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PRACTICUM: FORM AND POLICY

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A Convenient Truth: Greenhouse Gas Project Finance

Editor's Note: The following is an edited transcript of the presentations made at the Annual Meeting of the International Law and Practice Section of the NYSBA on January 30, 2008.

I. Welcoming Remarks

JOHN HANNA: My name is John Hanna. I have the honor to be the program chair, even though a lot of the creative muscle for this program was performed by Andrew Otis and Mark Rosenberg, who are the co-chairs for this program.

Marco Blanco is also here to say a few words. He is the Chair-Elect for this section and will remain in that position for at least three hours. Then he becomes, of course, the Chair.

MARCO BLANCO: Welcome, everybody. We are very pleased today to have a very exciting panel. At first, this program may seem like a very narrow panel on environmental issues because the topic is relating to greenhouse gas project financing. But I think, as you'll discover, that this program is one that involves really all areas of law because, in addition to finance; it involves tax; it involves putting together projects relating to "Clean Development Mechanism" or CDM under the Kyoto treaty.

I would like to hand the floor over to the presenter and moderator, John Hanna, and his two co-chairs, Andrew Otis and Mark Rosenberg.

MR. HANNA: Several years ago in Amsterdam, when we had the panel meeting there, we had two panels going on simultaneously: one on Sarbanes-Oxley and one on emission trading. The emission trading panel was very lightly attended and Sarbanes-Oxley, as usual, was a sellout. I was very tempted to walk next door to the Sarbanes-Oxley presentation and say, "If you're really interested in Sarbanes-Oxley, you should come next door to the presentation on emission trading because there's $8 billion of this stuff sloshing around at this point in Europe. When that much money is sloshing around, you ought to be paying attention because somebody is wasting assets."

We thought we would do a little play on words with the title "Convenient Truth." The newspapers are full of news about climate change and there are going to be clients who are going to want to know whether you know how to use this stuff for real, practical purposes.

II. Overview

The following is just a quick thumbnail overview because we really want to talk about the mechanics of doing a deal, not all the climate-change background, but you do need to know a little bit.

In 1992, the U.N. Framework Convention on Climate Change was signed and ultimately went into effect, and the United States was one of the countries that signed and ratified it.

It was a generalized convention. There were no numerical targets and goals. Parties were supposed to develop greenhouse gas inventories; the parties were supposed to develop unspecific national programs to reduce greenhouse gas emissions; and the parties were supposed to develop unspecific efforts to mitigate climate change.

There were two groups of nations: the developed nations were designated in Annex I and the emerging nations designated in Annex II. And as I said, the United States was a party.

The Annex I nations have numerical greenhouse-gas-reduction targets and timetables under the Kyoto Protocol, which was to implement the framework of the convention. As you may know, the U.S. is not a party to the Kyoto Protocol. Obviously, a lot of companies and subsidiaries abroad can make use of some of the protocol advantages.

Now the basis for—practical basis for—having emission trading is that the greenhouse gases are 3 percent of the atmosphere, but they are worldwide. So the highest of the greenhouse gases is carbon dioxide or CO_2, but there are other greenhouse gases. For example, methane is a greenhouse gas. Methane is 21 times more powerful a gas for greenhouse gas purposes than CO_2. In other words, removing one ton of methane is the equivalent of removing twenty-one tons of CO_2.

The removal of one ton of CO_2 in China will benefit New York City and vice versa, and on that basis you can work out an emission trading scheme. Because if you save it in Colombia, the whole world benefits, and therefore that is a basis for working out a system of emission trading across Annex I countries and Annex II countries.

So emission trading schemes were put together as part of the Kyoto Protocol to assist the Annex I nations to meet their emission limits. To the extent that they had difficulty meeting emission reduction limits, they could buy credits from Annex II countries, in effect, from people who had a surplus of credits, and Annex I countries can use those credits to meet their limits.

So the purpose was to help the Annex I countries achieve their limits and also assist Annex II countries.

They would do this in a number of ways. There are two mechanisms that deal with having projects in Annex II countries. We are going to deal with just one of the two: the Clean Development Mechanism or CDM. The CDM is, in fact, one of four schemes dealing with tradable emission units. And in the CDM, the Annex I entity funds the Annex II project. The CDM is the focus of this discussion.

Now this looks very neat and simple, but my colleagues here will tell you just how complicated it is going to get. But right now, we will start simply.

You have a project design by a project entity. It might be an engineering firm, for example, that has a great new device for reducing carbon and wants to put it into effect. The project has to be validated. Now, there are a lot of acronyms around here. One is a "DOE" or Designated Operational Entity. That is basically the equivalent of an auditing firm, and it reviews the project design and the host country's involvement.

The host country acts through something called a "Designated National Authority," which is something like an EPA, that certifies the project application.

And the Designated Operational Entity or DOE validates that the project is designed to reduce carbon emissions and certifies such finding to the executive board of the CDM. The executive board, which is the CDM management body within the UN, formally accepts a validated project as a CDM project activity.

Let us assume that it is at that stage that our hypothetical negotiation takes place. There are yet no emission credits to be traded, but this is where we are postulating the negotiation occurs, and it is generally where it does occur.

Upon acceptance of the project by the executive board, it is a validated project. The project is built and operates, and it is monitored by the DOE, the Designated Operational Entity accredited by the executive board of the CDM. The DOE actually monitors to see whether the greenhouse gas emissions are being reduced. If they are, the DOE—the Designated Operational Entity hired by the project sponsors—certifies this to the executive board.

At that point the carbon emission reduction units or CERs are issued as the project participants wish to have them issued.

We are not talking about small amounts of money here. There were 890 CDM projects registered in 2007. A billion credits under CDM are expected to be issued by the end of 2012, which is kind of a magic number because that is when the Kyoto Protocol ends, at least as of now. But you can see how many India, China and Brazil have, which are the biggest ones. And fifty-three percent of the projects involve energy.

Now, we have put together a hypothetical. This is simplified, but it involves construction and operation of the facility. In this case, we have picked a landfill. A landfill generates methane. The project sponsors are going to put in equipment to collect the methane for flaring.

Now in the real world, you would not waste it that way; instead, you would use it for generating power for a plant or something like that, but we tried that and we decided that the program would only be three weeks long as opposed to three hours long today, so we decided to simplify it. So we are just going to flare the methane.

We are estimating perhaps 500,000 tons a year of CO_2 equivalent. This is methane, of course, and the cost would involve project development and capital and the initial startup.

Let us remember that we have to operate this thing and monitor it in order to certify that there are, in fact, emission reductions. Its current status is pre-registration. So that is where we are.

Now, what we are going to start with is the question as to what investors are concerned about. And we are fortunate to have two speakers with us. We have Elizabeth Sager from JPMorgan Chase, who has been in the energy trading business for a long time in different regards, and she will tell you about what JPMorgan is doing.

And we also have Claude Devillers, who will be talking about the business side of things. He has been involved in advising how to do these types of deals for a long time.

Elizabeth Sager will start and then Claude will join in.

III. Perspective of the Financing Entity

ELIZABETH SAGER: Good morning. Thanks very much. I am Elizabeth Sager; I have been with JPMorgan for two years, and I have been in the energy business for well over ten years. My background has been primarily in U.S. products. I was very much involved in the development of the SO_2 market here in the United States and also very much involved in the development of the physical power market here in the United States.

About a year and a half ago, JPMorgan decided to get involved in the carbon space. So I had yet another opportunity to develop another market, which is not just U.S.-based, obviously, but very much a global market.

There are many, many challenges which we will address during this program. This first presentation is intended to give you more of just an overview about why you might want to pay attention to all the panelists up here and to all the expertise they have to bring to the table. This is a very, very difficult, confusing, uncertain, intensive marketplace at this point. If you think that it is a passing thing, I suggest it is not. I think that it is very much here to stay.

I will give you some numbers at the end of the presentation about what we at JPMorgan see as the size of the business. But if it gives you any idea of how committed we are is to this and how we think it is going to be the next largest market in the United States and globally, let me note that, within the past twelve months, we have hired fifteen new team members. We actually now have about twenty new employees globally as we try to get our arms around how we can take the carbon space, create the product that the global community is demanding, and turn that into something that all of us out there can actually participate in and satisfy either compliance or voluntary needs to reduce greenhouse gases.

JPMorgan has an active energy franchise in general. But you cannot have an energy franchise in today's marketplace without also dealing with the issue of greenhouse gas reductions.

Allow me to make a side comment: While we might have twenty people in the space right now, it takes probably five to seven lawyers to deal with all the issues associated with those twenty people. At this point, it is extremely intensive on the legal side: with intensive due diligence-required. So if you are looking for possible application of existing skills, this is one area where you very much might find yourself well within your skills set. It takes a tremendous amount of expertise in many different areas of practice.

Now allow me to jump real quickly to an overview of the products. When I say that the market is not going anywhere, I mean it is only going to get bigger, and, hopefully, it will get more defined over time. But to give you an idea of some of the products that are currently being traded right now, there is a very active EU allowance (EUA) market in Europe right now. So there is much activity in this regard, and it is the largest market right now. EUAs are a significant product currently being traded in Europe, and JPMorgan is very active in trading the EUAs on the emissions trading market.

There is also another product we talked about earlier that is also a developing marketplace where we participate actively in development and emission allowances. In the United States, there is currently no compliance-type program but there are many organizations out there that are interested either in voluntarily doing something they perceive as being the right thing to do in this current environment or in anticipating future legislative changes where they would have to mandatorily reduce greenhouse gas emissions. There is therefore a market for a credit known as a "Voluntary Emission Reduction" or VER. JPMorgan is very active in that area as well. We try to help organizations develop and create these VERs and then help them market them to end users who are interested in voluntarily keeping their greenhouse gas emissions in compliance.

Another category, which is something that is also hugely active right now in the United States, is that of renewable credits. States throughout the United States have imposed obligations on certain utilities, requiring them to obtain a certain amount of their energy from renewable resources. These have always been a component but they have become much larger at this stage because there are not nearly enough available credits out there to satisfy the various states. Thus, there are active markets for renewable energy credits which we have been trading very actively for the past three or four years.

Let me give you an overview of why this is important and might be a topic that could change your future career if you are interested in it. JPMorgan estimates the size of the market for the EU-ETS marketplace, as of 2007, at about $75 billion. By 2010, we estimate that it will be a $250 billion market. For the other compliance-driven programs under the Kyoto Protocol, we currently see the 2007 numbers at about $850 million growing to a staggering $3 to 5 billion by 2012.

In North America—which, I note again, is a voluntary market at this point—we currently see the marketplace at about $100 million. It is relatively small but we see it growing in 2012 to $650 million. But if you start bringing in a compliance requirement, which is going to happen at some point, it significantly grows to a $300 to $500 billion marketplace.

Any of you who have tried to work with someone to develop a power plant in the United States know that you cannot have a conversation about development of a power plant without talking about greenhouse gas issues. This is the case because there is such a firm belief that there will be changes in the future. Thus, unless you also build this factor into your economics, you will not know where you are headed. So this has a huge overlapping effect on the entire energy policy in the United States.

I would like to conclude by saying that, if you look at the presidential candidates currently, it does appear that each of them has some idea of creating an energy policy that will require the United States to reduce its greenhouse gases by some percentage. Thus, while there is not currently a federal scheme, I think the anticipation is that in two or three years' time, we will certainly have some type of mandatory compliance program in the United States.

This concludes my overview. We will talk later about some of the issues one faces when actually trying to work with entities to create these emission credits or allowances, both as buyer and as seller. But I wanted to give you an overview of how committed I think JPMorgan is to believing that this is something that is going to get only bigger and be an integral part of energy policy globally.

MR. HANNA: I would now like to welcome Claude Devillers, who is the Managing Director of Merzbach Carbon Finance.

CLAUDE DEVILLERS: Thank you, John. Good morning. My name is Claude Devillers. As John said, I am the founder of Merzbach Carbon Finance. We were one of the pioneers in this market, together with the World Bank. We started in 2002. As you can hear, I have a little bit of a French accent—I was born and raised there but I live in this country.

I want first to thank the New York State Bar Association for the invitation. It is great to be here. Thank you, John, and thank you, Andrew, also for the invitation.

Today, I am going to try to concentrate more on the business issues that we have encountered and hopefully leave you with some thoughts about them.

Elizabeth and John have described the market. It is certainly a market that is now growing very fast. The first start-up period is ending, at least in the Kyoto space and Europe. It is very impressive to see a large player coming into the game, such as JP Morgan. Most of the other investment banks have beefed up their operations over the past year or year and a half. So we now have some serious players in this market. Equity is coming in, financing is coming in. But most importantly, it is a trading market. Let us not forget about that.

As was said before, it is a regulatory market, so we are talking about a regulatory process. It is a very specific one, intensive one. And I just want to point out something: Of the about 7,000 projects in the making today, only fourteen percent have been registered. This means that they have completed the regulatory process and are now in a position to obtain some kind of attributes eventually.

So when you think about it, there are not too many winners in this race. This number may increase, but the game is capped. There is a limit to the issuance of credits, which is defined by the buyers' side: Today, this is mostly the EU.

The number of projects that will be eventually entitled to attributes in the Kyoto space is a finite number, and most of them have already been done. You will see a number of small projects coming online now. This means that there will be more and more going through the regulatory process, and, therefore, the performance of the regulatory process itself is becoming an issue, since for many of these projects timing is of the essence.

The topic I am concentrating on today—financing—is actually the topic that my firm has been concentrating on since 2002. We have actually designed products to answer the need of certain projects and to also comply with the requirement of investors. So let me talk a little bit more about the financing side.

First of all, not every project needs financing. Many of the early ones actually have not had any need for financing, for mainly two reasons. The first reason is they were sponsored by a deep pocket, such as a large corporation, say Chevron-Texaco. For example, a U.S. company, through its subsidiary in Europe, needed to receive some attributes for compliance with the European regulations. They got involved in a project somewhere in Latin America, and obviously they did not need financing because their access to capital is much cheaper than any financing that anyone could offer today in the financing world.

To give you another example of a situation where no financing is needed, many of the first projects have involved the destruction of industrial gases. John mentioned methane, which is not an industrial gas. I am talking here about HFC_{23}, which is a byproduct of HFC_{22}, or I am talking about N_2O. Those gases are byproducts of industrial processes, either nylon for N_2O or refrigerants for HFC_{22} or HFC_{23}. Destroying one ton of one of these gases is the equivalent of a much larger amount (thousands of tons) of CO_2 destroyed. Therefore, the cash flow that you can obtain from the sale of those attributes is extremely large and comes fairly quickly. Thus, because you may have a deep-pocket sponsor or a cash flow that is achieved pretty quickly, those projects obviously are not in need of financing.

So, which projects are in need of financing? This has been a major question for the development of this market, and the answer is that most all the other types need financing. These are smaller projects, developed in countries where it is difficult to have access to liquidity and, more specifically, long-term capital.

The first project I worked on was in Bulgaria. And it was with the World Bank, which was the buyer. And the company involved was a quality company in Bulgaria but it had at the time absolutely no access to long-term capital. It would have had to post collateral somewhere in Western Europe to obtain, for example, a $2 or $3 million loan.

This is the first category of projects needing financing: those located in markets where there is no access to long-term capital.

The second category consists of those where there is no little or no experience or education in the area. And among the 7,000 projects that are being developed, you would be surprised to see that thousands of them are developed by local people who are entrepreneurs most of the time. The developer might be, for example, a landfill owner or landfill operator that has no understanding of what project financing is. This is a real problem in itself. Many of these developers have shallow pockets. So they need the equity; they need the mezzanine debt; they need the senior secured debt—depending on where they stand in the cycle of their project.

These are the types of project which, in my view and in my experience of screening and working with over 200 projects, are in need of financing.

I will now touch on certain points that may be of interest in regard to the terms of the financing.

First, what can a sponsor expect in terms of amount and terms for their financing? The financing itself is only the monetization of future cash flows and involves the appreciation or the assessment of the risks associated with obtaining this future cash flow. This is the gist of putting a certain amount on the table.

As will be discussed in more detail, the emission reduction purchase agreements or ERPAs, which are the "off-take" contracts for purchasing those attributes, are most often based on payment upon delivery. There is some down payment, but today the common basis is payment-upon-delivery. Thus, the monetization of those contracts becomes an important issue for these projects, and assessment of the risks associated with these projects is obviously the first task one might be asked to perform, and it is probably the most difficult one as well.

Allow me to give you the bottom line. We have found that about forty percent of the value of the ERPAs is the result of the discounting or the monetization of the future cash flows, if it is based purely on ERPAs.

There are a number of projects that have other sources of revenues, like power purchase agreements or PPAs, tipping fees, and so forth, which can add to the strength and enhance the capability to obtain financing up front. An ERPA-based project would involve, for example, a landfill flaring or even an industrial gas, or reductions in fugitive emissions in a gas pipeline network: In these cases one would be mostly concerned with ERPA, not PPAs.

Let me mention forms of financing other than non-recourse. What I have been talking about is non-recourse financing based upon contracts. You have other players in this market who are offering basically down payments or financing against a bank guarantee. In this way, they are simply transferring the risks to a bank. These types of financing usually require more up-front collateral, so that the guaranty can be extinguished as quickly as possible. It is not necessarily comparable to non-recourse financing.

You have therefore these two approaches in the market. We have been a proponent of the first one, but it's important to know that there is also a practice on the second one, the guaranty. It is extremely difficult to articulate anything as to how financing will be structured beyond the end of the Kyoto Protocol, which occurs in 2012.

Now let me touch on balancing the risk among the different contractors or different players in a project. First, who are the players? Well, you have, first of all, the local sponsor, who is expecting to have some kind of upside for the work it has performed. I am thinking of one project in West Africa where they have worked fifteen years on developing the project and, when they saw the Kyoto Protocol coming into effect, were so happy. This is just an illustration of how the local sponsor has usually invested a very significant amount of sweat equity in the project. Then, obviously, you have a buyer—a buyer who has carbon attributes, upon delivery, as I mentioned before. You have an equity investor; you have a debt investor. And obviously, you can have a mixture of these: Thus, the buyer can also be an equity investor. We have seen this many times. Thus, the roles there are not necessarily always one or the other. There can be a mix, and usually a mix of these different players is involved. If you think about it, everyone wants a piece of the action, and having a piece of the action in this case refers to the attributes.

An issue can arise when it comes to a shortfall in the production of attributes. Who is going to get the first one? Is it the local sponsor? Is it the equity investor? Is it the lender? How do you prioritize between all of these players? This involves a very important balancing act, and any resolution is only the result of negotiations, which can be among the most complex.

Talking about shortfall, I would like to give you a little flavor. When the first project that was ever registered, which is a landfill in Brazil, started reducing greenhouse gases, the level of reduction was about sixty to seventy percent below what was expected. Thus, there was a significant shortfall that needed to be matched. Moreover, how do you balance the situation among the different players so that your projects can continue operating and not everyone loses their investment? This has been consistently true. You have landfills, i.e., the destruction of the biogas through either flaring or sending it into a power generation unit, have been infamous for their first year. Generation has been very often in the forty percentile of what was expected and then only later ramping up. There are a number of reasons for this. There are, for example, very few good operators of landfills. Thus, having a quality operator is very important. The same has been true for dam projects, where recently one recent statistic indicates that the level has been, I believe, around thirty percent below what was expected, and the same has been true for wind farms. Basically, what the market is discovering is that we are facing the same issues that occur in project financing, which is in the context of hydro-projects, for example, will you have enough water? In the case of biogas, there is no real model, and therefore you are not sure of what you are going to get. Thus, there is a need for a significant buffer in this business.

With regard to recourse lending and guaranties, there are many legal ramifications here. We are talking about an asset, which is a mixture of regulatory regime and measurement, as we discussed before. There is nothing to that asset other than regulation and measurement. So, what constitutes the recourse? If I have oil, you know, I can

get a lien on the tanker. But if there is only an asset that consists of regulation and measurement, how do I have recourse?

The first important piece of due diligence review that must be completed is to determine who has the rights. This can be extremely complex: Is it the municipality for a landfill? Is it the operator? Is it another third party? A number of legal issues must be grappled with in order to get clarity as to title.

With regard to recourse, you also have an evolving process within a regulatory regime that may implicate different laws. Let us say you have a local project that is also under the UN. How does that work? If you are working in the JI space—JI consists of those countries that have a cap, like Russia, Ukraine and so forth—the attributes are issued by these states, not by the UN.

What is your recourse in regard to the entity that is issuing the attribute? If you are working under the UN, what is your recourse against the UN body? What is your recourse against an independent engineer that has accreditation with the United Nations and will eventually make its comments, which most often are accepted by the UN regulator? Is there recourse against it? I remember that was one of the first questions I asked back in 2004 in regard to a project and learned that there was a $500 million insurance policy to cover the problem.

With regard to collateralization prior to 2012, the situation is much like any other in terms of the collateral you would take, but again, you will have some difficulties because the assets themselves are usually embedded within other ones. Clearly, in this regulatory process, there are boundaries. Take, for example, a CDM project and assume it involves the destruction of an industrial gas, for example. Assume further that I put in a $2 or $3 million burner. Where is the burner located? It is in the middle of the plant. Where is the feed stock coming from? It is coming from the plant.

Basically, you have issues of ring fencing. You have a landfill and you have feed stock, which is basically the refuse from municipalities, and you are working on the landfill for flaring and then sending the gas to the power engines to create electricity and sell it into the grid. Then, suddenly, a smart guy comes along and announces that he or she is going to erect a composting unit using the same refuse. So instead of the feed stock being directed towards your landfill, it is now split or perhaps even switched entirely from your operating unit to another one. This illustrates that defining the collateral can be a daunting proposition and a very risky one.

In terms of security, I want to touch base on the system of registries. It is a very interesting system. Currently, the attributes on the buy side—meaning, for those who will use them either for their own compliance needs or to trade—need to be registered. And the reason why you cannot do it in the U.S., but you can for the Kyoto space. However, you have to do it in a place where you have registries. So Europe has the most advanced system of registries.

This system of registry is not a plain vanilla one. We are not talking about a New York Stock Exchange-type where contracts and procedures are standardized. The Dutch registry will be rather lenient but the German registry will require that, to register an attribute, there must be a letter from the German Ministry of Environment stating that it is in the interest of Germany that the project was compliant with such-and-such regulation and so forth. And the French registry is also different, as is the Spanish one. You need to comply with a different set of regulations for each registry. So it is not a plain-vanilla issue to register your attributes. Moreover, it is not easy to move the attribute between different registries. There is currently a system called the "Community Independent Transaction Log" or CITL.

These are a sampling of the different issues that you may find.

What I want to leave you with is the following. First, we are talking about all the difficulties of project financing and, because we are talking small side, of inexperienced sponsors. Second, we are talking about an asset that is not your usual asset; and, third, we are talking of an environment which is not entirely set yet and that will be reset in the near future.

It is a wonderful field for legal work, as Elizabeth was mentioning. There is a great need for due diligence. I want to leave you with the idea that this is not your plain vanilla trading that you have known so far.

Thank you very much for your attention.

MS. SAGER: If I can just add one thing to the presentation, which I thought was excellent. I mentioned in my introduction that I have been involved in the SO_2 market and the power market in the United States. When we were doing that, it was so much simpler than the development of this market because electricity is electricity. In the SO_2 market it was clear what it was that you were trading at that point.

My background has always been on the trading side, developing trading markets that are robust and certain, and that have liquidity. And you have to have that expertise to be in that marketplace. But there is something that neither I nor anybody else in this marketplace has ever faced: that is, defining what the attribute is and how it gets created. This is an entirely new element in this marketplace that I do not think has existed in any other trading market that I have worked on: What is it? What is an attribute? How do you create it? How do you know it exists? How do you know it is good? How do you know

it is real? That is just a huge issue for all of us to be able to tackle, because we are not going to be able to have a tradable product unless we have all the certainty as to what is an attribute. On a personal level, this is what I have been struggling with when I have been in the market. If you are talking to me about the trading issue, that is going to be easy. But I cannot tell you what an attribute is. It is a very complicated thing, and unfortunately, also a shifting, complicated thing. That is where all of us as lawyers need to apply our expertise to build a framework to create a very definite, known thing called an attribute.

I think you did a great job highlighting some of the risks associated with defining what that attribute is and the complexities and how you need a whole different skill set besides just a trading skill kit.

IV. Legal Aspects Relating to Emission Trading Agreements

MR. HANNA: Our next speakers are going to dive into the legal aspects of all of this. How do you negotiate emission trading agreements? Andrew Otis of Curtis, Mallet-Prevost, Colt & Mosle will lead that discussion, along with Ernesto Cavalier from Colombia. If you look at his educational background, he is truly internationally educated on virtually every continent and practices all over the globe. He is a wonderful member of this Section.

Andrew, would you please lead off?

ANDREW OTIS: Thanks, John.

I am Andrew Otis from Curtis, Mallet-Prevost, Colt & Mosle. I want to thank John Hanna who actually was my mentor when I was a summer associate in 1980, a long time ago, and John helped me get my start in environmental law.

I have been working on environmental issues since 1990, and greenhouse gas emissions since 1992 when I worked on President Clinton's Climate Change Action Plan at the EPA. Over the last five years, I have had the privilege of working with Claude Devillers and others on these sorts of transactions. We began with a wind farm in Mexico; we have dealt with transactions in Eastern Europe and in other Latin America jurisdictions.

I am going to talk, and Ernesto and I are going to double-team this aspect of the presentation, because as you can see it mixes both international legal issues with local legal issues.

What we are going to do is describe some of the mechanisms that have been developed to address the uncertainties identified by Claude and Elizabeth. They are by no means perfect, but they are at least a start. I am going to use as an example some forms that have been developed by some organizations that deal with these issues a lot.

The first is the World Bank. The World Bank Carbon Fund is a billion-dollar carbon fund, which, at least until recently, was the single largest buyer in this market. They really began the market. They put together a form that is what most of the market would consider very buyer friendly. We are also going to use as an example a form developed for CDM transactions by the International Emissions Trading Association. Both of these represent efforts to standardize what is really, in fact, a negotiated transaction.

There is always this tension—in this area particularly, and in trading these sorts of commodities, generally—between standardizing the terms of trade to facilitate trade amongst parties and negotiating the specific issues that parties interact with. You will see in this part of the market as compared to other parts of the market—for example, trades of the European emission allowances—that this area is more negotiated because it really does depend on project development and project finance.

Buyers often use their own particular types of forms. They may try to standardize them, but it is still a negotiated process.

What I am not going to address is that there is a secondary market for CERs, as Certified Emission Reductions are referred to, from these projects that get transferred to buyers from projects, and then buyers will transfer them between buyers or into funds. This is called the secondary CER market. And I am not going to talk about that very much because that is really more of a standardized commodity trade.

Both the World Bank and the International Emissions Trading Association (IETA) use what is called a brief form and then they back them up with terms. Many of you will recognize this from other commodities trading situations, where there is a recognized form and then there is a set of terms behind it. They have what you probably easily recognize as provisions that you would see in other agreements: definitions and key provisions. As I said, they try to standardize them but they usually do not.

I am going to go through these key provisions to give you a sense of their flavor. I am not going to try to discuss them in detail. You will see these in a lot of agreements, and you will recognize them. Elizabeth and Claude already raised questions about delivery and payment. We are going to throw in here a discussion of title, which does not necessarily appear explicitly in the agreements as a separate issue, although Elizabeth correctly identified it as a separate issue. And you will begin to see elements that would show up in other project transactions, such as project development and operation. Obviously, as a default, they are going to be key. Remedies are going to be very key, especially in regard to how disputes are resolved. Termination events are also very important, as is governing law.

And you are going to see that there are going to be various jurisdictions involved, with the project entity located in one jurisdiction, usually the off-taker in another jurisdiction, and the financing party being located in a third jurisdiction.

Because of the bifurcation of the Kyoto Protocol setup between Annex I countries and Annex II countries and the relationship between the two, where these parties are in these given jurisdictions has an impact on their rights and ability to operate under the Kyoto Protocol. As Claude said, what registers they use also matter. So I am just going to give you a flavor of these issues as we go forward.

Conditions precedent. Both IETA and the World Bank have an obvious condition precedent requiring host country approval of the project. This is a key provision in regard to getting the project registered with the CDM board and getting the project ultimately able to generate credits. Where in that process host country approval, project registration, project review, and ultimately CER issuance, occur and where in that process the ERPA is negotiated will influence what these conditions precedent look like because there is relative uncertainty in each process. The uncertainty decreases as you move down the process towards issuance of the credits. Once the credits are issued into the CDM registry and they have ability to move into other registries, the credits are almost like a commodity at that point. However, as you move through the process of host country approval and registration, whether the project will ultimately be approved has varying levels of uncertainty.

You can see here that the World Bank really operates more as a development entity by having a CDM operations plan. What they want the buyer to do is develop a plan for getting a project registered, having the project's credits reviewed by an independent third party, having them issued by the CDM executive board, and actually operating the project. They want to have this step-by-step plan that they have agreed to; it is their way of attempting to assure themselves that the project will actually be developed. It is a good due diligence process for determining the capability of the project developer to actually operate the project, and it is something that they can point to down the road: They can then say, here is your milestone, where are you in relation to this? It is a way of increasing their ability to control a project.

Delivery by seller. Again there is always, as you can imagine, a statement as to the amount of CERs to be delivered. The statement can either be expressed in the form of a number, in the form of a percentage of total production, or it can even be total off-take. In both of these forms, the buyer opts to be—and has the seller commit to allow it to be—a project participant before the CDM executive board. What this means is that, as far as the CDM executive board is concerned, the buyer is an official participant in the project and can receive credits into the buyer's account with the CDM registry.

I am going to talk a little bit more about who is the focal point of communicating with the CDM executive board, and that is important because the focal point actually issues the instructions to the CDM executive board. One of the issues you are going to find here is that this is a UN agency, and it is not really clear who can compel the agency to do anything in the event of a dispute. However, what we have tried to do, and we will talk a little about this in the roundtable, is to set up a contractual provision to be able to compel the focal point to issue instructions to the CDM executive board, as a way of at least getting some jurisdictional control over who is able to move the credits around, because the thing you need to keep in mind here is that the credits are the thing. The ability to control the credits in the regulatory process is really your security. So who controls where the credits go, who controls who interacts with the CDM executive board, is the key component to controlling who ultimately gets the money out of the project.

As you can see, there is again a difference between IETA and the World Bank. IETA is really designed to be a form the parties can use and modify, and it is buyer-favorable because IETA really consists primarily of buyers, but it has some balance to it.

The World Bank is focused on making sure the World Bank as a buyer is covered, so you can see there are many more options for the World Bank to control the flow of credits. They have the possibility of a nominee. They are representing a fund, and they are able to assign their ability to receive credits to their fund members. They build this into the contract so they do not then need the consent of the project party going forward.

Transfer of title. This is a key issue, and I cannot overemphasize how important this is. First of all, you have to determine who has title, and that is, in and of itself, an amazingly complex question because you have to determine which law governs title, as well as what is allowed to be titled under that law, how title moves under that law, and what this is under that law. For example, is it a general intangible? What kind of thing is it? How does it already fit into the already existing property statutes of a jurisdiction? Ernesto is going to talk about this aspect with regard to Colombia. Is there in the jurisdiction some regulatory system that has been developed to determine title to this? When does title transfer? I have seen agreements that try to bifurcate equitable and legal title, which even presumes that this thing can have equitable versus legal title, which, to me, is an unknown.

Obviously buyers want to take title unencumbered. However, lenders want to encumber title to ensure that they can secure their loan. However, the payment from the buyer is the key to funding the loan. So how do you

structure the transfer of title to deal with both the uncertainties regarding title and the encumbrance issues? Those of you who have done project finance before will recognize this as an issue. Because the CERs come out of a government agency, they create a little bit of a different issue here.

With regard to payment by the buyer, payment is generally transferred on delivery, but what is delivery? Is delivery one of your bifurcated pieces of title? Is delivery presence in an account? Is delivery control over the CER? Is delivery issuance by the CDM executive board of the CER? It will vary depending where you are in the process and what kind of project this is. But again, the key is not only to use this document but the regulatory structure of the Kyoto Protocol to protect the interests of your party.

You will see here that there are tax issues. Not only are there tax issues in the local jurisdiction—China, for example, has created tax issues around the issuance of CERs—but there are value-added taxes. Europe is a big buyer for this. It is one of the main buyer markets. How do the value-added taxes fit into this and who pays? Obviously, the World Bank does not want to pay value-added taxes and most buyers do not. Sellers do not want to pay them either.

Ultimately, there is an amount of money that represents these CERs when a person is willing to pay a purchase price for the amount of CERs generated. That amount of money has to satisfy all the parties. It has to pay the financing; it has to pay the transaction costs; and it has to pay the tax. So who pays the tax and what the applicable tax is are always issues.

The World Bank, like a lot of financiers, or lenders, does not want to pay its costs, so its costs get deducted out of that pot as well.

Verification and monitoring. This really comes out of this CDM market. And I am just going to run through this quickly. Verification is the independent process. The unique thing about the Kyoto Protocol is that the entity that determines how many CERs you get is an independent third party that has been certified by the CDM executive board. Thus, it is like an auditor. Basically, it is not as if you make entries in your books, like an accounting situation where you say what you think your earnings were and then an auditor comes in and says that he or she does not agree. Rather, it is what the auditor says it is. Therefore, who gets to determine this auditor is a key component. What their process is going to be is a key component. Who they report to is a key component.

Focal point. I talked about this above: Who communicates with the CDM executive board and what authority do those persons have? Can they go on their own? Do they have a veto power or do they need power of approval by another party?

Share of proceeds. Well, the CDM executive board does not exist for free so they take a chunk out of each transaction. The question arises as to whose payment that is coming out of.

Monitoring report. Who gets to issue the monitoring report? Who reviews and approves it before it goes to the CDM executive board? Each of these agreements deals with this slightly differently.

Project development and operation. Again, there is a difference here. The IETA form is more of a neutral agreement allowing parties to figure out who is going to do this. The World Bank form, while it provides that it is the obligation of the seller, really wants to be involved in project development. The World Bank wants to have step-in rights in the event the project does not operate the way it is supposed to. Whether they are going to exercise those step-in rights is another question. Who pays for the World Bank to exercise its step-in rights? The World Bank does not have a lot of landfill operators on staff. They do not have any hydro-electric engineers. As a result, they have to hire somebody like Mike Scott to run their project or tell them what needs to be done. Who pays for that?

Seller events of default. This involves a long list so I am not going to go through it. The key thing here is that IETA does not have delivery failure as a seller event default. They have it as a separate issue that needs to be dealt with, but the World Bank has it as a seller event of default.

These events of default are key. What gets listed here as an event of default will determine what happens when it all goes kerflooey, and it might go kerflooey because these projects have in the past.

Buyer events of default. You will notice a very short list on the part of the World Bank and a much longer list on the part of IETA. The World Bank, really, as long as they pony up the money, that is pretty much it. That is all they really want to be responsible for. They do not anticipate that they will be insolvent so they do not include that as an event of default.

Remedies. Here is an interesting opportunity. There is a market for CERs. There is a bit of a secondary market for CERs. It is a negotiated market, but there is one. If you do not produce the CERs, are you required to go into the market and make the buyer whole? At what cost? Does it matter at any cost? Even if you do that, is the buyer entitled to some sort of liquidated damages? You have to remember that this is a regulatory market. Thus, if your buyer is a compliance buyer and it missed its compliance deadline or its compliance capability because you failed to provide CERs or the buyer had to go into the market itself to cover, the buyer is going to incur costs and, in theory, if it did not get into the market fast enough or there was, for whatever reason, a lack of liquidity, it potentially

will also incur fines. Is the project operator who is short responsible for that?

The interesting thing about the World Bank is that they have this notion of allowing makeup delivery in the future. If you are short in one year because you could not get the project up and running properly that year or you just did not configure it right, you can try to ramp it up in the next couple of years and have a delivery.

Termination events. It is interesting here that both forms include, as force majeure, a host country withdrawing from the Kyoto Protocol. This is an interesting possibility, although we have not seen this occur thus far. Given that this whole thing is going to fall apart in 2012, or at least that there is no determined next step after 2012, you have to word the force majeure language so that the natural end that everybody can foresee is not necessarily a force majeure event.

Delivery shortfall. IETA has a set of buyer remedies that you can choose from. It deals with it outside the events of default, which I think is actually an interesting idea because it gives you a track to go down before you get into dispute resolution.

Governing law. You see a lot of these agreements trying to be governed by the laws of jurisdiction where dispute resolution is convenient. You see London; you see New York. Even though the US is not a party, you can still use U.S. law to resolve a commercial dispute. You see international arbitration as the preferred method of resolving disputes in these agreements. The World Bank uses UNCITRAL arbitration, and I have seen ICC arbitration. I have even seen arbitration using U.S. arbitration forms. The IETA program has this expert process chosen by IETA, which is a nice little sales plug for them.

There is no perfect form. All of the forms have to be modified. The World Bank form is a good form for an active buyer that wants to be actively involved in the development of the project. It is not so good for someone who just wants to get a CER out of the process and does not really want to be involved in the development of the project. The IETA form is a little more balanced. It is easier to deal with sellers using the IETA form, and it has that delivery failure mechanism that is helpful.

Neither of the forms deals with the post-2012 period: What happens after 2012? This is a real issue, and it is not only a risk, it is also an opportunity. Most of these projects will continue to operate after 2012. The emission reduction they started with will continue. They will be generating credits, and they will be generating credits in a period of time that, in theory, is less credit-constrained because there is an expectation, realistic or not, that after 2012, the total pie, the total cap on emissions is going to go down. When the supply of credits goes down, the price goes up. So if you have locked in an option for post-2012 at a 2008 price, you could be in good shape. However, you take the risk that, after 2012, these credits might not be valuable because the structure may have changed in the interim.

Also noteworthy is that the IETA form deals only with CERs. There are other emission reductions that are generated by these projects. Elizabeth mentioned verified emission reductions; they can be outside the CER process. How do you deal with those? Who has the rights to those? How do they get moved around? Who has the project documents? This is important because this is like the little intellectual property of the project. If the project does not end up getting developed because the money does not come through or the operator is an incompetent, or for some other reason, who has the ability to take these documents and try again?

The provisions in the World Bank form regarding changes in law are not that great, and the provisions in the IETA form relating to costs to be borne by the seller probably need to get tweaked a little bit.

V. Considerations of Local Law

That concludes my presentation. I turn the program over to Ernesto Cavelier for a discussion of local law issues. Thank you.

ERNESTO CAVELIER: Thank you for inviting me to this presentation. I really appreciate being here. And thanks again to the New York State Bar Association for the invitation.

I am going to talk first about the nature of these CERs. But before going to that, I wanted to mention to you that Mr. Yasuo Fukuda announced in Japan last week that Japan is willing to begin commitments for the period after 2012. That is very good and welcome news for all the Kyoto Protocol fans. And the U.S. will necessarily need to respond to that because of Japan's position.

I am going to make a basic presentation on contract law in Colombia. I will try to fit these agreements that Andrew just mentioned under Colombian law to see how it works. It is going to be relatively basic from the Colombian viewpoint, but that is really what we need to do.

Let me speak initially about the nature of these CERs. What are those documents? Colombian law divides property into two areas: corporeal and noncorporeal or intangible. CERs fall into the category of intangibles, except that there may be some type of real certificate issued at some point. But that is still to be seen. If we take a look at the Colombian Civil Code, we will then see that the way of transferring these CERs will be as a movable, whether they are corporeal or not.

Now the transfer of a movable under the Civil Code may be made by different ways, according to Article 754 of the Colombian Civil Code. One way is for the party

transferring it to put it at the disposal of the other party in the agreed place. Since there is a registry for these CERs, the seller may put the CERs in the registry at the disposal of the purchaser. And that's how the transfer of title would be done in relation to CERs. Consequently, the effective transfer of the CERs is made evident by the register that has been chosen or arranged by the buyer. There is a provision pursuant to which the seller of the CERs is committed to deliver the CERs, allowing one party to put the CERs at the disposal of the other in the agreed place, according to the Colombian Civil Code.

According to the Colombian Civil Code, the purchase contract is a contract whereby one party commits to sell the other party goods, and the other party commits to pay money in return for those goods. And if that requirement is not met, then we may be confronting a different contract: It may be a bartered contract or something else. Thus, in this case, in order for the ERPA to be purchased by contract under Colombian law, the payment has to be made in money, as it is the case for CERs. Then the sale would be considered perfected when the parties have agreed on the thing, that is, the CERs, and on the price. And then you have a perfected purchase contract for CERs under Colombian law.

In regard to the price, Article 1864 of the Colombian Civil Code states that the price in a sales transaction must be determined by the parties or by a third party. Both are possibilities under the ERPA agreements. In one case, there is provision for each of the parties to nominate one broker and for both brokers then to choose an independent third-party broker to make the decision on the price. This fits perfectly well within the provisions of the Civil Code in Colombia.

In regard to payment, there are questions related to where and in which currencies should payment be made. As you know, Colombia has exchange controls, and therefore, the regulations on how to bring money into the country must be followed. Thus, in the case of the purchase of CERs, the payment would probably be made in foreign currency and not in Colombian currency, especially if the buyer is a foreign country. We would face a different situation if the buyer were a Colombian company where we will not have exchange issues or be subject to exchange regulations. If the payment is going to be made to the Colombian company from abroad and the Colombian company has to bring this money into Colombia, the money will have to be converted into pesos. Now, the Colombian company may, if it so desires and if it is sophisticated enough, set up a bank account in foreign currency outside of the country, where the money can be received. This would also fall within the requirements of the Civil Code for receipt of payment.

The issue arises as to what happens if one of the parties breaches the contract. That means that either the CERs are not available at the time they should have been ready to be transferred to the buyer or the buyer does not pay. What are the rules on indemnification of damages under Colombian law? The Colombian Civil Code speaks about compensation for material loss and the loss of profit, whether or not it is due to a breach or lack of compliance or delay in compliance. There are several decisions by the Colombian Supreme Court in this regard. The main thing is that, depending on the level of negligence, the situation will be different. When talking about negligence and willful misconduct, it is going to be difficult to exactly fit these concepts into the definitions of negligence and willful misconduct under U.S. or British law. As you know, in civil code countries, we have maybe three levels of negligence, and gross negligence is equivalent to willful misconduct, which is called in Spanish "*dolo*." This is one of the highest levels of negligence in Colombia.

The Colombian Supreme Court has held that monetary compensation for damages is available only when the damage is direct and certain. Damages can only be compensated when they result as an immediate consequence of negligence. This means that there are no consequential damages in Colombia. All damages have to proceed as a direct and immediate consequence of the fault.

The jurisprudence or the case law in this area has also developed, and it provides that, according to Article 1616 of the Colombian Civil Code, even in the case of willful misconduct or *dolo*, as I had mentioned above, the debtor will not be liable for compensation of all damages, and this means that there is no liability for consequential damages if those damages are not direct and immediate. This has been confirmed by several commentators. But then Article 1616 goes on to say that a distinction has to be made between those damages that could be foreseen and those that could not be foreseen at the time of entering into the contract.

If the damages are caused by willful misconduct, then the party that is at fault is liable not only for those damages that could be foreseen at the time of the contract, but also for those damages that could not have been foreseen at the time of contract. This is the highest level of indemnification that the party who is at fault will have to cover. But I believe that there are no consequential damages according to case law in the Colombian Supreme Court.

I would like now to turn to dispute resolution. As Andrew mentioned, the model contracts provide for arbitration in different ways. If we assume then that the contract contains an arbitration provision, the question to be decided on for a contract in Colombia is whether to choose domestic or international arbitration.

Domestic arbitration is increasingly popular in Colombia, because of the long delays in Colombia's judicial system. Arbitration is a way to avoid these delays. One might be able to obtain an arbitration decision in perhaps less than a year while the judicial system in

Colombia may take several years to reach a decision in the first instance. It is said in Colombia the life of a lawyer is measured by the number of ordinary proceedings that he or she can actually pursue. A lawyer in Colombia might be able to pursue three ordinary proceedings since each one will take perhaps fifteen years—that is, from the time an ordinary proceeding is commenced until it is concluded in the Constitutional court, maybe fifteen years have elapsed. This is why domestic arbitration has become more and more the mechanism of choice for resolving disputes.

If domestic arbitration is chosen, then you have to bear in mind that, in civil cases, the award is subject or will be subject to annulment by the tribunal or superior court, and then a decision of the superior court may be subject to the famous extraordinary trial recourse before the Colombia Supreme Court. Thus, even though the arbitration itself is a relatively short process, the process may be longer because of the recourse or appeals that may be taken to the courts.

It is not always clear that the parties can choose international arbitration; it can only be done if certain requirements of the law are met. First, the parties must, of course, expressly agree on international arbitration in writing. Second, the parties have to meet at least one of the following conditions: The parties must have a domicile in different countries, for instance, Colombia and the United States, or the performance of the contract must be carried out in different countries: Maybe one party is in Colombia, and another party is in the United States, or perhaps the condition will be met if there is a reduction of emissions in Colombia and the other party is paying outside Colombia.

The other possibility is fixing the place of arbitration in a different country, for instance, Switzerland or even the U.S. or at the International Chamber of Commerce in Paris. The other possibility is that the subject matter of the arbitration involves interests of more than one country. This is clearly the case for a purchaser in a contract for CERs.

The advantages of international arbitration are, of course, the swiftness of the proceedings and the fact that Colombia is a party to the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, known as the New York Convention. But an arbitration award issued outside the country may be subject to the process of approval by the Supreme Court of Colombia, whereby it is certified that the award does not impinge on the public or the rules of Colombian law. Thus, it may take additional time for the award to be enforced by a Colombian court in case the party subject to the award does not willingly comply with it. In such case, you will have to initiate an executory process, whereby the court actually will be entitled and will actually seize the goods of the party subject to the award.

To conclude, the nature of the CERs is more than that of goods. Delivery by registration in the name of a purchaser will make the contract a valid purchase contract under Colombian law. In case of breach of contract, there may be remedies under Colombian law, and you can have recourse to domestic or international arbitration. And finally, and this point is very important, if the parties choose international arbitration, foreign laws may be agreed to in the contract as the governing law.

Thank you very much.

MR. HANNA: Elizabeth, do you want to respond at all to anything that Ernesto just said?

MS. SAGER: Nothing specifically, but just to the point that I was emphasizing before, where there is so much complexity in taking these products—whether they are CERS or VERs or any other acronym describing an attribute—and turning them into something for which all of the due diligence will not have to be done by the rest of the participants who, on a compliance basis or voluntary basis, are trying to do something to reduce their greenhouse gas emission, but rather turning them into a marketable, tradable product.

The legal issues, the regulatory issues, the performance issues, the change of law issues, the force majeure issues are integral to taking the unit-specific, project-specific attributes and ultimately turning them into something that is marketable to every party who either has to comply or wants to comply with reducing its greenhouse gas emission.

All of these are very difficult, legally intensive, due diligence-intensive, people-intensive, knowledge-intensive matters that will have to be addressed in order for this marketplace to develop. The complexity is even further highlighted by the projects that are not based in jurisdictions that you commonly deal with. So you very much have to understand the local laws when drafting these contracts. It is a unique opportunity, I think, for all of us.

MR. HANNA: Thank you. We have two more presentations before we get to the round table. The first one of those is on risk assessment, risk management.

VI. Risk Management

MR. HANNA: We are very honored to have Gary Guzy, who is an environmental lawyer. There are not too many of them in the Section, actually. Gary is really a certified environmental lawyer. He was the general counsel to the Environmental Protection Agency at one point and served in other senior positions in the EPA. He then was a senior litigator with the Department of Justice. So he has been very much involved with Marsh and determining how you insure these risks. You have heard some allusions to that. And Gary will now make it all simple and explainable and easily comprehensible. Good luck, Gary.

MR. GUZY: Thank you, John, and Andrew. If by being a certified environmental lawyer you mean that I am as reliable as a certified emissions reduction, maybe there are doubts about my capabilities. Welcome, everyone. I also appreciate the invitation to be here. I say that with some regret, because I notice your next meeting is actually in Stockholm, and I wondered why you invited me here rather than to that meeting, which seems a little unfair. But in any event, it is good to be here regardless.

I want to spend some time talking about risk management strategies that can be deployed to help to optimize the value in the transactions that we have been talking about. I think it will really build on many of the themes that you have been hearing this morning. It will highlight the challenges, the complexity and the critical importance of addressing those issues as much as you can up front.

Let me just take one second and tell you what Marsh is, because in some cases, for many people, it is really sort of the largest company that no one has ever heard of. We are the largest insurance brokerage and risk advisory company in the world. We are a division of Marsh & McLennan Company. Marsh & McLennan is still there. We operate in 100 countries worldwide. We work with roughly eighty percent of the Global 500 and thousands of other corporations in helping them to understand the nature of their risk and then develop strategies to manage that risk. Where that involves placement of insurance, we act as their broker to place that insurance.

What we do not do is we do not underwrite risk. We do not take it on ourselves. We place it with insurance companies in the market. We have been very determined about the responsibility of the insurance industry to elevate the level of dialogue and conversation and understanding around climate change and climate risk issues. For that reason, we now work with the World Economic Forum to highlight climate change as part of the Global Risk Network. We are a member of the U.S. Climate Action Partnership, which, as many you of know, is a leading coalition of some twenty-seven major companies, some six NGOs who are advocating for and developing responsible economy-wide U.S. greenhouse gas legislation that has cap and trade as its primary feature. We work with the Pugh Center on Global Climate Change, with the Clinton Global Initiative, and a partnership with the Yale School of Forestry in a series to train corporate directors on climate risk.

I think you are getting the idea that there is a strong commitment to enhance the level of understanding around these issues. We have been spending a lot of time on carbon market issues, on carbon capture and storage, some of the significant technology issues. And I think all of that has resulted in our recognition as a best-in-class company on the climate leadership index of the Carbon Disclosure Project.

But as we have been discussing, in some ways this is a very strange enterprise that we are all involved in. I mean, we do not have a commodity that you can go out, touch and hold, and know precisely what it is. We have a commodity that is influenced in all sorts of unusual ways that really impact the risk and heightens the risk in these transactions.

We have a commodity that is defined by a set of regulations. And you have heard something about how those regulations move through the process and result in that commodity. Typically, the kinds of contracts that we are talking about are ones where there is a payment today for a commitment to generate and turn over emissions reductions in the future. Thus, there is that temporal aspect as well because in many instances, the commodity today is not yet in existence. You have to wait until there have been a series of steps that are a predicate to the production of what's going to be turned over in the contract.

In addition, oftentimes we are not talking about the most established or, in some instances, the best known of parties. We are talking about either project developers or project managers or sites where these projects are being housed that might have a fairly limited operational history. They might be new ventures because this is a new area. Thus, in some instances, it may be very difficult to amass a good sense of the operating capabilities of those companies.

Again, the premise of CDM is that it is happening in developing countries where there may be a lack of the kinds of capacity that we typically expect: There is a lack of risk-management capacity, a lack of emergency response capacity, a lack of an established insurance community or insurance protocols, and political issues that may add to that instability as well.

We are dealing with new technology. We are not dealing with oftentimes off-the-shelf, tried-and-true pieces of equipment. We are dealing with something that may be either a new technology itself or deployed in a different context than it has typically been deployed in the past. And we are dealing with a market that has a significant amount of volatility in it with prices that, last year, ranged—in Europe, for example, for the European allowance allocations—anywhere between about ten and twenty-five Euros, a very significant price swing that we see in the market.

In addition, the context in which companies become involved in these projects often means that the kind of due diligence that one might expect in a normal transaction sometimes falls by the wayside or there is the temptation to let it fall by the wayside. This is because, at least as we have seen for many of the early-stage efforts, there has been real competition to get at those relatively cheap greenhouse gas emission reductions.

Thus, there are real-time pressures that cut against the ordinary course of careful due diligence, risk assessment, and thinking about these issues. And frequently, I venture to say, there really is an inadequate set of risk and insurance considerations.

What you can start to see from the World Bank 2007 report, if you look at the timeline, is that, early on in the CDM process, projects were happening pretty much with equal distribution in many parts of the world. But increasingly, more and more projects are being done in Asia, and increasingly more and more projects are being done in China.

As we in the insurance industry see it, when you look at a portfolio of risk issues, the bigger the distribution of the kinds of activities that there are, the more you can spread the risk and the more that you can eliminate a large-scale coordinated potential for loss. The flip side of this is the more you consolidate activities of a particular type in a particular location, the more you may begin to see coordinated losses if there is one loss. You may heighten the level of loss that there is.

One of the real trends in this market is that the risk is becoming heightened because it is being consolidated geographically and also in terms of the technologies. It started out with all different projects of all different types. Increasingly, there is a stronger focus on hydro power, wind, biomass energy, some agriculture energy-efficiency projects, landfill, and gas. These are the kind of projects. Again, the fewer technologies there are, the more coordinated the risk, the higher the possibilities are for losses.

We have been talking about some of the contractual provisions that can help allocate that risk. One of the other things that has been implicit in what has been said is that the use of very careful measures to select projects is essential. You do not want to just jump into a project; rather, you want to think carefully about the costs, the benefits, and the risks, and give attention to it. Again, diversifying may be a good strategy as well.

On the whole, there are not a lot of obvious insurance-based products that have been available. But part of the consequence of this, and the way the market has been developing, is that you are beginning to see very significant disparities in price that result from these projects and from the risk management techniques, because of the different risk issues that are inherent in these projects. This is just an example, also from the World Bank, of the disparities in price in CERs and ERUs over time with a very significant range—I mean, 18 to 14.5—reflecting to a significant degree the different risk elements that are being put into these projects. And that differential in price and that concern about risk can become an impediment, quite frankly, to the ability of projects to actually continue to go forward.

Certainly there is price discounting that will affect the ability to invest in those projects today and to finance them and make them happen, to monetize the carbon value up-front in this structure of a forward-based contract, and to bring cash flows into a deal that represent the future carbon value that has all of that uncertainty attached to it. It also affects those lenders who are willing to participate in the deal and whether or not you ultimately can come to closure. Thus, these pricing issues have real effects on value. What is more, they can have real effects not only on project value but on company value as well, and we will spend more time talking about this.

The typical project cycle is recognizable as that of a kind of construction project: financing, construction, and commissioning. In terms of the what the CDM overlay is, you have to assess the carbon through a Project Design Document, validate, register, verify and certify it, and then have issuance of the credits. Again, this is a forward-based contract.

If you think about the kinds of risks that are inherent in that project cycle, they are all over the place. There is also a prepayment risk. There is the risk as to how good those counterparties themselves are. There are the political risk issues that I mentioned. There is a whole set of natural hazard issues, and at times, in developing countries, those issues can even be heightened, where, for example, there are significant areas of deforestation that can result in enhanced mud slides in developing countries.

There are questions of business interruption, the basic issue of whether technology will perform, all of the Kyoto Protocol regulatory risks regarding approval of the process that we have been talking about, as well as the risk inherent in how well the verification has been done.

I like to think of these risks in terms of baskets. There are the traditional and hidden political risks that include whether you can even convert the currency in a particular country; what the rules of that country will be; whether they will impose some kind of a tax that makes the transaction ultimately not viable; and there are traditional operational hazards, counterparty financial risk, pricing risk and technology risks.

What do we do about all of this? What is the best way to approach it? First off, you have to understand what these risks are in the context of a project. And it is critical to understand how significant they may be in the context of that project. We call this risk assessment, risk evaluation: understanding what the risks are, understanding the contractual underpinnings of a project, being able to get a handle on what the vulnerabilities are, where this could go awry.

Then there are probably, for many bolt-on technologies, a set of already existing insurance policies and approaches that are being used. It is critical to understand

those as well, not to let them fall by the wayside, but to look at whether there are policies already in place, either with existing entities or existing projects, to which something else might be added to achieve carbon emissions reductions. Is there something that already provides a set of protections, and how responsive will they be?

Then there is the question as to whether you can optimize that insurance if there are gaps between acceptable best practices globally and what is happening in a particular area. Are there ways to enhance the coverage, where there might be some basic loss-control approaches that can be used? An interruption in the supply chain should not cascade from a two-week interruption to a six-month interruption if you can put some basic protections in place. That should definitely be looked at as well. One should examine whether there are changes that can be made to existing traditional lines of insurance that can help to provide enhanced protections.

Then, lastly, are there specific insurance products that can be used to help to address these particular credit-delivery guaranty issues? Increasingly, the answer to that is becoming yes. There seems to be emerging a strong commitment from very capable, financially secure insurers to provide coverage of some elements of that entire spectrum of risk. In addition, there are a number of specialty markets that are also emerging that are beginning to provide coverage in this area as well.

I want to spend some time talking about the kinds of coverages that one can find in this area and what they are beginning to look like. But again, there is the question as to whether you can have coverages that address the future commitment to deliver carbon. And one of the key areas that I mentioned is political risk. The Overseas Private Investment Corporation offers a product that looks at expropriation and also looks at those activities which are tantamount to expropriation, whether it be by way of confiscatory taxes, lack of real legal process in the country, or whether there is some kind of undue burden that is created on the investment and fair investment-backed expectations.

A very large, capable insurer has something called a Kyoto multi-risk policy that is designed to respond to any registered CDM project and that involves a whole other set of issues: traditional damages; machinery breakdown; problems in the design, supply, construction, all the way through to the delivery of those credits; physical damages; and expropriation as well. One of the key questions in a policy like this is: What is the indemnity? What is the remedy? What is the payment that you get at the end?

There are a variety of approaches being used by insurers here. Some are just offering a fixed amount of money in the event that you do not have delivery of the credits. A few seem to be willing to take on the risk of an illiquid market. But others are trying creative things, like percentages, or the spot price as a way to help collar the risk and make the downside potential in a project as minimal as possible.

Some of the insurers—AIG has a product—have explicit requirements for what is known as self-insured retention or a deductible, where about twenty percent of the loss gets covered first by the parties and then the insurer steps in to provide an indemnification.

Lastly, there are some emerging structured products that blend risk transfer and finance in some ways. Swiss Re announced last week a new transaction that culminated in providing some protections to the Government of Luxembourg in securing some of these kinds of credits as well. That is lending some measure of price protection with some measure of risk protection in these areas.

It is not every project that will be susceptible to these kinds of protections. In part, the more common experience there is with a particular host country, the more likely it is that an underwriter is willing to step in: the more it is a tried-and-tested technology—offshore wind, hydro, biomass. Increasingly, insurers are willing to think about the long-range permanence issues regarding forestry, but there are not clear answers on that yet.

The more there is a history of how well developers are doing—the more it is a project that, in scale, an insurer feels like they can get their arms around and that they won't sink their company if it goes south—the more likely it is that there is the opportunity to achieve coverage.

One of the key and most interesting and promising ideas is whether it is possible to bundle up a series of small projects into a portfolio to minimize underwriting costs. One of the benefits of a portfolio-based approach is that you can structure it almost like reinsurance and use risk management tools like good project selection to really optimize the structure and value of a policy like that.

The kinds of information that insurers require are project design documents, the basic information we have been talking about, the contracts, as much information about the parties and the financing structure as possible. And increasingly, there are a number of resources that are available to help think about how you structure and unlock the value in these kinds of transactions.

Again, I encourage all of you, as you become involved in these transactions, to understand the risk issues up front as much as possible, to recognize that this is an emerging area, that, on the one hand, the difficulty of manuscripting a policy in every case might lead you to resist turning to the insurance markets. On the other hand, there is a real opportunity in these early days to customize these policies to be able to optimize the kinds of coverages that there are, and the consequences of doing that can affect not only the end of the project but the beginning financing and how possible it is to put together that project up front as well.

MR. HANNA: Thank you, Gary.

VII. Due Diligence

MR. HANNA: Well, Gary ended with the issue of due diligence, which is appropriate because that is the next topic we will be talking about.

Michael Scott, from ENVIRON is here. He has a truly international background, having been educated at Oxford. He is a chemist and works with ENVIRON, which is characterized almost uniformly by very high intelligence. And here again, he is head of the carbon markets portion of ENVIRON, an area about which people would have scratched their heads probably as recently as five years ago. And now it is a significant business.

MICHAEL SCOTT: Thank you, John, and thanks for the introduction. I am not sure I am one of the intelligent ones, but I will try to do my best. Thanks for the invitation to be here.

I am going to pick up on some of the themes you have heard already and drill down in particular into the area of technology performance that Gary alluded to a few moments ago. I will start with just going back through some of the basics of the landfill example that John had laid out this morning.

I will touch on the registration process and, really, the centerpiece of what I want to talk about though is some of the experience with underdelivery of CERs, where projects have fallen short and why, and perhaps, most importantly, what can you do by way of due diligence steps when you proceed going forward with an investment to make sure you have minimized those risks of underdelivery and questions about the design and implementation of projects.

Conceptually, the landfill gas recovery project is a very straightforward undertaking involving putting in a network of gas recovery wells spaced something like 50 to 150 feet apart and essentially applying a vacuum to suck out the gas and either flare it or use it to generate energy. Thus, the concept is very simple. The emission reductions are generated by destroying the methane and then getting certified emission reductions by going through the CDM process.

The project cycle has five phases. The first phase is the initial screening phase where we look at whether the project is worth undertaking and whether it passes certain fundamental tests in terms of the size of the project and in terms of the environmental setting.

The second phase is the technical assessment, which I would like to talk about in some more detail, since I think, as others have suggested, there has been a tendency to rush past it and not do enough in terms of technical assessment.

And then there are the design and construction stages where, again, there is opportunity to optimize how you install these systems so they actually will produce the optimum amount of gas, corresponding to the optimum amount of CERs that you are trying to generate.

The last phase is the monitoring of this process, which is also critical, but I am not going to spend much time on that here.

You have already heard about the project cycle in the previous presentations. The take-away from it is that the process is a lengthy and painful one. It can take a year, sometimes more, to go through the various steps, many of which are based on the lengthy approvals.

You have to prepare initially a Project Design Document, which is the key element that I am going to drill down in a moment. You need to get approval from the local host country, the Designated National Authority. You have to get an order to approve it, to validate the project, essentially, before it goes to the CDM executive board. Then you get the project registered. You start generating emission reductions. You then have to have those emission reductions verified and certified by an auditor that is different from the one that validated the project. All of this can take a year or more, and many things can go wrong.

The Project Design Document or PDD is sort of the guts of how the project is defined. And in the landfill context, there are several methodologies that have been approved. You have to use an approved methodology in the CDM world to be able to proceed with the project. I will focus on two important things: The PDD has to have in it an established baseline that you start from. In other words, if you did not do this project, what would be the emissions that are going into the atmosphere? Typically, this is done on a theoretical basis in the PDD. So there is an *ex-ante* estimate of the baseline emissions, and there is a tendency to be optimistic. People want their projects to be large emitters so the emissions reductions will be large. You cannot get any more of a credit than the amount you apply for. So you are sort of putting a ceiling on things. In that process, you also need to account for any regulatory or contractual requirements. If there is already some regulatory requirement to control methane emissions from your landfill, you have to subtract that from your baseline. You also need to have a monitoring methodology established in this document. Thus, you have to define clearly how you are going to measure the emission reductions. With landfills, it is fairly straightforward. You basically are taking credit for what you destroy. The only real adjustment to this is that, if you are using electricity to power the system for the blowers and the pumps, you need to subtract that from the net emission reductions that you are generating. That is typically a fairly small adjustment. Those are the two key points. There are a lot of other things the PDD has to satisfy; for example, environ-

mental impacts have to be looked at and you must also incorporate the stakeholder's comments and so forth.

The monitoring process is very important. You will only get credit for what you can satisfactorily show that you have been able to reduce. Thus, in the landfill context, what we are doing is basically capturing the gas or measuring the flow of gas through the flow meter, measuring the fraction of methane in the landfill gas, usually with a continuous analyzer, but you can take statistical samples as an alternative. It is not all methane, so usually landfill gas is going to be around fifty percent.

A lot of landfill projects are still flare-based because finding a use for the gas is not always easy, landfills being in locations that are not always handily placed for the energy to be used. The flare efficiencies are set. Again, the CDM rules define a number of these parameters. Up until fairly recently, you could take a higher credit for the destruction efficiency of the flare. A year ago, the rules were changed so that for an open flare, which is a relatively simple, low-cost item, you could only take fifty percent; and then for a closed flare, you get ninety percent. You can take higher credit if you actually measure both sides of the flare. But it costs more to do that; thus, on small projects it may or may not be viable to do that. It is a tightly controlled process. When things like these rule changes come in, if you have been working at ninety-five percent and now the rules cap you at ninety percent, these will be important issues to deal with.

You have to measure other parameters—temperature and pressure—but these are fairly straightforward things. Basically, if the monitoring equipment breaks down, you do not get credit for the period when the system is not operating properly. So the verification report addresses all these parameters to make sure there is, indeed, a record of the emission reductions occurring.

Now this is the major theme I want to get to: If we look at landfill projects, this is probably one of the most egregious examples, not the only one in the CDM world, but perhaps the most visible. What I am referring to is that there has been a significant under delivery of CERs. By that, I mean, the ex-post-measured reductions are significantly less than the theoretical ex-ante predictions in the PDDs.

The reasons for this really fall into a number of categories. Typically, the due diligence phase is done without sufficient attention to detail, so there is an unrealistic evaluation of waste characteristics.

People will assume that, when you have a certain mass of waste, it is going to generate landfill gas at a certain rate. Well, it may or may not, depending on what went into that landfill. If there is a pile of tires in one half of the landfill, you will have very different results than if it is municipal waste.

The landfill construction and operating conditions may be also very important. Usually, when we are doing this sort of work, we take site-specific sampling and tests either of waste or the gas itself. If you don't do that, you run the risk of getting surprises.

There are models that are used to estimate the amount of gas and there are some key parameters that go into those models. If you use the default parameters without getting site-specific data, again, you run the risk of inaccurately estimating gas production.

Then finally, with the operation and design of the system, you may not be collecting the optimal amount of gas that you would be able to.

Now, I just want to give you some examples of what I am talking about here in particular. This is for just basic landfill gas flaring projects. At the moment, there are probably between 900 and 1,000 projects registered under CDM. In total, about sixty-eight to seventy are landfill projects. But only about fourteen projects that have actually got measured CERs have been actually transacted. There are many projects registered, but, in terms of actually producing results, we are talking about fourteen. As far as the flaring projects go, you can go on the CDM Web site and figure out which projects are which. As for the ratio of the CERs predicted in the PDD to the CERs that were actually generated in the verified emission reports, these have varied enormously, from as low as nine percent to one case that has actually reached 104 percent, actually a little better than was predicted, with an average of about thirty-nine percent. Thus, there is a huge range here. In terms of dollars, if we are talking about a landfill that was predicted to generate five million tons of CERs a year at $20 a ton or thereabouts, if you are dropping to ten-to-thirty percent, we are talking about significant economic impacts.

If you look at the gas-to-energy projects, where people actually use the gas not just for flaring but for energy generation, we have a similar pattern. I would not attach any significance to the fact that the averages are about the same. I think it is pure coincidence. The ranges are still pretty much all over the map. The statistics go from about thirteen percent up to as high as fifty-five percent in this case. And again, geography-wise, there are two in Brazil, one in El Salvador, one in Mexico, and two in China. So, you see, there is a big under delivery issue.

Why does that happen? Again, it goes back to some of the technical points I mentioned earlier. When the ex-ante estimate is done, when the theoretical estimate is done on the PDD, it is usually based on a theoretical model. Fundamentally you need to look at the quantity of the waste, the age of the waste, and a couple of parameters of particular importance: L0, which is a measure of the composition of the waste. And there is a k term, the rate at which the waste decays, which is a function of moisture

content, the bird population in the landfill, the pH of the matrix and various other parameters. So these will vary from site to site.

When you start looking at those parameters and how you set them, you need to consider how the site is being operated, how it is constructed in terms of how leachate is managed at the site which affects the moisture, and whether there is cover material being applied. When you start sucking gas out of a landfill where there is no cover, you are essentially sucking air into the landfill and the bugs do not like the oxygen. Bugs basically need to be kept anaerobic.

The slopes of the landfill may limit how you can put wells in. There may be existing gas control measures which complicate life.

And the collection process is equally as important as the generation process. You need to worry about how effectively you collect the gas as opposed to just generate the gas. And the side slopes may play a big part in that process. Typically, we look at ranges of fifty to eighty-five percent of collection efficiency, which is a pretty big range.

Again, I am not going to get into too much detail here, but let us assume, for example, about a five-million-ton landfill that has been operating for twenty years. In 2008, we installed a gas collection system. This can result in a range of different k values, one at .05, one at .2. These are not untypical. So you can be outside these ranges. My point simply is that there could be a thirty percent initial difference in the amount of gas that is being collected. In some cases, there is a big under-production, which later on is made up, because people have overstated their k in this calculation. If you translate these items into dollars, we are talking, in this particular example, about differences that are in the range of two or three million dollars a year. So there are significant differences if you get these things wrong.

This is a similar example using generation rates and collection rates, and then varying the L0 which is the waste composition. In other words, if you go in and model your landfill based on a certain value for this L0 parameter—it assumes essentially a certain overall composition of the waste—and it turns out that the western third of the landfill is full of demolition material, you are going to get a surprise when you actually start to install your system.

How do you avoid some of these things? You need to do a detailed reconnaissance. These are some examples of the sorts of things that are not uncommon when we start looking at landfills that, on paper, are presented as looking promising in terms of tonnages and locations and so on. Take, as an example, an open dump, i.e., there is no cover. It affects the cost of the system significantly. You are going to have to cover the landfill. Another example might be a gas well, with a big rut next to it. With erosion like that, when you start pulling gas from those wells, you are going to start pulling air into the landfill. Yet another example might be a site where, because of inadequate leachate control measures, when you start to try to extract gas, you run into leachate, which is pushed inside the landfill and is causing a geyser to occur. You do not want that as an operational component. You need to have a landfill that has control of leachate management.

Since we have had a Colombian theme, let us take the example of a Bogota landfill which in 1997 suffered a major geotechnical failure. Basically, about a million yards of waste slid down the side of the landfill into a river. Now, this really occurred. One of my partners is involved in a forensic investigation of this. And the causes behind it were essentially lack of leachate control and gas control. So there was a buildup of core pressure in the waste material. These are the sorts of things that you need to evaluate in the due diligence process.

What do you do to try to reduce those uncertainties? Do a better job on the predictive analysis. You can do gas sampling to get a better sense of the methane content of the gas. You can do waste sampling or take a soil boring to see what you are actually dealing with. Ultimately you can take vacuum tests. Again, one of the other speakers alluded to the rush to get these projects done. Doing vacuum tests is quite time consuming, and it is quite expensive, maybe around a hundred thousand dollars where you are essentially putting in a test well and pulling gas to see what the measurement will be and measuring that impact with probes around it. But if you do not do those sorts of things, you really are taking a real shot in the dark on the ultimate performance on the system.

The last point I really want to make is that this process of due diligence extends beyond the initial valuation of the project to the design stage. Typically when people put landfill gas control systems in, they install a network of wells uniformly across the site. When we are really trying to optimize capture, you need to try to take into account the lack of homogeneity of the landfill. Thus, the sort of approach which makes more sense is to install the system in an incremental fashion, and as you test each well you will get a better indication of the behavior of the landfill in terms of its gas production potential, and you can modify the design as you go. So it is really essentially a case of incremental design and monitoring to try to optimize production.

So those are the key elements that I think we have found are very important to making these projects more successful, just from a technology performance point of view. And landfills, I would say, are a particularly sensitive beast in that you are not dealing with a nice homogeneous product in terms of reducing your emission reduction. I think this is one of the types of projects where the technology diligence is very important. I will conclude here. Thank you.

VIII. Roundtable Discussion

MR. HANNA: We have tried to show you with a remarkable group of experts over many different phases how you might do a project like this. But problems do occur, and also there are a lot of questions that may have arisen in the panelists' minds and your minds.

Mark Rosenberg is going to lead the roundtable discussion. Mark is a partner at Sullivan and Cromwell, where he is the coordinator for two groups: environmental and insurance. And it shows how broad the environmental concerns are spreading. I always thought environmental was terrific because it starts with "e," which stands for everything. Mark, would you like to lead us?

MARK ROSENBERG: Sure. First of all, to set the stage, our hypothetical is that everything has gone to hell in a handbasket. The project has not worked out at all. I do not know what it is. Maybe it was the due diligence. Maybe they did not do what was recommended. They only put these wells regularly spaced.

First of all, equipment has been stolen. That held things up, so credits were not going well. The host country is trying to impose a ten-percent tax, and that is affecting the financial viability of the project. And generally the credits are not being generated the way they were hoped to be. And I will add one more thing to the hypothetical. The project operator and the seller have both become insolvent. What are we going to do?

Before we get to the specific rights and remedies, there have been a number of questions raised that are threshold questions about who the parties are, the viability of the projects and contracting questions.

First of all, as a threshold issue, as a lawyer who has listened to this presentation, I have got a question about whether or not my clients in the U.S. can do this kind of thing. I am all excited: There is this great market, billions are going to be traded, this is a hot money-making opportunity. I have a U.S. client.

We have heard that, to qualify for these particular kinds of emission credits under the Kyoto regime, the CDM mechanism, you have to have a party from an Annex I country, and you have to have another contracting party who is going to be in a developing country. Well, the U.S. is listed as an Annex I country, but the U.S. is not a party to the Kyoto Protocol, so I have a question for the panelists here. Can I advise my client that it can take advantage of this, or is my client out of luck because the U.S. has not signed this Kyoto Protocol?

MR. BLANCO: I think you can tell your client that, yes, they can take advantage of it. You can also tell them it is a very good idea that they came to an international lawyer to help them take advantage of it, because they are probably going to have to set up a mechanism outside the United States. That mechanism is going to be in an Annex II country so they can take advantage of the Annex I registry system. There are a number of jurisdictions that are completely hospitable to outside entities using their registry system. The one that comes immediately to mind is the Netherlands, which has a very open registry system, and has really good corporate structures that can be used and also has access to a number of tax treaties that even the United States does not have. It is a really favorable jurisdiction.

MR. ROSENBERG: Anybody else have any thoughts?

MR. DEVILLERS: I would like to comment on this. If I am not mistaken, the issue is not about the registry particularly but about being a project participant. If I am not mistaken, if you are not a signatory to Kyoto—actually, the U.S. is a signatory but has not put it into force—you are not entitled to be a project participant. I believe that you are entitled to open an account with many of the registries. Thus, if you are not a project participant, basically, you cannot secure your rights to the projects. And that is really the issue and where I converge totally with what was just said.

MR. ROSENBERG: For purposes of qualifying under Kyoto, is it sufficient to set up a subsidiary in an Annex I country that has signed on to Kyoto, or is there some principle of law out there that says you look to ultimate ownership?

MR. BLANCO: Yes, it is sufficient to set up an entity in the Annex I country. That entity though needs to be the contract entity. To the extent that that entity is a special purpose vehicle (SPV) for a contract or even a vehicle that is going to be used for this purpose, it may need to be capitalized in some way. It needs to be able to perform its rights and obligations under the ERPA. And if it requires a guaranty from a U.S.-based company, then that may be a supplement.

GARY GUZY: Andrew, can I ask a follow-up question? You are not suggesting that a U.S. company could qualify by setting up that kind of offshore entity for U.S.-generated carbon emissions reductions are you?

MR. BLANCO: I am not. I am really focusing on the Kyoto structure. You bring up a good point. Do you want to elaborate on that?

MR. GUZY: Actually, I was going to say that there are probably two other ways that companies can take advantage of what is going on. One is the obvious one. If it is a U.S. company that has multinational operations and obligations in those countries, it can begin to take advantage of emissions reductions that are in CDM countries.

Then, secondly, while the quasi-technical registration elements of a CDM project might not be available to U.S.-based companies for U.S. operations, there is an emerging voluntary market in the U.S. and it has values that

are woefully short of European values or CDM project values, for example, because there is not the same set of regulatory price signals yet in place in the United States. But those prices are there. The Chicago climate exchange yesterday was trading at $2.30 per ton of carbon allocation, as the northeastern states come online with regional greenhouse gas initiatives, and the demand begins to build up in the U.S. This is also a speculative market about whether the Lieberman-Warner bill or some other piece of legislation will be put in place or who the various presidential nominees may be. These factors will probably continue to drive up values in the U.S. as well.

Thus, certainly there are those sets of opportunities. But I would just caution that everything we have said here about the risks, challenges, uncertainties, need for due diligence and careful contracting and lawyering for CDM projects is magnified in the context of the U.S. voluntary market, where there is a far less clear set of requirements and where there is just even more uncertainty about the validity of credits that ultimately get issued. This may not be legal uncertainty, but there is reputational uncertainty and there are real questions about the value of some of those credits.

MS. SAGER: I would like to add to that. Certainly from our perspective at JPMorgan, where we are active in the voluntary market, it is our reputation that is at stake when we go into the voluntary market. As a result, the due diligence that is required is entirely on our shoulders. Nobody else out there is looking at the validity of these attributes, which are nebulous at best. Due diligence is therefore one of the primary functions that we attempt to bring to the product. As the market develops in the United States, we need to be mindful of the fact that it is our on-the-ground due diligence and the requirements we place in contracts that help ensure that there are legitimate, true reductions in greenhouse gases. So I cannot overemphasize to you, that is what you are getting when you work through an organization like JPMorgan. It is our reputation that is at stake, because there is nobody else out there certifying these things.

MR. ROSENBERG: Let me ask you, Andrew, a follow-up question. You suggested that, if this U.S. company sets up a subsidiary in a qualifying Annex I country that is a party to Kyoto, you would not just be able to set up some special-purpose vehicle, but you would actually have to give it some substance, make it a contracting party, throw in some money.

If I am the U.S. company and I set up a subsidiary, assume it is a special-purpose vehicle, and I call it a contracting party, and I want to avoid all the hassles that go with actually making this something that is a substantial corporation, is anybody really going to challenge this? And if so, who? Why is it not okay to just set up some special-purpose vehicle in another Annex I country to do this and to get by with very little capitalization and have it be a contracting party?

MR. BLANCO: Again, the main obligation of this entity stems from the fact that the buyer is going to need to pay a price. So you are going to have to demonstrate to your counterpart with whom you are contracting that the entity is capable of making that payment. Now, whether this will be through some sort of capitalization or guaranty or something else, ultimately this is what the entity will have to do, and your counterpart is going to have to feel assured that the payment will be there when delivery occurs.

MR. ROSENBERG: There is another question that we got from an audience member that goes to who the parties are and reflects some potential confusion here as to who is doing what. The question is: What's the difference between the local sponsor and the equity holder? Are they the same, and, if not, how do they allocate risks and rewards? Please explain in more detail the identities of the local sponsor, the equity, the debt, the off-taker, the seller, the buyer.

MR. BLANCO: I would kick that to Claude.

MR. DEVILLERS: Before I answer this one, I just want to offer a remark on the preceding question. The attributes will be booked in Europe. The assets will be there. There is no right currently to bring them back to the U.S. other than monetary-wise. You will bring back a cash flow but the SPC will own all the assets.

As for the second question, as I alluded in my presentation, very often you have shallow pockets, i.e., local sponsors, who are usually the owners of a landfill or the operators of a landfill or the owners of a plant who want to finance their industrial process and so on and so forth. Thus, they may not have the financial capacity to make the investment up front. That is where they will look for an equity partner who has an understanding of the CDM process. You might have among them either an operator of this class of assets—I am thinking of companies like those in Asia or India—or you have people who specialize in making this project happen, that will be like trading emissions in the UK. The equity holder will come in with some equity and possibly some other financing. How do you split the upside? As I said, this is a negotiation matter.

MR. ROSENBERG: Could you have these two companies, say, the entity that is operating the project and in theory selling the credits, and the buyer both be subsidiaries of the same U.S. corporation? For example, I have my U.S. client, and he is still really into this and he likes the idea of setting up this subsidiary in the Netherlands somewhere. He asks himself why he needs to deal with some local entity in Colombia. He thinks he has a great idea and wants to set up his vehicle in the Netherlands, his Annex I country. He has lots of experience in landfills, and he is going to set up another subsidiary in Colombia, and he is going to have that subsidiary do the landfill and

generate the credits. He will have his other subsidiary take advantage of that. Can I tell him that that is okay?

MR. DEVILLERS: We have seen this normally in the hydro business. It is less common in the landfill sector because of the political ties. Thus, it really depends on the industry and how embedded it is in the political landscape.

MR. ROSENBERG: Are there any Colombian law issues that bear on this, Ernesto?

MR. CAVELIER: Well, not exactly related to these types of investments, but the general rules on investments will apply. Thus, you will have the freedom to make investments in Colombia in any field, perhaps with some minor exceptions, such as in the area of defense equipment and that type of thing. But otherwise the investments can be made at any time. And they will enjoy the full protection of the Colombian constitution.

MR. BLANCO: I would like to add one more thing. Ultimately, your U.S. client is going to have to do something with these CERs, assuming that they are CERs. They will not use them for compliance because they do not have a compliance obligation, so they will have to modify them. They will have to transfer or sell them to somebody, and that party will want to understand the structure that your client decided to use and why they have decided to use that structure. Thus, eventually you will have to show the relationship amongst these entities.

MS. SAGER: Or they can use them for their own voluntary reduction.

MR. BLANCO: If they are Voluntary Emission Reduction credits (VERs), they can bring them back to the U.S., no problem at all. If they are CERs, they have to stay within the pro-Kyoto Protocol.

MR. ROSENBERG: We have received a number of questions from audience members indicating some skepticism about the viability of projects like this, maybe generated in part by the discussion earlier about how many of these projects are not doing anywhere near what had been anticipated.

One of the questions is this: We talked about the delay that is inherent in actually getting the approval of these CERs, when we talked about a year or more. Kyoto expires in 2012, I do not have this project off the ground yet, and I am looking at putting together these project development documents, getting third-party verifications and that kind of thing. Is it really worthwhile even thinking about putting together a project like this now, starting in 2008?

MR. SCOTT: I think there was a bit of a mad scramble around the 2006–2007 time period for people trying to get projects into the pipeline by 2008. And I think people are still proceeding with the assumption that there will be something post-2012. If not Kyoto, it will be Kyoto-like, so I think there is still a lot of activity in regard to generating new projects, even though there is uncertainty.

MR. ROSENBERG: Yes, but they are relying really to some extent on speculation and hope. If nothing happens officially, then I guess they are relegated to the voluntary market that was talked about before.

MR. HANNA: It is speculation I guess, but in Bali where 10,000 people met to figure out where they were going next, even this U.S. administration agreed that something would be done, probably in the context of the framework convention, as opposed to Kyoto. At least this is what this administration said. But that was certainly a direction, and one got the feeling that there are a lot of countries that agree that something is going to happen after 2012. Just what that is, we do not know. What is more, Ernesto just came back with news from Japan, which is one of the first indications of a breakthrough there.

MR. ROSENBERG: Another questioner expresses some skepticism about the viability of these kinds of projects and asks: What is the typical cost per unit of credit to obtain registration and issuance of the credit and how is a credit typically valued in a representative issuing country such as the Netherlands, Germany or Russia?

I take it what he is getting at there is as follows: Given all the things that need to be done, particularly in order to make sure you are properly figuring out what the emissions credits are going to be, how much is this going to cost a company per credit, and how does that compare to what it can actually expect to receive per credit?

MR. DEVILLERS: Well, that is one of the first questions we asked ourselves: How much is the cost, and is it viable? For this reason we undertook a study in 2003, based on the cost of due diligence and so forth. And we determined a cost for a credit, without taking into consideration the element of risk, of about $3.50 to $4, at that time. Then you have to add on top of that the cost of your risk, as the representative of Marsh was describing earlier. And it has been our experience, in regard to project financing, to assess around five percent. I do not know if you would concur with this, but you are now probably in the $5 plus of pure cost for your credit.

How much can you sell your credit today? About seventy-five percent if the project is completed and runs, that is, about 75 percent of the EU allowance (EUA), which went down a little bit in the past few days, but is around twenty Euros. So you are now talking about fifteen Euros, which is about US $22.50, if I am not mistaken, for a credit for which the cost is theoretically around five Euros. This should give you an idea of the economic viability that you have there and the margin to absorb some of the unexpected costs.

MR. SCOTT: If I can just add to that, I think some of this will also depend on the type of technology. I think that there is a great rush to get the industrial gas projects, the HCFCs and the nitrous oxide projects because of the costs of actually generating those emission reductions were very low. Most of those are already now locked up or in the process of being locked up. I think landfills are still a relatively low-cost type of project. A lot of this depends on the scale of the project. If you go to other technologies, the smaller the project, the relative cost of all the transactional items involved starts to eat up some of the benefits. There are lots of little projects that people are trying to do, but it is a lot less attractive when you factor in all of this.

MR. ROSENBERG: Gary?

MR. GUZY: I have a few random thoughts that I think are pertinent. One is that I liked Claude's comparison to the cost of essentially a European allocation as the benchmark against which you might want to compare these projects. The result of a CDM project is not as certain as a European allocation. That is why you have some cost discounting. But nonetheless there was last year a seventy-billion-dollar global market in carbon trading. And companies who have to come into compliance are looking for the most cost-effective way to get this done.

The challenge is to find lower-cost, more efficient projects in developing countries or to leverage some of the equivalency values for CO_2 from capturing methane that is twenty-three times more destructive to the environment than a molecule of CO_2 or some of the HFC gases that were a part of the World Bank's umbrella carbon fund project. That latter project was an $850 million transaction that leveraged the fact that HFC gases are 11,000 times more destructive per molecule than a molecule of CO_2. There are enormous cost-efficiencies and economic value that can be mined here.

One other thought concerns looking at the future course of this market. Building on some of the earlier statements, the CDM effort was designed really to allow two tandem goals. One goal was to allow those who have to come into compliance to achieve that most cost-effectively. But there is a second goal that is equally important from the perspective of the developing country, and that is to allow for the transfer of clean technology to developing countries from the developed world. If you look at the negotiations in Bali, probably the overriding dynamic of those negotiations was that the developing world was saying to western economies that they bear responsibility for this problem and that they need to help the developing world figure out how to find solutions as it continues to develop. And no one doubts that those countries are going to continue to develop and to do so at a very aggressive pace. This only heightens the need for more effective means of technology transfer. And that was a central part of the Bali discussions. It will continue to be a central part of the negotiations going forward.

MR. BLANCO: I just want to add one additional perspective here, and I am about to throw out some numbers that I am recollecting from past experience. So, if these numbers are incorrect I hope the panel will correct me. I remember being in a conference in 2003 where a minister from the Netherlands said that its marginal cost of control (in other words, the cost of producing the tons necessary to achieve its Kyoto commitment) was fifty Euros per ton, and that he would gladly pay five for your projects. The marginal cost of control, as I understand it in Japan, is as much as double that. Thus, if they are looking to pay twenty or thirty Euros per ton, it is still a bargain for them.

MR. GUZY: Let me just add, if you have to throw out half of the credits because they prove unreliable but you can get them for five dollars a ton instead of fifty, why would you not do that? It is far more cost effective even if all of these risk issues result in making a project actually not yield what you thought it would yield. So from an investor's perspective, there still may be a motivation to engage in these projects even with significant risk in the entire system.

MR. ROSENBERG: We have a threshold question about what exactly is going to happen in 2012. What is it that is ending in 2012? Is it the emission caps for Annex I countries themselves or just the CDM process? If just the CDM process expires in 2012, should not the credits and allowances still be useful in Annex I countries?

MR. BLANCO: Unfortunately, it is all wrapped into one piece. This is the way I am going to explain it. If others disagree with me, please chime in. The obligations to reduce are wrapped in with the CDM and the other programs. Thus, the obligations to reduce end in 2012. The CDM, I guess, continues, although to be honest with you I am really not quite sure what happens with it.

There is an expectation, I think, that there will be a continuing obligation to reduce. What it looks like, how you satisfy it, what the market will look like is more uncertain.

MR. GUZY: I would just only add that the European Union, which treats itself essentially as a bubble for purposes of compliance with the Kyoto Protocol, was the first out of the box with developing an emissions trading system, the European Union Emission Trading System or EU-ETS, which has been going since 2005. It is sort of operating as an independent system which allows for compliance with the Kyoto's emission reductions obligations of those European community countries. But the European Union has said that its emission trading system will remain in effect beyond the expiration of the Kyoto Protocol obligations themselves.

Thus, as a technical matter, the European countries still will have compliance obligations independent of the Kyoto Protocol obligations themselves. It is a confusing and bizarre thing but that is where it stands.

MR. ROSENBERG: Someone in the audience has expressed a concern about host country and U.N. corruption. And they are wondering whether or not there is a problem for investors buying into U.N.-accredited projects in developing countries, given the existence of such corruption. Would anybody want to tackle that? Claude?

MR. DEVILLERS: So we have been dealing with the CDM executive board since 2004, I believe, that is, three to four years. There is a mechanism within the CDM that makes a fairly quick rotation of its members, most of whom are civil servants of other countries who do that as a second job. The short tenure and the fact that it is not their primary concern, I think are already two hedges against corruption at that level, and, if you go beyond that, it is directly the countries themselves that meet. On the operational side, however, the person rotates fast enough that I think it serves as a nice hedge.

MR. BLANCO: I do not think the CDM executive board and U.N. corruption is much of an issue. Local country corruption is an issue, as it is for any foreign direct investment in those companies. We have certainly all been in meetings when this has come up. Do I as a lawyer have to say I have to advise you that we in the United States have a Foreign Corrupt Practices Act here? Yes. This is dealt with in the same way it is done in every other type of direct foreign investment project.

MR. ROSENBERG: Let us get to some of the contractual drafting issues that might protect you in some of these hypothetical issues. We have got choice of law, choice of remedy, arbitration versus court action, and forum issues. For purposes of our hypothetical, let us assume that we have got a project in Columbia. I think I heard Ernesto say that Colombia will let the parties choose whatever law they want in the contract. Given that and assuming that the parties are generally satisfied with the law of certain jurisdictions law (one of the former panelists mentioned UK law), do I really need to care about Colombian law, Ernesto? I am going to do this contract, and I am going to provide for UK law, international arbitration, and payment outside Colombia. Why do I really need you?

MR. CAVELIER: That is a very good question. And the thing is that, yes, you may be protected by agreeing to Swiss, or French or UK law, for instance, and that will be valid when you agree to international arbitration. And the arbitration board or the arbitration tribunal will have to abide by that choice of law.

You will, however, have to think about Colombian law, because the company which will reduce emissions will be there and will have to comply with Colombian law in many ways. One of these legal requirements is getting the necessary approvals from the designated authority in Colombia for the project itself. And the designated authority in Colombia, for instance, is the Ministry of Environment, which will have to look into whether the company is established as it should be, whether the project is actually the company's property or in some way a concession of the Colombian company, and whether there are the proper authorizations for that project to reduce emissions, whether it is a landfill or other project. So there are certainly thousands of ways in which you have to be concerned about Colombian law.

But let us assume that you get past that, and you get into the question of whether there is any risk or possibility of a lack of compliance for the Colombian company. For example, if you actually show that the reduction of emissions has taken place but then you find that there has been a shortfall, as has happened in many other cases, what would you do? Moreover, you would have to look into Colombian law in any event, because, if you get an arbitration award and you have to enforce it in Colombia, how would you enforce it? Can you really seize goods of this company, or is this part of a municipality in Colombia so that you may not be able to seize the land where the landfill is or the piping which is owned by the municipality? There are many, many ways in which you would really have to be concerned about the provisions of Colombian law and regulations.

MS. SAGER: A couple other areas are also relevant. For example, if they are Colombian, then the Colombian bankruptcy laws obviously are relevant. Other things that you may want to look at, from more of an operational side, are the taxes that might come about since you might be deemed to be doing business in that country because you are entering into a transaction there. Some countries take an ownership interest. Thus, the question arises as to whether you are somehow getting tangled up in an ownership issue with another country that you are doing business in. There are ownership issues you need to take a look at.

MR. ROSENBERG: As far as the issues that one of the other speakers has mentioned, we have talked about how important it is to figure out what you have got title to. Just so it is clear, will Colombian law and public policy permit the parties to choose the law of some other jurisdiction to determine whether there is title to these credits? This affects issues of title, ownership, and transferability.

MR. CAVELIER: Well, definitely yes, if you have a provision there for choosing foreign law rather than Colombian law. Thus, you have your application provision, you have your national arbitration provision, and then you have your governing law provision.

In arbitration the question may be dealt with under the law chosen for that purpose (and not Colombian law). This will have to be accepted by the arbitration court and by the Colombian courts as well, because there are provisions in the Colombian law allowing for international arbitration and thereby allowing for the application of foreign law. This has been upheld by the constitutional court of Columbia too.

MR. ROSENBERG: For those on the panel who have so much experience with these kinds of transactions, is there some law, a particular jurisdiction, that if I am advising a client on this, I ought to be sure to select because it will provide the parties with certainty, and it will give the parties assurance that their contractual expectations will be met? Or, at the moment is there really no such jurisdiction out there because all of this is really too new?

MR. BLANCO: I will give you the answer my litigation department likes to hear, which is New York law. I have seen New York law and UK law. The situation is really not that much different from others where disputes are resolved by international arbitration. I think there is probably more focus on UK law simply because a lot of buyers in this space are European. I see projects coming out of Latin America that perhaps tend to focus a little more on European law because they are more familiar with that. It varies.

MR. ROSENBERG: Anybody else have any thoughts on that?

MS. SAGER: I would just agree. We see a lot of UK law and arbitration as well, although that is a much more difficult piece of negotiation to work through. People seem to agree on UK law but want arbitration in their host country.

MR. ROSENBERG: Is anybody aware of any arbitration or judicially litigated disputes in this area that have resulted in odd decisions that you would not expect?

MR. HANNA: Any decisions?

MR. ROSENBERG: Any decisions? Any disputes that have been arbitrated or litigated so far? As we have heard, some expectations have not been met, and I imagine somebody is not happy.

MR. BLANCO: Because a lot of this is arbitration, I have heard of arbitration disputes. I have not heard of outcomes, because they are confidential.

MR. ROSENBERG: That is not always the case. In Sweden there is a Swedish Supreme Court decision that says it is not confidential unless the parties have agreed to that. This was a case I was involved with. My award got overturned for breaching confidentiality but was then upheld by the Swedish Supreme Court.

Ernesto did you have any thoughts?

MR. CAVELIER: There may be a difference in Colombia. I believe it is the case in many other countries also. In regard to public entities that are not publicly traded but are state-owned or government-owned entities, at least in Colombia, the arbitration awards will go to the administrative courts for review, and that will bring about issues which are not strictly political. It is more important in that case to really take into account what is happening.

MR. ROSENBERG: As Ernesto was making his presentation, I was thinking that he really likes domestic arbitration in Colombia. That sounds great, expeditious, you can go right after the company there with the assets, and then I am kind of scratching my head, since the award is subject to judicial review. What is entailed there, Ernesto? Is the award final and enforceable when rendered? Am I going to have to wait until the courts in Columbia deal with this? And what are the standards under Colombian law for determining whether this award is legal or not?

MR. CAVELIER: Well, that is a broad question. An arbitral award can be reviewed by a civil tribunal, which is a panel of three judges. And it can be reviewed only because of nullity and not because of the substance of the matter discussed. Thus, the evidence, for instance, will not be discussed at the courts. There are other reasons why the award will be subject to annulment. And those are really procedural matters; they include, for instance, whether the arbitration was summoned in the right way or certain procedural issues were followed or not. And those will be under scrutiny by the courts but not necessarily the substance of a matter. It is more a question of whether certain rules were followed on the procedural side. That is probably as far as I can go with this question.

MR. ROSENBERG: Let me ask my question this way. Assume that I have got my award, and, by golly, I want to enforce it. I want the money now. Do I have to wait for this court in Columbia to decide if this is okay, or can I take my award and start seizing assets?

MR. CAVELIER: You can take it and start seizing assets. You can do that, provided the other party has not initiated the process of annulment. Thus, if the other party does not try to annul the arbitral award, then you can certainly go ahead and ask a Colombian court to start seizing assets of a party that failed to fulfill its obligation.

MR. ROSENBERG: Wait a minute! I have got my award. Does that mean that the party against whom I have the award has only to apply to the Colombian court for annulment for me to be stopped in my tracks?

MR. CAVELIER: Well, yes, that is exactly what it means. You are quite right. It is not difficult. I mean, it is only a question of how costly it is to fight for an annulment. And of course, the Colombian civil court will actually say that might not be the case. Your complaint would

then be thrown away because you are not right from the start.

MR. ROSENBERG: What is happening to the assets that are available to satisfy my award during this time? Is there some provisional remedy that I can take advantage of in Colombian courts, or can this Colombian party against whom I have the award just fold its tent and send its assets elsewhere, so that I will be out of luck, no matter what the Colombian courts decide concerning the nullity issue?

MR. CAVELIER: Well, it is a difficult situation since actually a Colombian company has many possibilities of disposing of the assets before a court judgment has been issued. There are few remedies you can use in order to avoid that. There are actions afterwards that you can take to try and annul the actions that have been taken by the Colombian company to avoid paying. Perhaps afterwards you could try to annul those contracts or the disposal of assets. But it is going to be really difficult to do that.

MR. ROSENBERG: One thing we have we have yet to explore in this roundtable discussion is insurance. Pardon me, but I am a little bit skeptical, and I would like to know what kinds of premiums are required for these kinds of insurance policies, and what kind of coverage really exists. For example, are there representations and warranties that the insured has to make about the viability of these credits? This would mean that, as soon as you do not get the credits, you think you can cash in on the insurance, but the insurer says that you have breached your representation and warranty, so you end up with really no coverage at all. How good are these products out there?

MR. GUZY: The policies that have been done have been very project-specific, and I think that is going to drive the answer to the question, I am sorry to say. It is difficult to answer in a minute, but the prices are ranging from essentially one or two Euros to up to ten Euros, depending on the nature of the coverage, the nature of the project, the risk challenges, and the risk profiling. Just about every one of these projects has a different risk profile, which is part of the complexity.

Yes, there are things which the insured has to do in order for the policy to actually pay. But, on the other hand, a few of them are really trying to assemble very broad ranges of coverage, everything from business interruption to paying for bond-related insurance to natural catastrophes to carbon-specific challenges and carbon-specific regulatory challenges.

MR. ROSENBERG: One last follow-up question: With these various projects that have not met expectations, some of them probably had insurance, are you aware of any situation in which the insurance company has actually paid on a policy involving this kind of thing?

MR. GUZY: Two thoughts. First, I am actually unaware of any claims that have been brought yet under these policies. Second, we have been talking in the abstract on a per-project basis. But the consequence on a company-wide basis for this kind of risk challenge and nonperformance of a CER project can be absolutely enormous. You look at a number of significant project developers, aggregators who have faced challenges with ultimate performance of their projects, and they have really suffered enormously in their share value and their subsequent ability to raise new capital. Thus, this can be devastating in the context of an individual project. It can be even more painful in the context of an overall company effort as well.

MR. HANNA: I certainly ask you all to join me in thanking the panel for all the hard work and expertise we have had here today. Thank you very much.

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New Sources of Infrastructure Financing in Brazil: An Update

By Andrew J. Dell'Olio

I. Introduction

Since taking office in 2003, Brazilian President Luiz Inácio Lula da Silva has promoted a pro-growth economic policy with a significant role for the state, focusing on infrastructure development. Toward this goal, the Lula administration has enacted several laws aimed at public-private cooperation in financing, building and operating such needed infrastructure. The law governing Public-Private Partnerships, or PPPs, was enacted in December 2004 and was the subject of an article in the Spring 2006 issue of the *Practicum*. This article examines developments in Brazilian infrastructure finance since that time.

The most significant aspect of the Brazilian government's recent economic strategy is the umbrella initiative referred to as the *Programa de Aceleração de Crescimento*, or PAC. The PAC proposes R$503.9 billion in infrastructure spending during the period 2007–2010, focused in the transportation, energy, and urban development sectors. The R$503.9 billion package will come from the federal, state and local governments in Brazil, as well as from the private sector, which is expected to contribute approximately forty percent of the total.[1] The spending is to be distributed as follows.

- R$58.3 billion for transportation.
- R$274.8 billion for energy.
- R$170.8 billion for urban development (including water/sewage, housing and mass transit).

In the transportation sector, the government plans to construct, repair and/or augment forty-five thousand kilometers of roads and 2,518 kilometers of railways, and plans to upgrade twelve ports and twenty airports.[2] In energy, the PAC calls for adding 12,386 megawatts of electrical generation, and 13,826 kilometers of new transmission lines to handle the new capacity, along with 4,526 kilometers of natural gas pipelines. Additionally, more than one hundred new facilities for the production of alternate fuels (ethanol and biodiesel) are planned. Out of the urban development budget, housing will receive R$106.3 billion, or sixty-two percent.

The PAC is a welcome initiative in Brazil's long-neglected infrastructure sector. The boom years of the 1970s were followed by the debt crisis of the 1980s and the fiscal austerity necessitated by the *Plano Real* and IMF agreements of the past fifteen years. Public spending on infrastructure, which averaged two percent of Brazilian GDP in the 1970s, fell to 0.15% in 1990. Between 1990 and 2006, it averaged 0.19%.[3] In addition to the demands placed on infrastructure due to population growth and regional development, the Brazilian economy has become a victim of its own success, resulting in an inability to transport increased volumes of commodities and manufactured products to their domestic and export markets. Studies estimate that infrastructure inefficiencies cost the Brazilian government and businesses R$90 billion annually, in terms of wasted energy and health care costs associated with pollution and poor sanitation.[4]

II. The FGTS Investment Fund

A. Policy Motivations and Legal Framework

Medida Provisória, or "MP" 349, issued on 22 January 2007, created a new, separate "Investment Fund" to be funded by the surplus assets of the *Fundo de Garantia por Tempo de Serviço*, or FGTS (Guarantee Fund for Time of Service).[5] MP 349 divided responsibilities for the Investment Fund's management among several agencies. The FGTS's managing council (*Conselho Curador do FGTS*), an agency of the Brazilian Ministry of Social Welfare, promulgates guidelines for the overall investment decisions the Investment Fund will make.[6] The *Caixa Econômica Federal*, a government bank, will administer the Investment Fund's day-to-day operations. The Brazilian CVM will oversee the Investment Fund's fiscal and accounting practices.[7] Unfortunately, the division of oversight responsibilities among these several agencies carries with it the potential for turf wars and political gridlock that may frustrate the government's intentions.

MP 349 allocated an initial amount of R$5 billion to the Investment Fund, which represents approximately twenty-five percent of the FGTS surplus.[8] The measure also included a provision for increasing this allocation to up to eighty percent of the surplus, upon recommendation of the *Caixa* and authorization of the *Conselho Curador*.[9] The Investment Fund can only be a minority shareholder in an infrastructure project, owning no more than thirty percent of the outstanding securities (either debt or equity).[10] Private-sector investment in a project receiving FGTS money must be at least thirty percent.[11] FGTS monies can be invested only in projects with a low investment risk rating from international rating agencies.[12]

With Brazilian interest rates falling steadily from their recent highs of near twenty percent, institutional (and individual) investors are seeking higher returns for their assets. With the government also altering the calculation basis for monetary correction to FGTS deposits, to reflect recent interest rate reductions, traditional FGTS deposits will earn less and investment options will be more at-

tractive to workers.[13] Pension funds and labor unions' welfare funds are especially interested in infrastructure finance since it serves the dual purposes of creating more industrial jobs as well as earning better returns for workers' assets.

The CVM issued their fiscal/accounting regulations on 26 November 2007, nearly a year after the enactment of MP 349.[14] The regulations require the *Caixa* to file quarterly, semi-annual and annual reports regarding the Investment Fund's assets, profitability and investment portfolios.[15] The regulations also impose joint and several liability on the *Caixa* and private asset management firms for losses caused by investment decisions that violate applicable law or CVM regulations.[16]

B. The Nature of FGTS

As a hybrid unemployment insurance and personal retirement fund, the FGTS accumulates assets from mandatory employer contributions, in amounts equivalent to 8.5% of monthly salary, deposited into personal employee accounts. It is important to remember that, unlike unemployment insurance in the United States, the Brazilian FGTS system is based on *personal* accounts. Higher-paid, longer-serving workers will naturally accumulate more in their accounts, which can normally be accessed in the event of a layoff. In fact, 18.73% of the twenty-six million workers in the FGTS system represent approximately eighty-five percent of the FGTS's overall assets.[17] Upon retirement, individual workers keep their accumulated balances and may draw from them as they choose. In this way, the FGTS system is different from traditional, collectivized unemployment insurance, in which workers with stable employment effectively subsidize the frequently unemployed, or from traditional pension plans, in which short-lived retirees subsidize those with long retirements. Workers may also draw from their personal FGTS accounts to purchase a primary residence at any time, or for expenses associated with a serious illness.

The accounts are maintained by the *Caixa* and the assets are invested in government securities, similar to Social Security assets in the United States. The assets earn interest at three percent above the *Taxa Referencial* or TR, an official inflationary index.[18] The FGTS currently maintains assets of approximately R$190 billion, of which, R$21 billion is considered "surplus," that is, in excess of obligations that would be paid out if the entire Brazilian workforce were unemployed tomorrow, an unlikely event in any scenario. The Investment Fund is required to seek, as a goal, investments that will yield at least six percent above the TR.[19]

C. Voluntary or Involuntary Contributions—or Both?

A debate over the voluntary nature of the Investment Fund occurred between the issuance of MP 349 and the enactment of its final version as Law 11,491. Several umbrella labor unions weighed in on the debate. The President of the *Força Sindical*, Paulo Pereira da Silva, also a deputy in the Brazilian Chamber of Deputies, unsuccessfully proposed an amendment to MP 349 that would have given individual workers the choice of whether or not funds proportionate to those in their individual accounts could be invested. The amendment would also have allowed the worker to choose the percentage of his/her account invested, if any.[20] Law 11,491, as it was ultimately enacted, treats the surplus in the aggregate, and therefore subjects all workers' assets to investment risk, proportionately. The *Força Sindical* views the government's use of the entire FGTS surplus as a confiscation of the workers' money. One can argue that the *Força Sindical*'s argument is flawed, considering that the government's plan is only to invest a portion of the *surplus*, which is "extra" money, and theoretically belongs not to the workers, but to the FGTS system itself. Labor unions see this differently. Presumably, there would be less money available for infrastructure finance if a significant percentage of workers chose not to invest. For this reason, the Lula administration prefers to retain full control over the investment decisions for the entire surplus.

However, Pereira da Silva was successful in suggesting another option, one that will eventually allow workers to invest up to ten percent of their *personal* FGTS balance in investments of their own choosing, not limited to public infrastructure projects.[21] This option is similar to the Bush Administration's unsuccessful Social Security proposal, in that it involves individual assets, not the surplus as a whole. Of course, these will be personal investments, without guaranteed rates of return, and with all investment risk borne by the individual workers. There is precedent for the use of FGTS money in at-risk investments. In August 2000, the Brazilian government sold shares of Petrobrás and offered special incentives for FGTS participants, including a twenty-percent discount in share prices. Workers were able to purchase shares through "Privatization Mutual Funds" using their FGTS balances. Although the government could only sell half the R$3.4 billion in Petrobrás shares it made available at that time, the investments have yielded a return of six hundred fifty percent over seven years.[22] When, in 2001, the government made available shares of Companhia Vale do Rio Doce (CVRD), it offered no discount, but demand from FGTS participants exceeded the R$1 billion offer by three times, and FGTS participants could only purchase one-third of what they sought. CVRD shares have yielded a return of seven hundred thirty percent since that time.[23] In light of the successful experiments with Petrobrás and CVRD, Brazilian workers may be willing risk personal FGTS assets again. However, this option will not be available for two or three years' time.[24] The Investment Fund's track record will certainly affect the level of interest in the individual investment option.

D. Guarantees

There is an obvious dichotomy between the security of Brazilian labor law, with its traditional FGTS regime, and the more dynamic, investment-oriented outlook of those who envision greater growth for the FGTS's assets. Brazilian labor unions seem interested in the opportunities, but reluctant about the risk that comes with them. What they may get is the best of both worlds: an apparent guarantee on return, as well as the growth potential. That guarantee will apparently be given by the *Caixa*, either directly or through a private insurance or surety-type contract.[25] The CVM has analyzed the issue and concluded that MP 349 permits, or at least does not prohibit, a private third-party guarantee for the Investment Fund's return. CVM President Marcelo Trinidade has stated this publicly and emphatically, after discussing the possibility of guarantees with labor leaders and the leadership of the São Paulo Stock Exchange (BOVESPA).[26] Pereira da Silva would prefer that *Caixa* itself make that guarantee, since the *Caixa* is the Investment Fund's administrator.[27] Others believe that the *Caixa* itself should oversee the entire process, from selecting projects and evaluating their financial soundness, to managing the construction and operation of the infrastructure facilities.[28]

After much debate, the *Conselho Curador* decided that the *Caixa* would levy a charge to guarantee the return on investment.[29] Initially, the *Caixa* suggested that an "insurance" surcharge for its guarantee be collected from the FGTS system.[30] Opposition from labor unions led the *Caixa* to consider passing the costs on to the private-sector partners in the project, by charging a surety rate that will vary according to risk on a project-by-project basis.[31] An unresolved question is whether private construction firms, already risking their own investment in the project, will be inclined to pay the additional costs of guaranteeing the FGTS's return on investments.

III. Additional Sources of Financing

Multilateral lending institutions are now involved more directly in infrastructure finance, either in direct lending to *specific* infrastructure projects or in advising governments as to the soundness of specific projects. The Inter-American Development Bank (IADB) signed a "protocol of cooperation" with the Brazilian BNDES, or Development Bank, pursuant to which both banks will cooperate in lending up to US$1.5 billion to Brazilian infrastructure projects.[32] In the past, multilateral lenders would make general loans to the governments of developing nations, and have little control over the implementation of projects. The new approach signals a more active involvement in the projects.

The IADB has established a US $20 million fund to promote PPPs in transportation and water/sewage projects in Latin America and the Caribbean. The Infrastructure Project Preparation Fund (InfraFund) will provide grants for the planning stage of projects, including feasibility studies; technical, economic, social and environmental assessments; project design; and preparation of documents for bidding processes.[33] The InfraFund will focus primarily on projects at the local level, which have traditionally had little private-sector participation in financing and development.[34]

The IADB's internal regulations limit its loans to the private sector to ten percent of its overall loan portfolio. The IADB's investment in any single private-sector project is generally limited to US$200 million, which can be increased to US$400 million on an exceptional basis. The IADB's participation also cannot exceed forty percent of the total cost of new projects or fifty percent of expansion projects.[35] While ten percent of its current portfolio would equal approximately US$5.2 billion, only three percent, or US$1.5 billion, is currently lent to the private sector.[36] The IADB has, however, shown an increased interest in lending to the private sector in general and, in particular, to projects involving public-private cooperation.[37] Under current Brazilian legislation regulating PPP's, the IADB may participate in Brazilian PPP's as a lender to engineering and construction firms. Lenders can eventually become direct partners with the Brazilian government if they exercise their "step-in rights" granted under the PPP law in the event of the private borrower's default.[38] Although ownership in defaulting private firms are uncharted waters for the IADB, we can look to the example of the BNDES, which temporarily took an equity stake in EletroPaulo as a result of AES's default on BNDES loans. One suggestion would be for the IADB's lending limits to be increased to match the percentage of the government's financial contribution to a PPP project, or to the government's equity percentage in the project's SPV, as the case may be.

Other multilateral lenders and governments have shown interest in Latin American infrastructure finance. U.S. Treasury Secretary Henry Paulson recently announced an agreement with the International Finance Corporation (IFC), a unit of the World Bank, aimed at encouraging private investment in infrastructure throughout Latin America.[39] The European Investment Bank is also negotiating an agreement with the BNDES to participate in Brazilian projects.[40]

Another domestic Brazilian source of financing comes from another of the workers' benefit funds. The Workers' Assistance Fund, known by its Portuguese acronym "FAT," or *Fundo de Amparo ao Trabalhador*, has allocated R$8 billion toward government programs. Of this total, R$3.3 billion will go toward the PAC, including infrastructure projects.[41]

IV. PPPs

Although the process had reached its final stage and was ready for implementation, the Lula administra-

tion ultimately decided against entering into a PPP for improvements to federal roadways BR-116 and BR-324, both located within the state of Bahia and involving a combined total of 655 km.[42] The *Tribunal das Contas da União* (TCU), the equivalent of a court of claims that has oversight authority over and adjudicates disputes involving public contracts and budgetary matters, had already given its approval to this project, the first scheduled roadway PPP. Tolls were to be set at R$3.50 per 100 kilometers, and the government was to contribute up to R$37 million annually for operating expenses. The project would have been awarded to the bidder proposing the lowest annual costs for the government.[43]

The government's own evaluation determined that BR-116 and BR-324 were sufficiently traveled so as to be attractive to a private concessionaire.[44] If the roads are viable as straightforward concessions, the government can avoid the expenditures required in a PPP. This is not the first time that the Lula administration has cancelled a planned PPP. The *Ferrovia Norte-Sul* railway project, originally contemplated as a PPP, has also been converted into a concession. (See Part VI *infra* regarding concessions for railways.) Additionally, the administration is seeking "another solution" for its planned PPP in the São Paulo railway project (*Ferroanel*).[45] These cancellations have led critics to speculate that the Brazilian federal government has abandoned its PPP program.[46] Nonetheless, the administration still plans several other roadway projects that may employ the PPP model, notably BR-040 and another section of BR-166, in Minas Gerais.

Despite the government's about-face on transportation infrastructure PPPs, there is at least one planned PPP for an information technology project. Banco do Brasil and the *Caixa* are seeking a partner to build and maintain a "Datacenter," which will support information technology management for the Brazilian financial system. Intended as a 25-year, R$300 million contract, this PPP is an "administrative" concession, in which the government pays directly for services performed. It is therefore not a true, "sponsored" PPP, which is the real innovation behind the PPP law.[47] Approximately one-fifth of the Datacenter's floor space will be reserved for Banco do Brasil's and the *Caixa's* use.[48] The remaining floor space may be used by the concessionaire for its own commercial purposes, and may also be leased to private banks for their IT support requirements. It is expected that revenues from leasing will reduce the government's outlays.

The Brazilian Association of Infrastructure and Base Industries, known by its Portuguese acronym of Abdib,[49] favors an arrangement whereby the technical/financial viability analyses for PPPs would be done by private firms, instead of by the TCU.[50] Abdib contends that the private sector would accelerate the approval process, as compared with the TCU. In fact, the analyses for the cancelled BR-116 and BR-324 PPP's were done by the IFC.

Abdib is also proposing its own two-tiered plan to improve Brazilian roadways. The plan recommends (1) upgrading 6,100 kilometers of Brazilian federal highways by granting traditional concessions to private operators and (2) upgrading the remaining 9,500 kilometers via PPPs. The plan would channel the revenue collected from the concessions toward financing the government's contributions to the PPPs, by placing such revenues in a special fund.[51] The special fund would receive additional monies from taxes paid by concessionaires from their profits on the roadways. Abdib favors earmarking these tax revenues specifically for PPPs and other infrastructure projects, whereas the government prefers the flexibility of treating them as general revenue, able to be allocated within the federal budget as needed.

Another industry group, the Confederação Nacional dos Transportes (CNT), is proposing a supplemental set of infrastructure projects. The CNT proposal incorporates all of the PAC's projects, and adds others, recommending a mixture of concessions and PPPs.[52] The CNT proposes creating a separate R$60 billion fund, capitalized by shares of state-owned companies. The government would contribute its shares held in excess of the fifty-one percent needed to maintain control.[53] The CNT views the creation of this fund as a means for the government to repay its "debt" to the transportation sector. Since 2002, the government has collected a fuel tax, the revenues of which were earmarked for transportation projects but ultimately used for other budgetary purposes.[54] According to the CNT's analysis, the revenues collected, with interest, would now total R$56 billion.[55]

The Brazilian government is also considering turning over to the BNDES the entire process of infrastructure development, both concessions and PPPs, as a method of accelerating these programs.[56] The BNDES would then control the bidding process as well as the administration of the facilities after construction, in addition to its natural role as a major lender to public projects. Presumably, the transfer of these responsibilities, from the competent ministries or agencies to the BNDES, would require a change in applicable legislation.

While the federal government has mostly opted for concessions, several Brazilian states have moved forward with PPPs. São Paulo is proceeding with the extension of the capital Metro system and Minas Gerais is hoping to transfer sixteen roadways to private operation during 2008. Minas is still studying the benefits of PPPs versus concessions, but seems to prefer PPPs.[57]

V. Concessions—Roadways

On 9 October 2007 the Brazilian government granted 25-year concessions for seven federal roadways, totaling 2,600 kilometers. The concessions represent the first major privatizations of the Lula administration and were delayed for several years due to private lawsuits and the

slow process of TCU approval.[58] The Spanish engineering firm Obrascon Huarte Lain (OHL) won five of the seven, including the two most sought-after, the *Régis Bittencourt* (São Paulo-Curitiba) and the *Fernão Dias* (São Paulo-Belo Horizonte).[59] Another Spanish firm, Acciona, submitted the winning bid for the BR-393 roadway, within Rio de Janeiro State. The only successful Brazilian bidder was the consortium BRVias, which acquired a 321-kilometer stretch of BR-153, the *Transbrasiliana*, within São Paulo State.

As with most public-sector procurement practices, concessions are awarded to the lowest qualified bidder. For roadways, this means the lowest toll rates. OHL submitted very aggressive bids, with reductions of between thirty-nine percent and sixty-five percent from the maximum toll rates set by the *Edital*.[60] One of the causes of the long delay in launching these privatizations was the government's controversial revision of the concessionaires' return on investment, i.e., the lowering of maximum tolls. That rate of return had initially been set at eighteen percent, but had been revised downward to 12.88%, and subsequently to 8.95%, which represents a ceiling.[61] Obviously, the actual return on investment will be substantially lower than the ceiling, due to the deep discounts offered by OHL and the other winning firms. Many experts feared that the lower toll rates would have discouraged qualified investors and defeated the very purpose of the concessions—improving service for the public.[62] As a comparison, rates of return for similar projects in Europe and the U.S. average twelve percent.[63] However, in Brazil, with its higher interest rates, investors can obtain returns of nearly twelve percent in no-risk bank deposits, and will therefore demand higher returns for risky infrastructure investments. As a comparison within Brazil, the rate of return for the *Rodoanel* "ring road" project around São Paulo was set at eighteen percent.[64]

Despite the government's lowering of the ceiling, the private sector did show substantial interest in the concession, with thirty companies submitting bids.[65] Brazilian officials attribute the level of interest to improved macroeconomic indicators, including a lowering of the "Brazil Risk," which makes doing business in Brazil more attractive and justifies accepting a lower rate of return.[66] Moreover, the *Edital* allows toll rates to be adjusted for inflation in the future; the bids only lock in a base price based on 2007 figures. In any event, as per the *Edital*, tolls will not be collected for approximately one year.

On 1 November 2007 the *Agência Nacional de Transportes Terrestres* (ANTT), the agency that administered the auction, ratified the results of the 9 October auctions. The ratification, originally scheduled for 19 October, was postponed twice by the ANTT due to the "complexity of analyzing the documentation presented" by the bidders.[67] In this auction, the ANTT employed a reverse process. In most auctions, bidders must pre-qualify as to technical competence and financial strength. For the 9 October auction, the ANTT evaluated these criteria post-bidding.[68] After ANTT ratification, all competitors had the opportunity to examine the winning proposals' documentation, which took place during the week of 5–9 November.

After reviewing OHL's documentation, the consortium PR/SC, one of the unsuccessful bidders, filed an administrative challenge based on OHL's extremely low bids.[69] PR/SC's challenge was made against three of OHL's five roadways, the *Régis Bittencourt*, the *Fernão Dias* and BR-101 (Curitiba-Florianópolis). The focus of PR/SC's challenge was the differential between OHL's and the other bids at auction, contending that the differential exceeded that permitted under applicable concession law.[70] Specifically, PR/SC contended that bids are invalid when they are lower than seventy percent of the prices set by the government *or* lower than seventy percent of the average of all other bids that were higher than fifty percent of the government's maximum price.[71] In fact, even before the ANTT ratified the result of the auction, PR/SC had already indicated its intention to appeal the matter to the TCU, and to higher courts if necessary, if the ANTT did not alter the auction's results.[72] The ANTT upheld the auction's results and disagreed with PR/SC's contention that the General Concessions Law applied to this auction and prohibited the vast differential between bids. According to the ANTT, the 9 October auction was governed instead by the Brazilian Privatization Program, the regulations for which do not govern bid differentials.[73] Anonymous sources at the TCU have indicated to the Brazilian press that the appeal will probably be denied on the same grounds.[74]

PR/SC was one of nine bidders to challenge the auction's results.[75] A total of nineteen specific legal actions were filed with the ANTT, all of which were dismissed.[76] Other competitors are considering filing actions with Brazilian antitrust authorities, arguing that OHL occupies a dominant position in the market for privately run roadways.[77]

OHL's lower bids were possible because OHL calculated the traffic volume based on growth in auto sales in Brazil, whereas its competitors used GDP growth as their bases.[78] OHL's calculation basis may be unorthodox and more risky, but it is permitted.[79] OHL's deep discounts aroused suspicion that it would be a low-cost, low-quality service provider. These suspicions were deepened by negative press in Spain regarding delays in OHL's progress schedule on several high-profile projects, including the Madrid-Barcelona high-speed railway. The chairman of the Brazilian Senate's Infrastructure Committee, Senator Marconi Perillo, has called for an investigation of OHL's qualifications.[80] In addition to the construction delays, there were six serious accidents on OHL projects in Spain

during a two-week period in October 2007, including the collapse of a station platform and a tunnel wall near Barcelona.[81] However, OHL has an otherwise good record in roadway administration in Spain. Two roads constructed and operated by OHL near Madrid (M-12 and M-45) are considered to be in excellent condition.[82] The Juan Carlos I tunnel, part of M-12, was voted the safest in Europe by an industry group.

OHL's low bids are also under suspicion due to allegations of improper subsidies from the Spanish government. The European Commission is investigating as an unfair competitive advantage a tax break granted to companies based in Spain that acquire five percent of foreign companies or participate in public works outside Spain.[83] Spanish officials deny that OHL received a subsidy.[84]

Within sixty days after the auction, the concessionaires were required to incorporate the SPV that will operate the roadways. The several contracts were signed on schedule in mid-February 2008, with the exception of BR-393, awaiting the outcome of court challenges to Acciona's results.[85] Within six months after signing the contracts, the concessionaires must effectuate minimum repairs and bring the roads up to minimum standards, and may only begin charging tolls after these requirements are met.[86] The ANTT estimates the costs of these basic repairs to be R$500 million.[87] Collectively, the concessionaires will invest R$20 billion on the seven roadways during the twenty-five years of the concessions, distributed as follows:

- R$5.1 billion in capital investments during the first five years, such as roadway resurfacing and widening.
- R$4 billion in capital investments during the remaining twenty years.
- R$10.9 billion in operational costs throughout the twenty-five years, including traffic inspection, towing service, emergency medical care, public telephones and truck weighing stations.[88]

Prior to the 9 October auctions, privately administered roads represented only 7.8% of paved roads throughout Brazil, a percentage that will now rise to twelve percent.[89]

The *Edital* for the BR-116 and BR-324 concessions was originally scheduled to be published on 20 December 2007, but has been pushed back to July of 2008.[90] Originally planned as PPP's, (see Part IV, *supra*) these two undertakings will be fifteen-year concessions, as opposed to the twenty-five-year periods granted in the 9 October round.[91] Transport Minister Alfredo Nascimento sees the shorter period as sufficient for concessionaires to recoup their capital investments and views the successful 9 October round as proof that the 8.95% ceiling is economically viable.[92] Three other important federal roadways, BR-040 (Brasília-Belo Horizonte), BR-060 (Brasília-Goiânia) and BR-101 (the coastal road between Rio de Janeiro and Espírito Santo), are currently under study and may be auctioned in April 2009.[93]

The Brazilian government is also studying additional methods of extracting revenue from infrastructure operations, such as permitting roadway concessionaires to lease billboard advertisements.

VI. Concessions—Railways

The government has also privatized several freight railways over the course of 2007 and is planning additional privatizations for 2008. In early October 2007, CVRD acquired a subconcession for an existing seven hundred twenty-kilometer stretch of the *Ferrovia Norte-Sul*, stretching from Açailândia (Maranhão) to Palmas (Toncantins). Without any competition at this auction, CVRD paid the minimum price of R$1.478 billion.[94] In addition to operating this portion, CVRD will have to finance the construction of a 359-kilometer portion, from Palmas to Araguaína by 2009. CVRD plans to invest R$416 million in these projects.[95] The *Ferrovia Norte-Sul* is administered by the state-owned Valec, which will supervise CVRD's upgrade and construction of the tracks.[96] Valec plans to auction another one thousand-kilometer portion of the *Ferrovia Norte-Sul*, between Palmas and Aparecida do Taboado (Mato Grosso do Sul) in March 2008.[97]

With this acquisition, CVRD will now operate 9,890 kilometers of railways in Brazil, integrating its mining operations with the transportation network necessary to carry its products to export markets.

Valec also has plans for fourteen regional passenger rail projects to operate on existing tracks, some currently in use, others abandoned.[98] The fourteen projects were preliminarily selected from a list of twenty-eight under consideration by a study group formed by the BNDES, the Transportation Ministry, local transportation authorities and private-sector companies. These fourteen projects are well distributed throughout Brazil: two each in São Paulo, Rio de Janeiro and Minas Gerais; one each in Rio Grande do Sul, Santa Catarina, Paraná, Bahia, Sergipe, and Pernambuco; and one shared between Maranhão and Piauí.[99] These fourteen projects vary from sixty kilometers to two hundred fifteen kilometers in track length. Valec hopes to begin the process of auctioning these projects in mid-2008 and is considering concessions, PPPs or a combination of both.[100]

The old dream of a high-speed train between the cities of Rio de Janeiro and São Paulo is also under consideration, separate from the other fourteen regional projects. The high-speed link would cost US$9 billion and require approximately two hundred kilometers of new bridges and tunnels for the four hundred three-kilometer trip, which would take one hour, twenty-five minutes and cost approximately R$110. The government foresees the

project as a concession, going to auction in the first half of 2009.[101] A spur of this line may also be built from São Paulo to Campinas, with the idea of connecting the three cities' main airports (Galeão-Guarulhos-Viracopos). The São Paulo-Campinas spur is envisioned as a PPP, pending the results of viability studies currently undertaken by the BNDES.[102]

VII. Ports/Airports

The federal government is in the early planning stages for a PPP to expand Congonhas airport in São Paulo. The government is also promoting a privatization model for aviation infrastructure and is considering a partial privatization of the federal airport operating authority, *Infraero*, by which forty-nine percent of the shares would become publicly traded.[103] Having declared the "Varig Model" a failure, the government is now looking to the private sector for a more efficient administration of Brazil's troubled aviation sector and seeks to structure the new *Infraero* on the Petrobrás model. Although the BNDES is presently conducting the necessary viability studies, the privatization process will take at least two or three years, according to *Infraero* President Sérgio Gaudenzi.[104]

Also part of the PAC, *Editais* for dredging at the ports of Rio Grande and Santos are expected in January and May 2008, respectively.[105] The government has announced a new model for longer-term contracts, which would give the private concessionaire a greater incentive. Whereas past models called only for a contractor to complete dredging operations, the new contracts will require the contractor/concessionaire to operate the port facility (and to maintain water depths) for a five-year term, renewable for an additional five years.

VIII. Water and Sewage Projects

The federal government also plans to assist state and local governments with water/sewage PPPs. Since many heavily indebted states and cities throughout Brazil are incapable of implementing needed water/sewage projects, the Lula administration is considering a mixed-finance operation. The BNDES would finance the construction phase, with building done by private companies.[106] The loans would be secured with the project's receivables. The state or local governments would then make their contributions to the project's operating expenses. If local governments have difficulty in making these contributions, the federal government is considering raising state and local governments' debt limits or directly funding the projects.[107] In the past, local governments and local water authorities were required to make down payments of ten percent when borrowing for water/sewage projects. The PAC now lowers that minimum to five percent. Private companies, which had to pay a minimum of twenty-five percent, can now contribute twenty percent.[108]

The draft version of the *Lei de Saneamento Básico* (Basic Sanitation Law) contained a provision granting a credit for corporate social security taxes in the amount equal to an investment made in a water/sewage facility. However, this provision was vetoed by President Lula, at the recommendation of Finance Minister Guido Mantega, who was concerned about the budgetary implications of conceding too many tax incentives.[109] Capital gains earned by workers via the FGTS Investment Fund will still be tax-exempt, for both sewage and transportation investments.[110]

IX. Housing

In addition to using FGTS funds for public infrastructure, the *Conselho Curador* is encouraging their increased use in financing home ownership, budgeting R$8.4 billion for new mortgage loan programs. While the FGTS system has been a principal source of home purchasing for many years, beginning in January 2008, greater numbers of workers will be able to use their FGTS funds to make mortgage payments. The percentage of the mortgage payment paid with FGTS funds will depend on a worker's salary level and on the ratio of the mortgage payments to salary, with lower-paid workers able to use a higher percentage.[111] FGTS participants will also receive a one-half percent discount on mortgage rates, although this reduced rate only applies to units costing up to R$130,000 and to workers earning up to R$4,900 monthly.[112] Fifteen-year fixed rate and thirty-year adjustable rate mortgages are available. The FGTS system is also lowering fixed mortgage interest rates by two percent for workers earning less than R$3,900 monthly.[113] Most importantly, workers earning over R$4,900 monthly will now be eligible to participate in the FGTS mortgage program at the slightly higher interest rates, whereas the old regulations completely excluded middle-class workers. The maximum value of homes financed by middle-class workers will be raised to R$350,000 and the maximum amount borrowed raised to R$245,000.[114] To qualify for the financing, workers must be in the FGTS system for at least three years and have at least ten percent of the home's value on deposit.[115]

A construction trade group, Sinduscon-SP,[116] is proposing a R$270 billion low-income housing construction program, to be implemented over a twelve-year period. Of the R$270 billion, twenty percent would come from homeowner savings, forty percent from mortgage financing and the remaining forty percent from government subsidies.[117] The government's share would equal R$108 billion over the life of the program, or R$9 billion per year. Current low-income housing subsidies are approximately R$4 billion per year.[118] Sinduscon-SP's proposal is modeled on the success of Mexico's program, which has focused primarily on savings through economies of scale and the streamlining of the credit and mortgage processes. According to Sinduscon-SP's study, prepared by a consulting firm, the Mexican program has reduced a 6.5 mil-

lion-unit housing deficit by half in three years.[119] Brazil's housing deficit of 7.9 million units is concentrated among the low income (ninety-two percent of the housing deficit is in households earning R$1,750 or less per month—or five minimum salaries).[120]

X. Fiscal Incentives

Also included in the PAC's stimulus package are an estimated R$6.6 billion in tax breaks for companies building public works encompassed by the PAC. A recent law grants construction companies and their suppliers an exemption from certain social security taxes, known as *PIS/Cofins.* There are two types of *PIS/Cofins* taxes, an income tax on monthly revenues and a sales tax on imported goods. The exemption applies to materials and equipment purchased or leased, and subcontracting services paid for, when these materials or services are used in a qualified infrastructure project.[121] For suppliers of qualified materials/services, the relief comes in the form of exempting those sales from the monthly calculations of taxable revenue, thereby lowering taxable income.[122] For construction companies importing qualified materials/services, their purchases are exempt from the sales tax, thereby lowering prices of their supplies.[123] To qualify for the exemption, a company must undertake a two-step process. It must submit a proposal to the ministry overseeing the project, which in turn issues an administrative ruling as to whether the project qualifies for the exemption. If successful, the company then presents the administrative ruling to the tax authorities.[124] Industry groups such as Abdib have criticized this two-part process as overly bureaucratic and susceptible to subjectivity regarding which projects will qualify.[125] Abdib also criticizes the fact that these tax breaks will only apply to *new* undertakings, which means that construction companies will not benefit from them until 2009.[126]

Another piece of PAC legislation, Law 11,478, grants tax relief to *privately run* investment funds focusing on infrastructure projects. The statute permits the incorporation of *Fundos de Investimento em Participações de Infra-Estrutura* or FIP-IEs, as closed mutual funds.[127] The FIP-IEs must have at least ten shareholders, and no shareholder may hold more than twenty percent of the fund's equity, or receive more than twenty percent of the fund's income.[128] At least ninety-five percent of the fund's assets must be invested in the equity or debt securities of SPVs formed to implement infrastructure projects.[129] The SPVs, which must be incorporated as *Sociedades Anônimas*, will presumably be formed as subsidiaries of the construction or engineering firms managing the project.[130] The FIP-IEs are not designed to be passive investors in the SPVs, but rather are to have corporate control, either via a majority share of the voting stock or by electing directors.[131] Individual investors are exempt from capital gains taxes, provided that they have held their shares in the funds for at least five years.[132] However, and despite Abdib's heavy lobbying for it, corporations are not entitled to these tax exemptions, and are taxed at rates varying between 15% and 22.5%, depending on the length of time their investments are held.[133]

Current Brazilian budgetary law limits tax breaks to a maximum of five years. Since infrastructure investments will clearly continue for longer than five years, there is pressure from industry leaders to change this. Some journalists have suggested amending the tax code to permit the deduction of roadway toll expenses on personal and corporate tax returns.[134]

The BNDES is also reducing the spreads on loans to infrastructure projects.

XI. Court Challenges

The Brazilian government acknowledges that there are one hundred forty-nine legal actions challenging various infrastructure projects, one hundred sixteen of which are part of the PAC.[135] Forty-six percent of these challenges are to eminent domain condemnations of real property.[136] The TCU, in which many of these challenges are brought, has determined that twenty-nine of the PAC's projects have "grave irregularities," such as over-billing, excessive change orders or irregular bidding and procurement processes.[137] The TCU's determinations are not binding, but the Brazilian Congress is likely to follow the TCU's recommendation and suspend work on these twenty-nine projects.[138]

Another of the PAC's legislative proposals are amendments to the General Concessions Law that would reduce and streamline these type of court challenges to public concessions and avoid the paralysis they cause.[139] While Abdib supports this legislative proposal, it advocates additional changes, such as the introduction of performance surety bonds for construction contracts, common in the U.S. construction industry.[140]

XII. Prognosis

Most of the PAC's initiatives are still in the planning stage. At its final meeting of 2007, on 20 December, the *Conselho Curador* approved the regulations governing the Investment Fund, although they have not yet been published as of the date of this article. In December, the *Conselho Curador* also formed the "Investment Committee," of twelve members, six from government and six from industry and labor.[141] We await the Committee's issuance of investment policy guidelines.

A vice-president at the *Caixa*, Wellington Moreira Franco, is also optimistic regarding a possible partnership between the *Caixa* and the BNDES by which the BNDES would act as a conduit for the Investment Fund's assets. Proposed by the *Caixa*, this partnership envisions the Investment Fund depositing its assets with the BNDES, like a regular banking depositor, and the BNDES making

loans to projects. Moreira Franco believes that projects could commence in as little as one hundred days after the *Caixa*-BNDES partnership is finalized.[142] While this timetable may be overly optimistic, there does seem to be a genuine effort by the Lula administration to address seriously Brazil's infrastructure needs. As such, even if the PAC is far from perfect, in both its planning and execution, it is sufficiently ambitious so that a good portion of the government's goals will likely be accomplished.

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Israel's New International Arbitration Rules

By Eric S. Sherby

I. Introduction

Since its founding in the early 1990s, the Israeli Institute of Commercial Arbitration (IICA)[1] has established itself as the leading arbitral institution in Israel. Yet until recently, the IICA had maintained only one set of arbitration rules, which did not distinguish between domestic (Israeli) cases and international cases. Recognizing the increasing number of disputes in Israel involving non-Israeli parties, the IICA recently adopted a separate set of rules for international cases.[2]

This article discusses the major features of the IICA's International Rules (the "Israeli Rules" or the "Rules"), with an emphasis on those issues of particular importance to non-Israeli parties to arbitrations.

II. The Language of the Arbitration—English "Rules"

The rules of many national and regional arbitration institutions provide that the institution or arbitrator has the discretion to select the language for the conduct of the arbitration. Article 17 of the Arbitration Rules of the United Nations Commission on International Trade Law (the "UNCITRAL Rules") provides as follows: "Subject to an agreement by the parties, the arbitral tribunal shall, promptly after its appointment, determine the language or languages to be used in the proceedings." The substance of Article 17 of the UNCITRAL Rules has been adopted in the international rules of many arbitral institutions, such as the Swiss Chamber of Commerce,[3] and the Japan Commercial Arbitration Association.[4]

The above-mentioned arbitral institutions (and the arbitrators appointed thereby), presumably, often decide that, when the arbitration agreement is in English, the language for the conduct of the arbitration should be English.

The IICA goes even further than the UNCITRAL Rules and the institutional rules that are modeled thereon. Rule 6.2(a) of the Israeli Rules provides that, when the language of the arbitration agreement is English, "the arbitration shall be conducted in English, unless the parties agree otherwise." In other words, when the arbitration agreement is in English, the issue of language is not an issue left to the discretion of the arbitrator or the IICA. There are only two, minor, exceptions, both of which would not apply if the arbitration agreement expressly states that the language of the arbitration is to be English:

> (a) If the arbitrator concludes that substantially all of the likely witnesses are Hebrew speakers, the arbitrator will usually have the discretion to order that oral examinations of those witnesses be conducted in Hebrew (Such rule has no effect on the language of the pleadings, affidavits, etc.); and
>
> (b) The arbitrator has the discretion to conduct purely "administrative hearings" in Hebrew.[5]

In summary, Rule 6.2(a) gives certainty to non-Israeli parties to English-language arbitration agreements that any dispute governed by the Rules will be arbitrated in English.

Such a rule is a departure from the prevailing practice in Israel; the author has been involved in several arbitrations that were conducted predominantly in Hebrew, even though the arbitration agreement was in English and a significant number of witnesses were non-Israeli residents who did not speak Hebrew.

III. Number of Arbitrators

A. When the Agreement Calls for Multiple Arbitrators

The general rule of the IICA is that disputes are adjudicated by a *sole* arbitrator.

In drafting its international rules, the IICA recognized that most arbitral institutions provide the option of arbitrating before three arbitrators; at the same time, the IICA realized that a three-arbitrator case can be expensive and that not every transnational dispute merits the costs inherent in three-arbitrator adjudication. In the Israeli context in particular, there is a perception that a contractual requirement of multiple arbitrators can be abused by the party that has the greater ability to bear the higher costs associated with such a case.

Therefore, Rules 1.1(a)(iv) and 4.2(b) attempt to establish a balance between the general rule of honoring the parties' pre-dispute agreement to use multiple arbitrators and the cost/burden of a three-arbitrator case.[6] Those rules provide that the parties' pre-dispute agreement to arbitrate before three arbitrators will be honored by the IICA, subject to one caveat: At least one party must, in its initial pleading with the IICA, make an express request for the appointment of three arbitrators. In other words, if the plaintiff fails to include a "multiple arbitrator statement" with its application to commence the arbitration, the plaintiff will be deemed to have *waived* any contractual right to request that the case be adjudicated by more than one arbitrator. Similarly, if the defendant fails to include a multiple arbitrator statement with its statement of defense, the defendant will be deemed to have waived any contractual right to request the appointment of multiple arbitrators.

(Any such waiver by the plaintiff does not affect any right of the defendant.)

The mechanism established by Rules 4.2(b) and 1.1(a)(iv) gives parties to an arbitration agreement the certainty that their pre-dispute selection of three arbitrators will be honored, subject simply to their paying sufficient attention to raise the issue at the first opportunity.

B. Three Arbitrators When Agreement Is Silent

Even when an arbitration agreement is silent as to the number of arbitrators, it might, nonetheless, be appropriate for three arbitrators to be appointed, so long as at least one party has timely requested such appointment. Rule 4.2(c) authorizes the IICA President to appoint more than one arbitrator when a timely request/notice has been filed. The rule gives substantial discretion to the President, who is to take into consideration various factors (in no particular order of importance) in deciding whether the dispute should be adjudicated by multiple arbitrators: (1) the costs inherent in a multiple-arbitrator case, (2) the subject matter of the dispute, (3) the complexities of the case; (4) the likely number of witnesses, and (5) "any other factors that justice and efficiency require."

As a practical matter, the author's experience is that the IICA hesitates to appoint three arbitrators absent a contractual provision calling for multiple arbitrators.

IV. Raising the Issue of Applicable Law Early

When an international arbitration agreement does not contain a governing law clause, the determination of the law applicable to the dispute is often a time-consuming and costly part of the arbitration proceeding. Therefore, Rules 1.1(c) and 2.1(c) require the parties to raise the issue of applicable law as early in the case as possible. Specifically, each party is required to state, in its initial pleading, whether it is of the view that the substantive law of a country other than Israel applies to the arbitration agreement.

One of the reasons for requiring the issue to be addressed early is to assist the President of the IICA in determining whether to appoint an arbitrator who is versed in the law of such non-Israeli jurisdiction (even though the mere assertion by a party that foreign law applies would not necessarily mean that the IICA or the arbitrator will accept such contention).

V. Security for Costs—the Playing Field Has Been Evened

Under Israeli civil practice, the general rule is that the losing party pays at least some amount of the prevailing party's legal costs, even if the losing party's position was devoid of "frivolous" or "vexatious" conduct.[7]

Israel's approach to costs is often felt at the outset of a case. Under Israeli civil practice, a defendant that is sued in court by a foreign plaintiff has the right to request that the court require the plaintiff to deposit security to ensure that, if the court awards costs against the plaintiff (at any stage of the case), the defendant will have available, in Israel, a source of funds for collecting on such an award. This procedure is designed to ensure that the defendant will not be forced to commence proceedings outside of Israel to collect on an award of costs. The practice of requiring a foreign plaintiff to deposit security has frequently been applied to arbitrations under Israeli law.

Rule 3.4 does away with such practice. It provides (in relevant part) that, in considering whether to order a party to deposit security for the arbitration expenses, "the arbitrator(s) shall not take into consideration that [a particular] party is based or domiciled outside of Israel or that such party does not have assets in Israel." Such provision recognizes that a non-Israeli party to an international transaction is not likely to consent to arbitrate before an Israeli arbitral institution if it knows that, by so consenting, it could be financially disadvantaged merely because it is a foreign entity.

VI. Evidence Gathering

Although Israeli courts have been inconsistent in permitting video-conferencing, the Rules recognize that advances in technology must be reflected in the conduct of international arbitration. Therefore, Rule 6.4 provides that "[n]othing herein shall be construed as restricting the discretion of the arbitrator(s), subject to an appropriate order regarding costs, to order video-conferencing or other forms of evidence-gathering." Presumably the party seeking to offer testimony via video-conferencing would be required to pay the costs associated with such procedure.

In addition, Rule 6.7 recognizes the importance in international arbitration of addressing special issues concerning witnesses from different countries. That rule provides that, when the arbitrator holds his/her (first) preliminary session with counsel for the parties, the arbitrator "shall, to the extent practical and subject to [the Rules,] determine the proceedings for . . . (as applicable) any special requirements with respect to foreign witnesses."

VII. Applicability of Substantive Law

A. Effect of Choice-of-Law Clause

To American lawyers, who are used to an arbitration regime in which an award can be vacated by a court if the arbitrator exhibited a "manifest disregard of the law," it is often surprising to learn that, under Israeli law, an arbitrator is not bound by substantive law unless the arbitration agreement provides otherwise (the "Default Rule"). The result of the Default Rule is that the failure by an Israeli arbitrator to apply substantive law is generally not a grounds for having a court vacate an award. (If the arbitration agreement does provide for the arbitrator to be bound by substantive law, his/her failure to apply substantive law usually will be a grounds for vacating the award.)

An ancillary issue is whether an agreement that contains both a choice-of-law (i.e., governing law) clause and an arbitration clause—but does not expressly state that the arbitrator is required to apply substantive law—trumps the Default Rule; in other words, is such an agreement considered one that requires the arbitrator to apply substantive law? Israeli case law does not provide a clear answer to that question.

The result of such lack of clarity is, for many non-Israeli lawyers (and their clients), a trap for the unwary. Many international practitioners are careful to ensure that their clients' international agreements do contain both an arbitration clause and a choice-of-law clause. However, because many such lawyers are unaware of the Default Rule, their contracts with Israeli parties usually do not state *expressly* that the arbitrator will be bound by substantive law.

In drafting its international rules, the IICA assumed that the inclusion of a choice-of-law clause usually indicates that the parties (at least those represented by counsel) expect the arbitrator to apply the substantive law chosen. Accordingly, Rule 8.2 provides, in relevant part: "Except when the context clearly indicates a contrary intention, (a) the inclusion in the Arbitration Agreement of a choice-of-law (governing law) clause shall constitute the parties' agreement that the arbitrator(s) will be bound by the substantive law so chosen." Such provision is intended to remove any ambiguity, in the construction of arbitration agreements, as to the intentions of the parties concerning the arbitrator being required to apply substantive law.

B. A Clear (Appealable) Award

As noted above, one of the grounds under Israeli law for requesting that a court vacate an arbitral award is that, despite the contractual requirement that the arbitrator render his award based upon substantive law, the arbitrator failed to do so.

As a result, in those cases in which the arbitration agreement does provide that the arbitrator is bound by substantive law, one of the most frequently asserted grounds for requesting that a court vacate an award is that the arbitrator failed to apply substantive law. In cases involving such an agreement, Rule 8.5 attempts to give the parties their "money's worth." That rule provides as follows: "In those cases in which the arbitrator(s) is/are bound by substantive law, . . . the award shall separately set forth the arbitrator's conclusions of fact and his conclusions of law."

The requirement to separately set forth conclusions of law and conclusions of fact is intended to make it easier for a court to review an arbitrator's conclusions of law (in a manner similar to that established in Rule 52(a)(1) of the Federal Rules of Civil Procedure).

VIII. Facilitating a Settlement

One of the universal criticisms of arbitration is that arbitrators have an economic incentive to prolong the resolution of cases and that, as a result, issues in a case that might be resolved early—were the matter before a court—are deferred unnecessarily by arbitrators.

In drafting its international rules, the IICA recognized that, in many commercial disputes, the early resolution of one or a few legal or factual issues can frequently lead to a prompt resolution of the entire dispute. (Examples of such issues include whether a claim is time-barred, whether a party has a right to assign its contractual obligations, and the effect of a waiver.)

Therefore, Section 7.1 provides that, "[t]o the extent that it appears that the early resolution of one or more issues in dispute is likely to facilitate a settlement, the arbitrator(s) is/are authorized to conduct the arbitration with a view toward reaching resolution of such issues."

Rule 7.1 does not purport to define those disputes in which early resolution of one or more issues can lead to a prompt resolution of the entire controversy; rather, the rule leaves the issue to the discretion of the arbitrator, based upon the facts of the particular case.

IX. Maintaining the Attorney-Client and Other Privileges

Israeli law concerning the attorney-client privilege is similar to the law of most states of the United States. Nonetheless, in drafting the Rules, the IICA recognized that the law concerning attorney-client privilege is not universal and that, despite those differences, the issue of privilege is often taken for granted in the decision by a business person to agree to resolve an international dispute out of court.

Inherent in the decision to arbitrate in a foreign country is the possibility that the law applied in the arbitration will not be one that recognizes the privileged nature of communications that have already taken place or which are likely to take place. While cognizant of such a problem, the Rules do not purport to solve it—in part because the nature of the problem is such that there is no "one-size-fits-all" solution. Rather, Rule 10.2 attempts to minimize the risk by according the issue of privilege a special status:

> Nothing herein shall be construed as derogating from the attorney-client privilege or any other privilege recognized by law. If a party is of the view that a privilege that is not recognized by Israeli law or which, under the circumstances, does not apply under Israeli law, should apply pursuant to the substantive law of some other country, the burden of proving the existence

and applicability of such privilege shall be upon such party. If that party makes a written application for the recognition and application of such privilege, to the extent that the arbitrator(s) denies(y) such application, such denial may be appealed within ten (10) Business Days to the President.

The denial of most motions by an arbitrator is (almost universally) not appealable. However, because the IICA recognizes the special importance of the issue of privileges in international disputes, Rule 10.2 allows the issue to be appealed to the President of the IICA. This section allows the arbitrators and the President to apply a choice-of-law analysis to determine whether it would be just to apply a privilege that would not otherwise exist under Israeli law.

Endnotes

1. *See* www.borerut.com, last visited on 7 April 2008. The IICA was founded by Israel's leading authority on arbitration, the late Professor Smadar Ottolenghi. Professor Ottolenghi served as President of the IICA until her untimely death in 2003.

   For the past several years, Judge (Retired) Amnon Straschnov—formerly a Judge of the Tel Aviv District Court—has served as the President of the IICA. *See* http://www.borerut.com/e-nasi.asp, last visited on 7 April 2008.
2. *See* www.borerut.com/foto-in/Rules%20-%20institute%20of%20arbitration.doc, last visited on 7 April 2008.
3. https://www.sccam.org/sa/en/rules.php ("[t]he Swiss Rules of International Arbitration are based on the UNCITRAL Arbitration Rules") , last visited on 7 April 2008.
4. http://www.jcaa.or.jp/e/arbitration-e/kisoku-e/pdf/e_shouji.pdf, last visited on 7 April 2008; *see* Rule 11(1) ("Unless otherwise agreed by the parties, the arbitral tribunal shall determine, without delay, the language or languages to be used in arbitral proceedings. The arbitral tribunal shall, in so determining, take into consideration whether interpreting or translating will be required and how the cost thereof should be allocated").
5. An "administrative hearing" is defined as one that involves counsel, but not the parties themselves, and as to which it is expected that the only matters to be dealt with are administrative. Rule 6.2(a).
6. Under Rule 4.2(b), notwithstanding any provision in an arbitration agreement, the President of the IICA always has the discretion *not* to appoint an even number of arbitrators.
7. Israeli courts have substantial discretion in determining the amount of costs; they take into account (a) the amount of the claim, (b) the amount of the relief that was actually awarded, and (c) the manner in which the litigants conducted the case.

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Funds and Families Moving Across Borders—A U.S. Perspective

By Glenn G. Fox

I. Hypothetical Fact Pattern

Marina Santiago de Keller, a citizen of a Latin American country and not a citizen of the United States, and Alan Keller, a citizen of the United States, have been married since 1983. Marina is forty-eight, and Alan is fifty. They have three children, aged seventeen, thirteen, and nine. The Keller family resides in New York City but spends at least two months a year in the Latin American country of which Marina is a citizen.

Marina operates a very successful marketing agency, which she founded in 1985 with her brother, Roberto Santiago. The business is headquartered in the Latin American country where Marina is a national, and it operates exclusively in Latin America, Spain, and Portugal. Marina and Roberto each own a fifty percent interest in the business.

Alan is a litigation attorney with a small firm in New York City and has an acute business sense. In recent years he has become involved with the operations of Marina and Roberto's marketing business and is now an employee of the agency. He also has become of counsel to his law firm in New York. Due to the growth of the business, it is expected that Marina and Alan will be spending more than two months a year in the Latin American country where Marina is a national, although they still will spend at least seven months a year in New York.

The Kellers' assets comprise the following:

- Marina's fifty percent interest in the Latin American business: $10,000,000.
- Townhouse in their joint names in Park Slope, Brooklyn: $4,000,000.
- Apartment in Marina's name in Latin America: $800,000.
- Smith Barney brokerage account in the U.S. in Alan's name: $300,000.
- Foreign brokerage account in Latin America in Marina's name: $400,000.
- Alan's 401(k) plan with his law firm: $200,000.

The Kellers have retained a U.S. attorney and an attorney from the Latin American jurisdiction where Marina is a national to assist them with their estate planning. Since Alan is an attorney (although not a trusts and estates attorney), and since he recently attended the Trust and Estate Panel at the ILPS Seasonal Meeting, he is very well versed in this area and would like the attorneys to address the following questions, as well as any others that may be relevant:

- What type of "advance planning" should the Kellers have in each jurisdiction with regard to powers of attorney, health care proxies, guardianships for the children, guardianships for the parents, etc.?
- What state's or country's law will apply to the disposition of their property upon their deaths?
- What are the consequences of dying without a will in each jurisdiction?
- What benefits are there to dying with a will in each jurisdiction?
- What (if any) transfer, death, inheritance, or estate taxes will be due upon their deaths in each jurisdiction?
- To the extent any taxes will be due upon either of their deaths, what estate planning techniques can be implemented in order to minimize such death taxes, and can U.S. or foreign trusts be used for such purposes?
- What is the recommended form of business entity that should be used by Marina and Roberto for the marketing business?

This article will address the Kellers' concerns from the perspective of U.S. law.

II. "Advance Planning"

A. Powers of Attorney

Since the Kellers maintain significant real and personal property in New York, they each should implement a durable general power of attorney. New York law[1] permits a person to designate an agent to act on his or her behalf in a wide variety of business and legal matters. New York General Obligations Law Section 5-1501 provides a standardized short form power of attorney that must be recognized by all financial institutions located in New York.[2]

Implementing powers of attorney will avoid the need to have a guardian appointed for either of the Kellers should one or both of them become incapacitated and unable to handle his or her financial affairs. The appointment of a guardian can be a very costly and time-consuming process under New York law.[3]

Among the powers that may be granted to an agent by the principal under a general durable power of attorney are the powers to act on the principal's behalf with re-

spect to the following: real estate transactions; chattel and goods transactions; bond, share, and commodity transactions; banking transactions; business operating transactions; insurance transactions; estate transactions; claims and litigation; personal relationships and affairs; benefits from military service; records, reports, and statements; retirement benefit transactions; gifts to the principal's spouse, children, more remote descendants, and parents, not to exceed in the aggregate $12,000 to each of such persons in any year; tax matters; and "all other matters."[4] The principal also may add tailored language for specific powers not enumerated in the statute.

B. Joint Accounts

Under New York law,[5] when assets are placed in the joint names of two or more individuals, the deposit becomes the property of such persons as joint tenants. The account, and all additions to and accruals on the account, will be held for the exclusive use of those persons and may be paid to either during the lifetime of both or to the survivor after the death of one of them.

Marina and Alan Keller may view a joint account as a simple form of estate planning, since it avoids the need to probate a will in order to transfer the assets upon death and allows either spouse to deal with the assets during life without the need for a power of attorney. There are, however, some negative aspects of a joint account, and in most cases the clients would be better served by proper powers of attorney and wills or revocable trusts.

The first negative aspect of a joint account is that the account may be subject to the claims of the creditors of both account holders. It has been held that Section 675 of the Banking Law provides a presumption that the parties to a joint bank account are entitled to equal shares of the account.[6] The presumption may be rebutted by evidence that the joint account was established as a convenience and not with the intention of conferring a beneficial interest on the other parties to the account.[7] If the debtors can overcome the presumption, one-half of the assets in the joint account may be fully subject to the claims of an account holder's creditors, even if that account holder did not contribute any assets to the account. This may be an issue if Alan faces a legal malpractice claim, for example.

Another reason that a joint account may be problematic relates to Marina's not being a U.S. citizen. Under Section 2056(d) of the Internal Revenue Code of 1986, as amended (the "Code"), assets that pass to a noncitizen spouse upon death will not be exempt from the U.S. estate tax, notwithstanding the unlimited marital deduction set forth in Code Section 2056(a), unless the assets pass to a trust called a "qualified domestic trust" or "QDOT." In addition, if the surviving spouse is not a U.S. citizen, *all* of the assets in the account will be deemed to be included in the estate of the first spouse to die (unless it can be proven that the surviving spouse contributed some or all of the assets to the account), rather than only fifty percent, as is the case when the surviving spouse is a U.S. citizen.[8] Therefore, if Alan creates a joint account for himself and Marina, all of the assets in the account will be subject to estate tax when Alan dies, unless Marina is able and willing to transfer the assets in the account to a QDOT after Alan's death.[9]

Finally, if all of the Kellers' assets are in joint accounts, they may not each have sufficient assets to fund a credit shelter trust created under their respective wills or revocable trusts to fund the $2,000,000 estate tax exemption amount.[10]

To avoid the above-referenced problems, it would be better for Alan and Marina to keep their assets in separate accounts, with proper powers of attorney and wills that, in Alan's case, would include a QDOT for Marina's benefit.

It should be noted that, although Code Section 2523(i) also prevents the marital deduction from applying to gifts to a noncitizen spouse in excess of $125,000 (indexed for inflation) in a given year, if Alan places assets in a joint account he will not be deemed to have made a taxable gift to Marina until she withdraws assets from the account.[11]

C. Health Care Proxies and Living Wills

To avoid the need for Alan and Marina to be maintained on artificial life support against their wishes for an extended period of time, each of them should implement a "health care proxy and living will." In such a document they each can set forth their health care wishes and designate someone to make health care decisions for them if they are unable to do so themselves.[12]

D. Revocable Trusts

Because the Kellers have property in two different jurisdictions, New York and a country in Latin America, it may be necessary for them to probate wills in several jurisdictions in order to properly dispose of their assets upon their deaths. In addition, in order to limit U.S. estate taxes to the greatest degree possible, it will be necessary for their wills to contain so-called "credit shelter trusts" and, in Alan's case, a QDOT. To avoid the need to probate their wills in more than one jurisdiction—and perhaps avoid the forced heirship rules that may be imposed by the Latin American country where Marina is a national—and to be sure that the credit shelter trust and QDOT are properly implemented, it may be better for the Kellers each to create a New York revocable trust while they are alive and transfer their respective assets to the trusts.

Alan and Marina each could be the trustee and sole beneficiary of his or her respective revocable trust during his or her lifetime. Upon their deaths the assets in the trusts would pass to credit shelter trusts, a QDOT, or other intended beneficiaries under the terms of the trusts.[13] To the extent assets are transferred to the revocable trusts while the Kellers are alive, probate and the forced heir-

ship rules in Latin America may be avoided. Whether this can be accomplished may depend on whether the laws in the Latin American country where Marina is a national will recognize a U.S. trust and allow it to trump the forced heirship rules.

1. Conflict of Law Issues with Respect to the Disposition of Property upon Death

Under New York law,[14] the manner in which real property descends upon the death of the owner is determined by the law of the jurisdiction where the property is located, and the manner in which personal property descends upon the death of the owner is determined by the jurisdiction where he or she is domiciled. Since the Kellers have personal property situated in both New York and Latin America, the question of domicile will be an important one, particularly since they plan to be spending up to five months a year in the Latin American country for business purposes.

If the Kellers would prefer to have New York law apply to the disposition of their personal property, including the disposition of Marina's interest in her Latin American marketing company, they should make sure they maintain sufficient ties with New York. In addition, local counsel should be retained in the Latin American country to confirm that their contacts there will not result in the application of local law to the disposition of their personal property there. Again, one solution to the domicile question, which may not have a clear answer, may be to implement and fund revocable trusts and thereby circumvent local forced heirship law in Latin America.

2. Intestacy: Disposition of the Estate of a New York Resident or of the New York Estate of a Non–New York Resident Who Dies Without a Will

If a New York resident dies without a will, or if a non–New York resident dies without a will owning real property situated in New York, the New York intestacy statute will determine the manner in which the property will descend upon death. In the Kellers' case, where they are married and have children, the first $50,000 of the estate of the first spouse to die will pass to the surviving spouse outright; fifty percent of the remainder of the estate of the first spouse to die also will pass to the surviving spouse; and the remaining fifty percent will pass to the children.

Thus, failure to implement proper wills or revocable trusts will accelerate estate tax, since, in Alan's case, a QDOT will not be created for Marina (unless she decides to transfer the assets inherited by intestacy to a postmortem QDOT that she creates), and roughly fifty percent of his estate will pass to his children. Also, the children will receive the assets at age eighteen. Had the Kellers implemented wills or revocable trusts, the assets could have been held in trust for the children until the children attained a later age of the Kellers' choosing. In addition, the Kellers would have been able to choose who would administer their estate and who would serve as trustee for and guardian of their children, and they also could have set up a succession plan for the family business, which the children may not be in a position to run on their own.

III. U.S. Estate and Gift Tax Structure

A. Domicile

For purposes of the U.S. estate and gift taxes, an alien is considered a U.S. resident if he or she is domiciled in the U.S. at the time of his or her death or at the time of a gift. If an alien enters the U.S. for even a brief period of time, with no definite present intention of later leaving the U.S., he or she is deemed to be domiciled in the U.S. and, therefore, is considered a U.S. resident for estate and gift tax purposes.[15] Thus, an alien may be considered a nonresident for estate tax purposes and a U.S. resident for income tax purposes, or vice versa, since the estate tax residency test is the more subjective domicile test just described, while the income tax residency test is met if the alien satisfies an objective day-count test known as the "substantial presence test" or holds a green card (i.e., is a lawfully admitted permanent resident of the U.S.).[16] (A discussion of the income tax residency tests is beyond the scope of this article.)

Under the estate and gift tax domicile rules discussed above, the determination of domicile is a factual issue that focuses on many factors, none of which is determinative. Some of the factors on which the IRS and courts focus are (i) the length of time spent in the U.S. and abroad and the amount of travel to and from the U.S. and between other countries; (ii) the value, size, and locations of the donor's or decedent's homes and whether he or she owned or rented them; (iii) whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.; (iv) the situs of valuable or meaningful tangible personal property; (v) where the alien's close friends and family are situated; (vi) the locales in which the alien has religious and social affiliations or in which he or she partakes in civic affairs; (vii) the locales in which the alien's business interests are situated; (viii) visa status; (ix) the places where the alien states that he or she resides in legal documents; (x) the jurisdiction where the alien is registered to vote; (xi) the jurisdiction that issued the alien's driver's license; and (xii) the alien's income tax filing status.[17]

B. Assets Subject to U.S. Estate and Gift Tax

Resident aliens and citizens of the U.S. are subject to U.S. estate tax, which is generally imposed at a rate of forty-five percent, on all of their worldwide property, wherever it is located, and are subject to U.S. gift tax (at the same rate) on gifts of worldwide property.[18] Generally, nonresident aliens are subject to federal estate tax only on "U.S.-situs" property, with no credit for foreign death taxes paid.[19] Nonresident aliens are also subject to federal

gift tax on lifetime gifts of U.S.-situs property, but not on gifts of U.S.-situs intangible property.[20]

U.S.-situs property includes the following: (i) real property located in the U.S.;[21] (ii) tangible personal property located in the U.S. (including cash, U.S. Treasury Bills, cars, furniture, jewelry, artwork, and the like);[22] (iii) shares of stock issued by a U.S. corporation;[23] (iv) subject to certain exceptions (set forth below), any debt obligation, the primary obligor of which is a U.S. person or the U.S., a state or any political subdivision of the U.S., or the District of Columbia, or any agency or instrumentality of any such government;[24] (v) property that is gratuitously transferred by a nonresident alien decedent while he or she is alive, by trust or otherwise, if (A) the nonresident alien decedent retained for his or her life (or for a period that cannot be ascertained without reference to his or her death) some type of possession, control, or enjoyment of said property or its income or the right to designate who will possess or enjoy the property, (B) possession or enjoyment of the property could be obtained only by surviving the decedent, and the decedent retained a reversionary interest in the property that exceeds five percent of the value of the property at the time of the decedent's death, (C) said property was, on the date of the nonresident alien decedent's death, subject to his or her right to alter or revoke the transfer (or if such a power was relinquished by the nonresident alien decedent within three years of the date of his or her death), *or* (D) if the decedent transferred within the three-year period prior to his or her death an interest in property that would have been included in his or her estate under any of the foregoing rules, *and* if the property so transferred was situated in the U.S. at the time of the transfer or at the time of the decedent's death;[25] and (vi) an interest in a partnership, if (A) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the U.S.[26] or (B) if the partnership is a separate legal entity under the laws of the jurisdiction where it was established, survives the death of a partner, and carries out its business in the U.S.[27]

Examples of assets that are deemed to be situated outside of the U.S. are: (i) shares of stock issued by a foreign corporation;[28] (ii) deposits with persons carrying on a banking business, deposits or withdrawable accounts with a federal or state chartered savings institution (if the interest on such accounts is withdrawable on demand subject only to customary notice requirements), and amounts held by an insurance company under an agreement to pay interest thereon, as long as, in each case, the interest on such deposits or amounts is not effectively connected with the conduct of a trade or business in the U.S. by the recipient thereof;[29] (iii) deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business;[30] (iv) "Portfolio Debt Obligations," as long as the decedent was a nonresident alien for income tax purposes (a Portfolio Debt Obligation will be considered U.S.-situs property if the decedent was a resident for income tax purposes, even if he or she was a nonresident alien for estate tax purposes);[31] and (v) proceeds from a life insurance policy on the nonresident alien decedent's life.[32]

Although nonresident aliens are also subject to gift tax on gifts of U.S.-situs property, gifts of U.S.-situs *intangible property* by a nonresident alien are generally exempt from the gift tax.[33] Property that is not considered intangible property and is therefore subject to federal gift tax when given away by a nonresident alien includes: (i) real property situated within the U.S.; (ii) tangible personal property situated within the U.S. at the time of the gift; and (iii) U.S. or foreign currency or cash situated within the U.S. at the time of the gift.[34]

Property that is considered intangible personal property and is therefore not subject to federal gift tax when given by a nonresident alien includes: (i) shares of stock issued by a U.S. or foreign corporation;[35] (ii) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the U.S., a state or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government;[36] and (iii) interests in U.S. or foreign partnerships, although there is some debate on whether partnership interests are intangible personal property.[37]

C. Application to Marina Santiago de Keller and Alan Keller

As a U.S. citizen, Alan will be subject to estate and gift taxation on his worldwide estate and worldwide gifts, regardless of his domicile. Therefore, the additional time that he will be spending in the Latin American country as a result of his position in Marina's company will not impact his exposure to U.S. estate, gift, and income tax. To the extent that his estate is subject to foreign estate or inheritance taxes he will receive a proportionate credit against his U.S. estate tax for the foreign taxes imposed upon property situated in the foreign jurisdiction based on a fraction the numerator of which is the value of the foreign property and the denominator of which is the value of the decedent's worldwide property.[38] The rules under Code Section 2101 discussed above for determining whether property is situated in the U.S. for purposes of imposing the estate tax on a nonresident alien's estate apply for this purpose as well.[39]

Since Marina is not a U.S. citizen, determining her domicile will be crucial for ascertaining whether she is subject to estate and gift tax on her worldwide assets or only on her U.S.-situs assets. The factors that weigh in favor of Marina's being considered a U.S. domiciliary are that she owns a significant home in the U.S.; that she presumably is a permanent resident of the U.S. for income tax purposes (i.e., she holds a green card); and that she and her children and spouse have spent, at least until recently,

approximately ten months a year in the U.S. Factors that weigh against Marina's being considered a U.S. domiciliary are that she owns a residence in Latin America; that she has a substantial business that is situated in Latin America; and that she and her family will be spending now about five months a year in Latin America.

Although not a litmus test for determining U.S. domicile status, Marina's retention of her green card probably will tip the scales in favor of her being considered a U.S. domiciliary, and she should plan her estate with this in mind. Should Marina relinquish her green card, which will have lingering income, estate, and gift tax consequences for a ten-year period thereafter,[40] and should she begin to spend a much more significant amount of time each year in the Latin American country, a colorable argument could be made that she no longer is domiciled in the U.S. The sale of her U.S. residence also will help in making this argument.

IV. Estate Planning Techniques That Can Be Implemented in Order to Minimize Death Taxes, Including the Use of U.S. and Foreign Trusts

Assuming that the estates of both Marina and Alan will be subject to U.S. estate tax, in order to minimize the ultimate value of their estates, the use of trusts of one form or another will play a crucial role. If Marina is interested in lowering the value of her estate for U.S. estate tax purposes, this will include the possibility of transferring her interests in her Latin American company to one or more types of trusts.

Therefore, before doing any estate tax planning for Marina, the initial question will be whether her interests in the company can be transferred to a trust (U.S. or non-U.S.) under the local law of the Latin American country where the company is formed and Marina is a national. If the interests in the company can be transferred to a trust under local law, the next question will be whether a U.S. trust can be used for this purpose. In this regard, it will be necessary to determine whether the company can be owned by a foreign entity under local law. If local law will allow the company to be owned by the U.S. trust, the next question is whether there will be negative income tax consequences in the Latin American country as a result of the ownership of Marina's fifty percent interest in the company by the trust.

If local law in the Latin American country prohibits the use of trusts or makes trusts cost-prohibitive from an income tax perspective, one alternative may be to transfer Marina's ownership interest in the company to a U.S. limited liability company ("LLC"), assuming that local law in the Latin American country would allow a U.S. LLC to own an interest in the Latin American company. If such an ownership structure is permitted, then Marina should be able to transfer her interest in the U.S. LLC to the trust, since local Latin American law probably will not be concerned with who owns the interests in the U.S. LLC (although this must be confirmed with local Latin American counsel).

Before Alan uses trusts, such as a QDOT or credit shelter trust, to hold assets for the benefit of Marina, it must be determined whether Marina's being the beneficiary of a trust will have negative income tax consequences for her in the Latin American country where she is a national and, perhaps, a resident. If trusts are prohibited or are cost prohibitive from an income tax perspective under local law in the Latin American country, it may be possible for Alan to achieve the same estate tax savings or deferral by incorporating into his estate planning documents life estates for Marina (rather than trusts) that are designed to achieve the same tax goals.[41]

If it is determined that Marina can transfer her interests in the company to a trust, and, moreover, she is no longer a U.S. resident for estate and gift tax purposes, she should give serious consideration to transferring her interests in the Latin American company, either during her lifetime or at the time of her death, to a so-called "dynasty" trust for the benefit of her husband and children. Since Marina would be transferring an interest in a foreign corporation or (if her company is a partnership) in a partnership that does not do business in the U.S., the transfer will not be subject to U.S. estate or gift taxes. If the dynasty trust for the benefit of her family has independent trustees, or if her family members are trustees and beneficiaries but their ability to make distributions to themselves are limited to so-called "ascertainable standards" of health, education, maintenance, and support, the trust assets should never be included in the estates of Alan or the children, as neither Alan nor the children will have a power of appointment.[42] Use of such a trust by a nonresident alien of the U.S. to benefit her U.S. relatives is a very strong estate planning technique. As a result of the intangibles exception to the gift tax, Marina can use the same type of trust to make gifts of intangible U.S.-situs assets (e.g., shares of stock in U.S. publicly traded corporations) to her children, assuming she is not a U.S. resident.

If Marina is a U.S. resident, and trusts are accepted in the Latin American country, she could recapitalize the company into voting and nonvoting shares and transfer the nonvoting shares to trusts for her children while she is alive, using her $1,000,000 gift tax exemption amount. Since she would be giving away nonvoting shares, she should be able to discount the value of the gifts for gift tax purposes. Marina's retention of the voting interests should not cause the interests that she has given away to be included in her estate.[43]

If Marina is a U.S. resident, and she wants to remove the appreciation of the interests in the Latin American company from her estate, she should consider implementing a "Grantor-Retained Annuity Trust," or "GRAT," under Code Section 2702. A GRAT is a statutorily recognized trust to which Marina would transfer interests in

the company and retain the right to an annuity for a term of years. If she survives the term of years, the remaining assets in the trust will pass to her children, or to trusts for their benefit, essentially free of federal gift and estate taxes. If she dies during the term of the trust, all of the trust assets will be included in her estate and will be subject to estate tax.

Under Internal Revenue Code rules,[44] the value of the gift of the remainder interest that passes to Marina's children is determined at the time that the trust is created by subtracting the actuarial value of her retained right to the annuity from the value of the property transferred to the trust. Generally speaking, if the grantor retains a relatively large annuity (close to the value of the property that was transferred to the trust), the gift tax value of the remainder that passes to the children will be small or, perhaps, zero under the actuarial tables.

The GRAT will achieve the goal of removing property from the grantor's estate at relatively no gift tax cost only if the return of income and appreciation of the trust during the trust term exceeds the interest rate imposed by the IRS, which in November 2007 was 5.2 percent, and which changes on a monthly basis. This is generally achieved by transferring property that is expected to appreciate significantly over the period of a short-term GRAT. For example, assume that in November 2007 Marina transferred $4,000,000 of assets that were expected to appreciate at a rate of ten percent a year to a three-year GRAT, and that she retained a thirty-eight percent annuity payable to herself and to her estate (after her death). This means that she would receive $1,500,000 a year from the trust. This high annuity rate is deemed, by the actuarial tables, to result in a gift with a present value of zero for the children. Based on the appreciation of ten percent a year, after the three years of $1,500,000 annuity payments there will be approximately $825,000 of assets remaining in the trust (assuming the stock does appreciate by ten percent annually) that will pass to the children gift-tax free. In effect, the appreciation of the assets over the three-year period escapes transfer taxes.

Trusts that Alan may want to take advantage of for purposes of transferring U.S. assets to the children with the least estate and gift tax consequences are a "Qualified Personal Residence Trust," also known as a "QPRT," under Code Section 2702, and an insurance trust.

A QPRT is an irrevocable trust to which Alan would transfer the family home in Brooklyn. Under the trust Alan would retain the right to reside in the home for a term of years that he selects. If Alan survives the term of years chosen for the QPRT, the home, or any successor residence, will pass to the Kellers' children without being included in Alan's taxable estate. As a result, Alan will have removed from his taxable estate not only the current value of the home but also any appreciation on the home.

The initial transfer to the QPRT will be a taxable gift. Under Code Section 2702 and the Treasury Regulations, the value of the gift, however, will be measured solely by the value of the remainder interest that passes to the children, which is only a fraction of the total value of the property. This "leveraging" of the $1,000,000 gift tax exemption amount is at the heart of the QPRT's advantage.

The extent to which the QPRT enables Alan to reduce the gift tax cost of the transfer is directly related to the term of years he selects and his age. The longer the term of years and the older that Alan is, the greater the value that can be transferred free of estate and gift taxes. Alan must keep in mind, however, that the QPRT technique only works if he survives the term of years. If he dies prior to the expiration of the term of years, the property will be included in his estate at its date-of-death value, as if there had been no initial transfer to the QPRT. Thus, it is important for Alan to select a term of years that he expects to survive.

There are some important ancillary issues of which Alan should be aware. The first relates to the expenses of the residence. Under IRS regulations, expenses of the trust (i.e., of the home) may be paid by the term holder. Therefore, during the retained term of years, Alan may pay the expenses. After the term of years, when the home is held for the benefit of the children, the children will have to pay for the expenses.

Second, if the home is sold, under the Treasury Regulations for Code Section 2702 the proceeds of sale must be rolled over into a new home within two years. If a new home is not purchased within the two-year period, the QPRT must convert to a trust that will provide Alan with annuity payments.

The third point relates to capital gains. If Alan were to retain the home or a replacement home until his death, his children would receive the property with a stepped-up basis equal to the date-of-death value of the property under Code Section 1041. As such, the date-of-death-value basis is an important advantage that is lost with a QPRT. The reason for this is that if the QPRT technique is successful, the children will receive the property with a basis equal to Alan's original cost basis in the property, since the stepped-up basis rules of Code Section 1041 apply only to bequests at death (not to *inter vivos* gifts). Thus, the children will have a much higher capital gains tax if they sell the property under this scenario. However, since the top estate tax rate is currently forty-five percent, and the combined state and federal capital gains tax rate is currently roughly twenty percent, the QPRT technique offers significant savings under current law.

The fourth point is that once the term of years expires, and the home is held in trust for the children or owned outright by them, if Alan and Marina want to use

the home, they will need to enter into a fair-market-value lease with the trusts or the children and pay fair-market-value rent. The rental payments will be subject to income tax when received by the children, but the payments will move additional assets out of the Kellers' estate, thus sheltering the assets from the higher estate tax.

Finally, Alan and Marina should consider acquiring life insurance to cover the estate taxes that will be due upon their deaths. Since life insurance owned by a U.S. resident or citizen decedent is included in his or her estate under Code Section 2042, the life insurance should not be owned by Alan or by Marina (if she is a U.S. resident). If the life insurance is owned by a properly structured life insurance trust, and the trust is designated as the beneficiary of the policy, the insurance proceeds will not be included in either Alan's or Marina's estate under Code Section 2042. After their deaths, the trust can purchase estate assets to provide the estate with the liquidity it will need to pay estate taxes. The assets ultimately owned by the trust will pass to the children under the terms of the trust. If it becomes clear that Marina is no longer a U.S. resident for estate tax purposes, she could own the policy on her life directly, without any concern that the insurance proceeds will be included in her estate (since life insurance is considered non–U.S.-situs property), and the funds could be used to pay any estate taxes on her U.S.-situs property.

V. IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS and other taxing authorities, the author informs you that any tax advice contained in this article is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed on any taxpayer or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Endnotes

1. GOL § 5-1501.
2. Under GOL § 5-1504 it is unlawful for a financial institution that is located in New York to refuse to honor a properly executed statutory short form power of attorney.
3. The procedures for the appointment and oversight of guardians are set forth in MHL art. 81.
4. See GOL §§ 5-1502A to 5-1502O for elaborations of each of these powers.
5. Banking L. § 675.
6. *See Phelps v. Kramer*, 102 A.D.2d 908, 477 N.Y.S.2d 743, 744 (3d Dept. 1984).
7. *Id.* at 908, 477 N.Y.S.2d at 744-45.
8. *See* I.R.C. §§ 2040(a), (b), 2056(d)(1)(B).
9. Postmortem transfer to a QDOT is permitted under I.R.C. § 2056(d)(2)(B).
10. *See* I.R.C. § 2010.
11. *See* Treas. Reg. § 25.2511-1(h)(4).
12. *See* PHL art. 29-C.
13. *See* EPTL § 7-1.1.
14. EPTL § 3-5.1(b).
15. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b).
16. *See* I.R.C. § 7701(b)(1)(A).
17. *See Farmers' Loan & Trust Co. v. U.S.*, 60 F.2d 618 (S.D.N.Y. 1932); *Paquette Est. v. Comm'r*, T.C.M. 1983-571 (1983); *Nienhuys Est. V. Comm'r*, 17 T.C. 1149 (1952); *Fokker Est. v. Comm'r*, 10 T.C. 1225 (1948).
18. *See* I.R.C. §§ 2001, 2031, 2501.
19. I.R.C. §§ 2101, 2103, 2106.
20. I.R.C. §§ 2501(a)(1), (2), 2511(a).
21. Treas. Reg. § 20.2104-1(a)(1).
22. *See* Treas. Reg. §§ 20.2104-1(a)(2), -1(a)(7)(ii), 25.2511-3(b)(4)(iv); *Blodgett v. Silberman*, 277 U.S. 1 (1928); Rev. Rul. 55-143, 1955-1 C.B. 465; Priv. Ltr. Rul. 81-38-103 (June 25, 1981).
23. *See* I.R.C. § 2104(a); Treas. Reg. § 20.2104-1(a)(5).
24. *See id.*
25. *See* I.R.C. § 2104(b).
26. *See Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934).
27. *See* Rev. Rul. 55-701, 1955-2 C. B. 836; Gen. Couns. Mem. 18,718, 1937-2 C. B. 476.
28. I.R.C. § 2104(a); Treas. Reg. § 20.2105-1(f).
29. I.R.C. § 2105(b)(1); Treas. Reg. § 20.2105-1(h).
30. I.R.C. § 2105(b)(2); Treas. Reg. § 20.2105-1(j).
31. I.R.C. § 2105(b)(3).
32. I.R.C. § 2105(a).
33. I.R.C. §§ 2501(a)(1) and (2), 2511(a).
34. *See* Treas. Reg. § 25.2511-3(a)(1), -3(b)(1); Treas. Reg. § 25.2511-3(a)(1), -3(b); Treas. Reg. § 25.2511-3(b)(4)(iv); Treas. Reg. § 25.2511-3(b)(2), -3(b)(4).
35. I.R.C. § 2511(b)(1); Treas. Reg. § 25.2511-3(b)(3).
36. I.R.C. § 2511(b)(2); Treas. Reg. § 25.2511-3(b)(4).
37. For authorities and commentaries that support the proposition that a partnership interest is an intangible, see *Blodgett v. Silberman*, 277 U.S. 1, 11 (1928); Priv. Ltr. Rul. 77-37-063 (June 17, 1977); 2 Rhoades and Langer, U.S. International Taxation and Tax Treaties, § 33.01[2][iii] (1998); Stafford Smiley, *Dispositions of U.S. Partnership Interests by Nonresident Aliens*, Business Entities, Summer 1991; Robert F. Hudson, Jr., *The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses*, Business Entities, Mar./Apr. 2002. For authority that indicates the IRS may question whether a partnership interest is an intangible asset, see Rev. Proc. 2007-7, 4.01(26), 2007-1 I. R. B. 227 (which states that the IRS will not ordinarily issue a ruling or determination letter on this issue).
38. I.R.C. § 2014.
39. I.R.C. § 2014.
40. *See* I.R.C. §§ 877, 2107.
41. *See, e.g.*, Treas. Reg. § 20.2056A-4 ("Procedures for conforming marital trusts and nontrust marital transfers to the requirements of a qualified domestic trust").
42. *See* I.R.C. § 2041.
43. *See* Prop. Treas. Reg. § 20.2036-1.
44. *See* Treas. Reg. § 25.2512-5(d).

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Recognition of Foreign Money Judgments in the United States with a Special Emphasis on the Recognition of Ukrainian Judgments

By Torsten M. Kracht and Oleh O. Beketov

I. Introduction

Many litigants who obtain money judgments from courts outside the United States incorrectly believe they cannot enforce their judgments against the judgment-debtor's assets in the United States because the United States is not currently a party to any international treaty concerning the recognition[1] of foreign money judgments.[2] Although it is true that the United States is not a party to any such treaty, foreign money judgments can be recognized in the United States under the laws of individual states. The first part of this article discusses generally the legal framework for recognition of foreign money judgments in the United States, while the second part deals with issues that may be specific to the recognition of judgments rendered by Ukrainian courts.

II. Recognition of Foreign Money Judgments by Courts in the United States

Before discussing whether courts in the United States will recognize foreign money judgments, it is important to note for readers unfamiliar with the United States legal system that the United States has state laws (including both statutes and common law) and federal laws (also including both statutes and common law). Generally, when state and federal laws addressing the same substantive areas conflict, federal law controls.[3] Because the United States has not yet joined any treaty or enacted federal laws that would be binding on the states concerning recognition of foreign money judgments, our discussion in this article focuses on state laws.[4]

Of the fifty states in the United States, thirty have adopted some version of a uniform set of laws on judgment recognition, named the Uniform Foreign Money-Judgments Recognition Act (UFMJRA or the "Act").[5] The Act was first proposed in 1962 by the National Conference of Commissioners on Uniform State Laws (NCCUSL).[6]

The Act allows recognition in the United States of "any foreign judgment that is final and conclusive and enforceable where rendered."[7] "Foreign judgment" is defined by the Act as "any judgment of a foreign state granting or denying recovery of a sum of money, other than a judgment for taxes, a fine or other penalty or a judgment for support in matrimonial or family matters."[8]

Of the twenty states that have *not* adopted the Act, the majority have common law concerning the enforcement of foreign judgments that is similar in many respects to the Act and to the 1895 U.S. Supreme Court case *Hilton v. Guyot*,[9] which set out the following factors for the recognition of foreign judgments: (1) "a full and fair trial," (2) rendered by a "court of competent jurisdiction," (3) "after due citation or voluntary appearance of the defendant," (4) "under a system of jurisprudence likely to secure an impartial administration of justice," (5) without anything "to show either prejudice in the court, or in the system of laws," (6) with no "fraud in procuring the judgment," and (7) with no "other special reason" for withholding recognition.[10] Although the *Hilton* court also required reciprocity (i.e., that the foreign court also recognize U.S. court judgments), most states in the United States have rejected the reciprocity requirement.[11]

A. The Uniform Foreign Money-Judgments Recognition Act

The starting point of the Act is that "final and conclusive" foreign money judgments are presumptively recognizable and should be treated like judgments rendered by a court of any state within the United States.[12] Thus, when a court in the United States that follows Section 3 of the Act is presented with a foreign money judgment, it must recognize the judgment unless one of the exceptions to recognition that are set forth in the Act is established.

Despite the presumption of recognition of foreign money judgments under the Act, courts in jurisdictions that have adopted the Act have discretion to deny recognition of the foreign judgment if the defendant did not receive timely notice, the foreign judgment was obtained by fraud, the cause of action underlying the foreign judgment is repugnant to the public policy of the state, the judgment conflicts with another final and conclusive judgment, the foreign forum was chosen contrary to an agreement between the parties, or if the foreign forum was "seriously inconvenient" to the defendant and personal jurisdiction was obtained only on the basis of personal service of process.[13] The Act also provides that the foreign judgment must be denied recognition if the issuing court lacked personal jurisdiction over the defendant.[14] Finally, the Act requires that the judgment to be recognized "grant[] or den[y] recovery of a sum of money," and it expressly excludes from recognition judgments concerning taxes, the imposition of a fine or penalty, and those concerning support in domestic matters.[15]

B. A Minority of U.S. States Have also Adopted a Reciprocity Requirement

Although most jurisdictions in the United States have abandoned the reciprocity requirement established by the Supreme Court in *Hilton v. Guyot*,[16] eight states have expressly added the reciprocity requirement back into their versions of the Act.[17] In these states, a party seeking recognition of a foreign money judgment must establish that the jurisdiction from which the judgment originated would recognize a money judgment originating from one of its courts.

C. The Revised Act

In 2005, the NCCUSL revised the original Act to address issues that had arisen in the states that had adopted it.[18] Specifically, the revised Act, known as the Uniform Foreign-Country Money Judgments Recognition Act (the "Revised Act"), clarifies that the party seeking recognition bears the burden of proving that the judgment is subject to the Act, but the opposing party bears the burden of proving any specific ground for non-recognition.[19] The Revised Act also sets out a procedure for recognition and enforcement, providing that recognition may be sought by filing an original action or it may be raised as a counterclaim, cross-claim or affirmative defense in a pending action.[20] And, the Revised Act establishes that a foreign money judgment must be enforced within fifteen years or within the period established by the jurisdiction that rendered the judgment, whichever is earlier.[21]

Currently, only the states of Idaho and Nevada have adopted the Revised Act, but adoption of the Revised Act is also pending before the legislatures of California and Michigan.

D. Conclusion

Subject to the various factors for judgment recognition discussed above, in a majority of states in the United States, a foreign judgment may be recognized even if the jurisdiction from which it was issued does not reciprocally recognize judgments from the United States. A minority of states in the United States, however, require that the foreign state reciprocally recognize judgments from the U.S. before they will recognize the foreign judgment. This point becomes especially important concerning judgments from countries like Ukraine, where reciprocity with the United States is not a settled issue.

III. Judgment Recognition in Ukraine

Like many parties that obtain money judgments outside the United States, a Ukrainian party that obtains a money judgment from a Ukrainian court, for example, may be reluctant to seek recognition of the judgment in the United States, because of a mistaken belief that recognition is not possible in the absence of a bilateral or multilateral treaty with the United States.

Although an international agreement on judgment recognition is required by the Civil Procedure Code of Ukraine to recognize foreign money judgments in Ukraine, the wording of the Civil Procedure Code of Ukraine indicates that it is also possible for foreign court decisions to be recognized on the basis of reciprocity.[22] In particular, according to the Code, the decision of a foreign court can be enforced in either of the following cases:

(i) if the recognition and enforcement is provided by an international treaty ratified by the Parliament of Ukraine; or

(ii) on the basis of reciprocity by an ad hoc agreement with the foreign country that issued the decision to be recognized.[23]

The Ukrainian Resolution on recognition and enforcement of foreign arbitral awards and foreign judgments[24] supports the first criterion and provides that, when considering recognition of a foreign judgment, Ukrainian courts must confirm the existence of an international treaty between Ukraine and the state where the foreign judgment was rendered before they may recognize it. If there is no such treaty, the court must deny the application for recognition[25]

As for the second criterion, the Resolution does not define an "application of reciprocity by an ad hoc agreement with a foreign country." This is not surprising, because the Resolution was adopted at the end of 1999 and the Code entered into force in September 2005. The authors of this article have not found any Ukrainian court case that explains how the reciprocity defined by the Ukrainian Civil Procedure Code applies in practice.

Accordingly, on the one hand, a literal reading of the Code suggests that reciprocity exists only if a respective ad hoc agreement is reached with the relevant foreign country. On the other hand, one might argue that absence of an ad hoc agreement is not an obstacle for the Ukrainian court to recognize foreign judgments from jurisdictions that recognize Ukrainian judgments. This latter view may be supported by reasoning that reciprocity is a principle of international law and that the Ukrainian Constitution provides recognition by Ukraine of international law principles and norms.[26]

The national courts of the Russian Federation arguably are a step ahead of those in Ukraine because they have already granted recognition of a U.K. court decision on grounds of reciprocity as a principle of international law. The importance of this development is underscored by the fact that international reciprocity is not defined in any statute of the Russian Federation and for a long time remained nothing but a doctrinal theory.[27] In fact, the Arbitrazh Procedure Code of the Russian Federation makes no mention of reciprocity and affirmatively re-

quires an international agreement on the subject before it will recognize the money judgment of a foreign state.[28] However, the invocation of international reciprocity by the Arbitrazh Court of the Moscow District (or Moscow Arbitrazh Court) in March 2006 erased any doubts regarding its applicability to the recognition of foreign judgments by the Russian Federation.[29] The Moscow Arbitrazh Court confirmed[30] the decision of the Arbitrazh Court of the City of Moscow,[31] which had allowed recognition and enforcement of a judgment rendered by the High Court of England and Wales in the case No HC 05 C01219 of June 2005 against OJSC "NK YUKOS" for payment of US $475,284,466.67.[32]

The Moscow Arbitrazh Court relied on the European Convention on Human Rights of 1950, together with Article 15, Paragraph 4 of the Russian Constitution, stating that commonly recognized principles and norms of international law and international treaties of the Russian Federation shall be a component part of its legal system.[33] Because it appears that the Russian Federation has accepted reciprocity as a norm of international law and a part of its legal framework, it appears that all U.S. jurisdictions, including those that have adopted a reciprocity requirement, could recognize money judgments of Russian Federation courts.

Whether Ukraine will similarly recognize reciprocity as a norm of international law and part of its legal framework, and/or whether it will otherwise conclude that reciprocity with the United States can be found in the absence of an express treaty, remains an open question.

We next discuss in general terms the contours and procedural safeguards of the Ukrainian legal system, for the purpose of demonstrating why Ukrainian judgments could be found enforceable under the laws of the various U.S. states that require such safeguards as a condition of recognition.

IV. Recognition of Money Judgments Rendered by Ukrainian Courts

A. Ukrainian Courts and Procedures

The Ukrainian court system is divided into two broad categories: (i) the public courts and (ii) the Constitutional Court.[34] The Constitutional Court is the sole court vested with jurisdiction to decide constitutional issues, and is not of immediate relevance to this article.[35] The public courts are divided into commercial courts, administrative courts, military courts and courts of general jurisdiction (which resolve disputes in civil and criminal matters). The commercial courts and courts of general jurisdiction are the courts relevant to this article because they have jurisdiction to enter money judgments.

Under the Ukrainian Constitution, the Supreme Court of Ukraine is the highest public court.[36] There are also lesser high courts that supervise resolution of disputes in specific judiciary areas, including the High Economic Court and the High Administrative Court.[37] The Constitution and the Court System Law prohibit creation of any extraordinary and particular courts.[38] Any delegation of the courts' powers to other state bodies and/or officials is forbidden.[39]

The jurisdiction of Ukrainian courts over particular judicial areas relating to commercial issues and the procedural rules of the courts are regulated by the Commercial Procedure Code[40] and the Civil Procedure Code.[41] The Ukrainian commercial courts resolve disputes in commercial matters between legal entities, or between legal entities and the state or its agencies, according to the rules of the Commercial Procedure Code.[42] The disputes that relate to civil, land, family, labor and housing matters are considered by the general courts under the rules of Civil Procedure Code.[43]

Ukrainian court proceedings are presided over by professional judges, and, when prescribed by law, assessors and juries.[44] The Ukrainian Constitution guarantees the independence and inviolability of judges.[45] Professional judges are elected for life by the Verkhovna Rada (Parliament).[46] Every appointed judge must be a lawyer with legal education equivalent to the U.S. juris doctor and have at least three years of experience as a practicing lawyer.[47] A judge cannot be a member of any political party or trade union, nor may he or she participate in any political activities.[48] Also, judges cannot occupy any other paid positions, except certain scientific, teaching or creative positions.[49]

B. Procedural and Substantive Rules Governing Ukrainian Courts

The administration of justice in Ukraine is premised on the equal application of the law and rules to all litigants without regard to sex, race, color of skin, language, political, religious or other views, national or social origins, wealth, occupation, place of residence, or other similar bases.[50] The Court System Law guarantees to every person (Ukrainian, foreign individual or legal entity) the protection of its rights, freedoms and legitimate interests by independent and impartial courts.[51] No one may be deprived of his or her right to the adjudication of his or her case by the appropriate court vested with jurisdiction over it.[52] Also, no one may be deprived of his or her right to participate in the court hearings of his or her case at any level of the process (e.g., trial court, appellate court, highest appellate court),[53] and any purported waiver of these rights is unenforceable as a matter of law.[54]

It is possible to appeal any decision of any trial court or court of first instance.[55] It is also possible to file a petition for certiorari (contesting the decision of the court of first instance and appellate court) with the relevant high court. In commercial cases this would be the High Commercial Court and in general jurisdiction cases,

the Supreme Court of Ukraine.[56] Under certain limited circumstances, petitions for certiorari of judgments of the High Commercial Court may also be made to the Supreme Court of Ukraine.[57]

Each of the Codes provides parties with a variety of equal procedural rights. The parties, in particular, may: review the materials in the court clerk's files; copy those files; participate in the court's hearings; submit evidence; file applications and claims; submit oral and written statements; defend against claims, evidentiary submissions and arguments of the opposing party; provide the court with an opinion as to any question that arises in the court hearing; participate in the investigation of evidence; and challenge the neutrality of the particular judge considering the case.[58]

Because of the importance of proper personal jurisdiction in any attempt to recognize foreign money judgments, we next review the Ukrainian rules governing service of process.

C. Personal Jurisdiction and Service of Process

According to each of the Codes, the defendant must be properly notified of the allegations being made against him and of the time and place of all court hearings. Proper notice of the claims against a party is the basis upon which the personal jurisdiction of a Ukrainian court over that party comes into existence. Resolution of any case without proper service of process or notice of hearings is ground for reversal on appeal.[59]

D. Personal Jurisdiction over Foreign Defendants

Ukrainian courts (both general and commercial) may exercise personal jurisdiction over any defendant who resides[60] or has a permanent place of business[61] in Ukraine. And the Law of Ukraine "On Private International Law" (PIL),[62] adopted in June 2005, sets forth uniform rules that allow general and commercial courts of Ukraine to exercise personal jurisdiction over a foreign defendant, if one the following requirements is met:[63]

a) parties to the contract agree that disputes arising thereunder will be resolved by the Ukrainian courts;

b) the foreign defendant has goods or immovable property located in Ukraine;

c) the foreign defendant's branch or representative office is located in Ukraine;

d) in tort cases, the harm was caused within Ukrainian territory;

e) in tort cases, the plaintiff is an individual who resides in Ukraine (regardless of whether the harm to the plaintiff occurred outside of Ukrainian territory); or

f) certain acts or events that are grounds for filing claim took place within Ukrainian territory.

In addition to the provisions of the PIL, the Civil Procedure Code allows general courts to establish personal jurisdiction over a foreign defendant if:

a) the dispute arose out of a contract signed with a foreign defendant, which states that the place of execution of the contract is in Ukraine or because of the contract's peculiarities it may be executed only in Ukraine;[64]

b) the claim is filed against a foreign defendant who was previously stayed or domiciled in Ukraine, then the respective general court that according to Civil Procedure Code has jurisdiction over that place of stay or residence may exercise personal jurisdiction over such foreign defendant;[65]

c) the claim naming the Ukrainian defendant and foreign defendant as co-defendants is filed in a general court.[66]

The Commercial Procedure Code of Ukraine similarly provides commercial courts of Ukraine with opportunities to exercise personal jurisdiction over a foreign defendant if any of the following applies:

a) the matter relates to infringement of intellectual property rights that occurred in Ukraine;[67]

b) the foreign defendant has a stake in a business entity registered in Ukraine and the dispute relates to the creation, activity, management or liquidation of that entity;[68] or

c) the claim naming the Ukrainian defendant and foreign defendant as co-defendants is filed in a commercial court.[69]

E. Service of Process under the Ukrainian Procedural Law

According to the Ukrainian procedural law and court practice, service of process in proceedings related to monetary issues is regulated by the Civil Procedure Code,[70] the Commercial Procedure Code,[71] the Hague Convention on Service Abroad (the Hague Convention),[72] and the International Agreements on Legal Assistance ratified by the Parliament of Ukraine. The provisions of the Codes apply when service of process is within the territory of Ukraine. The Hague Convention and international agreements apply to service of process outside Ukraine.

1. Service of Process under the Civil Procedure Code

According to the Civil Procedure Code, the court must send its subpoena in a way that allows the defendant (or other participant)[73] sufficient time to appear before the court and to prepare for the court hearing.[74] It allows service to be accomplished in one of the following ways:[75]

a) by “recommended letter”. According to the Rules on providing mail services,[76] this is a type of letter that must be delivered in person to the recipient. Also, the recipient has to acknowledge the receipt of the letter by signature;

b) by courier at the address indicated by the recipient;

c) upon the consent of one party, the court may provide that party with the subpoena to be served on any other party;

d) by telegram, fax or other means of service which ensure actual notice; or

e) directly during a court hearing.

According to the Civil Procedure Code, individuals are served at their places of residence, and legal entities are served at the addresses of their permanent place of business.[77] If the individual does not reside at the place of his or her residency, the subpoena may be served to the address of such individual’s place of employment.[78]

To be properly served in any of above ways, the subpoena has to be delivered in person.[79] In turn, the individual has to acknowledge receipt of the subpoena by signing the document.[80] In the case of service over a legal entity, any officer of the company may acknowledge receipt.[81] If the person to whom the subpoena is to be served is not found at the address of his or her residency, the subpoena may be delivered to any member of such person’s family who is above eighteen years of age and resides at the same address.[82] If no family members reside at the address, the subpoena may be delivered to the operator of the residency area[83] or respective executive body of the local authority.[84] Delivery of the subpoena to a person with power of attorney from the party to which the subpoena is addressed to receive process constitutes effective service of process.[85]

If the recipient of a subpoena resides or has its permanent place of business outside the territory of Ukraine, the subpoena must be served in accordance with the relevant provisions of the Hague Convention or other international agreement on legal assistance (discussed in more detail below).[86]

If the person or company officer to whom the subpoena is delivered in one of the above ways refuses to accept the subpoena, the person who delivered the subpoena may note this fact on the subpoena and return the subpoena to the court.[87] In such case, the person or entity who has refused to acknowledge service of process may nonetheless be determined to have been properly served.[88]

Finally, if the address of an individual’s residence or legal entity’s permanent place of business is unknown, the subpoena may be published in the press by the parties to the hearing, provided prior court authorization is granted.[89] Once the subpoena is published, the subpoena recipient will be considered to have been properly served with process.[90]

2. Service of Process under the Rules of the Commercial Procedure Code

The particulars of service of process in commercial courts are defined by the Commercial Procedure Code and practical rules of the High Economic Court of Ukraine (Practical Rules). According to the Commercial Procedure Code, the judge informs the parties about the time and place of a court hearing by sending a document titled “ruling” by mail or messenger, with receipt to be acknowledged by signature.[91] According to the Practical Rules,[92] the respective legal entity to receive the ruling of court hearing is considered to have been properly notified if the notice of hearing is sent to the address or addresses indicated in the claim (which addresses are taken from the official business register).

In the case of service over foreign participants in the court hearing, the court practice requires that service be performed pursuant to the Hague Convention or other applicable international agreement on legal assistance.[93]

3. Service of Process under the Hague Convention and International Agreements on Legal Assistance

Ukraine ratified the Hague Convention on 19 October 2000; however, it enacted the following reservations concerning the way process is served:[94]

(i) With regard to Article 8 of the Convention, service of judicial documents through diplomatic or consular agents of another State within the territory of Ukraine may be effected only upon nationals of the State in which the documents originate.[95]

(ii) With regard to Article 10 of the Convention, Ukraine will not use methods of transmission of judicial documents provided for in Article 10 of the Convention.[96]

Also, according to Ukraine’s reservations, if all the requirements of the second paragraph of Article 15 of the Convention are met, in particular the following:

a) the document was transmitted by one of the methods provided for in this Convention;

b) a period of time of not less than *six months,* considered adequate by the Ukrainian judge in the particular case, has elapsed since the date of the transmission of the document; and

c) no certificate of service of any kind has been received, even though every reasonable effort has been made to obtain it through the competent authorities of the State addressed;

then, notwithstanding the provisions of the first paragraph of Article 15 of the Convention, the Ukrainian judge may render judgment even if no confirmation of receipt or delivery of court documents was received.[97]

If the subpoena recipient is located in a country that is not a party to the Hague Convention, service of process will be effected based on international treaty on legal assistance ratified by the Parliament of Ukraine. For example, although Kazakhstan is not a party to the Hague Convention, it is a party to the Minsk Convention "On Legal Assistance and Legal Relations in Civil, Family and Criminal Matters" (the "Minsk Convention") [98] in which Ukraine also participates. The Minsk Convention contains the respective provisions on service of court documents on Kazakh nationals/companies.

If the participant of the court hearing is located in a country that is both a member of the Hague Convention and the respective international treaty on legal assistance (e.g., Russia participates both in the Hague Convention and the Minsk Convention), then the provisions of the treaty that entered into force most recently govern.[99]

If the participant of the court hearing is located in a country that is neither a member of the Hague Service Convention nor party to an independent agreement with Ukraine, then, according to the Civil Procedure Code, service will be effected through diplomatic or consular institutions of Ukraine.[100]

4. Conclusion Concerning Ukrainian Money Judgments

Based on these procedural and substantive guarantees of due process, the transparency of the Ukrainian court system, the impartiality of Ukrainian judges and proceedings and the conclusiveness of Ukrainian money judgments, generally speaking, Ukrainian money judgments may be enforceable in many U.S. states. Of course, litigants should expect that, when seeking recognition of a Ukrainian judgment in the United States, the judgment debtor would try to challenge recognition by establishing one or more of the elements discussed in Section 1 that would permit a U.S. court to avoid application of the presumptions under the Act and Revised Act in regard to recognition of foreign judgments. The authors of this article have been unable to locate any reported decision to date in which a court in the United States has considered the recognition of a Ukrainian judgment.

V. Conclusion

Although there appear to be no published opinions in the United States in which a court has expressly recognized a Russian or Ukrainian judgment, the Act, the Revised Act and relevant common laws in effect in the United States certainly provide a mechanism that would support the recognition from these jurisdictions. However, recognition of Ukrainian money judgments is unlikely in those U.S. states with a reciprocity requirement, because there is no treaty or precedent that would ensure enforcement in Ukraine of a money judgment entered by a U.S. court.

Endnotes

1. Before a money judgment can be enforced, it must be recognized by the court in the jurisdiction in which the assets against which the judgment-creditor wants to enforce are located. *See, e.g., Matusevitch v. Telnikoff*, 877 F. Supp. 1, 2 (D.D.C. 1995).
2. Although the U.S. is not a party to any convention on the enforcement of money judgments, it is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. T.A.I.S. No. 6997, 3 U.S.T. 2517, 330 U.N.T.S. 38 (10 June 1958).
3. U.S. Const. art. VI, § 2.
4. Some federal courts in dicta have suggested that federal common law may guide aspects of the enforcement of foreign judgments, but regulation of this field is generally regarded to be governed by substantive state law. *See, e.g., Samportex Ltd. v. Phila. Chewing Gum Corp.*, 318 F. Supp. 161, 167 (E.D. Pa. 1970) ("It is clear . . . that the law governing the enforceability of foreign judgments by a federal court is the law of the state in which the court is located."). In June 2005, the Hague Conference on Private International Law finalized the Hague Convention on Choice of Court Agreements, which governs recognition of foreign money judgments. As of the date of this article, only Mexico had ratified the text. *See* http://www.hcch.net/index_en.php?act=conventions.text&cid=98 (visited 17 April 2008). It will likely be several years before the United States ratifies and implements the Convention, which addresses the recognition of foreign money judgments.
5. *Uniform Foreign Money-Judgments Recognition Act of 1962*, 13 U.L.A. 149 (1986) (UMFJRA).
6. Additionally, the District of Columbia and the U.S. Virgin Islands have adopted the UFMJRA. For a current list of states that have adopted the Act, see the National Conference of Commissioners on Uniform State Laws UFMJRA Fact Sheet at http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ufmjra.asp, (visited 17 April 2008).
7. UFMJRA § 2.
8. *Id.* § 1.
9. 159 U.S. 113 (1895).
10. *Id.* at 202-03 (1895). *See, e.g., In re Marriage of Goode*, 997 P.2d 244, 248 (Or. Ct. App. 2000) ("A rule of general application is that a judgment entered by a court of a foreign nation is entitled to recognition to the same extent and with as broad a scope as it has by law or usage in the courts of the jurisdiction where rendered") (restating material elements of *Hilton* factors).
11. *See Hilton*, 159 U.S. at 228; *compare*, *e.g.*, *Tahan v. Hodgson*, 662 F.2d 862, 867-68, n.21 (D.C. Cir. 1981) ("It is unlikely that reciprocity is any longer a federally mandated requirement") (discussing undesirability of court involvement with "national," "political" issue of reciprocity).
12. *See* UFMJRA § 3. Article IV § 1 of the U.S. Constitution provides that each state must give full faith and credit to the judgment of a sister state. *See, e.g., Pac. Employers Ins. Co. v. Indus. Accident Comm'n*, 306 U.S. 493, 497 (1939).
13. UFMJRA § 4(b)(6).

14. *Id.* § 4(a)(2).
15. *Id.* §§ 1, 3.
16. 159 U.S. 113 (1895).
17. *See* Memorandum from the Uniform Law Commissioners to the Drafting Committee to Amend the Uniform Foreign Money-Judgments Recognition Act, 8 (June 7, 2004), available at www.law.upenn.edu/bll/archives/ulc/ufmjra/2004AnnMtgRpt.doc (visited 17 April 2008).
18. www.law.upenn.edu/bll/archives/ulc/ufmjra/2005AMAPPText.pdf, last visited on 3 July 2008.
19. *See* Revised Act §§ 3(c), 4(d).
20. *Id.* § 6.
21. *Id.* § 9.
22. Civil Procedure Code of Ukraine, adopted on March 18, 2004 (entered into force September 2004) # 1618-IV, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
23. *I*d. art. 390.
24. Resolution of the Plenum of the Supreme Court of Ukraine "On the Practice of Consideration by the Courts of Applications on Recognition and Enforcement of the Judgments of Foreign Courts and Foreign Arbitral Awards Rendered in the Course of International Commercial Arbitration on the Territory of Ukraine" ("Resolution"), adopted on December 24, 1999 # 12, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008). *See* art. 3. The Resolutions of the Supreme Court of Ukraine are documents explaining application of the Ukrainian legislation. Resolutions are addressed by the Supreme Court of Ukraine to the courts of lower instances.
25. *Id*. art. 4.
26. Constitution of Ukraine, adopted on June 28, 1996, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).

    According to Article 18 of the Constitution, the external policy of Ukraine is directed for guaranteeing of its national interests and security via supporting of peaceful and mutually beneficial cooperation with other members of world community under universally known principles and norms of international law.
27. Dmitry Dyakin and Alexander Vaneev, *New perspectives for business litigation in Russia*, 71 THE EUROPEAN LAWYER 56 (Sept. 2007).
28. Artbitrazh Procedural Code of the Russian Federation, art. 241, http://www.consultant.ru/popular/apkrf/ (Russian text) (visited 17 April 2008).
29. Dyakin and Vaneev, note 27 s*upra*.
30. Order of the Arbitrazh Court of the Moscow district No. KG–A40/698–06–P of 2 March 2006 (*cert. denied*).
31. Decision of the Arbitrazh Court of the City of Moscow in the case No. A40-53839/05-8-388 of 21 December 2005.
32. In the U.K. proceeding the defendant was sued by multiple plaintiffs, including BNP Paribas S.A., Citibank N.A., Commerzbank Aktiengesellschaft, Caylon S.A., Deutsche Bank A.G., ING Bank N.V., Societe Generale Bank S.A., KBS Bank N.V., UFJ Bank Nederland N.V., Hillside Apex Fund Ltd., Thames River Traditional Funds PLC, VR Global Partners L.P., Shephert Investments International Ltd. and Stark Trading.
33. Dyakin and Vaneev, note 27 s*upra*.
34. The Law of Ukraine "On court system of Ukraine," adopted on February 07, 2002, No. 3018-III, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text), art. 3 (visited 17 April 2008).
35. *Id.*
36. Constitution of Ukraine, note 26 s*upra*, art. 125.
37. *Id.*
38. *Id.* Court System Law of Ukraine, note 34 *supra*, art. 3.
39. Constitution of Ukraine, note 26 s*upra*, art. 124.
40. Commercial Procedure Code of Ukraine, adopted on November 06, 1991, No. 1998-XII, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
41. Civil Procedure Code of Ukraine, note 22 s*upra*.
42. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 1, art. 12.
43. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 15.
44. Constitution of Ukraine, note 26 s*upra*, art. 127.
45. *Id*. art. 126.
46. *Id*.
47. *Id*. art. 127.
48. *Id*.
49. *Id*.
50. Court System Law of Ukraine, note 34 *supra*, art. 7.
51. *Id*. art. 6.
52. *Id*.
53. *Id*.
54. *Id*.
55. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 91; Civil Procedure Code of Ukraine, note 22 s*upra*, art. 292.
56. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 107; Civil Procedure Code of Ukraine, note 22 s*upra*, art. 324.
57. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 111 (14).
58. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 22; Civil Procedure Code of Ukraine, note 22 s*upra*, art. 27.
59. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 104, art. 111 (10); Civil Procedure Code of Ukraine, note 22 s*upra*, art. 311, art. 338.
60. Civil Code of Ukraine art. 29, adopted on 16 January 2003 (entered into force 1 January 2004), http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008). Article 29 of the Civil Code states that *place of residence* means house, apartment and room in the hotel, hostel, etc. in certain inhabited locality where the individual resides on a permanent or temporary basis.
61. *Id*. art. 93 defines "permanent place of business" of legal entity as the address of its governing body or individual that/who according to charter or law acts on behalf of such legal entity.
62. Law of Ukraine, "On Private International Law," No. 2709 – IV adopted on 23 June 2005, art. 76, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
63. *Id*.
64. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 110.
65. *Id*.
66. *Id*. art. 113.
67. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 16.
68. *Id*.
69. *Id*. art. 12.
70. Civil Procedure Code of Ukraine, note 22 s*upra*.
71. Commercial Procedure Code of Ukraine, note 40 s*upra*.
72. Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters ("The Hague Convention") (concluded on 15 November 1965, entered into force 10 February 1969), http://www.hcch.net/index_en.php?act=conventions.text&cid=17 (visited 17 April 2008).

73. Civil Procedure Code of Ukraine, note 22 *supra,* art. 26, the participants of the court hearing are parties (claimants and defendants), third parties on the side of either claimant or defendant, representatives of the parties or third parties.

    There are two kinds of third parties under Ukrainian procedural law: (1) those that have a personal interest in the subject matter of the claim and (2) those that do not have a personal interest in the subject matter of the claim; however, [a] [the] decision of the court may influence their legal relationships with either claimant or defendant.

74. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 74.
75. *Id*.
76. The Resolution of the Cabinet of Ministers (Government) of Ukraine "On providing post services in Ukraine," adopted on 17 August 2002, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
77. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 74.
78. *Id.*
79. *Id.* art. 76.
80. *Id.*
81. *Id.*
82. *Id.*
83. The Code refers to the organization that operates residency area matters as "ZHEK." ZHEK is a municipal enterprise that is empowered by the local authorities to operate and control residency areas' commercial matters (including buildings where all apartments were privatized) which were constructed at state expense.
84. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 76.
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id*.
89. According to the special Order of the Cabinet of Ministers (Government) of Ukraine, the subpoena has to be published in newspaper of national circulation and newspapers of local circulation at the last known place of residence of the party to be served. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 74.
90. *Id*.
91. Commercial Procedure Code of Ukraine, note 40 s*upra*, art. 87.
92. Explanation of the High Economic Court of Ukraine "On certain issues of application the Commercial Procedure Code of Ukraine," No. 02-5/289 adopted on 18 September 1997, clause 3.6, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
93. Explanation of the High Economic Court of Ukraine "On certain issues of consideration of cases with participation of foreign legal entities and organizations," No.04-5/608 adopted on 31 May 2002, clause 8, http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi (Ukrainian text) (visited 17 April 2008).
94. *See* reservations of Ukraine to the Hague Convention, http://travel.state.gov/law/info/judicial/judicial_686.html (visited 17 April 2008).
95. The Hague Convention, note 72 s*upra*, art. 8, "Each contracting state shall be free to effect service of judicial documents upon persons abroad, without application of any compulsion, directly thorough its diplomatic or consular agents; Any state may declare that it is opposed to such service within its territory, unless the document is to be served upon a national of the State in which the documents originate."
96. The Hague Convention, note 72 s*upra*, art. 10,

    > Provided the state of destination does not object, the present Convention shall not interfere with:
    >
    > (a) the freedom to send judicial documents, by postal channels, directly to persons abroad,
    >
    > (b) the freedom of judicial officers, officials or other competent persons of the State of origin to effect service of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination,
    >
    > (c) the freedom of any person interested in a judicial proceeding to effect service of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination.

97. The Hague Convention, note 72 s*upra*, paragraph first, art. 15,

    > Where a writ of summons or an equivalent document had to be transmitted abroad for the purpose of service, under the provisions of the present Convention, and the defendant has not appeared, judgment shall not be given until it is established that:
    >
    > a) the document was served by a method prescribed by the internal law of the State addressed for the service of documents in domestic actions upon persons who are within its territory, or
    >
    > b) the document was actually delivered to the defendant or to his residence by another method provided for by this Convention,
    >
    > and that in either of these cases the service or the delivery was effected in sufficient time to enable the defendant to defend.

98. The Minsk Convention "On Legal Assistance and Legal Relations in Civil, Family and Criminal Matters," adopted on 22 January 1993, http://www.rada.gov.ua (Ukrainian text), (visited 17 April 2008).
99. Resolution, note 24 *supra,* art. 1.
100. Civil Procedure Code of Ukraine, note 22 s*upra*, art. 76.

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Argentina v. Uruguay at the International Court of Justice: Pulp Mills on the River Uruguay

By Eduardo Jiménez de Aréchaga

I. Introduction

The purpose of this article is to discuss the border dispute between Uruguay and Argentina, regarding the construction of two pulp mills on the Uruguayan bank of the Uruguay River, which constitutes the common boundary of these two countries.

II. Background

In April 1961, Argentina and Uruguay signed a treaty defining their common boundary on the Uruguay River and providing for the future establishment of a joint regime for the use of the river. The treaty entered into force with the signing by the two countries of the Statute of the Uruguay River in February 1975 (hereinafter the "1975 Statute").[1]

The purpose of the 1975 Statute was (i) to establish a joint regime for the use of the river; (ii) to set up an "Administrative Commission of the Uruguay River" (hereinafter "CARU," in its Spanish acronym), whose functions include regulation and coordination; (iii) to establish a procedure for prior notification and consultation through CARU in the event any party planned to carry out works likely to affect navigation, the régime of the river, or the quality of its waters; and (vi) to establish that any controversy relating to the application of the 1975 Statute would be resolved by the ICJ.

The procedure of prior notification and consultation through CARU mentioned in the previous paragraph basically requires that a party must consult the other party by notifying CARU of the projected works, and in the event the notified party fails to respond within one hundred eighty days after the notification or if the notified party otherwise raises no objections, the project can proceed. In the event of objections, the objecting party has the recourse of raising those objections by the dispute resolution mechanism established in the 1975 Statute, but not by imposing a ban on the project until the objections are resolved by the ICJ.

III. Origins of the Controversy

In October 2003, the Spanish Grupo Empresarial Ence (hereinafter "Ence") received authorization to construct a pulp mill on the Uruguayan bank of the Uruguay River, fourteen miles from the city of Fray Bentos. Soon thereafter the Finnish company Oy Metsä-Botnia AB (hereinafter "Botnia") announced its plans to build another pulp mill in the same area.

These announcements generated protests from the Argentinean residents of neighboring Gualeguaychu. But after some diplomatic exchanges, in March 2004 the Ministers of Foreign Affairs of both countries solved the diplomatic rift, authorized the projects, and agreed to channel the information about the projects through CARU.

However, in 2005 the advancement of the projects sparked more protests in Gualeguaychu, which later intensified into the first blockades of the San Martin Bridge (one of the three bridges joining the two countries). At the same time, Argentina was holding its midterm elections, so the pulp mills quickly became a campaign issue.

Following the International Finance Corporation's December 2005 release of Cumulative Impact Studies concluding that the technical requirements of the plants had been fulfilled and the quality of the water and the air in the region would not suffer any damage, more protests occurred, concluding in the total blockade of the San Martin Bridge during the summer tourist season in Uruguay, when many tourists from Argentina customarily enter Uruguay over those bridges.

This produced a new diplomatic rift, with the result that Uruguay accused Argentina of preventing the free circulation of people and goods established in the MERCOSUR Treaty, and Uruguay filed a claim with the MERCOSUR Ad Hoc Arbitral Tribunal.

After the failure of direct negotiations by the two Presidents during March and April of 2006, in May 2006 Argentina filed a suit with the International Court of Justice, which included a request for provisional measures, petitioning that, pending the Court's final judgment, Uruguay be ordered to suspend the construction of the pulp mills.[2]

IV. The Arguments in the ICJ Proceedings

The positions of the two countries were presented in court proceedings on 8 and 9 June 2006 at the Peace Palace in The Hague, Netherlands.

A. Argentine's Position

In the proceedings Argentina instituted against Uruguay at the ICJ, Argentina alleged that Uruguay breached its obligations under the 1975 Statute by authorizing the construction of the two pulp mills on the Uruguay River. The supposed breaches were the failure to comply with the obligation of prior notification to CARU

and the obligation to adopt all necessary measures to protect the waters of the river and prevent their pollution.

At the oral hearings, Argentina argued that Uruguay violated Argentina's procedural and substantive rights under the 1975 Statute. Argentina contended that the 1975 Statute created the obligation to prevent pollution and avoid causing consequential economic losses, such as to tourism, and that each country must prescribe measures in accordance with applicable international standards. Argentina claimed that Uruguay had not complied with these obligations.

Argentina also contended that the 1975 Statute grants a number of procedural rights: first, the right to be notified by Uruguay before work began; second, the right to express views that are taken into account in the design of a proposed project; and, third, the right to have the ICJ resolve any differences before construction takes place.

Argentina's interpretation was that Uruguay had the obligation not to carry out any works unless (i) Argentina expressed no objections; (ii) Argentina failed to respond to Uruguay's notification; or (iii) the Court established the conditions under which the work would be carried out. Argentina contended that none of these three conditions had been met.

As for the bilateral agreement that had been reached in March 2004, Argentina alleged that that Agreement between the Ministers of Foreign Affairs of both countries was not a bilateral agreement to the effect that construction of the Ence mill could proceed as planned. Argentina argued that, instead, the March 2004 arrangement was simply that Uruguay would transmit all the information on Ence to CARU and that CARU would begin monitoring water quality, but that Uruguay had failed to supply the information promised.

Finally, Argentina argued that in this case there existed the necessary pre-condition of urgency for provisional measures, since damage might occur before the judgment on the merits, given that the mills would commence operation before the Court's final decision. Argentina argued that the suspension of the construction was the only way to prevent the plants from becoming a *fait accompli*.[3]

B. Uruguay's Position

Uruguay contended that it had fully complied with the 1975 Statute and was applying both the highest and the most appropriate international standards of pollution control to the two mills.

While not disputing the jurisdiction provision included in the 1975 Statute, Uruguay disputed the inclusion of some of Argentina's claims on the ground that they do not concern the 1975 Statute, such as tourism, urban and rural property values, professional activities, unemployment levels, etc.

As for compliance with the 1975 Statute, Uruguay stated that it had met its obligations under the 1975 Statute (which expressly permits the use of the river for industrial purposes), and contended that the latter did not give either party a "right of veto" over the implementation by the other party of industrial development projects, but limited itself to creating an obligation for the parties to engage in a full and good-faith exchange of information under the procedures provided by the 1975 Statute or agreed between them. Uruguay noted that, having complied fully with that obligation by informing Argentina—through CARU or other channels—of the pulp mills projects (with in-depth description and supplying a substantial amount of information), it had made Argentina aware of the absence of any risk with regard to their potential environmental impact on the Uruguay River.

It is obvious that this issue is of fundamental importance to the merits of the case, especially in light of the fact that Argentina has publicly accused Uruguay of violating the 1975 Statute and engrafted that perception onto public opinion. However, Argentina's accusation is still on shaky grounds, because, in the absence of a specific provision in a treaty (the 1975 Statute) explicitly giving the other country a right to veto a project, under international law the principle is that of prior consultation. That Argentina has a limited prior consultation right under the 1975 Statute is also supported by other evidence relevant to the interpretation of this treaty, such as the unilateral declarations made by Argentina's Executive Power when ratifying the 1975 Statute, very relevant Argentinean doctrine, and prior state practice in the application of the 1975 Statute.

As for the significance of the bilateral agreement, Uruguay disputed Argentina's interpretation of the effects of this Agreement. Uruguay's interpretation was that both sides had agreed that the Ence mill could be built according to the Uruguayan plan, that Uruguay would provide Argentina with information regarding its specifications and operation, and that CARU would monitor the quality of the river water once the mill became operational, in order to ensure compliance with the 1975 Statute. Uruguay also contended that the terms of the bilateral agreement had been extended to apply to the projected Botnia mill as well.

Uruguay argued that there was no current or imminent threat to any right of Argentina, so that the conditions of risk of irreparable harm and urgency were not fulfilled. Moreover, considering the environmental impact assessments and the regulatory controls and strict licensing conditions imposed by Uruguayan law for the construction and operation of the mills, Uruguay guaran-

teed that they would not cause any harm to the Uruguay River or to Argentina, and that the mills would comply with the Best Available Techniques (BAT) and abide by the strict requirements imposed by the latest European Union recommendations. Uruguay pointed out that, before the mills become operational, a number of further conditions would have to be met, and even if it were to be considered that the operation of the mills might lead to pollution, the alleged peril was not sufficiently certain or immediate to satisfy the requirement of imminence or urgency.

Lastly, Uruguay argued that suspending construction of the mills would cause such economic loss to the companies involved, and so jeopardize the entire two projects, as to irreparably prejudice its sovereign right to implement sustainable economic development projects in its own territory.[4]

V. The ICJ's July 2006 Order

After taking notice of Uruguay's claim that the Court's jurisdiction does not include all of Argentina claims, the Court deferred analysis of the issue for the merits phase, and concluded it had *prima facie* jurisdiction to address the request for provisional measures based on the text of the 1975 Statute.

The Court deferred to the merits stage the question of whether Uruguay may have failed to adhere fully to the provisions of the 1975 Statute when it authorized the construction of the two mills. However, the Court concluded that, if in fact the latter contains a "no construction" obligation, and hence the project could only proceed if agreed to by both parties (or, lacking such agreement, only when the Court had ruled on the dispute), any consequent violations of the 1975 Statute could be remedied at the merits stage.

As for the rights of a substantive nature invoked by Argentina, while recognizing the concerns expressed by Argentina for the need to protect its natural environment, Uruguay had noted in its papers that nothing in the record demonstrated that (i) the actual decision by Uruguay to authorize the construction of the mills posed an imminent threat of irreparable damage to the aquatic environment of the Uruguay River; (ii) there was no evidence suggesting that any pollution resulting from the commissioning of the mills would be of a character to cause irreparable damage to the Uruguay River; and (iii) in any event, the supposed threat of pollution was not imminent.

The Court added that it was not persuaded that Argentina's rights would no longer be capable of receiving protection if the Court were to decide not to suspend construction of the mills. The Court noted that Uruguay was bearing all risks relating to any future finding on the merits, and that construction could not be deemed to create a *fait accompli*, because the Court had not excluded the possibility of ordering the suspension, modification or dismantling of the works.

For that reason the Court denied Argentina's request for provisional relief by a vote of fourteen to one.[5]

A few months after the ICJ decision, the MERCOSUR Ad Hoc Arbitral Tribunal issued its ruling, which stated that Argentina had lacked due diligence and had adopted a permissive attitude toward the blockades, which was incompatible with the commitments made by the signatories of the MERCOSUR Treaty to guarantee the free circulation of people and goods. However it denied Uruguay's petition to order Argentina to adopt appropriate measures in case of future blockades, since it exceeded the jurisdiction of the Arbitral Tribunal.[6]

In September 2006, Ence announced that it was canceling the project and moving it to a new location.[7] Shortly thereafter, in October 2006, despite the massive lobbying effort from the Argentinean Government, the IFC released its final Cumulative Impact Study, which concluded that the Botnia plant was consistent with their environmental policies and procedures.[8]

In October and November 2006, as a consequence of the IFC report and the ongoing advance of the works at Botnia, new blockades of the San Martin Bridge were installed, which prompted Uruguay to request the ICJ to indicate provisional measures.[9]

In November 2006, during the XVI Ibero-American Summit in Montevideo, President Kirchner of Argentina asked King Juan Carlos of Spain to facilitate the renewal of negotiations between the two countries. As a result, a preparatory meeting was held in Spain in April of 2007, and two technical meetings were held in New York in May and July of 2007.

VI. The ICJ's January 2007 Order

As mentioned above, the request submitted by Uruguay in November 2006 was generated by the renewal of the blockades, an action which Uruguay claimed caused it significant economic injury, against which Argentina has failed to take any steps. Uruguay also alleged that the stated purpose of the actions was to force it to accede to Argentina's demand that it permanently end construction of the Botnia pulp mill, the subject matter of the dispute, and to prevent the plant from ever coming into operation.

The referred application requested the Court to rule that, while awaiting the final judgment of the Court, Argentina was to take all reasonable and appropriate steps at its disposal to prevent or end the interruption of transit between Uruguay and Argentina.

At the oral hearings in December 2006, Argentina challenged the jurisdiction of the Court on the ground that the request had no link with the 1975 Statute or with

the Application instituting proceedings, since none of the rights potentially affected by the roadblocks (right to freedom of transport and freedom of commerce) were rights governed by the 1975 Statute of the Uruguay River.[10]

Uruguay disputed these claims, alleging that those roadblocks constituted unlawful acts that violated and threatened irreparable harm to the very rights which it was defending before the Court, since they were directly, intimately and integrally related to the subject matter of the case before the Court.[11]

Argentina also pointed out that Uruguay had already received a MERCOSUR ad hoc Arbitral Tribunal ruling in relation to the roadblocks, and that such decision constituted *res judicata* with respect to the parties. Uruguay denied this allegation by arguing that the decision concerned different roadblocks (at another time and with a different purpose) and that it had not instituted any further proceedings within the MERCOSUR dispute settlement mechanisms with respect to the existing roadblocks.

After concluding in its previous Order that it had *prima facie* jurisdiction, the ICJ found that the Court's Statute authorized provisional measures to preserve the respective rights of both parties, and that the rights of the respondent (Uruguay) were not dependent solely on the way in which the applicant (Argentina) formulates its application.

The Court found that, in principle, the following constituted claimed rights: (i) Uruguay's right to construct the Botnia plant, pending a final decision by the Court; and (ii) Uruguay's right to have the merits of the present case resolved by the Court. Both rights had a connection with the subject matter of the proceedings initiated by Argentina and could in principle be protected by the indication of provisional measures, so the Court concluded that it had the jurisdiction to address the request. The Court also found that the rights invoked by Uruguay before the MERCOSUR ad hoc tribunal were different from those of the present case.

Notwithstanding the above, the Court expressed the view that, despite the blockades, the construction of the Botnia plant had progressed since the previous Order, and hence it was not convinced that the blockades irreparably prejudiced the rights which Uruguay claimed in the pending case, adding that it had not been proved that such a risk was imminent. The Court consequently found that the circumstances of the case were not such as to require the provisional measures requested by Uruguay to prevent or end the interruption of transit and the blockading of the bridges and the roads linking them.

For that reason it denied Uruguay's request by a vote of fourteen to one.[12]

One could view the ruling of the Court as borrowing a page from the famous U.S. Supreme Court case of *Marbury v. Madison*, since the Court asserted a very contentious jurisdiction to decide an issue, but avoided the controversy by ruling in favor of the defendant, nevertheless setting a very important precedent for future cases.

Following the ICJ January decision, the only relevant events were the filing of the memorial and counter-memorial by each country in January and July 2007,[13] the facilitation meetings previously mentioned, and the fact that the blockade of the San Martin Bridge continues (with blockades in some instances of the other two bridges, creating a total blockade). In addition, just recently an ICJ Order granted the parties the right to file a reply and rejoinder of the written pleadings.[14]

VII. Final Conclusions

As we have seen during the oral hearings of the July Order, the case revolves around four main issues, the first three being procedural and the last one of substance:

– Whether the 1975 Statute provides Argentina with a veto right or only with a prior consultation right;

– If the 1975 Statute grants only a prior consultation right, whether Uruguay has properly respected such consultation right;

– If, on the contrary, the 1975 Statute grants a veto or prior agreement right, whether the Foreign Ministries' Agreement constituted such an authorization or consent; and

– the substantive issue of whether the effluents produced by the mills are acceptable according to international standards and thus permissible under the sustainable development principle.

On this final issue it is important to note that, after the first provisional measures proceedings were concluded, an independent party (the IFC) concluded that the plant was consistent with their environmental policies and procedures, and that some Argentinean pulp mills which use a more polluting technology are updating their technology to the one used by the Uruguayan plants.

Endnotes

1. The text of the Statute of the Uruguay River can be found at www.caru.org.uy/publicaciones/The-River-Uruguay-executive-commission-Uruguay-Paysandu.pdf, last visited on 29 May 2008.

2. The International Court of Justice Docket of the Case is recorded at <http://www.icj-cij.org/docket/index.php?p1=3&p2=1&code=au&case=135&k=88>, last visited on 29 May 2008.

3. Argentina's pleadings at the oral proceedings are described at <http://www.icj-cij.org/docket/index.php?p1=3&p2=1&k=88&case=135&code=au&p3=2. Argentine's position at the public sitting held on Thursday, 8 June 2006, at 10 a.m., at the Peace Palace appears at http://www.icj-cij.org/docket/files/135/13124.pdf, with a translation to English from French and vice versa at http://

www.icj-cij.org/docket/files/135/13126.pdf.; Argentina's position at the public sitting held on Friday, 9 June 2006, at 10 a.m., at the Peace Palace appears at http://www.icj-cij.org/docket/files/135/13132.pdf, with a translation to English from French and vice versa at http://www.icj-cij.org/docket/files/135/13134.pdf. (The Web sites cited in this endnote were last visited on 29 May 2008.)

4. Uruguay's pleadings at the oral proceedings are described at <http://www.icj-cij.org/docket/index.php?p1=3&p2=1&k=88&case=135&code=au&p3=2. Uruguay's position at the public sitting held on Thursday, 8 June 2006, at 3 p.m., at the Peace Palace appears at http://www.icj-cij.org/docket/files/135/13128.pdf, with a translation to English from French and vice versa http://www.icj-cij.org/docket/files/135/13130.pdf; and Uruguay's position at the public sitting held on Friday, 9 June 2006, at 4:30 p.m., at the Peace Palace, appears at http://www.icj-cij.org/docket/files/135/13136.pdf, with a translation to English from French and vice versa at http://www.icj-cij.org/docket/files/135/13138.pdf. (The Web sites cited in this endnote were last visited on 29 May 2008.)

5. The Order of 13 July 2006 in regard to Requests for the indication of Provisional Measures appears at http://www.icj-cij.org/docket/files/135/11235.pdf. A summary of Order of 13 July 2006 appears at http://www.icj-cij.org/docket/index.php?sum=661&code=au&p1=3&p2=1&case=135&k=88&p3=5>. (The Web sites cited in this endnote were last visited on 29 May 2008.)

6. The MERCOSUR Ad Hoc Tribunal Arbitral Award in Spanish appears at http://www.mercosur.int/msweb/portal%20intermediario/es/controversias/arquivos/VII%20LAUDO.pdf, last visited on 29 May 2008.

7. The Press release from the Uruguayan Presidency announcing that Ence was canceling the project and moving it to a new location appears at http://www.presidencia.gub.uy/_web/noticias/2006/09/2006092109.htm, last visited on 29 May 2008.

8. Among the IFC Documents are the Approval by IFC and MIGA Board of the Orion Pulp Mill in Uruguay at http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=F76F15A5FE7735918525722D0058F472; as well as the Final Cumulative Impact Study - Oct 2006 at http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_Pulp_Mills_CIS_Final.

   The Draft Cumulative Impact Study (Dec 2005) appears at http://www.ifc.org/ifcext/lac.nsf/Content/Uruguay_Pulp_Mills_CIS. (The Web sites cited in this endnote were last visited on 29 May 2008.)

9. The request of Uruguay for the indication of provisional measures is recorded at http://www.icj-cij.org/docket/files/135/13485.pdf, last visited on 29 May 2008.

10. Argentina's pleadings at the oral proceedings at the public sitting held on Monday, 18 December 2006, at 3 p.m., at the Peace Palace, can be found at http://www.icj-cij.org/docket/files/135/13531.pdf, with the translation to English from French and vice versa appears at http://www.icj-cij.org/docket/files/135/13539.pdf; and at the public sitting held on Tuesday, 19 December 2006, at 4.30 p.m., at the Peace Palace can be found at http://www.icj-cij.org/docket/files/135/13533.pdf, with the translation to English from French and vice versa <http://www.icj-cij.org/docket/files/135/13543.pdf. (The Web sites cited in this endnote were last visited on 29 May 2008.)

11. Uruguay's pleadings at the oral proceedings at the public sitting held on Monday 18 December 2006, at 10 a.m., at the Peace Palace can be found at http://www.icj-cij.org/docket/files/135/13529.pdf, with a translation to English from French and vice versa http://www.icj-cij.org/docket/files/135/13537.pdf, and at the public sitting held on Tuesday, 19 December 2006, at 10 p.m., at the Peace Palace, can be found at http://www.icj-cij.org/docket/files/135/13535.pdf, with the Translation to English from French and vice versa http://www.icj-cij.org/docket/files/135/13541.pdf. (The Web sites cited in this endnote were last visited on 29 May 2008.)

12. The Order of 23 January 2007 in regard to Request for the Indication of Provisional Measures appears at http://www.icj-cij.org/docket/files/135/13615.pdf.

    A summary of Order of 23 January 2007 appears at http://www.icj-cij.org/docket/index.php?sum=666&code=au&p1=3&p2=1&case=135&k=88&p3=5. (The Web sites cited in this endnote were last visited on 29 May 2008.)

13. The Order of 13 July 2006 in regard to the fixing of time limits for memorial and counter-memorial appears at http://www.icj-cij.org/docket/files/135/11247.pdf, last visited on 29 May 2008.

14. The Order of 14 September 2007 in regard to the fixing of time limits for the Reply and Rejoinder appears at http://www.icj-cij.org/docket/files/135/14051.pdf, last visited on 29 May 2008.

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Disclaimer: The preceding article reflects the author's personal opinions, and should not be understood in any way as representing Uruguay or Uruguay's formal position on any given subject.

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