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PRACTICUM: FORM AND POLICY

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The Taxation of German Settlors, Beneficiaries and Remaindermen of U.S. (and non-U.S.) Trusts

By Dr. Christian von Oertzen

I. Private Law Framework

A. Recognition of Common-Law Trusts (Private International Law Rules)

The concept of a trust is unknown in German civil law. This makes German/Anglo-American estate planning difficult. The German treatment of trusts is typically determined by analogizing the trust in question to some other legal arrangement recognized under German law.

1. Testamentary Trusts

A testamentary trust is a legal institution under the law of succession. Therefore, it is subject to Article 25(1) of the German Introductory Act to the Civil Law Code (*EGBGB*). All legal questions and legal succession *mortis causa* are governed by the nationality (not residence) of the decedent/settlor until 17 August 2015. The reference given is a reference to foreign law, including its conflict-of-law principles.

From 17 August 2015 the E.U. directive on succession applies, meaning that in principle the law of the domicile of the deceased applies. However, the testator has the right to opt for the laws of the testator's citizenship in the testator's last will.

2. *Inter Vivos* Trusts

Two different views are taken in Germany with respect to *inter vivos* trusts. According to one view they are legal institutions similar to a contract for debt (*Schuldvertrag*),[1] in which case the principles of the international law of contracts for debt will be apply. Thereby, an *inter vivos* trust could also be created by German nationals serving as settlors. Another more restrictive view considers the trust to be a legal institution under corporate law, in which case the link will be the same as under international corporate law.

3. Trust Assets

The question as to whether specific assets may be effectively made part of the trust assets must be examined separately. This is a legal issue which is subject to the relevant conflict-of-laws rule governing all legal questions *in rem*.

In regard to German property, this means that assets may only become trust assets if the relevant legal system *in rem* offers such a provision. Under German property law, the *numerus clausus* of the rights *in rem* applies. The Federal Supreme Court ruled in 1985 that a legal trust relationship is incompatible with German public policy for structural reasons.[2] An effective legal trust relationship may not be created with respect to assets subject to German property law. German assets (*e.g.*, claims governed by German law, German shares in business enterprises, real estate) may not effectively become trust assets under civil law.

4. Forced Heirship Rights and Trusts

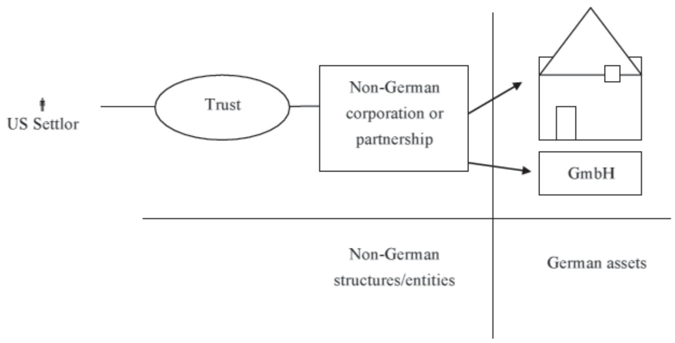
If the German law of succession is applicable, the trust must be compared with the German law on forced heirship rights. The transfer of property to a trust in which the trust settlor is the beneficiary must be assessed, economically, as the making of a gift while retaining a usufruct right (*Nießbrauch*) for the benefit of the donor. The consequence thereof is that such transfer will be deemed insignificant and that the assets will increase the inheritance in terms of the law on forced heirship rights, when calculating the monetary claim under Section 2303 *et seq*. of the German Civil Code (*BGB*). These rules may apply in the event a German living in the United States creates *inter vivos* trusts like GRATs, GRITs or GRUTs. Revocable trusts will likewise be treated as ineffective for structuring (*e.g.*, a grantor trust). These rules also apply for claims under the German statutory matrimonial property regime of the community of surplus (*Zugewinngemeinschaft*).

B. Civil Law Planning Recommendations

For the reasons mentioned above, the following rules should be carefully considered when advising on the creation of a trust with a German connection.

- If the German settlor is living in the United States, the trust should be created *inter vivos*, and its management should be outside of Germany; in such a situation testamentary trusts in the future also may work.
- If the settlor of the trust is a U.S. citizen, problems in creating a testamentary trust or a trust *inter vivos* should be avoidable.
- There are also no civil law problems if a German becomes a beneficiary or a remainderman in the situation described under the foregoing bullet. Also, in such a situation, under German conflict-of-law rules, the relationship between the German beneficiary and the trustee is governed by the applicable trust laws determined by U.S. conflict-of-law principles.

- Assets governed by German law should not be transferred to the trust or if they are transferred, the structure should be done in the following way:



- One should also keep in mind that, under German law, it is not possible to circumvent forced heirship rights or marital claims under the German matrimonial property regime of the community of surplus (*Zugewinngemeinschaft*), which is the statutory German matrimonial property regime if the settlor of the trust is a German citizen.

II. Direct and Indirect Taxation of Trusts and Their Settlors, Beneficiaries and Remaindermen

A. Overview of the German Tax System

1. Income and Transfer Taxes

Germany imposes a federal personal income tax on the worldwide income of resident individuals (hereafter Income Tax Act or ITA). Resident corporations, associations and certain segregated pools of assets are subject to federal corporate income tax (hereafter Corporate Income Tax Act or CITA). In addition to federal income taxes, municipalities are authorized to levy a local trade tax on the profits of commercial enterprises owned by individuals, partnerships and corporations (hereafter Trade Tax Act or TTA).

Transfers at death and gratuitous transfers are subject to the federal inheritance and gift tax (hereafter Inheritance and Gift Tax Act or IGTA). The federal inheritance and gift tax code contains specific provisions dealing with the creation, the distribution, and the dissolution of trusts. They contain specific provisions with a penalty tax for "foreign entities aimed at the binding of assets." Also, the German Foreign Tax Act (FTA) contains a specific provision dealing with foreign family foundations and family trusts and imposes a specific income taxation on the undistributed income of such tax entities.

2. Basic Inheritance and Gift Tax Principles

Germany imposes an inheritance tax on the transfer of property at death. Unlike an estate tax that subjects the decedent's estate as a whole to taxation, the inheritance tax looks at the accretion of each individual heir's wealth or at their enrichment. Accordingly, each heir is ultimately liable for tax on his or her individual share of the estate. The inheritance tax also takes into account the family relationship between the decedent and the heirs. Section 15 IGTA defines three classes of transferees that are eligible for varying personal exemptions and preferential rate structures, depending on the closeness of their family relationship to the decedent. The decedent's wife, children, grandchildren form class I and enjoy the highest exemption amounts and the lowest tax rates. By contrast, taxpayers in class III are entitled only to a very small personal exemption, and the top tax rate is fifty percent for taxable transfers in excess of six million Euros.

The gift tax is levied on gratuitous transfers by one taxpayer to another taxpayer. Like the inheritance tax, it is based on the concept of accretion of wealth or enrichment. Under the enrichment doctrine, only transfers that are not contingent on future events and that result in a present benefit to the transferee are taxable. While the income tax employs factual criteria such as so-called economic ownership (beneficial ownership) in addition to legal criteria to identify taxable transfers, the inheritance and gift tax takes a more formal approach. As a rule, a taxable transfer requires that the transferee obtain legal title to the property or at least an enforceable claim under private law. The gift tax complements the inheritance tax. Under Section 14 of the IGTA, gratuitous transfers and transfers at death by an individual to the same recipient within ten years are aggregated into one transfer. Section 15 of the IGTA also applies to gratuitous transfers and combinations of gratuitous transfers and transfers at death within the ten-year time limit of Section 14 of the IGTA. In 1999 Germany amended the Inheritance and Gift Tax Act to deal with transfers to and from foreign trusts.

The rate of tax therefore depends on the relationship between the donor and the donee and the amount given by that donor to that donee. The following tax-free allowances are available under Section 16 of the IGTA:

	Relationship to Donor/ Decedent	**Allowance (Euros)**
Tax class I	Spouse	500,000
	Child or stepchild	400,000
	Grandchild	200,000
	Other descendant or (in the case of inheritance, upon death) parent or grandparent	100,000
Tax class II	Parent or grandparent in the case of a lifetime gift, sibling, niece or nephew, stepparent, son- or daughter-in-law, mother- or father-in-law, former spouse	20,000
Tax class III	Other (like trusts)	20,000

If neither the donor nor the donee has a place of residence or habitual abode in Germany, the tax free allowance is limited to EUR 2,000.

After deducting the tax-free allowance, the tax rate applicable to the gift of inheritance is as follows under Section 19 of the IGTA.

Amount of gift/inheritance	Tax rate (per cent)		
	Tax class I	Tax class II	Tax class III
Up to € 75,000	7	15	30
€ 75,000 - € 300,000	11	20	30
€ 300,001 - € 600,000	15	25	30
€ 600,001 - € 6,000,000	19	30	30
€ 6,000,000 - € 13,000,000	23	35	50
€ 13,000,001 - € 26,000,000	27	40	50
More than € 26,000,000	30	43	50

3. Basic Income Tax Principles

Basic income tax principles, as far as they are relevant for this overview, will be explained within the context of trust-specific issues.

B. Inheritance and Gift Tax

1. Case Law Prior to 1999

Prior to 1999 the Federal Finance Court ruled repeatedly that setting up a testamentary trust did not trigger inheritance tax.[3] In accordance with the enrichment doctrine, the Court held that the transfer of property to the trustee did not result in a taxable transfer to the beneficiaries because the beneficiaries did not acquire legal title to the trust property. The mere fact that they could expect future benefits was not sufficient to constitute a present taxable transfer under private law. The trustee, in turn, was not liable for inheritance tax either because he was a fiduciary who did not benefit from the transfer. The trust as such was not a legal entity and could not be treated as a taxpayer for inheritance and gift tax purposes. Most commentators took the position that case law also applied to the creation of *inter vivos* trusts. Consequently, the gratuitous transfer of property to a trust did not qualify as a gift and thus was not subject to gift tax.

Case law created an opportunity for inheritance and gift tax planning. By setting up a trust under foreign law, wealthy families could defer the inheritance tax that otherwise would have arisen upon the death of the transferor until the day the beneficiaries and/or remaindermen actually received payments from the trust. What is more, trust arrangements were utilized for generation-skipping transfers that eliminated the inheritance tax burden for one or more generations of a family.[4]

2. 1999 Amendment of the Inheritance and Gift Tax Act

The IGTA was amended in 1999 to close the inheritance tax loophole for trusts.[5] Although the amendment does not use the term "trust," it is clear from the legislative materials that the amendment was primarily intended to deal with transfers to and from foreign discretionary dynasty trusts.[6] The statutory language is intentionally broad so as to cover a wide array of possible trust arrangements. As a result, a large part of the legal discussion of the classification of foreign trusts for purposes of the inheritance and gift tax has become moot. The new legislation expressly addresses the creation of a trust, the distribution of income from a trust and the dissolution of a trust.

3. Creation of a Trust

(a) Testamentary Trust

(i) Inheritance Tax

Under Section 3(2)(1) of the IGTA, the creation of a testamentary trust by a resident of Germany is deemed to be a taxable transfer at death. The same applies if a non-resident in Germany transfers so-called *Inlandsvermögen* (domestic assets) within the meaning of Section 121 of the Valutation Act (*BewG*) to a foreign trust. This could be the case, for example, if a U.S. citizen transfered German real estate via a U.S. transparent limited partnership to a U.S. trust.

However, the language of the statute is quite vague, so it can be difficult to determine which types of trust arrangements are subject to taxation. The taxable event is defined as "an act in accordance with the testator's instructions that creates or contributes to a foreign pool of assets which has as its purpose the segregation of property."[7]

In most cases, a testamentary trust validly created under the laws of a foreign jurisdiction will fulfil the requirements of the first part of the definition as the trustee receives property according to the testamentary instructions of the decedent. Also, its purpose is to segregate property, *i.e.*, to set aside and keep together certain assets on behalf of the beneficiaries and the remaindermen of the trust. For example, a dynasty trust set up for U.S. generation-skipping tax purposes would clearly fulfill the criteria.

On the other hand, it is questionable whether this type of taxation can apply to testamentary trusts created within a will of a German domiciliary, due to the reasons mentioned in Part II.A. above.

It is also unclear whether German trust taxation also applies in cases where *inter vivos* revocable trusts become irrevocable upon the death of the settlor, and the trust has as its only purpose the avoidance of probate proceedings (as is often the case in the United States), and the trust arrangement is designed to distribute the assets to the beneficiaries. Here one can argue that the trust has no dynastic function, and therefore the German taxation rules for foreign trusts with German beneficiaries should not kick in. Instead, the beneficiaries would be taxed with their distributions from the trust in the relationship which existed between the trust settlor and the beneficiary. The situation should be similar to the taxation of a U.S. estate with German beneficiaries without a trust.[8]

(ii) Trusts as Taxpayers

The amended Inheritance and Gift Tax Act does not dwell on the issue of whether a trust is a legal entity. Section 20(1)(2) of the IGTA flatly states that the foreign pool of assets as such is liable to inheritance tax. By contrast, the trustee, beneficiaries and remaindermen are not liable for tax for the reasons stated in the Federal Finance Court's decisions prior to 1999.[9] Since there is no family relationship between the trust and the decedent, the reduced tax rates for transfers to family members do not apply to the transfer of property to a testamentary trust. The trust is a category III taxpayer, and the tax rate ranges from thirty percent to fifty percent, depending on the value of the property. The strict denial of reduced rates for intra-family transfers is somewhat surprising from a tax-policy perspective, since Section 15(2) of the IGTA allows preferential treatment of transfers to certain domestic "family foundations," *i.e.*, foundations situated in Germany, primarily for the benefit of a specific family or specific families.

By treating a foreign pool of assets as a taxpayer, Section 20(1)(2) of the IGTA raises a number of enforcement and tax collection issues. While the local tax office has authority under Section 20(1)(2) of the IGTA to assess inheritance tax on the transfer of property to a trust, it is not clear whether the tax assessment and the payment order are enforceable if the trust property is located in a foreign jurisdiction. In addition, the local tax office may even bring a claim against the trustee, who is not a taxpayer pursuant to Section 20(1)(2) of the IGTA but may be personally liable as a representative of the trust pursuant to Section 69 of the Tax Procedure Act.[10]

(b) *Inter Vivos* Trusts

Depending on the type of trust arrangement, the creation of an *inter vivos* trust by a resident of Germany may result in a taxable gift under Section 7 of the IGTA. Section 7 of the IGTA contains a catalogue of taxable gratuitous transfers that are subject to the gift tax. Pursuant to Section 7(1)(8) of the IGTA, which is very similar to Section 3(2)(1) of the IGTA, "the creation or contribution to a foreign pool of assets which has as its purpose the segregation of property" is deemed to constitute a taxable event.

(i) Fiduciary Arrangements

If the settlor retains control over how the property in trust is used, and if the settlor has the right to terminate the trust at any time and without any restrictions, the creation of the trust is not a taxable event. Under the general tax doctrine of beneficial ownership pursuant to Section 39 of the Tax Procedure Act, the property in trust is attributed to the settlor even though the trustee acquires legal title to it.[11] From the German perspective, this type of trust is classified as a fiduciary arrangement under which the trustee merely has the function of an asset manager. As the economic risks and rewards connected with to the property remain with the settlor, the transfer of legal title is irrelevant for gift tax purposes. This should be the case if the settlor creates a grantor trust. The Fiscal Court of Baden-Württemberg, in its decision of 15 July 2010,[12] clarified that a grantor trust is not a creation or contribution to a foreign pool of assets which has as its purpose the segregation of property. The decision was upheld by the Federal Finance Court.[13]

(ii) Irrevocable *Inter Vivos* Trusts

By contrast, setting up an irrevocable trust results in a separation of legal title and equitable ownership and is a proof of the settlor's intention to segregate property on behalf of the beneficiaries and remaindermen. Since the economic risks and benefits of the property are transferred to the trust and the trust property is no longer controlled by the settlor, the transfer of property to the trust is subject to gift tax. This interpretation of Section 7(1)(8) of the IGTA is consistent with the legislature's intention to close the loophole that existed under the previous case law. Nevertheless, some uncertainty remains.

(iii) Revocable Trusts

It has been argued that revocable trusts are comparable to fiduciary arrangements and thus not within the purview of Section 7(1)(8) of the IGTA because the settlor has retained the right to unwind the trust at any time.[14] However, the statutory language does not differentiate between irrevocable and revocable trusts. Even though the settlor may revoke the trust at a later time, the purpose of a revocable trust may be to segregate certain assets from the property of the settlor and to relinquish control at least temporarily. Taking into account the objective of Section 7(1)(8), taxation can be justified. If the settlor later decides to revoke the trust, the gift tax paid on the creation of the trust is refundable under Section 29(1)(1) of the IGTA.[15] Nevertheless, these rules may only apply in cases where the beneficiary and the settlor are not the same persons, which, in a revocable trust situation, is not very often the case. In case settlor and beneficiary are the same person there is no "segregation of property." This was also the view of the Federal Fiscal Court in 2012.[16]

(iv) Gratuitous Transfers to Existing Trusts

Gratuitous transfers by the resident to an existing trust are subject to gift tax pursuant to Section 7(1)(1) of the IGTA.

(v) Trusts as Taxpayers

Section 20(1)(2) of the IGTA applies not only to transfers at death but also to gratuitous transfers involving *inter vivos* trusts. As a consequence, the trust is deemed to be a transferee for gift tax purposes and is tax liable. The gift tax is computed by applying class III tax rates to the taxable amount as determined by a valuation of the transferred property. Treating the trust as a taxpayer for gift tax purposes raises enforcement issues very similar to those discussed above. However, the settlor is also liable for gift tax under Section 20(1)(2) of the IGTA, so the local tax office can collect the gift tax from a resident taxpayer and thus avoid possible enforcement issues.[17]

4. Distribution of Trust Property and Trust Income

The creation of a trust does not result in inheritance or gift taxation of the beneficiaries or the remaindermen, since these persons do not receive a present benefit under the accretion of wealth or so-called enrichment doctrine. This applies in any case if the trust is set up as a discretionary trust. These rules also apply if the beneficiary is entitled to regular distributions like in a fixed-interest trust. The Financial Court of Baden-Württemberg ruled that the beneficiary designation in a fixed-interest trust itself does not trigger inheritance or gift taxes.[18] Only the actual distributions are taxable. This decision was upheld by the Federal Fiscal Court.[19]

The distribution of trust property to the remaindermen also constitutes a taxable gift under Section 7(1)(9) IGTA if the remainderman is a resident of Germany. Section 7(1)(9) applies to distributions upon the dissolution of testamentary as well as *inter vivos* trusts. It also applies to distributions of property from a trust that continues to exist, although the statutory language may imply otherwise. The wording of Section 7(1)(9) is as follows: "Transfers upon the dissolution of a foreign pool of assets, having the purpose of segregating property, as well as transfers to intermediate beneficiaries during the existence of the pool of assets…are deemed to be a taxable gift." Although the term "intermediate beneficiaries" is not defined, the majority of commentators construe it to include any distribution of trust income or trust property to any beneficiary or any remainderman during the existence of the trust. This is also the view of the Federal Fiscal Court.[20]

As a result, trust property that was subject to inheritance or gift tax when it was transferred to the trust will be subject to a second level of gift tax when it is distributed to the remaindermen. In addition, trust income that is not retained by the trust but distributed to beneficiaries who are residents of Germany will also be subject to gift tax regardless of any income tax that might be imposed on the income.[21] Section 7 (1)(9) of the IGTA applies to distributions of income from discretionary trusts.[22] Section 7 (1)(9) also applies to distributions of income from fixed-interest trusts as mentioned above.

It is clear that the gift tax arises on the actual receipt of trust income or trust property by the recipient of a discretionary trust.[23] In Section 15(2)(2) of the IGTA family relationships are taken into account in determining the applicable tax rate. Depending on their proximity to the decedent or settlor, beneficiaries and remaindermen can qualify for either class I or class III of the gift tax rate system. However, the determination of the tax rate class can pose difficulties if the trust property was contributed by different persons. The Fiscal Court of Baden-Württemberg, in its decision of 15 July 2010,[24] clarified that any distribution from a grantor trust to the grantor, and the termination of the grantor trust and repayment of trust corpus to the grantor do not trigger German inheritance and gift taxes. This decision was upheld by the Federal Fiscal Court.

5. Backup Inheritance Tax

Section 1(1)(4) of the IGTA imposes a so-called backup inheritance tax on certain domestic family foundations. The backup inheritance tax arises in thirty-year intervals. Its objective is to subject family foundations to inheritance tax that would otherwise remain untaxed due to their perpetual existence. The backup inheritance tax does not apply to foreign trusts.[25]

6. The U.S./German Estate and Gift Tax Treaty

(a) Article 12 of the Double Taxation Treaty

Article 12 of the U.S./German Estate and Gift Tax Treaty contains special provisions for trusts. In Article 12(1) both contracting states reserve the right to apply their respective rules governing the recognition of a taxable event with respect to transfers of property to and from trusts. Article 12(3) provides that "in a case where a transfer of property to a trust results in no taxable transfer at such time under the German inheritance and gift tax, the beneficiary of the trust may elect within five years after such transfer to be subject to all German taxation (including income taxation) as if a taxable transfer had occurred to him at the time of such transfer."

The election was necessary to avoid double taxation prior to the 1999 amendment to the Inheritance and Gift Tax Act. Under the old rules, the creation of the trust was not a taxable event and inheritance tax was imposed on later distributions to beneficiaries and remainderman. In many cases, U.S. estate tax could not be credited against the inheritance tax due to a five-year limitation on creditable foreign estate and inheritances taxes under Section 21(1)(4) of the IGTA.

Habammer, a member of the German Finance Administration, takes the position that the election under Article 12(3) is irrelevant for transfers after 1999 because the creation of a trust is subject to taxation in the U.S. and in Germany in the same year.[26] Other commentators point out that gift tax will arise on later distributions to beneficiaries and remainderman, so there is still a need for the election.[27]

In the established practice of the German revenue service, the option provided by Article 12 (3) is available for a German beneficiary or remainderman in cases where

Germany did not have the right to tax the creation of the trust under the treaty, *e.g.*, if a U.S. citizen domiciled in the United States is creating in his will a U.S. testamentary trust with its seat in the United States with non-German assets.

This election right is a very powerful planning tool, especially when taking account of the higher U.S. transfer taxes compared to their German counterparts when assets are transferred within in the family. Usually, the credit of U.S. transfer taxes against German transfer taxes lead to the result that no German transfer taxes are due anymore.

It is unclear whether Article 12 Section 3 Estate Tax Double Taxation Treaty also applies to distributions from the trust to the beneficiary in cases where they have elected to be treated as if they had acquired the trust assets outright. Jülicher[28] is of the opinion that in cases where a German beneficiary has elected under Article 12 Section 3 of the Treaty that distributions from the trust to the German beneficiary or remainderman are no longer to be subject to German gift taxes, the result of this specific election right is that, for gift tax purposes (concerning income taxes see Part II.C.8.), the beneficiary is treated as if the beneficiary would own the assets outright. Then distributions to him are not gift taxable. Nevertheless, caution should be taken when making use of this election right, especially when it is planned that trust assets should not be distributed to the German beneficiary. In cases where a beneficiary passes away, one could be of the opinion that for inheritance tax purposes the beneficiary is then treated as if the beneficiary were owner of the trust assets which the beneficiary then at the moment of death returns to the trust so that the German special inheritance creation tax for foreign trusts would be applicable. This problem has thus far not been debated in German literature. The author is of the opinion that this is not the case because the German creation tax for foreign trusts only applies when assets are transferred to a trust. Here in this situation, only the fictitious ownership ends, but there is no transfer of legal title. Under German gift and inheritance tax principles, only an enrichment of a trust can be taxed. Since no enrichment occurs, the trust assets should not be treated as being taxable part of the estate of the deceased German beneficiary. Nevertheless, a private letter ruling is recommended when making use of the election right of Article 12 Section 3 of the Double Taxation Treaty.

(b) The Ten-Year Rule of Article 4 Section 3 of the Double Taxation Treaty

In the tie-breaker rules of the U.S./German Estate and Gift Tax Treaty, it is said that if an individual, at the individual's death or upon the making of a gift, was (i) a citizen of one contracting state and not also a citizen of the other contracting state and (ii) by reasons of the provisions of Section 1 (of Article 4) domiciled in both contracting states and (iii) by reasons of the provisions of Section 1 (of Article 4) domiciled in the other contracting state for not more than ten years, then the domicile of that individual and of the members of the individual's family forming part of the individual's household and fulfilling the same requirements shall be deemed, notwithstanding the provisions of Section 2 (of Article 4), to be in the contracting state of which they were citizens.

This means that a U.S. citizen coming from the United States to Germany is protected against German estate and gift taxation on their worldwide estate during the U.S. citizen's first ten years in Germany if (i) the beneficiary/heir is domiciled in the U.S. and no German real estate or business assets are transferred to the beneficiary/heir or (ii) the beneficiary/heir is a U.S. citizen who has been living for fewer than ten years in Germany in the same household as the testator and no German real estate or business assets are transferred to him.

This means that trust strategies for liquid assets in the first ten years for U.S. citizens after coming to Germany are still viable and must not be amended. Nevertheless, this is only the case if the trust qualifies for U.S. and German tax purposes as a U.S. trust.

On the other hand, this also means that a German citizen coming from Germany to the United States is exposed to the German trust taxation for inheritance and gift taxes on the German citizen's worldwide estate although the German citizen may have already become domiciled for United States transfer taxes in the United States. Therefore, Germans in their first ten years in the U.S. should avoid using trusts or should only use trusts which do not qualify under the German inheritance and gift tax rules as trusts within the meaning of special trust taxation in Germany (like a grantor trust). Nevertheless, if they created a grantor trust, then passed away within their first ten years in the United States, the German special taxation rules for trusts would apply and would lead to very high German taxes.

The application of Article 4 Section 3 of the Double Taxation Treaty can also be beneficial to incoming U.S. heirs or donees who receive payments from U.S. trusts because, some years ago, the Berlin revenue service issued to the author a private letter ruling that a U.S. citizen living in Germany for fewer than ten years but receiving distributions from U.S. trusts is protected under the U.S./German Estate and Gift Tax Treaty due to Article 4 Section 3 of the Treaty from the German specific trust taxation. Only the German income taxation remains.

(c) Article 10 Section 6 of the Double Taxation Treaty and the Need for QDOTs for German Surviving Spouses

Due to Article 10 Section 6 of the U.S./German Estate and Gift Tax Treaty, the surviving German spouse of a U.S. citizen is entitled to a special marital deduction for

U.S. estate tax purposes if (i) at the time of a decedent´s death, the decedent was domiciled in Germany or the United States, (ii) the surviving spouse was at the time of the decedent´s death domiciled in either Germany or the United States, (iii) if both the decedent and the surviving spouse were domiciled in the United States at the time of the decedent´s death and one or both were German and (iv) the executor of the decedent's estate elects the benefits of Article 10 Section 6 of the Treaty and waives any benefits of any other estate tax marital deduction that would be allowed under U.S. laws on the U.S. estate tax return filed for the decedent´s estate by the date on which a QDOT election could be made under U.S. laws. Therefore, Article 10 Section 6 currently gives the German spouse of a U.S. citizen a very high U.S. tax allowance.

Another way to avoid the need for a QDOT would be if the German surviving spouse becomes a dual citizen during the lifetime of the U.S. spouse or before filing the U.S. estate tax return.

(d) Overview on the Right of Taxation and the Tax Credit System Between the U.S. and Germany Under the Double Taxation Treaty

Right to tax U.S.A./Germany						
Residence of decedent	**Nationality of decedent**	**Residence as per Article 4**	**Heir**	**Right to tax**	**Special provisions**	**Tax credit system**
G	Irrelevant	G	G	G	U.S.A.: real estate /business assets	Credit of U.S. tax in G with respect to real estate/ business assets in the U.S. (Art. 11 para. 9 sub-paragraph a))
U.S.A.	Irrelevant	U.S.A.	U.S.A.	U.S.A.	G: real estate/ business assets	Credit of German tax in the U.S. with respect to real estate/business assets in G (Art. 11 para. 2, sub-paragraph a))
G	G	G	U.S.A.	G	U.S.A.: real estate /business assets	Credit of U.S. tax in G with respect to real estate/ business assets in the U.S. (Art. 11 para. 3 sub-paragraph a))
U.S.A.	Irrelevant	U.S.A.	G	U.S.A./G	–	– Credit or U.S. tax in G: exception U.S. tax on real estate/business assets in G (Art. 11 para. 3 subparagraph a)) – Creditation of German tax in the U.S. with respect to real estate/business assets in G (Art. 11 para. 3 sub-paragraph a))
G	U.S.A.	G	Irrelevant	U.S.A./G	–	– Credit or German tax in the U.S.: exception German tax on real estate/business assets in the U.S. (Art. 11 para. 2 subparagraph b)) – Creditation of U.S. tax in G with respect to real estate/ business assets in the U.S. (Art. 11 para. 3 sub-paragraph a))

7. Inheritance and Gift Tax Planning Recommendations

- If a U.S. citizen domiciled in the United States creates a testamentary or *inter vivos* trust with U.S. assets, this does not trigger any German inheritance or gift taxes.
- In cases in which Germany does not have the right to tax the creation of a U.S. trust, *e.g.*, because due to treaty protection under the U.S./German Estate and Gift Tax Treaty, the German beneficiary can elect to be treated as if the beneficiary had acquired outright ownership of the trust assets, then U.S. transfer taxes would be credited against German transfer taxes.
- Distributions from a trust (income and corpus) are gifts to the German beneficiaries and are taxed according to the relationship between the settlor and the beneficiary.
- A U.S. citizen domiciled in Germany has, for the first ten years after coming to Germany, to a certain extent treaty protection for estate and gift tax purposes and can receive distributions from a U.S. trust free of German gift taxes (although this is disputed to some degree).
- Germans coming to the United States are, for their first ten years in the country, still exposed to the German inheritance and gift tax when creating U.S. trusts.

C. Income Tax

1. Classification of Trusts

From an income tax perspective, a trust can be classified as a fiscally transparent conduit (fiduciary arrangement), as a separate legal entity that is treated as a corporate taxpayer, or as a "family trust" that is subject to a special tax regime on undistributed income. There is no general rule for the classification of certain types of trusts, since the courts examine not just the legal framework of a foreign trust but also the facts and circumstances of each case.

(a) Fiduciary Arrangement (Conduit)

Under the doctrine of fiduciary arrangement (*Treuhandverhältnis*), the transfer of property by a taxpayer to another person is irrelevant for income tax purposes, if (i) the transferee acts solely for the benefit of the transferor, (ii) the transfer is subject to strict guidelines imposed by the transferor, and (iii) the transferor is empowered to terminate the fiduciary arrangement at any time. A trust that fulfils these criteria is likely to be treated as a fiscally transparent conduit.[29] The trust property is attributed to the settlor, and the trust's items of income and deductions are included in the taxable income of the settlor. This is the case in the event of a grantor trust.

(i) Revocable Trust

According to these strict criteria, a revocable *inter vivos* trust will not automatically be classified as a conduit merely because the settlor can revoke the trust and thus regain ownership of the property.[30] The taxpayer is also required to show that he is in control of the trust property during the existence of the trust as discussed above. If the beneficiaries and/or remaindermen have control over the trust property, the trust income will be taxed to them. In practice, however, the latter is not likely to happen as an arrangement under which the beneficiaries and/or remaindermen control the trust property would probably not qualify as a trust under foreign law.

(ii) Irrevocable Trust

By contrast, an irrevocable trust will, with a very high probability, never be treated as a conduit, since neither the settlor nor the beneficiaries have the authority to terminate the trust at any time.[31] This is also true with respect to a testamentary trust that is irrevocable by definition.

(b) Trusts as Separate Legal Entities and Taxpayers

A trust that is not classified as a fiduciary arrangement will be treated as a so-called entity taxpayer pursuant to Section 1 or Section 2 of the Corporate Income Tax Act. Corporate income tax is not only imposed on foreign entities that are taxpayers in their countries of residence and comparable to domestic corporations, such as publicly or privately held corporations or domestic associations, but it is also imposed on domestic or foreign pools of assets (*Vermögensmassen*) if the pool of assets—without being a separate legal entity under domestic or foreign law—is deemed to have an independent economic existence. In two landmark decisions dating back to 1992, the Federal Finance Court held that a trust created under the laws of Jersey and a U.S. testamentary trust will be treated as a corporate taxpayer pursuant to Section 2(1) of the CITA if the trust property (i) consists of a pool of assets set aside for a specific purpose, (ii) is no longer controlled by the settlor, and independently generates income. The rationale behind this decision is obvious: While the settlor has disposed of the property and the (future) income in a way that prevents the attribution of property and income to him, the trustee who owns and manages the property does not enjoy the benefits of ownership and thus cannot be taxed on the income either. If income tax law were to tolerate this type of tax planning arrangement, the income generated and accumulated by the trust would end up in a fiscal "no-man's land" and escape taxation.

Moreover, if the place of effective management of the trust is situated in Germany, the trust will be taxed on its worldwide income—so-called unlimited tax liability (*unbeschränkte Steuerpflicht*) pursuant to Section 1(1) of the CITA. Otherwise only income from German sources is subject to taxation under Section 2(1) of the CITA. A trust does not only have business income like a corporation but can, like an individual, also have private income.

The rules discussed above apply to discretionary trusts as well as to fixed-interest trusts. One could argue that there is no need to treat a fixed interest trust as a taxpayer pursuant to Section 2(1) of the CITA because the trust's income is distributed to the beneficiaries on an annual basis and thus subject to income tax in the hands of the beneficiaries. However, the attribution of trust income to the beneficiaries would not be consistent with the attribution of income doctrine, which requires either a contractual relationship between the taxpayer and the debtor or an active role of the taxpayer in the management of the income-producing asset. The beneficiaries do not meet these criteria, since the trustee enters into contracts and is responsible for managing the trust property.[32]

2. Family Trusts within the Meaning of FTA Section 15 (Special Tax Regime for Undistributed Income)

Section 15 of the FTA contains a special income tax regime for foreign so-called family foundations that are not subject to taxation of worldwide income and thus could be utilized to shelter income from taxation. A foreign family foundation is defined as an entity that has neither a registered office (*Satzungssitz*) nor a place of effective management in Germany and was created to benefit the members of a family. The latter requirement is fulfilled if more than one-half of the foundation's property and income is set aside for the founder and/or his relatives.[33] In Section 15 (1) of the FTA a proportionate share of the foundation's income is included annually in the income of the settlor or those beneficiaries and remaindermen who are German residents. Section 15 (4) of the FTA extends this taxation mechanism to foreign "pools of assets" that were set up to benefit a family as required by Section 15 (2) of the FTA.

In a decision in 1992, the Federal Court of Taxation applied Section 15 (4) to a Jersey trust, in which the trust's income was allocated to the settlor, who was still alive, and a German resident[34] and, in a decision of 2 February 1994,[35] U.S. testamentary trust, to the beneficiaries living in Germany. The court held that the trust had been created for the benefit of the settlor's wife and children and was thus comparable to a family foundation and subject to the special taxation regime in Section 15 of the FTA. As a result, the trust's worldwide income was included in the settlor's income for the taxable year.

If a German resident becomes a discretionary beneficiary of a U.S. trust and is benefited by more than one-half of the trust's property and income (alone or together with other family members), the trust will qualify as a family foundation within the meaning of Section 15 (2) of the FTA. Thus, its worldwide income will be allocated to the settlor if the settlor is resident in Germany and will therefore be subject to German taxation. If the German resident is only a beneficiary together with other (non-German) beneficiaries, then the beneficiary is exposed to taxation on the undistributed income on a pro rata basis.

3. Exemption for EU/EEA Trusts

Section 15(6) of the FTA excludes family foundations having their registered office or place of effective management in EU/EEA member countries from the special taxation regime, provided that (i) the trust's property is extracted from the power of disposition of the settlor and his relatives and (ii) Germany and the respective state have entered into a certain exchange of information agreement.

Typically, the place of management of a trust is with the trustee. Nevertheless, when determining the place of management of a trust one should also consider the rights and duties of a protector's committee if one exists. It is a subject of debate whether or not Section 15(6) of the FTA is applicable to a U.S. trust which also has a registered office or place of management within the EU/EEA.

4. Tax Consequences and Taxation Regime Pursuant to FTA Section 15

In accordance with the special taxation regime established by Section 15 of the FTA, which is applicable if the place of effective management of the trust is located in the United States, property and (positive) income[36] of the U.S. family trust are attributed to the beneficiary on a pro rata basis if the beneficiary is a German resident. As long as the beneficiary is alive and the trust income accumulates to the trust, the trust income—as determined by German tax law—is added to the taxable income of the beneficiary on a pro rata basis. The beneficiary is entitled to a foreign tax credit with respect to foreign income taxes the trust paid on the income.[37] The trust income is included in the taxable income of the beneficiary in the taxable year in which the income arises under general income tax rules on level of the trust.[38] Distributions of accumulated trust income that was subject to taxation in a prior year are not taxed a second time pursuant to Section 20 (1) No. 9 of the Income Tax Act, as discussed in Part II.C.5. below.

If the trust qualifies as a foreign family trust within the meaning of Section 15 of the FTA, which is not exempt under Section 15 (6), its property and income is attributed to the beneficiary on a pro rata basis and added to their taxable German income. According to Section 20 (1) of the FTA, double tax treaties cannot prevent the allocation of income pursuant to Section 15 (1) of the FTA. However, distributions of accumulated trust income that have been taxed under Section 15 will not be taxed a second time, according to Section 20 (1) no. 9 of the ITA, when distributed to the German beneficiaries. Nevertheless, gift tax will arise in cases where the beneficiary has not or cannot make use of the election right provided by Article 12 Section 3 of the U.S./German Estate and Gift Tax Treaty.

In German tax literature complex strategies are discussed for avoiding the adverse German tax consequences of Section 15 of the FTA.

5. Distributions from an Irrevocable Trust

Generally, distributions of foreign irrevocable trusts are subject to German income tax pursuant to Section 20 (1) no. 9 of the ITA. This is true with regard to periodic or ad hoc distributions of trust income as well as to distributions of trust property (repayment of capital). Only repayments at the expense of the tax contribution account in terms of Section 27 of the CITA are not taxable. However, trusts resident in third countries like the United States cannot refund distributions at the expense of the tax contribution account.[39] Such distributions are taxed under the final flat-tax regime at a tax rate of 26.375 percent (plus solidarity surcharge and, if applicable, church tax) of the fair market value of the distributed assets. Due to this law, not only income but also trust corpus is income taxable when distributed to a German beneficiary or remainderman. As mentioned above, the gift tax is also triggered.

A distribution from a foreign irrevocable trust to the German beneficiary or remainderman is not taxed under Section 20 (1) No. 9 of the Income Tax Act if the relevant income was already attributed to the German beneficiary under Section 15 of the FTA.

6. No Credit for German Gift Taxes on German Income Taxes and Vice Versa

Pursuant to Section 35b of the IGTA, inheritance tax can be credited against German income tax if triggered by inheritance but not by donation. However, German tax law provides neither for a credit of the income tax paid by the beneficiary on the gift tax nor vice versa.[40]

7. The U.S./German Income Tax Treaty

Article 1 Section (6) of the U.S./German Income Tax Treaty specifies that Germany is not prevented from applying the German CFC Rules and in particular the undistributed income attribution rules under Section 15 of the FTA to a German beneficiary. The treaty also specifies that distributions from a U.S. trust are income taxable in Germany for the resident beneficiary in Article 21 of the Treaty. It is the German understanding of Article 21 that the U.S. is not entitled to impose a withholding tax on a distribution from a U.S. trust to a German beneficiary.

8. Influence of Article 12 Section (3) U.S./German Estate and Gift Tax Treaty on the Income Taxation of the German Beneficiaries

It is conversely a subject of debate whether Section 15 of the FTA and Rules thereunder and Section 20 (1) No. 9 of the Income Tax Act also apply if the German beneficiary under the U.S./German Estate and Gift Tax Treaty makes use of the election right granted in Article 12 Section (3) of the U.S./German Estate and Gift Tax Treaty.

The author is of the opinion that it is arguable, due to the wording of Article 12 Section (3), that Section 15 and Section 20 (1) No. 9 should no longer apply because the Estate and Gift Tax Treaty states that the German beneficiary is subject to all German taxation (*including income taxation*) as if a taxable transfer had occurred to the beneficiary at the time of such transfer to a trust.

Then the beneficiary should be taxed as if the beneficiary would be an outright owner of the trust assets, and therefore all the tax exemptions and tax rules should apply for private individuals receiving outright income from these assets. This would, for example, mean that income from interest or capital gains on securities would be taxed within the favorable German "final flat tax regime."

9. Income Tax Planning Recommendations

- All income or any asset which flows through an irrevocable trust is exposed for the German beneficiary not only to a gift tax but also to an income tax. German gift taxes cannot be credited against the German income taxes and vice versa.
- To a certain extent, U.S. taxes borne by the trust can be credited against the German Section 15 FTA tax.
- If a German resident is a beneficiary of a U.S. trust, then strategies should be initiated by the trust so that the German beneficiary is not exposed to the Section 15 FTA taxation.

Endnotes

1. EGBGB Art. 27 *et seq*.
2. Judgment of the German Supreme Court dated 13 June 1984, published in 1985 IPRAX 22, 23.
3. Decisions of 20 December 1957, 1959 BStB1. III 79; 31 May 1961, 1961 BStB1. III 312; 7 May 1986, 1986 BStB1. II 615, 1990 BFH/NV 235.
4. Habammer, 2002 DSTR 425, 430.
5. Wienbracke, 2007 STEUERREVUE 409.
6. BT-DRUCKS. 14/23, 11 November 1998, at 200.
7. The statutory language resembles the terminology used by § 2(1) of the CITA. Therefore, it has been argued that a foreign pool of assets that is classified as a taxable entity under § 2(1) of the CITA is also a "taxable trust" for purposes of the inheritance gift tax. *See* von Oertzen, 2002 DSTR 433.
8. Decision of 8 June 1988, 1988 BStBl II 808: In the event of a U.S. estate governed by U.S. laws, the beneficiaries are taxed in the personal relationship at the moment of death of the decedent, although the executor of the respective U.S. estate has not paid out and will not pay out the assets of the estate to the beneficiary in the short term.
9. The situation is more complex if the trust is not a discretionary trust but a fixed interest trust. (See also the discussions about QDOTs with German beneficiaries.)
10. Habammer, note 4 *supra*, 425, 431.
11. It should be mentioned that the concept of so-called economic or beneficial ownership is not a general inheritance and gift tax concept. There seems to be agreement, however, that the creation of a legal arrangement that qualifies as a "fiduciary arrangement" pursuant to § 39(2) of the Tax Procedure Act is not a taxable transfer.
12. 2010 EFG 162 *et seq*.
13. Federal Finance Court, decision of 27 September 2012, 2013 BStBl. II 84.
14. Füger/v. Oertzen, 1999 ISTR 11, 13.
15. Wienbracke, note 5 *supra*, 409, 413.
16. Federal Finance Court, decision of 27 September 2012, 2013 BStBl. II 84.
17. Wienbracke, 2007 STEUERREVUE 490, 495.
18. FG Baden-Württemberg, 2011 EFG 160.
19. Federal Finance Court, decision of 27 September 2012, 2013 BStBl. II 84.
20. *Id*. at 84.
21. Habammer, note 4 *supra,* 425, 431.
22. Wienbracke, note 17 *supra*, 490, 497.
23. Habammer, note 4 *supra*, 425, 431.
24. 2010 EFG 164.
25. Wienbracke, note 17 *supra*, 490, 502.
26. Habammer, note 4 *supra*, 425, 432.
27. von Oertzen, 2002 DStR 433; Debatin/Wassermeyer/Hundt, Art. 12 DBA-USA/E, annot. 47 *et seq*.
28. Jülicher, 2001 IStR 178 ff.
29. Seibold, 1993 DSTR 545, 546; Habammer, note 4 *supra*, 425, 427; BFH decision of 5 November 1992, 1993 BStBl. II 388, 390.
30. Habammer, note 4 *supra*, 425, 427; Seibold, note 29 *supra*, 545, 547.
31. Federal Finance Court, decision of 2 February 1994, 1994 BStBl. II 727.
32. Seibold, note 29 *supra*, at 545, 546 *et seq.*; Wienbracke, 2007 RIW 201, 202. The Federal Finance Court reached a similar conclusion in a case where three U.S. testamentary trusts distributed all trust income annually to the beneficiary who was resident of Germany, decision of 2 February 1994, 1994 BStBl. II 727.
33. *See* FTA §15(2).
34. Federal Court of Taxation, decision dated 5 November 1992—I R 39/92, 1993 BStBl. II 388.
35. 1994 BStBl. 727.
36. Negative income cannot be allocated to the settlor/beneficiary. *See* FTA §15(7) sentence 2.
37. *See* FTA §15(5).
38. Rundshagen, in S/K/K, Sec. 15 AStG marginal no. 48.
39. See Elser/Dürrschmidt, 2010 ISTR 79, 82.
40. Seltenreich/Rödl/Preißer *et al*., Sec. 7 marginal no. 10 at 443; Jülicher, note 28 *supra*, at 202; Habammer, note 4 *supra*, 425, 429.

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Enforcement of Intellectual Property Rights by Preliminary Injunction Proceedings in Germany

By Thies Bösling

I. Introduction

Holders of intellectual property rights—patents, trademarks, designs, utility patents, or copyrights—may enforce their claims to cease-and-desist by way of a preliminary injunction. In clear-cut infringement cases, a German court may even issue a preliminary injunction *ex parte*.

Fast, powerful and cost-efficient, the preliminary injunction has become the favorite litigation tool of many intellectual property right owners from Germany and abroad. Its manifest upside is that it enables right holders to stop the distribution of infringing goods quickly, virtually closing down a major European market within a few business days. By way of a preemptive strike, right holders may even request a preliminary injunction where the sale or distribution of the infringing goods has not yet begun but an act of infringement is imminent. In international disputes, a preliminary injunction with German or EU-wide scope may be just about enough to bring the defendant to the negotiation table.

This article intends to provide international readers with an overview of the course of procedure and timeline of preliminary injunction proceedings in Germany and illuminate some of its advantages and drawbacks.

II. Prerequisites to Apply for a Preliminary Injunction

The owner of an intellectual property right may apply for a preliminary injunction where the owner's rights are being infringed by a third party or where there is a concrete threat that an act of infringement will occur. The petitioner need not be domiciled or have a representation in Germany, but the scope of the intellectual property right at issue must extend to Germany, and the petitioner must be represented by German counsel before the court.[1] In its motion for an injunction, the petitioning owner must make the *prima facie* case of an actual or imminent infringement[2] and must show that the owner treated the matter without undue delay after becoming aware of (i) the identity of the infringer,[3] and (ii) the acts that constitute the alleged infringement. Since compensation for damages that were caused by the infringement cannot be claimed in preliminary injunction proceedings, the petitioner is under no obligation to show actual harm. Also, the petitioner is not required to initiate main proceedings against the defendant before or at the time of filing for a preliminary injunction.

The petition for a preliminary injunction typically corresponds to a full-blown court writ, comparable to a complaint in main proceedings. There is no standard form, nor is there a limitation on the number of pages or pieces of evidence which the petitioner may submit. The content of the petition will typically include the following elements.

- A motion to enjoin the defendant from committing a specific act of infringement, which must be clearly defined (*e.g.*, by making reference to images of the infringing product or advertisement).
- A statement of grounds which (i) substantiates the petitioning owner's intellectual property right, (ii) describes the relevant act of infringement, (iii) explains how and when the petitioner became aware of the relevant facts and which further steps were taken to stop it, and (iv) states the arguments of law which the petitioning owner wishes to bring forward in support of the owner's claim.
- *Prima facie* evidence to demonstrate the validity of the intellectual property right concerned (typically including up-to-date excerpts from the trademark, patent or design register), comprehensive documentation of the act of infringement (*e.g.*, photographs or screenshots of the infringing product or advertisement, product samples, invoices or delivery notes) and, in order to show that the matter was treated without undue delay, an affidavit of an employee or officer of the petitioner which confirms in lieu of an oath when and how the owner became aware of the infringement.

Unlike in main proceedings, the court will only conduct a cursory review of the facts and evidence of the case in order to ensure a speedy trial. As a consequence, the standard of proof in preliminary injunction proceedings is lower than in main proceedings. The petitioner need only demonstrate a preponderance of evidence[4]—while in main proceedings he or she must produce clear and convincing evidence[5]—in support of the relevant propositions. However, even in preliminary injunction proceedings the court will conduct a full-blown legal examination of the facts and evidence before it.

III. Urgency Requirement

The overarching concept of preliminary injunction proceedings is the so-called "urgency requirement"

(Dringlichkeitsgebot).[6] This entails, in short, that the petitioner is required to act without undue delay throughout the entire proceedings and must take action towards stopping the infringement as quickly as possible. Most importantly, the petition must be filed within a reasonably short time frame in order to demonstrate that the petitioner considers the case to be an "urgent" matter.

Procedural law does not specify a uniform time limit within which a petition for a preliminary injunction must be filed. Instead, the assessment of whether the petitioner treated the matter with adequate urgency is left to the discretion of the courts. As a rule of thumb, the maximum time span which courts deem acceptable ranges between four weeks and two months after the petitioner become aware of the infringement, depending on the circumstances of the individual case. However, there are notable differences between the various court districts. For example, while the regional court of Munich applies a strict four-week deadline, the regional courts of Berlin and Düsseldorf generally hold that a period of six to eight weeks is within the acceptable range.

While speedy filing of the petition is essential in order to comply with the "urgency requirement," the petitioner remains under the obligation to act without undue delay throughout the proceedings until the injunction is granted and takes effect. This entails, for example, that the petitioner runs the risk of being able to prove the urgency of the case by (i) generously extending deadlines to the defendant, (ii) exhausting deadlines for filings to the court, (iii) requesting or consenting to the adjournment of court hearings to a later date than originally scheduled, or (iv) offering or agreeing to generous settlement conditions such as extensive sell-off periods for infringing goods or a waiver of penalties for continued infringements.

IV. Requirement of an Advance Warning Letter

One of the special features of preliminary injunction proceedings in Germany is that an injunction may be issued *ex parte*, that is, without the defendant being heard in court or being invited to file observations on the petition first. In order not to deprive the defendant of its right to due process of law, courts generally require the petitioner to warn the defendant by way of a formal letter *(Abmahnung)*[7] before requesting a preliminary injunction from the court. A copy of the warning letter and the defendant's response, if any, should be attached to the petition in order to show that the defendant was given the opportunity to bring forward any facts and arguments in defense against the infringement claim.

The warning letter should contain all relevant information which the defendant requires in order to make a sound assessment of whether its own actions infringe upon the rights of the sender. The warning letter will therefore typically comprise a substantiation of the petitioner's relevant intellectual property rights, a brief outline of the alleged act of infringement, a reference to the applicable statutes and legal doctrines, and an unequivocal request to resolve the dispute by incurring the obligation to cease and desist subject to a reasonable contractual penalty in order to avoid court proceedings.

The time limit for the defendant to tender such a declaration will typically be between twenty-four hours and five business days. A draft declaration prepared by the owner that the defendant may use will typically be attached to the warning letter, but the defendant may opt to modify the draft or formulate a declaration to cease and desist itself. This entails the risk, however, that the right holder may not accept the declaration as sufficient to eliminate the risk of recurring infringements and still move for a preliminary injunction.

V. Defense Mechanism: Protective Writ *(Schutzschrift)*

Where the defendant receives a warning letter which he or she believes is not justified, the defendant may deposit a protective writ *(Schutzschrift)* in which the defendant presents the evidence, facts and arguments it wishes to bring forward in defense against the claim. In particular, the defendant may provide evidence that the petitioner has been aware of the alleged infringement for a period of time long enough to disprove the urgency of the matter or challenge the validity of the allegedly infringed intellectual property right, *e.g.*, by showing that the allegedly infringed trademark has not been put to genuine use in commerce. Since the defendant will often be unable to anticipate which forum the petitioner will choose, the defendant will strive to deposit the protective writ with every court where the petition for a preliminary injunction may potentially be filed. In order to facilitate the filing of protective writs, a centralized online filing system has been established in which, from 1 January 2016, every court is obliged to participate.

VI. Geographic Scope of Injunction

As a general rule, German courts are competent to issue a preliminary injunction with effect in the territory of the Federal Republic of Germany only. However, where the petitioner's intellectual property is protected by a supranational right with effect in the entire European Union (namely a Community Trademark or Community Design) and the defendant is domiciled in Germany, German courts may issue an injunction with effect in the entire EU. The same applies where the defendant is domiciled outside the EU but has an establishment in Germany.[8]

VII. Forum Choice

Depending on the registered place of business of the defendant, the type of intellectual property right in question, and the location where the infringement occurs, the petitioner will often be able to choose between two or more courts as a venue to apply for a preliminary injunction.[9] This holds true, in particular, where acts of infringement occur online. Courts which are widely respected for their expertise in intellectual property include the courts of

- Hamburg
- Düsseldorf
- Mannheim (in particular for patents and utility patents)
- Munich
- Frankfurt

Since the courts of Berlin are known for a relatively generous interpretation of the urgency requirement, Berlin is often regarded as a last resort when the filing might be considered too late in other court districts.

Given that German law has not adopted the doctrine of *stare decisis*, and decisions in preliminary injunction proceedings are not subject to judicial review by the Federal Court of Justice, there are notable differences in the interpretation of law between the various regional court districts. As a result, the chance to petition successfully for a preliminary injunction may differ significantly depending on the geographic location within Germany where jurisdiction can be established. A substantial part of the filing strategy therefore consists in identifying the court which promotes an interpretation of the law that is most in favor of the petitioner's case, establishing the jurisdiction of that court, and eventually drafting a petition that is custom-tailored to the legal views and prior case law of the selected court.

VIII. Decision on Preliminary Injunction

The court will process a petition for a preliminary injunction without any delay, possibly on the same business day. If, based on the review of the petition and the defendant's protective writ *(Schutzschrift)* or response to the warning letter *(Abmahnung)*, if any, the court is satisfied that the prerequisites for a preliminary injunction are met, it will issue the injunction immediately and forward the document to the petitioner either by mail or by courier. The injunction will not enter into force before service of notice is effected on the defendant. Since the court does not serve the injunction *ex officio*, service must be arranged by the petitioner either through a court-appointed enforcement officer or, where the defendant is represented by German counsel, from attorney to attorney.[10] If the injunction is not served within one month after it was issued and received by the petitioner, it will become unenforceable.[11] The petitioner must therefore ensure speedy service.

On the other hand, where the court comes to the conclusion that the petition is not justified, the court will customarily inform the petitioner immediately and allow the petition to be withdrawn. If the petitioner withdraws, the defendant may not become aware that the petition was ever filed unless the defendant deposited a protective writ with the court after receiving the warning letter from the petitioner. The petitioner may also uphold the petition and request the court to issue a formal rejection which the petitioner may then appeal. In that case, the court will inform the defendant that a preliminary injunction was applied for and the motion was rejected.

When the court is in doubt whether the petition for a preliminary injunction is justified, it may also request the parties to file (additional) written statements and evidence or schedule an oral hearing. After the conclusion of the oral hearing, the court will either grant or reject the injunction.

IX. Remedies of the Defendant

Once the preliminary injunction is issued and served upon the defendant, the following remedies are available to the defendant.

- The defendant may file an objection *(Widerspruch)*[12] and demand an oral hearing before the court that issued the injunction. If the court upholds the injunction following the oral hearing, it will issue a reasoned decision,[13] which the defendant may then appeal to the Higher Regional Court.[14] The objection is the remedy of choice in the majority of the cases when the defendant does not accept the preliminary injunction as a final settlement of the dispute.
- Alternatively, the defendant may request the petitioner to initiate main proceedings within a certain time limit to be set at the discretion of the court[15] (typically one month). The defendant will choose this option where the defendant believes that the petitioner will be unable to prove the relevant facts, *e.g.*, the validity of the intellectual property rights at issue, under the stricter standards of proof in main proceedings.
- The defendant may also request that the injunction be lifted were the relevant circumstances of the case have changed.[16] A typical case would be that the intellectual property right at issue was declared invalid after the preliminary injunction was issued.

None of the aforementioned remedies is subject to a time limit, owing to the fact that the injunction is only "preliminary."

When, upon the appeal by the defendant, the preliminary injunction turns out to be unfounded from the start, the petitioner incurs strict liability for damages, including lost profits.[17] Depending on the time span during which the injunction was in force, the amount of damages may therefore be substantial.

X. Request to Accept the Preliminary Injunction as a Final Settlement

Where the defendant does not challenge the preliminary injunction within a reasonable grace period of at least two weeks after the injunction has taken effect, the petitioner may request the defendant to accept the injunction as a final settlement and to waive all its remedies by way of a formal declaration *(Abschlussschreiben).* If the defendant refuses to do so, the petitioner will often consider initiating main proceedings, including claims for damages and reimbursement of legal fees against the defendant.

XI. General Timeline

The general timeline for preliminary injunction proceedings in Germany will typically be as follows.

- Within three, preferably within two, weeks after becoming aware of the infringement, a warning letter should be sent to the defendant, requesting a declaration to cease and desist within a time limit of one to five business days.
- Within four weeks after becoming aware of the infringement, the petition for a preliminary injunction should be filed with the competent court.
- The court may generally be expected to decide whether to grant or reject the injunction or to schedule an oral hearing within three to five business days following the receipt of the petition, in clear-cut cases even within twenty-four hours.
- After the injunction is issued, the petitioner should receive the relevant court documents within three business days, allowing the petitioner to serve the injunction to the defendant without delay.
- If the defendant is represented by a German attorney in court, the injunction may be served directly to the defendant's attorney. In all other cases where the defendant is domiciled in Germany or has an establishment in this country, the preliminary injunction must be served through a court bailiff, which takes approximately five to ten business days. Where the defendant is domiciled abroad, lacks an establishment in Germany and is not represented by a German attorney, service must be effected through the international office of the court. This may take several months.
- After a period of two to three weeks after the injunction was served on the defendant, the petitioner will formally request the defendant to accept the injunction as a final settlement—unless the defendant has filed a motion to challenge the injunction.
- If the defendant does not accept the injunction and the case progresses into further court proceedings, it make take twelve months or longer until a final court decision on the injunction is issued.

XII. Costs

The courts charge a fee for handling a petition for a preliminary injunction. The court fee must be borne by the losing party, be it the defendant or the petitioner.[18] When the motion is upheld only in part, the costs will be allocated between the parties at a quota left to the discretion of the court.[19] However, where the petitioner prevails but the court fee cannot be recovered from the defendant for lack of funds, the petitioner incurs liability as a secondary debtor.

The amount of the court fee will depend on the so-called "value of the dispute" *(Streitwert)*,[20] which will be determined by the court at its sole discretion. The "value of the dispute" predominantly serves as a vehicle to calculate legal fees. It is unrelated to the possible amount of damages which the petitioner may have suffered as a result of the infringement. Typically, German courts assume that the "value of the dispute" in infringement proceedings is anywhere between the equivalent of US$ 115,000 and US$ 285,000, resulting in a court fee of anywhere between the equivalent of US$ 1,800 and US$ 3,700. The court fees will double if the court renders a decision following an oral hearing and will be reduced by a third if the parties settle the case amicably.

The prevailing party also has a claim to demand the reimbursement of a statutory attorney's fee,[21] the amount of which again depends on the "value of the dispute." While the statutory fee will seldom cover the actual costs of the petitioner, it will make up for a significant portion of the petitioner's expenditures if the motion is upheld.

XIII. Conclusion

Preliminary injunction proceedings are the method of choice for enforcing intellectual property rights in Germany, provided the right holder is ready to act quickly, decisively, and aggressively. This fact has been known to German intellectual property right holders for more than a century, and foreign right owners as well are increasingly becoming aware of the advantages of starting preliminary injunction proceedings in Germany.

The importance of Germany as a venue for preliminary injunction proceedings is being reinforced by the implementation of supranational intellectual property rights in the European Union. These rights allow the owner to enforce EU-wide claims in German courts, provided the defendant is domiciled in this country or, if domiciled outside the EU, has an establishment in Germany. At present, this namely concerns the Community Trademarks and Community Designs, while a unitary patent system is yet to materialize in the European Union. Once a Community Patent comes into operation, the importance of Germany as a venue for intellectual property litigation will be further reinforced.

Companies in IP-related industries that do business in Germany should familiarize themselves with the basic functioning of the German preliminary injunction system, even if they have no intention to use it actively. Once an allegation of infringement arises, the threat of an *ex parte* injunction may already be imminent. In that situation, defendants should be prepared to react quickly and decisively to defend their position.

Endnotes

1. Zivilprozessordnung [ZPO] § 78 (F.R.G.).
2. ZPO § 920 I, II (F.R.G.).
3. ZPO §§ 935, 940 (F.R.G.).
4. ZPO §§ 920 II (F.R.G.).
5. ZPO § 286 (F.R.G.).
6. ZPO §§ 935, 940 (F.R.G.).
7. Gesetz gegen den Unlauteren Wettbewerb [UWG] § 12 I (F.R.G.).
8. Council Regulation (EC) No 207/2009, OJ L 78/1 [CTMR], Artt. 97, 98; Council Regulation (EC) No 6/2002, OJ L 3/1 [CDR], Arts. 82, 83.
9. ZPO § 35 (F.R.G.).
10. ZPO § 195 (F.R.G.).
11. ZPO § 929 II (F.R.G.).
12. ZPO § 924 (F.R.G.).
13. ZPO § 925 (F.R.G.).
14. ZPO 511 (F.R.G.).
15. ZPO § 926 (F.R.G.).
16. ZPO § 927 (F.R.G.).
17. ZPO § 945 (F.R.G.).
18. ZPO § 91 I (F.R.G.).
19. ZPO § 92 I (F.R.G.).
20. Gerichtskostengesetz [GKG] § 3 (F.R.G.).
21. ZPO § 91 II (F.R.G.).

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Introduction: Pitfalls in Private M&A, A Panel Contribution

At the 2014 Seasonal Meeting of the International Section of the New York State Bar Association, held in Vienna, Austria, from 15 to 17 October 2014, a panel of legal practitioners from the United States and several European countries, co-chaired by Carl-Olof Bouveng of Advokatfirman Lindahl and Gregory E. Ostling of Wachtell, Lipton, Rosen & Katz, addressed a series of common "pitfalls" in the area of private merger and acquisition transactions in their respective country or region.

The panel explored certain issues which repeatedly and specifically arise in acquisitions made by U.S. investors in Europe. The reasons for such issues arising may vary, but are often based on fundamental differences between the common law and civil law jurisdictions, as well as general cultural differences in the practice of law.

The specific common pitfalls they addressed were as follows:

1. Letter of Intent

A statement of intent as set out in a letter of intent may to a varying degree be binding. The contributions explore the differences in "how binding" the letter is and the basis therefor. Furthermore, the remedies available and the calculation of damages upon breach of a statement of intent are discussed.

2. Government Approvals

In many business sectors and industries approval or consent by the government or local authority is required for an investment or acquisition by foreign interest. Some countries are quite lax while others require government scrutiny to a larger extent. Currently, there may also be increased interest from governments to get involved and have a say in foreign investments.

3. Conditions for Closing

There is typically a "waiting" period between signing of an agreement and closing, because certain matters must be taken care of to complete the transaction, including for example government approvals, other regulatory filings and consents from third parties. Due to the closing not occurring immediately, the purchaser may also want to get comfortable that nothing has happened between signing and closing which would cause the purchaser to reconsider its willingness to proceed to closing. On the other hand the seller would prefer the purchaser to be bound to proceed to close without being able to withdraw, for example, because of adverse changes in the company/assets to be transferred or in the market generally. The contributions discuss to what extent there are different views and expectation as to "how bound the purchaser shall be" already at signing and how extensive conditions can be expected. Conditions discussed include material adverse change, breach of representations and warranties, financing and others.

4. Employment and Unions Influence on a Transaction

The employment environments in the United States and in various European jurisdictions vary widely. In Europe, employment protection and severance pay are critical issues in any transaction affecting employees. Unions and works councils may also have a say in the transaction. A specific concern in Europe is the handling of employee data under European data protection regulations. The contributions touch on some key issues in doing a transaction in Europe.

5. Sandbagging

A U.S. purchaser would expect sellers to give absolute warranties rather than carving out any knowledge gained by purchaser from due diligence. Arguably a European purchaser would be more willing to agree to exclude from the sellers' liability any issues the purchaser may have gained knowledge about in the course of due diligence.

6. M&A Insurance

The use of indemnity insurance to broadly cover all representations and warranties may have become increasingly popular in Europe or at least in some countries and areas of business phenomenon, but less popular among U.S. investors.

7. Dispute Resolution and Choice of Law

The choice between resolution of disputes in court or in arbitration is discussed, and whether certain jurisdictions have a tendency to favor arbitration to courts. Is there also any tendency to seek a neutral venue and perhaps also "neutral law" in acquisition or is the "law of the target" generally accepted?

The contributions of the respective country and regional representatives follow.

Pitfalls in Private M&A in Austria

By Dr. Andreas W. Mayr

I. Letter of Intent

A letter of intent ("LOI") has become standard in Austrian transactions in order to promote a constructive atmosphere in negotiations between the involved parties and to work toward a successful signing. The intent of the parties determines the legal nature (the binding effect) of an LOI. A potential purchaser is generally not willing to agree to the LOI having a binding effect, since the purchaser likely does not want the ending of the negotiations to trigger an obligation to indemnify the other party for losses in connection with a breach of a binding LOI.

Generally, the LOI cannot be seen as an offer to conclude a contract with respect to the main topics mentioned. On the other hand, it cannot be ruled out that the parties in fact intended to make such a binding offer. In such case, however, this intention must be evident (*i.e.*, additional written or oral agreements). Under Austrian law, the mutual intention of the parties has priority over all other kind of written or oral declarations. Additionally, an LOI could also be legally binding if the sender shows a behavior which must, from an objective point of view, certainly be seen as an offer. Therefore, the receiver (*Erklärungsempfänger*) of such letter of intent can rely on this behavior, even though the sender had another intention.[1]

Furthermore, an LOI is non-binding if it does not include mutual consent (a meeting of the minds, *Willensübereinkunft*) on the purchase price, or if it does not describe the target in sufficient detail. Therefore, the *essentialia negotii*, Section 861 of the Austrian Civil Code, must be determined. Otherwise, the LOI could be a tentative agreement (*Vorvertrag*, *Punktation*; *e.g.*, an offer by a potential purchaser) and may oblige the offering party to enter into an asset or share purchase agreement ("APA" or "SPA").

To qualify an LOI as a tentative agreement, the parties must implement the specific obligations of the future main contract and explicitly declare the letter to be a firm and binding commitment to finalize the main contract.[2]

It is also possible that the LOI creates ancillary rights and accessory obligations, even though the main contract is not going to be concluded. Such ancillary rights and accessory obligations include typically the refund of expenses originating from efforts made in the course of negotiations. Therefore, the letter could implement a clause which validly guarantees the refund of expenses which occurred until the date of withdrawal from the contract. However, on the other hand such a refund of expenses could also be excluded.[3]

In order to avoid any doubt about the binding effects of a LOI, the parties often choose to implement a non-binding clause in the LOI.

> **Example:**
> *This Letter of Intent is not binding upon any party hereto and is not intended to create any binding obligation on any party to enter into any definitive agreement containing the terms set forth in this Letter of Intent.*

Even if an LOI is deemed non-binding, the refusing party may be liable for potential claims under the principle of *culpa in contrahendo* ("cic"). Thus, an arbitrary refusal to continue negotiations may create liability based upon: (i) the obligation to duly inform; (ii) a protection obligation; and (iii) the duty of care.

With respect to cic, it is necessary to mention that an LOI that is not formed as a tentative agreement cannot at all create a legal obligation to conclude a contract. The formal freedom to conclude a contract still remains in force, even though the recipient of the letter was totally sure that the sender wanted to conclude the contract. Cic mainly covers the compensation for damages that result from the culpable behavior of the sender, but it cannot lead to the conclusion of the contract.[4]

II. Regulatory Approvals

The Austrian Anti-Trust Authority evaluates filings in connection with mergers and acquisitions. The acquisition of a company, in whole or substantial part, is defined as a merger under Section 7(1)(1) of the Austrian Anti-Trust Act 2005. Furthermore, the acquisition of a twenty-five percent stake, as well as a (subsequent) acquisition of a fifty percent stake is also deemed a concentration falling within the scope of the Act.[5] However, Section 20 of the Act follows an economic approach in evaluating facts and circumstances falling within the scope of this Act; *i.e.*, a twenty percent stake may be deemed a concentration, if atypical statutory rights are included, which are normally linked to stakes of at least twenty-five percent.[6]

Such a concentration must, under Section 9 of the Act, be registered with the Austrian Anti-Trust Authority if the involved companies have:

– a worldwide turnover of more than EUR 300 Million;*

– a national turnover of more than EUR 30 Million;* and

– at least two companies have a worldwide turnover of more than EUR 5 Million each.

No registration is required if:

– only one of the involved companies has a national turnover of more than EUR 5 Million; and

– the other involved companies have a worldwide turnover of less than EUR 30 Million.*

Media companies have to multiply by two hundred the above figures marked by an asterisk, whereas companies providing ancillary services for media companies have to multiply those figures by twenty.

One specific pitfall may be the exemption for media companies and the "catch all" clause under Section 20 of the Act: both may trigger an obligation to register a merger under Section 9 of the Act.

III. Conditions for Closing

The approval, non-prohibition, clearance or expiry of waiting periods under the Austrian Anti-Trust Act is a major element of the closing conditions. Furthermore, the parties may agree on a separate catalogue granting the purchaser the option to waive certain rights if the competent anti-trust authority is only prepared to approve the concentration subject to conditions or obligations.

The purchaser may also request the seller to include a binding statement that no material adverse change has occurred between signing and closing. Consequently, the parties agree upon potential material changes to the target company. Such material changes could include the loss of a key client, decrease of product quality and the commission of any business related criminal offenses (*e.g.*, tax fraud, bribery, etc.). If one of the enumerated material changes would take place, the purchaser would have the right to rescind the signed agreement.

In the case of an equity investment of a private equity fund in an Austrian stock corporation, through participation in a share capital increase of the target, usually the formal registration of the share capital increase in the commercial register is a condition for the closing of the deal.

In general, to conduct a share capital increase, an increase-resolution of the shareholder meeting is necessary. The buyer must subscribe to the newly issued shares through the signing of a share subscription certificate (*Zeichnungsschein*) and must deposit the amount on the acquired shares.

Besides the shareholder resolution, the implementation of the share capital increase must be proven in order to successfully register the capital increase in the commercial register. Parts of the implementation to be proven to successfully register the capital increase include:

- There has been the completion of the payment for the shares by the buyer.
- There has been the execution/waiver of any other subscriptions rights for the new shares.
- The shares are free of charges.
- The shares have been officially issued.

On the financial side, it is common to provide the purchaser with a bank guarantee for potential claims against the seller under the given "reps and warranties."

Additional closing conditions may refer to restructuring measures to be concluded prior to closing in order to have "the bride dressed up."

IV. Employment and Union Influence on a Transaction

The sale of a company or a part of it (*Betriebsübergang*) might have an impact on the current employment relationships. If the transaction is structured as an asset deal the rules on transfer of businesses stipulated by Section 3 et seq. of the Austrian Employment Harmonization Act (*Arbeitsvertragsrechts-Anpassungsgesetz*—"AVRAG") will be triggered.

Each employment relationship automatically transfers (*ex lege*), with all rights and obligations, to the purchaser according to Section 3(1) of AVRAG. This provision is mandatory law, which means that neither the seller nor the purchaser, nor the employment contract or collective agreements, can alter Section 3(1) of AVRAG. However, this provision does not apply in the case of restructuring procedures without the debtor (seller) in possession or in the case of the insolvency of the seller.

The definition of a part of the company is a key issue with regard to employment relationships. Art 1(1b) of the E.U. Directive 2001/23/EG defines a *Betriebsübergang* as "…a transfer of an [long-term] economic entity which retains its identity, meaning an organised grouping of resources which has the objective of [autonomously] pursuing an economic activity, whether or not that activity is central or ancillary." Thus, a main criterion for an economic entity to trigger Section 3(1) of AVRAG is whether the entity retains its identity. However, the identity will be deemed retained if the economic entity is de-organized within the acquiring company, whereas the acquiring company is still able to use the production factors (*e.g.*, key employees of the former economic entity) of the economic entity for the same economic purpose.[7]

Since 1 January 2008 severance payments to employees (also members of the Management Board (*Vorstand*) and CEOs (*Geschäftsführer*)) are subject to a new system. Employees who have entered into an employment contract after 31 December 2002 will have 1.53% of their salary transferred into an employee provision fund. In contrast to the former system, under the new system the employee, after the termination of the employment contract, is entitled to receive the funds paid into the account, irrespective of how the employment relationship was terminated (*e.g.*, dismissal, firing, premature redemption, etc).[8]

An incorrect interpretation of an economic unit may cause the purchaser *ex lege* to have all the employment relationships "attached" to the economic unit and, thus, transferred via the merger.

V. Sandbagging

Generally, in Austria there is no warranty for totally obvious defects, which must be noticed through proper examination or deficiencies which are disclosed through Due Diligence ("DD") review. But if the seller explicitly guaranteed for lack of defects, then the seller is responsible and liable for any defects.

For example: The seller of a company guaranteed for an existing license right, which lasts for ten years. The buyer recognized through the DD that this license right is already expired. In this case, the seller is obligated to renew the license right and fulfil the seller's obligation, even though the buyer knew about this deficiency and the buyer had the ability to seek remedy after the closing of the deal, notwithstanding pre-existing knowledge of the inaccuracy or breach (= "sandbagging"). Only through an explicit clause inserted into the contract, stating that the seller cannot seek remedy for any inaccuracy which the purchaser came to know through the DD, avoids the seller's liability (= "anti-sandbagging clause").[9]

In Austria it is common practice to carve out the purchaser's knowledge gained during the due diligence examination of the target company, but only to the extent that:

- disclosure is made in full;
- disclosure documents are traceable (meaning they are stored in a virtual data room related to certain topics);
- oral information exchanged during management Q&A sessions is recorded in writing; and
- written documents are true, accurate and complete.

VI. M&A Insurance[10]

A warranty and indemnity insurance should cover the liability for violation of contractual warranty promises. Furthermore, environmental risks and risks of litigation that are difficult to assess could be covered. These types of insurance are an exception to the general principle in Austria that warranty claims are not insurable.[11]

M&A Insurance can be concluded by:

- The purchaser (as a buy-side insurance to secure its claims, which can be directly claimed against the underwriter); or
- The seller (sell-side insurance), whereby the purchaser still claims its warranty interest directly against the seller, and consequently the insurance company indemnifies the seller.

The underwriter usually will make an offer based on the examination of the realized DD, whereby the premiums generally ranges from one to 1.75 percent of the insured risk. Commonly, the insurance policy contains exclusion of liability and policy retentions or the underwriter asks the buyer for a "No-Claims-Declaration."[12]

In general, insurance is also in the interest of the seller, since the purchaser does not have to pay much attention to the financial standing of the seller and it is not necessary to retain parts of the buying price. Therefore, a "clean-exit" without reserves is possible.

Recent developments show that M&A insurance use in Austria is growing substantially. However, the number remains low: only five percent of all M&A transactions use such insurance, and only a small number of M&A transactions are carved out with insurance for "reps & warranties" of the seller in non-public deals.

A key issue with M&A insurance and its increasing popularity is the ability to give the purchaser comfort—especially with regard to environmental issues such as asbestos liabilities, pollution of soil and groundwater, etc.—within the time frame agreed to in the agreement.

VII. Dispute Resolution and Choice of Law

A. Choice of Law

In general, the law governing the arbitration itself and the law applicable to the merits of the dispute are the two areas of laws which are crucial for an arbitral procedure. The parties are free to choose the applicable substantive law that is to be applied to the merits of a dispute by an arbitral tribunal which is seated in Austria, according to Section 603 of the Austrian Code of Civil Procedure (ABGB). Generally, there are no formal requirements for the choice of law, and any law could be chosen and, only the limitations of the *ordre public* rule must be taken into account.[13] Recent developments show that the law of the target company is commonly accepted as the applicable law.

If the parties fail to choose the law, it is in the free discretion of the arbitral tribunal in Austria to determine the applicable law. This choice is limited by international treaties which have priority over national provisions, by fundamental principles of Austrian legal order, and Austrian substantive public policy. European Union law, like antitrust provisions, can also be seen as public policy and therefore must not be excluded through a choice of law.[14]

B. Arbitration

In Austria, Section 582 of the ABGB contains the general rule, which states that every claim involving an economic interest can be decided by an arbitral tribunal. Therefore, actions which are connected to the jurisdiction of administrative authorities, the Austrian Constitutional Court (VfGH) or Administrative Court of Austria (VwGH), and also criminal proceedings, are not arbitrable. Furthermore, Section 582 Paragraph 2 of the ABGB enumerates actions which cannot be negotiated before an arbitral tribunal, like claims in family law matters. With respect to M&A transactions, the Austrian arbitration law does not state what sort of corporate disputes can be ruled upon by an arbitral tribunal. But the following issues which are subject to an arbitration agreement in legal writing and case law could illustrate the scope:[15]

- Actions for dissolution.
- The designation of auditors.
- Disputes arising out of challenges to notarial deeds, which were the basis for the assignment of shares.
- The right to information by shareholders.
- Disputes arising out of deficiencies in shareholder resolutions relating to a limited liability company (*GmbH*) or a stock corporation (*AG*).

In general, choice of law is often connected to arbitral proceedings in "larger transactions." The main reason for parties to choose arbitration is the desire to have any dispute decided behind closed doors, *i.e.*, not made publicly accessible and the decision publicly available. Moreover, the parties mostly have the opportunity to choose the arbitrator, who often is not only a lawyer but also an expert in the area or topic at issue. One reason to choose Austria (and indeed Vienna) as the place of arbitration is the recent revision of its arbitral law. Since 1 January 2014 the Austrian Supreme Court is the one and only authority to set aside an arbitral award. With only one instance to challenge an award, legal remedies are limited and legal certainty is achieved "in a timely manner." Furthermore, the enforcement of domestic arbitral awards serviced by Austrian courts is guaranteed, since an award only can be set aside if the subject matter of the dispute cannot be ruled by an arbitral tribunal according to Austrian law or if the award violates fundamental values of the Austrian legal system. In such a case an action to set aside a domestic award must be brought before the competent court within the period of three months after the award was served.

Endnotes

1. Lutter, Der Letter of Intent 22 (1998).
2. *Id*., 29.
3. *Id*., 39.
4. *Id*., 65 ff.
5. A. Petsche/F. Urlesberger, Kurzkommentar Kartellgesetz 2005 (2007) §7 KartG 46 ff.
6. F. Mittendorfer, Unternehmenskauf in der Praxis 5/53 (2012).
7. *Id*., 2/35 ff.
8. http://www.arbeiterkammer.at/beratung/arbeitundrecht/abfertigung/Abfertigung_neu.html.
9. W. Brugger, Unternehmenserwerb 819 ff. (2014).
10. Lloyd's, *M&A insurance grows as confidence increases*, 16 April 2014.
11. W. Brugger, note 9 *supra*, 1052.
12. *Id*., 1054.
13. E. Poulton, Arbitration of M&A Transactions 31 (2014).
14. *Id*., 34.
15. *Id*., 35.

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Pitfalls in Private M&A in Central and Eastern Europe

By Guido Panzera

I. Letter of Intent

Letters of intent are commonly used in mid-market Central and Eastern European ("CEE") deals. However, the reasoning behind their use varies widely. While U.S. practitioners often take for granted the purpose of a Letter of Intent or Term Sheet as the roadmap for the transaction, in general, local CEE targets often attribute much more importance to this stage of the process. For example, we commonly see an overlying reluctance of CEE targets to engage in due diligence or pursue a transaction without a definitive and binding commitment to enter into the deal that exceeds the parameters often found in a standard letter of intent.

Following are some key issues to be aware of when dealing with local Letters of Intent:

A. Make Sure the Form Works with the Governing Law

We often see last minute changes in the governing law of a Letter of Intent. This can have significant effects on enforceability, regardless of the contractual intent of the parties. For example, a Letter of Intent governed by Czech law might contain a no-shop provision that is secured by an enforceable penalty provision. A last minute change to English law would drastically change the buyer's ability to enforce that penalty upon the target's breach of the no-shop, even though it was seemingly explicitly agreed to in the Letter of Intent. Thus, the form and language of a Letter of Intent must be carefully considered in the context of the governing law, and often modified significantly upon a change of that law.

A careful review of all provisions based on the governing law is critical, particularly to ensure that an obligation is binding or non-binding, as the case may be.

B. Do Not Trust Contractual Intent Over Legal Obligations

The governing law will dictate whether or which legal principles override contractual intent. For example, under New York law, the parties can generally govern their entire relationship by contract. Certain civil law principles override that ability to contractually agree on all principles. For example, the parties will often stipulate in the Letter of Intent that it is nonbinding. However, in many regional jurisdictions, even if the Letter of Intent is stated to be non-binding, the parties will remain liable for *culpa in contrahendo*, or pre-contractual liability for damages. Thus, a party that terminates negotiations without a legitimate reason could be liable for damages caused to the other party.

In addition to liability for *culpa in contrahendo*, a signed Letter of Intent would likely create an obligation to comply with principles of fair dealing, meaning that the parties must take reasonable steps to achieve the goals set out in the Letter of Intent.

C. Consider the Practicality of Enforcing Binding Obligations

Even if due care is taken to ensure that provisions are enforceable under governing law, the practicalities of enforcement may be quite difficult. For example, assume a Hungarian target breaches a no-shop provision in a Letter of Intent governed by Hungarian law and there is a provision for arbitration in the London Court of International Arbitration. It might be a no-brainer for the London arbitrators to rule in favor of the potential buyer. However, that arbitration decision must then be enforced in the Hungarian courts in order to obtain any recourse.

Although most countries in the region are party to the New York Convention on recognition and enforcement of foreign arbitral judgments, the local procedures to enforce these judgments vary significantly.[1] Thus, local counsel and potentially an executor are required to obtain a judgment at the local court and enforce the court's judgment if the defendant is delinquent in payment. This dual-step process can be prohibitive due to the time and expense necessary to enforce. Accordingly, it is worthwhile having a frank discussion with clients seeking enforceable provisions on the practicalities of and expectations regarding recourse for breached Letter of Intent provisions. The answer often is that binding provisions in Letters of Intent serve well as a deterrent but in practice are rather difficult to enforce.

II. Government Approvals

Foreign investors should take an early and proactive approach to understanding the risks and limitations of an investment, particularly based on the industry involved and intended operations in the target country.

A. Know the Political Climate of the Target Country

Generally, most CEE countries welcome and foster foreign investment through incentive schemes. However, what seem to be open policies can change quickly. For example, Slovakia is currently led by a left-leaning government that recently increased its formerly heavily promoted flat tax rate on businesses. Hungary is now led by a nationalist government that recently imposed a crisis tax on certain sectors and is seen to prefer measures that appear to disadvantage foreign investors. Thus, even if a country appears to be friendly to foreign investors currently, it can easily shift its policies in the opposite direction, as is the case with Slovakia and Hungary. It is worthwhile to understand what may be on the horizon if there is a change of power.

B. Consider Merger Control in All Applicable Jurisdictions

As a first step, one should consider whether the deal requires merger approval or notification under the E.U. merger control regime. Even if no notification is required at the E.U. level, there could be merger approval requirements at the local level, which covers all jurisdictions of the parties, including the target and the target group and the acquirer and the acquiring syndicate.

For example, M&A transactions must be notified to and cleared by the Slovak Antimonopoly Office if all of the following conditions are met:

– revenue of the parties to the transaction exceeds the Slovak statutory threshold;

– the transaction is either a merger, joint venture or leads to a change of control; and

– the transaction is not notifiable under the E.U. merger control regime (Regulation No. 134/2004).

The Slovak Competition Act provides for a "suspension obligation" (fairly common in many CEE jurisdictions), which prevents the parties from completing a transaction subject to notification before it is cleared by the Antimonopoly Office. Breach of this obligation can lead to a fine up to ten percent of the revenue of the group that acquires control of the target.

C. Consider Other Governmental Approvals That May Be Required

The merger control hurdle might not be the only issue that affects completion of the transaction. Many CEE jurisdictions require mandatory takeover bids if more than a threshold percentage of shares of a target with a public float is purchased. Additionally, sector specific rules might limit or even prohibit transfers of industry-related licenses that are part of M&A transactions (even in share purchase deals). For example, in Slovakia the Council for Broadcasting and Retransmission must approve the purchase of television and radio broadcasters. If this approval is not obtained, the licenses are automatically annulled.

III. Conditions for Closing

Closing conditions are quite normal in mid-market CEE transactions, as simultaneous sign-and-close transactions are rare. The particular closing conditions are negotiated on a case-by-case basis and there does not appear to be a generally accepted set of standards in the region. In fact, the extent to which closing conditions are accepted seems to depend heavily on the familiarity of opposing counsel with international standards.

A. Less Experienced Practitioners Often Mean Less Nuanced (and More Painful) Negotiations

In a customary international transaction, two experienced international practitioners might have a general understanding on the suitability of a MAC in a particular deal, and their negotiations would normally focus in more detail on specifics, such as whether "financial prospects" should be included in the definition of "Material Adverse Change." As familiarity with international standards decreases, the negotiations become less nuanced and focus less on the cause and reasoning behind the provision and more on the general fairness of its presence. Typically, this could result in one of three responses that often betray a lack of experience in international standard deals (and are generally applicable to all issues, not just MAC negotiations):

- *Ignorance.* A seller might completely ignore an overly and overtly buyer-friendly MAC clause. Although at first it may seem like a victory, this should not necessarily be so comforting to the buyer. It could signal that the target was not fully informed and does not completely understand or care about the crucial importance of the MAC. That could result in a much delayed negotiation if and when the target realizes the significance of the provision. It could also have flow-through consequences to the transaction and implications on a MAC claim.

- *Wholesale Deletion.* More commonly, a target will simply delete the entire concept of the MAC with no justification whatsoever. This approach is, of course, justified in certain circumstances. However, it is often used to completely avoid market standard requirements. In those cases, the reinsertion, explanation and subsequent negotiation within acceptable parameters can be very time-consuming (and expensive).

- *Reciprocal Insertion.* Another common approach is the "reciprocity" negotiation. This would involve opposing counsel demanding that the seller have a MAC clause simply because the buyer has a MAC clause, whether or not that demand is realistic or makes any sort of sense in the context of the transaction. It also normally involves a straight repetition of the provision, rather than incorporating the same concept into a seller-friendly concept.

B. General Lack of Trust with the Closing Process Increases Time and Expense

This often results in what U.S. practitioners might consider unnecessary escrow requirements, particularly for lower priced transactions. In general, U.S. practitioners are often comfortable with reviewing all closing documents, giving the green light to fund, and then exchanging documents upon confirmation from the buyer's bank that a wire was sent. Unless otherwise agreed, when our clients wire the money in a U.S. transaction it is irrevocable and both sides are comfortable that the deal is effectively closed.

However, in CEE deals parties often refuse to exchange documents and close until the money actually hits the target account. Proof that payment has been sent is usually not acceptable. Since cross-border wires are not simultaneous, this can take days. On one hand, there is a legitimate concern in many jurisdictions that wires can be cancelled by the buyer even after they are sent. On the other hand, there does not seem to be a practical appreciation that stopping the wire transfer and proceeding with the closing would most certainly amount to criminal fraud (in which case, if that was a real concern, you probably would not want to be doing a deal with that counterparty in any event). Thus, it is very common to see elongated and expensive escrow arrangements, even for small ticket deals.

IV. Employment and Union Influence

Generally, employment and union influence are fairly limited in mid-market deals, particularly because these deals normally involve targets without a large number of employees. In large ticket deals (such as the sale of a majority interest in SPP, Slovakia's leading natural gas supplier), unions and employee concerns may have a more significant impact. However, unlike notification and other requirements under English law, we generally see more lax requirements with respect to employee notification.

In Slovakia, issues may arise in the lack of flexibility concerning termination of employees as a part of a transaction. For example, the Slovak Labor Code is strict on reasons for employee termination and requires fairly long notice periods along with mandatory severance. Obviously, if the employees were party to a collective bargaining agreement with the target, these layoff requirements would probably be more substantial. However, Slovak employees generally have limited rights to prevent a transaction from occurring: as the general rule, by operation of law the employees are part of the transaction and do not have veto or other rights to void the deal.

To avoid layoff complications in Slovakia, it is possible to structure a transaction as an asset purchase. However, asset deals are not common practice in the jurisdiction and are not very feasible for use in connection with the transfer of an entire business. Employees are automatically transferred to the acquirer if there is a transfer of an entire business or a separable part of the business.

V. Sandbagging

Before considering whether reliance on knowledge of a breached warranty is acceptable, it is worthwhile to take a step back and consider local players' general views on diligence and warranties.

A. Lack of Familiarity with the Process

Generally, those targets with less experience in international deals do not quite appreciate the reason for and interplay between due diligence and warranties. A common theme coming from targets is that warranties are not necessary or acceptable, particularly after the buyer has done a time-consuming due diligence investigation. We have been involved in a number of negotiations where sellers stated in all seriousness that they refuse to give any warranties whatsoever because the buyer should have satisfied itself with its diligence investigation.

B. Hesitancy of Local Counsel to Advise Targets on Market Standards

Even experienced local CEE counsel are sometimes reluctant to advise their clients on accepted international standards. While U.S. and English lawyers would normally not hesitate to proactively tell a client that its demands are way off-market and explain why, a CEE practitioner might not take the same approach. Moreover, CEE clients might not be as receptive to that advice, as the relationship between client and counsel does not seem to take on the same significance as a client relying on a deal lawyer, who serves as an overall advisor with a breadth of legal, commercial and transactional experience. In fact, it is not unusual for CEE clients to view their attorneys solely as legal draftpersons who are only tangentially involved in deals. Thus, do not expect opposing counsel to always educate clients on best practice approaches to transactions.

C. Use of Sandbagging

Due to the lack of appreciation of the interplay of diligence, warranties and disclosures against warranties, it is often an uphill battle for buyers to incorporate a pro-sandbagging provision in the warranties. That does not mean that those representing buyers should not attempt to incorporate the provision explicitly and forcefully explain why these provisions are accepted internationally, particularly in light of carefully drafted and considered disclosure schedules. However, do not be surprised by fierce objections to these provisions.

Of course, you would need to analyze enforceability on a country-by-country basis, but at least under Slovak law, sandbagging is enforceable. The general concept under the Slovak Commercial Code is that the seller is liable for all defects, regardless of whether the buyer knew of the defects at the time of purchase. Accordingly, it would not be a stretch to enforce a contractual sandbagging provision under Slovak law.

VI. Representation and Warranty Insurance

While there are indications that usage of R&W insurance in CEE is on the rise,[2] it still remains rare to use R&W insurance in mid-market CEE transactions. In fact, we recently surveyed Slovak branches of international insurance carriers and were advised that general R&W insurance, without further specificity, would be difficult to impossible to obtain in Slovakia. Of course, this is a very small CEE jurisdiction, but there is no pattern of practice for insurers to rely on. At least in Slovakia, we are probably a long way away from this becoming standard practice, even in larger deals.

VII. Dispute Resolution

As a general rule, foreign investors normally prefer neutral governing law and arbitration to ensure fair treatment and transparency in the event of a dispute. However, there are other considerations, such as expense and comfort, that play a large role in these choices.

A. Neutral Governing Law

English law is normally the neutral law of choice in CEE transactions, although Swiss law and Dutch law are not unheard of. Local targets often forcefully argue to keep the local law of their jurisdiction. These arguments are usually based in part on a cost and expense analysis of having to hire expensive English lawyers or other non-local practitioners. Generally speaking, unless buyers are completely comfortable with local law principles and the ability of their attorneys to explain those principles, neutral law is a preferable alternative. However, beware of assuming concepts in neutral law are the same as U.S. legal concepts. One of the most prominent examples is the meaning of representations, warranties and indemnities under English law as compared to New York law.

B. Arbitration

Generally, there is a trend toward expanding the scope of arbitrable disputes in CEE.[3] Foreign investors often feel more comfortable with a professional arbitration that is expected to be faster, more efficient and transparent than local courts. This has much to do with a perceived lack of precedential decisions in a civil law system and a lack of experience, transparency and efficiency in the courts. On the other hand, many local practitioners believe in the predictability of their courts and prefer to avoid what is considered an unnecessary expense in arbitration.

Endnotes

1. Wolters Kluwer, *Five Facts About Recognition and Enforcement of Foreign Awards in Central and Eastern Europe* (26 June 2014).
2. See White & Case, Annual Review 2011, *English Law: More than Common*.
3. Wilmer Cutler Pickering Hale and Dorr LLP, *International Arbitration in Central and Eastern Europe: A Diversity of Approaches* in INTERNATIONAL ARBITRATION 2014 (July 2014).

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Pitfalls in Private M&A in France

By Benoît Charrière-Bournazel

This presentation deals with the acquisition of private (non-listed) companies in France and outlines the main pitfalls to bear in mind. It focuses on pitfalls that are likely to be of interest to someone who is not familiar with acquisitions of private companies in France. It is not designed to be a general explanation of the acquisition process, or a detailed summary of the standard provisions of an acquisition agreement. The general provisions of French civil and commercial law will apply to a private company acquisition, and, in particular, the Civil Code and the Commercial Code.

France does not have a great reputation among international investors. Surprisingly, however, the cross-border M&A market has been quite buoyant since the start of the year with significant cross-border transactions, such as GE-Alstom, making the news. The level of foreign investments in France has increased by a third from 2013 and France remains third in Europe behind the United Kingdom and Germany. Interestingly, France still attracts investors from the United States, the United Kingdom and Germany, but struggles to attract investments from emerging countries such as China, Brazil and India.

I. Letter of Intent

In complex transactions it is common for the first step to be the negotiation and execution of the following preliminary agreements: (i) confidentiality letter (often containing non-solicitation covenants with respect to employees and customers); (ii) exclusivity agreement; and (iii) letter of intent (also known as memorandum of understanding, term sheet or heads of agreement). These agreements can be separate or incorporated into one document. There is no rule with respect to the form of such agreements and sometimes they are presented as letters rather than formal agreements.

As in other jurisdictions, the aim of the letter of intent is to summarize the main points that have been agreed upon in principle and set out the roadmap for the subsequent steps of the transaction. Care needs to be taken not to conclude a legally binding agreement inadvertently. The term "subject to contract," although understood, does not have legal significance in France. It is therefore important to use unambiguous language in the letter of intent to state which provisions are legally binding and which are not. Only a limited number of provisions will be expressed as being legally binding: confidentiality; exclusivity; terms relating to payment of break fees; etc. Confidentiality and exclusivity agreements will generally apply for a fixed period, failing which they could be considered unenforceable. The confidentiality undertaking will usually apply for two to three years following termination of negotiations, or longer if the information disclosed is particularly sensitive and justifies a longer period.

A letter of intent could be construed as a binding agreement under French law if it contains key terms such as parties, price and conditions precedent and if it is not clear that the parties do not intend to be legally bound by it. Accordingly, the parties should define the issues that they consider to be essential to the deal and on which no agreement has yet been reached. Also, there is generally a strong moral obligation not to deviate from the terms subsequently, so care needs to be taken in the drafting of such documents even at this early stage.

Equally, certain conditions that are drafted in a subjective way and that depend on actions or views of one party only (*conditions potestatives*) may be considered void by the courts and so result in a non-conditional agreement having been reached. For example, a condition relating to "the results of the due diligence being considered satisfactory to the purchaser" could be considered void on this basis.

In addition, the Civil Code provides for an obligation to negotiate in good faith, which applies at all stages of a commercial relationship, both in pre-contractual and contractual stages. From a practical point of view, this means that prudence is required when running auction processes, deciding what information to disclose to a purchaser, and terminating negotiations. Liability can potentially be incurred for misleading a party into thinking that it is the only purchaser with whom negotiations are being conducted, thus leading it to incur expense in the acquisition process.

A party could also be required to compensate another where it pulls out of negotiations abruptly without giving reasons for doing so, or where the target is sold to a third party while negotiations were pending with another interested purchaser. The level of damages awarded for breach of the duty to negotiate in good faith is usually limited to those that are designed to put the party into the position that it would have been in had the negotiations not taken place (in other words, compensation for wasted costs and expenses, rather than damages for lost opportunity). This is why it is important to specify a break fee clause in a letter of intent in order to clarify what the parties expect in the event that the deal does not proceed in the way it was intended to, due mainly to the actions of one of the parties.

(However, as a break fee constitutes a penalty provision, a judge would be entitled to reduce its amount should it be significantly higher than the real level of damage likely to be incurred.)

An application for an antitrust clearance can be submitted once a letter of intent has been signed.

II. Government Approvals

A. Introduction

In most circumstances, a private acquisition in France by a foreign investor requires some form of regulatory consent or government approval.

Specific requirements (administrative approvals, certificates, etc.) may arise in certain sectors, for example when the target company is a financial institution or a telecommunications company: relevant information can be found on the Business Start-up Agency's website at http://www.apce.com/pid316/informations-sectorielles.html.

Merger control regulations, whether at the E.U. or French level, may also apply: an acquisition, a merger, the setting up of a joint venture or any other lasting change of control over a company is subject to a prior notification to, and approval by, either the European Commission, or the French Minister of the Economy, if applicable thresholds are met. When investing in France, companies should therefore seek the advice of competition lawyers.

Foreign investment regulation is the one area that has significantly changed in recent months in France and on which we should focus our attention. Main industrial countries have implemented protection measures trying to protect their national champions and requiring prior government approval in specific sectors: the United States (Exon-Florio 1988); China; the United Kingdom (Enterprise Act 2002); Germany (2009); Italy (2012); and Spain (2013).

France was no different and passed legislation in 2005 applicable essentially to the defense and gambling sectors. In the recent competition between General Electric and Siemens to acquire Alstom's energy business, the French Government, rather than making a large investment into Alstom, decided to increase the level of scrutiny over foreign investments of this type. The French government (at the initiative of the French Minister of Economy Arnaud Montebourg and Prime Minister Manuel Valls) issued a decree substantially extending the business sectors in which the French Ministry of Economy ("FME") has a right to monitor and restrict foreign investments in France pursuant to Article L 151-3 of the French Monetary and Financial Code ("CMF"). The decree, which came into force on 16 May 2014, was enacted to augment the authority of the French government to intervene in transactions in specific sectors such as Alstom's and to impose conditions on foreign investors such as reselling parts of the business to other French companies or safeguarding employment. Additional sectors subject to prior authorization by the FME now include energy, transport, water, public health and telecommunications. The decree applies to transactions in progress on or after 16 May 2014, and the possible review by the European Commission of whether the decree complies with E.U. regulations will not suspend its entry into force.

B. Foreign Investment Regulation in France

Foreign investments in France are regulated by Articles L 151-1 to L 151-4 and Articles R 151-1 to R 153-12 of the French CMF. In principle, foreign investment in France can be freely made and is subject only to a simple declaration whether administrative or statistic. Nevertheless, prior approval of the FME is necessary for foreign investments made in sectors regarded as "sensitive." The new Decree significantly increased the list of sensitive sectors.

1. Statistic Declaration

Pursuant to Article R 152-3 of the CMF, the following operations must be declared to the Banque de France when their amount is at least fifteen million Euros: (i) acquisition or sale by a foreign entity of at least ten percent of the equity or voting rights of the French target; (ii) intragroup transaction and real estate investment; and (iii) acquisition or sale of real estate properties in France by non-residents.

Pursuant to Article R 152-4 of the CMF, the following operations must be declared to the Treasury Department: (i) creation or extension of activity of a French company held directly or indirectly by foreign companies or non-resident individuals when they amount to at least 1.5 million Euros; (ii) real estate property acquisitions in France by foreign investors when they amount to at least 1.5 million Euros; (iii) acquisitions of agricultural lands giving rise to wine exploitation; (iv) liquidation of direct foreign investments in France; and (v) realization of operations submitted to prior authorization by the FME.

Declarations must be sent within twenty working days after closing of the transaction. Any failure to comply is subject to criminal fines and imprisonment.

2. Administrative Declaration

Pursuant to Article R 152-5 al. 1 of the CMF, the following transactions, when made by a foreign entity, are subject to a so-called "administrative declaration," which must be sent to the Treasury Department:

- Direct investments by a foreign company or a non-resident individual:
  - creation of a new business;

- acquisition of all or part of a business from a French company;
- acquisition of more than 33.33% of the equity or voting rights of the French target company.

- Above transactions carried out by a French company, when more than 33.33% of its voting rights or equity share are held by one or several non-resident individuals or foreign companies.
- Any transactions, such as the granting of loans or substantial guarantees, the purchase of patents or licenses, the acquisition of commercial contracts or the provision of technical assistance, leading to the de facto takeover of the control of a French company by a foreign company or a non-resident individual; and
- Indirect foreign investments, meaning any transaction not carried out in France, resulting in the change in control of a non-resident company holding an interest in a French company when more than 33.33% of the equity or voting rights of that French company are held by foreign companies or non-resident individuals.

Pursuant to Article R 152-5 of the CMF, a number of transactions are exempt from the administrative declaration such as: (i) The creation of a new activity or the extension of the business of an existing French undertaking directly or indirectly held by foreign companies or foreign natural persons; (ii) the increase of a shareholding in a company controlled by foreign investors where the holding is already more than fifty percent of the share capital or voting rights; (iii) direct investments between companies belonging to the same group of companies; (iv) investments under 1.5 million Euros in specific businesses; and (v) the purchase of agricultural land.

When the administrative declaration is required, the declaration must be addressed to the FME at the Treasury Department upon "realization of the investment": formalization of the parties' agreement such as the signature of a contract, publication of a public bid or acquisition of an asset constituting a direct investment in France. Non-compliance with the administrative declaration is subject to a small criminal fine of 750 euros.

3. Prior Approval

As was previously the case, the new Decree requires that, prior to making an investment in sensitive sectors, foreign investors notify the FME of the proposed investment and receive authorization. Requirement for prior approval depends both on the nature of the targeted entity's activity and the operation itself.

French legislation establishes a distinction between non-E.U. investors, E.U. investors and Foreign Controlled French Investors (*i.e.* a company subject to French law controlled either by a foreign individual, a company established abroad or a French citizen residing abroad).

French legislation also establishes the following sectors as being "sensitive" or "extra-sensitive."

"Sensitive sectors" relate to activities listed below from (i) to (vii). Definitions of "sensitive sectors" are much more limited when applied to E.U. investors and Foreign Controlled French Investors, the distinction being in most cases that investments in a defined sector by an E.U. investor is restricted only to the extent necessary to fight terrorism and criminal activities.

(i) Businesses involving the gambling industry (except casinos) (only applicable to non-E.U. investors);

(ii) Regulated businesses providing private security services;

(iii) Businesses involved in the research and development or manufacture of means of fighting the illegal use of pathogens or toxic substances by terrorists and preventing the adverse health-related consequences of such case;

(iv) Businesses dealing with wiretapping and mail interception equipment;

(v) Businesses licensed to audit and certify services relating to the security of information technology systems and products;

(vi) Businesses providing goods or services relating to the security of the information systems of public or private-sector companies managing critical infrastructures; and

(vii) Businesses relating to dual civil and military technology goods and services.

"Extra-sensitive sectors" relate to activities listed below from (viii) to (xii). For such sectors, French legislation applies to a uniform definition, regardless of whether the investor is of E.U. or non-E.U. origin or a Foreign Controlled French Investor.

(viii) Businesses involved in providing cryptology goods and services;

(ix) Businesses possessing defense secret information;

(x) Businesses involved in the research, development and sale of weapons, munitions, powder, or explosive substances to be used for military ends or war, and other restricted materials;

(xi) Businesses involving a company that has entered into a design or equipment supply contract with the French Defense Ministry, whether directly or through a subcontractor concerning dual-use items and technology or items listed above; and

(xii) As introduced by the new Decree, businesses related to equipment, products or services, including those relating to the safety and the proper functioning of facilities and equipment, essential to guarantee the French national interests in terms of public policy, public security or national defense, as listed below:

- Integrity, safety and supply of water in accordance with public health standards;
- Integrity, safety and supply of energy resources (including electricity, gas; hydrocarbons);
- Integrity, safety and exploitation of transport networks and services;
- Integrity, safety and exploitation of electronic communication networks and services;
- Integrity, safety and exploitation of an installation, facility or structure of critical importance within the meaning of Article L 1333-1 and L 1332-2 of the French Defense Code; and
- Public health protection.

Article R. 153-1 provides that non-E.U. investors are required to seek prior authorization from the FME for any of the following investments in sensitive and extra-sensitive sectors:

(i) Direct or indirect acquisition of the control of an undertaking established in France, the notion of "control" being defined in Article L 233-3 of the French Commercial Code. It should be noted that the holding of more than fifty percent of the share capital or the voting rights of the company is not necessary to be deemed to control a company and that French corporate law takes into account the de facto control of a company.

(ii) Acquisition of all or part of the business of an undertaking established in France; and

(iii) Acquisition of more than 33.33% of equity or voting rights of an undertaking established in France.

E.U. investors are required to seek prior authorization from the FME for any of the following investments:

(i) Pursuant to Article R 153-4 of the CMF, direct or indirect acquisition of the control of an undertaking established in France only to the extent the investment relates to "extra-sensitive" sectors; and

(ii) Pursuant to Articles R 153-4 and R 153-5 of the CMF, acquisition of all or part of the business of an undertaking established in France, whether the investment relates to sensitive or extra-sensitive sectors.

Pursuant to Article R 153-5-2 of the CMF, Foreign Controlled French Investors are only compelled to file a request for authorization when they are engaged in the acquisition of all or part of the business of an undertaking established in France and involved in "extra-sensitive sectors."

Article R 153-7 provides that investors may submit a ruling request to the FME to ascertain whether or not the contemplated investment will require prior authorization. The FME has then a two-month period to respond. However, failure to respond does not mean that the investor is released from its obligation to file a request for authorization.

Prior authorization requests must be sent in three original copies to the FME. The Ministry has two months from receipt of the application to notify its decision. Failure to reply within two months constitutes tacit approval on its part.

Approval can be subject to conditions, such as the continuation of the activity of the business, the fulfilment of contractual obligations under agreements with the French State, or an undertaking not to sell the business to a third party. In addition, Article R 153-9 of the CMF provides that the French Minister of the Economy has the ability to grant authorization upon the condition of the divestment of all or part of the sensitive activity of the targeted undertaking to a third party independent from the foreign investor.

A foreign investment which contravenes the prior approval procedure or which does not comply with the conditions imposed by the Minister will be null and void. The FME may request that the investor unwind the transaction at its own costs. If ordered, rescission must be accomplished within twelve months maximum. Should the investor fail to comply with such request, the FME may impose severe sanctions such as fines, which may amount to twice the amount of the transaction, and criminal sanctions. The grounds for rejection of the investment are set forth in Article R 153-10 of the CMF.

Decisions of the FME are subject to full review, and foreign investors may contest the conditions imposed for authorization or the refusal to authorize before administrative law courts.

The net effect of the Decree for foreign investors is a broadening of the type of transactions requiring prior governmental authorization, but with a clearer framework for negotiations to obtain clearance. From a practical standpoint, parties to M&A transactions involving foreign investments in France should check carefully whether the new legislation applies, and if it does, provide for relevant condition precedent in their agreement.

III. Conditions for Closing

In simple transactions, and where possible, it is preferable to provide for signing and closing to occur simultaneously. However, this is not always possible because there are conditions precedents to be fulfilled.

Common conditions precedent may include third party or regulatory consents to be obtained (such as the prior approval of the FME as described above), financing conditions, approval of E.U. and French competition authorities, shareholders' approval, clearance from tax authorities, reorganization of target's business, and industry specific consents.

A deadline for fulfilment of the conditions is usually stipulated and if they have not been complied with by the relevant date, either of the parties is able to walk away from the deal without liability or, in certain circumstances, a "break fee" may become payable by the party "at fault."

A. Financing Conditions

To the extent financing is required, buyer will argue that closing of the transaction should be conditional upon the buyer obtaining appropriate financing.

In addition to the issue of common shares, buyers may obtain finance needed for acquisitions by either of the following methods: issuing preferred shares to allow the company to raise finance without diluting the powers of the existing shareholders; issuing debt securities (holders of such debt securities are creditors of the company, remunerated by interest, and are not involved in the management or decision-making process of the company); taking out credit facilities (short, medium or long-term financing is available from all commercial banks and foreign-owned companies are treated in the same manner as local entities in that respect).

However, French law prohibits the grant by a company of financial assistance (whether by the granting of a loan or a guarantee or security) for the purchase or subscription of its own shares: breach of this prohibition makes the transaction void and is a criminal offense.

B. Representations and Warranties

When a closing is to take place at a later date, the buyer will argue that representations and warranties should be repeated at the closing. In that case, the seller will argue that it should update its disclosures against the warranties (therefore avoiding liability under the repeated warranties). The impact and consequence of such additional disclosure are often the subjects of considerable negotiation.

As a compromise, when the period between signing and closing is short, often the warranties are only given on signing with a "management of business within the ordinary course" warranty and a "no material adverse change" warranty until closing. It is then standard to provide for covenants requiring the business of the target company to be run in the normal and ordinary course and restricting the actions that can be taken between signature and closing.

C. MAC Clause

The buyer will also wish to include in the sale agreement a clause providing that it can walk away from the deal if there is a "material adverse change" in the company's position between signature and closing (a so-called "MAC clause"). In France, a MAC clause is permitted in private acquisitions, but not in the context of public bids. Also, it should not be drafted in a subjective way and depend on actions or views of one party only ("*conditions potestatives*") since it may then be considered void by the courts. Although events triggering the MAC clause could be both internal and external to the target company, it is common to exclude from the definition material adverse changes affecting the overall economy or the particular industry in which the company operates.

In any case, the precise definition of events triggering the MAC clause is likely to give rise to some difficult negotiations, particularly in view of the lack of French case law on the point. Limited French case law has defined a number of conditions applicable to the event triggering the MAC clause: (i) not predictable; (ii) cannot be internal to the target company to the extent thorough due diligence was conducted; (iii) not known to the party alleging it; (iv) arising after signature of the sale agreement.[1]

Given its Anglo-Saxon origins, U.S. case law can also be useful in the drafting, and in the application of, the MAC clause. Thus the MAC clause: (i) cannot be too broad; (ii) the party alleging it cannot pursue the negotiation and signature of the sale agreement while knowing of the event(s) triggering the MAC clause; (iii) consequences of the triggering event must be appreciated over the long term (*i.e.*, several years); and (iv) the triggering event should pose a substantial threat to the realization of the sale agreement.

To the extent those conditions are met the buyer will have to prove that the seller failed to provide relevant information about the event(s) triggering the MAC clause and that such failure caused damages to the buyer.

IV. Employment and Unions Influence on a Transaction

Employment and benefits are definitely one area where specialist advice will be required. French employment law is notoriously complex and an extensive Labor Code sets out much of the law. Pensions, on the other hand, do not require as much attention as in other jurisdictions (for example, the United Kingdom) as private pension schemes are rare and most employees benefit from the State Scheme organized by the French social security system.

A. Consultation of the Works Council

One of the first questions to be asked in the sale process is whether there will be a requirement to inform and consult any works council in connection with the transaction, as this can be a time-consuming and onerous procedure. A company with more than fifty employees is required to have a works council (*comité d'entreprise*). Companies with fewer than fifty employees may choose to set up a works council.

Articles L 2323-6 and L 2323-19 of the Labor Code require an employer to inform and consult its works council on all issues relating to the organization, management and running of the company. This includes any modification of the economic or legal organization, including merger, acquisition or sale of the company.

Companies with fewer than eleven employees have no obligation to inform and consult, but can do so voluntarily. Also, in the context of a public offering, the company making the offer is not obliged to consult the works council prior to do so. However it must inform the works council within two working days after the publication of the press release.[2]

The requirement to inform and consult gives rise to two main practical concerns: confidentiality and timing. Parties are usually reluctant to inform the works council (particularly that of the target company) of a proposed acquisition until it is done and in the public domain. Yet the requirement is to inform and consult the works council before any binding agreement is entered into. This means the consultation has to be completed at the earliest stage, *i.e.*, before *signature* of the acquisition agreement. Thus, works council consultation cannot be dealt with as a pre-closing condition. Nor is it a procedure that can be done overnight, since it is necessary to convene the works council, provide it with relevant and sufficient information, and then give it time to reflect and ask any additional questions.

There is no requirement to give a copy of the acquisition agreement to the works council, or to reveal its terms. The works council is likely to be more interested in practical matters such as the timing of the transaction, its impact on employment within the relevant companies and proposed plans for the future. Obviously, much of this information can only be provided by the purchaser, who is not involved in the consultation of the target company's works council at this stage, but may agree to provide information, or even attend a meeting to answer questions.

It should be noted that the works council is not required to "approve" the transaction, but rather only to consider it and render an "opinion" (*avis*), which can be positive or negative. The transaction cannot be signed until such opinion has been given. Until recently this meant that signature could potentially be significantly delayed if the opinion were not provided promptly. However, recent legislation provides that, unless a different timetable has been expressly agreed upon, the works council shall be deemed to have given a negative opinion if it has not given its opinion within one month from the date of provision to it of the necessary information.

Further, the timetable could be extended up to an extra two months. One extra month will be granted if the works council exercises the "alert procedure" (*droit d'alerte*), which entitles it to have an expert appointed to prepare a report on the situation of the company, thus giving two months to the works council to render its opinion. The works council could benefit from another extra month (leading up to three months in total) if the Hygiene, Security and Work Conditions council (*comité d'hygiène, de sécurité et des conditions de travail*) has to be involved.

Sanctions for not complying with this procedure are severe. Chief executive officers of offending companies may be criminally liable (*délit d'entrave*). In addition, under civil law, a works council can require a court to issue an injunction (*référé-suspension*) against the seller, prohibiting the latter from selling the company's shares so long as the works council is not duly informed and consulted.

B. Information to Employees

Brand new Law 2014-856 of 31 July 2014 (in force from 2 August 2014) imposed upon companies without a works council and other small to mid-size companies with a works council a duty to provide information to employees directly (i) every three years on their ability to make an offer for fifty percent or more of the shares or the business of the company and (ii) at least two months before a proposed sale of fifty percent or more of the shares or business transfer.

The purpose of this legislation is to enable employees potentially to make an offer for the shares or the business of their company. Employees must be provided with notification of the proposal at least two months prior to the proposed transaction at the same time as the information and consultation of the works council (if any). Decree 2014-1254 of 28 October 2014, issued pursuant to the Law of 31 July 2014, specifies that the two-month period starts from the ownership transfer date. Where freely transferable shares are concerned, it is the date of registration of the shares in the transferee's account. Otherwise, the date to be taken into account is the date when both parties reach a mutual consent on the object and price of the transaction. Moreover, the Decree specifies the various ways to determine with certainty the date and time of information receipt. On that basis, personal delivery with receipt seems the safest way to perform the notification obligation.

Employees have two months to respond and present an offer to acquire the shares or business. If employees are not interested, the sale to any third party may take place before the expiry of the two-month period (provided each employee has expressly stated that he/she is not interested) and in any case within two years after the notification to the employees. Otherwise, the notification must be repeated.

Employees must keep the information confidential and can be assisted by representatives of local chambers of commerce or by individuals to be determined by Decree. The aforementioned Decree does not specify what category of persons is allowed to assist the employees. However, it states that employees should inform their employer without delay of their choice to be assisted, and that such person who may assist them is bound by an obligation of confidentiality.

Failure to comply with the notification obligation may result in the share sale/business transfer being held null and void.

This new legislation applies to transactions closed on or after 1 November 2014. However, the Decree specifies that transactions completed after 1 November 2014 but resulting from an exclusive negotiation which has been concluded prior to 1 November 2014 are not subject to it.

The Decree does not address the general triennial obligation of employees' information. It therefore appears that this obligation is not effective yet.

Please note that a parliamentary commission was launched on 12 January 2015 and should present its conclusions before 15 March 2015. It is charged with assessing the different ways to apply the new employees' right of information so that it does not have negative effects on transactions relating to businesses and shares.

C. Employee Data Protection

The French law "*informatique et liberté*" of 6 January 1978 was passed to implement E.U. directive 95/46/CE, relating to the protection and circulation of data. Article 68 of the French law prohibits, subject to criminal and administrative sanctions, any transfer of personal data outside the European Economic Area (EEA). Article 69, however, derogates from this principle to the extent that the country of the data recipient guarantees a sufficient level of protection for such data.

Adequate protection may result from (i) legislative provisions of the State hosting the data recipient; (ii) Model Clauses approved by the European Commission found in the contract passed between the data controller and recipient or Binding Corporate Rules (BCRs) found in the company's internal regulations that are designed to allow intragroup personal data transfer outside the EEA in compliance with Article 25 of the Data Protection Directive; or (iii) compliance with the so-called U.S./E.U. Safe Harbor principles when the data recipient is located in the United States.

Data subjects must consent to their data being transferred outside the EEA unless the transfer is necessary for:

– protection of individual's life or the public interest;

– compliance with obligations allowing the acknowledgement, the exercise, or the defense of a legal right;

– consultation of a public register intended for the public's information; or

– performance of a contract between the data controller and the individual, or for pre-contractual measures undertaken at the individual's request.

Protection of employee data is especially relevant in the context of pre-acquisition due diligence where the parties should take the following steps.

- Check the existence and validity of the treatment and information procedures put in place in the target company.
- Transfer and store any data recovered by the buyer and its advisers by secured means in secured places to avoid any unauthorized access and treatment from third parties.
- Prior to any transfer of data, inform employees about such transfer and type of information transferred. Employees should then have the ability to exercise their right of rectification if needed.

- Make a declaration to the French data protection authority ("CNIL") and seek its authorization. Transfer of data will be possible only after the authorization is granted by the CNIL.

D. Severance Payments and Employee Dismissal

If the legal structure of a company is modified by, among other things, a takeover, sale, merger, modification of business or incorporation, pursuant to Article L 1224 of the Labor Code all employment contracts that are in force on the day of the modification must remain in force between the new employer and the employees, subject to certain conditions specified by case law and to any severance provisions (so-called "golden parachutes") that may be included in the target's employment agreements.

Under French law, golden parachutes included in management's employment agreements may be triggered by dismissal or resignation of management following their company's change of control. Golden parachutes must be approved by the Board of Directors and controlled by the Auditors. In public companies, shareholders must also approve severance payments. However, the amount of golden parachutes is subject to very little control—a judge may only decrease the amount if it is obviously excessive.[3]

Otherwise, normal rules of dismissal apply: in the case of an individual dismissal, the employer must have a "real and serious" reason for terminating the employee's employment contract. In the case of collective dismissals, a redundancy procedure must be implemented in order to avoid liability (redundancies may be justifiable if they are as a result of unfavorable economic conditions or restructuring undertaken in order to maintain the competitiveness of the business).

The business transfer in itself will not be enough to justify the dismissal. French courts increasingly view redundancies carried out before a business transfer as unlawful and deem them to be carried out to circumvent the automatic transfer of employment contracts. In these circumstances, the redundancies may be held to be null and void.

V. Sandbagging

Pre-acquisition due diligence is standard in the context of company acquisitions in France. Although the purchaser will want to protect itself through contractual representations, warranties and indemnification provisions, it will prefer to verify the state of the target even before committing to the purchase.

Due diligence procedures are similar to those in other jurisdictions and are likely to cover financial, legal, tax, operational, environmental and business issues. Thanks to virtual data rooms, due diligence can now be conducted more simply without the requirement to move large groups of professionals and consultants and without resulting in significant disturbance of management of the target.

Provision of vendor due diligence reports is a fairly common practice in France in the context of private equity transactions, or where there is a requirement to conclude the sale rapidly. In this case, the purchaser should be sure to obtain a clear reliance letter from the firms who have conducted the due diligence, enabling it to have recourse in the event of a claim.

Certain information relating to the target provided by the vendor should be checked against information obtainable from public agencies such as the Commercial Registry, the Land Charges Registry and the Patents and Trademarks Office. It is advisable to request a full search of the target company and any subsidiaries at the Commercial Registry, which will provide confirmation as to the current officers, auditors (if any), registered charges and liens, commencement of bankruptcy or administration proceedings, last filed accounts, etc.

If the target company owns significant real estate it would be advisable to instruct a notary to investigate and/or certify the title. In France, notaries are responsible for dealing with transfers of real estate and registration of mortgages over real estate. If the real estate is likely to be contaminated, it is standard practice to have a specialized firm conduct an environmental audit. Equally, where intellectual property is an important element of the target's business, it is usual to ask a specialized firm of patent and trademark agents to investigate and confirm registration and ownership.

The due diligence process can have an impact not only on the price negotiations, but also the terms of the representations, warranties and indemnities, particularly where the purchaser wishes to be specifically indemnified for risks identified in the course of the due diligence. Ironically, the vendor will also want the purchaser to conduct extensive due diligence, since this may enable it to limit the scope of the warranties required to be given.

In the sale agreement, the seller usually states that the warranties are subject to formal disclosure of certain facts. French legal practice is similar to the disclosure letter procedure in the United Kingdom: disclosures are set out in an appendix or schedule to the SPA and tend to take the form of a bundle of documentation generally provided in the course of due diligence. It is standard for a seller to seek to exclude any information disclosed in the course of due diligence from the scope of the warranties and to request from the buyer an agreement not to sue or claim indemnification on the basis of these disclosed facts. This is likely to be resisted by the purchaser.

Another question is whether purchaser can still sue for breach of warranty if purchaser has actual knowledge of a matter which qualifies as a warranty (but this matter has not been formally disclosed by the seller in the disclosure bundle). If the purchaser's actual knowledge is proved by the seller, the purchaser will probably not be able to sue for breach of warranty. Often, the purchaser warrants to the seller that it does not have any knowledge of a fact that may give rise to a claim.

Certain sellers, and particularly private equity funds, will significantly limit the level of warranty cover proposed to a purchaser in the sale agreement on the basis that (i) they were not involved in the management of the company, and (ii) the purchaser has been given an opportunity to conduct full due diligence. This is a point that should be clarified at the outset in order to avoid wasted time and expense. It is rare, however, even for private equity sellers in France, to give no warranties, other than warranties as to capacity, incorporation of the target company and ownership of shares, as is sometimes the case in other jurisdictions (such as the U.K.).

VI. M&A insurance

In cross-border transactions involving French companies, the usual approach to indemnification is that the buyer is indemnified from and against all liability, losses, costs and so on, incurred as a result of a breach of any representation, warranty or covenant of the seller. A cap is often provided which is usually higher than in a U.S. context (ranging from thirty percent to one hundred percent of the purchase price). Further, the indemnification clause usually survives for a certain number of years (up to three years for general matters and seven years for tax, environmental and social matters). As a result, the buyer often seeks protection against the potential financial downturn of the seller.

A wide range of guarantees is available to the buyer, including "representations and warranties insurance." This indemnity insurance allows sellers to agree to indemnification with no liability attached other than payment of the insurance premium. Their cover can be extended from three to seven years depending on the risks insured. A deductible ("franchise") usually applies.

There are two types of indemnity insurance policies: a "seller policy," which is triggered by a claim from the buyer against the seller who can then claim indemnification from the insurance carrier, and a "buyer policy," which is triggered by the loss or damage suffered by the seller, who can then claim indemnification from the insurance directly upon the loss or damage arising.

In French transactions, however, such indemnity insurance is not very common: It is offered by only a limited number of insurance carriers.

Premiums are very high, which makes it less attractive to sellers. Premiums usually vary from three to five percent of the amount of the guarantee, with a minimum of around two hundred thousand Euros. Fees of insurance carrier's advisers must be added for the audit. It is therefore recommended to use such insurance for transactions with a minimum value of twenty to twenty-five million Euros, *i.e.*, guarantee amount to cover between three and five million Euros.

In addition, buyers are reluctant to use this mechanism in view of the numerous exclusions that the insurance company will seek to include in the policy. Typical exclusions include any risks identified in the disclosure bundle, areas not covered by due diligence, post-closing price adjustments such as earn-outs, fines and penalties that remain personal.

It is more common for buyers to obtain from sellers other guarantees to cover the sellers' indemnification obligations resulting from a breach of the representations and warranties. French law provides for a wide spectrum of guarantees from a mere letter of comfort from the parent company of the seller (subject to prior authorization from its board of directors) to an "on-demand" bank guarantee or a personal guarantee (*caution personnelle*) from individual sellers or the management of corporate sellers. Alternatively, the buyer could request that part of the purchase price be put into escrow, be retained or be set-off against deferred consideration payments.

VII. Dispute Resolution and Choice of Law

French law would normally be selected as the governing law if the assets are located in France. In the context of cross-border transactions, and particularly in asset transactions, the master agreement would be governed by the law of either the seller or the buyer and French law would govern local transfer deeds or bills of sale. In share transactions, it is fairly common for parties to choose a neutral law. For instance, a U.S. buyer and French sellers may end up choosing English or Swiss law as the governing law, even if the target is French. However, even if foreign law is chosen, mandatory provisions of French law would continue to apply (*e.g.*, obligations to consult the works council and transfer of shares formalities).

If French law were selected, disputes would be submitted to French courts for resolution unless there are compelling reasons to select arbitration. The dispute resolution clause in the agreement should clearly identify the court to avoid jurisdictional disputes. (For example: "Disputes arising in connection with this Agreement shall be submitted to the Commercial courts of Paris.") If no jurisdiction is stated, the plaintiff would have to commence proceedings in the courts having jurisdiction over the place where the registered office (or residence) of the defendant is located.

French court proceedings can be conducted relatively quickly and are inexpensive compared to U.S. or U.K. court proceedings. There is no system of "discovery" and much of the procedure takes the form of submission of documentary pleadings and evidence. Awards of "costs" against a losing party are generally nominal and limited to expenses and only a fraction of the lawyers' fees incurred.

There is no longer any distinction between "solicitors" and "barristers" in France and therefore lawyers may negotiate the agreements and also appear before the courts to plead in the event of a dispute. Court hearings are generally short, especially before the commercial courts, and oral testimony of the parties is generally not required.

It is also common for parties to agree to negotiate in good faith for a period of time determined in the agreement to try to resolve their differences amicably before turning to judicial resolution or arbitration. Mediation also exists in France, but it is not usual for parties to a share purchase agreement to provide for mediation as a preliminary step.

Alternatively, parties may select arbitration if they are concerned about confidentiality, the ability of the judges to consider certain technical issues, or other aspects of court proceedings. Judges in the commercial courts are not qualified lawyers and this in itself sometimes leads parties to opt for arbitration. It is fairly common for parties to share purchase agreements to select ICC arbitration or, alternatively, ad hoc arbitration (which avoids the requirement of payment of fees to the arbitration institution which has established the applicable rules). In ad hoc arbitration, the main terms of the arbitration procedure will be set out in the agreement. Resolution of disputes by arbitration is confidential and usually quicker, but likely to be more expensive than court proceedings.

Endnotes

1. CA Paris, 24 May 2005, 3ème ch., sect. A, RG n°04/00865.
2. Article L 2323-25 of the French Labor Code issued from the *Florange* Law 2014-384 of 29 March 2014.
3. *Cour de Cassation*, *chambre sociale*, 5 March 2014, no.12-23.106.

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Pitfalls in Private M&A in Poland

By Anna Dąbrowska

I. Letters of Intent

Following their adoption from common law countries, letters of intent are increasingly used in Poland to indicate the parties' intention and anticipated goals in a contemplated transaction. Certain questions and doubts may arise in practice, since this concept has neither been introduced into legislation nor analyzed in jurisprudence. In general, letters of intent do not have binding character. This rule does, however, have exceptions.

A lack of regulations can be a recurring source of misgivings and makes it necessary to analyze each case individually. However, legal institutions existing in Polish legislation prove helpful in this regard. The Polish Civil Code compels all negotiating parties to act fairly and honestly. Consequently, a party entering into or conducting negotiations in breach of good custom, such as without intent to execute a contract, must remedy any damage suffered by the counterparty due to its reliance on contract execution. The term "breach of good custom" is interpreted broadly. Therefore, a wide variety of situations may fall within the scope of this provision. A letter of intent can serve as material evidence of good or bad faith of a contracting party and thereby may be a useful instrument for the recovery of potential claims.

However, as the character of a document is determined by its content and not by its name the parties should take care when drafting a letter of intent.

II. Government Approvals

Statistics show that the largest M&A transactions in Poland in 2012 and 2013 involved entities operating in heavily regulated sectors. Most M&A transactions in 2012 concerned industry, whereas the highest trading volumes were observed in the financial sector (banking and insurance).[1] This trend continued in 2013 where the merger of nitrogen plants Zakłady Azotowe in Tarnów Mościce with Zakłady Azotowe Puławy gave rise to Grupa Azoty—the second largest chemical conglomerate in Europe.[2] According to statistics published by the Polish Office of Competition and Consumer Protection, 156 decisions approving mergers were issued in 2013.[3]

A. Succession of Concessions, Licenses and Permits

Under Polish law, the principle of general succession of rights and obligations encompasses permits, concessions and reliefs that are transferred on the merger date to an acquiring or newly created company. Exceptions may derive from (i) a statute regulating a specific sector or (ii) a decision granting a permit, concession, or relief. Regulatory decisions may stipulate that a concession, permit or license either can be transferred only under certain conditions or cannot be transferred at all. Therefore, certain sectors must be given careful attention such as energy, gambling, broadcasting, natural resources, explosives etc. To illustrate potential risks, it can be pointed out that the Polish energy regulator is authorized to annul or change the scope of concession (*e.g.* for production, distribution and transmission of electricity or gas) in the case of a merger. Also, a transfer of concessions to mine minerals may be subject to regulatory intervention. A legal successor must prove to a relevant authority its ability to fulfill all legal requirements related thereto (*e.g.* title to real estate, holding of sufficient funds to be deposited in a special bank account called Liquidation of a Mining Facility Fund etc.). The regulator may decide not to approve a transfer of concession due to public policy, such as national security, environmental protection or reasonable management of mineral resources.

B. Competition Clearance

Under Polish law, M&A transactions are checked for restriction of competition if (i) they are deemed to be a concentration of ownership and (ii) statutory thresholds are met. Competition clearance is mainly required for mergers and acquisitions of independent undertakings or establishment of joint ventures.

A merger cannot be implemented until clearance from the competition office is obtained.

C. Transfers of Real Estate

Specific regulations apply to transfers of real estate to entities defined as "foreigners" (from outside the EEC, except for Switzerland). If shares are acquired in a Polish company, it becomes a "controlled" company if foreigners jointly, directly or indirectly hold at least fifty percent of votes at shareholder meetings or have a dominant position within the meaning of the law (*e.g.* due to their rights to appoint members of corporate bodies). In such case, a prior permit from the Minister of Internal Affairs must be obtained; otherwise, the transfer of shares is null and void.

III. Conditions for Closing

"Material adverse change" ("MAC") or "material adverse effect" clauses in M&A contracts are becoming common practice in Poland, which fits well with a general trend observed in Central Europe. Thus, a study suggested that MAC clauses are more prevalent in this region than in any other part of Europe.[4] Under Polish law contracting parties may qualify any circumstance as a MAC clause.

As MAC clauses facilitate resolution of a contract or renegotiation of its terms, absence of relevant provisions may be the source of difficulties where material adverse business or economic effects occur. Under Polish law, however, contracting parties may still benefit from a statutory clause according to which if, due to an extraordinary change in circumstances, a performance entails excessive difficulties or exposes one of the parties to a serious loss that the parties did not foresee when executing a contract, a court may upon consideration of the parties' interests and in accordance with equitable principles, designate the manner of performing an obligation, the value of performance or even decide that a contract be dissolved. When dissolving a contract, the court may, as needed, decide on how accounts will be settled between the parties, being guided by the principles set forth above.

This clause may be applied if restrictively interpreted statutory premises are met. Importantly for the M&A practice, a MAC clause would typically give broader protection to parties in case of material adverse effects than that described above, even though the two may at times overlap. For instance, a MAC clause in a contract may cover a change caused by one of the parties, whereas such change would not be covered by a statutory clause. Moreover, its application means that court intervention is required, whereas a MAC clause would typically entitle the party to "escape" from closing solely on contractual grounds.

IV. Employment and Unions

A. Transferring an Employing Establishment

As a consequence of transferring an employing establishment, the new employer by law becomes party to existing employment relationships. From the time of transfer, the new employer automatically acquires all rights and obligations under existing employment.

For one year after a transfer of an employing undertaking, or part of it, the new employer must observe the terms of the collective bargaining agreement that applied to the transferred employees, unless it is decided to apply more favorable terms and conditions of work and remuneration.

Polish labor law does not provide a definition of the term "transfer of employing establishment." Assessment of whether there is a transfer of an employing undertaking or its part (especially when not all of the employees and assets are to be transferred) generally depends on the court's subjective opinion in each particular case.

B. Information Obligations

Information/consultation obligations on a transfer vary depending on whether trade unions/works council have been established.

As a rule both the transferor and the transferee must inform their employees in writing of the transfer of the employing undertaking, or part of it. Where a trade union exists, instead of the obligation to inform each employee, Polish companies must notify the trade union in writing of the expected time of transfer.

Intended amendments on conditions of employment must be negotiated and agreed upon with trade unions no later than thirty days from the date on which information on actions was served. However, in case of failure to reach such agreement, the employer is free to act.

If a works council has been created it also may need to be informed and consulted.

While neither employees nor enterprise trade union members have a "veto" right to effectively block a transaction under Polish law, all legal requirements related to information must be fulfilled—otherwise a fine may be imposed.

V. Sandbagging

The contractual concept of sandbagging is becoming a permanent fixture on the Polish M&A map. Exclusion of seller's liability with respect to information and documentation disclosed to the buyer during the due diligence process is turning out to be a norm. The scope of such limitation of seller's liability depends on the parties' negotiating positions, but it is seldom omitted in contracts.

The Polish law also provides certain regulations pertaining to consequences of information being made known to the buyer. The general rule is based on implied warranty for defects (physical and legal). This principle may be extended, limited or excluded.

The seller will not be liable for damages when the aggrieved party knew of a defect, but completed a transaction anyway. The burden of proving buyer's knowledge lies with the seller and in practice it is difficult to prove what the buyer actually knew or did not know. This aspect of proof is contentious, but the prevalent opinion is that mere disclosure of documentation to a buyer (*e.g.* during due diligence) does not necessarily impute knowledge of defects, even if they would be apparent from searches in documentation. The state of a buyer's knowledge as to acquired rights must be assessed on a case-by-case basis.

Regardless of the above, the seller cannot be excluded from liability if a defect was dishonestly concealed from a buyer. Hiding information from a buyer may amount to deceit, so exclusions or limitations of an implied warranty for defects regime would not be binding.

VI. M&A Insurance

Warranty & Indemnity insurance plays an increasingly important role in the successful completion of M&A deals in Europe. According to a study published by CMS[5] in March 2014, the number of transactions involving W&I insurance in Europe has recently risen and amounted to nine percent in 2013, despite the general fall in transaction volumes.

Data provided by a market leader in insurance brokerage showed a thirty-two-percent increase in the number of W&I deals in the first half of 2013 compared to 2012 in Europe, Middle East and Africa, with an average limit placed per deal of USD 30 million.[6] Buyer-side policies are more popular in Europe than seller-side ones. They typically allow a buyer to bring its indemnification claim directly against an insurer and without any recourse towards the seller. Data provided by the broker[7] shows that buyer-side policies constituted sixty-five percent of all W&I policies in Europe, the Middle East and Africa in the first half of 2012, as compared to seventy-eight percent in the Americas.

M&A insurance products in Poland have evolved in recent years, but W&I insurance still remains a new and niche product. Nevertheless, it is seen as a means of reducing significant risks inherent to M&A transactions (such as the risk that a party providing a warranty may not exist when the counterparty claims a breach of warranty) and avoiding unwanted arrangements (such as escrow arrangement) and is slowly but steadily becoming more prevalent in the Polish market. Optimism was voiced about the future of W&I insurance on the Polish market with specialists predicting that such instruments will become more popular in coming years. At present, W&I insurance is most popular among private equity funds seeking to exit particular investments.

Premiums in Poland typically amount to one and one-half percent to two percent of purchased insurance coverage. As a rule, they are higher for tax and environmental insurance, in which case they are two percent to six percent of purchased coverage. A minimum premium in Poland and other countries in Central Eastern Europe is about EUR 80,000. Typically, W&I insurance policy protects an insured party for up to twenty-four months from the closing date.

VII. Dispute Resolution and Choice of Law

A. Dispute Resolution

It is a common practice in Polish M&A contracts to submit disputes arising thereunder to arbitration. Out-of-court proceedings are perceived as faster and more confidential. Moreover, arbitrators seem to deal with complex issues better than common-court judges. However, the cost of arbitration proceedings is significantly higher in comparison with court fees in Poland.

Choice of a permanent court of arbitration is more common than *ad hoc* tribunals. There are several dozen permanent courts of arbitration in Poland and two of them, namely the Court of Arbitration at the Polish Chamber of Commerce and the Court of Arbitration at the Polish Confederation Lewiatan, play a key role in arbitrating commercial matters. Both courts have experienced an increase in case load in recent years.

In certain circumstances an arbitral award may be set aside by Polish courts. According to the Polish Civil Procedure Code, a common court may nullify an award which is in conflict with fundamental principles of national legal order. This "public policy clause" is a subject of controversy. It is postulated to clarify its meaning and adopt its restrictive interpretation. It shall be understood to cover only the most fundamental constitutional principles and overriding rules in specific areas of law.

Unlike in most European countries, an arbitration clause under Polish law does not survive a declaration of bankruptcy of the party it binds. Arbitration proceedings pending when such a declaration is made are discontinued. However, this principle likely will be changed during upcoming amendments of Polish insolvency and restructuring laws.

B. Choice of Law

Pursuant to the Rome I Regulation,[8] which directly applies under Polish law, it is possible to make a choice of law for contractual obligations, in case of a transaction that has a foreign (international) element.

If an agreement does not bear "international" features, parties cannot freely choose the agreement's governing law. Share purchase agreements are not excluded from the scope of the Rome I Regulation, so the choice of applicable law is left to the parties' discretion (if their contract concerns at least two legal systems). Although there is some controversy in the Polish doctrine, the prevailing position is that the transfer of title to shares must be governed by Polish law.

As a consequence provisions regulating the form of transfer of shares, (*e.g.* in writing with notarized signatures) will apply, even if the transfer contract is concluded abroad.

Endnotes

1. Press release—EY Report: Poland has the second highest number of M&A transactions in the region, available at: http://ey.media.pl/pr/236028/raport-ey-polska-drugim-krajem-w-regionie-pod-wzgledem-liczby-przeprowadzonych-transakcji-fuzji-i-przejec-w-2012-roku.
2. Press release—EY Report: Poland has the second highest trading volumes in M&A transaction in the region, available at: http://ey.media.pl/pr/258825/raport-ey-polska-druga-w-regionie-pod-wzgledem-wartosci-transakcji-m-a.
3. Report on the activity of the Polish Office of Competition and Consumer Protection in 2013, available at: http://www.uokik.gov.pl/sprawozdania_z_dzialalnosci_urzedu.php.
4. *CMS European M&A Study 2014*, available at: http://www.cms-hs.com/Hubbard.FileSystem/files/Publication/ 43087c2d-6be1-4dd7-acc9-010374c3a216/7483b893-e478-44a4-8fed-f49aa917d8cf/Presentation/ PublicationAttachment/0dbf534b-1daa-464a-b13d-1b0eeef47619/MA_Study_2014_ExecutiveSummary.pdf.
5. Marsh, *Enhancing and protecting value in M&A transactions—current trends and techniques in managing M&A risks*, 18 September 2013 Conference materials.
6. *CMS European M&A Study 2014*, note 4 *supra*.
7. Marsh Insights: *Transactional risk update*, October 2012.
8. Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I); OJ L 177 of 4 July 2008.

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Pitfalls in Private M&A in Sweden

By Carl-Olof Bouveng

I. Letter of Intent

In an M&A transaction in Sweden, it is common for the parties to enter into an initial document setting out some preliminary terms and stating an intent to enter into an agreement and complete the transaction. Since there are few mandatory requirements for a contract to be binding under Swedish law, it is particularly important to make clear that the letter of intent is non-binding and only states the intent at the time. The letter may also contain provisions about exclusivity, non-disclosure, non-solicitation, etc., and such provisions can be effectively indicated to be binding. Also a letter of intent should include a governing law provision and a dispute resolution mechanism to ensure that the effect is interpreted under relevant laws and in an appropriate procedure.

A party that enters into a letter of intent stating that it will negotiate an agreement for the transfer of shares or business assets can always withdraw from such negotiations in good faith. It must be careful to make sure that it immediately notifies the other party once its intentions and interest in the transaction have changed. Otherwise it may be held liable under *culpa in contrahendo* for the costs incurred by the other party in relying on the prior intentions, or, differently put, that the other party will be placed in the same position as if the letter of intent had not been signed and the negotiations had not taken place.

It is, however, often hard to prove that the other party has acted under "false" intentions and that it has caused damage. Therefore, the amount of any damages would normally be quite limited. In order to have a stronger document, a break fee is sometimes agreed upon. A break fee would not be enforceable if unreasonable, but would normally be considered reasonable, and therefore be upheld, if the fee provided for is somewhere in the neighborhood of the costs incurred in the negotiations.

II. Government Approvals

Generally, foreign parties are permitted to invest in Sweden. It has not been considered necessary to restrict the access to Swedish assets for foreign investors. In certain regulated sectors, a government license may be dependent on an evaluation of the owner. This is the case in, for example, the financial sector.

Under competition laws a mandatory notification to the Swedish Competition Authority (SCA) is to be made when a concentration arises and the following thresholds are met:

– the Swedish combined aggregate annual turnover in Sweden of the undertakings concerned exceeds SEK 1 billion in the preceding financial year; and

– each of at least two of the undertakings concerned have a turnover in Sweden exceeding SEK 200 million in the preceding financial year.

The whole group of each undertaking is included in the calculation of turnover. A notification must be made prior to the completion of the concentration transaction. Upon receipt of a complete notification, the Competition Authority has twenty-five working days to issue a decision either approving the concentration or initiating a special (in-depth) investigation. During this twenty-five-day period the parties must not take any actions to complete the concentration (the "stand still" period). If the Competition Authority receives commitments from the parties the period will be automatically extended to thirty-five working days.

After a decision to initiate a special investigation, the Competition Authority has an additional three months to review the concentration, and this period may be further extended. At the end of the review period, the Competition Authority must decide either to approve the concentration or to apply to the Stockholm District Court for a prohibition. A concentration may be prohibited if it would significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position, or if a prohibition would interfere with important national interests of security and supply of resources. If a concentration is prohibited, it becomes void. A third party cannot appeal an approval of a concentration.

Also, the competition law regime of the European Union ("E.U.") as described below may come into play.

Concentrations are subject to mandatory notification to the European Commission in accordance with Council Regulation number 139/2004 (the "ECMR") if the below thresholds are met:

– the aggregate world-wide turnover of all the undertakings concerned, *i.e.*, typically the purchaser (including the group of companies to which it belongs), and the target (including the group of companies that it controls), exceeds €5 billion; and

– the E.U.-wide turnover of each of at least two undertakings concerned exceeds €250 million.

However, the ECMR does not apply if a merger has its primary impact within a single Member State. This is deemed to be the case when more than two-thirds of the E.U. turnover of each of the parties involved in the merger is in one and the same Member State ("two-thirds rule"). In addition, the ECMR is also applicable to smaller concentrations with effect within at least three Member States of the E.U., if all of the following thresholds are met:

- the aggregated world-wide turnover of all the undertakings concerned exceeds €2.5 billion;
- the E.U.-wide turnover of each of at least two undertakings concerned exceeds €100 million;
- the aggregated turnover of all the undertakings concerned exceeds €100 million in each of at least three member states; and
- in each of those three member states, at least two undertakings concerned each had a turnover exceeding €25 million, unless the two-thirds rule is applicable. (See above.)

If the above thresholds are met, notification to the European Commission is mandatory and must be made before completing the concentration. Notification can be made in "short form," if the concentration is unlikely to raise competition concerns. Within twenty-five working days from receiving a formal notification, the Commission has to decide whether the ECMR applies ("Phase I") and, if so, whether to approve the merger or to open formal proceedings ("Phase II"). The Commission has the power to prohibit a merger if it would significantly impede effective competition in the common market or in a substantial part of it.

III. Conditions for Closing

Traditionally a typical Swedish transaction would contain only few conditions for closing and not include for example a "material adverse change" clause ("MAC"). Largely it has been accepted that the purchaser effectively assumes some risk already as of signing, and will be obliged to proceed to closing also if the target has been impaired compared to its condition at signing.

Should the transaction be subject to a merger filing as discussed above, the somewhat more extended time between signing and closing may give rise to increased concerns, and in contracts involving foreign parties it is becoming more common to include conditions relating to MAC and the correctness of warranties. MAC clauses are generally enforceable in private transactions, but not in public bids over shares in listed companies. Also a discretionary right for the purchaser to determine whether a MAC event is at hand would typically be enforceable, but it is important that it is clearly worded to ensure that the parties' joint intentions are unambiguous.

Financing conditions are not common in the current market. The buyer is normally required to have financing available already when signing the agreement or sometimes even when making the offer in a controlled auction. The concept of "certain funds" as required in a public bid under applicable takeover rules has consequently also come to be the norm in private transactions.

IV. Employment and Unions Influence

The sale of a company or its business often has an impact on the employees. If the transaction is structured as an asset deal, the rules on transfer of undertaking will apply and, if the transferred entity retains its economic identity, the employees will normally have a right to transfer to the buyer with unaltered terms and conditions of employment. As provided under E.U. law, the employees' rights are mandatory. The rules on transfer of undertakings will also apply in other situations, such as outsourcing or the change from one service provider to another. Swedish law has, in this regard, fully implemented the E.U. directive 2001/23/EC.

Except in very specific situations, the seller is not permitted before the transfer to carry out dismissals based on redundancies occurring as a result of the transfer. Consequently, the buyer must normally deal with any such redundancies.

Even if economic reasons (redundancy) in principle always constitute "just cause" for dismissal in Sweden, the rules for determining which employees become redundant are very strict. The basic principle is that the employee with the longest aggregate period of employment with the company should be the last to become redundant. This is also referred to as the principle of "first in, last out." Employees are also entitled to continued employment if they have "sufficient qualifications" for one of the alternative jobs that remain available in the company.

If two undertakings have been merged, transferred employees are entitled to count their aggregated tenure in both companies. As a result of this rule, the transferee will face a situation where the newly transferred employees will be able to "compete" with the employees of the buyer already employed prior to the transfer. This will complicate the selection in subsequent redundancies in the buyer's business.

Before a decision to transfer a business is taken, an employer is obliged to carry out consultations with the trade unions that have collective agreements with the company, or that have members at the company. The same applies before a decision is taken to restructure a company and declare employees redundant. Consultations with the employee representatives are carried out with the unions, rather than with works councils. The duty to inform and consult unions also applies if there is only one employee affected by the transfer or the redundancy. Thus, from this perspective the Swedish legislator has implemented E.U. law more strictly than required, since E.U. law requires such consultations only if the number of affected employees is at least fifty.

The unions have a right to be consulted about and informed of the transaction, but their approval is not required. Negligence to carry out union consultations cannot delay or inhibit a transaction, but might entitle the unions to damages.

V. Sandbagging

In Sweden, it would arguably follow from statutory law that a buyer is not entitled to effectively raise a claim for a "defect" or discrepancy of which the buyer had knowledge at the time of signing. However, freedom of contract applies and, if the claim is based on a warranty or other contract wording, the effect of the knowledge would largely depend on how the warranty provision, indemnities and other provisions have been worded. For this reason, it is mostly customary to explicitly set out in the purchase agreement what effect the knowledge of the buyer will have and then often a substantial amount of time is spent on negotiating the definition of "knowledge." It is probably fair to say that it is customary for anti-sandbagging provisions to be included in the purchase agreement, *i.e.*, the buyer accepts that its actual knowledge of a circumstance, and that such circumstance gives rise to a claim, will prevent such buyer from effectively making a claim. It is also not unusual that "what the buyer should have known upon reasonable inquiries or making a customary due diligence" pursuant to contractual provisions would prevent the buyer from making a claim.

For known risks the buyer would include a specific indemnity in the agreement, rather than relying on a warranty that under law or due to an anti-sandbagging provision may be ineffective.

VI. R&W Insurance

Representations & Warranties Insurance ("RWI") has become increasingly common on the Nordic market in the past ten years. An RWI is in short an insurance covering any breach of the warranties under a purchase agreement. RWI became relevant on the Nordic markets earlier than on many other markets and then not least among financial investors. It has now become increasingly popular not only for financial investors but also for "corporates." Insurance brokers claim that RWI is used in ten to fifteen percent of all Nordic deals and that now also large-cap transactions increasingly include an RWI.

The RWI is often a buy-side insurance introduced into the transaction at a late stage because the parties cannot agree on the scope of the warranties, and in particular on the maximum amount of liability and the survival period for the warranties. However, it has also become a tool used at an early stage; for example by the seller in an auction process where the insurance is stapled to the auction documentation to enable the seller to make a "clean" exit and expedite the distribution of proceeds to the investors. A buyer may also choose to make an offer relying on RWI and then offer the seller to be released from all, or most of, the liability under the warranties.

The premium payable by the insured was in the past fairly high but with increased competition, a more mature market and a more developed product the rate has rapidly decreased. In the Nordic market, the premium currently is about one to one and one-half percent of the insured limit. However, it could be significantly higher if there are known risks, and also in really large "mega" deals, where the risks are considered greater. The premium level will also depend on other factors, such as the insurance limit compared to the enterprise value and the retention to be assumed by the insured as well as the breadth of warranties and disclosure.

When considering an RWI, it should be noted that the process of pricing and documentation of insurance terms typically requires ten days to two weeks. The insurer will need to become comfortable with the risk. The insurer would more easily become comfortable if the seller himself is at some risk, *i.e.*, the insurance does not kick in until the seller has indemnified part of the damage due to a warranty breach, because the warranties can then be assumed to have been carefully tailored to limit liability and the disclosure process to have been thorough.

VII. Dispute Resolution and Choice of Law

Agreements in an M&A transaction would normally refer to arbitration as the device for dispute resolution. The reason is primarily confidentiality, speed, competence and arguably also costs. As an effect of more complex commercial disputes in Sweden, including share and business transfers, often being resolved in arbitration, courts have limited experience in this kind of dispute. Furthermore, in arbitration the parties may ensure that experienced arbitrators are appointed. Even if arbitrators are costly, it may be more cost effective with a focused arbitration with no regular right to appeal than in a court proceeding where a judgment in a lower court may be appealed.

If the target is a Swedish company, it is with few exceptions accepted that Swedish law would govern the agreement. The parties are, however, free to choose any other governing law and such choice would under Swedish choice of law rules be upheld at least between commercial parties.

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Pitfalls in Private M&A in the United Kingdom

By Graham Gibb

I. Letters of Intent

Letters of intent (or equivalent documents such as heads of terms or memoranda of understanding) are frequently used in the U.K. as a preliminary step in an M&A transaction. Normally they are expressly stated to be non-binding and are used for moral force only. However, letters of intent may, by their express terms, or on their true construction, indicate binding contractual intention. Where the language of a letter of intent does not expressly negate contractual intention, it is open to the courts to hold the parties bound by the documents and courts may be inclined to hold such documents binding where parties have acted on the document for a long period of time or have expended considerable sums of money in reliance on it.

Letters of intent should make it entirely clear that the parties intend the document to be a non-binding pre-agreement (as opposed to a binding but conditional agreement). This is normally done expressly and by adding the words "Subject to Contract" at the beginning of the document. It is possible that a letter of intent may be worded so that some parts of it have contractual force, such as provisions on confidentiality, non-solicitation and break-fees, while the rest of it does not.

There is no implied duty to negotiate or otherwise behave in good faith under English law, but this may be introduced contractually in a letter of intent. Further, while an "agreement to agree" is also not binding under English law, a letter of intent can introduce obligations to act reasonably in considering proposals and in dealing with the other side. Additionally, statements made in a letter of intent, or in connection with the negotiations to which they relate, have the potential to create liability for misrepresentation or negligent misstatement, even where the heads of terms do not create a contract.

Damages for loss are available as a right where a party has broken a legally binding term in a letter of intent. Such damages would be quantified with the aim of putting the innocent party in the position it would have been in had the contract been properly performed. A binding provision in a letter of intent may have a liquidated damages clause. Care must be taken to ensure that a liquidated damages clause is not in fact a penalty clause, since such clauses are generally not enforceable. Specific performance or an injunction may be available as a discretionary, equitable remedy of the court. In exercising its discretion, the court will consider any delay in asking for the order, whether the party seeking performance is prepared to perform its side of the contract, whether the party against whom the order is sought would suffer hardship, the difference between the benefit the order would give to one party and the cost of performance to another and whether any third party rights would be affected.

II. Governmental Approvals

The 1980s saw a marked reversal of previous "protectionist" policies in the U.K. Since then it has been the policy of the successive governments to keep Britain "open for business" and to encourage foreign ownership and investment. Merger policy is now clearer, predictable and largely depoliticized. Indeed venture capitalist Jon Moulton noted that the U.K. is the "most open market on earth."

However, recently there has been a re-politicization of the issue. Several large M&A deals (*e.g.* Kraft/Cadbury, Pfizer/AstraZeneca, News Corporation/BSkyB) have become embroiled in discussions about whether the U.K. is now insufficiently protectionist in comparison to the United States and the rest of the European Union.

Lord Heseltine, in his review of industry policy in 2012, argued that the government should be prepared to override the market and block takeovers that threaten vital national interests. In May 2014 Heseltine reiterated this viewpoint, telling the BBC that ministers should have "reserve powers" to protect British companies when crucial interests are at risk. Here he gave the example of the U.K.'s "science base" being a crucial interest—clearly alluding to Pfizer's bid for AstraZeneca.

However, there is still legislation that allows the government to intervene in public interest situations. Under Section 42 of the Enterprise Act 2002 (the "EA"), the Secretary of State may issue an intervention notice to the Competition and Markets Authority (the "CMA") if he believes that it is or may be the case that one or more public interest considerations are relevant to the consideration of the relevant merger situation. Public interest considerations are considerations which are specified in Section 58 of the EA. At present, national security, the accuracy and freedom of newspapers, the quality and plurality of the media (including newspapers and broadcast media) and the stability of the U.K. financial system are specified in Section 58. Section 58(3) does, however, provide that the Secretary of State may by order modify the specified considerations in Section 58, and Section 42(3) allows the Secretary of State, when issuing an intervention notice, to rely upon a public interest consideration which is not specified in Section 58 but which, in the opinion of the Secretary of State, ought to be so specified.

Indeed, while not a foreign investment case, the Secretary of State used its power under Section 42 and Section 58(3) in an attempt to facilitate the merger between Lloyds TSB and HBOS, which might otherwise have been blocked on competition grounds. The intervention notice was issued on the basis that the stability of the U.K. financial system (which was not specified at the time) ought to be specified as a public interest consideration and that the merger, while posing competition concerns, was in the public interest, since it would promote stability within the U.K.'s financial markets.

Section 67(2) of the EA allows the Secretary of State to give a European intervention notice (in accordance with Article 21(4) of Regulation 139/2004—the EU Merger Regulation) to the CMA where one or more public interest considerations are concerned. Such a notice was used in 2011 when News Corporation bid to acquire the sixty-one percent of BskyB that it did not already own. The then Business Secretary used the specified public interest consideration in Section 58(2C)(a), relating to the sufficiency of plurality of persons with control of media enterprises.

III. Conditions to Closing

The level of conditionality in private transactions is a matter for negotiation and is quite specific to the transaction at hand. It may be the case that shareholders' approval is needed in respect of the purchasing entity as well as the selling entity. The transaction may be subject to competition clearances or other regulatory clearances. Consents from material third parties such as major customers or suppliers may be sought, and tax clearances may be needed. Financing conditions would not be standard. The agreement between the purchaser and the seller will typically set out the timing of satisfaction of conditions, whether a waiver of the conditions can be implemented, and a long-stop date by which the conditions to completion must be satisfied or waived. As discussed below, the agreement is also likely to provide for the situation where a party has failed to complete a condition and the obligations to satisfy conditions.

Material Adverse Change ("MAC") clauses are sometimes used in private transactions, but they are used less in the United Kingdom than in the United States. Similar protection can be obtained by the repetition of warranties, which is more common. When used, MAC clauses are normally tightly drafted in relation to the business being sold.

It is also worth mentioning that it is effectively impossible to invoke a MAC clause in the acquisition of a *public* target. In the U.K. the termination of public combination transactions is subject to the City Code on Takeovers and Mergers and the scrutiny of the Panel on Takeovers and Mergers. The attempt of WPP Group plc in 2001 to withdraw its offer to purchase Tempus Group plc in 2001 due to the turbulent economic landscape following the September 11 attacks failed. The Panel ruled that a MAC had not occurred and provided guidance as to when a MAC clause could be properly asserted. The Panel stated that detrimental circumstances of material significance to the bidder in the context of the offer would have to exist for a MAC to have occurred. The Panel underscored the high threshold required to enable a MAC condition to be invoked, which requires "[an] adverse change of very considerable significance striking at the heart of the purpose of the transaction in question." While the Panel stated that the test does not require a bidder to demonstrate frustration of contract in the legal sense, the threshold is a very high one. The Panel did not permit WPP to withdraw its offer to acquire Tempus.

When there is a split contract exchange and completion, the agreement should stipulate whether the warranties given at exchange will be repeated at completion and what will occur should a breach of warranty come to light between exchange and completion. The agreement will usually provide for whether the purchaser will be able to terminate the agreement and claim damages for a breach of warranty. Also, the agreement will usually provide for whether a termination right or right to damages for a breach of warranty should depend on the materiality of the breach. Unlike in the United States, where the practice is to have the accuracy of repeated warranties as a condition to completion, in the United Kingdom sellers seek to resist repeating warranties at completion and argue for repetition of only those warranties over which they have direct control. It is unusual in the United Kingdom for the accuracy of all the warranties to be a pre-condition to completion. Rather than repeating warranties at completion, sellers may be required at contract exchange to undertake that they will not take or permit any action between exchange and completion that may cause a breach of warranties.

A significant difference in U.K. and U.S. agreements is the reference to "representations." While used interchangeably with "warranties" in the U.S., reference to "representations" in the U.K. is typically excluded, based on the argument that its inclusion may give rise to tortious claims and a right of rescission under the Misrepresentation Act of 1967. In practice, sellers resist the term "representation" in a U.K. agreement and also express that contractual damages will be the buyer's only remedy for breach of contract.

IV. Employment Issues and Union Influence

When a business changes hands as a result of a share sale, there is no change in the identity of the employer. The target company remains the employer and all rights, duties and liabilities owed by or to the employees continue to be owed by or to that company. In contrast, where the sale takes place by way of an asset disposal, the original position was that the employees were left behind unless the purchasing entity wished for them to be employees of the purchasing entity. This was altered in 1982 when legislation introduced provisions which provided that, where the asset sale amounted to the transfer of a business as a going concern, all rights, duties and liabilities in relation to employees were transferred with the business and the buyer was obliged to continue the employment of the employees on their old terms and conditions of employment. The relevant legislation in force at the moment is the Transfer of Undertakings (Protection of Employment) Regulations 2006 (SI 2006/246) ("TUPE").

The general position is that TUPE only applies to the transfer of an undertaking and not to a share sale. However, TUPE would apply to an asset transfer carried out as a precursor to a share sale to ensure that the relevant assets are contained in, or removed from, the corporate entity whose shares are to be sold. There may also be a transfer of the undertaking (or part of the undertaking) to a holding company following a share sale, or to a parent company that has used a subsidiary to purchase the shares of the target company.

Protections afforded to employees under TUPE include the following:

- Protection against dismissal: dismissals are automatically unfair if the sole or principal reason for the dismissal is the transfer, unless the impetus is an economic, technical or organizational reason ("ETO").
- Protection against changing terms of employment: any changes to the employees' terms of employment are void if the sole or principal reason for the change is the transfer itself or a reason connected with a transfer which is not an ETO entailing changes in the workforce. If, however, the reason for the variation is the transfer but the terms of the contract permit the employer to make the variation, the change will be permitted.
- There is a statutory obligation to inform and consult employee representatives, and a failure to do so may lead to a compensatory award of up to thirteen weeks' actual pay for each affected employee.
- While the employment contracts of the transferring employees automatically transfer under TUPE, contractual rights relating to old age, invalidity or survivors' benefits under occupational pension schemes do not transfer. This is known as TUPE's "pensions exception." However, occupational pension rights that do not relate to old age, invalidity or survivors' benefits do transfer.
- On a share sale, the purchaser acquires the pension liabilities of the seller. In the most extreme circumstances, *i.e.*, where pension liabilities amount to more than the company's worth (such as can be the case with final salary schemes), a share sale may be abandoned and an asset sale may be pursued instead.
- Union recognition transfers to the buyer, provided the organized grouping retains a distinct identity after the transfer (Regulation 6 of TUPE). This means that certain rights that are afforded only to recognized trade unions (such as the right to disclosure of information for collective bargaining or for union training) are treated as transferred.
- Regarding share sales: where the target company recognizes a trade union which has bargaining and representation rights on behalf of its workforce (or sections of it), that recognition will remain in place after a share purchase. There may, however, in respect of share sales, be obligations to consult with any national works-council, and cross-border share purchases may trigger obligations to consult any European works-council which the seller or buyer's group has established.
- Employees may qualify for redundancy pay if the employer has ceased, or intends to cease, continuing the business or the requirements for employees to perform work of a specific type or to conduct it at the location in which the employees are employed has ceased or diminished. Thus, a redundancy applies where the workforce is reorganized and there is less work and/or changes in conditions results in the new job being different from the old one. The test for redundancy is whether the employer requires fewer (or no) workers to do work of a specific kind at a particular location and not just whether the work itself has ceased or diminished.
- Redundancy pay is determined entirely by the terms of an employee's contract of employment or, if it is silent in that respect, by the statutory provisions. The statutory provisions provide that employees will get half a week's pay for each full year worked under twenty-two years of age, one week's pay for each full year worked between the ages of twenty-two and forty and one and a half week's pay for each full year worked when the employee was forty-one or over.

V. Sandbagging

Whether a buyer can pursue a claim for breach of warranty where it knew before completion that the warranty in question was untrue, even though the breach had not been formally disclosed, has been considered in two key cases: *Eurocopy plc v Teesdale and Others*[1] and, later, in *Infiniteland Ltd v Artisan Contracting Limited*.[2]

In *Infiniteland*, a knowledge-saving provision stated that the buyer's rights and remedies in respect of any breach of warranties were not affected by any investigation made by it or on its behalf into the affairs of any of the target companies (except to the extent that such investigation gave the buyer actual knowledge of the relevant facts or circumstances).

The position after *Infiniteland* is as follows:

- If the agreement specifically states that the buyer cannot sue if it knew of a breach, then courts are likely to give effect to that, *i.e.*, the buyer cannot sue.
- If the agreement specifically states that the buyer can still sue despite knowing of a breach, then the courts are likely to give effect to that and let the buyer sue.
- If the agreement is silent on this point, then the buyer can probably still sue, but a court will not be very sympathetic to a buyer claiming for a breach of warranty about which it knew: it will assume that the breach affected the purchase price the buyer agreed to pay on the deal, meaning it will be very difficult for a buyer to prove it has also suffered any loss. Also, a court will take a very dim view if it thinks a buyer is acting unfairly, and will penalize accordingly.

Clauses in an acquisition agreement regarding the effect of the buyer's knowledge on its ability to sue often make reference to and sometimes differentiate between different types of knowledge that a buyer might have—actual, constructive and imputed knowledge. In *Infiniteland*, the majority of judges concurred that knowledge of a buyer's agent (imputed knowledge) was not actual knowledge. In other words, the types of knowledge remain distinct.

Given the uncertainty of the law in the United Kingdom in this regard, a buyer would be well advised to seek specific indemnity cover or a reduction to the purchase price rather than rely on a knowledge-saving provision where it did, in fact, have actual knowledge of a breach of warranty.

VI. M&A Insurance

Warranty and indemnity insurance ("W&I insurance") and other transactional insurance products are increasingly being used in the United Kingdom to bridge the gap between buyers' and sellers' expectations.

According to a Marsh study,[3] interest in M&A insurance has grown 155% over the last three years to 2013. This study also showed that in the two-year period 2011 and 2012 W&I insurance was either taken out or actively contemplated in eight percent of transactions, rising to nine percent in 2013. The most popular cover was W&I insurance, but M&A insurance can also deal with tax and other liabilities that are yet to crystallize, such as potential litigation, environmental and asbestos liabilities.

While insurance is offered to both sellers and buyers, it is more likely to be taken out by a buyer: seventy-six percent of relevant policies are taken out by buyers.

The London market is the biggest and most established market for W&I insurance, with the ability to provide over £300 million of coverage per policy. Most insurers have a global authority and will look at risks anywhere in the world, regardless of location. Premium rates in the United Kingdom are lower than in the United States. Perhaps this is so because the United States is considered more litigious, but also U.S. transactions have tended to include very broad representations and warranties on an indemnity basis with no general disclosure provisions and less extensive litigation provisions for claims than other jurisdictions—so the perceived risk profile is higher.

The net premiums on a U.K. and European transaction are currently between 0.9% to 1.6% of the insured limit. In addition, insureds must pay insurance premium tax at six percent of the total premium.

VII. Dispute Resolution and Choice of Law

In the U.K. the majority of M&A will provide for disputes to be resolved by litigation. Arbitration is not unknown, but changes to the litigation process to increase efficiency have slowed down a general shift to arbitration.

Parties are free to choose their own governing law. For deals involving U.K. entities, this will normally be English law. Indeed English law is frequently used as the choice of law for multi-national deals where there is no other nexus to the United Kingdom.

Endnotes

1. [1992] BCLC 1067 (an interlocutory application).
2. [2005] EWCA Civ 758 (although this was obiter).
3. Marsh, *Enhancing and protecting value in M&A Transactions—annual trends and techniques in managing M&A risks* (18 September 2013), conference materials.

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Pitfalls in Private M&A—A U.S. Perspective

By Gregory E. Ostling

I. Letter of Intent

Letters of intent are frequently used in corporate transactions in the United States for several reasons. At the outset of negotiations, both the seller and the purchaser might want to test the waters and demonstrate their commitment to the proposed transaction. If the transaction structure or its terms are rather complicated, fixing in writing such structure or certain key economic and procedural terms, including agreeing on a time frame for executing definitive agreements, can ensure consistent expectations on both sides. In other words, letters of intent can identify deal breakers, saving the parties from unnecessary expenditure of time and money. A letter of intent can also provide preliminary documentation to third parties, such as prospective lenders or investors, to evaluate the transaction for the purpose of providing financing. Sometimes, a letter of intent signed at an early stage of the transaction can be used for regulatory purposes, *e.g.*, for filing a premerger notification under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, thereby initiating the waiting period.

In substance, a letter of intent usually describes key economic terms, sometimes including parameters for determining the purchase price, and certain procedural terms as to timing, allocation of drafting responsibilities, etc., thereby providing an outline for the transaction. The letter of intent will often be used as the basis for drafting the final transaction documents.

As a typical preliminary agreement, the letter of intent in the United States is mostly—but not entirely—an agreement to agree. In the vast majority of the cases, the letter of intent, given its cursory nature, is nonbinding as to the terms and to the consummation of the possible transaction itself. It is usually considered to be a nonbinding expression of the parties' current understanding of the prospective transaction. However, letters of intent sometimes contain explicitly binding provisions regarding confidentiality, non-solicitation, the grant of an exclusivity period, expense reimbursement provisions, and choice of law.

If a letter of intent does not contain provisions indicating that it is meant to be nonbinding or does not state that the parties will only be bound upon execution of the definitive agreements, the letter may be enforceable in court. The Delaware Court of Chancery ruled in a 2009 bench decision on a motion for a temporary restraining order that a jilted bidder had asserted colorable claims that a target had breached the no-shop/exclusivity and confidentiality provisions of a letter of intent as well as its obligation to negotiate in good faith.[1] In reaching its decision, the court stated that parties that wish to enter into nonbinding letters of intent can "readily do that by expressly saying that the letter of intent is nonbinding," and that contracts "do not have inherent fiduciary outs." This is an important aspect to be considered when drafting letters of intent in the United States. In addition, since letters of intent can be partially binding, if the parties do not want any provisions to be deemed binding, it is important to state so unambiguously in the letter of intent.

In extreme circumstances, however, a party can be held responsible even if the letter of intent explicitly states that it is nonbinding. In a 2013 case, *PharmAthene, Inc. v. SIGA Technologies, Inc.*,[2] a Delaware court granted "benefit of the bargain" damages for breach of a duty to negotiate in good faith based on an expressly nonbinding letter of intent. SIGA, which owned a potentially valuable antiviral drug, no longer had the resources to develop or exploit that drug. While PharmAthene was interested in a merger, SIGA was looking for funding and offered to enter into a license in exchange. The parties attached terms of a licensing agreement term sheet (the "LATS") to a merger agreement term sheet, which provided that, if merger negotiations broke down, the parties would nevertheless negotiate a licensing agreement in accordance with the terms of the LATS. When merger negotiations ultimately fell apart, SIGA's financial situation had improved significantly. SIGA claimed that the LATS was nonbinding and attempted to negotiate a licensing agreement with terms drastically different from the LATS. Even though the LATS was not signed and expressly stated on each page that it was "nonbinding," the court found that the incorporation of the LATS into the merger agreement and the language requiring negotiation of an agreement "in accordance with" the terms of the LATS obligated the parties to negotiate toward a license agreement with economic terms substantially similar to the terms of the LATS.

In case of a breach of a letter of intent, the damages are not limited to compensation for fees and expenses. As an example, in the aforementioned case of *PharmAthene*, the Delaware court ruled that PharmAthene could recover the benefit of the bargain damages, *i.e.*, the value of the licensing agreement that would have been entered into prior to the merger negotiations.[3] In fact, this case has caused practitioners to consider a different choice of law, such as New York law—but only for the letter of intent, not for the definitive transaction agreements.

II. Governmental Approvals

In addition to securities (for listed companies), antitrust and industry-specific regulations, as applicable, U.S. acquisitions by non-U.S. purchasers must take into account the national security review of the Committee on Foreign Investment in the United States ("CFIUS") under the Exon-Florio Amendment to the Defense Production Act ("Exon-

Florio Act"), as amended. This review particularly applies if the U.S. target is in a sensitive industry or if the non-U.S. purchaser is partly or wholly government-owned. CFIUS reviews have attracted some public attention, *e.g.*, in the attempt of Dubai Ports World to buy the U.S. port assets of the Peninsular and Oriental Steam Navigation Company, or in certain acquisitions involving private Chinese technology company Huawei, including its acquisition of the intellectual property of a U.S. computer software company, 3Leaf, in 2010.

CFIUS is a multi-agency committee that, within thirty days, reviews mergers, acquisitions or takeovers by or with foreign persons which could result in foreign control of any person engaged in interstate commerce in the United States, to determine the effects of the transaction on the national security of the United States. If (i) CFIUS finds that the transaction threatens to impair the national security of the United States, or the transaction involves (ii) investments by non-U.S. governments or (iii) investments in U.S. critical infrastructure, technology or energy assets, CFIUS will conduct an investigation of the effects of a covered transaction on the national security of the United States, which investigation shall end within forty-five days. The Exon-Florio Act provides that after CFIUS has completed the investigation, the President has the authority to suspend or prohibit any such merger, acquisition or takeover if the President believes that the foreign interest exercising control might take action that threatens to impair the national security, and other provisions of law are not adequate to protect the national security.

While the Treasury Department, as the leader of CFIUS, takes a broad view of what constitutes "control," control status generally is fact specific, and subject to a number of statutory guidelines, including with respect to implications of possession of a board seat or the exercise of pro rata voting rights, and whether the investor wields a degree of influence sufficient to determine, direct or decide "important" matters. CFIUS typically considers the control requirement satisfied if a minority foreign investor obtains protective supermajority rights. Inversely, certain minority shareholder protections and negative rights may be held by non-U.S. investors without rendering such investors in control of an entity. In more general terms, as a CFIUS review is only applicable when the foreign person is acquiring "control" over a U.S. business, the parties might consider structuring a transaction such that the investor is not acquiring "control," and the review can be avoided. For non-U.S. investments of ten percent or less of the voting securities of a U.S. business, CFIUS regulations issued by the U.S. Department of the Treasury provide an exemption if such investment is made "solely for the purpose of passive investment."

The vast majority of transactions that are reviewed are cleared within the initial review period of thirty days. However, the 2013 CFIUS Annual Report shows that the number of investigations in 2011 and 2012 have increased. CFIUS is increasingly concerned about potential cybersecurity threats to national security or critical infrastructure systems. If an investigation may reasonably be expected or if competing bidders are likely to take advantage of the uncertainty of a potential investigation, it can be prudent to make a voluntary filing with CFIUS. In fact, in the vast majority of cases, a CFIUS review begins with the parties filing a voluntary joint notice. If possible, the parties will notify the agency of a pending transaction in advance and provide a "pre-filing" one week prior to the final filing. Generally, discussions with U.S. Treasury officials initiated prior to the filing can help avoid delay or potential disapproval, *e.g.*, by suggesting methods of mitigation early in the review process.

III. Conditions for Closing

Private M&A transactions both in the United States and Europe usually defer the closing in order to obtain governmental approvals, regulatory filings or third-party consents. However, there are some notable differences when it comes to a purchaser's obligation to close the deal. An essential closing condition very common in the United States is the accuracy of a seller's (in the case of a stock sale) or a target's (in the case of a merger) representations—a study recently conducted by the American Bar Association (the "U.S. Study")[4] found that ninety-nine percent of the deals examined required seller's/target's representations to be accurate at least at closing (fifty-seven percent requiring accuracy at both signing and closing). Quite to the contrary, a study on European private M&A conducted by the American Bar Association (the "European Study")[5] found the accuracy of representations included as a condition to closing in only thirty-five percent of the deals examined (twenty-four percent requiring accuracy at both signing and closing). In other words, while the inaccuracy of the representations at closing in the United States generally grants a walk right to the purchaser, in almost two-thirds of the deals examined in the European Study, the purchaser remains obliged to close the deal—in those cases, the accuracy of representations only serves as a basis for purchaser's indemnification claim.

These differences radiate on the level of accuracy. According to the U.S. Study, in fifty-three percent of the deals, the accuracy of seller's/target's representations at closing was qualified by a materiality standard, and in the remaining forty-seven percent of the deals, accuracy was qualified by an MAE standard. The findings of the European Study draw a different picture: more than half (fifty-two percent) of the European deals examined required the representations to be accurate "in all respects," *i.e.*, included no materiality qualifier at all. The remaining deals were qualified by materiality and/or MAE standards. Note that an earlier version (2010) of the European Study found that seventy-nine percent of the deals examined required the representations to be accurate "in all respects," which might indicate some adoption of the U.S. standard over the past years.

Substantial differences can also be observed when looking at purchaser's material adverse change ("MAC") conditions. Such conditions were included in the vast majority (ninety-four percent) of the deals examined in the U.S. Study, but in only twenty-four percent of the deals examined in the European Study. Hence, walk rights in the event of a material adverse change in respect of the target seem to be four times more common in the United States. Similarly, sixty-seven percent of the deals examined in the U.S. Study provided for the absence of legal proceedings challenging the transaction as a closing condition. An equivalent provision was included in only twelve percent of the deals examined in the European Study, which reflects that the United States is a more litigious environment than most European countries.

For debt-financed acquisitions, provisions dealing with the risk of financial failure are not uncommon in private M&A deals involving U.S. parties. In the past, particularly private equity purchasers demanded financing outs, *i.e.*, walk rights in case of a financing failure, to protect themselves against the risk of financing failure. The deal technology, however, has evolved (somewhat in response to the recent financial crisis) to a different risk-allocation method by granting the purchaser a walk right in combination with a reverse break-up fee, often coupled with language providing for specific performance around any equity financing.

IV. Employment and Union Influence on a Transaction

Coming from an employment-at-will perspective, and with statutory job protections being the rare exception, U.S. acquirers generally are used to a high level of flexibility on the employment aspects of M&A transactions. If the deal is structured as a share deal, a purchaser is free to lay off all or part of its newly acquired U.S. employees without any severance payments to be made—in the absence of employees' contractual, quasi-contractual or union contract rights not to be fired. A stock purchaser is also free to implement other employment-related measures post-closing, such as changing employees' job titles, transferring them to different work locations, adjusting salaries, discontinuing benefits or otherwise restructuring. In the United States, employers' freedom to reduce work terms is broad, and there is no doctrine of "vested and acquired rights" as there is in many other, including European, countries.

If the deal is structured as an asset purchase, the purchaser's freedom is even broader. With few exceptions applicable to a workforce represented by labor unions, U.S. labor law generally does not apply the "acquired rights" concept or a doctrine of "successorship," which means that a purchaser acquiring assets pertaining to a business does not assume any employment contract and is not required to offer the seller's U.S. employees a job at all. Hence, a purchaser can choose to offer seller's U.S. employees a job and unilaterally determine the work conditions, which can be materially lower than the previous conditions.

In line with the above, and in contrast to many European jurisdictions, private M&A transactions in the United States generally do not require the target's and/or seller's works council's (or a similar employee representative organ's) advice or even approval of the transaction.

V. Sandbagging

Private M&A transactions usually involve due diligence in the United States. When a purchaser gains knowledge from the conduct of due diligence, the question arises whether such knowledge should limit its rights (anti-sandbagging), or if purchaser's rights should remain unaffected (pro-sandbagging). A pro-sandbagging provision provides that, even if the purchaser knows of the problem—a noncompliance, breach of a contract or of another representation, warranty or covenant or any other risk—it could close the transaction with that knowledge, and then proceed against ("sandbag") the seller for recourse under the transaction agreement. A pro-sandbagging indemnification provision could read as follows:

> The rights of the Purchaser to indemnification, payment, reimbursement, or any other remedy under this Agreement will not be impacted, limited or affected by any investigation or diligence conducted or any Knowledge acquired by Purchaser at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, any representation, warranty, covenant or obligation.

While many transaction agreements in the United States are silent on sandbagging, pro-sandbagging provisions are common in the United States. Indeed, the U.S. Study found that forty-one percent of the transaction agreements explicitly stated that purchaser's rights would not be affected by any investigation conducted or knowledge acquired. Only one-tenth of the agreements contained anti-sandbagging provisions. In the remaining cases (forty-nine percent), the transaction agreements were silent on sandbagging—in such cases, it depends on the state law governing the agreement whether sandbagging is allowed or not. On the other hand, European purchasers seem to be more willing to accept anti-sandbagging provisions, which the European Study found in forty-seven percent of the transaction agreements. Additionally, eight percent of the agreements provided for a representation that the purchaser has no knowledge of any breach or inaccuracy, which has a similar (restricting) effect on the purchaser's rights.

While pro-sandbagging provisions are twice as common in the United States, the rights granted to a sandbagging purchaser in the United States and in Europe are similar. In the United States, a common remedy is a combination of indemnification and walk rights, which the U.S. Study found in half of the cases. Most of the remaining U.S. deals (forty-three percent) examined limited purchaser's rights to indemnification claims. The European Study draws a similar picture, with the majority of the European deals (sixty-four percent) not providing for any limitations.

VI. R&W Insurance

Representations and warranties insurance ("R&W insurance"), a tool not always considered by advisors, can serve as an effective solution to break a logjam over indemnification issues in a transaction. It might be of particular interest in a scenario where a private equity fund desires to sell a portfolio company and wants to return the profits to its investors immediately, without being restricted by any subsequent payments to a purchaser in connection with indemnification for representations and warranties that may be demanded by the purchaser. Also, in auction processes where indemnification is clearly going to be a major point for the seller, R&W insurance can serve to enhance the quality of a bid.

R&W insurance is subject to restrictions and involves a few downsides. First, it increases the upfront costs in the fees and premiums charged by the insurance company (and raises the question of which party—seller, purchaser or both—should bear those costs). Second, if the logjam is coming from a risk known to the parties, the insurance company may refuse coverage or ask for a high premium. Third, parties often consider this tool only at an advanced stage of the transaction, when it may be too late, since sometimes insurance companies insist on conducting a due diligence on their own. While it might not be the right solution for every transaction, every party and every risk, where existence or scope of indemnity has become a major item of discussion, R&W insurance can serve as a resolution and should therefore be considered as early as possible.

VII. Dispute Resolution and Choice of Law

From a U.S. perspective, there are three procedural alternatives when it comes to dealing with disputes: private arbitration; court systems involving only a judge; and court systems involving a jury. A U.S. party to a transaction agreement will usually aim to exclude the third alternative. This fact is confirmed by the U.S. Study, which identified a waiver of jury trials in eighty-two percent of the transaction agreements.

Dispute resolution mechanisms are not very widespread in the United States, mostly due to rising costs. The U.S. Study found that only fifteen percent of the transaction agreements included an alternative dispute resolution provision. Out of this subset, eighty-six percent were assigned to binding arbitration, five percent to mediation and the remainder to a two-step system of mediation followed by binding arbitration. Specified arbitrators were about evenly divided between the American Arbitration Association (fifty-five percent) and Judicial Arbitration & Mediation Services (forty percent). In comparison, the European Study shows that, in the deals examined, arbitration was chosen four times more frequently—sixty-four percent of the transaction agreements provided for arbitration; the remainder were assigned to the courts. In the majority of the cases (eighty-five percent), the parties chose a national or local arbitration body, and thirteen percent opted for the ICC Rules.

There are also significant variations in the way arbitration expenses are dealt with. According to the U.S. Study, expenses were evenly split or apportioned in fifty-five percent of the cases, fifteen percent provided for the loser to pay, ten percent assigned cost allocation to be determined by the arbitrator, and the remaining twenty percent were silent on expenses. Looking at the European side, the vast majority of the deals examined in the European Study (seventy-eight percent) were silent on expenses, fifteen percent provided for the cost allocation to be determined by the arbitrator, and the remainder were either governed by the "loser pays" rule (five percent) or split the costs evenly (two percent).

The majority of U.S. corporate transactions are governed by either Delaware or New York law. In such jurisdictions, parties expect the legal framework to be more predictable, as a significant number of companies are incorporated in Delaware, related financing documents are often governed by New York law, and the judiciary in both jurisdictions is considered sophisticated, with many known court decisions. In Europe, the "law of the target" seems to be generally accepted, which the European Study found in eighty-three percent of the transaction agreements, followed by seller's law and purchaser's law. Out of the eight deals where the applicable law was neither target's nor seller's nor purchaser's law, five deals opted for the laws of England, two for New York and one for Delaware law.

Endnotes

1. *Global Asset Capital, LLC v. Rubicon US Reit, Inc.*, No. 5071-UCC (Del. Ch., 16 Nov. 2009).
2. 67 A.3d 330 (Del. 2013).
3. *Id.*, 67 A.3d at 351.
4. American Bar Association, *Private Mergers & Acquisitions Deal Points Study (Including Transactions Completed in 2012)*. The U.S. Study analyzed publicly available acquisition agreements for 136 transactions that were completed in 2012 and involved private targets which were acquired by public companies. The U.S. Study covered a transaction range between $17.2m and $4.7b across a broad range of industry sectors.
5. American Bar Association, *2013 European Private Target M&A Deal Points Study (For Transactions in 2009, 2010 or 2011)*. The European Study analyzed share purchase agreements (share deals only, 101 deals in total) for acquisitions of privately held targets in Europe, which were signed or closed in 2009, 2010 or 2011 (covering a range of transaction values of at least €20m up to €1.2b).

Gregory E. Ostling is a partner at Wachtell, Lipton, Rosen & Katz in New York City.

Chapter News

Note from the Chapter News Editor

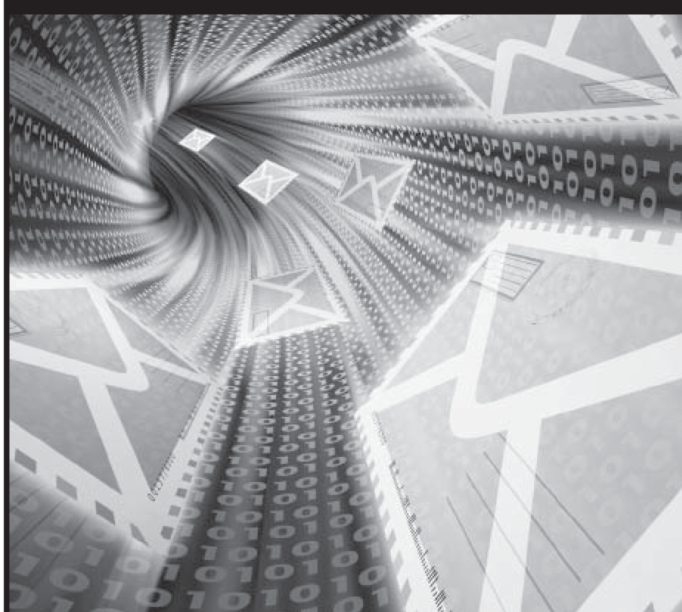
We welcome you to a new version of an old format. Originally, over twenty-five years ago, the *Practicum* included news of Section meetings and of the various committees and chapters of the International Section. At some point in time, what was one, divided into two, and such news was reported in a separate publication entitled *Chapter News*.

With this edition of the *Practicum*, our Section reinstates our old format: including in the *Practicum* news of the Section and its various chapters and committees. The *Chapter News* and the *Practicum* have always been complementary, as they both aim to highlight that which is relevant in the day-to-day lives of our Section Members and their practices, and they both have endeavored to provide this information in a digestible and accessible manner. While the *Practicum* will continue to focus on substantive peer-written articles, it will now also include chapter news that continues to focus on providing updates on Section activities.

In launching this new format, we are taking the opportunity to highlight one of our most active committees, the Committee on International Microfinance & Financial Inclusion. Highlighting what your particular chapter or committee is doing is a great way to get other Section Members interested and involved. Please let us know what your chapters and committees are doing. We would love to highlight your activities in our next edition, for which we are currently accepting contributions. We look forward to hearing your thoughts on this new format, and, of course, we welcome your participation.

Dunniela Kaufman

Request for Chapter News Contributions



Chapter News Contributions are welcomed and greatly appreciated. Please let us know about your recent publications, speeches, future events, firm news, country news, and member news.

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Contributions should be submitted in electronic document format (pdfs are NOT acceptable).

www.nysba.org

Committee Report: MAFIC

True to its mission, the Section's Committee on International Microfinance and Financial Inclusion (MAFIC) addresses microfinance and other methods of financial inclusion via both commercial and non-profit sectors. As a cross-cutting discipline, microfinance and legal issues relating to financial inclusion impact various work streams, including, for example, banking and e-banking, international investment, insurance, secured transactions, security interests, alternative dispute resolution, poverty eradication, and women's rights.

MAFIC started the year 2014 out strong by serving as a marketing sponsor for the University of Michigan's Legal Symposium on Impact Investing on 2 October 2014. The symposium covered three topics: (i) the role of lawyers in impact investing and how to build a legal community of practice for impact investing; (ii) what investment models are most appropriate to aggregate capital for impact investing; and (iii) how social mission is shaping documentation of impact investments. Panelists included attorneys from impact investors such as Developing World Markets, Acumen Fund, Ashoka and MCE Social Capital; law firms such as Reed Smith, Bingham McCutchen, Paul Weiss, and Sidley Austin; and academic institutions such as NYU School of Law and University of Michigan School of Law. The symposium was viewed by hundreds in-person and online and generated enormous enthusiasm toward building a stronger legal community of practice to advance impact investing.

MAFIC continues to provide input into the work of standard-setting bodies, such as UNCITRAL, to promote the development of best practices. On 15 October 2014, we participated in the International Section's Seasonal Meeting in Vienna, Austria. At the meeting, we had a special "UNCITRAL Day," where the various panelists highlighted the work of the UN Commission on International Trade Law. On this day, MAFIC, in partnership with the Section's Women's Rights Committee, sponsored a panel featuring two speakers from the UN Industrial Development Organization and a Vienna-based entrepreneur and philanthropist to discuss *Women, Entrepreneurism and Access to Finance*. Panelists addressed the challenges faced by female entrepreneurs as well as government and non-governmental interventions that have been successful in increasing access to finance.

Further, Committee member Diane Chapman attended the meeting of UNCITRAL's Working Group WGI on Micro, Small to Medium Enterprises, held in Vienna from 17-21 November 2014. And the Working Group will reconvene 13-17 April 2015 in New York to discuss and further develop these issues. This issue of the *Practicum* contains Diane's observations from the November 2014 meeting.

MAFIC held its Financial Inclusion and the Law Series teleconference event on 22 July 2014 under the theme *Agriculture-based Communities and Access to Financial Services.* Members and friends of MAFIC joined a discussion with Michelle Buckles, Sustainable Finance Director at the Rainforest Alliance, and Richard Leftley, Chief Executive Officer at MicroEnsure, and explored issues relating to access to finance for agriculture-based communities. The speakers explored financial security in agriculture-based communities, with particular emphasis on small farming enterprises, including an overview of how financial service providers are meeting their needs.

The increased interest in virtual currencies and other payments innovations has led to the rapid emergence of different types of currencies in payments mechanisms. The Committee is thrilled to co-sponsor during Global Law Week 2015 a panel entitled "Hot Topics in Virtual Currencies: Policy, Regulatory, and Business Issues." The event will take place on Friday, 15 May 2015 (9:45 am), at the Federal Reserve Bank of New York. Our very own Azish Filabi will be one of the moderators for the panel.

The Section, through MAFIC, will serve as marketing sponsor of an all-day conference on Monday, 11 May 2015 on "Legal Issues in Impact Investing" at the Washington, D.C., office of Morgan Lewis. The conference is organized by the Impact Investing Legal Working Group (MAFIC member Aaron Burke is one of the lead organizers of the Working Group). The conference will feature panels of leading lawyers who work in the area of impact investing—in business, academia, government, multilateral development institutions, and nonprofit organizations and foundations. Panel topics include:

- How are investors aggregating capital for impact investing?
- What are the newest social finance innovations in impact investing?
- How can we build a robust legal community of practice in impact investing?
- How can we advance the development of regulatory regimes and government policies that promote impact investing?

In other news, MAFIC is happy to announce that Microfinance Transparency has launched its new work on the regulation of pricing transparency across the globe. MAFIC has served as an editor and supervisor for the process between Microfinance Transparency and pro bono counsel in providing the public an accessible and efficient resource about regulations relating to transparency and credit worldwide. Check it out here: www.mftransparency.org/regulation.

Feel free to contact co-chairs Julee Milham (julee@milhamLaw.com) and Azish Filabi (Azish.Filabi@ny.frb.org) if you would like to receive more information about events (www.nysba.org/mafic). Many thanks to Theano Manolopoulou, MAFIC Vice Chair for Outreach, for drafting this MAFIC news announcement.

Meeting Report: UNCITRAL Micro, Small to Medium Enterprises Working Group WGI in Vienna, 17-21 November 2014

I. Introduction

Following the Commission meeting in New York in July 2014, effective participation in world trade by micro, small and medium enterprises (MSMEs) became the new topic for UNCITRAL's Working Group I. For developed countries, existing corporate laws may be seen as unduly complex for the conduct of business and the regulation of MSMEs. In developing countries, the ability to incorporate offers the possibility of bringing businesses into the formal economy and the global supply chain.

The second meeting of WG I in relation to its MSME mandate took place in Vienna from 17 to 21 November 2014. The early deliberations of WG I at this meeting provided member states with an opportunity to compare their existing corporate laws, as well as consider best practices in business registration and begin to consider an international registration systems. There was also a presentation by the Financial Action Task Force (which operates under the OECD) on international fraud, anti-money laundering and counter-terrorism funding. All of these issues involved significant trepidation for member states and observers. Many participants articulated their commitment to creating a new text that will enhance cross-border trade and provide transparency for MSMEs and expressed their desire for these entities to be incorporated to enable them to operate in a formalised market.

During the meeting, a convergence of views emerged in favor of an inclusive rather than exclusive approach when forming MSMEs, in order to capture a wider range of business and enterprise. A more inclusive approach also acknowledged what might be considered to be a micro or small enterprise in a developing country might not be the same in a more advanced economy. The mandate of this Working Group requires that the experience of developing countries be taken into account, including the limitation on the resources of MSMEs and access to services that will enable them to incorporate, operate and regulate.

Discussion was intense on regulation of MSMEs and whether companies should be registered even if they only have a sole member. There was also some discussion regarding whether single person entities were within the current mandate of this Working Group. Some participants were concerned that limiting the work to single individuals would undermine efforts for incorporation of MSMEs which may later aspire to become cross-border businesses. There was also concern that unnecessary complexity may be created as to the ability to take on partners and raise capital if the scope of the work is not wide enough to incorporate these developments. Consensus was for the Working Group to deliberate on a model that would incorporate single or several person entities to provide more flexibility and limited liability.

There was mixed support for the Working Paper presented by Colombia on the floor, with some countries in favor of using this paper as a framework to build the new international law for MSMEs.[1] Other countries were not ready to use this paper as a framework and sought further clarification of issues, preferring to use the Colombian paper as a reference for the group and an example of how a developing country has successfully implemented its own domestic law for MSMEs.

II. Simplified Form of Business Registration and Incorporation

The Working Group discussed how a simplified form of business registration and incorporation could be drafted to allow MSMEs to grow and join the formal sector. They acknowledged that traditional business models present possible barriers for MSMEs as their establishment is too costly and they face over regulation and high compliance costs with high relative liability.[2]

In response to the last Working Group session, a paper was prepared to analyze the best practices around the world for business registration.[3] This research found that the best structure usually involves standard registration forms and fees, minimum capital requirement and unique business identification numbers.

Best practice was established as being standardization of the incorporation document which provides simplification of requirements and procedures for incorporation of the business, minimizing judicial involvement in registration and limiting the use of notarial services and lawyers.

Another important element was found to be reducing or eliminating the minimum capital requirement. This was discussed at length at the session as many countries had ex-ante or ex-post checking requirements, which included the use of notaries and substantial capital requirements.

The use of notaries was extensively debated between countries, with some participants not convinced that their use could be limited or removed in circumstances of simplified incorporation. Concern was raised as to the potential for fraud or money laundering and the unauthorized use of business to facilitate crime. One observer stated that a company cannot commit a crime by incorporation; crime is committed through its operation and this should be dealt with as a regulatory (ex-post) issue to avoid placing undue restrictions on registering MSMEs.

Whether directors were investigated ex-ante or ex-post was also a significant area of discussion on the floor, which was left to another session for further debate.

Registration fees were also discussed and the paper[4] found that there are normally three types of fees levied by registries: registration fees; fines and fees for information products; and annual fees. Best practice countries were found to bring more companies into the formal sector and then get their revenue from taxation and government rather than registration fees. The use of a flat fee schedule was particularly common.

There was also a panel and discussion on the use of business registries as entry points of business start-ups, the kinds of regulatory and registration support different countries provide to entrepreneurs, forms of registration and forms of referral to respective government agencies for incorporation and other business support services. Registries also support business throughout their lifecycle in structure and registration and play a role in de-registration if the business ceases to exist. It was noted that registration and incorporation are different issues and some questioned whether registration of micro-business was really all that was needed rather than formal incorporation, or if registration should be a step to incorporation.

III. Presentations

Both Italy and France provided presentations. Excerpts from these presentations are provided below. Their formal submissions to the United Nations are included in UNCITRAL Working Paper A/CN9.WG1.WP87.

A. Presentation by Italy[5]

> In Italy there is a principle where if there is a private bank account and I own my apartment and I conduct a business, creditors can go after my personal assets. Liability is only limited under law. You can segregate assets by a public deed which is registered. In case of insolvency by the settlor, the capital fund is protected. This is used only for family and cannot be used outside of that. We have a new tool for corporations' needs—these are capital funds for a specific purpose. You must clearly state which activities are covered and then the company has to present a financial plan which shows that the assets segregated are adequate to cover the activities nominated. There are a number of limitations. It cannot exceed 10% of the equity of the company and it has to be registered and made public. Creditors can oppose the establishment of this fund. Assets are segregated and are only set aside for the specified activities. This is only for corporations.
>
> In 2006 the Civil Code introduced a new instrument of a more general nature. Movable goods can be submitted to a specific purpose. It is not just business and incorporation activities, it can also be for the benefit of a natural or legal person or other entities. This has to be established by public deed and registered. This is then separated from other assets to the beneficiary of the fund. The settlor and the beneficiary of the fund cannot be the same person. The Civil Code permits constitution by the members of the consortium and claims.

B. Presentation by France[6]

> In France, these laws are designed for limited liability of the entrepreneur in order to reduce the risks involved for the entrepreneur and to lower this barrier to starting a business while introducing greater flexibility in the operation of companies, which, as legal entities, were previously subject to restrictive rules which were unsuited to MSMEs.
>
> A simplified tax and social treatment is applied to these entities and individual enterprises are identified as "auto-entrepreneurs" which are identified by turnover and are subject to concessional tax an social security treatment. Professional activity and commercial assets hold limited liability to the entrepreneur's personal assets.

IV. Future Work

There was brief discussion as to the type of text that the Working Group should develop to give effect to the MSME mandate. However, no decision was agreed to, since such a decision was regarded as premature. It was, however, agreed that WP85[7] should be expanded to include the following topics:

- Parts 4-5—Best Practices in Business Registration and Reforms Underpinning Business Registration be analyzed as principles.
- An analysis of all business models to see what fits under which system.
- Definitions should be analyzed, *e.g.*, registration, registry and incorporation.
- Work on the minimum information to be given on the registry.
- Work on Chapter 3—*Organisation and Function of Business Registries;* footnote 26 should be further analyzed.

There needs to also be a distinction between legal standards and legislative operations.

The next meeting for this Working Group will be held from 13 to 17 April 2015 in New York to discuss and further develop these issues. A similar synopsis will be provided in the next edition of the Chapter News.

Diane Chapman
New South Wales, Australia

Endnotes

1. A/CN.9/WG.I/WP.83 - Observations by the Government of Colombia.
2. A/CN9.800.
3. A/CN9.WG1.WP85.
4. *Id.*
5. A/CN9.WG1.WP87.
6. *Id.*
7. A/CN9.WG1.WP85.

Interview: UNCITRAL Working Group III on Online Dispute Resolution— A Conversation with Soo-geun Oh, Chairman 2010-2014

The United Nations Commission on International Trade Law (UNCITRAL) Working Group (WG) III was created to draft procedural rules for online dispute resolution (ODR) of claims arising out of cross-border electronic commerce transactions, including business-to-business and business-to-consumer low-value, high-volume transactions. The working group has also been tasked with providing guidelines for ODR providers and neutrals, as well as providing for substantive legal principles for resolving disputes, and cross-border enforcement mechanisms. It is the hope that a global ODR system will improve access to justice by providing an efficient, low-cost, and reliable method of dispute resolution, and, in so doing, contribute to the expansion of cross-border commerce and economic growth.

Since the rules produced by WG III are soft law instruments, rather than treaties, requirements and restrictions imposed by the laws of the various jurisdictions involved in the process may limit the ability of private parties to enter into agreements to use certain types of ODR. Former Chairman Soo-geun Oh, a professor at Ewha Womans University College of Law in Seoul, Korea, discusses some of the challenges encountered in creating a global ODR system capable of providing fair procedures and results that are enforceable across borders.

Q How did you become involved in WG III?

A My experience with UNCITRAL first began in Working Group V on Insolvency Law, where I represented the Korean government for about ten years, and also served as the Vice-Chair from time to time. In 2009, I was elected Chairman of the UNCITRAL Commission's annual-meeting. At that time, the Commission agreed that a study be prepared on possible future work on the subject of ODR in cross-border e-commerce transactions. Subsequently, in March 2010, a colloquium was held in Vienna on the desirability of developing an international standard for ODR. The commonly shared view at the colloquium was that traditional judicial venues do not offer adequate redress for cross-border e-commerce disputes. Rather, those disputes were viewed as requiring tailored mechanisms that do not impose costs, delays, and burdens disproportionate to the economic value of the claims. Acknowledging the strong support for ODR that emerged from the colloquium, the Commission decided to establish a working group at its annual meeting in July 2010. Thereafter, I was elected Chair of the newly created Working Group III on Online Dispute Resolution, and have served in that capacity for four years.

Q What aspects of your experience in WG III did you find most interesting?

A The rulemaking process in the UNCITRAL context is quite intriguing from a sociological point of view, because the documents produced are the result of negotiation, conciliation, and compromise among the delegates of the several participating countries. The process is really a learning curve. There can be very different levels of conceptualization and understanding in the areas of e-commerce and consumer protection among the various jurisdictions represented. Thus, establishing a global ODR rule requires a process by which delegates explain their domestic law, resolve conflicts with the laws of other jurisdictions, and agree on a proposed solution that comports with the ability of the parties to enter into binding ODR agreements at the time they make contracts online. In my view, the confrontations we have observed in WG III are not truly political in nature. Rather, they stem from different approaches in applying traditional legal rules to the new world of online cross-border transactions. Some jurisdiction have a liberal approach, others are more conservative. Ideally, a global ODR rule should represent advancement from the status quo, but should not be too far removed from current commercial practices in this field. Undoubtedly, the final product of the working group process is a work of art.

Q What are the most controversial issues that have emerged so far?

A Initially, everyone assumed that ODR involved primarily technical issues. However, we soon discovered that a global ODR system could not exist without reconciling substantial differences among jurisdictions regarding the treatment of arbitration awards in consumer disputes. Indeed, a major point of contention has been whether or not online arbitration should be a mandatory component of ODR. In certain countries—most of Europe as well as Canada—mandatory law renders pre-dispute agreements to arbitrate non-binding upon consumers, while in other countries, such as the United States, those agreements are not prohibited and the resulting arbitral awards are valid and enforceable. Since the presence of an ODR mandatory arbitration phase would be problematic in certain countries, WG III has proposed that the rules should provide for a "two-track" system. "Track I" would include negotiation, facilitated settlement, and arbitration phases, while "Track II" would only provide for negotiation and facilitated settlement. Currently, a difficult issue to resolve is how to guide the vendor or consumer to choose the proper track, which would depend upon the jurisdiction and the status of the purchaser. A related problem is finding agreement on what constitutes a "consumer," since the concept is defined differently in different jurisdictions. Some argue that, strategically, it would have been easier to begin the working group mandate by focusing only on business-to-business low-value, high-volume transactions. However, addressing the consumer protection issue is an important step for UNCITRAL because every commercial transaction is related to consumers in some way.

Q Experts in the field of existing ODR practice argue that requiring private ODR providers to apply different rules (Track I or Track II) on the basis of nationality would be commercially impracticable and unlikely to happen, because every additional request for information in an online business transaction means customers lost. Do you agree?

A The experts say that the ODR rules should provide certain principles, such as due process, transparency, impartiality, but the ODR administrators should have the flexibility to design their own ODR process based on the marketplace, i.e., specific customers and industry. Here, the issue is the level of detail of the procedural requirements prepared by WG III. In my opinion, the working group cannot simply state a few principles. Due process, transparency, impartiality, and accountability should be an integral part of the ODR rules, but these rules need to be more detailed and specific. However, I agree that we should find a balancing point and not draft rules that are overly prescriptive.

Q How will the ODR system be implemented at a practical level?

A As far as I understand, in many countries consumer disputes would be handled by governmental consumer protection agencies, which would serve as the primary ODR administrator. This is certainly the case in several East Asian countries, where the government develops ODR platforms that can be used free of charge by consumer agencies or NGOs, while fees are collected from the sellers. European countries have a similar approach, but the United States does not follow this trend.

Q In regard to business-to-business transactions, what vendors are likely to use the ODR rules?

A The target is small and medium-sized vendors, who do not have enough resources or power to deal with their suppliers. Large globalized companies, such as Amazon or eBay, do not need the UNCITRAL ODR rules because they are themselves ODR administrators or they can hire an ODR administrator. Eventually, though, the UNCITRAL ODR rules will become a guideline for all administrators, and big companies will not be comfortable employing contradicting rules. I truly believe the UNCITRAL rules have the potential to become the international standard for ODR.

Q What enforcement mechanisms are envisioned by the ODR system?

A In "Track I," the process will end by producing an award enforceable under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. In "Track II," the decision rendered by the neutral does not have an enforcement mechanism yet. However, I believe that in most cases vendors will honor the recommendation made by the neutral. Private enforcement mechanisms, such as chargebacks, could be adopted and used by vendors or providers, but I am not sure whether the rules will have any express provisions on private enforcement.

Q How did WG III deal with personal jurisdiction and applicable law issues that typically arise in cross-border disputes?

A What makes the ODR project more complicated than others is that online transactions and ODR present realities that do not comport with traditional ways of thinking about jurisdiction and applicable law at the local level. For example, it is not easy to determine where an online transaction took place, for purposes of determining jurisdiction and governing law. The ODR rules aim at creating a self-contained system that is based on the parties' consent to jurisdiction and resolution of disputes based on principles of fairness, justice, and reasonableness, as well as trade usage. We tried to avoid the need to choose an applicable law by limiting the types of claims that can be raised in ODR. The rules only apply to claims alleging that goods sold or services rendered were not delivered, not timely delivered, not properly charged or debited, and/or not provided in accordance with the sales or services contract, and claims that full payment was not received for goods or services provided. Tort claims are excluded. Experts in this field opine that ninety-nine percent of disputes over online transactions could be resolved using ODR and without commencing a court action, which would implicate jurisdictional and choice of law issues.

Q Finally, what role will lawyers play in ODR?

A ODR can provide rational decisions in high volume cases if all the relevant information is provided. For the ODR system to function effectively and efficiently, practitioners will have to supply data, monitor the process, and assess the final recommendation or award rendered. Thus, there could be new business opportunities for lawyers in practice areas where ODR will become the main dispute resolution avenue.

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Law Report: A Cold Shoulder to Foreign Judgments—Securing Recognition in Denmark

Recognition of judgments rendered outside the European Union (and EFTA)—*e.g.*, from a New York court—may meet significant obstacles if enforcement is sought in Denmark. These obstacles, and associated legal costs and delays, may be avoided with careful consideration and selection of a suitable dispute resolution mechanism.[1]

I. Recognition of Foreign Judgments

Recognition of foreign judgments concerns the question of whether a judgment is given legal effect *outside* the jurisdiction in which it was rendered. Recognition under Danish law provides a foreign judgment with *material legal effect*, barring the filing of a new case concerning the same matter before the Danish court.

Within the E.U., Brussels I (Regulation 44/2001) has provided a regional, harmonized approach. Under Article 33(1), a judgment rendered in a Member State is to be recognized in the other Member States without any special procedure being required. In 2015, Brussels I will be replaced by Regulation 1215/2012, but neither regulation deals with the recognition of foreign judgments rendered *outside* E.U. Member States. Accordingly, this matter is still left to be dealt with on a national level.

II. Judgments from Outside the E.U./EFTA: Not Welcome!

In Denmark, according to Article 223a of the Danish Administration of Justice Act, unless a treaty or resolution has been concluded with the foreign jurisdiction in question, the foreign judgment is not recognized. In other words: Unless Denmark has an agreement regarding mutual recognition, it does not recognize a New York judgment!

When the provision was originally enacted in 1932, the intention had been to facilitate a progressive approach towards recognition of foreign judgments through a series of bilateral treaties and resolutions. Unfortunately, the bilateral treaties proved few and far between, and the resolution empowerment has only been exercised once.

Accordingly, foreign judgments originating from outside the E.U./EFTA (and thus falling outside the scope of Brussels I) have no (statutory) recognition in Denmark, and the prevailing party will therefore have to initiate renewed proceedings in Denmark.

III. Non-statutory Basis for Recognition?

The unfriendly Danish approach towards recognition of foreign judgments has led some scholars to suggest a non-statutory basis for recognition of foreign judgments, *i.e.*, recognition without a treaty or resolution. Two somewhat recent decisions from the Danish High Courts have been identified by such scholars as reflecting a principle of non-statutory recognition.

A. The *Taster Wine* Case

In *Taster Wine*,[2] the Danish Eastern High Court held that an Argentinean judgment could be used as the basis for filing a claim in the estate of a Danish company.

In its finding, the Danish High Court emphasized that the parties had, through forum-selection and choice-of-law provisions, agreed to refer disputes to Argentinean courts applying Argentinean law. Accordingly, the court found that the Danish company "as a general rule…was obligated to follow the judgments rendered in accordance with Argentinean law by Argentinean courts concerning payment of the disputed claim."

Since there is neither a treaty nor resolution between Denmark and Argentina concerning recognition of judgments, Danish courts do not have the authority to recognize an Argentinean judgment. Instead, the Eastern High Court reasoned in its decision that the estate "as a general rule" was obligated to abide by the Argentinean judgment by reference to considerations regarding upholding the agreement between the parties concerning forum and choice-of-law, rather than recognition *per se*.

Accordingly, the court made an independent assessment as to the *weight* to be attributed to the Argentinean judgment as *evidence* of the existence of the Argentinean party's claims against the Danish estate. In evaluating the evidential weight of the Argentinean judgment, the court noted that, inter alia, the judgment was elaborate and that no due process concerns or flaws and deficiencies in the Argentinean judgment had been evidenced before the Danish court. The Argentinean judgment was therefore given significant weight when the Danish court decided whether the judgment could be used as the basis for filing a claim against the estate.

B. The *Kenneth P. Weiss* Case

In *Kenneth P. Weiss*,[3] the Danish Western High Court found that a claim, initially determined by non-binding arbitration and subsequently "confirmed" by a binding decision from a Florida court, did not have the necessary clarity to serve as the basis on which a bankruptcy notice could be issued.

In its reasoning, the Danish Western High Court emphasized the fact that there had been no arbitration agreement between the parties, and the court's assessment was therefore merely of the decision from the Florida court. Since there is neither a treaty nor a resolution between the United States and Denmark concerning the mutual recognition of judgments, the Western High Court simply made an independent assessment of the *weight* to be attributed to the U.S. decision as *evidence* of the existence of the claim.

In evaluating the evidential weight of the Florida decision, the Western High Court highlighted that the decision had been rendered solely on the basis of (one-sided) evidence provided by the U.S. creditor. Accordingly, the possible defenses or arguments that the Danish debtor may have presented against the claim had not been heard. Based on the evidence regarding the issuance of the judgment, the Western High Court concluded that it had not been proven with sufficient certainty that the U.S. creditor had a claim against the Danish debtor.

IV. An Important Distinction

In both *Taster Wine* and *Kenneth P. Weiss*, the Danish High Courts did not recognize the foreign judgments, but rather attributed varying degrees of evidentiary weight to them. This distinction is fundamental in relation to the procedural process that is undertaken.

Where the foreign judgment is not recognized, the Danish courts are entitled to conduct a broad reassessment of the merits of the case. The Danish courts may attribute a significant amount of weight (as in *Taster Wine*) or very little weight (as in *Kenneth P. Weiss*) to the foreign judgment, but it is important to note that in non-recognition, the foreign judgment simply becomes one of several pieces of evidence on which the Danish courts will base their decision.

Based on a review of existing case law since 1933, there seem to be two key factors which Danish courts consider when assessing the evidentiary weight of a foreign judgment: (i) whether the foreign court (rightfully) applied its own national laws when assessing the merits of the case; and (ii) whether a forum-selection agreement provided the foreign court with jurisdiction.

If the foreign court rightfully applied its own national laws when assessing the merits of the case, the Danish courts generally defer to the foreign judgment. It requires significant and weighty evidence showing that the foreign court was materially mistaken, or that fundamental due process requirements have not been fulfilled, for such deference to be derogated from.

Secondly, the central weight attributed to forum-selection agreements by Danish courts reflects the fundamental notion that agreements, provided they are lawful, are to be upheld and enforced. Where a party has agreed to submit disputes to a foreign jurisdiction, such party should not be able to hide in Denmark, claiming lack of recognition, if the result of the agreement—the judgment rendered by the foreign jurisdiction—goes against him.

V. Tactical Considerations

A foreign judgment based on a valid choice-of-law and forum-selection agreement will, all other things being equal, be attributed significant (and likely *de facto* decisive) weight in subsequent proceedings in Denmark. This should not, however, eclipse the fact that subsequent proceedings in Denmark are still necessary to have the judgment recognized in Denmark.

Conversely, recognition of foreign arbitral awards under the Danish Arbitration Act is based on a smooth, quick and well-known system. Under Section 38 of the Act, *all* foreign arbitral awards, irrespective of where they were made, will be recognized in Denmark, subject only to the few exceptions listed in Article 39 of the Act, which mirrors Article 36 of the UNCITRAL Model Law on International Commercial Arbitration.

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Endnotes

1. The authors have completed an extensive analysis of the subject, which is published (in Danish) in the *Danish Weekly Law Reports*, ref. UfR 2013B.185.
2. Judgment from the Danish Eastern High Court, 31 May 2001, *Taster Wine A/S vs. Gargantini*, published in the *Danish Weekly Law Reports*, ref. UfR 2001 1949.
3. Decision from the Danish Western High Court, 7 July 2011, *Kenneth P. Weiss and Green Shoe Ltd. vs. S*, published in the *Danish Weekly Law Reports*, ref. UfR 2011 3001.

Law Report: Israel Keeps Up with Worldwide Trend of Information Exchange and Tax Collection

I. Introduction

Many countries, especially members of the G20, have agreed to cooperate in the areas of information exchange and tax collection. Legislation has been passed to this effect, including FATCA in the United States and similar laws in the United Kingdom and other countries. Israel is part of this worldwide movement toward transparency and cooperation. In the summer of 2013, the Israeli Knesset (parliament) passed the Law for the Change of National Priorities (commonly known as the "Arrangements Law"). The Arrangements Law amended various laws, including the taxation of trusts legislation. In addition, the Tax Authority published a Voluntary Disclosure Procedure in September 2014 in an attempt to collect taxes from undeclared assets owned by Israeli residents.

This report summarizes the amendments contained in the Arrangements Law as they relate to the taxation of trusts and the requirements of filing tax reports by trustees, as well as the voluntary disclosure program.

II. Taxation of Trusts

Prior to the enactment of the Arrangements Law, a certain trust categorization permitted a reporting and tax exemption in Israel with no time limit: this was known as a "foreign settlor trust." The main requirements were: (i) the settlor's residence be abroad; and (ii) the location of the assets and income be abroad. This benefited mainly Israeli beneficiaries whose family members abroad settled trusts for their benefit that remained tax free in Israel.

The Arrangements Law abolished this foreign settlor trust category. Such trusts settled by non-residents for the benefit of Israeli resident beneficiaries are now defined, pursuant to the Arrangements Law, as Israeli resident beneficiary trusts and the trustee is now obliged to file annual tax reports. The requirements for this categorization include an immediate family relationship between settlor and beneficiaries ("Family Trust") and the settlor remaining alive in the relevant tax year. Where a trust does not qualify as a Family Trust, it will be categorized as an Israeli resident's trust and taxed on its worldwide income at the rates applicable to individuals.

The Family Trust is taxed in one of two ways:

- Distributions to beneficiaries are taxed at the rate of thirty percent of the distribution amount unless the trustee provides evidence of income and principal portions of the distribution. Distributions solely of principal are not taxable. While evidence of principal and interest distributions may be complicated, it is more likely that distributions will be taxed at thirty percent of the distributed amount.
- The trustee may choose to file annual reports and pay tax annually at the rate of twenty-five percent on income accrued annually. This option requires the preparation of balance sheets, annual reporting and annual tax payments on realized gains. Upon the filing of annual returns and the payment of the relevant taxes, distributions to beneficiaries are not taxable. This route, once chosen by the trustee, is irreversible.

The new law came into force on 1 January 2014. The law provided an extension of time for filing reports of trustees until June 2015.

III. Voluntary Disclosure

A new voluntary disclosure procedure, published in September 2014, applies to undeclared assets and income held abroad by Israeli resident individuals. It includes three options: a standard voluntary disclosure procedure; a fast track procedure; and an anonymous procedure.

The two latter options are available under a temporary order valid for a period of one year, up to September 2015.

All procedures require the submission of an application that includes all factual information, including sources of income, relevant tax years and estimates of taxes owed. None of the procedures relieve the taxpayer from the payment of interest, index linkage payments or civil fines. Upon payment of all sums owed, no criminal proceedings will be commenced against the applicant.

Applications will be approved only if the Tax Authority (or any other governmental agency) does not possess any prior information relating to the applicant, the applicant's spouse, the applicant's company or business partners.

The fast track procedure may be chosen where the total amount of the undeclared funds does not exceed two million shekels (approximately US $500,000) and the taxable income does not exceed 500,000 shekels (approximately US $140,000) in the reporting year. Anonymous applications may not be submitted under the fast track option.

The anonymous procedure permits the submission of anonymous applications in which all other relevant details are included. The identity of the applicant is revealed once an agreement on the financial terms is reached. The procedure is finalized after the identity is disclosed and the Tax Authority confirms that it possesses no prior information relating to the applicant.

It is noteworthy that Swiss banks are encouraging their clients to participate in the voluntary disclosure procedure and cooperate fully with the client's advisors.

IV. Conclusion

The changes in Israel are no different from those taking place in other jurisdictions. The global economy, increased cooperation among governments and various other issues have resulted in the need for individuals to voluntarily disclose unreported assets and income.

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Law Report: The Telematic Process in Italy

I. Introduction

The Civil Telematic Process ("PCT") is a project initiated by the Ministry of Justice that is aimed at improving the quality of judicial services in the civil law sector. This new technological architecture is enabled through the online remote execution of operations (such as document filing, transmission of communications and notifications, consultation of the proceedings status using the registry held by the chancery, consultation of the files and case law), which previously were only available by physically visiting the Court chancery.

As of 31 July 2014, over 1,046,665 court decisions were issued digitally (*i.e.*, written by the judges directly using their telematic control panel), 570,185 deposits were digitally performed, and over 11,863,243 communications and notifications were carried out online by the chanceries. The cost savings amounted to 41.5 million Euros.

The telematic process regulation comes at the final stage of the long and gradual computerization of justice administration procedure, carried out in Italy in order to rationalize the management of civil mistrial proceedings, with an aim to drastically reduce proceeding times.

II. Historical Background

The first steps to digitalization date back to 1997, when, implementing Law No. 59 of 15 March 1997, Presidential Decree No. 513 of 10 November 1997, the criteria and means for the composition, storing and transmission of documents through electronic supports were adopted. The law provides for digital signature regulation, defined as the result of a computerized procedure (the so-called "validation"), based on a system of coupled asymmetric keys, allowing the signer and the recipient to show and verify the source and integrity of a document or a set of documents.

The excessive length of trials was the impetus for the adoption of an organic regulation of the telematics proceeding. Presidential Decree No. 12 of 2001 regulates the use of informatic and telematic support in civil and administrative proceedings and in the trials before the Court of Auditors. This regulation identifies the fundamental instruments involved in the telematics proceedings. In addition to informatics document and digital signature, the Decree regulates the "justice domain": a "set of hardware and software resources, through which the judicial administration electronically manages all sorts of activities, data, services, communications and procedures" and the "civil computer system," a subset of the justice domain resources, used to treat the civil proceeding. According to the Decree, all acts and measures adopted in the trial can be performed by means of electronic documents signed with the digital signature. The set of technical and operative rules for the management of the civil information system, for access of the parties and for the filing of documents, is delegated to a subsequent regulation jointly adopted by the Ministry of Justice and the Authority for Informatics in Public Administration.

Pursuant to the above disposition, the Minister of Justice, after the first set of technical rules adopted in 2004 and the subsequent version approved by the Decree of 17 July 2008, issued Decree No. 44 of 21 February 2011 ("Regulation concerning technical rules for the adoption of information technology in civil and criminal process"). The need for the latest set of rules arose after the adoption of Law Decree No. 193/2009, which, besides extending the legislation on telematic proceeding to criminal trials, affirmed that all digital communications and notifications pertaining to civil proceedings must be performed through certified e-mail.

The key nature of the issue can be confirmed by looking at the frequency and number of the legislative interventions. On 14 March 2011, the Government proposed the Extraordinary Plan for the Computerization of Justice, to be enacted in an eighteen-month period. This plan fell within the wider E-Government Plan 2012, which sees informatics transformation of the judicial system as one of the main goals of the Government. Furthermore, in 2012 Law Decree No. 179 was adopted, integrating the judicial regulation of telematics notifications both in the civil and criminal sector and modifying the Italian bankruptcy law in order to make the use of certified e-mail possible in all stages of the insolvency procedures.

Finally, as already mentioned, Stability Law for the year 2013 (Law No. 228/2012) definitively decreed that electronic filing was compulsory: starting on 30 June 2014 the electronic deposit of all judicial acts and documents became compulsory in civil trials. The above regulation does not eliminate the general rule stating that, in case of information system malfunctioning, the judge can allow the deposit of the paper version of the document or order the deposit of a paper copy of the document (for specific reasons).

III. Procedures

The Stability Law goes beyond the mere listing of the acts to be filed on electronic support; it indicates also the formalities to be followed in the deposit in order to be in compliance with the legislation and regulations pertaining to the signing, transmitting and reception of electronic documents. Given the complexity of the subject, a brief analysis of the fundamental instruments constituting the telematic civil proceeding is appropriate.

A. Electronic Document

The code for digital administration (Legislative Decree No. 82 of 3 July 2005) defines the electronic document as "the digital representation of any act, fact or data legally relevant."

The generic electronic document (as well as the document signed with a simple electronic signature) is regulated by Articles 20 and 21 of the above mentioned code. According to the law, electronic document formation, the retention on digital support, and the transmission by means of telematic instruments are valid and relevant to the extent of the law.

The most problematic issues pertaining to the electronic document are its suitability to satisfy the requirements of written form and its evidentiary value. The law explicitly solves both problems by stating that the judge is free to evaluate the validity of the electronic document, taking into account the support characteristics in terms of quality, safeness, integrity and immutability.

B. Digital Signature

The generic electronic document is considered equal to the document signed with an electronic signature. That is, the set of electronic data used as means of digital identification (for example, the signature inserted at the bottom of a text document or attached as a portable document format).

However, the relevance is different when the electronic document is signed using an advanced electronic signature (electronic signature that allows the identification of the signing party and guarantees the unique connection between document and subscriber), a qualified signature (advanced signature based on a qualified certificate and implemented through a safe device for signature creation), or a digital signature, that is, the qualified signature based on a system of cryptographic keys (a public one and a private one linked between themselves) allowing the subscriber through the private key and the recipient through the public one, respectively, to signify and verify the origin and integrity of an electronic document or set of documents.

The documents compiled as above explained are considered Mechanical Reproductions pursuant to Article 2712 of the Italian Civil Code and are explicitly recognized as private writing. The electronic document subscribed with an advanced or certified electronic signature or with a digital signature have the effectiveness ensured by Article 2702 of the Civil Code, according to which "the private writing gives full proof, until a false complaint is filed." The solution provided by the law is a judicial fiction, whose reason lies in the will to avoid the integration of all the relevant dispositions of the civil code.

C. Justice Domain

As mentioned above, the justice domain is the set of hardware and software resources through which the judicial administration digitally manages all kinds of activity, data, service, communication and procedure. The systems of the domain are structured according to the Code for digital administration, to the Code for the protection of personal data and particularly to the provisions regarding safety of the data.

Among the resources pertaining to the justice domain, one must recall certified e-mail. That is, the e-mail service that gives back to the sender a short receipt attesting the fulfilled delivery for every electronic document made available to the recipient, thus certifying date and time of the dispatch. In the telematic civil process, the certified e-mail is the favored instrument used to perform notifications. Effectively, Law No. 2 of 28 January 2009 calls for the compulsory adoption of a certified e-mail address for every lawyer affiliated to bar associations, and sanctioning the Associations that do not make public all the lawyers' e-mail addresses on their websites. Moreover, all public administrations must communicate to the DigitPA (national organ for the computerization of public service) using their certified email; finally, starting on 30 June 2012, all companies were obliged to equip themselves with a certified address.

Another innovative resource is the Digital Dossier, which collects all acts, documents, attachments, certified e-mail receipts and procedure data created by anyone, or the telematic copy of the same when filed in paper format. The system managing the digital dossier is the part of the document system held by the Ministry of Justice dedicated to the storage and retrieval of all electronic documents. The keeping and preserving of the digital dossier is equivalent to the holding of the paper dossier by the chancery, and includes the duty of storing the original documents on paper support, as stated in the Code for the digital administration and in the judicial legislation.

D. Civil Computer System

The civil computer system ("SICI") is the subset of the justice domain through which the administration manages the civil proceedings.

In particular, the system must guarantee: (i) individualization of the judicial office and of the subject; (ii) performing the allowed activities (consultation, insertion, modification or communication of acts or data); the fulfilled receipt of a communication; and (iii)the automatic legitimation for the access granted to lawyers and public officials.

The main resources pertaining to the SICI are: (i) the local manager; (ii) the management system of judicial record, (iii) the judge's console; (iv) the digital document registry held by the chancery (the so called repository), and (v) the access points for the qualified external users.

The telematic civil proceeding has the potential to revolutionize the Italian judicial system in terms of a reasonable decrease in the length of the proceedings and rationalization of access to resources. It represents a great advantage for all the professionals taking part in the trial. First of all, it will allow lawyers to save time and resources now necessary to personally perform the activities in the chancery. Furthermore, it will guarantee the judges and chancery employees a consistent simplification in the managements of the files.

The news pertaining to the computerization of the civil trial represents an important signal that Italy gives to foreign nations, who are generally skeptical when dealing with the Italian judicial system. The simplification will effectively benefit the international operators, who will be able to count on a system of judicial access that is more timely and efficient.

Glossary

Telematic Civil Proceeding: project enacted by the Ministry of Justice to improve the quality of judicial services, through complete computerization of the civil trial.

Electronic Document: electronic representation of acts, facts or legally relevant data.

Electronic Signature: set of electronic data (in DOC, PDF and similar formats) used as signature of an electronic document.

Advanced Electronic Signature: electronic signature that allows the identification and unique connection of the subscriber to the document.

Qualified Electronic Signature: advanced electronic signature realized by means of a safe device for the creation of signatures.

Digital Signature: validation mechanism that allows verifying with certainty the origin and integrity of an electronic document.

Justice Domain: set of resources through which the judicial administration digitally manages every activity and procedure.

Certified E-mail: e-mail service certifying date and time of the dispatch of communications, by giving back to the sender receipts of fulfilled delivery.

Digital Dossier: instrument collecting all the acts, documents and data of the proceeding and the digital copies of documents deposit on paper support.

Civil Computer System: subset of the judicial domain dedicated to the electronic management of the civil trial.

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Law Report: Cuba Enacts New Foreign Investment Law

I. Introduction

On 29 March 2014 the Republic of Cuba enacted Law No. 118 of 2014,[1] commonly known as the Foreign Investment Law. This was not the current Cuban regime's first attempt to encourage foreign direct investment in the island. Law 118 abrogated Law No. 77 of 1995, also known as the Foreign Investment Law, and Law Decree No. 50 of 1982 "On business associations between Cuban and foreign entities."[2] The new law offers increased incentives to foreign investors in a single instrument while maintaining government control of new investments.

Although Cuba has been isolated from the United States, there has been ample foreign investment and Cuba has entered into various bilateral treaties. Cuba has double taxation agreements with Spain, Barbados, Italy, Russia, Portugal, Qatar, Lebanon, China, Vietnam, Austria, Ukraine and Venezuela. Sixty-three bilateral investment protection treaties have been signed, of which thirty-nine are in force.[3] More than fifty percent of investment projects in Cuba come from the European Union, with Spain being the largest investor in tourism, financial services, water, cement and other sectors. Canada has traditionally been another important investor in tourism, energy and nickel, as have the Peoples' Republic of China, Brazil and Venezuela.[4] However, the last meeting in Panama City between Presidents Barack Obama and Raul Castro of the United States and Cuba, respectively, and moves toward regularization of diplomatic and commercial relations between both countries have increased interest stateside in renewing foreign investment in the Cuban island nation.[5]

Foreign investment in Cuba is subject to government authorization (the "Authorization"), with Law No. 118 specifically excluding investments in health and education general services, as well as non-commercial activities of the armed forces. While in most countries, investors approach state-owned enterprises for a possible venture, in Cuba the Council of Ministers pre-approves specific projects subject to foreign investment, which will be published in a Portfolio of Opportunities for Foreign Investment (*Cartera de Oportunidades de inversión extranjera*) and released by the Ministry of Foreign Trade and Investment. Government entities have the duty of submitting to the Ministry listings of business opportunities available for investment, subject to the State policies.[6]

In terms of process, once terms are negotiated with one of the Cuban companies in the prospectus, an application is filed before the Ministry for formation of the foreign investment entity or international joint venture under regulations in Decree No. 325/2014.[7] Government authorization is granted by the Council of Ministers. However, approval by the Council of State is also required for investments in public utilities, public services and natural resources—excluding "at risk" international joint venture agreements. The application must be approved or denied in no more than sixty calendar days.[8] In specific sectors, the Council of Ministers may delegate approval in special administration units, which are required to grant or deny an application in forty-five days or less.

II. Forms of Foreign Investment Authorization

Foreign investment under Law No. 118 may be carried out as:

– a direct investment, where the foreign investor participates as a shareholder in a company of mixed-capital or with fully foreign-owned capital or with in-kind contributions in international joint-venture agreements (in Spanish *contratos de asociación económica internacional*), with effective participation in control of the business; or

– investments in shares or other securities, public or private, which are not direct investment.[9]

International joint venture agreements specified under the law are "at risk" agreements for mining prospecting, construction, agriculture production, hotel management or services and professional services agreements.[10]

Mixed-capital companies are separate entities formed pursuant to a joint venture agreement by Cuban juridical persons and foreign investors in registered share contributions approved in the relevant Authorization. The mixed-capital company is formed by Articles of Incorporation along with the text of the Authorization and the Joint-Venture Agreement in a deed registered in the Mercantile Registry. The mixed-capital companies may form subsidiaries or branches in Cuba or abroad, as well as have shares in entities abroad.[11]

The international joint venture agreement has many of the typical features of such an agreement elsewhere, but its purpose and terms are subject to the scope of the Authorization. Each party makes contributions, which comprise an accumulation of contributions of which they are owners without becoming social capital, and may become a common fund as long as ownership of said assets by each partner is specified. These agreements and their terms for termination must be executed in a public deed and enter into force upon their registration in the Mercantile Registry. Once granted, the parties cannot change the terms except by mutual agreement and subject to approval of the entity which granted its Authorization.[12]

International joint venture agreements for hotel management, production or services or professional services agreements do not result in formation of a common fund. Instead, international joint venture agreements for hotel management, production or services, which have as their purpose to improve customer service or quality of production and benefit from the use of an internationally known trademark, do not share their earnings, and payments to the foreign investor are subject to the results of its performance.[13]

International joint venture agreements for professional services are entered into with foreign consulting companies with international prestige and have as their purpose jointly providing audit, tax consulting, corporate appraisal and finance services, organization re-engineering services, marketing, business management and insurance intermediation. No mention is made of law firms (whose formation is regulated by the Ministry of Justice) and the reference to insurance specifically refers to intermediation and not coverage of risks.[14]

Enterprises of fully foreign-owned capital are businesses where the foreign investors exercise control, exercise all rights and answer for all obligations stated in the Authorization. Enterprises can be sole proprietorships, Cuban subsidiaries and branches in Cuba of foreign entities. Cuban subsidiaries may form offices, representations, branches and other subsidiaries in Cuba or abroad, as well as own shares in entities abroad.[15]

The Foreign Investment Law allows real estate investments under ownership or other in rem rights for private homes, homes or offices of foreign entities, or real estate projects for tourism purposes.[16]

III. Special Currency, Tax and Labor Regime

Cuban and foreign parties under the Foreign Investment Law are allowed to open bank accounts in Cuban banks, but only Cuban parties of international joint ventures and other foreign-capital entities may ask Banco Central de Cuba for permission to have accounts in freely convertible currency with banks abroad and receive foreign financing.[17]

Local workers working at Foreign Investment Law businesses must be Cuban citizens or permanent residents. These workers are hired by an employment company proposed by the Ministry of Foreign Trade and authorized by the Ministry of Labor and Social Security. On an exceptional basis, a mixed-capital enterprise may be granted in its Authorization a waiver to hire local workers directly. However, non-permanent residents may work in management positions of foreign-capital entities.[18]

A special taxation regime is enacted under which:

- Foreign investor partners are granted a tax exemption from income and dividend earned from mixed-capital enterprises and international joint ventures.
- Mixed-capital enterprise as well as Cuban and foreign partners of international joint ventures pay income tax at a rate of fifteen percent of the net taxable income and goods and sales tax at a fifty-percent discount.
- An income tax holiday of eight years from the date of formation is granted to mixed-capital enterprises as well as Cuban and foreign partners of international joint ventures, subject to renewal by the Council of Ministers, as well as a one-year goods and sales tax holiday and full exemption from the tax on the use of labor.
- Income tax exemptions may be granted on amounts authorized for reinvestment, for the period that said reinvestment is approved.
- However, income tax may be increased up to fifty percent in cases of natural resources as decided by the Council of Ministers.
- Mixed-capital enterprises as well as Cuban and foreign partners of international joint ventures during their investment recovery period are exempt from fifty percent of fees for use of beaches, forests and water and one hundred percent of local development territorial assessments.
- Cuban and foreign parties of international joint ventures for hotel management, production or outsourcing of professional services are excluded from these benefits and are taxed at normal rates. Foreign investors of these entities are exempt from goods and services tax.
- Foreign investment entities are exempt from customs taxes for importation of machinery and equipment during the investment process, under criteria of the Ministry of Finance and Prices, and the Council of Ministers may grant additional custom tax exemptions for other imports.[19]

Fully foreign-owned capital entities are subject to normal tax rates, but may receive any tax benefits which the Ministry of Finance may grant for public interest reasons.

IV. Dispute Resolution

Conflicts arising from relations between partners of the foreign investment entities are generally resolved according to the terms of their respective agreements. In foreign investment entities authorized to perform activities related to natural resources, public services and public works, conflicts between partners will be heard before the Economy Section of the relevant People's Provincial Tribunal.

Conflicts arising from omissions by government entities in matters related to foreign investment will be always be resolved by the Economy Section of the relevant People's Provincial Tribunal.

Litigation on the performance of economic contracts involving foreign investment entities and other non-partner Cuban entities or individuals may be resolved by the relevant Economy Section of the relevant People's Provincial Tribunal, although arbitration under Cuban law may be conducted instead.[20]

Prospective investors have to take into consideration that enactment of this Foreign Investment Law does not imply installation of a market economy in Cuba. The Law clearly provides that foreign investment is regulated within a framework of the law, sovereignty, independence and mutual benefit, in order to contribute to Cuban economic development within a prosperous and sustainable socialist economy.[21]

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Endnotes

1. *Ley de la Inversión Extranjera* (hereinafter "FIL" or "Foreign Investment Law") was approved on 29 March 2014, and published in the Extraordinary Official Gazette 20 of 16 April 2014, along with its regulations and complementary provisions. *See* http://www.gacetaoficial.cu/pdf/GO_X_20_2014.rar.
2. FIL, Final Provisions, Second.
3. Ministry of Foreign Trade and Investment, Portfolio of Opportunities for Foreign Investment (*Cartera de Oportunidades de inversión extranjera*), Cuba, 2014.
4. Identity of foreign investors in Cuba is not disclosed by Cuban authorities. *See* Diplomatic Information Office of Ministry for Foreign Affairs and Cooperation, Ficha Pais Cuba, Spain, 2014, at 4.
5. As of the time of drafting, Cuba sanctions by the U.S. remain in place. For ongoing changes to the policy, see http://www.treasury.gov/resource-center/sanctions/Programs/page/cuba.aspx.
6. FIL, Arts. 19 to 21.
7. *Reglamento de la Ley de la Inversión Extranjera* was approved on 9 April 2014, and published in the Extraordinary Official Gazette 20 of 16 April 2014. *See* http://www.gacetaoficial.cu/pdf/GO_X_20_2014.rar.
8. FIL, Art. 22.
9. *Id.*, Art. 12.
10. *Id.*, Art. 13.
11. *Id.*, Art. 14.
12. *Id.*, Art. 15.1, 15.5 to 15.7.
13. *Id.*, Art. 15.2 to 15.3.
14. *Id.*, Art. 15.4.
15. *Id.*, Art. 16.
16. *Id.*, Art. 17.
17. *Id.*, Art. 25.
18. *Id.*, Art. 27 to 32.
19. *Id.*, Art. 34 to 47.
20. *Id.*, Art. 60 to 61.
21. *Id.*, Art. 1.1.

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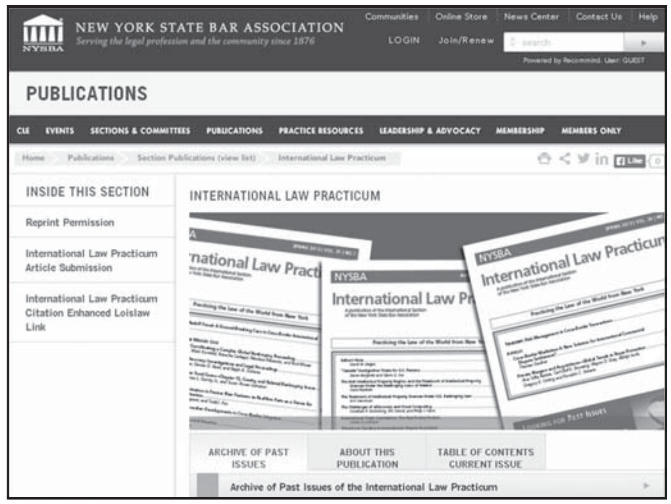

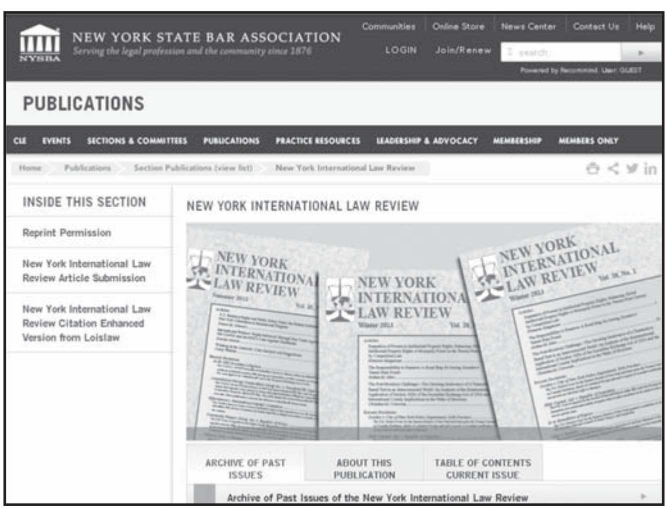

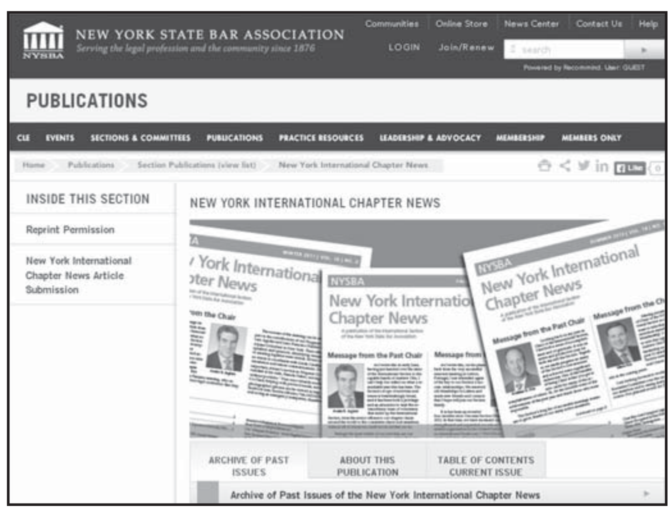

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