal Cadillac Oldsmobile GMC Truck, Inc.*, 142 F.3d 631 (3d Cir. 1998) (where termination was not effective until rejection of appeal by Pennsylvania Vehicle Board, and appeal was not rejected until after bankruptcy filing, franchise agreement was part of bankruptcy estate and subject to automatic stay).

75. *See Bruno Wine & Spirits, Inc. v. Guimarra Vineyards*, 573 F. Supp. 337 (E.D.Wis. 1983) (applying Wisconsin Fair Dealership Law).

76. *See Comp III, Inc. v. Computerland Corp.*, 136 B.R. 636 (Bankr. S.D.N.Y. 1992) (summary judgment for franchisor denied where contract allowed termination upon insolvency but did not specify definition of insolvency to be used, and franchisee met balance sheet test but may not have met common law test for insolvency).

77. *See Dunkin Donuts of Puerto Rico, Inc. v. Santa Rosa Enterprises, Inc.*, Bus. Fran. Guide (CCH) ¶ 8914 (Bankr. D.P.R. 1987).

78. 11 U.S.C. § 365(n).

79. *See*, *e.g.*, *Kealey Pharmacy & Home Care Service, Inc. v. Walgreen Co.*, 539 F. Supp. 1357 (W.D. Wis. 1982), *aff'd*, 761 F.2d 345 (7th Cir. 1985); *Westfield Centre Service, Inc. v. Cities Service Oil Co.*, 86 N.J. 453, 432 A.2d 48 (1981).

80. *E.g.*, N.Y. Alc. Bev. Law § 55-c; New Jersey Malt Alcoholic Beverage Practices Act, N.J.S.A §§ 33:1-93.13 *et seq*.

81. *See Doctor's Associates v. Casarotta*, 517 U.S. 681, 116 S. Ct. 1652 (1996); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 513 U.S. 1040, 115 S. Ct. 1212 (1995); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Southland v. Keating*, 465 U.S. 1 (1984); *KKW Enterprises, Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp.*, 84 F.3d 42 (1st Cir. 1999) (upholding clause calling for arbitration outside Rhode Island despite franchise law provision that contract requiring venue outside Rhode Island is unenforceable); *Doctor's Associates, Inc. v. Hamilton*, 150 F.3d 157 (2d Cir. 1998); *S+L+H S.p.A v. Miller – St. Nazianz, Inc.*, 988 F.2d 1518 (7th Cir. 1993); *Saturn Distribution Corp. v. Williams*, 905 F.2d 719 (4th Cir. 1990); *Mitsubishi Motors v. Soler Chrysler-Plymouth, Inc.*, 723 F.2d 155, 158 (1st Cir. 1983); *aff'd*, 473 U.S. 614 (1985); *Medika Int'l, Inc. v. Scanlan Int'l, Inc.*, 830 F. Supp. 81 (D.P.R. 1993); *Salon Brokers, Inc. v. Sebastian Int'l, Inc.*, Bus. Fran. Guide (CCH) ¶ 9586 (Mich. Ct. App. 1990). *But see Hambell v. Alphagraphics Franchising, Inc.*, 779 F. Supp. 910 (E.D. Mich. 1991); *Sterling Truck Corp. v. Sacramento Valley Ford Truck Sales*, 751 N.E.2d 517 (Ohio Ct. App. 2001), *appeal denied*, 748 N.E.2d 547 (Ohio 2001) (arbitration clause superseded by state law granting California New Motor Vehicle Board authority to determine existence of good cause for termination, because of severability clause which provided that "any provision of this Agreement which in any way contravenes any law of any relevant jurisdiction shall be deemed not to be a part of this Agreement in such jurisdiction"); *Barter Exchange, Inc. of Chicago v. Barter Exchange, Inc.*, 238 Ill. App. 3d 187, 179 Ill. Dec. 354, 606 N.E.2d 186 (Ill. App. Ct. 1992, *appeal denied,* 149 Ill. 2d 647, 183 Ill. Dec. 858, 612 N.E.2d 510 (Ill. 1993) (franchisor's failure to register under state franchise law made franchise agreement void, so arbitration clause was unenforceable); *contra, Cusamano v. Norell Health Care, Inc.*, 239 Ill. App.3d 648, 180 Ill. Dec. 352, 607 N.E.2d 246 (Ill. App. 1993) (rejecting *Barter Exchange, Inc. of Chicago, supra*, and enforcing arbitration, but rejecting choice of law clause).

82. *See Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985) (holding antitrust claims arbitrable in international context without reaching question as to domestic claims); *Nghiem v. NEC Electronic, Inc.*, 25 F.3d 1437 (9th Cir.), *cert. denied*, 513 U.S. 1044, 115 S. Ct. 638 (1994); *Kotam Electronics, Inc. v. JBL Consumer Products, Inc.*, 93 F.3d 724 (11th Cir. 1996) (*en banc*), *cert. denied*, 519 U.S. 1110, 117 S. Ct. 946 (1997) (domestic antitrust claims arbitrable); *Kowalski v. Chicago Tribune Co.,* 854 F.2d 168 (7th Cir. 1988). *Cf. Sanjuan v. Amer. Bd. of Psychiatry & Neurology*, 40 F.3d 247, 250 (7th Cir. 1994) (arbitrability of antitrust disputes depends on neutrality of arbitrators; agreement to arbitrate before board of directors of producers' association is unenforceable). The leading case holding domestic antitrust claims nonarbitrable was *American Safety Equip. Corp. v. J.P. Maguire & Co.*, 391 F.2d 821 (2d Cir. 1968). Although the Second Circuit has yet to abandon its *American Safety* holding explicitly, the courts have determined that, after *Mitsubishi*, *American Safety* no longer remains good law. *See In re Currency Conversion Fee Antitrust Litigation*, 265 F. Supp. 2d 385, 409 (S.D.N.Y. 2003) (*American Safety* has been "effectively overruled"); *N.Y. Cross Harbor Railroad Terminal Corp. v. Consolidated Rail Corp.,* 72 F. Supp. 2d 70, 79-80 (E.D.N.Y. 1998) (lower courts have subjected domestic antitrust claims to arbitration); *Hough v. Merrill Lynch,* 757 F. Supp. 283, 286 (S.D. N.Y.) *aff'd without op.*, 946 F.2d 883 (2d Cir. 1991) (holding that reasoning of *Mitsubishi* applies equally to domestic claims, affirmed by Second Circuit); *Gemco Latinoamerica, Inc. v. Seiko Time Corp.*, 671 F. Supp. 972, 978-80 (S.D.N.Y. 1987) (Second Circuit would abandon *American Safety* rule if confronted with issue). And in 2004, the Second Circuit, without citing *American Safety*, nonetheless held ocean shipping antitrust claims to be arbitrable, without any reference to their international character, and cited *In re Currency Conversion Fee Antitrust Litigation* with approval. *JLM Industries, Inc. v. Stolt Nielsen S.A.*, Trade Cas. (CCH) ¶ 74,590 (2d Cir. 2004).

83. *Laxmi Investments, LLC v. Golf USA*, 193 F.2d 1095, (9th Cir. 1999). *See also Great Earth Companies, Inc. v. Simons*, 2000 WL 640829, Bus. Fran. Guide (CCH) ¶ 11,823 (S.D.N.Y. 2000) (arbitration provision upheld but New York choice of forum unenforceable because franchisor had fraudulently misrepresented that Michigan Franchise Investment Law prohibited enforcement of out of state forum selection provision; franchisee reasonably relied on misrepresentation). *But see Bradley v. Harris Research, Inc.*, 2001 U.S. App. LEXIS 27284, Bus. Fran. Guide (CCH) ¶ 12,221 (9th Cir. 2001) (Federal Arbitration Act preempts California Franchise Investment Act provision making non-California forum clause unenforceable; distinguishing *Laxmi*, because plaintiff failed to show UFOC language suggesting clause might be unenforceable); *Gingiss Int'l, Inc. v. L&H Tuxes, Inc.*, Bus. Fran. Guide (CCH) ¶ 12,372 (N.D. Ill. 2002) at n.7 (criticizing *Laxmi* as disregarding preemptive effect of Federal Arbitration Act).

84. *Ticknor v. Choice Hotels Int'l*, 265 F.3d 931 (9th Cir. 2001). *See also Circuit City Stores, Inc. v. Adams*, 2002 WL 152986 (9th Cir. 2002) (arbitration clause unconscionable where employees had to arbitrate but employer did not, relief was limited, employee rights were otherwise restricted and employee had to share costs of

arbitration); *Blair v. Scott Specialty Gases*, 283 F. 3d 595 (3rd Cir. 2002) (permitting plaintiff to show arbitration clause requiring her to pay half of arbitration costs imposed prohibitive burden that would prevent vindication of her statutory rights).

85. Punitive damages are unavailable in arbitration in some states, thus lessening a supplier's exposure for wrongful termination. Many jurisdictions do, however, allow arbitrators to award punitive damages. *Ledee v. Ceramiche Ragno*, 684 F.2d 184 (1st Cir. 1982) (enforcing selection of forum in spite of statute prohibiting arbitration outside Puerto Rico). *But see Great Earth Companies, Inc. v. Simons*, 2000 WL 640829, Bus. Fran. Guide (CCH) ¶ 11,823 (S.D.N.Y. 2000) (arbitration provision upheld but New York choice of forum unenforceable because franchisor had fraudulently misrepresented that Michigan Franchise Investment Law prohibited enforcement of out of state forum selection provision; franchisee reasonably relied on misrepresentation). Moreover, the Eighth Circuit has held that, even where the law of a state governing a contract does not recognize an arbitral award of punitive damages, such an award is available under an arbitration clause adopting the rules of the American Arbitration Association because the Federal Arbitration Act, and not state law, governs. *Compare, e.g., Garrity v. Lyle Stuart, Inc.,* 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976) (award of punitive damages is beyond authority of arbitrators); *Anderson v. Nichols*, 359 S.E.2d 117, 121 n.1 (W.Va. 1987) (same); *Shaw v. Kuhnel & Associates, Inc.*, 698 P.2d 880, 882 (N.M. 1985) (same); *with Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6, 9-12 (1st Cir. 1989) (award of punitive damages is within authority of arbitrators); *Baker v. Sadick,* 162 Cal. App. 3d 618, 208 Cal. Rptr. 676 (4th Dist. 1984); *Grissom v. Greener & Sumner Construction, Inc.,* 676 S.W.2d 709, 711 (Tex. App. 1984) (same). As the judicial attitude toward arbitration becomes more and more favorable, and as still greater deference is given to the policies of the Federal Arbitration Act, it may well be that punitive damages will be universally held to be within the scope of the arbitrators' authority, at least where the agreement does not expressly limit such power. Until then, however, arbitration may, in some jurisdictions, limit a supplier's exposure.

86. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 115 S. Ct. 1212 (1995). Treble damages have been distinguished from punitive damages. S*ee Investment Partners, L.P. v. Glamour Shots Licensing, Inc*., Bus. Fran. Guide (CCH) ¶ 12,371 (5th Cir. 2002) (permitting award of treble damages by arbitrator despite arbitration clause prohibiting punitive damages). But precluding an award of treble damages might be deemed to render the arbitration agreement void as against public policy by undermining rights guaranteed by the antitrust laws. *Id.*

87. *Ledee v. Ceramiche Ragno*, 684 F.2d 184 (1st Cir. 1982) (enforcing selection of forum in spite of statute prohibiting arbitration outside Puerto Rico). *But see Great Earth Companies, Inc. v. Simons*, 2000 WL 640829, Bus. Fran. Guide (CCH) ¶ 11,823 (S.D.N.Y. 2000) (arbitration provision upheld, but New York choice of forum unenforceable because franchisor had fraudulently misrepresented that Michigan Franchise Investment Law prohibited enforcement of out of state forum selection provision; franchisee reasonably relied on misrepresentation).

88. *Jones v. GNC Franchising, Inc*., 211 F.3d 495 (9th Cir.), *cert. denied*, 531 U.S. 928 (2000) (Pennsylvania forum selection clause in franchise agreement between California franchisee and Pennsylvania franchisor was violative of public policy expressed in California Franchise Relations Act and therefore unenforceable). In contrast, the opposite conclusion was reached a few months earlier by a district court in *Duarte v. GNC Franchising, Inc*., Bus. Fran. Guide (CCH) ¶11,815 (C.D. Cal. 2000) (upholding Pennsylvania forum selection clause in franchise agreement between Pennsylvania franchisor and California franchisee, even though invalid under California Franchise Relations Act, because federal law provided for consideration of forum selection clause in determining appropriateness of transfer and the case did not turn on matters specific to any franchise store in California).

89. 471 U.S. 462 (1985).

90. *See, e.g., ECC Computer Centers of Illinois, Inc. v. Entre Computer Centers, Inc.*, 597 F. Supp. 1182 (N.D. Ill. 1984); *Kubis & Perszyk Associates, Inc. v. Sun Microsystems, Inc.*, 146 N.J. 176, 680 A.2d 618 (N.J. 1996) (forum clause in contract arguably subject to Franchise Practices Act presumptively invalid; to rebut presumption, franchisor must show clause was not imposed on franchisee). *See also Davis v. Great American Cleaners, Inc.*, 1996 Mass. Super. LEXIS 218, Bus. Fran. Guide (CCH) ¶ 10,979 (Mass. Super. Ct. 1996) (forum clause not enforced due to unequal bargaining power, burden on franchisee). *But see Moseley v. Electronic Realty Associates, L.P.*, Bus. Fran. Guide (CCH) ¶ 11,430 (Ala. Ct. Civ. App. 1998) (enforcing Kansas choice of forum against Alabama franchisee).

91. *See, e.g.,* Ark. Laws of 1993, Act 310; Cal. Bus. & Prof. Code § 20040.5; Laws of Puerto Rico Ann. tit. 10, ch. 14, § 278c.

92. *Stewart Organization, Inc. v. Ricoh Corp.*, 487 U.S. 22 (1988).

93. *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 111 S. Ct. 1522 (1991). *See Caribe BMW, Inc. v. Bayerische Motoren Werke Aktiengesellschaft*, 821 F. Supp. 802 (D.P.R. 1993) (enforcing choice of German forum in international agreement despite local dealer protection law), *rev'd on other grounds,* 19 F.3d 745, 754 (1st Cir. 1994) (Breyer, C.J.) (remanding to determine whether forum clause covered antitrust and dealer protection law claims). *See also Dickerson v. Signs Now, Inc.*, 1994 WL 184442, Bus. Fran. Guide (CCH) ¶ 10,573 (E.D. Pa. 1994) (enforcing Alabama choice of forum in franchise agreement).

94. *Eisaman v. Cinema Grill Systems, Inc.*, 87 F. Supp. 2d 446 (D. Md. 1999).

95. *Moses v. Business Card Express, Inc.,* 929 F.2d 1131 (6th Cir. 1991).

96. *Silverman v. Carvel Corp.*, 2001 U.S. Dist. LEXIS 21095, Bus. Fran. Guide (CCH) ¶12,228 (W.D. N.Y. 2001).

97. *Cadapult Graphic Systems, Inc. v. Tektronix Inc*., 98 F. Supp. 2d 560 (D.C. N.J. 2000) (28 U.S.C. § 1404(a) was applied so that valid forum selection clause selecting Oregon was entitled to substantial consideration and enforced against plaintiff in the absence of evidence of fraud or overreaching).

98. *Marel Corp. v. Encad Inc.*, 2001 U.S. Dist. LEXIS 21209, Bus. Fran. Guide (CCH) ¶12,227 (D.P.R. 2001).

99. *See Docksider, Ltd. v. Sea Technology, Ltd.*, 875 F.2d 762 (9th Cir. 1989).

100. *Stawski Distributing Co., Inc. v. Browery Zywiec, S.A.*, 349 F. 2d 1023 (7th Cir. 2003).

101. *See, e.g., Instructional Systems, Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 341-46, 614 A.D.2d 124, 133-35 (1992); *Dunes Hospitality, LLC v. Country Kitchen International, Inc.*, 623 N.W.2d 484 (S.D. Sup. Ct. 2001) (choice of Minnesota law disregarded because forum state public policy would be violated and most significant contacts occurred in forum state); *Covert Chevrolet-Oldsmobile, Inc. v. General Motors Corp.* No. 05-00-01170-CV, 2001 WL 950274 (Tex. App. 21 Aug. 2001) (not designated for publication) (Texas law applied to indemnification claim by dealer for costs of lawsuits against it brought in Texas by Texas residents despite choice of law provision selecting Michigan law; Texas had most significant relationship to dispute); *Ticknor et al. v. Choice Hotels Int'l*, 265 F.3d 931 (9th Cir. 2001) (choice of Maryland law in a motel franchise agreement not enforced based on fact that only contact between franchisor and franchisee took place in Montana, the motel was operated in Montana and Maryland law would have violated Montana public policy); *Guild Wineries and Distilleries v. Whitehall Co., Ltd.*, 853 F.2d 755 (9th Cir. 1988) (giving preclusive effect to administrative ruling refusing to enforce choice of law provision); *Caribbean Wholesales and Service Corp. v. US JVC Corp.*, 855 F. Supp. 627, 633 (S.D.N.Y. 1996) (application of contractual choice of New York law would violate public policy of Puerto Rico); *Winer Motors, Inc. v. Jaguar Rover Triumph, Inc.*, 208 N.J. Super. 666, 506 A.2d 817 (1986); *South Bend Consumer Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209 (N.D. Ind. 1983); *R&R Associates of Connecticut, Inc. v. Deltona Corp.*, Bus. Fran. Guide (CCH) ¶ 7526 (D. Conn. 1980). *Ingmar GB Ltd. v. Eaton Leonard Technologies, Inc.*, Case C-381/98 (Times Law

Report 16 Nov. 2000) (the European Court of Justice held that the English Commercial Agents Regulations must be applied where a commercial agent carried on his activities in a member state although the principal was based in a non-member state and the license agreement was governed by California law).

102. *See, e.g., Unarce v. Staff Builders,* Bus. Fran . Guide (CCH) ¶ 10,746 (9th Cir. 1996) (not for publication) (choice of law clause not enforced where validity of agreement containing it is challenged).

103. *See, e.g., JRT, Inc. v. TCBY Systems, Inc.*, 52 F.3d 734, (8th Cir. 1995) (enforcing choice of Arkansas law despite Michigan Franchise Investment Law antiwaiver provision because provision did not specifically address choice of law clauses); *Cherokee Pump & Equipment, Inc. v. Aurora Pump*, 38 F.3d 246 (5th Cir. 1994) (enforcing choice of Illinois law to permit termination of Louisiana distributorship in manner prohibited by Louisiana statute); *Modern Computer Systems, Inc. v. Modern Banking Systems, Inc.*, 871 F.2d 734 (8th Cir. 1989) (enforcing contractual choice of law clause); *Tele-Save Merchandising Co. v. Consumers Distributing Co.,* 814 F.2d 1120 (6th Cir 1987) (same); *Carousel Systems, Inc. v. Ordway*, 1996 WL 208359, Bus. Fran. Guide (CCH) ¶ 10,914 (E.D. Pa. 1996); *Banek Inc. v. Yogurt Ventures, U.S.A., Inc.*, Bus. Fran. Guide (CCH) ¶ 10,112 (E.D. Mich 1992) (enforcing contractual choice of law clause), *aff'd*, 6 F.3d 357 (6th Cir. 1993) (not designated for publication) (state franchise law antiwaiver provision did not preclude enforcing choice of law clause in absence of provision barring such clauses); *Cottman Transmission Systems, Inc. v. Melody*, 869 F. Supp. 1180, 1188 (E.D. Pa. 1994) (enforcing choice of Pennsylvania law, which does not cause substantial erosion of California statutory rights, to dismiss franchisee claims under California Franchise Investment Law); *Hardee's Food Systems, Inc. v. Bennett*, 1994 WL 1372628, Bus. Fran. Guide (CCH) ¶ 10,453 (S.D. Fla. 1994) (enforcing contractual choice of N.C. law, rejecting claim under Fla. franchise statute); *Faltings v. Int'l Bus. Machines Corp.,* 854 F. 2d 1316 (Table) (4th Cir. 1988) (not designated for publication) (enforcing contractual choice of law clause); *United Wholesale Liquor Co. v. Brown-Forman Distillers Corp.*, 108 N.M. 467, 775 P.2d 233 (N.M. 1989) (enforcing contractual choice of law clause); *Carlock v. Pillsbury Co.,* 719 F. Supp. 791 (D. Minn. 1989) (same). *But see Electrical and Magneto Service Co. v. AMBAC Int'l Corp.*, 941 F.2d 660 (8th Cir. 1991) (refusing to honor contractual choice of law clause); *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990) (same); *Caribbean Wholesales & Service Corp. v. US JVC Corp.*, 855 F. Supp. 627 (S.D.N.Y. 1994) (same); *Flynn Beverage Inc. v. Joseph E. Seagram & Sons, Inc.*, 815 F. Supp. 1174 (C.D. Ill. 1993) (same); *Economou v. Physicians Weight Loss Centers of America*, 1991 WL 185217, Bus. Fran. Guide (CCH) ¶ 9836 (N.D. Ohio 1991) (same); *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Colo. 1990) (same). *Cf. Pelican State Supply Co., Inc. v. Cushman, Inc.*, 39 F.3d 1184 (8th Cir. 1994) (unpublished opinion) (choice of Nebraska law did not make Nebraska state dealer law applicable to out-of-state dealer, where statute by its terms governed only dealers in Nebraska).

104. Minn. Stat. § 80C.21. *See also* S.D. Laws of 1991, H.B. No. 1044, § 3.

105. *Grand Kensington, LLC v. Burger King Corp.*, 81 F. Supp. 2d 834 (E.D. Mich. 2000).

106. *Solman Distributors, Inc. v. Brown-Forman Corp.,* 888 F.2d 170 (1st Cir. 1989).

107. *Electrical and Magneto Service Co v. AMBAC Int'l Corp.*, 941 F.2d 660, at 663-64 (8th Cir. 1991) (distinguishing *Modern Computer Systems,* n.103 *supra*).

108. *LaGuardia Associates v. Holiday Hospitality Franchising, Inc.*, 92 F. Supp. 2d 119 (E.D.N.Y. 2000) (Tennessee choice of law provision between New York franchisee and Georgia franchisor unenforceable for lack of rational relationship to state).

109. *Compare Faltings v. Int'l Bus. Machines Corp.*, 854 F. 2d 1316 (Table), 1988 WL 83316 (4th Cir. 1988) (not designated for publication) (choice of New York law precludes application of more restrictive New Jersey Franchise Practices Act); *Barnes v. Burger King Corp.*, 932 F. Supp. 1441 (S.D. Fla. 1996) (California franchisee lacked standing to assert claim under Florida Franchise Act, despite contractual choice of Florida law); and *Edelen and Boyer Co. v. Kawasaki Loaders, Inc.*, 1992 WL 236909, Bus. Fran. Guide (CCH) ¶ 10,171 (E.D. Pa. 1992) (Georgia heavy equipment dealer law not applicable to franchises outside Georgia, notwithstanding choice of Georgia law in franchise agreement); *with Tractor and Farm Supply, Inc. v. Ford New Holland, Inc.*, 898 F. Supp. 1198 (W.D. Ky. 1995); *Burger King Corp. v. Austin*, 805 F. Supp. 1007, 1022-23 (S.D.Fla. 1992) (allowing counterclaim by Georgia franchisees under Florida Franchise Act where franchise agreement chose Florida law); *McGowan v. Pillsbury Co.*, 723 F. Supp. 530 (W.D. Wash. 1989) (allowing claim that New York Franchise Sales Act was violated where agreement with Washington franchisee chose New York law); and *Dep't of Motor Vehicles v. Mercedes-Benz*, 408 So. 2d 627 (Fla. 1981), *modified*, 455 So.2d 404 (Fla. 1984) (applying New Jersey Franchise Practices Act to Florida franchise where contract chose New Jersey law).

110. *Sutter Home Winery, Inc. v. Vintage Selections, Ltd.*, 971 F.2d 401, 406 (9th Cir. 1992).

111. *Sterling Truck Corp. v. Sacramento Valley Ford Truck Sales,* 751 N.E.2d 517 (Ohio Ct. App.), *appeal denied*, 748 N.E.2d 547 (Ohio 2001).

112. *See Valley Juice Ltd., Inc. v. Evian Waters of France, Inc.*, 87 F.3d 604 (2d Cir. 1996) (choice of New York law to govern agreement did not preclude claim under Massachusetts "little FTC Act," as it would have had the agreement also stated rights of parties were to be governed by New York law); *see also Heating & Air Specialist, Inc. v. Jones*, 180 F.3d 923 (8th Cir. 1999) (provisions that Texas law governed "interpretation" of contract applied only Texas rules of statutory construction, not Texas substantive law).

113. United Nations Convention on Contracts for the International Sales of Goods, S. Treaty Doc. No. 9, 98th Cong., 1st Sess. 22 (1983), reprinted at 15 U.S.C. app. 52 (1997) (the "CISG").

114. CISG Arts. 1, 6.

115. CISG Art. 11.

116. CISG Art. 29.

117. CISG Art. 8; *MCC-Marble Ceramic Center, Inc. v. Ceramica Noyvo d'Agostino, S.p.A.*, 144 F.2d 1384 (11th Cir. 1998) (parol evidence is to be admitted and considered as to parties' intent, even if the oral conduct contradicts the written contract).

118. CISG Art. 19 (no contract results if acceptance contains terms that materially alter the offer).

119. *Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co., Inc.*, 2001 U.S. Dist. LEXIS 15191, 2001WL 1000927 (N.D. Ill. 2001) (awarding attorneys' fees to prevailing party under CISG Art. 74 as expenses stipulated by parties as foreseeable to be incurred as a result of breach).

120. 9 U.S.C. §§ 1 *et seq.*

121. *See, e.g., Good(E) Business Systems, Inc. v. Raytheon Co.*, 614 F. Supp. 428, 430-31 (W.D. Wis. 1985). *See also Volt Information Sciences, Inc. v. Stanford University*, 489 U.S. 468 (1989) (choice of California law included California rules regarding arbitrability, which were applied to stay arbitration); *Yates v. Doctor's Assocs., Inc.* 140 Ill. Dec. 359, 193 Ill. App. 3d 431, 549 N.E.2d 1010 (Ill. App. 1990).

122. *Stawski Distributing Co., Inc. v. Browary Zywice, S.A.*, 349 F.3d 1023 (7th Cir. 2003).

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International Distribution Contracts: A Guide to Drafting Key Contract Provisions from a European (and, in Particular, French) Perspective

By Franz Hepp de Sevelinges

I. Introduction

The precise content of a distribution contract depends chiefly on the agreement of the parties: a sharp contrast to many other types of contracts—such as sales contracts (*contrats de vente*)[1]—that are regulated by French law. However, this does not mean that the parties have complete freedom to arrange their contractual relationship, since numerous constraints must be considered. The task of drafting the distribution contract thus takes on particular importance.

If the relevant laws on distribution have their source in civil law, they will have been influenced to a large extent by competition law. In Europe, vertical distribution contracts must also comply with antitrust provisions of the European Union (EU), above and beyond any applicable antitrust provisions in the United States. While drafting a distribution contract that may affect the European market, a lawyer should always be aware of European and domestic competition law provisions that may be applicable in the specific case. European (and national) provisions on agency constitute a further legal constraint that lawyers need to bear in mind.

This article presents the main issues that have to be addressed when drafting key provisions of distribution contracts that have to comply with European laws.

II. Overview of Competition Law

A. European Antitrust Law

1. Applicability of European Antitrust Law

In order for European antitrust rules to apply, the agreement or underlying activity must be capable of appreciably affecting trade between Member States of the EU. In the case of vertical agreements, European competition authorities and courts consider not only the agreement at issue, but also the cumulative effect of parallel networks of similar agreements. In the view of the European Commission, there is a presumption that an agreement is not capable of appreciably affecting trade between Member States if the combined aggregate market share of the parties in any relevant market within the European Community (EC) that is affected by the agreement does not exceed five percent and, in the case of vertical agreements, the aggregate annual turnover (i.e., sales) of the supplier within the EC of the products covered by the agreement does not exceed €40 million.[2]

If the supplier and the distributor are from different Member States, the agreement is almost automatically capable of affecting trade between Member States, as long as the above-mentioned thresholds are met. In the area of international distribution, one party will often be registered in a country outside the European Union. This does not preclude the application of European antitrust law, since these provisions apply regardless of where the "undertakings" are located or where the agreement has been concluded, provided that the agreement or practice is either implemented within the EC[3] or produces effects inside the EC.

Additionally, trade between Member States may be affected if the distribution agreement prevents re-importation into the EC, for example, if a supplier within the EC prohibits a distributor in a country that is not an EC-member from selling in any territory other than the contractual territory, including territory within the EC. However, the criteria used by the European Court of Justice in order to evaluate whether trade between Member States is affected in such an agreement are not likely to be easily fulfilled.[4]

Whenever EU antitrust law is applicable, it must be administered by the national competition authorities and courts, to the same extent as domestic competition law (if applicable). The application of national competition law may not lead to the prohibition of agreements that are legal under EU antitrust law, but Member States may apply stricter domestic law on unilateral conduct engaged in by undertakings.[5]

The key provisions of European antitrust law are contained in Articles 81 and 82 of the European Community Treaty (the "EC Treaty"),[6] prohibiting respectively restrictive agreements and abuse of a dominant position.

2. Restrictive Agreements: EC Treaty Article 81(1)

Article 81(1) of the EC Treaty prohibits "*all agreements between undertakings...which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market.*" In order for an agreement to be considered contrary to article 81 (1) ECT, it must have been concluded between independent undertakings: in other words, Article 81(1) is not applicable if one of the parties is an agent of the other, nor is it applicable to inter-group agreements.[7]

Typically, article 81(1) EC Treaty covers horizontal agreements between competitors. However, since the judgment of the European Court of Justice in *Consten*,[8] vertical agreements, and thus distribution contracts, are also potentially covered by this provision.

3. Abuse of a Dominant Market Position: EC Treaty Article 82

Article 82 of the EC Treaty prohibits the abuse by a dominant undertaking (or a number of combined dominant undertakings) of their market position. In order for Article 82 to apply, the undertaking must be dominant in the relevant market. This is the case not only if the company holds a monopoly: it can also be true if the company's market share is in excess of forty percent (although, in some cases, even a lower threshold will be considered as dominant). Several factors are examined (e.g., the position of competitors) in determining whether the entity is in a position to behave "*to an appreciable extent independent of its competitors, customers and ultimately of its consumers*."[9]

As far as distribution contracts are concerned, abuse can take the form of imposing exclusive purchasing and supply obligations, excessive or discriminatory pricing, loyalty-inducing rebates, *de facto* control of distributors' prices, and the like.

4. Consequences of Infringement of EU Antitrust Rules

An agreement falling within Article 81(1) of the EC Treaty and not somehow exempt is not enforceable. The offending part or the entire agreement (if the offending provisions cannot be meaningfully severed) will be void pursuant to Article 81(2) of the EC Treaty. Moreover, an infringement may lead to the imposition of penalties by the European Commission or by a national competition authority of up to ten percent of the worldwide turnover (i.e., sales) of the undertaking in the preceding business year.[10]

Moreover, third parties adversely affected by an anti-competitive agreement may sue for damages for any loss which they can establish to have suffered as a result of the infringement. The claimant seeking damages may be the other party to the contract.[11] However, according to the European Court of Justice, EC law does not preclude a provision of national law barring a party to a contract that restricts or distorts competition from relying on its own unlawful actions to obtain damages where it is established that that party bears significant responsibility for the distortion of competition.[12]

B. French Competition Law

French law prohibits, in addition to the practices already covered by EU antitrust law, so-called restrictive practices, such as the following: [13]

- Resale with a loss (revente à perte)
- Non-communication of general terms and conditions and price lists (which is contrary to the obligation of transparency)
- Imposing obligations on a contracting party that create an imbalance in the rights and obligations of the parties
- An abrupt termination of a contractual relationship without observing an appropriate notice period
- The threat to terminate an agreement in order to obtain benefits that are clearly abusive

The EC Treaty allows Member States to impose stricter provisions prohibiting abuse, and Article L.420-2 (2) of the French Commercial Code prohibits abuse of "economic dependence." The lawyer drafting a distribution agreement should keep these provisions in mind, especially since some of them provide for criminal sanctions.

III. The Differing Rights and Obligations of the Parties to a Distribution Contract

A. Overview

The nature of a typical distribution contract is that the distributor resells and promotes the supplier's products on a regular basis. Two matters that are typically essential and likely to generate conflict between the parties are (i) the freedom of each party to decide the location in which and the customer group to which it may sell the products and (ii) the determination of the price to be paid for the products.

B. Determining the Customer Group

1. Type of Distribution Contract

The freedom of the parties to choose their contracting party—that is, the purchaser of their goods or services or the party from whom they buy goods or services—depends on the type of distribution contract in question. For example, in a "selective" distribution contract, described below, the supplier is able to impose stricter restrictions on the distributor than would be the case in an "exclusive" distribution contract.

2. Exclusive Distribution Contract (*accord de distribution exclusive*)

In an exclusive distribution arrangement, the supplier undertakes not to supply its products to other distributors in a given territory but may reserve the right to perform direct sales to customers in that territory. In the case of exclusive supply obligations, the supplier undertakes to sell its products only to one distributor.

3. Non-exclusive Distribution Contract (*accord de distribution non-exclusive*)

In a non-exclusive distribution arrangement, the supplier reserves the right to appoint multiple distributors in a given territory and to supply its products to them.

4. Exclusive Purchase Contract (*accord d'achat exclusif*)

In an exclusive purchase arrangement, the distributor undertakes to buy products from one supplier only. This type of contract is treated in more detail in Section V below in regard to covenants not to compete.

5. Selective Distribution Contract (*accord de distribution sélective*)

In a selective distribution arrangement, the supplier undertakes to sell the contract goods or services to distributors selected on the basis of specified criteria (qualitative and/or quantitative). The distributors undertake not to sell such goods or services to unauthorized distributors. Selective distribution is commonplace and appropriate for goods that require a high level of expertise on the part of the distributor, such as technical and luxury products.

6. Variations

The types of arrangements discussed in the foregoing Sections III.B. 2 through 5 can to some extent be combined. For example, the supplier may be bound by an exclusivity provision insofar as the territory of distribution is concerned, and there may be an obligation imposed on the distributor to buy its products exclusively from the supplier.

C. Choice of the Customer: Impact of EU Antitrust Law

To attempt to restrict a party's ability to resell a product *a priori* is classified by Article 81 of the EC Treaty as an infringement as it restricts competition. It is, however, still possible to avoid the consequences of infringement if the agreement satisfies the criteria for exemption provided in Article 81(3) of the EC Treaty, that is, the agreement must contribute to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, without imposing disproportionate restrictions on the undertakings concerned or affording the undertakings the possibility of eliminating competition in respect of a substantial part of the products in question. In order to facilitate this assessment, the Commission has adopted a number of block exemption regulations. The regulations contain conditions under which certain categories of agreements will be presumed exempt. Each of these regulations contains the following categories:

(1) restrictions on competition that are permitted for the corresponding type of agreement;

(2) restrictions that are prohibited and preclude the exemption from applying; and

(3) provisions that are not likely to be enforceable, but which do not endanger the rest of the agreement.

If an agreement meets all the requirements of the applicable regulation, it will automatically be exempt.

Distribution contracts are therefore specifically drafted in order to fit within the EC's block exemption for vertical agreements (the "Exemption Regulation").[14] For the motor vehicle sector, a special exemption regulation exists containing provisions that differ from those of the general Exemption Regulation.[15]

In order for an agreement to fall *prima facie* within the Exemption Regulation, the supplier's share of the market in which it sells the contract goods or services must not exceed thirty percent. If the agreement contains an exclusive supply obligation (i.e., any direct or indirect obligation causing the supplier to sell the goods or services specified in the agreement to only one buyer inside the EC), the benefit of the Exemption Regulation is only available if the buyer's share of the purchasing market does not exceed thirty percent.[16] If this threshold is exceeded, the agreement is not covered by the Exemption Regulation but must be carefully reviewed, specifically with regard to the impact of Article 81(3) of the EC Treaty and the Commission's Guidelines on Vertical Restraints.[17]

Once a distribution contract falls within the ambit of the Exemption Regulation, the individual clauses of that contract still must be examined, since not all types of clauses will be permitted. If the agreement contains hardcore restrictions, the Exemption Regulation will not apply to the agreement, which must therefore be reviewed with regard to Article 81(3) of the EC Treaty. Although it is theoretically possible that an agreement containing hardcore restrictions might be considered exempt on the basis of Article 81(3) of the EC Treaty, it is unlikely. Clauses that are unacceptable and not enforceable do not necessarily prevent the other provisions of the distribution contract from being exempt.

According to the Exemption Regulation, the restriction on the territory in which the buyer may sell the contract goods or services or a restriction on the customers to whom the buyer may sell them is, in principle, a hardcore restriction, which means that an agreement containing such a clause would not be exempt, even if the market share of the supplier did not exceed thirty percent. However, some restrictions on territory and the customer group are permitted, that is, they do not prevent a distribution contract from being exempt. The following are examples of these:

(1) *A restriction on active sales in an exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to a specific buyer, where*

such restriction does not limit sales by the customers of the buyer—In the case of an exclusive distribution contract, the supplier cannot prohibit the distributor from passively selling the products to customers outside its territory. According to the Guidelines on Vertical Restraints, "active" sales entail actively approaching individual customers or a specific customer group within another distributor's territory by conducting a direct mail campaign or making sales visits, for example, or through advertisements specifically targeted at the customer group in question. A "passive" sale is a reference to a party responding to unsolicited requests from individual customers.

In order to clarify the meaning of passive and active sales as far as distribution over the Internet is concerned, the draft Guidelines on Vertical Restraints[18] include examples of forbidden restrictions on passive sales, for example requiring distributors to do the following:

- Prevent customers in another territory from viewing their Web site or automatically reroute them.
- Terminate Internet transactions if credit card details reveal an address outside the distributor's territory.
- Limit the proportion of overall sales made over the Internet.
- Pay a higher price for products intended to be resold online.

(2) *A restriction on sales to end users by a buyer operating at the wholesale level of trade.*

(3) *A restriction on sales to unauthorized distributors by the members of a selective distribution system*—The restriction of active or passive sales to end users by members of a selective distribution system is a hardcore restriction which prevents the distribution contract from being exempt on the basis of the Exemption Regulation. The same is true for restrictions on cross-supplies between distributors within a selective distribution system, including between distributors at a different level of trade.

(4) *A restriction on the buyer's ability to sell components, supplied for the purposes of incorporation, to customers who would use them to manufacture the same type of goods as those produced by the supplier*—If the market share of the supplier does not exceed thirty percent, the restrictions mentioned above are permitted. If the supplier's market share exceeds thirty percent, such restrictions are not necessarily forbidden, but they need to be evaluated with reference to Article 81(3) of the EC Treaty and the Guidelines on Vertical Restraints. The same is true for agreements where the supplier's market share does not exceed thirty percent, but which contain hardcore restrictions. It is unlikely that distribution contracts containing hardcore restrictions will be exempt on the basis of Article 81(3) of the EC Treaty, but it is not impossible, if the parties can prove that their distribution system leads to efficiencies.

D. Distribution over the Internet

Suppliers may be reluctant to allow their distributors to use the Internet for the resale of their products, since the nature of the Internet makes it difficult to restrict the distributors' freedom to choose their customers. However, the European Commission is in favor of the use of the Internet as a means of fostering the integration of the Common Market. Accordingly, the Guidelines on Vertical Restraints specify that every distributor must be free to use the Internet to advertise or to sell products. Use of the Internet can be prohibited only insofar as it would lead to active selling into other distributors' exclusive territories or customer groups. The mere fact of the distributor's Web site being accessible from other territories, as a consequence of the technology, cannot be considered as active sales. The draft Guidelines on Vertical Restraints[19] now specify what should be considered as passive sales over the Internet.

The supplier may require that quality standards be applied to the Internet site used to resell its goods, in particular in a selective distribution system, just as the supplier may require quality standards for a shop or for advertising and promotion in general. An outright ban on Internet selling is only possible if there is an objective justification, e.g., if the products are not suitable for distribution over the Internet. That would be the case, for example, for pharmaceuticals. The criteria that allow a ban on Internet selling must be comparable to those for sales from a traditional retail outlet (namely, the need to maintain the brand image and reputation of the products) and must be applied indiscriminately.

In 2006, the French Competition Council stated that the absence, in the framework distribution contract of a French manufacturer of watches, of rules applicable to online sales, in circumstances where some individual authorizations had been granted to some approved customer stores, was anticompetitive. The manufacturer modified the contract so that current and future distributors were granted the possibility to sell over the Internet. However, the Council accepted the possibility that the supplier could refuse to afford access to its selective distribution network to companies selling exclusively over the Internet.[20]

Thus, the supplier's potential to restrict the distributor's right to sell outside a given territory or to sell to customers of its choice is somewhat limited.

E. Pricing

1. Resale Prices

According to the Exemption Regulation, resale price maintenance, i.e., the restriction of the buyer's ability to determine its sale price, is a hardcore restriction. However, the supplier may impose a maximum sale price or recommend a sale price, provided that this does not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties.

Therefore, a distribution contract allowing the supplier to determine the resale price applied by the distributor is unlikely to be valid. However, an exemption on the basis of Article 81(3) of the EC Treaty is not impossible, since such policies can bring about efficiencies, such as providing distributors with the means to increase promotional efforts and to successfully enter a new market.[21]

Thus the supplier's freedom to reserve rights on resale prices is restricted.

2. Sale Prices

According to French case law, the prices paid by the distributor in order to buy the suppliers' products do not have to be precisely determined in the distribution contract, but French courts will ensure that there is no abuse in the subsequent determination of the price.[22] For that reason the parties should insert a clause making the subsequent sale prices objectively determinable. This might be done by providing that sale prices will be determined by a third party. In practice, sale prices are often determined by reference to the supplier's current price list, which is annexed to the distribution contract and which the supplier is authorized to modify unilaterally. This is advantageous for the supplier, but does not preclude the contract from being attacked for abuse in subsequent price fixing. Therefore it may be advisable to insert restrictions on the supplier's ability to modify the price list, such as limiting the number of pricing modifications to one per year.

The pricing policy of an undertaking in a dominant market position might be considered contrary to Article 82 of the EC Treaty: these would be, for example, abuses consisting of discriminatory pricing,[23] excessive pricing, bundling or fidelity pricing.

As the foregoing discussion illustrates, EU antitrust law restricts the supplier's freedom to reserve substantial rights in areas such as pricing and choice of customers.

F. The Distinction Between an Agency and a Distributorship

A qualification as an agency according to the applicable civil law does not necessarily immunize the agreement against the effects of antitrust law, which has its own definition of agency. According to the definition under EU antitrust law, an agent is a legal person or an individual who is vested with the power to negotiate and/or conclude contracts on behalf of another person (i.e., the principal), either in the agent's own name or in the name of the principal, for the purchase of goods or services by the principal or for the sale of goods or services supplied by the principal.

The more rights the supplier reserves, the more likely it is that the relationship will qualify as an agency.

In order to qualify a given relationship, the European Commission and courts examine to what extent the distributor/agent assumes the financial or commercial risk in relation to the sold products or services. The European Commission's Guidelines on Vertical Restraints contain a section on agency and provide a non-exhaustive list of the types of risk an agent should not bear. Thus, if the agent does not gain ownership of the principal's goods and does not bear the risk for assuming the distribution costs (e.g., shipping), sales promotion, maintaining stocks of the goods, operating a post-sale repair or warranty service, product liability to third parties or liability for customers' non-performance, the qualification as agent is justified.

The consequence of the qualification of a contract as agency agreement is that Article 81 of the EC Treaty is not applicable, since it requires an agreement between independent undertakings. Thus, agency agreements do not have to be drafted so as to fit within the Exemption Regulation. Although this consequence might be beneficial to the supplier, the other consequences are likely to be considered detrimental to its interests, since commercial agents enjoy a protected status in the EU (in particular since the principal is obliged to pay indemnification or compensation upon termination of the agreement, discussed below in Section IV.C.3.b).

G. Treatment of New Products

In general, the distributed products are defined by reference to a product list annexed to the distribution contract. In principle a distribution contract can only be modified by the mutual agreement of the parties. Nonetheless, it is often provided that the supplier may unilaterally remove products from and add new products to the product list. However, if the clause is formulated in that way, the distribution contract runs the risk of being declared void, since the supplier's obligation would not be regarded as fixed, but rather as arbitrary. For this reason, it is recommended that a list with products that may later be added to the product list also be attached to the contract. The parties should also insert a clause specifying in what circumstances new products can be added, e.g., upon expansion of the supplier's activity, a change in fashion, technical improvement, or the like.[24] It may also be provided that new products be added by mutual agreement of the parties.

If, however, the type of product completely changes, a new contract should be entered into, at least if the different nature of the product requires a modification of the other provisions of the agreement. For instance, a selective distribution system might be justified in the case of sophisticated products (e.g., luxury or technical products), but not in the case of products the resale of which does not require any special expertise.

IV. Termination

A. Restrictions on the Right of the Parties to Terminate the Relationship

Under French law, the sudden termination of an established commercial relationship without abiding by a notice period that takes into account the duration of the relationship makes the terminating party liable to the other party for damages suffered as a result of the abrupt termination of the contract. In the event of an act of God or nonperformance by the other party of its obligations, no notice period needs to be complied with.[25] The term "established commercial relationship" refers to contracts that have been concluded for an indefinite, as well as those concluded for a definite, term, but it also encompasses non-formalized occasional but constant forms of cooperation. French courts consider this termination provision applicable if the established commercial relationship is essentially linked to the French territory, even if the law chosen by the parties is not French law.[26]

Only compensation for damages resulting from the sudden nature of the termination can be sought; the terminated party is not entitled to recover for damages resulting from the termination as such.

Apart from being required to comply with a notice period, the party having the right to terminate the distribution contract must not use its right in an abusive manner, the concept of abuse being one that has been interpreted by French case law.

In case of agreements that are performed over time, like distribution contracts, French law distinguishes agreements concluded for an indefinite term and those concluded for a definite term. Agreements concluded for an indefinite term can in general be terminated unilaterally by either party upon its complying with a certain notice requirement. However, distribution contracts are in most cases concluded for a definite term, which may in some cases be renewed by the parties either explicitly or tacitly. It should be noted that EU antitrust law imposes a maximum duration of five years for non-compete clauses. Thus if a distribution contract contains such a non-compete clause, the parties should ensure that its term does not exceed five years. (See Section V.A.1 below.) In the case of a contract having a definite term, the agreement cannot be terminated before the end of that term, except in the event of non-execution or some other event that the parties may contractually stipulate.

It is important that the parties include a provision allowing each party to terminate the contract in certain circumstances. In fact, without such a provision, the party wishing to terminate the contract would have to request a court to order such termination. Article 1184 of the French Civil Code provides that, if a party to a contract does not perform its obligations, the other party has the right to request the termination of the agreement in court. This is known as the principle of judicial termination. It is, however, also recognized that the parties can include a provision in their contract allowing each of the parties to terminate the contract in such case, unilaterally, without any court determination. In the case of special circumstances—for example, upon a serious default of one of the parties causing irreparable damage to the other—the contract can be terminated unilaterally even if it does not include such a termination clause.

B. Termination Clause and Grounds for Termination

A termination clause may allow each party to terminate the distribution contract unilaterally, without observing a notice period or having to justify the decision or having to pay any indemnification. In order to draft the clause concerning the events allowing for such termination of the contract, a general provision may be included to the effect that, if a party does not meet its obligations under the contract and does not remedy the default within a certain time frame, the other party is entitled to terminate the contract. Then specific events that are considered by the parties important enough to serve as triggers of such a right of termination should be enumerated.

The following are some examples from the supplier's perspective:

(1) The distributor sells products that compete with those of the supplier in violation of the contract.

(2) The distributor does not meet its contractual purchasing objectives.

(3) The distributor infringes the supplier's intellectual property rights.

(4) The distributor does not obtain an approval necessary for the distribution of the products.

The following are some examples from the distributor's perspective:

(1) The supplier does not perform its obligations with respect to the supply of the contractual goods or services in sufficient quality and quantity.

(2) The supplier sells its products to clients situated in the distributor's territory, in violation of its contractual obligations.

(3) The supplier transfers any of the trade marks used on the distributed products to a third person.

The following are some examples applicable to both parties:

(1) A party becomes insolvent.[27]

(2) There is a change in control of one of the parties.

Both the supplier and the distributor may want to include events of default in the distribution contract that would allow them to terminate the contract before the end of the term, without observing a notice period. If the parties decided not to include such specific events of default, either party would have to observe a prior notice period as stipulated by law. [28] The termination grounds that are most important for the parties will vary, depending on the particular case. In practice the supplier will often be in a stronger position than the distributor and may therefore be expected to impose termination grounds that are more favorable to it.

Distribution contracts concluded for an indefinite period of time may be terminated at any time (subject to compliance with any prior notice period stipulated by law) but without any obligation for the terminating party to grant an opportunity to cure (unless it is so stipulated in the contract). It cannot be excluded, however, that a French judge may disregard a termination clause if he considers that the party having terminated the contract has not been loyal and used its termination right abusively.[29]

If a distributor considers that the termination of the distribution contract by the supplier was unjust and that he suffered damage, he may of course sue the supplier in court and bring an action for damages. However, the parties may include in their distribution contract a penalty clause obligating the terminating party to indemnify the other party in the event of any sudden or abusive termination of the contract. French courts have the power to revise these penalty clauses if they are obviously excessive or insignificant.[30]

C. Consequences of Termination

1. How Determined

The consequences of a termination of the distribution contract will be determined principally by the terms of the contract; they may, however, also be affected by the requirements of law, such as those relating to competition or the protection of intermediaries.

2. Contractually Stipulated Consequences

The supplier may want to provide in the distribution contract that none of the parties can claim indemnity from the other due to the termination of the contract in accordance with its terms. This clause might be ineffective if the distribution contract is re-qualified into an agency contract (see Section IV.C.3 below).

The supplier should provide in the contract that the distributor must inform its clients at the termination of the contract about the fact that it is no longer the exclusive distributor of the products in the territory and that the distributor must stop using the supplier's trademarks, trade names and other intellectual property rights connected with the distributed products.

The parties should agree on the post-termination disposition of products remaining in the distributor's possession (whether or not defective), as well as on the post-termination destruction of advertising materials in the distributor's possession.

In that portion of the distribution contract dealing with the consequences of termination, provision should also be made for the settlement of outstanding debts owing from one party to the other.

3. Consequences Pursuant to Provisions of Law

(a) Distributors Compared with Agents

In most Member States, distributors do not enjoy the same protection as commercial agents, who are in a comfortable position due to laws which regulate their rights and obligations and which allow them to receive a compensatory payment from the principal on termination of their contract.

(b) Commercial Agents

Unlike distributors, commercial agents enjoy special protection under EU law. Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents (the "Commercial Agents Directive")[31] sets out a number of significant rights for commercial agents, which it defines as self-employed intermediaries who have continuing authority to negotiate the sale or the purchase of goods on behalf of another person (i.e., the principal), or to negotiate and conclude such transactions on behalf and in the name of that principal.[32] In some Member States, intermediaries in regard to services are also covered.[33]

The Commercial Agents Directive applies to self-employed[34] commercial agents, who can be individuals or corporations. The protections of the Commercial Agents Directive are mainly as follows:

(1) The right to a written agreement;

(2) Rules on the entitlement to commissions and on the due date for the payment of commissions;

(3) Rights to commissions after termination in respect of transactions generated by the agent;

(4) Minimum notice period; and

(5) The right to indemnification or compensation in the case of termination.

The most contentious right is the right of the agent to indemnification or compensation upon termination of the agreement. Under Article 17 of the Commercial Agents Directive, Member States have the option of adopting either the compensation concept or the indemnity concept.

Compensation refers to damage suffered by the agent due to the termination of the agency agreement. It applies regardless of contractual damages.[35] The agent is entitled to be compensated for any damages incurred, in particular where termination takes place in circumstances depriving the agent of a commission that proper performance of the contract would have provided to him, while the agent was providing the principal with substantial benefits linked to the agent's activities. Furthermore, an agent is entitled to compensation if the termination prevents the agent from amortizing costs and expenses incurred in the performance of the agency contract according to advice of the principal.[36]

There is an indemnification obligation if (i) the principal continues to derive substantial benefits from the activity of the agent who has brought new customers or increased the volume of business with existing customers, and (ii) the payment of this indemnification is equitable, having regard to all circumstances and, in particular, the commission lost by the agent on the business transacted with such customers.[37]

The amount of indemnification is capped at one year's commission averaged over the preceding five years, or, if less, the duration of the agreement.[38] Indemnification is justified by the goodwill created by the agent. If no goodwill has been created, no indemnification need be paid.

In a recent decision,[39] the European Court of Justice has clarified the different criteria used for determining such indemnification. A German court had asked whether it was possible to limit the agent's right to indemnification to the amount of commission lost as a result of the termination of the agency contract, even though the benefits that the principal continues to derive are of a higher monetary value. In its judgment, the court stated that the discretion that Member States have to adjust the indemnity in order to make it equitable (which is the second criterion) cannot be construed to the effect that the indemnity can only be adjusted downwards. Therefore, it is not possible to automatically limit the amount of the indemnity by the amount of commission lost as a result of the termination of the agency contract, since the Commercial Agents Directive seeks in particular to protect commercial agents in their relations with their principals.

While Germany has chosen the indemnity concept,[40] France has applied the Commercial Agents Directive by introducing the compensation concept.[41] Under French case law, the level of compensation is equivalent to the gross commissions of the last two years calculated by using the average of the commission earned during the last three years of the agency contract, courts being able to award a different sum if there is evidence that the actual loss was in fact greater or smaller, for example, if the agent's activity has actually not led to the conclusion of new contracts or if an agent takes clients with him or her.[42] French courts have specified that, if an agency contract is terminated by the principal before the end of the contractual term, the agent is entitled to compensation for the damage resulting from the loss of revenue until the end of the contractual term plus compensation for the damage resulting from the loss of revenue for the future (corresponding to the compensation resulting indirectly from the Commercial Agents Directive).[43]

Neither compensation nor indemnity is payable (i) if the principal has terminated the contract because of default attributable to the agent that would justify immediate termination of the contract under national law, (ii) if the agent has terminated the contract, unless such termination is justified by circumstances attributable to the principal, or (iii) if the agent, with consent of the principal, assigns its rights and duties under the contract to another person.[44] The French *Cour de Cassation* has held that the burden of proof is on the principal to prove that the agent was in breach if the agent alleges that the failure to meet contractual targets was due to economic stagnation or competition from the principal.[45]

The parties to an agency contract may not deviate from the provisions of the Commercial Agents Directive in regard to indemnity and compensation.[46]

The European Court of Justice has ruled that the guaranteed rights of agents on termination still applied where an agent carried on its activity in a Member State although the principal was established in a non-member country and a clause of the contract stipulated that the contract was to be governed by the law of that country.[47] The choice-of-law clause remains valid with regard to other aspects, (e.g., establishment of a breach or non-performance).[48] Thus, a principal cannot simply contract out of the Commercial Agents Directive. However, as far as an agent's activity outside the EU is concerned, the Commercial Agents Directive, as well as national implementing legislation, can be excluded.

Since these rights to indemnity and compensation do not, in principle, apply to distribution contracts, parties often insert a clause excluding an agency arrangement between them. However, it is not excluded when a "formal" distribution contract is re-qualified as an agency contract. In Germany, agents' rights may be applied to distributors if their situation is similar (see Section IV.C.3.c).

(c) Distributors

EU law provides no particular basis for distributors to claim compensation or indemnity upon a rightful termination. Such claims may of course arise out of the contract, grounds for indemnification being, for example, the failure to terminate according to the terms of the contract, the failure to give notice, the fact that there were no reasonable grounds for termination, and the like, which take the form of damages for wrongful termination, but there is no European legal basis for the payment of compensation or indemnity solely on the ground that the distribution contract has been terminated.

The same situation prevails in France, with courts refusing to grant distributors the right to indemnity for loss of clients, in the absence of a contractual provision providing such a remedy.

In some countries, however, protection of distributors has arisen out of the protection of commercial agents. For instance, under German statutory law there is no protection for distributors. However, German courts have extended agency protection to distributors and other independent sales people.[49] The protection will apply if the specific situation of the person or legal entity resembles the position of an agent. In general, the more a distributor is integrated into the sales organization of the supplier, the more likely it will be that the courts will award compensation. Such integration is likely to be found if control or influence is exercised over marketing, pricing, minimum sales requirements, or reporting obligations of the distributor, or in the case of other similar control mechanisms. Furthermore, in order to award indemnity to distributors, the courts require that the distributor must be obliged contractually to transfer its client data to the supplier upon termination of the contract, which would allow the supplier to profit from the distributor's activity.[50] A prior contractual exclusion of any indemnification of distributors in this case would not be effective.

The Swiss *Bundesgericht* has recently issued a similar decision, stating that the distributor, in analogous application of the law on agency, is entitled to indemnification upon termination of its contract if it is integrated into the sales organization of the supplier and has only limited economic autonomy, which makes its situation comparable to that of an agent. Moreover, the distributor must have built up or extended a client base, which will, upon termination of the distribution contract, be transferred to the supplier. Unlike German courts, the Swiss court does not seem to require a contractual obligation to transfer the client data; thus, a factual transfer would be sufficient.[51]

Thus, there are legal requirements for the payment of compensation or indemnification upon termination in all EU Member States insofar as agents are concerned, and in some Member States insofar as (some) distributors are concerned.

V. Restrictive Covenants: Covenants Not to Compete and Non-Solicitation Clauses

A. Covenants Not to Compete

1. Non-Compete Clauses and the Prohibition Against Restrictive Agreements

Non-compete clauses are restrictive of (intra-brand) competition and thus contrary to Article 81(1) of the EC Treaty but may be exempt under Article 81(3) of the EC Treaty or the Exemption Regulation. However, Article 5 of the Exemption Regulation imposes certain conditions for the exemption.

Under the Exemption Regulation, a non-compete obligation means any direct or indirect obligation causing the buyer not to manufacture, purchase, sell or resell goods or services that compete with the contract goods or services, or any direct or indirect obligation on the buyer to purchase from the supplier or from another undertaking designated by the supplier more than eighty percent of the buyer's total purchases of the contract goods or services. Quantity forcing is thus also covered to a certain extent.

Non-compete clauses are in principle exempt if the supplier's market share does not exceed thirty percent. If the supplier's market share exceeds the threshold, an exemption may be granted pursuant to Article 81(3) of the EC Treaty and the Guidelines on Vertical Restraints.

However, Article 5(a) of the Exemption Regulation provides that the exemption will not apply to any direct or indirect non-compete obligation the duration of which is indefinite or exceeds five years. A non-compete obligation that is tacitly renewable beyond a period of five years is deemed to have been concluded for an indefinite duration.

If there is an obligation on the buyer to purchase more than eighty percent of the total amount from the same supplier and if that obligation is indefinite, is automatically renewable or exceeds five years, it will not be enforceable, but, unlike hardcore restrictions, it will not result in the voiding of the rest of the contract, provided that it is severable from the other clauses. This has to be determined on a case-by-case basis.

For example, a contract between a brewery and a tenant that attempted to ensure that, during the twenty-year term of the lease, the tenant would buy beer exclusively from the brewery (a "beer tie") was judged violative of Article 81 of the EC Treaty.[52]

Furthermore, post-termination covenants not to compete are only exempt and enforceable if they are necessary to protect the supplier's substantial know-how, have a duration of less than one year after termination of the agreement, and are limited to the supplier's market and the premises on which the buyer operated during the contract period.[53]

Finally, Article 5(c) of the Exemption Regulation provides that the exemption will not apply to any direct or indirect obligation that causes the members of a selective distribution system not to sell the brands of specific competitors. This prohibition attempts to avoid a collective boycott of a competing supplier, a situation whereby a number of suppliers using the same selective distribution outlets attempt to prevent one specific competitor or a number of specific competitors from using these outlets to distribute their products. In the case of a selective distribution arrangement, the appointed dealers can only be obliged not to resell competing brands in general.

Additionally, Article L.330-1 of the French Commercial Code limits the duration of exclusive purchase clauses to ten years. French courts may apply this provision if the distributor has its registered seat in France, regardless of the fact that the law controlling the distribution contract is or is not the French law.[54] If the parties have included a clause lasting longer than ten years, French courts will consider reducing the term of such clause to ten.

A supplier may restrict a distributor's ability to distribute competing products during and after the term of the contract. However, there are legal limitations on such restrictions.

2. Non-Compete Clauses and the Prohibition Against Abuse of a Dominant Market Position

Exclusive purchase obligations may also be contrary to Article 82 of the EC Treaty if the supplier is in a dominant market position. For example, some suppliers of food and drink products require exclusivity in the contacts relating to outlets or vending machines (when they supply such machines). The Commission has taken into account dominance of the suppliers as well as the dependence of retailers in condemning such provisions. For instance, in the *Van den Bergh* case,[55] an ice cream manufacturer who held a dominant position in the Irish market provided ice cream retailers with freezer cabinets (in which the manufacturer retained ownership), but only so long as they were used exclusively for the supplier's products. The distribution contracts did not contain a clause to the effect that the distributors were not allowed to sell competing ice cream products, but the freezer exclusivity clause had the same practical effect, since it was economically not viable for a distributor to install a second freezer cabinet in order to sell competitors' products.

The Court of First Instance approved the Commission's decision having found that the freezer exclusivity clause was a violation of Article 81(1) of the EC Treaty, and that the supplier's inducing a distributor to enter into agreements to maintain the cabinets subject to a condition of exclusivity constituted an infringement of Article 82 of the EC Treaty. The court's argument focused upon the fact that the freezer exclusivity clause in reality created outlet exclusivity. The court conceded that such a clause might have had a beneficial effect on competition in a balanced market by contributing to an improvement in production and distribution of goods.

In the *Coca Cola* case,[56] the Commission accepted undertakings from Coca Cola Enterprises that the equipment exclusivity contracts would not amount to outlet exclusivity. The commitments reduced contract duration, gave customers the option of repayment and termination without penalty, and freed up a certain share of refrigeration space.

3. Drafting Non-Compete Clauses

In order to avoid uncertainty concerning products that must not be sold by a distributor, the agreement might contain a list of permitted products that the distributor can sell, that is, in addition to the contract products.

Such a clause might read as follows:

> Distributor shall not sell any products that are competitive with any of the Products within the Territory. The products listed in Annex 1 are deemed not to be competitive with Products. The Parties may from time to time agree to extend by mutual agreement the list of products listed in Annex 1.

B. Non-Solicitation Clauses

Distribution contracts in Europe do not necessarily contain special provisions preventing one party from recruiting another party's employees. The need for such clauses depends on the relationship between the parties in light of the nature of the products, that is, whether the parties ascribe importance to employees' expertise. It is not conditioned on the parties being competitors. In fact, in a vertical relationship the parties are usually not competitors, but competing undertakings also sometimes enter into vertical arrangements.

The parties must determine what restrictions are appropriate to prevent the supplier and distributor from recruiting each other's employees.

From an antitrust law perspective, a non-solicitation clause is generally not problematic, since it is not defined as a hardcore restriction or as a non-compete obligation within the Exemption Regulation.

In the absence of a non-solicitation clause in a distribution contract, a party may still be liable under Article 1382 of the French Civil Code for engaging in unfair competition if it hires an employee of another party to the contract, provided that such party is at fault for doing so. The mere fact of hiring employees of another party to the contract would not be considered as unlawful. For a party to be liable, special circumstances have to be proved, e.g., a mass hiring of employees causing the disorganization of the previous employer's company or the knowledge of the existence of a non-compete clause contained in the employment contract.[57]

VI. Product Recalls

The distributed products may be defective. The defect may concern a single product, but it can also be a structural defect that might lead to a large-scale product recall.

Directive 2001/95/EC of the European Parliament and of the Council of 3 December 2001[58] on general product safety provides that product recall is the obligation of producers (i.e., product manufacturers). Within the limits of their respective activities, producers must adopt measures commensurate with the characteristics of the products that they supply, enabling them (i) to be informed of the risks which these products might pose and (ii) to take appropriate action including, if necessary to avoid these risks, withdrawal from the market (i.e., before the products have been sold to consumers), adequately and effectively warning consumers, or recalling products from consumers.

The recalling of products should take place as a last resort—only if other measures would not suffice to prevent the risks involved, if the producers consider it necessary or if they are obliged to do so pursuant to action taken by the competent authority.

Distributors must act with due care to ensure compliance with applicable safety requirements, especially by not supplying products that they know, or should have known, do not comply with applicable safety requirements. Moreover, they must participate in monitoring the safety of products placed on the market, especially by distributing information concerning product risks, keeping and providing the documentation necessary for tracing the origin of products, and cooperating in the action taken by producers and competent authorities to avoid risks.

The supplier generally undertakes to indemnify the distributor for the damages incurred as a result of defects in the supplier's products, including a product recall.

VII. Infringement of Intellectual Property Rights

If a distribution contract confers on one party an exclusive right to exploit specific intellectual property rights (e.g., by way of an exclusive license of intellectual property), the validity of such contract may be questioned in light of EU competition law: in fact, such a contract could have a negative impact on competition, in particular if intellectual property rights are invoked to justify exclusivity and to create barriers to importation and free trade within the EU.[59]

If such a license were, however, only ancillary to the contract, the Exemption Regulation—provided that the other exemption requirements are satisfied—may exempt the entire agreement, including the clause granting the intellectual property license. [60] The term "ancillary," in this context, refers to the situation where the grant of the license in the distribution contract is done purely in connection with the distribution scheme and does not have the character of an agreement or of a concerted practice having as its object or effect the isolation or partitioning of a common market.

A. Warranties Regarding Intellectual Property Rights

A supplier usually warrants that it is the lawful owner of the trademark in the territory granted to the distributor. The distributor does not usually provide any intellectual property rights but is generally granted the right to use the supplier's trademark. However, the distributor may also provide intellectual property rights, in particular if the parties are competitors and if their distribution agreement is part of a larger agreement.

The supplier usually (but not necessarily) grants the distributor the right to use its trademark.[61] A trademark license is used in franchising agreements, but rarely in distribution agreements where the distributor is restricted to the sale of finished products.

B. Infringement of Intellectual Property Rights by the Distributor

1. Distributor's Infringement of Supplier's Intellectual Property Rights

The distribution contract usually explicitly states that nothing contained in the distribution contract is to be interpreted as permitting, for the benefit of the distributor, the transfer or granting of rights of the supplier's intellectual property.

Infringement of the suppliers' intellectual property rights by the distributor may be a valid ground for the supplier to immediately terminate the distribution contract.

2. Distributor's Infringement of Third Parties' Intellectual Property Rights

In the event that the supplier's use of intellectual property infringes a third party's prevailing intellectual property rights, the supplier will usually compensate the distributor for any damages suffered as a result of an action brought by the third party against the distributor.

C. Third Parties' Infringement of Supplier's Intellectual Property Rights

1. The Typical Case: Sale of Products Bearing Trademarks That Are Re-imported from Outside the EEA

If due to EU antitrust law, a supplier is not able to forbid the passive resale of products by a distributor to a buyer situated outside the distributor's allocated territory, the supplier may find a remedy in EU law on intellectual property grounds, allowing a supplier to prevent parallel importing of its trademarked products from a country outside the European Economic Area (EEA) into the EEA.

Article 7(1) of First Council Directive 89/104/EEC dated 21 December 1988 coordinates the laws of Member States relating to trademarks (the "Trade Mark

Directive").[62] It provides that "*the trade mark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent*." The European Court of Justice has interpreted this provision in a case where an Austrian manufacturer of spectacles had sold some out-of-fashion products for a reduced price to a distributor in Bulgaria (at the time not yet a member of the EEA) with the instruction not to re-export them to the Community. The spectacles reappeared on the Austrian market, and the manufacturer brought an action for interim relief, seeking an injunction restraining the importer from offering the spectacles for sale in Austria under its trademark.

The European Court of Justice, however, ruled that, contrary to the Austrian interpretation, Article 7(1) of the Trade Mark Directive did not allow Member States to adopt rules providing for the international exhaustion of trademark rights, i.e., in respect to products put on the market outside the EEA under the trademark by the proprietor or with its consent.[63] Therefore, the supplier could rely on its trademark rights in order to prevent the re-importation of its products from countries outside the EEA.

This remedy is not available in regard to products that the supplier has put on the market of a member state of the EEA. However, no exhaustion of intellectual property rights will occur if the distributor is able to prove legitimate grounds for its resistance to the resale of its products by the third party, for example, a modification of the condition of the products.[64]

2. Obligation of the Distributor to Cooperate

It is generally provided that the distributor is to inform the supplier if it gains knowledge of any infringement of the supplier's intellectual property rights or of any act of unfair competition by third parties.

If the supplier decides to sue a third party for infringement of its intellectual property rights, the distributor should (unless special circumstances exist) cooperate with the supplier, who will direct the proceedings.

VIII. Limitations on Liability and Indemnification

A. Legal Scope of Liability

Liability is determined according to the applicable law of the distribution contract. If the jurisdiction clause provides for French law to govern, the principles regarding liability will be regulated by the French Civil Code (namely, Articles 1146 to 1155). According to these provisions, a party who does not abide by the contract is liable to the other party, i.e., damages can be sought by the other party (*dommages et intérêts*), if the damages were foreseeable.

If the parties do not specify anything to the contrary, a party who does not abide by all of the obligations contained in the contract will be liable to the other party. It is not necessary to explicitly specify the areas in which the parties will be liable.

B. Contractual Limitations on Liability and Restrictions on Such Limitations

1. Restrictive Approach of the French Courts

Clauses limiting liability are narrowly interpreted by the French courts and in a manner that is favorable to the party not benefitting from such restriction. A clause precluding damages for lost profits would only be applicable if the distribution contract were terminated in accordance with its terms. If the supplier terminated the contract that it was not entitled to terminate, the supplier could not refer to a clause precluding damages for lost profits, and French courts would require that the distributor be restored to the financial position that the distributor would have been in, had the distribution contract been performed in accordance with its terms.[65]

In this regard, a clause in which a distributor waives its right to damages has been judged invalid where the supplier violated its obligation not to directly supply former clients of the distributor in the event of termination of the distribution contract at the supplier's initiative.[66]

French courts have established several valid liability-limitation clauses. Such clauses are ineffective if the defaulting party commits an intentional or serious default (*dol ou faute lourde*).[67] Liability-limitation clauses are also ineffective if the damage results from the non-execution of an "essential obligation," which goes to the justification for or purpose of the contract (i.e., the "cause" for the parties contracting with each other). This principle was established in a case where a French company specialized in fast shipping services limited its liability in its contracts to the amount paid by the client for the transport, whereas the real damage was much higher, since the remitting party had missed the deadline to participate in a tender offer, due to the failure of the shipping company to deliver the mail in time. The French courts ruled that the limitation of liability was ineffective, since the very purpose of the contract was that the mail be delivered before the deadline.[68]

Applying this principle to an exclusive distribution contract, for example, the supplier whose essential obligation is to grant exclusivity to the distributor in a given territory would not be able to limit its liability in the event it breaches this exclusivity obligation.

Furthermore, a clause limiting liability cannot include limitations on compensation for physical injury to an employee of a contractor. Clauses limiting liability in contracts between a business and consumers at large are not tolerated.[69]

2. Possible Contractual Limitation on Liability

Apart from the restrictions stated above, parties to a distribution contract are free to limit liability or subject liability to certain conditions. For example, the supplier assumes liability for claims by third parties that are asserted against the distributor if the distributed products are defective due to the manufacture by the supplier (see Section VIII.D below). However, this liability may be conditioned (and thus limited) under certain circumstances, e.g., that the distributor notify the supplier of the claim within a certain time period after having been informed of the claim.

The supplier may undertake to replace defective products at its own cost. This obligation may also be subjected to certain conditions, e.g., that the distributor returns the defective products to the supplier within a certain time period.

It is also possible to expressly limit the financial amount of indemnity to be paid by the liable party.

C. Contractual Provision Regarding Indemnification

As far as contractual indemnification is concerned, the parties may provide that, when a distribution contract is terminated, the distributor will be indemnified for any lost clients (*indemnité de clientèle*).

The parties may also state an exact sum in the contract that must be paid if one party does not fulfill its obligations. This is a type of a contractual penalty. French courts control the amount of such penalties and will modify the penalty if it is evidently excessive or insignificant.[70]

For an explanation regarding the special type of indemnification paid to commercial agents as a result of contract termination, see Section IV.C.3.b above.

D. Liability Toward Third Parties

In accordance with the French legal principle that a contract is only enforceable as between the contracting parties, a supplier is generally not liable directly to the distributor's clients. The distributor may, however, assert its own claim against the supplier and thus obtain an amount equal to the damages paid to the third party if the damages were due to the fault of the supplier or if the supplier otherwise had a contractual duty to the distributor that was breached and resulted in such damages.

There are, however, some important exceptions to this general principle. Thus, the distributor's customer may bring an action for damages directly against the supplier if the products have a hidden defect (*vice caché*) or if they are dangerous due to a defect (which would be on a theory of liability for defective products),[71] in which case the customer may seek damages from the manufacturer, the final seller, or any intermediary.[72]

The contracting parties may include a clause to the effect that, if a third party brings an action against either the distributor or the supplier in relation to a defective product manufactured by the supplier, the supplier will defend or settle the action (enabling the distributor to refer to the supplier any actions brought against the distributor). This is based on the rationale that the supplier is to bear liability for defective products and will have at its disposal all possible information concerning the manufacture of the product in question.

E. Statute of Limitations

French law places a five-year time period in which either party may bring an action against the other.[73] According to Article 2254 of the French Civil Code, the parties may shorten (or extend) the duration of the statutory limitations. However, they cannot reduce the duration to less than one year.

IX. Choice of Law and Forum

A. Introduction

Since the parties to an international distribution contract may come from two different countries and jurisdictions, the choice of a neutral jurisdiction (in regard to both governing law and forum for resolving disputes) would appear to be an acceptable compromise. However, if the parties choose a neutral jurisdiction, rarely will either party be familiar with the chosen neutral law or fluent in that country's language. Consequently, parties to a distribution contract will agree to the law of one party's home Member State; generally the law of the supplier's country Member State is chosen.

Therefore, no generic recommendation can be given regarding the choice of a neutral jurisdiction for the governing law or choice of forum.

B. Choice of Law

As far as the framework (distribution) contract is concerned,[74] the choice of law applicable to contracts is regulated by the convention on the law applicable to contractual obligations opened for signature in Rome on 19 June 1980 (the "Rome Convention"). The Rome Convention will be replaced by Regulation (EC) no 593/2008 of the European Parliament and of the Council dated 17 June 2008 on the law applicable to contractual obligations (Rome I) ("Rome I Regulation"),[75] with effect from 17 December 2009. The Rome Convention will continue to apply to parties in Denmark and the United Kingdom, as neither countries participated in the adoption and application of the Rome I Regulation. In this section, reference will be made to the rules of the Rome I Regulation.

Under Article 3 of the Rome I Regulation, the parties are free to determine the law that is to govern their contract. The choice is to be expressly made or demonstrated by the terms of the contract or the circumstances of the case. Parties can select the law applicable to the whole, or to only part of the, contract. Thus there are no statutory or other legal restrictions on the choice of law.

However, the Rome I Regulation provides that, if all other elements relevant to the situation at the time of the choice are connected with a certain country other than the country that has been chosen to govern the contract, the choice of the parties will not prejudice the application of provisions of the law of that other country, which cannot be avoided by agreement.[76]

The Rome I Regulation establishes overriding mandatory provisions (*lois de police*) that must be complied with. Such provisions safeguard a country's public interests (whether political, social or economic) to such an extent that they apply to any situation falling within their scope, irrespective of the law chosen to govern a particular contract. The concept of "overriding mandatory provisions" is to be distinguished from provisions which cannot be avoided by agreement and should be construed more restrictively.

According to Paragraphs 2 and 3 of Article 9 of the Rome I Regulation, a judge may apply the overriding mandatory provisions of the forum, notwithstanding the law applicable according to the Rome I Regulation. A judge may also apply the overriding mandatory provisions of the country (other than the forum) where the obligations arise from the contract and must be performed, insofar as the overriding mandatory provisions render the performance of the contract unlawful. In considering whether to give effect to the provisions, the nature, purpose and likely consequence of their application or non-application must be considered.

Paragraph 4 of Article 3 of the Rome I Regulation provides that, if all other elements relevant to the situation at the time of the choice of law are located in one or more Member States, the parties' choice of applicable law other than that of a Member State will not prejudice the application of provisions of Community law, where appropriate as implemented in the Member State of the forum. This cannot be avoided by agreement. Thus, EU law can also belong to the category of provisions that cannot be avoided by agreement. For example, the parties cannot exclude EU antitrust law by choosing a foreign law. The same is true for some aspects of EU law in relation to agency (see Section IV.C.3.b above).

Therefore, there are certain provisions of local law that will be applied irrespective of the parties choice of a different law to govern their contract.

C. Choice of Forum: National Courts

Jurisdictional issues in the EU are regulated, *inter alia*, by the Council Regulation (EC) No 44/2001 dated 22 December 2000 regarding jurisdiction recognition and enforcement of judgments in civil and commercial matters, also referred to as the "Brussels Regulation,"[77] since it is based on the Brussels Convention of 1968,[78] (an international treaty signed by the EU Member States and containing essentially the same rules as the new Brussels Regulation, with some minor differences). The Brussels Convention is still applicable to relations between Denmark and all other Member States.

According to Article 23 of the Brussels Regulation, the parties to a contract can decide which Member State's courts shall have jurisdiction to adjudicate a dispute, with the exception of disputes involving consumers (who can sue in their country of domicile if the other party pursues commercial or professional activities in the Member State of the consumer's domicile or, by any means, directs such activities to that Member State[79]).

In order to be effective, the forum-selection clause must be in writing or evidenced in writing, or in a form which accords with practices which the parties have established between themselves or, in international trade or commerce, in a form which accords with a usage of which the parties are or ought to have been aware of and which in such trade or commerce is widely practiced. Communication by electronic means that provides a durable record of the contract is equivalent to a "writing."

If the Brussels Regulation is not applicable or if it refers to the national law of the Member States, jurisdiction is determined according to national rules. In France, Article 48 of the French Code of Civil Procedure sets forth the requirements for valid jurisdiction clauses. These are only effective between business people or parties (as opposed to consumers) and must be clearly stated in the contract.

It thus can be said that there are few legal restrictions regarding the choice of forum, and they are not relevant in the context of a distribution contract since such contracts are always concluded between commercial parties.

X. Arbitration

Under Article 27 of the Brussels Regulation, where proceedings involve the same action and the same parties but are brought in the courts of different Member States, all courts (apart from the court first seized) must stay proceedings until the court first seized determines jurisdiction. This procedural requirement can be an obstacle to an "exclusive jurisdiction" clause in a distribution contract, since the European Court of Justice has ruled that there is no exception to Article 27 of the Brussels Regulation even if the jurisdiction of the court subsequently seized was asserted pursuant to a contractual clause conferring jurisdiction on that court.[80] Additionally, the European Court of Justice has ruled that anti-suit injunctions, by means of which one court could prevent a foreign court from carrying on with its proceedings to determine jurisdiction, are not compatible with the Brussels Regulation.[81]

In a similar case concerning payment of interest on a loan, a German company commenced proceedings against its lenders in Germany, in breach of an exclusive jurisdiction clause in favor of English courts. In a suit brought by the lenders, the English High Court ruled that the proceedings commenced by the lenders were required to be stayed under Article 27 of the Brussels Regulation. The German court finally declined jurisdiction, but only after an eighteen-month delay.[82] However, Article 27 of the Brussels Regulation did not prevent the English court from granting an order in the meantime, preventing the German borrower from disposing of its most valuable assets without the consent of the lenders, the cause of action being different from the proceedings pending in Germany.

To avoid this conflict, the parties should include an arbitration clause in the distribution contract, since arbitration is outside the scope of the Brussels Regulation. Thus, the arbitration tribunal would not have to stay proceedings in favor of a court first seized in breach of an arbitration agreement. However, in *Allianz SpA and Generali Assicurazioni Generali SpA v. West Tankers Inc.*,[83] the European Court of Justice stated that anti-suit injunctions are incompatible with the Brussels Regulation, even if the court of a Member State issues the injunction on the grounds that the proceedings commenced before a court of another Member State would be contrary to an arbitration agreement. Thus, the applicability of an arbitration agreement, including in particular its validity, does fall within the scope of the Brussels Regulation.

With regard to the location of the arbitration, there may be an advantage in choosing Switzerland, since the parties might then have a chance to avoid, to a certain degree, the European antitrust rules. Recently, the Swiss *Bundesgericht* has decided that antitrust rules (including European antitrust rules) are not part of Swiss public policy. A national court would only be able to annul an arbitral award if it were contrary to public policy. Thus, a court could not control the way in which an arbitration tribunal applied antitrust rules. However, if a party requests the application, a Swiss arbitration tribunal would still be obliged to apply European antitrust law, considered by the *Bundesgericht* to be a foreign overriding mandatory provision (*loi de police étrangère*) even if the parties have chosen Swiss law as the law applicable to their contractual relationship. A court may thus annul an arbitration award if the arbitration tribunal did not apply antitrust law despite a party's request, but the court would not be able to examine whether antitrust rules were correctly applied.[84]

Unlike the Swiss *Bundesgericht*, the European Court of Justice does consider Article 81 of the EC Treaty to be part of a Member States' public policy, which means that a national court to which an application is made for annulment of an arbitration award must grant that application if it finds that the award in question is in fact contrary to Article 81 of the EC Treaty (if its domestic rules of procedure require it to grant an application for annulment founded on a failure to observe national rules of public policy).[85]

To conclude, whereas the application of antitrust rules by arbitration tribunals in the EU Member States is strictly controlled, a Swiss arbitration tribunal has more latitude in applying these rules. Thus, there may be advantages in choosing arbitration.

Endnotes

1. Regulated by French C. Civ. arts. 1582 to 1701.
2. Commission guidelines on the effect on trade concept are contained in Articles 81 and 82 of the Treaty Establishing the European Community, consolidated version at 2006 O.J. (C 321E) (hereinafter the "EC Treaty"), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:321E:0001:0331:EN:pdf (last visited on 11 Dec. 2009).
3. Judgment of the European Court of Justice of 27 Sept. 1988, Joined Cases C-89/85 and others, *Ahlström Osakeyhtiö v. Comm'n*, 1989 E.C.R. I-05193. It is noted that the EC Treaty does not define the word "undertaking," but it has been found, in the context of European anticompetition law, to encompass any entity engaged in an economic activity. *See, e.g.,* Case C-41/90, *Hoefner v. Macrotron GmBH* , 1991 E.C.R. I-01979.
4. Judgment of the European Court of Justice of 28 Apr. 1998, Case C-306/96, *Javico Int'l v. Yves Saint Laurent Parfums SA,* 1998 E.C.R. I-01983.
5. Article 3 of Council Regulation (EC) No 1/2003 of 16 Dec. 2002, on the implementation of the rules on competition laid down in EC Treaty arts. 81, 82, 2003 O.J. (L 1) 1 (EC).
6. *See* note 2 *supra.*
7. Judgment of the European Court of Justice of 24 Oct. 1996, Case C-73/95P, *Viho Europe BV v. Comm'n*, 1996 E.C.R. I-05457.
8. Judgment of the European Court of Justice of 13 July 1966, Joined Cases 56/64 & 58/64, *Établissements Consten S.à.R.L . v. Comm'n*, 1966 E.C.R. 299.
9. Judgment of the European Court of Justice of 14 Feb. 1978, Case 27/76, *United Brands Co. v. Comm'n,* 1978 E.C.R. 207.
10. Article 23(2) of Council Regulation (EC) No 1/2003 of 16 Dec. 2002, on the implementation of the rules on competition laid down in EC Treaty arts. 81, 82, 2003 O.J. (L 1) 1 (EC).
11. Judgment of the European Court of Justice of 20 Sept. 2001, Case C-453/99, *Courage Ltd v. Bernard Crehan*, 2001 E.C.R. I-06297.
12. *Id.*
13. French C. Com. arts. L.442-1 to L.442-10.
14. Commission Regulation (EC) No 2790/1999 of 22 Dec. 1999 on the application of EC Treaty art. 81(3) to categories of vertical agreements and concerted practices, 1999 O.J. (L 336) 21 (EC) (hereinafter sometimes referred to as the "Exemption Regulation").
15. Commission Regulation (EC) No 1400/2002 of 31 July 2002 on the application of EC Treaty art. 81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector, 2002 O.J. (L 203) 30 (EC).
16. Exemption Regulation, note 14 *supra,* art. 3.
17. Guidelines on Vertical Restraints, 2000 O.J. (C 291) 1.
18. In July 2009, the European Commission launched a public consultation on the review of the Exemption Regulation, note 14 *supra,* (among others), which is due to expire in May 2010, and of the corresponding Guidelines on Vertical Restraints, note 17 *supra.*
19. Draft Commission Notice (Guidelines on Vertical Constraints), available at http://ec.europa.eu/competition/consultations/2009_vertical_agreements/draft_notice_en.pdf (last visited on 7 Jan. 2010).
20. Decision No 06-D-24 of the French Competition Council of 24 July 2006, Festina France, available at http://www.

autoritedelaconcurrence.fr/pdf/avis/06d24.pdf (last visited on 11 Dec. 2009).

21. This possibility of exemption is only mentioned by the draft Guidelines on Vertical Restraints.
22. Lamy Droit Economique 2009, point 4074.
23. Judgment of the Court of First Instance of 7 October 1999, Case T-228/97, *Irish Sugar plc v. Comm'n*, 1999 E.C.R. II-02969.
24. Lamy Droit Economique 2009, point 4485.
25. French C. Com. art. L.442-6 (5).
26. Lamy Droit Economique 2009, update under point 4033; Versailles, 14 Oct. 2004 (Droit et patrimoine 2005.116).
27. The effect of this clause might be frustrated by French C. Com. art. L.622-13, which provides that notwithstanding any contractual provision, no termination of an ongoing contract may be the result of the opening of insolvency proceedings alone.
28. French C. Com. Art. L. 442-6.
29. Lamy Droit Economique 2009, point 4016.
30. Lamy Droit Economique 2009, point 4291.
31. 1986 O.J. (L 382) 17 (EEC) (hereinafter , the "Commercial Agents Directive").
32. *Id.* art. 1.2.
33. Michael J. Dean, *International Distribution Overview of Relevant Distribution Laws: Europe*, § 7.2 (Mar. 2007), available at http://www.lexisnexis.com/documents/pdf/20080428113839_large.rtf (last visited 11 Dec. 2009) (hereinafter "Dean").
34. "Self-employed" means that the agent is not an employee.
35. Dean, note 33 *supra,* § 7.4.
36. Commercial Agents Directive, note 31 *supra,* art. 17.3.
37. Commercial Agents Directive, note 31 *supra,* art. 17.2 (a).
38. Commercial Agents Directive, note 31 *supra,* art. 17.2 (b).
39. Judgment of the European Court of Justice of 26 Mar. 2009, Case C-348/07, *Turgay Semen v. Deutsche Tamoil GmbH,* available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62007J0348:EN:HTML (last visited on 6 Jan. 2010).
40. German HGB art. 89b.
41. French C. Com. art. L.134-12.
42. Lamy Droit Economique 2008, point 4097.
43. Lamy Droit Economique 2008, point 4098.
44. Commercial Agents Directive, note 31 *supra,* art. 18.
45. Lamy Droit Economique 2009, point 3692.
46. Commercial Agents Directive, note 31 *supra,* art. 19.
47. Judgment of the European Court of Justice of 9 Nov. 2000, Case C-381/98, *Ingmar GB Ltd v. Eaton Leonard Tech. Inc.*, 2000 E.C.R. I-09305.
48. Dean, note 33 *supra,* § 7.7.
49. Judgment of the *Bundesgerichtshof* of 11 Dec. 1958, BGHZ 29, at 83.
50. Judgment of the *Bundesgerichtshof* of 13 June 2007, BB 2007, at 1586.
51. BGE, 134 III 497.
52. Judgment of the European Court of Justice of 20 Sept. 2001, Case C-453/99, *Courage Ltd v. Bernard Crehan*, 2001 E.C.R. I-06297.
53. Exemption Regulation, note 14 *supra,* art. 5(b).
54. Lamy Droit Economique 2009, point 4033.
55. Judgment of the Court of First Instance of 23 Oct. 2003, Case T-65/98, *Van den Bergh Foods Ltd v. Comm'n,* 2003 E.C.R. II-04653.
56. Commission decision COMP/A.39.116/B2 – Coca-Cola of 22 June 2005.
57. Mémento pratique Francis Lefèbvre, Concurrence Consommation, 2009-2010, point 8180.
58. 2001 O.J. (L 11) 4 (EC).
59. Judgement of the European Court of Justice of 15 June 1976, 51/75, 1976 E.C.R. I 811.
60. Exemption Regulation, note 14 *supra,* art. 2 , 3.
61. Lamy Droit Economique 2009, point 4445.
62. 1989 O.J. (L 40) 1 (EEC).
63. Judgment of the European Court of Justice of 16 July 1998, Case C-355/96, *Silhouette Int'l Schmied GmbH & Co. KG v. Hartlauer Handelsgesellschaft mbH*, 1998 E.C.R. I-04799.
64. Lamy Droit Economique 2009, point 4917.
65. Lamy Droit Economique 2009, point 4290.
66. Lamy Droit Economique 2009, point 4277.
67. Cour d'appel de Paris, 15 Sept. 1992.
68. Cour de cassation, chambre commerciale, 22 Oct. 1996, *SA Bancherau v. Chronopost* (Bull. no. 261).
69. French C. Cons. art. L. 132-1.
70. French C. Civ. art. 1152.
71. Lamy Droit Economique 2009, point 4465.
72. French C. Civ. art. 1386-7.
73. *Id.* art. 2224.
74. The application contracts (sale contracts) may fall under the United Nations Convention on contracts for the international sale of goods, Vienna 11 April 1980, which determines substantial rules. If this convention is not applicable, for example, if it has been excluded, the applicable law should be determined by the Hague Convention of 15 June 1955 on the law applicable to international sales of goods (if the forum is in France, which has signed this treaty).
75. 2008 O.J. (L. 177) 6 (EC) (hereinafter, the "Rome I Regulation"). The name "Rome I" is used in order to distinguish it from Regulation (EC) no 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II), 2007 O.J. (L. 199) 40 (EC).
76. Rome I Regulation, note 75 *supra,* art. 3(3).
77. 2001 O.J. (L 12) 1 (EC) (hereinafter the "Brussels Regulation").
78. Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, signed on 27 Sept. 1968, 1972 O.J. (L 299) 32.
79. Brussels Regulation, note 77 *supra*, arts. 15 and 16.
80. Judgment of the European Court of Justice of 9 Dec. 2003, Case C-116/02, *Erich Gasser GmbH v. MISAT Srl*, 2003 E.C.R. I-14693.
81. Judgments of the European Court of Justice of 27 Apr. 2004, Case C-159/02, *Gregory Paul Turner v. Felix Fareed Ismail Grovit e.a.*, 2004 E.C.R. I-03565, and of 10 Feb. 2009, Case C-185/07, *Allianz SpA v. West Tankers Inc*, 2009 E.C.R. 1.
82. Judgment of the *Landgericht Mainz* of 13 Sept. 2005, *PrimaCom AG v. JP Morgan Europe Ltd*.
83. Judgment of the European Court of Justice of 10 Feb. 2009, Case C-185/07, *Allianz SpA v. West Tankers Inc.*, 2009 E.C.R. I-0000.
84. Judgment of the *Bundesgericht* of 8 Mar. 2006, ATF 132III389.
85. Judgment of the European Court of Justice of 1 June 1999, Case C-126/97, *Eco Swiss China Time Ltd v. Benetton Int'l NV,* 1999 E.C.R. I-03055.

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Overview of PRC Income Taxation of Resident Enterprises and Nonresident Enterprises

By Julie H. Cheng

I. Introduction

The Chinese income taxation of foreign direct investment, cross-border technology or trademark licensing, leasing and loan transactions, and other business activities of foreign companies (i.e., nonresident enterprises) in the People's Republic of China ("China" or "PRC") is now governed by the *Enterprise Income Tax Law of the People's Republic of China* (the "EIT Law"), its detailed implementing regulations (the "Implementing Regulations"), and tax circulars subsequently issued by the Ministry of Finance and/or the State Administration of Taxation (the "SAT"). The EIT Law was promulgated on 16 March 2007, and the Implementing Regulations were promulgated on 28 November 2007.

The EIT Law and the Implementing Regulations replaced the *Foreign Investment Enterprise and Foreign Enterprise Income Tax Law of the People's Republic of China* ("FIE&FE Tax Law") issued on 9 April 1991 and its implementing regulations issued on 30 June 1991.

II. Taxpayers

The taxpayers governed by the EIT Law are following:

- State-owned enterprises, collectively owned enterprises, privately owned enterprises, and foreign investment enterprises ("FIEs"), such as Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures and wholly foreign-owned enterprises.
- Foreign companies that do not have a place of effective management in China, but (i) are engaged in production or other business activities through a place or establishment in China, or (ii) although they do not have a place or establishment in China, derive income from sources within China.
- Other entities other than partnerships and tax-exempt organizations such as public schools.

III. Taxation of Foreign Investment Enterprises

Under the EIT Law, FIEs are subject to income tax at the rate of twenty-five percent (or a lower rate if they meet certain requirements under the EIT Law and its Implementing Regulations) on their net income from production or other business operations both inside and outside China. FIEs may obtain a foreign tax credit with respect to the income taxes they have paid to foreign governments on income from such foreign countries.

IV. Taxation of Nonresident Enterprises with a Place or Establishment in China

As defined in Article 2 of the EIT Law and Article 4 of the Implementing Regulations, the term "Nonresident Enterprises" refers to enterprises which were incorporated in a foreign country/jurisdiction and whose place of effective management is not located in China. However, these enterprises either engage in production or other business activities through a "place or establishment" in China, or derive "income from sources within China," even though they do not have a "place or establishment" for production or other business activities in China. Article 5 of the Implementing Regulations further defines the "place or establishment" to include a management office, business establishment, representative office, factory, site for extraction of natural resources, place where services are provided, site for operating a construction, installation, assembly, repair or exploration project, and the place of business of an agent who has the authority to sign contracts and exercises authority to conclude contracts on behalf of a Nonresident Enterprise.

Nonresident Enterprises which carry out business in China through a place or establishment therein are generally taxed on their profits generated from business activities of their place or establishment in China in the same manner as FIEs are taxed. However, unlike FIEs, Nonresident Enterprises would generally be subject to income tax on a deemed profit basis (generally, ten percent but may, in some cases, be up to forty percent of revenue), or in the case of PRC representative offices of Nonresident Enterprises most frequently on a cost-plus basis. The following subparts A through D of this Part IV describe the type of activities which are considered an establishment of a Nonresident Enterprise subject to Chinese enterprise income tax (and a five-percent business tax).

A. Representative Office

Under the EIT Law, the *Interim Regulations of the People's Republic of China Concerning Business Tax* and the *Interim Provisions Concerning the Levy of Consolidated Industrial and Commercial Tax and Corporate Income Tax on Resident Representative Offices of Foreign Enterprises*,[1] PRC representative offices of Nonresident Enterprises in China ("ROs") are subject to enterprise income tax (and a five-percent business tax) with respect to any of the following activities:

- Engaging in liaison activities, negotiations, and introductory services performed in China on behalf of clients of their head offices located outside of China.

- Conducting market surveys, collecting commercial information, and providing consulting services in China on behalf of clients regardless of whether the clients pay for such services on a retainer or other basis.
- Engaging in liaison activities and negotiations, intermediation and introductions in China on behalf of other companies.

However, an RO would be exempted from income tax (and business tax) (i) if the head office of the RO is a foreign manufacturer and the RO acts solely for its "head office," by limiting its activities to conducting market surveys, promoting the sale of head office's products in China, or performing other business liaison services for the head office; or (ii) if the RO earns income for services performed primarily outside of China on behalf of enterprises located within China.

- ROs in theory can be taxed using
- the "actual revenue and expense method,"[2]
- the "deemed profits method,"[3] or
- the "cost-plus method."[4]

But in practice, except for ROs of foreign law firms and accounting firms, most ROs have been taxed on a cost-plus basis, and it is difficult to obtain the tax-exemption status for ROs.

B. Consignment Sales and Service Centres

Under prior law, the General Taxation Bureau (now the SAT) of the Ministry of Finance, in a notice circulated on 6 October 1983, provided regulations concerning an independent operating establishment that was set up by a Chinese entity on behalf of a Foreign Enterprise where the business of that establishment consisted entirely or substantially of (i) selling goods on commission for a foreign enterprise (i.e., Nonresident Enterprise); or (ii) maintaining and selling spare and replacement parts for machinery and products sold by a foreign enterprise.

Such a business was taxable as an establishment of the foreign enterprise on its profits under the *PRC Income Tax Law Concerning Foreign Enterprises* (the "Foreign Enterprise Income Tax Law"),[5] and its operating income was subject to CICT, which is now replaced by value added tax and business tax. Although the Foreign Enterprise Income Tax Law was first replaced by the FIE&FE Tax Law on 1 July 1991 and subsequently the EIT Law replaced the FIE&FE Tax Law on 1 January 2008, the SAT has been following the same regulations in taxing consignment sales and service centers. Currently, there is no indication that such practice will change in the foreseeable future.

C. Management Companies

Under the Foreign Enterprise Income Tax law, the General Taxation Bureau (now the SAT) took the position that foreign management companies, such as hotel management companies, that obtain income from the provision of management services to enterprises in China were deemed to have taxable establishments in China and were subject to enterprise income tax on their profits and CICT on their gross revenue from such services. If such companies had difficulty in substantiating their net income, they could be taxed on deemed profit, which was to be determined by the tax authorities having jurisdiction over the place where the managed hotel is located at a rate of between twenty percent to forty percent of gross revenues.

The SAT has adopted the same approach in taxing hotel management companies under the FIE&FE Tax Law and EIT Law, subject to the permanent establishment ("PE") provisions under an applicable tax treaty.

D. Offshore and Onshore Oil Contractors

Under the Foreign Enterprise Income Tax Law, the offshore Oil Taxation Bureau ("OOTB," now part of the SAT) of the Ministry of Finance determined that foreign companies (including subcontractors) that carry out petroleum exploitation and/or provide operating services offshore were engaging in business operations in China and had taxable establishments. Also, foreign companies that contracted to exploit offshore petroleum resources were to be taxed on a deemed profit basis. The OOTB temporarily set that rate at ten percent of gross revenue or contract price.

The SAT has been following the same approach in determining whether a foreign company engaged in offshore petroleum exploitation operations is taxable in China. The same approach has also been used in the taxation of foreign companies engaged in onshore petroleum operations. These practices have continued irrespective of the change of the corporate income tax law in the past eighteen years or so. Where a bilateral tax treaty applies, the PE provisions under the applicable tax treaty have been followed in determining if the offshore or onshore petroleum exploitation or provision of services related to such activities would constitute a PE in China and thereby subject the Nonresident Enterprise to PRC enterprise income tax in respect of income attributable to such PE.

V. Taxation of Nonresident Enterprises Without Establishments in China

Under the EIT Law, Nonresident Enterprises without a place or establishment in China but deriving "income from sources within China" are subject to a withholding tax of twenty percent. However, the Implementing Regulations has reduced the withholding tax rate for outgoing dividends, interest, royalties and other passive income to ten percent.

The EIT Law has done away with the temporary withholding tax exemption vis-à-vis profits (i.e., dividends) distributed by FIEs to Nonresident Enterprises which were granted pursuant to Article 19(1) of the FIE&FE Income Tax Law.[6]

"Income from sources within China" of Nonresident Enterprises without a place or establishment in China typically includes the following:

- Profits (dividends) obtained from enterprises within China.
- Interest derived from inside China on deposits, loan, bonds, advance payments made provisionally on another's behalf or deferred payments.
- Rental on assets leased to and used by parties in China.
- Royalties generated by providing for use in China patent rights, proprietary technology, trade mark rights, copyright and other such rights.
- Earnings from assigning assets, such as buildings, structures and their auxiliary facilities and land use rights.
- Other income derived from inside China and stipulated as taxable by the Ministry of Finance and/or the SAT.

VI. Taxation Upon Liquidation

The EIT Law expressly provides for taxing, at normal rates, gains realized upon the liquidation of an FIE, based on the excess of AB where:

> A = the value of the assets of the FIE remaining after all its debts have been paid, and all retained earnings have been distributed to the investors,
>
> <u>Over</u>
>
> B = the amount of registered capital invested in the FIE by investors.

VII. Determination of Taxable Income

A. Basic Accounting Rules

Under the EIT Law and its Implementing Regulations, accounts must be recorded in the Chinese language (or in Chinese *and* a foreign language) and must be audited by public accountants registered in China. Enterprises must report taxable income on an accruals basis. Special provisions govern the realization and calculation of taxable income of enterprises that earn in-kind income.

For example, an enterprise that receives revenue form a cooperative joint venture in the form of products will be deemed to derive such revenue when it receives the relevant products. The amount of income so derived must be calculated either on the basis of the price at which the products are sold to third parties or by reference to the current market price of the same products.

Similarly, a Nonresident Enterprise engaged in cooperative oil exploration with a Chinese party is deemed to derive income when it receives its share of crude oil. The amount of its income must be calculated on the basis of a periodically adjusted price set by reference to the international market price of crude oil of the same quality.

B. Inventories

Inventories of merchandise, finished products, products in process, semi-finished products, raw materials and other goods must be valued at their historical cost, i.e., the actual costs the taxpayer incurred in acquiring the assets.

In accounting for inventory values, enterprises may select any one of the following methods:

- First in, first out.
- Last in, first out.
- Moving average.
- Weighted average.

Once a method of accounting for inventory has been selected, the method may not be changed arbitrarily. However, if an enterprise desires to change its method of inventory accounting, it may apply to the tax authorities for approval before the commencement of the tax year in which the change is to be implemented.

C. Depreciation

The depreciable basis is the historical cost. For purchased assets, the cost is equal to the purchase price plus transportation, installation and other related expenses incurred before the item is placed in service. For items manufactured or built by the taxpayer, the cost is equal to the actual expenditures incurred in the course of manufacturing or construction. In the case of assets contributed to capital by an investor, the depreciable basis is a reasonable cost determined on the basis of the age of the assets, the value agreed upon by the investors of the investee enterprise at the time of investment, and by relevant market prices.

Depreciation is generally to be taken on a straight-line basis and the residual value of fixed assets to be deducted from the acquisition cost of the assets before depreciation is computed. Under the FIE&FE Income Tax Law, taxpayers were required to deduct ten-percent residual value from their fixed assets. However, under the EIT Law, no specific percentage of residual value is mandated, so long as the chosen percentage is reasonable, given the type of fixed assets in question. In special situations where accelerated methods of depreciation appear to be appropriate or other modifications in the straight-line method are justifiable, an enterprise may apply for special treatment to the tax authorities having jurisdiction over the district where the enterprise is located, who in turn will relay the request to the SAT or its provincial counterpart for final approval.

The Implementing Regulation set forth minimum depreciation periods for certain fixed assets as follows:

- Twenty years for buildings and structures.
- Ten years for trains, ships, machines, mechanical equipment, and other production equipment.
- Five years for electronic equipment and means of transport other than trains and ships.

Depreciation begins with the month in which the property is placed in service, and ends with the month after the property is retired.

The EIT Law does not appear to alter previous practice regarding the depreciation attributable to fixed assets that constitute part of a joint venture's registered capital (the "Registered Capital"), where such assets have been contributed directly to the Registered Capital or were bought or constructed using funds contributed to the Registered Capital. Thus, funds attributable to such depreciation may not be withdrawn from the joint venture and used to repay the participants' capital investment until the end of the joint venture term. However, depreciation recovered on fixed assets purchased using loans may be used to repay such loans.

D. Amortization

Intangible assets, such as patents, proprietary technology, trademarks, copyrights and land use rights, are assessed on the basis of their original cost, subject to a condition of reasonableness, and may generally be amortized using the straight-line method according to the useful life set forth in the agreement providing for the transfer of such assets. Where no useful life is provided for, or where an enterprise itself develops intangible assets, the period of amortization may not be less than ten years.

Reasonable exploration expenses of an enterprise engaged in the exploration of petroleum may be amortized in stages against the revenue derived from oil fields in commercial operation, although in no event may the period be less than one year.

E. Start-up Costs

Under the FIE&FE Income Tax Law, expenses incurred during an enterprise's period of preparation could be amortized in stages from the month following the month in which operations commenced. The period of preparation was deemed to begin on the date on which approval is granted for preparation of the enterprise until the date of commencement of production and business operations (including trial production and operations). The minimum amortization period for the start-up costs was five years. It is not clear under the EIT Law and its Implementing Regulations whether the practice of allowing amortization of start-up costs will continue.

F. Non-deductible Items

The following items are not deductible in computing taxable income:

- expenditures incurred on the acquisition or development of intangible assets;
- interest on capital;
- income tax payments;
- fines for illegal operations and losses resulting from the confiscation of property;
- overdue tax surcharges and other tax penalties;
- donations and contributions other than those listed under the EIT Law;
- payments made to sponsor sports and other events;
- provisions made without the prior approval of the tax authorities;
- management fees paid to another enterprise; and
- other expenditures not related to production or business operations.

There are also limits which depend upon the net sales and operating revenue of an enterprise, on the amount of entertainment expenses that may be deducted.

G. Deemed Income

If an enterprise is unable to submit complete and accurate evidence of its costs and expenses and to accurately compute its taxable income, the local tax authority will compute the enterprise's taxable income by using a profit rate determined by reference to the profit level of other enterprises. The deemed profit rate has been used for small private enterprises and representative offices or other establishments of Nonresident Enterprises in China.

H. Capital Gains

As under prior tax laws, no special tax treatment is allowed for sales of capital assets, sales of shares or ownership interests in another enterprise, or sales of property used in a trade or business.

I. Loss Carryforwards

Losses may be carried forward for up to five years. However, no loss carrybacks are allowed under any circumstances.

VIII. Transfer Pricing and Other Special Tax Adjustments

In addition to introducing the new concepts such as cost sharing, foreign controlled foreign corporations, thin capitalization and general anti tax avoidance, Chapter 6 of the EIT Law re-codified transfer pricing provisions and mandated contemporaneous documentation requirements.

A. Transfer Pricing

Article 41 of the EIT Law authorizes the tax authorities to make "reasonable adjustments" if the business dealings between two "associated enterprises" were not conducted in accordance with the "arm's length principle," thereby causing the taxable income of either of the associated enterprises to decrease. It further requires that when calculating their respective income tax payable, "associated enterprises" shall use the "arm's length principle" to allocate expenses incurred in joint development or purchase of intangible assets, or in joint provision or receipt of services. Article 43 of the EIT Law mandates that enterprises are to provide information regarding transactions with "associated enterprises," by filing annual transfer pricing information returns together with their annual income tax returns.

The term "Associated Enterprises" is defined in Article 109 of the Implementing Regulations as a company which (i) directly or indirectly controls, or is controlled by, another company in respect of another company's funds, business operations, or sales and purchases, etc.; or (ii) is controlled along with another company by a common third party; or (iii) has mutual interests with another company.

"Arm's length principle" is defined by Article 110 of the Implementing Regulations to refer to the fair transaction pricing that unrelated parties to a transaction would follow during their ordinary course of business.

If the tax authorities determine that transactions between associated enterprises are not conducted at fair market prices, the authorities are empowered by Article 111 of the Implementing Regulations to adjust the prices and resulting revenues according to the following methods:

- Comparable uncontrolled prices.
- Resale price.
- Cost plus.
- Transactional net margin.
- Profit split.
- Other methods.

The acceptable methods adopted by China are the same as those prescribed in the OECD guidelines, including the Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, Profit Split Method, and other methods that are consistent with the arm's length principle. The Chinese transfer pricing regulations do not prescribe any hierarchy of methods, instead requiring selection of the "most reasonable method," in contrast to the OECD guidelines, which establish a hierarchy in which methods should be considered.

The most direct way to establish whether the conditions made or imposed between associated enterprises is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises. Consequently, the Comparable Uncontrolled Price Method should be used whenever possible. If the Comparable Uncontrolled Price Method cannot be used, the guidelines state that the other traditional transaction methods, the resale price and cost plus methods, are preferable to the other methods.

B. General Anti-tax Avoidance

Article 47 of the EIT Law provides that the tax authorities have the right to make reasonable adjustments if an enterprise carries out a business arrangement with an "unreasonable commercial purpose," thereby reducing its taxable income. An "unreasonable commercial purpose" is further defined by the Implementing Regulations as having the objective of avoiding, exempting or delaying income tax payment.

The tax authorities may initiate investigations of enterprises which are suspected of engaging in tax avoidance activities such as:

- Abuse of preferential tax treatment;
- Abuse of tax treaties;
- Abuse of a company's corporate structure;
- Transacting with companies registered in a tax haven to avoid taxes; and
- Other business arrangements without bona fide commercial purposes.

IX. Avoidance of Double Taxation

Under Article 24 of the EIT Law and Article 17 of the Implementing Regulations, if an FIE invests in another enterprise in China, dividends received from the other enterprise are excluded from taxable income. However, the FIE is similarly not permitted to deduct such investment from, or set off any expenses arising from such an investment against, its own taxable income in the current tax year.

X. Tax Consolidation

Two or more Chinese branches of a Nonresident Enterprise may file a consolidated tax return[7] under certain conditions. Like Nonresident Enterprises, FIEs and other resident enterprises are authorized by Article 50 of the EIT Law to consolidate profits and losses from various branches with those of the head office. However, given the conflict of interest between the local and central governments in collecting revenues from resident enterprises, as a compromise the branches and head office of enterprises are now required to file and pre-pay income tax to their respective competent tax authorities according to a formula determined by the SAT, and after the end of each tax year, the head office is required to file a consolidated income tax return with its competent tax bureau, settling the income tax payable for the entire tax year concerned.

XI. Investigation and Disputes

As under prior law, the tax authorities have the right to investigate the financial affairs, account books, and tax affairs of enterprises under the FIE&FE Income Tax Law; in the event of disputes on payment of taxes, a taxpayer has to first make tax payment and to later appeal to the tax authorities at a higher level. Likewise, a taxpayer must first exhaust administrative remedies before seeking judicial review of the decision of the tax authorities. However, the Chinese courts have not to date been extensively involved in resolving disputes between tax authorities and FIEs and other corporate taxpayers. It remains to be seen how effective the Chinese courts will be in resolving such tax disputes.

XII. Penalties for Non-Compliance, Tax Evasion and Tax Fraud

The EIT Law provides, in conjunction with the PRC Administrative Law on the Levying and Collection of Taxes and its implementing regulations ("Tax Enforcement Law and Regulations"), various penalties for not complying with tax laws and for tax evasion and tax fraud. The amount of penalties ranges from CNY 2,000 to CNY 5,000 for (i) failure to carry out tax registration; (ii) failure to set up and maintain books and accounts as required by the tax laws; and (iii) failure to submit to the tax authorities financial and accounting systems or methods.

The EIT Law, the Tax Enforcement Law and Regulations and the PRC Criminal Law also provide for penalties, administrative sanctions and criminal liabilities for underpayment of taxes and tax evasion. These penalties, administrative sanctions and imprisonment vary from a penalty of not more than five times the amount of tax underpaid or evaded to imprisonment of not more than seven years, depending on the seriousness of the violation.

Endnotes

1. The *Interim Provisions* were promulgated on 14 May 1985 under prior tax law and continue to be in effect, except that the business tax has replaced the Consolidated Industrial and Commercial Tax ("CICT"), irrespective of the implementation of an enterprise income tax law changed in 1991 and 2008, respectively.
2. Under the "actual revenue and expense method," an RO must report to the tax authorities its revenues and expenses for the tax period in question, supported by relevant contracts and expense vouchers and receipts; gross revenue is subject to a five-percent business tax and profits are subject to a twenty-five percent enterprise income tax.
3. Under the deemed profits method, gross revenues are subject to the five-percent business tax but profit is deemed generally taxable at ten percent of the gross revenues, and the deemed profit is then subject to enterprise income tax at twenty-five percent.
4. Under the cost-plus method, revenues are generally deemed to be 117.65% of the office's expenses for the tax period; a business tax must be paid on deemed revenue at the rate of five percent, and ten percent of the deemed revenue is subject to a twenty-five percent income tax.
5. This was the income tax law which applied to foreign enterprises (what are now called "Nonresident Enterprises") from the late 1970s through the end of June 1991.
6. Article 19 of the FIE&FE Income Tax Law provided that generally a twenty-percent withholding tax would apply to payments of certain types of income from PRC enterprises (which would include FIEs) to foreign enterprises without an establishment or place of business in China. However, Art. 19(1) of the FIE&FE Income Tax Law entirely exempted from withholding tax dividends paid by an FIE to its foreign investor.
7. Although a group of companies is not allowed to file a consolidated tax return.

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The Tax Regime of Singapore

By Pieter L. de Ridder

I. Introduction

This article will discuss the aspects of the tax law of Singapore associated with a company incorporated in Singapore and a tax resident of Singapore (hereinafter "Singapore Company") used as a regional base for investments in Asia.

II. The Singapore Income Tax Law

A. Onshore versus Offshore

The key charging section in the Income Tax Law of Singapore ("ITA") is Section 10(1)(a), which states that income tax is due on the income of a Singapore Company "accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of gains or profits from any trade, business, profession or vocation, for whatever period of time such trade, business, profession or vocation may have been carried on or exercised." Furthermore, subsections (d), (f) and (g) of Section 10(1) of the ITA provide that "dividends, interest or discounts" and "rents, royalties, premiums and any other profits arising from property" and "any gains or profits of an income nature not falling within any of the preceding paragraphs," respectively, are also taxable in Singapore if they are accrued or derived from Singapore or received in Singapore from outside Singapore.

Based on the wording of Section 10 of the ITA, a distinction has to be made between income that is "accrued in or derived from Singapore or received in Singapore from outside Singapore," which is commonly referred to as "onshore sourced income," on the one side, as opposed to income that is not accrued etc. in Singapore in the abovementioned sense, which is referred to as "offshore sourced income." Onshore sourced income is taxable income in Singapore, whereas offshore sourced income is not taxable in Singapore.

B. Capital Income versus Trading Income

Another distinction that has to be made in Singapore is that income that has a capital nature ("capital" income) is not taxable, whereas income that is part of the business of the Singapore Company (referred to as income of a "trading nature") is taxable income. For completeness it should be noted that income that is of a *trading nature* will not be taxable in Singapore if it is offshore sourced income. Similarly, income that is of a *capital nature* (capital gains) will not be taxable even if it is onshore sourced income.

The distinction between "capital" income (non-taxable) and "trading" income (taxable) deserves special attention. If a Singapore Company would sell shares of a subsidiary company or stock of another company, the resulting profit, if any, could be considered "trading income" and thus taxable, if the Singapore Company would have bought the shares or stock with the intention of selling it at a profit, regardless of how long the Singapore Company might have owned these shares. Similarly, if the Singapore Company would not have earned any significant dividend income from these shares or stock, there will be a presumption of an intention to sell at a profit in the abovementioned sense. What may also matter is how the Singapore Company will have financed the purchase of the shares or the stock. A high degree of debt funding may strengthen the notion that the shares were purchased to make a profit on the sale, thus exposing the sales profits to income tax in Singapore at the normal income tax rate.

C. Tax-Exempt Income and Tax Incentives

Section 13 of the ITA contains various items of income which are specifically exempted from income tax. Within the context of this article, Sections 13(8) through 13(11) of the ITA are relevant, since they provide for income tax exemption on foreign dividends, foreign branch profits, and income from service fees (thus non-interest income) earned by a Singapore Company—provided the pertinent conditions, discussed below, are met.

Furthermore, Section 13(12) of the ITA provides for a discretionary exemption from tax of income earned by a Singapore Company if it is considered in Singapore's interest to do so, as determined by the Singapore authorities. The income tax exemptions under Section 13 of the ITA apply regardless of whether the foreign income is remitted to Singapore, whereas foreign-sourced income of a revenue nature which falls outside the scope of Section 13 would become taxable income once the income is remitted to Singapore or if it is deemed pursuant to Section 10(25) of the ITA to have been remitted to Singapore.

The Singapore government offers a number of tax incentive schemes that may apply to the Singapore Company if it meets the pertinent substance requirements. The substance concerned would typically relate to a certain amount of annual operating expenditures incurred in Singapore (referred to generally as Total Business Spending, or "TBS"), the employment of a certain number of experienced personnel to run the business, and a qualifying number of services or types of investment carried out by the Singapore Company. The tax incentives could range from a reduced income tax rate to a temporary exemption from income tax, and would apply for a certain period of time only (generally between three and five years), but may be renewed afterward provided additional substance is created or generated in Singapore. The tax incentive would typically have to be negotiated with the Singapore government.

As noted above, Section 13 of the ITA contains a number of specific income tax exemptions. On 21 May 2003, the IRAS published a tax circular, "Tax exemption for foreign sourced dividends, foreign branch profits and foreign sourced service income," in which it stated that foreign dividends, foreign service fees and foreign branch profits are exempted from income tax in Singapore, even if remitted to Singapore, provided that all the following conditions are met:

- The headline income tax rate (defined as "the highest corporate income tax rate of the foreign jurisdiction" in the year that the income is earned) must be at least fifteen percent.
- The income earned in that foreign jurisdiction must have been subjected to tax in that jurisdiction.
- If the Singapore Company would have a branch in the foreign jurisdiction, the profits of the branch must qualify as "profits from a trade or business carried on by the foreign branch, which does not cover non-trade or non-business income, such as interest income or royalty income."

III. Certain Aspects of the Singapore Tax Regime

A. Generally

Section 14 of the ITA stipulates that all outgoings and expenses wholly and exclusively incurred by the Singapore Company in the production of taxable income will be tax deductible against any taxable income earned by the Singapore Company. If expenses are of a capital nature, they are generally not tax deductible. If the income earned by the Singapore Company is investment income and not income from a trade or business, then certain limitations exist under the ITA in respect to the deductibility of expenses.

The current income tax rate applicable to the Singapore Company on its taxable income is seventeen percent.

B. Withholding

Dividends paid by the Singapore Company to its shareholders are not subject to withholding tax in Singapore, regardless of where the shareholders are located and regardless of whether the dividends are paid out of taxable or non-taxable income of Singapore Company.

Pursuant to Sections 12(6) and 12(7) of the ITA, certain payments made by the Singapore Company would be subject to withholding tax in Singapore if these payments are derived or deemed derived from Singapore. This would apply to interest, royalty, rental payments to non-resident taxpayers (i.e., overseas parties as well as foreign entities who have a taxable presence in Singapore) and payment of service fees in respect to management or technical services rendered to the Singapore Company, unless specifically exempted from withholding tax. The withholding tax rate is currently seventeen percent on service fees, twenty percent on director's remunerations and ten percent on royalties, unless reduced under a favorable tax treaty. The withholding tax rate is fifteen percent on interest and rental payments for the use of movable property in Singapore. These withholding tax rates are generally reduced under a favorable tax treaty between Singapore and the country of the recipient. If the payments can be attributed to an overseas branch office of Singapore Company, these payments would generally be considered outside the scope of the withholding tax provisions, on the basis that they would then generally not be "derived from Singapore."

C. Cross-Border Services

Based on the Singapore tax authority policy, any business profits earned by the Singapore Company will be considered offshore-sourced income only if and to the extent that these profits can be attributed to an overseas permanent establishment (PE) of the Singapore Company. The PE's jurisdiction must subject these profits to income tax in that jurisdiction, and income tax must have been paid in that jurisdiction on these profits. If any of these conditions are not met, the income earned by the Singapore Company will be treated as taxable income in Singapore.

Based on Section 10(25) of the ITA, foreign-sourced income will be deemed to have been remitted to Singapore if it is used to repay loans incurred in respect of a trade or business carried on in Singapore or if the overseas income is used to purchase movable goods which are brought to Singapore.

Based on Sections 50 and 50A of the Income Tax Act, the Singapore Company will be entitled to claim a tax credit against the income tax liability for any foreign withholding tax suffered by the Singapore Company on its foreign income. This would apply to overseas dividends, interest income, royalty income and service fee income. The amount of the credit is restricted to the amount of income tax due on that income in Singapore. Consequently, any excess foreign withholding tax cannot reduce the income tax liability on other income earned by the Singapore Company. Further, if the Singapore Company earns foreign dividend income that is not exempt from income tax based on either Section 13(8) or 13(12) discussed above, the Singapore Company will be allowed to claim a tax credit for the income tax suffered by the overseas company—provided the Singapore Company owns at least twenty-five percent of the overseas company. Tax treaties generally provide for a lower threshold in order to claim underlying income tax credit. In order to effect a tax credit, the Singapore Company would have to produce a residence certificate issued by the competent tax authority in the foreign country.

D. GST

Singapore levies a Goods and Services Tax (GST) at the rate of seven percent on services rendered in Singapore as well as on the importation or sale of goods in Singapore. Export sales are zero rated. Services rendered to parties outside Singapore are generally also zero rated unless the service can be said to "belong" in Singapore (e.g., if they relate to goods or companies located and in existence in Singapore). Services rendered by overseas parties to a Singapore Company would generally be out of scope for GST in Singapore, and thus also free of GST. Singapore's GST is a typical VAT-type system, where input GST is creditable against output GST unless the Singapore Company would engage in exempt activities. Financial services or purchases of stock or debt instruments are generally exempt activities/supplies and thus not subject to GST.

E. Capital Tax

There is no capital tax in Singapore. Neither is there a tax on the formation of a Singapore Company, aside from a nominal registration duty payable to the registry of companies (ACRA).

There is a stamp duty in Singapore on the purchase or sale of shares of Singapore-incorporated companies (which would be relevant if the shares of the Singapore Company itself would be sold or if shares of another Singapore incorporated company would be transacted). The stamp duty is due on the actual value of the stock/shares, unless the par value is higher, and is shared fifty-fifty between seller and purchaser unless it is contractually agreed that one party will bear the entire stamp duty. Qualifying internal reorganizations are exempted from stamp duty.

There is also a stamp duty on the sale of real property located in Singapore, including the transfer of rental agreements. The rate ranges between one and three percent, depending on the value of the real property transaction.

There is an annual Property Tax at the rate of ten percent on the value of the annual rent in the event a Singapore Company owns real property rented out to tenants.

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Taxation in India

By Shreya Rao and Parul Jain

I. Introduction

From the country's first comprehensive tax law, introduced in 1860, to the oven-fresh Direct Tax Bill, 2009, which is currently under discussion, Indian income tax law has come a long way. The periodic developments to the code reflect the gradual progression of the Indian economy—from a captive colony, to a politically independent but economically closed country ruled by the license Raj, to a free economy, predicted to be one of the fastest growing in the world. In this paper we analyze some of the salient features of the Indian income tax system.

II. Residence and Tax Liability

Income tax in India is governed by the provisions of the Income Tax Act, 1961 ("ITA" or the "Act"), as annually revised by the Finance Act enacted by the Parliament. In a cross border situation, it is also important to consider the impact of the several bilateral double taxation avoidance tax treaties ("DTAA") that India has entered into, which provide relief from double taxation.

Taxable units under Indian tax laws include an individual, a Hindu undivided family; a company; a partnership firm; an association of persons or a body of individuals, whether incorporated or not; local authorities and every artificial juridical person. The computation mechanism provides for classification of all income into five distinct heads, as applicable: (i) salary income; (ii) income from house property; (iii) business profits; (iv) capital gains; and (v) income from other sources. Taxable income is generally computed after deduction of expenses in accordance with the provisions laid down in the ITA.

Non-residents and residents are treated differently under the ITA, as a consequence of which the Act contains detailed rules for the determination of a taxable unit as resident or non-resident.

An individual is considered a resident in India for tax purposes depending upon the number of days of physical presence in India. In accordance with the provisions of ITA, three different residential statuses of an individual are possible, which determine the scope of taxation of the income in the hands of such individual. An individual can be (i) an ordinary resident, (ii) a resident who is not ordinarily resident ("RNOR"), or (iii) a non-resident.[1]

Companies are considered Indian residents if *incorporated* in India. A company incorporated outside India may be considered Indian resident only if the control and management of its affairs are situated wholly in India. The presence of the board of directors in India and the conduct of meetings in India are considered to be indicative of control in India.[2] An Indian resident company is subject to Indian tax on its global income. Partnership firms, "Associations of Persons," or a "Body of Individuals"[3] are considered resident in India, unless the entire management and control of its affairs are situated wholly outside India. Consequently, even a fraction of management and control of such entity in India would result in such unit being considered a tax resident in India and therefore liable to tax on its worldwide income.

Resident taxpayers are subject to tax in India with respect to their global income, while nonresidents are taxed in India on income received, accruing or arising in India, or deemed to have been received, accrued or arisen in India or from any source in India. An RNOR, on the other hand, is taxed in India only on his or her India-sourced income. Further, an RNOR is also taxed in India on income which accrues or arises to the RNOR outside India if it is derived from a business controlled in or a profession set up in India. The ITA also provides that a non-resident person or a company may also be taxed in India if it earns income from a "business connection" in India.

"Business connection" is the Indian domestic tax law equivalent of the concept of Permanent Establishment **(**"PE"**)** under a DTAA scenario. The term "business connection," however, has a much wider connotation. This term has been given an inclusive definition under the ITA to include any business activity carried out through a person, acting on behalf of a non-resident, who concludes contracts, secures orders and maintains a stock of goods and merchandise in India.[4]

The concept of permanent establishment is detailed in the DTAAs, which provide for the business of an enterprise of one country being carried out in the other country through a fixed place of business therein. With respect to a non-resident who is a resident of a country with which India has signed a DTAA, the provisions of the ITA apply only to the extent they are more beneficial.[5] India has an extensive network of DTAAs with approximately seventy-five countries, some of which, such as Mauritius, Cyprus and Singapore, serve as favorable tax jurisdictions for investing into India.

III. Corporate Tax Rates

Domestic companies and companies managed and controlled wholly in India are currently taxed at the rate of 33.99%.[6] Branches of foreign companies or foreign companies that are held to have a business connection or a PE in India are subject tax at the rate of 42.23%.[7] Further, when the income tax payable on total income is less than fifteen percent of the book profits of a company, the company is subject to the Minimum Alternate Tax ("MAT"). The effective MAT rate would be 16.995% for Indian companies[8] and 15.836 % in case of foreign companies.[9] An exemption from MAT may be available to entities located in or carrying on development of Special Economic Zones ("SEZ").

India recently passed legislation allowing for the creation of limited liability partnerships ("LLP"). LLPs in India are more like companies than their counterparts in other countries. Further, they are more tax efficient, since the tax rate applicable to them is 30.9%, and since they are (as partnerships) not covered by the MAT and the dividend distribution tax. The LLP Act allows for foreign investment into an LLP, but there is an ambiguity as to whether such foreign investment is allowed from an exchange control perspective. Clarity on the issue would be worth watching out for, since there could be several benefits to investing through an LLP structure.

IV. Dividends

Dividends are tax exempt in the hands of resident and non-resident shareholders in India. However, the Indian company declaring the dividends is required to pay an additional corporate tax called a Dividend Distribution Tax ("DDT") at an effective rate of 16.995%.[10] DDT creates a double layer of tax at the corporate level: after it is paid, the actual profit distributed to the shareholders of the company is reduced by almost forty-three percent.

Partial relief from the DDT is available in the event of intergroup transfers under a single-tier structure, where parent companies can claim deduction of the DDT paid by a subsidiary. However, companies with multi-tier subsidiaries continue to suffer the cascading effect of the dividend distribution tax. For example, foreign companies investing through intermediary entities may not truly enjoy the benefits of the DDT credit. It is important to note that the DDT is not a withholding tax. Hence the benefit of lower withholding tax rates provided under the DTAAs entered into by India with other countries would not be available. Furthermore, it may be difficult to obtain foreign tax credit for the DDT paid in India, since the DDT is paid by the company and may not qualify as "income tax" for credit purposes.

V. Interest

Interest is taxable at the rates applicable to income, i.e., 33.99% for residents and 42.23% for non-residents giving Indian currency loans. Non-residents enjoy a beneficial rate of 21.115% tax on interest on foreign currency loans and 10.558% on foreign currency convertible bonds. The tax is required to be withheld at the source by the resident payer at the time of making payment.

Interest is a tax-deductible expense for the Indian resident (e.g., the wholly owned subsidiary) only if the applicable tax has been withheld before making the payments to the non-resident. It is important to note that these rates may be reduced by making debt investments through a favorable jurisdiction such as Cyprus or Netherlands, since the DTAAs entered into with these countries provide for a lowered withholding rate of ten percent on interest.

VI. Royalties / Fees for Technical Services

Payments considered royalties and fees for technical services ("FTS") are taxed at the rate of ten percent, provided that the agreement was executed on or after 1 June 2005. Royalties / FTS pertaining to agreements executed prior to that date may be taxed at the higher rate of twenty percent.

The ITA contains elaborate definitions of both terms. However, it should be noted that, in the context of FTS, a different definition is contained in certain DTAAs entered into by India, such as the DTAAs with the U.S. and UK. The India-UK and India-U.S. DTAAs contain an FTS clause that requires the provider to "make available" technical knowledge, experience, skill, know-how or processes etc. in order for the payment to be considered FTS.[11] If the service fails to satisfy these criteria, the payment is considered business income and is taxable only where recipient of such services has an Indian PE to which the income is attributable. The DTAA position may thus be more beneficial than that contained in the ITA.

VII. Capital Gains

Capital gains are classified into short-term capital gains and long-term capital gains, depending on whether the asset sold is a long-term asset or short-term asset. Shares of a company, securities listed on a recognized stock exchange, and specified units of a mutual fund are treated as long-term capital assets if held for more than twelve months. In other cases, a long-term capital asset is one that is held for a period of more than thirty-six months.

Residents are permitted to avail themselves of indexation benefits in the case of sales of long-term capital assets (excluding debentures). Non-residents may compute capital gains in a foreign currency and take advantage of the exchange rate fluctuation. The tax rates applicable to capital gains are as below. It may be noted that these rates would differ depending on whether the security is traded off the stock exchange or on the stock exchange, with the payment of a securities transaction tax.

India's DTAAs enable the reduction of Indian capital gains tax in the event investments are made by a company organized in jurisdictions such as Mauritius, Cyprus and Singapore. The India-Mauritius DTAA provides that Mauritius retains the sole right to tax its residents on capital gains from the transfer of Indian assets. Since Mauritius does not currently tax capital gains, such gains would be tax exempt in India as well as Mauritius.

With regard to such structuring, it should be noted that tax authorities at lower levels often take an aggressive stand and deny treaty benefits to Mauritius-based companies. Recently, in the case of *E*Trade Mauritius Limited*, the tax authorities denied treaty benefits to the Mauritius company by disregarding an intermediate shareholding company in Mauritius. In another case involving Vodafone (discussed below in Part XII on Indian Judicial Developments), the existence of the Mauritius subsidiary was looked through entirely. Revenue authorities sought to levy tax on the transfer of a foreign entity between two non-residents, merely because of the presence of an underlying Indian entity. However, the Supreme Court of India has clarified in cases such as *Azadi Bachao Andolan*[12] that a Mauritius company is entitled to avail itself of the treaty benefits if it has been granted a Tax Residency Certificate by the Financial Services Commission in Mauritius.[13]

Set forth in Appendix A is a chart showing the various short-term and long-term capital gains rates for resident corporations and non-resident/foreign corporations.

VIII. Transfer Pricing

Globalization and technological developments have resulted in an increasingly strong network of multinationals around the globe, and it is estimated that over sixty percent[14] of world trade involves multinational enterprises. The consequent prevalence of cross-border transfers of tangibles and intangibles has induced most countries to enact aggressive transfer pricing regulations to mitigate erosion of their tax base.

The Government of India formally enacted transfer pricing regulations in 2001, largely based on the model proposed by the Organisation for Economic Cooperation and Development ("OECD"). These regulations prevent tax avoidance schemes involving transfers to nonresident group entities, by stating that cross-border transactions between associated enterprises are required to be on an arm's length basis.

The computation of "arm's length" payment remains a contentious issue. India does not yet have an advance pricing mechanism, although it has been proposed by the recent Direct Tax Code Bill, 2009 discussed below. Meanwhile, a specialized dispute resolution bench for transfer pricing has been set up at the level of the Commissioner of Income Tax, in order to aid expeditious disposal of such matters.

IX. Withholding Taxes

Indian withholding tax requirements apply on specific payments to residents (salary, rental payments, royalty, contractor fees, etc.) as well as taxable payments made by any person to non-residents. Tricky issues arise where the transaction involves two non-residents, since withholding tax requirements may still apply if the income is taxable in India. The revenue authorities tend to consider withholding tax obligations to be applicable to transactions between non-residents, but tax practitioners are increasingly of the view that a withholding tax provision is intended for administrative convenience and should not apply in such a scenario. In the recent times the Revenue has been taking an aggressive stance with respect to such withholding tax obligations. In the recent cases of Vodafone and E*Trade, the nonresident payors were directed to withhold taxes, failing which they would be considered taxpayers in default.

X. Tax Holiday

The ITA currently provides for direct tax incentives for areas classified as free trade zones ("FTZ"), software technology park ("STP"), special economic zones ("SEZ") etc. These benefits vary depending on the classification of the zone, and range from a deduction of one-hundred percent of profits and gains for the initial setup years, exemption from MAT, tax-free dividend benefits, indirect tax benefits, etc. Investors seeking to set up operations in India should explore the possibility of availing themselves of one of the numerous tax holidays on offer, especially for export-oriented undertakings and up and coming sectors such as biotechnology, software, scientific research, etc. It may be noted that some of these benefits, such as those applicable to STPs, may be done away with in the coming financial year.

XI. Advance Rulings

The litigation process in India can be drawn out and time-consuming. The advance ruling mechanism has proved vital in avoiding long, drawn out and expensive litigations and enabling non-residents to plan their Indian operations with certainty and precise knowledge of their Indian tax liability.

The mechanism provides that an application can be made to the Authority for Advance Rulings ("AAR") by non-residents, residents transacting with non-residents, and certain others who wish to seek clarity with respect to their Indian tax liability. The ruling can be sought for transactions undertaken or proposed to be undertaken, but not for purely hypothetical situations. An advance ruling cannot be sought where the question is already pending before any tax authority, tribunal or court, or involves determination of fair market value of any property, or relates to a transaction which is designed *prima facie* for avoidance of income tax. Decisions are required to be provided within six months after filing. The rulings are private in nature, but are considered binding on the applicant and the income tax authorities with respect to the transaction in question. However, they do carry persuasive value.

AAR rulings are considered final and there is no provision for appeal under the ITA. However, taxpayers are permitted appeal to the High Court by way of writ petition, or the Supreme Court may hear the appeal by way of a special leave petition (SLP). In both cases, courts retain the discretion to admit the application if they consider that there has been a violation of the taxpayer's rights.

XII. Indian Judicial Developments

As discussed above, revenue authorities of late have been taking an aggressive stance with regard to investments made through intermediary entities. Recently in the *Vodafone* case, claims were made in relation to a transfer among non-residents of an entity situated outside India, on the grounds that the transferred entity had underlying Indian shares. In this case, Hutchison Tele Limited, a Cayman Islands company, sold part of its wholly owned subsidiary, CGP Investments (Cayman Islands), to Vodafone International Holdings BV, a Dutch company. CGP Investments (Cayman Islands) in turn had the controlling interest in an underlying Indian company, Vodafone Essar Limited, into which investments were made through multiple other subsidiaries. Tax authorities alleged that the transaction was taxable in India since it involved the transfer of a controlling stake of an Indian company. If such a charge were to be upheld, it would raise questions as to the legitimate reach of India's extraterritorial jurisdiction. However, the case is *subjudice* and the position therefore is unclear.

Notwithstanding recent developments, it should be noted that the Indian judiciary does make an effort to be in consonance with international tax developments around the world. In the case of *CIT v. Visakhapatnam Port Trust*,[15] the judiciary re-emphasized the importance of paying due heed to developments in international tax, and relied on the OECD model to reach a conclusion. Similarly, in *Deputy Commissioner of Income Tax v. ITC*,[16] it was held that the Indian interpretation of a DTAA must be in consonance with the principles of international law. Therefore, while reading and interpreting a treaty, one must take into consideration the protocol and also the manner in which other DTAAs are worded and interpreted.[17]

The higher courts have also issued judgments differentiating between tax evasion and tax avoidance and held that tax avoidance is a legitimate way to plan one's affairs. The Supreme Court of India, in its landmark ruling in *Azadi Bachao Andolan*,[18] held that every transaction or arrangement with the effect of reducing the taxpayer's burden cannot be looked upon with disfavor. Taxpayers were held to have the right to place reliance upon an existing legal framework to plan their affairs.

It is hoped that Indian courts will continue to pay heed to international norms in cases such as *Vodafone*, and provide the taxpayer due relief from aggressive actions by the authorities.

XIII. Direct Tax Code Bill, 2009 and Concluding Thoughts

The provisions discussed so far belong to the ITA as it stands today. It is important to mention that the draft of a new tax code is currently under discussion. The Direct Tax Code Bill, 2009 ("DTC"), intended to reform the Indian tax system, has come under fire for the radical nature of changes proposed.

For example, the DTC proposes reduction of corporate tax rate to a uniform twenty-five percent, making no distinction between foreign and Indian income earners. However, the reduction is misleading, since the DTC also introduces an MAT at the rate of two percent on gross assets. No economic rationale is provided for using gross assets as a base, and no credit is provided for MAT payable by underlying group companies, which could create a cascading effect as gross "profit." It has been said that the MAT is to include investments as well. Moreover, the concept of carry forward of MAT credit has been done away with. In fact, contrary to the intentions behind the MAT scheme, even genuine loss-making companies would be subject to the MAT. Effectively the levy would work as a wealth tax on companies, and would negatively affect capital intensive enterprises.

Further, the capital gains tax rate has been increased from zero to thirty percent in cases of listed securities transferred by non-residents. A sudden rise in the capital gains rate by thirty percent is bound to create panic in the markets. Further, by treating capital gains from the sale of business capital assets as business income and differentiating such assets from investment assets, the Code has added another degree of complication to the consummation of mergers and acquisitions.

The bill also proposes a slew of measures aimed at anti-avoidance, including the general anti-avoidance rules (GAAR), which provide tax authorities with unfettered power to disregard or re-characterize transactions and reallocate income. Another controversial proposal is the "later in time" doctrine, which gives effect to the treaty or domestic provision, whichever is later in time. Currently Section 90 of the ITA allows the taxpayer to take refuge under the treaty provision or ITA, whichever is more beneficial. A later-in-time clause may render pointless several decades of Indian international tax jurisprudence and a wide network of over seventy comprehensive tax treaties.

Such aggressive provisions would not only frustrate legitimate instances of tax planning but would also force taxpayers into protracted litigation. The Code has widened the corporate residency threshold by providing that even part control or management of a foreign company in India would render it an Indian resident, which would then be subject it to taxation of its worldwide profits.

One wonders if the process of reform could be a balancing act between a range of divergent interests, or if it mandates such a marked departure from established law. The Indian economy today has the potential for tremendous growth and what it needs is a tax system that provides certainty for the taxpayer, ease of administration, and equity or fairness. Hopefully, we will soon see a more forward-looking version of the DTC.

Endnotes

1. ***Residents***: The ITA provides that an individual shall be a resident of India if he satisfies either of the two following criteria:
    a. He is in India for a period or periods amounting to 182 days or more in the previous year; or
    b. He is in India for a period or periods amounting to 60 days or more and has spent 365 days or more in the 4 years preceding the previous year.

    However, in the case of a citizen of India or a person of Indian origin who comes on a visit to India, the 60-day test has been relaxed and such person would be a resident of India only if he visits India for period or periods amounting to 182 days or more.

    Residents but Not Ordinarily Resident (RNOR): Even in a scenario where an individual qualifies as a resident under the criteria set out above, he may qualify as being an RNOR for tax purposes. A resident individual is an RNOR in any previous year if either of the following criteria is met:
    a. The individual has been a non-resident in India in nine out of the ten previous years preceding that year; or
    b. The individual, during the previous seven years preceding that year, has been in India for a period of, or periods amounting to, seven-hundred and twenty-nine days or less.

    Non-Residents: Any person who does not qualify as a resident would qualify as a non-resident for a particular year.
2. 110 TTJ 920(Delhi).
3. Association of Persons and Body of Individuals are concepts contained in the ITA, the definitions of which have been developed by Indian case law.
4. The Supreme Court of India, in a landmark ruling in *Commissioner of Income Tax v. R. D. Aggarwal* [(1965) 56 ITR 20 SC], enunciated the test for establishing the existence of a "real and intimate connection" between a resident and a non-resident. It was observed that a business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories that contributes directly or indirectly to the earning of those profits or gains.
5. Section 90 of the ITA.
6. This is inclusive of a thirty-percent basic tax rate plus a surcharge of ten percent and an education cess of three percent on the tax plus surcharge. [NDA—The additional tax is referred to as a "cess."].
7. This includes a forty-percent basic tax rate plus surcharge of 2.5 percent and education cess of three percent on tax plus surcharge.
8. This includes a fifteen-percent basic tax rate plus surcharge of ten percent and education cess of three percent on tax plus surcharge.
9. This includes a fifteen-percent basic tax rate plus surcharge of 2.5 percent and education cess of three percent on tax plus surcharge.
10. This includes a fifteen-percent basic tax rate plus surcharge of ten percent and education cess of three percent on tax plus surcharge.
11. Technical knowledge is considered to be "made available" only when the person to whom such services are rendered can further apply the same on its own.
12. 263 ITR 706.
13. This has been reiterated in cases such as *M/s Saraswati Holding Corporation Inc.* [ITA No. 2889/ Del./ 2007].
14. Neighbour, *Transfer pricing: Keeping it at arm's length*, OECD Observer (April 2002).
15. 144 ITR 146.
16. 82 ITD 239.
17. Similarly, in the case of *Daimler Chrysler India v. DCIT* [2009-TIOL-68-ITAT], it was held by the Income Tax Tribunal that, in a cross border tax issue, due regard must be paid to the manner in which the other country would treat a similar transaction.
18. 263 ITR 706.

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APPENDIX A

Particulars	Resident Corporations	Non-resident/ Foreign Corporations
Short-term capital gains arising on sale of shares and units of an equity-oriented fund on a recognized Indian stock exchange	16.995%*	15.836%*
Other short-term capital gains	33.99%	42.23%[1]
Long-term capital gains arising on sale of shares and units of an equity-oriented fund on a recognized Indian stock exchange[2]	0%*	0%*
Long-term capital gains arising on sale of shares and units of an equity-oriented mutual fund off a recognized Indian stock exchange	11.33%[3]	10.558%[4]
Other long-term capital gains	22.66%	21.115%

*Provided the applicable STT is paid.

Endnotes

1. 31.67% in case listed securities and 15.84% in case of unlisted securities held by a company registered as a Foreign Institutional Investor ("FII").
2. The income by way of the long-term capital gains shall be taken into account while calculating the book profits and income tax payable under the provisions applicable to Minimum Alternate Tax.
3. In case indexation benefits are availed of, the same will be taxed at 22.66%.
4. 10.558% in case of unlisted securities held by a company registered as an FII.

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